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Notes

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NOTES

Antitrust Law—The Vertical Price Squeeze as Predatory Pricing Under Section 2 of the Sherman Act

Anticompetitive conduct is an essential element of the monopolization offense under section 2 of the Sherman Act.[1] The monopolist's pricing behavior may itself be sufficiently destructive of competition to constitute violative conduct.[2] Price behavior has long been governed by vague standards under section 2,[3] but more precise rules are being developed.[4] In *Greyhound Computer Corp. v. International Business Machines Corp.*,[5] the United States Court of Appeals for the Ninth Circuit overlooked the possibility of applying these developing rules to the price behavior of a vertically integrated[6] monopolist.[7] The court instead applied general definitions of monopolizing conduct and in effect held that evidence of the ill effects suffered by competitors as a result of a monopolist's pricing policies is sufficient to support a finding of monopolization.[8] Although the court did not discuss it as such, the price behavior involved in *Greyhound* was a vertical prize squeeze.[9] The case can, therefore, be used to illustrate

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1. 15 U.S.C. § 2 (1976). The other essential element of monopolization is monopoly power in the relevant market. *See generally* P. AREEDA, ANTITRUST ANALYSIS: PROBLEMS, TEXT, CASES ¶¶ 227-259 (2d ed. 1974).

15 U.S.C. § 2 (1976) provides: "Every person who shall monopolize, or attempt to monopolize, or combine or conspire with any other person or persons, to monopolize any part of the trade or commerce among the several States, . . . shall be deemed guilty of a felony . . . ."

Private plaintiffs may recover treble damages for violations of the Sherman Act. *Id.* § 15 (1976).

2. *See, e.g.*, Standard Oil Co. v. United States, 222 U.S. 1, 43, 72-74 (1911).

3. *See* International Air Indus., Inc. v. American Excelsior Co., 517 F.2d 714, 722 (5th Cir. 1975), *cert. denied*, 424 U.S. 943 (1976) (listing various standards that have been applied in predatory pricing cases). *See also* Areeda & Turner, *Predatory Pricing and Related Practices under Section 2 of the Sherman Act*, 88 HARV. L. REV. 697, 697-98 (1975).

4. *See* text accompanying notes 50-66 *infra*.

5. 559 F.2d 488 (9th Cir. 1977), *cert. denied*, 98 S. Ct. 782 (1978).

6. Vertical integration exists when a firm operates at more than one level in the chain of production or distribution. P. AREEDA, *supra* note 1, ¶ 500, at 498. *See also* F. SCHERER, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE 69-71 (1970).

7. It is noteworthy that the Ninth Circuit, which failed to see the relevance of precise predatory pricing rules in *Greyhound*, has elsewhere taken the lead in embracing these developing rules. *See* Hanson v. Shell Oil Co., 541 F.2d 1352, 1358-59 (9th Cir. 1976), *cert. denied*, 429 U.S. 1074 (1977).

8. 559 F.2d at 499-501. The court thus appears to have erroneously applied the Sherman Act to protect competitors rather than competition. *See* Pacific Eng'r & Prod. Co. v. Kerr-McGee Corp., 551 F.2d 790, 795 (10th Cir.), *cert. denied*, 98 S. Ct. 234 (1977).

9. *See* text accompanying notes 67-76 *infra*.

significant possibilities for applying precise predatory pricing rules[10] to price behavior within a vertically integrated structure. *Greyhound* also illustrates the need for precise rules in such cases, for the *Greyhound* court, in applying general standards of conduct, failed to address adequately the important issues raised by the case.

Plaintiff in *Greyhound*, a computer leasing company, buys computers and leases them to users, competing at the leasing level with other leasing companies and with various manufacturers who lease and sell computers.[11] Because customers generally prefer to lease computers from the International Business Machines Corporation (IBM), the leasing companies buy primarily from IBM.[12] IBM, however, has traditionally preferred to lease its own computers rather than sell them, in order to minimize competition from IBM-manufactured computers owned by others.[13] Therefore, when the

10. Predatory pricing is forbidden under the monopolization and attempt provisions of Sherman Act § 2, 15 U.S.C. § 2 (1976), under Clayton Act § 2 as amended by the Robinson-Patman Act, *id.* § 13 (1976), and under Robinson-Patman Act § 3, *id.* § 13a. The issues are the same under all of these provisions. Pacific Eng'r & Prod. Co. v. Kerr-McGee Corp., 551 F.2d 790, 798-99 (10th Cir.), *cert. denied*, 98 S. Ct. 234 (1977); International Air Indus., Inc. v. American Excelsior Co., 517 F.2d 714, 720 n.10 (5th Cir. 1975), *cert. denied*, 424 U.S. 943 (1976); Areeda & Turner, *supra* note 3, at 697 n.1, 726-28; Williamson, *Predatory Pricing: A Strategic and Welfare Analysis*, 87 YALE L.J. 284, 284 n.1 (1977). To the extent that Robinson-Patman doctrine has differed from the Sherman Act approach, it offers little help in the formulation of desirable rules for predatory pricing. *See generally* Sherwood, *Robinson-Patman Act Primary Line Injury: Meanderings from Porto Rico to Utah—and Beyond*, 16 U.C.L.A. L. REV. 304 (1969).

11. 559 F.2d at 492; *see* Pantages, *An Introduction to Leasing*, 14 DATAMATION, Aug. 1968, at 26. In order to compete with the manufacturer, a leasing company must generally underprice the manufacturer's lease price, because the leasing company's price often does not include support services such as maintenance and because some customers will prefer to deal directly with the manufacturer if the prices are equal. Leasing companies are able to underprice the manufacturer's prices because they lease the equipment for longer than its economic life expectancy as reflected in the manufacturer's rental rates. Leasing companies thus bear the risk of economic obsolescence, which is a function of the technological obsolescence and declining prices that result from rapid innovation. *Id.* at 492 n.1; G. BROCK, THE U.S. COMPUTER INDUSTRY: A STUDY OF MARKET POWER 177 (1975); W. SHARPE, THE ECONOMICS OF COMPUTERS 498 (1969); J. SOMA, THE COMPUTER INDUSTRY 60-61 (1976); Gardner, *Leasing: A Phenomenon that Drains the Balance Sheets of All But IBM*, 21 DATAMATION, July 1975, at 78.

12. 559 F.2d at 503 n.35; G. BROCK, *supra* note 11, at 177; W. SHARPE, *supra* note 11, at 494.

13. IBM can face competition from IBM-made computers in the hands of the leasing companies and in the sales market for used computers. This competition is potentially quite significant because computers are virtually indestructible. 559 F.2d at 491. They are, however, subject to obsolescence. IBM did not sell its equipment at all until it was required to do so under the terms of a 1956 consent decree, United States v. International Business Mach. Corp., 1956 Trade Cas. ¶ 68,245, at 71,123 (S.D.N.Y. 1956). In order to ensure the effectiveness of this requirement the consent decree contained a provision requiring sale terms to be "commercially reasonable" in relation to lease terms. *Id.* In addition to preventing competition from IBM-made computers, IBM's leasing-only policy hindered competing manufacturers' efforts to copy IBM equipment and to design compatible equipment, efforts that are generally approved under a competitive policy. *See* United States v. United Shoe Mach. Corp., 110 F. Supp. 295, 325, 350 (D. Mass. 1953), *aff'd per curiam*, 347 U.S. 521 (1954).

In competing with leasing companies that deal in IBM computers, IBM can use two

leasing companies began to grow in importance in the mid-1960's,[14] IBM became concerned about the resulting increase in sales and the proportionate decrease in its own leases.[15] The actions taken by IBM in response to the growth of the leasing companies formed the basis of the *Greyhound* complaint.

From the late 1960's to 1971, when IBM introduced its fourth generation of computers,[16] IBM substantially increased the ratio of its purchase price to its lease price.[17] This ratio, called the multiplier,[18] determines the margin within which the leasing companies must operate because they must pay the IBM purchase price and must compete with the IBM lease price.[19] Before the multiplier was increased, leasing companies had to lease a computer for approximately forty-two months to recover the purchase price;

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methods that depend on its status as manufacturer (as distinguished from lessor). First, IBM can price its computers so as to make unattractive the purchase of IBM computers for leasing purposes. This is the allegation of the *Greyhound* case. It is arguable that such a policy would violate the 1956 consent decree's requirement that sale terms be commercially reasonable in relation to lease terms. The consent decree did not specify a sale/lease price ratio, however, and the burden of proving unreasonableness would probably be a heavy one for a leasing company. This is especially true since the decree was framed with user-purchasers in mind, not leasing companies; independent leasing companies did not exist in 1956. *See* G. BROCK, *supra* note 11, at 177; W. SHARPE, *supra* note 11, at 494. The second IBM method of competing with the leasing companies is to introduce innovations that make the leasing companies' stock of computers less attractive to customers, thus devaluing that stock. These innovations, however, also devalue IBM's stock of leasing computers. *See* note 16 *infra*. *See generally* Note, *Innovation Competition: Beyond Telex v. IBM*, 28 STAN. L. REV. 285 (1976).

14. G. BROCK, *supra* note 11, at 177; W. SHARPE, *supra* note 11, at 494.

15. 559 F.2d at 498. *See also* G. BROCK, *supra* note 11, at 178; W. SHARPE, *supra* note 11, at 495.

According to the court of appeals, IBM preferred leasing because leasing revenues were more constant than sales revenues, which were usually bunched in the first years after the introduction of a new product. In addition, leasing generated particularly attractive profits after the equipment was fully depreciated and facilitated the introduction of innovations, because the lessee was not inhibited by a large investment in either the new or the old machines. This last point is qualified by the fact that IBM *is* inhibited by a large investment in the old machines. For other motivations, see note 13 *supra*. It should also be noted that IBM's profit rate on leases was about 50% higher than that on sales. J. SOMA, *supra* note 11, at 61.

16. There have been four generations of IBM computers since the inception of the industry in the early 1950's; the industry generally has followed a similar pattern. The first generation was based on vacuum tubes, the second on transistors and the third on the integrated circuit. The fourth generation, represented by the IBM System 370, is less clearly distinguished from its predecessor than were previous generations and is sometimes considered part of the third generation; it is based on a further development of the integrated circuit. *See* J. SOMA, *supra* note 11, at 9-32. *See also* G. BROCK, *supra* note 11, at 11-21. This characteristic of the fourth generation suggests that as the industry reaches maturity, innovation may lose some of its generational nature and take on a steadier, more incremental character. *See* J. SOMA, *supra* at 24, 136-37. Steadier innovation might not so severely devalue existing computers, especially in view of the fact that upgrading present systems will be easier as a result of the incremental character of innovation. *See* G. BROCK, *supra* at 17.

17. IBM contended that this increase did not in fact occur; the court of appeals found that it did. 559 F.2d at 500-01 & 501 n.30.

18. *Id.* at 500.

19. See text accompanying notes 69-76 *infra* for a discussion of the vertical price squeeze.

after the multiplier was increased, they had to lease a computer for forty-eight months to recover the purchase price.[20] The increase in the multiplier thus made it more difficult for the leasing companies to recover their costs on a new computer, and to this extent made the purchase of new computers unattractive to the leasing companies.[21] Greyhound claimed that the result was a restriction of competition in the leasing market in violation of section 2.[22]

IBM also increased the price at which it sold used computers. This was accomplished in 1963 and 1964 by substantially curtailing the technological discount that IBM had offered previously on the purchase price of used computers.[23] This discount is a reflection of the rapidity with which computers become obsolescent in the face of frequent innovation.[24] It had previously amounted to ten percent of the original purchase price per year, with seventy-five percent being the maximum possible reduction over time. In 1964, however, IBM set the discount at twelve percent for the first year, and eliminated the discount for succeeding years; this change applied to the third generation of IBM computers, which was introduced in that year.[25] Greyhound presented evidence that this change ended the previously quite profitable practice of buying equipment late in a product cycle at a low price that could be quickly recovered. Instead, purchases were inhibited late in a product cycle because the leasing companies did not wish to pay relatively high prices for older equipment that might soon be devalued by the introduction of a new generation of computers; the leasing companies' inventory growth was therefore curtailed. Greyhound contended that the result was an unlawful restriction of competition in the leasing market.[26]

The trial court granted IBM a directed verdict at the close of plaintiff's case.[27] The court of appeals reversed, holding that Greyhound had established a prima facie case of monopolization.[28] The court concluded that

20. 559 F.2d at 500-01.

21. *Id.* Greyhound claimed that as a result, its access to IBM computers had been virtually eliminated. *Id. See also* G. BROCK, *supra* note 11, at 178.

22. 559 F.2d at 500-01.

23. *Id.* at 499-500. IBM sold used computers to both leasing and sales dealers and sold new computers to its lessees on purchase options. It did not, however, sell used computers generally, preferring to retire them in favor of newer models. W. SHARPE, *supra* note 11, at 500-01.

24. *See* note 16 *supra*.

25. 559 F.2d at 499-500. IBM had already reduced the discount in 1963, but not as drastically as with the 1964 change. *Id.*

26. *Id.*

27. 1972 Trade Cas. ¶ 74,205 (D. Ariz. 1972). The district judge found that Greyhound had not established that IBM had monopoly power in a relevant market and, apparently, alternatively found that IBM's conduct did not meet the monopolization requirement. *Id.*

28. 559 F.2d at 503. The court also held that Greyhound had established a prima facie case

there was sufficient evidence that a jury could reasonably conclude that IBM had monopoly power[29] in the relevant market—computer leasing.[30] It then found the evidence sufficient to support a finding that the increase in the multiplier had "severely restricted" leasing company access to new IBM computers[31] and that the change in the technological discount had largely eliminated the leasing companies' purchases of older equipment.[32] On the basis of these findings, the court held that a jury could find the IBM pricing policies were "unnecessarily exclusionary" and were thus an unlawful means of maintaining the IBM monopoly in the leasing market.[33]

Greyhound relied on the contention that IBM's pricing policies had hindered Greyhound's purchase of IBM computers; this contention was based upon the assumption that IBM had monopoly power in the sales market.[34] IBM contended in the court of appeals that Greyhound should therefore be required to prove the existence of this power, but the court held such proof to be unnecessary.[35] Although it acknowledged that Greyhound could have proceeded on the theory that IBM had used monopoly power in the sales market to gain an advantage in the leasing market,[36] the court held that Greyhound was also entitled to recover upon showing that "IBM employed exclusionary tactics to maintain an existing monopoly in the lease market."[37] Because of the exclusionary effects in the leasing market caused by the IBM pricing policies, the court held that Greyhound had presented a prima facie case of monopolization.[38]

The modern view of monopolization stems from Judge Learned Hand's opinion in *United States v. Aluminum Co. of America (Alcoa)*.[39] Prior to *Alcoa*, abusive or coercive behavior was an essential element of

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of attempt to monopolize. *Id.* at 505. This aspect of *Greyhound* is an illustration of the Ninth Circuit's unique attempt doctrine. *See* Blecher & Stegman, *Hanson v. Shell Oil Co.: A Straw in the Wind?*, 38 OHIO ST. L.J. 269, 275-77, 275 nn.55 & 57 (1977); Cooper, *Attempts and Monopolization: A Mildly Expansionary Answer to the Prophylactic Riddle of Section Two*, 72 MICH. L. REV. 373, 419-21 (1974).

29. 559 F.2d at 494-95. The court found this to be a close question, but "[c]onsidering the weighty presumption in favor of a jury determination" concluded that leasing was a relevant market. *Id.*

30. *Id.* at 496-97.

31. *Id.* at 501.

32. *Id.* at 499.

33. *Id.* at 502-03.

34. IBM allegedly raised its sales price relative to its lease price. To accomplish this, it must have had the power to raise its sales price. *See* text accompanying notes 81-87 *infra*.

35. 559 F.2d at 503.

36. *Id.* (citing Otter Tail Power Co. v. United States, 410 U.S. 366, 377 (1973); United States v. Griffith, 334 U.S. 100, 107 (1948)).

37. *Id.* (citing United States v. United Shoe Mach. Corp., 110 F. Supp. 295, 343 (D. Mass. 1953), *aff'd per curiam*, 347 U.S. 521 (1954)).

38. *Id.*

39. 148 F.2d 416 (2d Cir. 1945). This case is commonly referred to simply as *Alcoa*.

monopolization.[40] In *Alcoa*, the United States Court of Appeals for the Second Circuit[41] decreased plaintiffs' burden of proof by holding that a finding of monopolization could be based upon conduct that excluded competition from the market[42] and was not economically "inevitable" to a well-run business.[43] This general formulation is the basis for more recent definitions of monopolizing conduct,[44] including several formulated by the Supreme Court.[45]

These general definitions have sometimes been applied without great difficulty.[46] Often, however, problems can arise in distinguishing unnecessarily exclusionary conduct from economically inevitable conduct.[47] Such problems are particularly severe when the conduct under attack is simply the monopolist's pricing behavior, as is the case in *Greyhound*. The monopolist is confronted with a continuous range of possible prices;[48] most of these prices are exclusionary to some degree,[49] and all of them can be said to be nonessential. Thus the general formulae of *Alcoa* and its successors offer the monopolist little guidance in choosing from the range of possible prices and offer the courts little guidance in judging the monopolist's choice.

A recognition of this difficulty has led to debate concerning the proper predatory pricing standards. Professors Areeda and Turner have recently

40. *See* P. AREEDA, *supra* note 1, ¶ 210(a). *See also* United States v. United Shoe Mach. Corp., 110 F. Supp. 295, 341 (D. Mass. 1953), *aff'd per curiam*, 347 U.S. 521 (1954).

41. The court was sitting as a surrogate for the Supreme Court under Act of June 9, 1944, ch. 239, 58 Stat. 272 (current version at 28 U.S.C. § 2109 (1970)), when the Supreme Court could not muster its statutory quorum for the case. 148 F.2d at 421.

42. 148 F.2d at 129-30.

43. *Id.* at 431. It is possible to view Judge Hand's opinion as holding that when monopoly is proved, the burden shifts to the defendant to show that its conduct cannot be condemned because it is merely the exercise of skill, foresight and industry. *See* United States v. United Shoe Mach. Corp., 110 F. Supp. 295, 342 (D. Mass. 1953), *aff'd per curiam*, 347 U.S. 521 (1954). This view of monopolization has not, however, prevailed. *See* United States v. Grinnell Corp., 384 U.S. 563, 576 n.7 (1966).

44. *See, e.g.*, United States v. United Shoe Mach. Corp., 110 F. Supp. 295, 344-45 (D. Mass. 1953), *aff'd per curiam*, 347 U.S. 521 (1954) (relying on *Alcoa*, holding that unnecessarily exclusionary conduct would constitute monopolization); Cooper, *supra* note 28, at 390 & n.51.

45. *See, e.g.*, United States v. Grinnell Corp., 384 U.S. 563, 570-71 (1966) (monopolizing conduct is "the willful acquisition or maintenance of [monopoly] power as distinguished from growth or development as a consequence of a superior product, business acumen, or historic accident"). This was the definition used by the *Greyhound* court. 559 F.2d at 492, 498. *See also* American Tobacco Co. v. United States, 328 U.S. 781, 811-15 (1946).

46. Where the challenged conduct is a discrete action with consequences that can be analytically isolated and evaluated, the general definition works well enough. The leasing-only policy of United Shoe Machinery Corporation is an example. United States v. United Shoe Mach. Corp., 110 F. Supp. 295, 325, 350 (D. Mass. 1953), *aff'd per curiam*, 347 U.S. 521 (1954).

47. *See* Turner, *The Scope of Antitrust and Other Economic Regulatory Policies*, 82 HARV. L. REV. 1207, 1219 (1969).

48. Price behavior is thus sharply distinguished from the discrete actions discussed at note 46 *supra*.

49. Any price below the monopolist's short-run profit maximization price will exclude the firms that would enter if those high profits were in fact being made.

offered a set of rules more clearly delineating the predatory pricing offense by defining it in terms of objective and quantifiable criteria.[50] Areeda and Turner suggest that a monopolist's pricing practices should not be held to be predatory without proof that its price was below its marginal cost[51] or, as a more easily ascertainable surrogate, average variable cost.[52] Limit pricing, in which the monopolist maintains a price lower than its short-run profit maximizing price in order to discourage new entry but does not price below average variable cost,[53] would be allowed on the ground that such behavior is a legitimate competitive strategy that excludes only less efficient rivals from the market.[54] Furthermore, Areeda and Turner would allow temporary reductions to average variable cost (reductions that may significantly deter competition)[55] on the same grounds.[56]

Reaction to this proposal has been varied. The courts have increasingly cited the Areeda-Turner position,[57] and they appear to welcome the

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50. Areeda & Turner, *supra* note 3.

51. *Id.* at 709-16. Marginal cost is the incremental cost of producing an additional increment of output. *Id.* at 700.

52. *Id.* at 716-18. Variable costs are those that vary with output; they include costs for, among other things, supplies and labor; variable costs are distinguished from fixed costs, which do not in the short run vary with output. *Id.* at 700. If marginal cost is below average total cost, pricing at marginal cost indefinitely is impossible, because the cost of overhead, including the cost of capital, is not recovered. Therefore, a monopolist's marginal cost pricing policy may drive an equally efficient competitor out of the market if that competitor has less "staying power" (that is, access to capital) than the monopolist. *Id.* at 710. Areeda and Turner admit that this possibility is troublesome but for several reasons see "no satisfactory method of eliminating this risk." *Id.* at 711. The equally efficient competitor bears losses at marginal cost pricing only to the extent that the monopolist does. Furthermore, if any price floor *above* marginal cost is imposed, less efficient firms will also be allowed to survive. In addition, the administrative problems in determining and applying an appropriate price floor above marginal cost would be insurmountable. *Id.*

Professor Williamson believes that average total cost is the appropriate price floor. Williamson, *supra* note 10, at 321-23. The courts, however, have increasingly followed the Turner and Areeda position, *see* cases cited note 57 *infra*, so the following discussion will use marginal (or average variable) cost pricing rules.

53. *See generally* F. SCHERER, *supra* note 6, at 219-34.

54. Areeda & Turner, *supra* note 3, at 705-06. The potential competition from possible new entrants is valued precisely because it restrains the monopolist from reaping all possible profits. *See, e.g.*, United States v. Penn-Olin Chem. Co., 378 U.S. 158, 173-74 (1964). Therefore, the monopolist should not be condemned for reacting to this competitive influence. Note, *Telex v. IBM: Monopoly Pricing Under Section 2 of the Sherman Act*, 84 YALE L.J. 558, 562-63, 568-69, 576-83 (1975). Furthermore, actual competition from equally efficient firms remains possible. *See* note 52 *supra*.

55. Temporary reductions can deter competition by teaching competitors, actual or potential, the lesson that future competition may be vigorously met by the monopolist. *See* Areeda & Turner, *supra* note 3, at 706; Note, *supra* note 54, at 564-65. *See also* Williamson, *supra* note 10, at 290-93.

56. Areeda & Turner, *supra* note 3, at 706-12.

57. Pacific Eng'r & Prod. Co. v. Kerr-McGee Corp., 551 F.2d 790, 797 (10th Cir.), *cert. denied*, 98 S. Ct. 234 (1977); Hanson v. Shell Oil Co., 541 F.2d 1352, 1358 (9th Cir. 1976), *cert. denied*, 429 U.S. 1074 (1977); National Ass'n of Regulatory Util. Comm'rs v. FCC, 525 F.2d 630, 638 n.34 (D.C. Cir.), *cert. denied*, 425 U.S. 992 (1976); International Air Indus., Inc. v.

increased certainty offered by purely cost-based rules.[58] This judicial acceptance, however, has not been unreserved. Some courts may be willing to hold that a monopolist's pricing behavior is predatory even if its prices remain above average variable cost, if those prices are low enough to hurt competition and the other prerequisites for predation exist in the market.[59] This approach to predatory pricing has been echoed by commentators who argue that the relationship between the monopolist's costs and its prices is but one factor among several to be considered in predatory pricing cases.[60] Thus it is argued that some temporary or selective price cuts are predatory, even if the resulting prices are above average variable cost, if they significantly deter competition.[61]

The arguments against purely cost-based predatory pricing rules do not fully answer the concerns of the Areeda-Turner position.[62] If the effect of the monopolist's prices on its competitors rather than the relation of those prices to its own costs is seen as the crucial factor in the existence of predation, then the monopolist may be forced to overprice its product in order to protect less efficient competitors.[63] If the short-run costs of the monopolist are rejected as a guide to decision in favor of a more comprehensive consideration of the long-range economic effects of the monopolist's pricing policies,[64] then the courts are given the task of supervising prices on

American Excelsior Co., 517 F.2d 714, 723-25 (5th Cir. 1975), *cert. denied*, 424 U.S. 943 (1976); Weber v. Wynne, 431 F. Supp. 1048, 1059 (D.N.J. 1977).

58. *See* International Air Indus., Inc. v. American Excelsior Co., 517 F.2d 714, 722-23 (5th Cir. 1975), *cert. denied*, 424 U.S. 943 (1976).

59. *See, e.g., id.* at 724. The court did, however, express some doubt as to the validity of this approach, and in general praised the Areeda-Turner view highly. For an approach more antithetical to the Areeda-Turner view, see, *e.g.*, Telex Corp. v. International Business Machs. Corp., 367 F. Supp. 258, 299 (N.D. Okla. 1973), *rev'd and remanded*, 510 F.2d 894, 926-28 (10th Cir. 1975).

60. Blecher & Stegman, *supra* note 28; Scherer, *Predatory Pricing and the Sherman Act: A Comment*, 89 HARV. L. REV. 869 (1976) (reply to Areeda & Turner). *See also* Cooper, *supra* note 28, 435-40; Note, *supra* note 54.

61. Note, *supra* note 54, at 569-70, 579. *See also* Williamson, *supra* note 10, at 292-93, 334.

62. An exception is Professor Williamson's approach. Like Areeda and Turner, Williamson rejects a wide ranging consideration of the economic environment of price behavior. Williamson, *supra* note 10, at 288 n.16. He argues, however, that the monopolist's troublesome response to new entry is best dealt with by rules governing expansions of output rather than by rules governing price-cutting. He proposes a rule under which a monopolist would be prohibited from expanding its output in the short run after significant new entry. This grace period, Williamson contends, would give the entrant a fair start toward reaching economies of scale. After this period expires, cost-based predatory pricing rules would again be relevant. *Id.* at 331-37. Although it is a significant contribution to the predatory pricing debate, this approach is not helpful in *Greyhound* because Greyhound was an established company, having entered the industry in 1962. 559 F.2d at 500 n.27.

63. Areeda & Turner, *supra* note 3, at 705-06; *see also* F. SCHERER, *supra* note 6, at 216-19; Note, *supra* note 54, at 576-79.

64. *See* Scherer, *supra* note 60, at 890 (rejecting short-run costs as crucial factor).

the basis of "intrinsically speculative and indeterminate"[65] considerations, rather than on the basis of clear, bright-line rules. As a result, every price change by a monopolist may become the occasion for a massive antitrust suit. Ultimately, the courts may be catapulted into the task of ongoing price supervision.[66]

Predatory pricing analysis examines conduct in its horizontal context; that is, predatory prices are prohibited because of their effect on competition within a single market. If, however, a monopolist operates on successive market levels, as IBM does,[67] then its behavior must be examined for vertical implications as well. The question of what behavior, including price behavior, within a vertically integrated structure is prohibited has been another problem area in the law of monopolization.[68] If precise predatory

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65. Areeda & Turner, *Scherer on Predatory Pricing: A Reply*, 89 HARV. L. REV. 891, 897 (1976). *But see* Scherer, *Some Last Words on Predatory Pricing*, 89 HARV. L. REV. 901, 902-03 (1976) (Areeda-Turner concern hinges on fear of excessive private treble damage actions and is misplaced in context of government antitrust enforcement).

66. Although this problem is particularly acute in the context of private antitrust actions, it is certainly arguable that the adversary model is an inappropriate vehicle for choosing welfare-maximizing prices regardless of the identity of the plaintiff. *See* Williamson, *supra* note 10, at 288 n.16 (long-run welfare maximizing approach advocated by Scherer evidently contemplates supplanting antitrust enforcement with a price commission); *cf.* Areeda & Turner, *supra* note 65, at 896-97 (no "suitable, administrable rules" could be formulated to incorporate long-run welfare maximizing factors identified by Scherer).

67. One level is the manufacturing and sales market; another level is the leasing market for computers obtained from the sales division.

68. *See* Bork, *Vertical Integration and the Sherman Act: The Legal History of an Economic Misconception*, 22 U. CHI. L. REV. 157 (1954) [hereinafter cited as Bork, *Vertical Integration and the Sherman Act*]. Bork concludes that the antitrust laws should be entirely indifferent to vertical considerations. *Id.* at 200-01. Bork continues to adhere to this view. *See* Bork, *Vertical Integration and Competitive Processes*, in PUBLIC POLICY TOWARD MERGERS 139, 149 (J. Weston & S. Peltzman eds. 1969). *Contra*, P. AREEDA, *supra* note 1, ¶ 609(a), at 675 ("neither the monopolist nor the law should be indifferent" to the extension of market power through vertical integration).

Vertical integration may exist to achieve increased efficiencies, *see* F. SCHERER, *supra* note 6, at 70, 86-87, or it may exist as a tool for the extension or protection of market power, *see* P. AREEDA, *supra* ¶ 609. A monopolist that is vertically integrated can always gain a monopoly at the second level if it wishes; for example, assuming no legal constraints, it may simply refuse to deal with anyone on the second level except its own second level division. *See* Note, *Refusals to Deal by Vertically Integrated Monopolists*, 87 HARV. L. REV. 1720 (1974) (discussing Otter Tail Power Co. v. United States, 410 U.S. 366 (1973)). It is often stated that this extension of market power is not socially detrimental because even a firm that has a monopoly at both levels can make only one monopoly profit. This is so because the monopolist has a single short-run profit maximization price for the product as it emerges from the second level and the monopolist can make the entire monopoly profit at either level or can split it up however the monopolist wishes. If the monopolist charges more than this price, output will drop, as will the total profits for both levels. *See* P. AREEDA, *supra* ¶ 609(a), at 675; Bork, *Vertical Integration and the Sherman Act, supra* at 172 n.65, 196. This analysis assumes that the product of the first level exists in a fixed proportion in the product of the second level. *See id.* at 172 n.65. It has been argued that if the product of the first level is used in variable proportions at the second level, vertical integration may increase monopoly profits. *See* McGee & Bassett, *Vertical Integration Revisited*, 19 J.L. ECON. 17, 22, 25-28 (1976) (discussing and refuting this contention, concluding that the increased monopoly profits result from the horizontal market

pricing rules can be applied to conduct at a single level of a vertically integrated firm, then some of the problems may be eliminated.

The pricing behavior at issue in *Greyhound* was a vertical price squeeze, although the court did not discuss it as such.[69] The squeeze is a means by which a vertically integrated monopolist can control the profit margin of its unintegrated second level competitors who must buy its first level product. The monopolist's second level price puts a ceiling on the prices of its second level competitors, because they must compete with that price; its first level price puts a floor under the competitors' costs, because they presumably must purchase the first level product from the monopolist.[70] Thus, by manipulating its prices at the first and second levels, the

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power at the second level, not vertical integration). IBM's mainframe computers are a relatively fixed proportional input into the leasing level; for every computer that the leasing companies lease, they generally had to buy one IBM computer. *See* text accompanying note 12 *supra*. The proportion of IBM peripheral devices and support services (other than maintenance, which is usually obtained from IBM) purchased by the leasing companies is quite variable, however. *See* G. BROCK, *supra* note 11, at 177-78; W. SHARPE, *supra* note 11, at 494-95. Thus, if variable proportions allow an increase in profits through vertical integration, then the greater the extent of IBM's integration (*i.e.*, the greater the extent of its leasing monopoly), the more monopoly profits IBM can make. This possibility should be seriously considered, for IBM's profit rate on peripheral devices and support services is about 50% higher than the rate on mainframe units. Thus, if through vertical integration IBM were able to increase the proportions of these services used by lessees, its profits might rise significantly. Even if IBM took over the leasing level completely, however, it could not legally tie these services or products to the leasing of mainframe computers, *see, e.g.*, Times-Picayune Publishing Co. v. United States, 345 U.S. 594 (1953); therefore, this motive for extending its market power may be insubstantial.

Vertical integration may allow an increase in monopoly profits if it is necessary to a scheme of systematic price discrimination. Such discrimination may be socially beneficial if it increases output by lowering price to some consumers who would otherwise be unable to obtain the product. *See* P. AREEDA, *supra* ¶ 609, at 675 & n.36; W. BOWMAN, PATENT AND ANTITRUST LAW: A LEGAL AND ECONOMIC APPRAISAL 100-16 (1973); Note, *supra* at 1729. Even if monopoly profits cannot be increased by vertical integration, other reasons may exist for the extension of market power by this means. If a monopolist is vertically integrated, its smaller first level competitors may be forced to be vertically integrated also, in order to assure themselves of a market for their product. This requirement may hinder the operation of those competitors by increasing their capital requirements. Furthermore, if new entrants into the first level have to enter at both levels, the additional capital required may raise significant entry barriers. P. AREEDA, *supra* ¶ 609(a), at 675; J. BAIN, BARRIERS TO NEW COMPETITION 145-47 (1956). This capital entry barrier argument is vigorously contested by vertical integration apologists on the ground that the capital market will finance new entry into any market where excess profits are being made. *See, e.g.*, Bork, *Vertical Integration and the Sherman Act, supra* at 195. This response does not completely rebut the entry barrier argument, however, because imperfections in the capital market may prevent the ready financing of new entrants. *See, e.g.*, J. BAIN, *supra* at 146; Note, *supra* at 1729.

69. The absence of such a discussion seems strange, because the Greyhound allegation concerning the increase in the multiplier is explicitly an allegation of a squeeze; the Greyhound argument concerning the change in the technological discount is also a squeeze allegation, though less explicitly so.

70. They must purchase the first level product of the monopolist to the extent that that product is a fixed-proportional requirement for second level production and to the extent that the monopolist lacks competition that could supply second level needs. In other words, the monopolist's ability to put a floor under second level costs is limited by the elasticity of the demand curve facing the monopolist. *See* McGee & Bassett, *supra* note 68, at 25, 32 & n.37.

monopolist can squeeze the profit margin of its second level competitors to whatever level it wishes.[71] Squeezing those profits merely to competitive levels is socially beneficial,[72] and should therefore be lawful;[73] however, by squeezing the profits to unremunerative levels, the monopolist can drive competitors out of the market and gain a monopoly at the second level. It seems clear that such a use of the squeeze to gain a second level monopoly would constitute a section 2 violation[74] unless the squeeze were the result of efficiencies possessed by the monopolist at the second level[75] or efficiencies resulting from vertical integration.[76] Given that a squeeze to competitive

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71. P. AREEDA, *supra* note 1, ¶ 609(c).

It has been argued that the vertical price squeeze is simply the use of a "deep pocket" from one market to subsidize predatory pricing in another market, and is thus possible only if the integrated firm is willing to forego a return on the capital that it has invested in the market in which it is underpricing. Bork, *Vertical Integration and the Sherman Act, supra* note 68, at 198-99; *cf.* Peltzman, *Issues in Vertical Integration Policy*, in PUBLIC POLICY TOWARD MERGERS, *supra* note 68, at 167, 172 ("price squeeze is simply another name for predatory price cutting"). This is incorrect, for the vertically integrated monopolist can set its second level price at the profit maximization level and can set its first level price to its competitors at a point at which they cannot meet its second level price. If the monopolist has sufficient capacity at the second level to meet the entire demand at the profit maximization price, then it can squeeze the unintegrated second level competitors while profit maximizing, thus making the maximum possible return on investment.

72. Profits at the second level may be above competitive levels if the second level competitors exercise market power, either singly or in collusion. The existence of this "remaximization" is not inconsistent with the fact that there is only one monopoly profit to be gained from integration across successive market levels, because there will be a smaller demand at this remaximizing price, and total industry profits will fall as output is further restricted. A squeeze to competitive profit margins at the second level prevents this result and is thus socially beneficial. *See, e.g.*, P. AREEDA, *supra* note 1, ¶ 609(c); Note, *supra* note 68, at 1731. *But cf.* Albrecht v. Herald Co., 390 U.S. 145 (1968) (squeeze to competitive profit levels, effected by maximum price provision in contract, per se unlawful under Sherman Act § 1 because of the inherent dangers in all price fixing). A squeeze to competitive profit levels can be viewed as simply a squeeze imposed by competition. An unintegrated second level firm could force second level profits down to competitive levels through vigorous price competition. Thus, if the monopolist forces second level prices only to competitive levels, its conduct may be viewed as simply legitimate price competition at the second level.

73. United States v. Aluminum Co. of Am., 148 F.2d at 437-38 (profit squeeze not unlawful if unintegrated second level competition can make a "living profit" at prevailing prices).

74. *Id.; cf.* Otter Tail Power Co. v. United States, 410 U.S. 366, 377-79 (1973) (refusal to deal with second level competitors violates § 2); Eastman Kodak Co. v. Southern Photo Materials Corp., 273 U.S. 359, 375 (1927) (refusal to deal with second level competitors violates § 2). *See also* Note, *supra* note 68, at 1754-61 (refusal to deal can be effected through vertical price squeeze).

75. Supplying a product at a lower price because of superior efficiencies would seem to be a variety of "growth . . . as a consequence of a superior product [or] business acumen" allowed by the Sherman Act. United States v. Grinnell Corp., 384 U.S. 563, 570-71 (1966).

76. *See id. But see* Brown Shoe Co. v. United States, 370 U.S. 294, 344 (1962) (marketing efficiencies created by vertical merger would have deleterious effects on competitors; merger disallowed, in part for this reason). Conceding that such efficiencies are desirable, difficult questions remain concerning the burden of proof as to those efficiencies. *See* Areeda, *Structure-Performance Assumptions in Recent Merger Cases*, in PUBLIC POLICY TOWARD MERGERS, *supra* note 68, at 27, 36-39 (efficiency justification for merger under Clayton Act § 7).

profit levels is permissible, however, the formulation of standards to determine when the squeeze has become predatory is difficult.

Judge Hand examined this problem in the *Alcoa* case and held that a prima facie case of a predatory squeeze had been established on the basis of evidence that unintegrated second level firms could not make a "living profit" by paying Alcoa's first level price and competing with its second level price.[77] This holding would seem to permit a finding of predation on the basis of the effect of a monopolist's prices on its competitors. The holding, however, was premised explicitly on the assumption that Alcoa's second level costs were equal to its competitors' costs.[78] Thus *Alcoa* may alternatively be read as holding that the existence of predation, even in the context of a vertical price squeeze, is in essence a function of the monopolist's prices and its costs.[79]

This reading of *Alcoa* suggests that cost-based predatory pricing rules may be applied to allegations of a vertical price squeeze. The monopolist's second level prices can be examined to see if they would be predatory if the monopolist's second level division were to purchase the first level product at the same price that its competitors must pay.[80] *Greyhound* offered the Ninth

Furthermore, any desirable efficiencies must be balanced against possible anticompetitive effects. *See* Note, *supra* note 68, at 1730-32.

77. 148 F.2d at 437-38.

78. *Id.* at 437.

79. The alternative reading of *Alcoa* is expressed in text following note 68 *supra*. This reading seems inconsistent with the remainder of *Alcoa*. If the monopolist is able to underprice its second level competitors and still recover its own second level costs, then the monopolist would seem to be operating more efficiently than those competitors. This efficiency would seem to be a variety of the "skill, foresight, and industry" that Hand viewed as acceptable conduct. *See* 148 F.2d at 430. Moreover, in his discussion of the squeeze, Hand apparently accepted the district court's position that a squeeze was impossible if Alcoa were not selling "below the cost of [second level] production, measuring ingot price as part of the cost." *Id.* at 437.

80. A somewhat similar approach is advocated in Note, *supra* note 68, at 1760. The analysis there advocated would also assume that the monopolist's second level division purchases the first level product at the same price that the second level competitors must pay. It would then compare the monopolist's "rate of profit from . . . sales of the final product," *id.*, with the rate of profit gained from sales of the first level product to second level competitors; the monopolist would be allowed to charge any prices that did not cause the first figure to fall below the second.

This approach would not allow the monopolist to profit maximize at the first level while competing at the second level. Antitrust policy, however, does not discourage such behavior. *See* notes 72 & 73 and accompanying text *supra*. If "rate of profit from . . . sales of the final product" refers to simply the second level rate of profit, then a monopolist that profit-maximizes at the first level while competing at the second would almost always violate the rule, because the competitive second level rate of profit would almost always be below the rate of profit at the first level. If "rate of profit from . . . sales of the final product" means the rate of profit for both levels combined, then the monopolist would still be forbidden to profit maximize at the first level while competing at the second. The monopolist has some of its capital invested in its competitive second level subsidiary, which receives a lower rate of return than its first level monopoly. The total rate of profit will, therefore, be somewhat lower than the first level

Circuit the opportunity to take such an approach. The *Greyhound* court, however, did not recognize this possibility, perhaps because the court did not recognize the case as an instance of a vertical price squeeze.

Greyhound contended that IBM had hindered Greyhound's purchase of IBM computers by raising the purchase price relative to the IBM lease price.[81] Thus Greyhound's case necessarily rested on the premise that IBM had the power to control price in the manufacturing and sales market.[82] The court of appeals held, however, that Greyhound was not required to prove the existence of that power.[83] Greyhound was instead allowed to rely simply on the theory, stemming from general definitions of monopolization, that IBM had used exclusionary practices to maintain an existing monopoly in the leasing market.[84] The IBM leasing monopoly, however, is dependent on IBM dominance of the manufacturing and sales market, because the IBM leasing division leases only IBM computers. Moreover, the conduct challenged by Greyhound—specifically, the adjustment of the multiplier and technological discount—occurred at least partially in the sales market.[85] Thus, IBM may be found to have monopolized the leasing market on the basis of conduct that occurred *outside* the leasing market. This approach to the analysis of a vertical squeeze is unusual, in that other cases have been based on proof of monopoly power at the first level.[86] The *Greyhound* approach, dispensing with formal proof of first level power, seems acceptable so long as the factual existence of the squeeze is solidly proved.[87] It is important to recognize, however, that a necessary implication of the

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rate of profit. Thus, a monopolist's profit maximization at the first level and competition at the second level would always violate the proposed rule.

The proposed rule goes astray in using rate of profit, rather than amount of monopoly profit, as a basis for comparison. If the dollar amount of monopoly profit earned at both levels from the monopolist's sale of the final product (a figure that excludes the *competitive* profit made at the second level) were compared to the amount of monopoly profit made from first level sales to second level competitors, a rule prohibiting the first figure from falling below the second would be consistent with antitrust policy. Violation of the rule would indicate that the monopolist was charging its competitors more than it charged its subsidiary. *See* text accompanying notes 93 & 94 *infra*.

81. *See* note 17 and accompanying text *supra*.

82. A vertical price squeeze cannot occur in the absence of market power at the first level. Without such power, a firm cannot raise its first level price without losing sales. *Cf.* Peltzman, *supra* note 71, at 172 (price squeeze impossible without market power of the first level or cheaper access to capital; the latter, however, is better analyzed as merely predatory pricing).

83. 559 F.2d at 503.

84. *Id.* (citing United States v. Grinnell Corp., 384 U.S. 563, 570-71 (1966); United States v. United Shoe Mach. Corp., 110 F. Supp. 295, 343 (D. Mass. 1953), *aff'd per curiam*, 347 U.S. 521 (1954)); *see* text accompanying notes 37-38 *supra*.

85. The court's opinion does not make clear to what extent the sales price and the lease price, respectively, were changed to accomplish the change in the multiplier. *See* 559 F.2d at 500-01.

86. *E.g.*, Alcoa, 148 F.2d at 438.

87. "Greyhound was not required to prove the source of IBM's power to do what Greyhound's evidence indicated IBM in fact did." 559 F.2d at 503.

Greyhound ruling is that IBM had monopoly power in the sales market. The existence of such power, though Greyhound was not required to prove it, is a premise of further analysis of IBM's squeeze of the leasing companies.

Accepting that IBM was squeezing the leasing companies, the court was further required to decide whether the squeeze was predatory. The court held that Greyhound had established a prima facie case of predation on the basis of evidence that Greyhound had sharply reduced its purchases of new equipment when the multiplier was raised and largely ceased buying older equipment when the technological discount was reduced.[88] Thus, the court relied entirely on evidence of the effect of IBM's pricing behavior on competitors in holding that behavior predatory.[89]

Greyhound might be seen as simply an application of the *Alcoa* "living profit" principle. The *Greyhound* court's disregard of IBM's costs, however, is a disturbing departure from the *Alcoa* approach. The *Greyhound* court did not assume, as Judge Hand did in *Alcoa*, that IBM's second level costs were equal to those of its second level competitors. Nor did the *Greyhound* court state that IBM could rebut the inference of predation with evidence of its own costs. The failure of the court of appeals to mention this possibility raises the question whether the court realized that a determination of IBM's leasing division costs is central to the issue of predation.[90] If the court did not recognize the existence of this crucial issue, there is a danger that in the future the court may permit even weaker evidence to constitute a prima facie case of monopolization. Thus, by relying on general definitions of monopolization,[91] the court may overlook crucial issues and allow unmeritorious cases to reach the jury. This is the specter raised by *Greyhound*.

Despite the failure of the court to perceive it as such, *Greyhound* offers an opportunity for a rigorous approach to the analysis of a vertical price squeeze through the application of precise predatory pricing rules to a vertically integrated structure. The question raised by applying cost-based rules to the *Greyhound* vertical squeeze is whether the IBM lease price

88. *See id.* at 499-501.

89. In its holding on the technological discount, the court also relied to a degree on evidence, in the form of internal IBM memoranda, that IBM had a subjective intent to monopolize. *Id.* at 499. Intent has been a dead issue in the law of monopolization since Judge Hand laid it to rest in *Alcoa*. 148 F.2d at 431-32. The *Greyhound* court's resurrection of it may simply be a spillover from the court's discussion of the attempt claim, 559 F.2d at 504-05, since specific intent is relevant in attempt cases. *See generally* sources cited at note 28 *supra*.

90. *See* text accompanying notes 50-56 *supra*.

91. The court relied generally on the *Grinnell* definition of monopolizing conduct, United States v. Grinnell Corp., 384 U.S. 563, 570-71 (1966); *see* note 45 *supra*, finding that IBM's actions represented the willful maintenance of monopoly power. 559 F.2d at 498. As already noted, *see* text accompanying notes 47-49 *supra*, this definition is not useful as a guide to judging price behavior.

would be below the IBM leasing division's average variable cost if that division's cost for an IBM computer were the same as that of the leasing companies.[92] If the IBM leasing division "pays" the same price as the leasing competitors and the IBM lease price is below the leasing division's average variable cost, then Greyhound has established a clear case of predation. If the leasing division remains profitable because it "pays" less for computers than do the leasing companies, then IBM's adjustment of the multiplier and technological discount emerges as an instance of systematic price discrimination that offers no welfare gain to society[93] unless the discrimination reflects efficiencies of vertical integration.[94] In the absence of such efficiencies, this discrimination should constitute a section 2 violation.[95]

If the IBM sales division charges the same price to the IBM leasing division and the leasing companies, and the IBM lease price is not less than the leasing division's average variable cost, then several possibilities remain. IBM may be squeezing the leasing companies only to competitive profit levels,[96] or IBM may be more efficient at the leasing level than the leasing companies and therefore able to underprice them.[97] In either event, IBM should not be held to have monopolized the leasing market.[98] A contrary conclusion would require IBM to adhere to an "umbrella price"[99] in order to give rivals a share of monopoly profits or to protect them from their own inefficiency. IBM may also be able to underprice its second level competitors because of efficiencies resulting from vertical integration. IBM should probably be allowed to reap the benefit of these efficiencies, as a primary goal of the antitrust laws is to promote the efficient allocation of resources.[100]

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92. This approach entails a difficult problem of attributing joint or common costs among the divisions of the monopolist. *See* Note, *supra* note 68, at 1760 & n.220. Nevertheless, despite its difficulties, this approach seems the most reliable way to analyze a vertical price squeeze. *Id.*

93. For a discussion of price discrimination through vertical integration, see note 68 *supra*.

94. *But see* Brown Shoe Co. v. United States, 370 U.S. 294, 344 (1962).

95. *See, e.g.*, United States v. Grinnell Corp., 236 F. Supp. 244, 256 (D.R.I. 1964), *aff'd*, 384 U.S. 563 (1966); Note, *supra* note 54, at 558 n.5. *See also* Note, *supra* note 68, at 1728 n.52.

96. Greyhound claimed damages based on a 30% profit margin. 559 F.2d at 507 & n.40 (derived).

97. There is no indication in the record to support this position.

98. *See* notes 75 & 76 and accompanying text *supra*.

99. An umbrella price is a price so high that it encourages entry even by less efficient firms. *See* Note, *supra* note 54, at 561-62.

100. *See* notes 75 & 76 *supra*.

A final possibility is that if consumers prefer to lease directly from IBM, then IBM can charge a premium price that allows it to compete with the leasing companies at a higher price than they can charge. Therefore, IBM can cut its lease price to the leasing division's average variable cost (a dollar figure that does not include the accumulated good will that gives IBM its

If predatory pricing policy is not analyzed exclusively on the basis of cost-based rules, other factors may be relied upon to support Greyhound's prima facie case.[101] The *Greyhound* court failed to examine adequately the market conditions that would make a predatory squeeze profitable for IBM, when such an examination would have strengthened its holding.

The squeeze in *Greyhound* was directed at one of the submarkets of the computer systems industry,[102] the leasing market. The pattern of competition in the industry has been for IBM to compete vigorously when it is challenged in single submarkets while reaping greater profits in those submarkets in which it faces little competition.[103] IBM has thereby gained a reputation as "hyperaggressive,"[104] which may have discouraged investment in IBM's competitors[105] and deterred competition in all of the industry's submarkets.

Discouraging entry into single submarkets is important to IBM because a major barrier to entry into the manufacture of mainframe computers is the necessity of entering a number of other submarkets simultaneously in order to market a computer system.[106] If strong, independent companies were to develop in the various submarkets, entry into mainframe manufacturing might well be easier.[107] The leasing market is particularly important in this regard because in the absence of leasing companies to market the computers of various manufacturers[108] a new manufacturer must make a large capital

premium status), and the leasing companies would have to price *below* their average variable cost to stay competitive, assuming equal costs at the leasing level, because they lack IBM's premium value. This possibility presents a difficult problem for predatory pricing analysis. The prices are not predatory under strict cost-based rules; yet if these prices are permitted, an entrenched monopolist may obtain an almost impregnable position. *See* Sherwood, *supra* note 10, at 341 n.194; Note, *supra* note 54, at 573 n.78, 574 n.84. One solution would be to deduct the premium value, assuming that can be calculated, *see id.* at 573 n.78, from the monopolist's price before applying the cost-based predatory pricing rules.

101. The market must be examined to determine the existence of the prerequisites of predation, such as substantial entry barriers. *See* Scherer, *supra* note 60, at 890.

102. The industry is composed of a number of submarkets, including mainframe manufacture, peripheral devices, maintenance, software, and distributional submarkets such as leasing. *See generally* J. SOMA, *supra* note 11, at 129-45.

103. W. SHEPHERD, MARKET POWER AND ECONOMIC WELFARE 229 (1970). For example, IBM engaged in a vigorous campaign against the newly developed manufacturers of peripheral devices designed for IBM computers and at the same time raised its mainframe prices. *See generally* G. BROCK, *supra* note 11, at 132-34, 173-77.

104. G. BROCK, *supra* note 11, at 63.

105. *Id.* at 62-63; *see* Gardner, *supra* note 11, at 82-86.

106. G. BROCK, *supra* note 11, at 62, 231; J. SOMA, *supra* note 11, at 41-43; *cf.* note 68 *supra* (entry barriers raised by dual entry requirement resulting from vertical integration).

107. *See* G. BROCK, *supra* note 11, at 60-61, 231.

108. Even though the leasing companies do not now generally handle computers by other makers, they might do so in the future, when both they and the other manufacturers are stronger. *Cf.* J. SOMA, *supra* note 11, at 129-36 (structural atomization of industry submarkets likely to continue).

investment in a stock of computers for leasing.[109] This requirement is in fact the major capital entry barrier into the manufacturing market.[110] Thus, by restricting the growth of strong leasing companies, IBM maintains significant capital entry barriers in the manufacturing market.

These additional and more subjective factors support the conclusion that IBM violated the antitrust laws by engaging in a socially undesirable price squeeze. It should be remembered, however, that when predatory pricing analysis is opened to considerations beyond the monopolist's costs the advantages of the cost-based rules are diminished, and the analysis leans toward the "intrinsically speculative and indeterminate"[111] approach such rules are designed to avoid.

The problem of determining standards for a monopolist's price behavior is compounded when that behavior occurs on successive market levels, as in the *Greyhound* case. Clear and precise standards are needed to guide the monopolist and the courts. Such standards are available in the form of cost-based predatory pricing rules, which can be applied to the vertically integrated monopolist. The court of appeals in *Greyhound* overlooked the possibility of such an application, relying on general definitions of monopolization to find a prima facie case of monopolization. The court overlooked or ignored the crucial issue of IBM's costs as a measure of the propriety of its prices; IBM's potential defenses based on cost considerations went unnoticed, leaving open the unhappy possibility that even weaker cases will be approved in the future. The *Greyhound* court thus decided, for badly flawed reasons, to enter the economic thicket of judicial supervision of IBM's pricing policies.

MICHAEL L. BALL

Criminal Procedure—Pen Registers: Compelling Third Party Assistance Under the All Writs Act

A pen register is a mechanical device that records the outgoing numbers dialed on a monitored telephone, but that does not overhear oral communications or record whether a call is actually completed.[1] Because

109. G. BROCK, *supra* note 11, at 57-60.
110. *Id.*; J. SOMA, *supra* note 11, at 41.
111. Areeda & Turner, *supra* note 65, at 897.

1. A pen register is attached to a telephone line usually at a central telephone office. In

pen registers, unlike wiretapping and eavesdropping devices,[2] are not governed by Title III of the Omnibus Crime Control and Safe Streets Act of 1968 (Title III),[3] the manner of their use has remained a matter within the discretion of the federal courts. In *United States v. New York Telephone Co.*[4] the United States Supreme Court considered the question whether a United States District Court may properly direct a telephone company to provide federal law enforcement officials the facilities and technical assistance necessary for the execution of its order authorizing the use of pen registers. The Court held that the district court had power under Federal Rule of Criminal Procedure 41 (rule 41)[5] to authorize the use of pen registers, and power under the All Writs Act[6] to order the telephone company to furnish assistance. Although the *New York Telephone Co.* decision is consistent with recent courts of appeals rulings[7] and with congressional action concerning electronic surveillance under Title III,[8] it

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the case of a rotary dial telephone, it records on a paper tape dashes equal in number to the number dialed; for incoming calls, it records a dash for each ring of the telephone but does not identify the number from which the incoming call originated. *See* United States v. Caplan, 255 F. Supp. 805, 807 (E.D. Mich. 1966). In the case of a touch tone telephone, the device (TR-12) prints the digits dialed in Arabic numerals. *See* United States v. Focarile, 340 F. Supp. 1033, 1039-40 (D. Md.), *aff'd sub nom.* United States v. Giordano, 469 F.2d 522 (4th Cir. 1972), *aff'd mem.*, 473 F.2d 906 (4th Cir. 1973), *aff'd*, 416 U.S. 505 (1974).

2. "Wiretapping" is the interception of communication by means of a physical connection with a communications system at a point between the sender and the receiver; "eavesdropping" refers to the interception of communication by means of a mechanical or electronic device that is not physically connected with the communications system. 74 AM. JUR. 2d *Telecommunications* §§ 211, 216 (1974). *See generally* A. WESTIN, PRIVACY AND FREEDOM 73-78 (1967).

3. Pub. L. No. 90-351, §§ 801-804, 82 Stat. 211 (1968). Section 802 of Title III amended part I of title 18, United States Code, by adding a new chapter entitled "Chapter 119—Wire Interception and Interception of Oral Communication" (18 U.S.C. §§ 2510-2520 (1970)). Section 803 of Title III amended § 605 of the Communications Act of 1934, ch. 652, § 605, 48 Stat. 1064 (formerly codified at 47 U.S.C. § 605 (1964)), to conform with the new chapter, which was intended to be a comprehensive electronic surveillance statute. Omnibus Crime Control and Safe Streets Act of 1968, Pub. L. No. 90-351, § 803, 82 Stat. 211 (codified at 47 U.S.C. § 605 (1970)). *See generally* S. REP. NO. 1097, 90th Cong., 2d Sess. 89-109, *reprinted in* [1968] U.S. CODE CONG. & AD. NEWS 2112, 2177-97 [hereinafter cited as SENATE REPORT]. *See also* text accompanying notes 19-30 *infra*.

4. 98 S. Ct. 364 (1977).

5. Rule 41(b) authorizes federal magistrates and state judges to issue a warrant to search for and seize any "(1) property that constitutes evidence of the commission of a criminal offense; or (2) contraband, the fruits of crime, or things otherwise criminally possessed; or (3) property designed or intended for use or which is or has been used as the means of committing a criminal offense." FED. R. CRIM. P. 41(b). *See also* text accompanying notes 32-37 *infra*.

6. 28 U.S.C. § 1651(a) (1970); *see* text accompanying note 48 *infra*.

7. *See* Michigan Bell Tel. Co. v. United States, 565 F.2d 385 (6th Cir. 1977); United States v. Southwestern Bell Tel. Co., 546 F.2d 243 (8th Cir. 1976), *cert. denied*, 98 S. Ct. 716 (1978); United States v. Illinois Bell Tel. Co., 531 F.2d 809 (7th Cir. 1976). *But see* Application of the United States for an Order Authorizing Use of a Pen Register Device, 407 F. Supp. 398 (W.D. Mo. 1976).

8. Congress amended Title III in 1970 by adding the following language to § 2518(4):

> An order authorizing the interception of a wire or oral communication shall, upon request of the applicant, direct that a communication common carrier . . . shall

raises serious questions about the scope of authority conferred by rule 41 and the All Writs Act.

The United States District Court for the Southern District of New York issued an order authorizing agents of the Federal Bureau of Investigation (FBI) to install and use pen registers on two telephones upon finding that there was probable cause to believe that the two telephones were being used in connection with an illegal gambling operation.[9] The order also directed the New York Telephone Company (the Company) to furnish the FBI "[a]ll information, facilities, and technical assistance" necessary to employ the pen registers unobtrusively,[10] and it directed the FBI to compensate the Company at prevailing rates.[11] The Company provided the FBI with the information it needed to install the pen registers, but it refused to lease the lines to the FBI that were required to install the pen registers in an inconspicuous location, away from the building containing the telephones.[12] The district court denied the Company's motion to vacate that part of the order directing it to provide assistance, and the Company appealed.[13]

The Court of Appeals for the Second Circuit affirmed that part of the order authorizing the use of pen registers, concluding that pen registers are not subject to the provisions of Title III and that district courts have power, either inherently or as a "logical derivative" of rule 41, to order pen register surveillance upon a showing of probable cause.[14] The Second Circuit,

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> furnish the applicant forthwith all information, facilities, and technical assistance necessary to accomplish the interception unobtrusively and with a minimum of interference with the services that such carrier . . . is according the person whose communications are to be intercepted.

Act of July 29, 1970, Pub. L. No. 91-358, § 211(b), 84 Stat. 654 (codified at 18 U.S.C. § 2518(4) (1970)). The amendment provides further that such carrier be compensated at prevailing rates. *Id.* It was passed following the decision of the United States Court of Appeals for the Ninth Circuit in Application of the United States for Relief, 427 F.2d 639 (9th Cir. 1970), which held that, absent specific statutory authority, a district court was without power to compel a telephone company to provide assistance in the interception of wire communications conducted pursuant to Title III. *Id.* at 644. *See also* note 91 *infra*.

9. 98 S. Ct. at 367.

10. *In re* Order Authorizing the Use of a Pen Register, 538 F.2d 956, 957 (2d Cir. 1976), *rev'd sub nom.* United States v. New York Tel. Co., 98 S. Ct. 364 (1977). The language that the district court used in its order tracked the language of the 1970 amendment to Title III. *Compare* 538 F.2d at 957 *with* note 8 *supra*.

11. 98 S. Ct. at 367.

12. The Company advised the FBI to string its own wires from the "subject apartment" to another location where the pen registers could be installed, but the FBI determined that this could not be accomplished without alerting the suspects and jeopardizing the investigation. *Id.*

13. *In re* Order Authorizing the Use of a Pen Register, 416 F. Supp. 800 (S.D.N.Y.), *aff'd in part and rev'd in part*, 538 F.2d 956 (2d Cir. 1976), *rev'd sub nom.* United States v. New York Tel. Co., 98 S. Ct. 364 (1977). The Second Circuit denied the Company's motion to stay the pen register order pending appeal, and the Company then provided the leased lines. 98 S. Ct. at 368.

14. *In re* Order Authorizing the Use of a Pen Register, 538 F.2d 956, 960 (2d Cir. 1976), *noted in* 8 RUT.-CAM. L.J. 538 (1977). The court concluded that the power to order pen register surveillance is the equivalent of the power to order a search pursuant to a search warrant, and is

however, reversed that part of the order directing the Company to provide facilities and technical assistance. It assumed, *arguendo*, that a district court has authority to compel assistance by the Company, but concluded that "in the absence of specific and properly limited Congressional action, it was an abuse of discretion for the District Court to order the Telephone Company to furnish technical assistance."[15] The Supreme Court interpreted the Second Circuit's holding "as generally barring district courts from ordering any party to assist in the installation or operation of a pen register."[16] It agreed "that the power of federal courts to impose duties upon third parties is not without limits,"[17] but the Court concluded that the district court was authorized by the All Writs Act to order the Company to provide technical assistance to implement the pen register order.[18]

The decision of the Supreme Court in *New York Telephone Co.* can best be understood in light of the statutory authority upon which it relies—Title III, rule 41 and the All Writs Act. Title III was intended to be a comprehensive electronic surveillance statute,[19] prohibiting all wiretapping and other types of electronic surveillance[20] except by law enforcement officials[21] investigating specified crimes[22] and acting pursuant to rigid procedures[23] under judicial supervision.[24] Title III, however, authorizes only those orders "authorizing or approving the *interception* of a wire or oral communication."[25] "Intercept" is defined as "the *aural* acquisition of the

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thus subject to the requirements of the fourth amendment. Because the district court issued the order upon a showing of probable cause, the court held that it had been properly granted. *Id.*

15. *Id.* at 961. Judge Mansfield dissented on the grounds that the district court had power under the All Writs Act to compel the Company to provide assistance and that it did not abuse its discretion in exercising that power. He noted that the result of holding that the Company cannot be directed to provide assistance in installing pen registers might result in more intrusive electronic surveillance for the reason that the Company can be required to provide assistance in installing a wiretap under Title III. *Id.* at 964 n.1 (Mansfield, J., dissenting).

16. 98 S. Ct. at 372.

17. *Id.*

18. *Id.* Justice White delivered the opinion of the Court. Justice Stevens filed an opinion dissenting in part in which Justice Brennan and Justice Marshall joined, and in which Justice Stewart joined in part. Justice Stevens took the position that Congress has not given district courts the power either to authorize the use of a pen register under rule 41 or to require private parties to assist in carrying out such surveillance under the All Writs Act. He concluded that because federal courts are courts of limited jurisdiction, and because those limits should be adhered to strictly when a court purports to authorize and implement the invasion of an individual's privacy, the Court's "rush to achieve a logical result" in this case must await congressional action. *Id.* at 375-76 (Stevens, J., dissenting in part).

19. *See generally* SENATE REPORT, *supra* note 3, at 66-67, *reprinted in* [1968] U.S. CODE CONG. & AD. NEWS at 2153-54. *See also* Blakey & Hancock, *A Proposed Electronic Surveillance Control Act*, 43 NOTRE DAME LAW. 657 (1968).

20. 18 U.S.C. § 2511 (1970).

21. *Id.* § 2516.

22. *Id.*

23. *Id.* § 2518.

24. *Id.* § 2519.

25. *Id.* § 2518(1) (emphasis added).

contents of any wire or oral communication."[26] Because pen registers do not "aurally"[27] acquire the "contents"[28] of any communication, they are not covered by Title III;[29] each court of appeals that has considered the matter has so concluded.[30] The question presented, therefore, concerns the source of the district courts' authority to issue pen register orders. The courts of appeals have found a basis for that authority either in the "inherent power" of a district court[31] or in rule 41.

Rule 41(b) authorizes a federal magistrate to issue a warrant to search for and seize, among other things, "property that constitutes evidence of the commission of a criminal offense."[32] The difficulty in using the rule to authorize the issuance of a pen register order is that the evidence seized by means of the pen register—numbers dialed on a telephone—does not fit the definition of the term "property." Rule 41(h) defines property "to include documents, books, papers and any other *tangible* objects."[33] Thus, strictly construed, rule 41 does not purport to authorize warrants to search for and seize "nontangibles" such as evidence gained as a result of pen register surveillance.[34] Of the four courts of appeals that have invoked rule 41 as authority for the issuance of a pen register order, three have done so by

26. *Id.* § 2510(4) (emphasis added).

27. "Aural" is not defined in Title III. The OXFORD ENGLISH DICTIONARY gives the following definition: "1. Of or pertaining to the organ of hearing. 2. Received or perceived by the ear."

28. "Contents" is defined as "includ[ing] any information concerning the identity of the parties to such communication or the existence, substance, purport, or meaning of that communication." 18 U.S.C. § 2510(8) (1970).

29. The Senate report on Title III indicates that pen registers were intended to be excluded from coverage: "The proposed legislation is not intended to prevent the tracing of phone calls. The use of a 'pen register,' for example, would be permissible. . . . The proposed legislation is intended to protect the privacy of the communication itself and not the means of communication." SENATE REPORT, *supra* note 3, at 90, *reprinted in* [1968] U.S. CODE CONG. & AD. NEWS at 2178 (citation omitted). Both the Supreme Court and the Second Circuit cited this language in support of their conclusion that pen registers are not covered by Title III. *See* 98 S. Ct. at 370; *In re* Order Authorizing the Use of a Pen Register, 538 F.2d 956, 958 (2d Cir. 1976).

30. *See* Hodge v. Mountain States Tel. & Tel. Co., 555 F.2d 254 (9th Cir. 1977); United States v. Clegg, 509 F.2d 605 (5th Cir. 1975); United States v. Falcone, 505 F.2d 478 (3d Cir. 1974), *cert. denied*, 420 U.S. 955 (1975); cases cited note 7 *supra*. *But cf.* United States v. Lanza, 341 F. Supp. 405 (M.D. Fla. 1972) (pen register used in conjunction with wiretap is authorized by Title III wiretap order).

31. Both the Eighth and the Seventh Circuits have suggested that the inherent authority of a district court to issue a pen register order has been "necessitated" by the special nature of electronic communications. *See* United States v. Southwestern Bell Tel. Co., 546 F.2d 243, 245 & n.5 (8th Cir. 1976), *cert. denied*, 98 S. Ct. 716 (1978); United States v. Illinois Bell Tel. Co., 531 F.2d 809, 811 & n.2 (7th Cir. 1976).

32. FED. R. CRIM. P. 41(b); *see* note 5 *supra*.

33. FED. R. CRIM. P. 41(h) (emphasis added).

34. *But cf.* Katz v. United States, 389 U.S. 347, 355 n.16 (1967) (dicta that rule 41(d) would not require prior notice of an otherwise constitutionally valid order authorizing electronic surveillance); 3 C. WRIGHT, FEDERAL PRACTICE AND PROCEDURE § 661, at 21 (1969) (rule 41 should be read as applying to verbal statements).

analogy.[35] Only the Sixth Circuit, in *Michigan Bell Telephone Co. v. United States*,[36] actually held that rule 41 gives district courts that power.[37]

The question whether a district court is empowered to issue a valid order does not arise in most cases of electronic surveillance, because Title III expressly authorizes the interception of wire and oral communications subject to the procedures therein;[38] however, because pen registers are outside the scope of Title III, the authority to issue an order for their use must be found, if at all, in the pre-1968 power of a federal magistrate to order electronic surveillance.[39] In *Katz v. United States*,[40] decided in 1967, the United States Supreme Court indicated that a magistrate's power to order electronic surveillance is equivalent to his power to issue a search warrant,[41] and that such an order could properly issue if the manner of its issuance met constitutional standards.[42] Thus, unless Congress intended in 1968 to pro-

35. *See* United States v. Southwestern Bell Tel. Co., 546 F.2d 243, 245 n.5 (8th Cir. 1976), *cert. denied*, 98 S. Ct. 716 (1978); *In re* Order Authorizing the Use of a Pen Register, 538 F.2d 956, 959 (2d Cir. 1976), *rev'd sub nom.* United States v. New York Tel. Co., 98 S. Ct. 364 (1977); United States v. Illinois Bell Tel. Co., 531 F.2d 809, 811 n.2, 813 (7th Cir. 1976).

36. 565 F.2d 385 (6th Cir. 1977). *Michigan Bell Telephone Co.* actually involved the use of a "trapping" or "tracing" device, but the Sixth Circuit concluded that the rules applicable to pen registers were controlling. *Id.* at 388. A trace determines the telephone numbers of calls *incoming* to the monitored telephone. *Id.* at 388 n.5.

37. *Id.* at 389.

38. *See* text accompanying notes 19-24 *supra*.

39. The United States Supreme Court first addressed the issue of electronic surveillance in Olmstead v. United States, 277 U.S. 438 (1928). In *Olmstead*, the Court held that neither the fourth nor the fifth amendment barred admission into evidence of information obtained by tapping defendants' telephone lines. *Id.* at 462, 466. Congress then enacted the Communications Act of 1934, § 605 of which prohibited the interception without authorization and divulgence or publication of any wire or radio communication. Ch. 652, § 605, 48 Stat. 1064 (codified at 47 U.S.C. § 605 (1970)). In Nardone v. United States, 302 U.S. 379 (1937), *enforced*, 308 U.S. 338 (1939), the Court applied the exclusionary rule to evidence offered in a federal prosecution that was obtained in violation of § 605. 302 U.S. at 382; 308 U.S. at 340. The Court considered electronic eavesdropping for the first time in Goldman v. United States, 316 U.S. 129 (1942), and relied upon *Olmstead* in holding that there was no violation of the fourth amendment because there was no physical trespass in connection with the eavesdropping. *Id.* at 135. In Silverman v. United States, 365 U.S. 505 (1961), however, the Court held that evidence obtained by means of a "spike mike"—a spike with a microphone attached inserted into a party wall—was inadmissible because there was "actual intrusion into a constitutionally protected area" in violation of the fourth amendment. *Id.* at 512. Finally, in Berger v. New York, 388 U.S. 41 (1967), the Court held that "conversation" is protected by the fourth amendment and that the use of electronic devices to capture it constitutes a "search." *Id.* at 51. The Court then found that a New York statute authorizing electronic eavesdropping failed to meet the requirements of the fourth amendment. *Id.* at 58-60; *cf.* Osborn v. United States, 385 U.S. 323, 329 (1966) (evidence obtained by means of recording device authorized subject to "precise and discriminate" procedures admissible). *See generally* C. WRIGHT, *supra* note 34, § 665.

40. 389 U.S. 347 (1967).

41. *Id.* at 354-56 & 355 n.16.

42. The Court indicated that electronic surveillance would be constitutionally permissible under the following circumstances: law enforcement officials must obtain advance authorization.by a neutral magistrate upon a showing of probable cause; they must observe the precise

hibit *all* types of electronic surveillance except that expressly authorized under Title III,[43] the permissibility of the use of pen registers arguably depends solely on compliance with the requirements of the fourth amendment. This was in fact the conclusion reached by four Supreme Court Justices in *United States v. Giordano*[44] upon finding that pen registers are not subject to the provisions of Title III.[45] Relying upon the specific language of Justice Powell in *Giordano*, each court of appeals that has directly confronted the matter has decided that the power to order pen register surveillance is either a power analogous to that in rule 41 or the power lodged in rule 41 itself.[46] The power to order pen register surveillance is a nullity however, when, as in this case, the telephone company refuses to provide facilities and technical assistance.[47] Consequently, the lower courts have looked to the All Writs Act for the authority to compel assistance.

The All Writs Act provides: "The Supreme Court and all courts established by Act of Congress may issue all writs necessary or appropriate in aid of their respective jurisdictions and agreeable to the usages and principles of law."[48] Because district courts are "courts established by Act of Congress," the statute applies to them.[49] It is primarily invoked by the Supreme Court[50] and the courts of appeals,[51] however, in the exercise of their appellate jurisdiction; the power to grant a writ is characterized as an appellate power.[52] The writs more commonly issued under the Act are writs of mandamus or prohibition,[53] although the Act itself authorizes "all writs"

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limits established by a specific order; and they must notify the authorizing magistrate of all that is seized. *Id.* at 356. Those requirements were not met in *Katz*. *Id.*

43. Congress intended to prohibit the interception and disclosure of *all* wire or oral communication except as otherwise provided in Title III. SENATE REPORT, *supra* note 3, at 90, 91, *reprinted in* [1968] U.S. CODE CONG. & AD. NEWS at 2178, 2180. "Intercept" is a defined term, however, and does not reach the use of pen registers. *See* note 29 *supra*.

44. 416 U.S. 505, 548 (1974) (Powell, J., concurring in part and dissenting in part).

45. *Id.* at 553-54 (Powell, J., concurring in part and dissenting in part). The Court did not reach the issue because it concluded that the evidence obtained by means of the pen register was derived from an illegal wire interception. Pen register surveillance had been authorized by extension orders following the initial illegal wiretap order. *Id.* at 533 n.19.

46. *See* cases cited in notes 35 & 36 *supra*.

47. The Second Circuit found that without the Company's technical assistance, the pen register order would be "worthless." *In re* Order Authorizing the Use of a Pen Register, 538 F.2d 956, 961 (2d Cir. 1976).

48. 28 U.S.C. § 1651(a) (1970).

49. 9 MOORE'S FEDERAL PRACTICE ¶ 110.26, at 278 (2d ed. 1975).

50. *Id.* ¶ 110.27.

51. *Id.* ¶ 110.28.

52. 16 C. WRIGHT, A. MILLER, E. COOPER & E. GRESSMAN, FEDERAL PRACTICE AND PROCEDURE § 3932, at 184 & n.3 (1977) [hereinafter cited as WRIGHT & MILLER].

53. MOORE'S FEDERAL PRACTICE, *supra* note 49, ¶ 110.26, at 278. For an excellent summary of the All Writs Act and the power to issue a writ of mandamus, see Judge Friendly's opinion in United States v. Weinstein, 452 F.2d 704, 709-13 (2d Cir. 1971), *cert. denied*, 406 U.S. 917 (1972).

and that language has been interpreted flexibly to include such writs as common law certiorari and habeas corpus as well as injunctions.[54]

The language of the statute itself prescribes several limitations on its scope. First, it authorizes only those writs that are "necessary or appropriate." Although the common law writs upon which the Act is based were considered "extraordinary remedies,"[55] the Supreme Court has at times used broad language in defining the scope of the Act,[56] and the standard against which its use must be tested is one of sound judicial discretion.[57] The writ must also be "agreeable to the usages and principles of law." The Court has not interpreted that to mean agreeable to the usages and principles of common or English law;[58] the limitation is, in effect, also one of judicial discretion.[59] The most sharply defined limitation on the use of the Act is that the writ must be "in aid of [the courts'] respective jurisdictions." This means that the Act does not confer or extend a federal court's jurisdiction,[60] and that it can properly be invoked by a district court only with respect to jurisdiction otherwise obtained.[61] Thus, the proper exercise of power under the Act depends, first, upon whether the court invoking the Act has met the jurisdictional requirement and, second, upon whether the specific action taken by the court constitutes an abuse of that power.

The threshold question that the Supreme Court addressed in *New York Telephone Co.* was whether pen registers are covered under Title III. The Court concluded they are not,[62] and in so concluding removed pen register orders from both the authority of Title III and its rigid procedural safeguards. The conclusion that pen registers do not pose the same threat to privacy as wiretapping and eavesdropping, and therefore need not be

54. *See, e.g.*, FTC v. Dean Foods Co., 384 U.S. 597 (1966) (court of appeals empowered to temporarily enjoin consummation of merger pending FTC proceedings); United States Alkali Export Ass'n, Inc. v. United States, 325 U.S. 196 (1945) (Supreme Court empowered to review district court order by writ of certiorari); Adams v. United States *ex rel.* McCann, 317 U.S. 269 (1942) (court of appeals already having jurisdiction of proceeding empowered to issue writ of habeas corpus).

55. WRIGHT & MILLER, *supra* note 52, § 3933, at 213.

56. In Adams v. United States *ex rel.* McCann, 317 U.S. 269 (1942), the Court used the following language: "Unless appropriately confined by Congress, a federal court may avail itself of all auxiliary writs as aids in the performance of its duties, when the use of such historic aids is calculated in its sound judgment to achieve the ends of justice entrusted to it." *Id.* at 273. This language has been widely quoted. *See, e.g.*, United States v. New York Tel. Co., 98 S. Ct. at 372.

57. *See Ex parte* Republic of Peru, 318 U.S. 578, 584 (1943); Adams v. United States *ex rel.* McCann, 317 U.S. 269, 273 (1942).

58. *See* Price v. Johnston, 334 U.S. 266, 281-82 (1948).

59. *Id.* at 284.

60. *See* MOORE'S FEDERAL PRACTICE, *supra* note 49, ¶ 110.26, at 282-83.

61. *Id.* ¶ 110.29, at 318; *see* Commercial Security Bank v. Walker Bank & Trust Co., 456 F.2d 1352, 1355 (10th Cir. 1972); Brittingham v. Commissioner, 451 F.2d 315, 317 (5th Cir. 1971).

62. 98 S. Ct. at 369.

accorded the same safeguards, is supported by the Court's rationale—as expressed in *Berger v. New York*[63] and *Katz*—that the fourth amendment protects oral communications.[64] Under that rationale, the question arises whether the use of a pen register should be subject to the requirements of the fourth amendment at all since the device does not overhear oral communications. In fact, the Court has never directly addressed that question[65] and left it unanswered in *New York Telephone Co.*[66] If pen registers could be employed without a warrant—like mail covers[67]—then judicial authorization would be unnecessary in the first place, and a district court would presumably lack the requisite jurisdiction to invoke the All Writs Act to order a telephone company to provide assistance.[68] The anomalous result would be that the decision whether to allow a pen register to be used in a particular case would be made by the telephone company rather than by a federal magistrate. The Court avoided this problem in *New York Telephone Co.* by assuming that the use of a pen register constituted a "search" within the meaning of the fourth amendment,[69] and it found authority for the district court to order its use in rule 41.

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63. 388 U.S. 41 (1967).

64. In *Berger*, the Court held that "conversation" was protected by the fourth amendment. *Id.* at 51; *see* note 39 *supra*. In *Katz*, the Court concluded that listening to and recording petitioner's "words" constituted a search and seizure within the meaning of the fourth amendment. 389 U.S. at 353; *see* note 42 and text accompanying notes 40-42 *supra*.

65. The widely-quoted statement in *Giordano* that pen registers are subject to the requirements of the fourth amendment is in a separate opinion and is not part of the holding of the case. *See* note 45 *supra*.

66. 98 S. Ct. at 369 n.7. It is arguable that the use of a pen register by law enforcement officials violates the "justifiable" expectation of privacy that the person under investigation has in using the monitored telephone, and that such an expectation of privacy is protected by the fourth amendment. *See* United States v. White, 401 U.S. 745, 752 (1971) (clarifying *Katz*). *But see* Note, *The Legal Constraints Upon the Use of the Pen Register as a Law Enforcement Tool*, 60 CORNELL L. REV. 1028, 1042-47 (1975) (fourth amendment does not bar the use of pen registers); *cf.* Note, *Tracking Katz: Beepers, Privacy, and the Fourth Amendment*, 86 YALE L.J. 1461 (1977) (use of "beepers"—electronic tracking devices—invades fourth amendment rights in most cases and should be subject to statutory warrant requirements).

67. The post office conducts a mail cover by

> furnishing the Government with the information appearing on the face of the envelope addressed to the particular address: *i.e.*, addressee, postmark, name and address of sender (if it appears), and class of mail. The actual mail is delivered to the addressee and only the letter-carrier's notation reaches the Government agency which requests the mail cover.

United States v. Balistrieri, 403 F.2d 472, 475 n.2 (7th Cir. 1968), *cert. denied*, 402 U.S. 953 (1971). Mail covers have been found to be outside the protection of the fourth amendment. *See, e.g.*, Lustinger v. United States, 386 F.2d 132, 139 (9th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968).

68. Justice Stevens reasoned that "[i]f . . . the individual's privacy interest is not constitutionally protected, judicial intervention is both unnecessary and unauthorized." On this hypothesis, the district court's order authorizing the pen registers was a "nullity" and therefore could not support the further order requiring the Company to provide assistance. 98 S. Ct. at 379 (Stevens, J., dissenting in part); *see* text accompanying note 61 *supra*.

69. *See* 98 S. Ct. at 370.

The Supreme Court's conclusion that rule 41 authorizes the use of pen registers is not supported by a literal reading of the rule itself, which limits its scope to tangible property.[70] Nonetheless, the Court has recognized in *Katz* and in *Osborn v. United States*[71] that nontangibles such as oral communications can be the objects of a proper search and seizure.[72] Moreover, Congress clearly intended that the permissibility of pen registers survive the enactment of Title III.[73] Finally, a federal magistrate is already empowered under Title III to order more intrusive electronic surveillance that does intercept oral communications.[74] In light of these considerations, the Court interpreted rule 41 flexibly to effectuate its purpose of prescribing the requirements of a constitutionally valid search and seizure.

The practical effect of this part of the *New York Telephone Co.* decision will be to ensure that the procedural safeguards of rule 41 apply to pen register orders.[75] The result of noncompliance with those requirements will be the exclusion of any evidence obtained by means of the surveillance from use in a criminal prosecution.[76] Problems of construction are certain to arise because the rule as written is not intended to include nontangible property.[77] The purpose of deterring unlawful conduct in the area of criminal investigation will be better served, however, by subjecting the use of pen registers to the procedures of rule 41 than to none at all. Moreover, when pen registers are used in conjunction with wiretaps, as they frequently are, their use arguably will be subject to the even stricter procedures of Title III.[78]

70. *See* text accompanying note 33 *supra*. The Court cited FED. R. CRIM. P. 57(b) to support its conclusion, but that rule is inapposite. Rule 57(b) specifically concerns two problems: the nonconformity of federal criminal procedure to state criminal procedure and the details of trial procedure; it is not a general grant of authority. *See* FED. R. CRIM. P. 57(b), Notes of Advisory Comm.

71. 385 U.S. 323 (1966).

72. 389 U.S. at 354-56 & 355 n.16; 385 U.S. at 329-31.

73. *See* note 29 *supra*.

74. *See* text accompanying notes 19-24 *supra*.

75. *See* FED. R. CRIM. P. 41; *id.*, Notes of Advisory Comm.

76. "[E]vidence obtained in violation of the Fourth Amendment" and fruits of illegally seized evidence "cannot be used in a criminal proceeding against the victim of an illegal search and seizure." United States v. Calandra, 414 U.S. 338, 347 (1974); *see* FED. R. CRIM. P. 41(e).

77. The Court addressed two of these problems in dicta— the notice requirement of rule 41(d) and the requirement that the search be conducted within 10 days—and concluded that neither barred the use of rule 41 to authorize a pen register order. 98 S. Ct. at 371 n.16.

78. At least one court has held that a pen register is an interception of a wire communication within the meaning of Title III when used in conjunction with a court-ordered wiretap. United States v. Lanza, 341 F. Supp. 405, 422 (M.D. Fla. 1972).

From the point of view of the telephone company, the Court's characterization of the use of a pen register as a "search and seizure" within the meaning of the fourth amendment is more problematic. Because it is now clear that a rule 41 warrant is required to use a pen register in a criminal investigation, it could be argued that the telephone company's use of pen registers for business purposes constitutes a violation of the fourth amendment. The telephone company

Before the Supreme Court's decision that the All Writs Act authorizes a district court to order a telephone company to provide facilities and technical assistance in connection with a pen register order, three federal courts of appeals faced the identical issue;[79] of those three, only the Sixth Circuit, in *Michigan Bell Telephone Co.*, actually held that the All Writs Act empowered the district court to order the telephone company to provide assistance.[80] In reaching its conclusion, the Supreme Court failed to confront the difficult problem raised by Justice Stevens in the dissent: whether the district court had obtained jurisdiction, apart from the All Writs Act, over the "dispute" between the FBI and the Company.[81] The Court evidently assumed that the original jurisdiction exercised by the district court in authorizing the use of pen registers was sufficient in scope to include the telephone company whose cooperation was necessary for the execution of the order,[82] even though the Company was a third party not the target of the investigation. On the basis of that rationale, however, a district court could theoretically, upon a mere showing of probable cause, compel

uses pen registers in the normal course of business to check for defective dials and overbilling. *See* United States v. Dote, 371 F.2d 176, 181 (7th Cir. 1966). They are also used to investigate annoying or obscene telephone calls. *See* Claerhout, *The Pen Register*, 20 DRAKE L. REV. 108, 110-11 (1970). *See generally* Note, *The Legal Constraints Upon the Use of the Pen Register as a Law Enforcement Tool*, *supra* note 66, at 1029 & n.11. Pen registers, however, are not prohibited by either Title III or § 605 of the Communications Act of 1934. Section 803 of Title III amended the Communications Act of 1934, ch. 652, § 605, 48 Stat. 1064 (formerly codified at 47 U.S.C. § 605 (1964)), to prohibit the interception and divulgence of "any radio communication." Omnibus Crime Control and Safe Streets Act of 1968, Pub. L. No. 90-351, § 803, 82 Stat. 197 (codified at 47 U.S.C. § 605 (1970)). Before this amendment to § 605, the Seventh Circuit had held in *Dote* that § 605 prohibited the use of pen registers, *see* 371 F.2d at 181, but that holding has since been overruled, Korman v. United States, 486 F.2d 926, 931-32 (7th Cir. 1973). Moreover, unlike Title III, rule 41 confers authority but does not proscribe otherwise lawful activity. At least one court has held that the use of a pen register by the telephone company did not violate the subscriber's rights under either the fourth or fifth amendments. State v. Holliday, 169 N.W.2d 768 (Iowa 1969). It is also clear that there is no bar to the use of evidence unlawfully obtained by private persons so long as the government played no part in the unlawful conduct. C. WRIGHT, *supra* note 34, § 661, at 20. Finally, 18 U.S.C. § 2511(2)(a)(i) (1970) provides that it is not unlawful for a communication common carrier "to intercept, disclose, or use that [wire] communication in the normal course of [its] employment."

79. Michigan Bell Tel. Co. v. United States, 565 F.2d 385 (6th Cir. 1977); United States v. Southwestern Bell Tel. Co., 546 F.2d 243 (8th Cir. 1976), *cert. denied*, 98 S. Ct. 716 (1978); United States v. Illinois Bell Tel. Co., 531 F.2d 809 (7th Cir. 1976).

80. 565 F.2d at 389. Both the Eighth and the Seventh Circuits held that the All Writs Act was "analogous" authority to the district court's power to order the telephone company's assistance to prevent the frustration of its order. United States v. Southwestern Bell Tel. Co., 546 F.2d 243, 246 & n.7 (8th Cir. 1976), *cert. denied*, 98 S. Ct. 716 (1978); United States v. Illinois Bell Tel. Co., 531 F.2d 809, 814 (7th Cir. 1976). Both Circuits found that the district court's "inherent authority" to order pen register surveillance extended to the authority to order the telephone company's assistance. 546 F.2d at 246; 531 F.2d at 811; *see* note 31 *supra*.

81. 98 S. Ct. at 380 n.19 (Stevens, J., dissenting).

82. *See id.* at 372. Otherwise, the district court would not have met the requirement that the exercise of authority under the Act be in aid of the court's jurisdiction. *See* text accompanying notes 60 & 61 *supra*.

any unwilling third party, under the threat of contempt, to provide such assistance as the court in its discretion deemed necessary to effectuate its order. This proposition is indeed unsettling;[83] however, the holding in *New York Telephone Co.* is substantially more limited.

The Court presented three major justifications for its decision. First, the Company itself, a regulated public utility,[84] offered no substantial reasons why it should not provide assistance in investigating the suspected illegal use of its facilities,[85] and the order provided that the Company be compensated at prevailing rates for any assistance that it furnished the FBI.[86] Second, the Company was in the unique position of being able to deny the FBI the means to carry out its investigation.[87] Finally, Congress provided in a 1970 amendment to Title III that a "communication common carrier" such as the Company can be ordered to provide "information, facilities, and technical assistance" in connection with electronic surveillance authorized under Title III.[88] In light of these circumstances, the Court understood this to be an extraordinary case that justified an extraordinary remedy.

The real significance of the *New York Telephone Co.* decision lies in its potential to be misinterpreted by the lower federal courts as precedent for expanding the scope of rule 41 and the All Writs Act. Because the Supreme Court apparently found that the district court had obtained original jurisdiction over the Company under rule 41, it is possible to read *New York Telephone Co.* broadly as sanctioning the use of the All Writs Act to order any third party to assist in the implementation of a search warrant. If district courts interpret the decision as authority for invoking the All Writs Act to

83. The Second Circuit expressed its reluctance to approve the district court's order compelling the Company to provide assistance in the following language:

> Perhaps the most important factor weighing against the propriety of the order is that without Congressional authority, such an order could establish a most undesirable, if not dangerous and unwise, precedent for the authority of federal courts to impress unwilling aid on private third parties. . . . In this best of all possible worlds it is a law of nature that one thing leads to another. It is better not to take the first step.

In re Order Authorizing the Use of a Pen Register, 538 F.2d 596, 962 (2d Cir. 1976).

84. 98 S. Ct. at 373. The Sixth Circuit emphasized in *Michigan Bell Telephone Co.* that "a telephone company is no ordinary third party. It is a public utility, enjoying a monopoly in an essential area of communications." 565 F.2d at 389.

85. *See* 98 S. Ct. at 373. At the same time that Congress amended Title III to empower district courts to compel communication common carriers to provide assistance in connection with wiretap orders, it also provided that good faith compliance with such orders is a complete defense to both criminal and civil liability. Act of July 29, 1970, Pub. L. No. 91-358, § 211(a), (c), 84 Stat. 473 (codified at 18 U.S.C. §§ 2511(2)(a)(ii), 2520 (1970)). This defense would be neither available nor necessary in the case of pen registers, because they are not prohibited by Title III in the first place. *See* Application of the United States for an Order Authorizing Use of a Pen Register Device, 407 F. Supp. 398, 403 n.3 (W.D. Mo. 1976).

86. 98 S. Ct. at 373.

87. *Id.* at 373-74.

88. *Id.* at 374; *see* note 8 *supra*.

compel tangentially involved third parties to assist in the execution of their orders, then *New York Telephone Co.* will be dangerous precedent in the hands of overzealous law enforcement officials and federal magistrates. Although clear abuses of discretion should not withstand judicial review, the results could nonetheless be oppressive. If, however, *New York Telephone Co.* is viewed as a pragmatic solution limited to the problem of executing pen register surveillance in the absence of specific legislation, then the decision will have little precedential value in other areas of search and seizure. Several practical considerations militate in favor of the latter interpretation.

First, in criminal investigations that typically involve the use of pen registers—gambling, racketeering and wirefraud— the evidence obtained by means of electronic surveillance is essential to successful prosecution.[89] Moreover, the ongoing and "professional" nature of such criminal activity demands sophisticated surveillance techniques.[90] Telephone companies virtually control the means and expertise necessary to conduct such investigations. As long as they are compensated for providing their services in connection with pen register surveillance at prevailing rates, they have no substantial interest to protect by not providing the facilities and assistance. Second, Congress has already given district courts the power to direct communication common carriers such as the telephone company to provide such assistance in connection with court-ordered electronic surveillance under Title III.[91] The only reason that pen register surveillance cannot be enforced under that authority is that in 1968 Congress did not consider pen registers intrusive enough to be prohibited by Title III. Common sense dictates that if a district court can order the telephone company to assist in executing a wiretap order that intercepts oral communications, it should be

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89. *See, e.g.*, United States v. Clegg, 509 F.2d 605, 608-09 & 608 n.2 (5th Cir. 1975). *See generally* SENATE REPORT, *supra* note 3, at 71-74, *reprinted in* [1968] U.S. CODE CONG. & AD. NEWS at 2159-61 (quoting UNITED STATES PRESIDENT'S COMM'N ON LAW ENFORCEMENT AND ADMINISTRATION OF JUSTICE, THE CHALLENGE OF CRIME IN A FREE SOCIETY 201-02 (1967)); Silver, *The Wiretapping-Eavesdropping Problem: A Prosecutor's View*, 44 MINN. L. REV. 835 (1960).

90. For an example of the difficulties encountered in conducting electronic surveillance against organized criminal activity, see Michigan Bell Tel. Co. v. United States, 565 F.2d at 386.

91. *See* note 8 *supra*. There are no reported cases challenging the constitutionality of the 1970 amendment to Title III which gave federal magistrates the power to order third parties to provide assistance. Act of July 29, 1970, Pub. L. No. 91-358, § 211(b), 84 Stat. 473 (codified at 18 U.S.C. § 2518(4) (1970)). The constitutionality of Title III, and particularly § 2518, has been confirmed. *See, e.g.*, United States v. Fucarile, 340 F. Supp. 1033, 1037-38 (D. Md.), *aff'd sub nom.* United States v. Giordano, 469 F.2d 522 (4th Cir. 1972), *aff'd mem.*, 473 F.2d 906 (4th Cir. 1973), *aff'd*, 416 U.S. 505 (1974). It should also be noted that the 1970 amendment extends not only to communication common carriers but to "landlord[s], custodian[s] or any other person[s]." 18 U.S.C. § 2518(4) (1970). Thus, even if the telephone companies have conceded the validity of the section, there are other parties with potential standing to contest its constitutionality.

able to direct the same company to assist in determining the number to which the intercepted call was placed or from which it originated.[92] Finally, as the Court itself recognized, federal courts may not impose unreasonable burdens upon third parties.[93] The use of the All Writs Act is reserved for truly extraordinary cases and the decision in *New York Telephone Co.*, necessitated by a unique and compelling set of circumstances, in no way modifies that restriction. The Court decided that this was one of the rare cases in which use of the All Writs Act was justified; however, the obvious potential for abuse in imposing *any* burden upon a third party should demand that such power be used sparingly. In this context, the words of Judge Mansfield are pertinent: "Were the necessity lesser, or the burden greater, in some future case, a district court might not be justified in invoking its extraordinary powers."[94] Viewed in this manner, the decision in *New York Telephone Co.* represents a judicial solution to a problem that should eventually be cured by remedial legislation,[95] not an expansion of the scope of authority conferred by either rule 41 or the All Writs Act.

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92. *New York Telephone Co.* should logically apply to the use of tracing devices as well as to the use of pen registers. *See* note 36 *supra*.

93. 98 S. Ct. at 372.

94. *In re* Order Authorizing the Use of a Pen Register, 538 F.2d 956, 965 (2d Cir. 1976) (Mansfield, J., concurring and dissenting), *rev'd sub nom.* United States v. New York Tel. Co., 98 S. Ct. 364 (1977).

95. The problem will not be cured by the Criminal Code Reform Act of 1977 as it reads in the present House version of that bill. H.R. 6869, 95th Cong., 1st Sess. (1977). Section 3108(f) defines "intercept" to mean "to acquire the contents of a communication through the use of an eavesdropping device," *id.* § 3108(f), and § 1526(c) of the bill defines "eavesdropping device" as "an electronic, mechanical, or other device or apparatus that can be used to intercept a private oral communication," *id.* § 1526(c). Thus, pen registers would still be outside the scope of the Act. It should be noted that the bill contains a section identical to 18 U.S.C. § 2518(4) (1970), which empowers a federal magistrate to compel a communication common carrier to provide assistance in connection with a court-ordered interception. H.R. 6869, § 3105(b)(2), 95th Cong., 1st Sess. (1977).

Securities Regulation—Limiting Private Rights of Action Under the Antifraud Provisions of the Securities Exchange Act of 1934

From the enactment of the Securities Exchange Act (Exchange Act)[1] in 1934 through 1972, United States Supreme Court opinions enabled and encouraged the expansion of implied private rights of action under the antifraud provisions of the Act.[2] The Court's infrequent reviews of lower court decisions[3] were pro-plaintiff, geared toward vigorous enforcement of the Act[4] and the accomplishment of its "broad remedial purposes."[5] Since 1972, however, Supreme Court opinions in securities fraud cases have shifted dramatically. These more recent opinions have been pro-defendant and have had the effect of restricting the scope of permissible litigation under the antifraud provisions of the securities laws.[6] As a result, many

1. Securities Exchange Act of 1934, ch. 404, 48 Stat. 881, *as amended by* Act of June 29, 1968 (Williams Act), Pub. L. No. 90-439, 82 Stat. 454 (codified as additionally amended at 15 U.S.C.A. §§ 78a-78u (West 1971 & Cum. Supp. 1977)).

2. The antifraud provisions of the Exchange Act are: *id.* § 9(a) (codified at 15 U.S.C. § 78i(a) (1970)) (manipulation of security prices); *id.* § 10(b) (codified at 15 U.S.C. § 78j(b) (1970)) (fraud in the purchase or sale of securities); *id.* § 14(a) (codified at 15 U.S.C. § 78n(a) (1970)) (fraud in proxy solicitation); Act of June 29, 1968 (Williams Act), Pub. L. No. 90-439, § 14e, 82 Stat. 454 (codified at 15 U.S.C. § 78n(e) (1970)) (fraud in tender offers).

3. Between the passage of the Securities Exchange Act in 1934 and 1972, the Court issued six decisions interpreting antifraud provisions of the Act. In chronological order the decisions were: J.I. Case Co. v. Borak, 377 U.S. 426 (1964) (merger effected through circulation of false and misleading proxy statement; implied private right of action exists under § 14(a) of the Exchange Act as to both derivative and direct causes); Tcherepnin v. Knight, 389 U.S. 332 (1967) (withdrawable savings shares in savings and loan association are securities within the meaning of the Exchange Act; investors who purchase shares in reliance upon misleading advertisements are entitled to protection under § 10(b) of the Exchange Act); SEC v. National Sec., Inc., 393 U.S. 453 (1969) (purchase or sale requirement of § 10(b) of the Exchange Act does not prevent Securities and Exchange Commission (SEC) injunctive action against accomplishment of merger through misleading statements); Mills v. Electric Auto-Lite Co., 396 U.S. 375 (1970) (stockholders can prove that merger was accomplished through proxy statement that failed to disclose material information by showing that statement is an essential link in transaction); Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6 (1971) (implied private right of action under § 10(b) of the Exchange Act in favor of insurance company, represented by New York Commissioner of Insurance on behalf of creditors, when individual defrauded company by purchasing all of its shares through use of reserve fund); Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972) (plaintiffs allowed to recover from bank employees who persuaded them to cash in their stock in the Ute Development Corporation without disclosing non-Indian resale market at higher price even though plaintiffs did not prove reliance).

4. *See, e.g.*, J.I. Case Co. v. Borak, 377 U.S. 426, 433-34 (1964).

5. *Id.* at 431.

6. From 1972 until the end of the 1976 October Term, the Supreme Court decided six cases interpreting antifraud provisions of the Exchange Act. In chronological order the decisions were: Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975) (plaintiffs who did not purchase shares that defendant was required to offer them as result of antitrust consent decree because of overly pessimistic statement accompanying offering did not have standing to sue under § 10(b) of the Exchange Act); Rondeau v. Mosinee Paper Corp., 422 U.S. 49 (1975) (plaintiffs not entitled to injunctive relief against successful take-over bidder who had failed to

investors who suffer injury because of manipulative securities transactions are now prevented from seeking relief in federal courts.[7] This result is illustrated in *Crane Co. v. American Standard, Inc. (Crane III)*,[8] a case in which a federal district court took note of the recent decisions and held that a defeated tender offeror had no right of relief against a company that defeated its offer by fraudulent practices that violated the Exchange Act. The inability of the court to reach the issues of fraud presented in *Crane* raises disturbing questions about the future of federal securities fraud litigation.

The *Crane* suit arose out of a battle for control of Westinghouse Air Brake, Incorporated. In the summer of 1967 representatives of Crane approached Air Brake management about a possible merger of the two companies and simultaneously began purchasing Air Brake shares on the open market.[9] In November Air Brake informed Crane that it was not interested in a merger; Crane responded by increasing its purchases of Air Brake stock. Late in December Blyth and Company, investment bankers and representatives of American Standard, Incorporated, Crane's largest competitor in the plumbing industry, informed Air Brake that Standard would be interested in helping Air Brake resist Crane's incipient take-over bid.[10] Shortly thereafter, the directors of Air Brake approved a plan to merge into Standard.[11] Under the proposed terms of merger, Air Brake stock, then quoted at $36, would be exchanged for Standard convertible preferred stock

disclose its purpose as required by § 13(d) of the Exchange Act; plaintiff did not show irreparable harm and there was an adequate remedy at law); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) (defendant auditor not liable to purchaser as aider and abettor for failure to discover client's fraudulent securities sales scheme because there was no allegation of scienter); TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438 (1976) (plaintiff could not recover under § 14(a) of the Exchange Act based on allegations that defendants had accomplished a merger through a misleading proxy statement because plaintiff had not shown substantial likelihood that omitted fact would have had actual significance in deliberations of reasonable shareholder); Piper v. Chris-Craft Indus., Inc., 430 U.S. 1 (1977) (tender offeror whose offer was defeated by practices that violated the Exchange Act has no standing to sue for damages under § 14(e) of the Williams Act); Santa Fe Indus. v. Green, 430 U.S. 462 (1977) (minority shareholders of company merged into defendant under Delaware short-form procedure cannot recover on grounds of unfairness and lack of notice because § 10(b) of the Exchange Act is not concerned with fairness and the disclosure requirements are controlled by state law).

7. *See generally* Aranow, Einhorn & Berlstein, *Standing to Sue to Challenge Violations of the Williams Act*, 32 BUS. LAW. 1755 (1977); Lowenfels, *Recent Supreme Court Decisions Under the Federal Securities Laws: The Pendulum Swings*, 65 GEO. L.J. 891 (1977).

8. 439 F. Supp. 945 (S.D.N.Y. 1977) [hereinafter cited as *Crane III*].

9. *Id.* at 946-47.

10. *Id.*

11. On February 20, 1968, Crane filed schedule 14-B, a form required by SEC rule 14a-11(c), 17 C.F.R. § 240.14a-11(c) (1977), as a prerequisite to soliciting proxies for the election of a corporation's board of directors. The Air Brake directors immediately met to discuss Blyth's February 19, 1968, proposal to merge Air Brake into Standard. On March 4 the directors met in formal session and voted for the merger. On March 5 Air Brake informed its shareholders of the action taken by the directors and of the terms of the merger agreement. Crane Co. v. Westinghouse Air Brake Co., 419 F.2d 787, 791 (2d Cir. 1969), *cert. denied*, 400 U.S. 822 (1970) [hereinafter cited as *Crane I*].

worth approximately \$50. After announcement of the proposed terms Air Brake stock rose to \$44 on the New York Stock Exchange.[12]

The controversial phase of the take-over contest began on April 8, when Crane mailed to Air Brake shareholders an offer to exchange Air Brake stock for Crane subordinated debentures worth approximately \$50. During the same week, Air Brake mailed its proxy statement soliciting proxies in favor of the proposed Standard merger.[13] On April 19, the day Crane's offer was to expire, Standard purchased 82,400 shares on the market for cash at an average price of \$49.08, while it engaged in undisclosed private sales of 100,000 shares to a friendly investment company at 44½ and 20,000 shares to a friendly investment banking house at 44⅞.[14] This maneuver precluded any hope of success for Crane's initial offer.[15] Although Crane finally managed to obtain 32% of the shares of Air Brake, the proxy count at the May 16 meeting of Air Brake shareholders ran heavily in favor of the Standard merger;[16] consequently, on June 7 that merger was consummated. Crane's stock interest in Air Brake was converted into Standard shares by the merger. On June 13, under threat of a divestiture

12. Crane I, 419 F.2d 787, 791 (2d Cir. 1969), *cert. denied*, 400 U.S. 822 (1970).

13. *Id.*

14. Crane III, 439 F. Supp. at 947. The last day of a tender offer is often the most important because of the activity of professional risk arbitrageurs, a small group of individuals associated with member firms of the New York Stock Exchange. Professional arbitrageurs make large open-market purchases of the target company's shares somewhere between the market price and the tender offer price for the purpose of subsequently tendering their shares at a profit. The arbitrageurs usually wait until the last possible moment before deciding whether to tender their shares. *See* E. ARANOW & H. EINHORN, TENDER OFFERS FOR CORPORATE CONTROL 173-91 (1973). On April 19 arbitrageurs saw the tape price of Air Brake rise five points. This sudden rise would cause the arbitrageurs not to tender their shares if they believed they could sell on the market at 50 or above or if they believed that the rise in price would result in the defeat of the tender offer and the consequent risk that shares tendered would be returned and the market price would fall. The arbitrageurs could not accurately assess the market for Air Brake shares because they and other investors were unaware that the sudden demand for Air Brake shares was artificially created by Standard (of the 26,300 shares traded at 50 that day, all but 100 were bought by Standard, Crane I, 419 F.2d 787, 893 (2d Cir. 1969), *cert. denied*, 400 U.S. 822 (1970)), and they were unaware of Standard's two private sales of 120,000 shares (Standard's telegram to one of its private purchasers confirming the sale was marked "HIGHLY CONFIDENTIAL," *id.*). These private sales were made at approximately the same price that Air Brake opened at on April 19 and were indicative of the true market demand for Air Brake shares. *Id.* If Air Brake shares had remained at 45 throughout the day the arbitrageurs would likely have tendered to realize their profit on the offer as the price spread would make it probable that ordinary shareholders would tender, the offer would be a success, and the risk of nonacceptance would be low.

In the early proceedings in *Crane* the number of Air Brake shares purchased by Standard was erroneously reported to have been 170,200. At the 1976 trial it was brought to the court's attention that the correct figure was 82,400. Crane III, 439 F. Supp. at 947 n.1.

15. Having fallen short of control, Crane extended its offer past April 19. Even with this extension, however, it was not able to secure the necessary number of shares. Crane I, 419 F.2d 787, 791 (2d Cir. 1969), *cert. denied*, 400 U.S. 822 (1970).

16. The proxy count was 2,903,869 for the merger and 1,180,298 against. Almost all of the proxies against the merger were voted by Crane. *Id.*

action to be brought by Standard under the antitrust laws, Crane sold all but 10,000 of its shares of Standard, earning a substantial profit.[17]

In the midst of the take-over contest Crane filed two suits against its opponents in federal district court. The first, against Air Brake, alleged misrepresentation in the Air Brake proxy statement and requested an injunction against continued solicitation and use of the proxies.[18] The second suit, naming Standard and Blyth as defendants, attacked Standard's April 19 transactions in stock as illegal purchases of proxies and as "market manipulation" and "fraud in connection with the purchase or sale of securities."[19]

17. Crane earned a profit of "several million dollars" and later disposed of all but 1000 of the remaining shares. *Id.*

Shortly after Crane sold its stock, Standard and several Standard shareholders filed suit against Crane alleging that Crane's sale of Standard shares within six months of its purchase of Air Brake shares was a violation of § 16(b) of the Exchange Act, 15 U.S.C. § 78p(b) (1970) (regulating short swing profits on insider trading). Crane entered a counterclaim for damages it had sustained by virtue of Standard's allegedly fraudulent action opposing its tender offer. In American Standard, Inc. v. Crane Co., 346 F. Supp. 1153 (S.D.N.Y. 1971), the judge granted Standard's motion for summary judgment and denied Crane's. On appeal, 510 F.2d 1043 (2d Cir. 1974), *cert. denied*, 421 U.S. 1000 (1975), the court of appeals reversed. Following the rationale of Kern County Land Co. v. Occidental Corp., 411 U.S. 582 (1973), the court held that § 16(b) liability should not be imposed on Crane for its sale because plaintiffs had failed to show that there was any likelihood that Crane, as a 10% shareholder, had access to or had abused inside information. 510 F.2d at 1053-56. After the court of appeals decision Crane dropped its counterclaim and proceeded to pursue its damages in Crane III, 439 F. Supp. 945 (S.D.N.Y. 1977).

18. Crane Co. v. American Standard, Inc., 490 F.2d 332, 335 (2d Cir. 1973) [hereinafter cited as *Crane II*]. This suit was filed April 17, 1968.

19. Crane I, 419 F.2d 787, 791-92 (2d Cir. 1969), *cert. denied*, 400 U.S. 822 (1970). Illegal purchases of proxies are a violation of § 14(a) of the Exchange Act, 15 U.S.C. 378n(a) (1970); "market manipulation" is a violation of § 9(a)(2), *id.* § 78i(a)(2), and "fraud in connection with the purchase or sale of securities" is a violation of § 10(b), *id.* § 78j(b), and SEC rule 10b-5, 17 C.F.R. § 240.10b-5 (1977).

Section 9(a)(2) makes it unlawful:

> To effect, alone or with one or more other persons, a series of transactions in any security registered on a national securities exchange creating actual or apparent active trading in such security or raising or depressing the price of such security, for the purpose of inducing the purchase or sale of such security by others.

15 U.S.C. § 78i(a)(2) (1970). Liability for a violation of § 9(a)(2) is provided by § 9(e):

> Any person who willfully participates in any act or transaction in violation of subsections (a), (b), or (c) of this section, shall be liable to any person who shall purchase or sell any security at a price which was affected by such act or transaction, and the person so injured may sue in law or in equity in any court of competent jurisdiction to recover the damages sustained as a result of any such act or transaction.

Id. § 78i(e). Section 10(b) reads as follows:

> 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— .
>
> . . . .
>
> (b) To 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.

Id. § 78j(b). Rule 10b-5, adopted by the SEC pursuant to § 10(b), provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means

Crane prayed for an injunction against Standard voting its Air Brake stock, consummating the merger or performing any further acts that violated the Exchange Act[20] and also for "such other and further relief as may be just and proper."[21] The two suits were consolidated for trial and on June 5, 1968, the district judge entered an order dismissing the consolidated complaint on the merits.[22] On appeal, the Court of Appeals for the Second Circuit in *Crane Co. v. Westinghouse Air Brake Co. (Crane I)*[23] affirmed the dismissal except as to the claims against Standard for its April 19 stock transactions. On remand to the district court for a determination of appropriate relief, the proceedings were stultified by an order granting Standard's motion to have all issues relitigated before a jury.[24] At Crane's request the order was certified for appeal,[25] and in 1973 the case returned to the court of

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> 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 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.

17 C.F.R. § 240.10b-5 (1977).

20. Crane III, 439 F. Supp. at 947.

21. *Id.*

22. Crane II, 490 F.2d 332, 335 (2d Cir. 1969).

23. 419 F.2d 787 (2d Cir. 1969), *cert. denied*, 400 U.S. 822 (1970). The court held that the April 19 transactions violated §§ 9(a)(2) and 10(b) of the Exchange Act and rule 10b-5, *see* note 19 *supra*, and that Crane was entitled to such relief as in equity might be required for the injury it suffered as a result of these transactions. 419 F.2d at 792, 804. The court rejected Standard's defense that it had acted in good faith simply to increase its voting position in Air Brake while keeping its holdings of Air Brake stock below 10% in order to avoid problems under § 16(b) of the Exchange Act. *Id.* at 792. Section 16(b), 15 U.S.C. § 78p(b) (1970), allows the issuer to recover any profits made on "any purchase and sale, or any sale and purchase of any equity security of such issuer . . . within any period of less than 6 months" by corporate insiders. *Id.*

24. The proceedings on remand are described in Crane II, 490 F.2d 332, 337-39 (2d Cir. 1969). One district court order on remand was reported in Crane Co. v. American Standard, Inc., 326 F. Supp. 766 (S.D.N.Y. 1971). On remand Crane disclosed the following claims for monetary relief:

> (1) the difference in value between Crane's 32% block of Air Brake Stock, including the value of control, and the Standard shares which were received in exchange therefor after the merger of Air Brake into Standard, (2) similar damages with respect to Air Brake stock which Crane was prevented from acquiring as a result of Standard's alleged manipulation and deceit, (3) the value to Crane of control of Air Brake, (4) the loss which Crane allegedly suffered from the forced sale of its Air Brake stock, for antitrust reasons, subsequent to the merger, and (5) punitive damages.

Crane II, 490 F.2d at 337 n.6. These claims led Standard to move for an order "defining and limiting the issues." The court granted this "to the extent of striking as a nonjury issue the assessment of any money damages other than such amounts as may be required to render equitable relief effective." 326 F. Supp. at 776-77. In addition, the order stated that if Crane decided to formally amend its complaint to include the claims, Standard would be entitled to a jury trial. This order was reaffirmed by another order issued July 6, 1973. The latter order became the subject of a new appeal to the Second Circuit. 490 F.2d at 334-35.

25. Crane II, 490 F.2d 332, 334-35 (2d Cir. 1969).

appeals as *Crane Co. v. American Standard, Inc. (Crane II)*.[26] The appellate court ruled that the district court's order was erroneous and remanded, directing the district court "to get on with the task" of determining relief.[27] On remand, the district court (*Crane III*)[28] held a hearing on the issue of relief. After this hearing, but before the court had rendered its opinion, the Supreme Court decided *Piper v. Chris-Craft Industries, Inc.*,[29] which held that a defeated tender offeror had no private right of action under section 14(e) of the Exchange Act or SEC rule 10b-6.[30] In September 1977 the district court, taking note of *Chris-Craft* and other recent Supreme Court opinions,[31] held that Crane was entitled to no relief.[32]

The history of the availability of relief to tender offerors under the anti-fraud provisions of the Exchange Act is essentially the history of the *Crane* case. *Crane I* established the right of a tender offeror to claim relief under these provisions. It was hailed as a landmark decision[33] and was instrumen-

26. 490 F.2d 332 (2d Cir. 1973).
27. *Id.* at 345.
28. Crane III, 439 F. Supp. 945 (S.D.N.Y. 1977).
29. 430 U.S. 1 (1977).
30. *Chris Craft* involved the question whether a tender offeror suing in its capacity as a take-over bidder had standing to sue for damages under § 14(e), 15 U.S.C. § 78n(e) (1970) (making fraud in connection with a tender offer unlawful), or rule 10b-6, 17 C.F.R. § 240.10b-6 (1977) (making purchases of securities outside the tender offer by the offeror unlawful). Chris-Craft sought to gain control over Piper. Piper decided to fight the attempt with the assistance of Bangor Punta and First Boston Corporation. Chris-Craft made a tender offer and Bangor Punta countered with its own offer. In the course of the competition Chris-Craft filed suit alleging that Piper had made misleading statements to Piper shareholders in opposition to the tender offer, that Bangor Punta had made material omissions in its tender offer statement filed with the SEC, that First Boston was liable for certifying the statement (all this in violation of § 14(e)) and that Bangor Punta had purchased 120,000 shares in a private sale during the pendency of its tender offer in violation of rule 10b-6 and proposed rule 10b-13, 17 C.F.R. § 240.10b-13 (1977) (adopted Nov. 10, 1969). The Supreme Court held that the legislative history of the Act of June 29, 1968 (Williams Act), Pub. L. No. 90-439, 82 Stat. 454 (codified as amended at 15 U.S.C.A. §§ 78*l*, 78m, 78n (West 1971 & Cum. Supp. 1977)), which amended the Exchange Act by adding § 14(e), showed that Congress passed the Act solely for the purpose of protecting public investors who are confronted with a tender offer, 430 U.S. at 35, and that a private right of action could be implied only in favor of " 'the class for whose *especial* benefit the statute was enacted.' " *Id.* at 37 (quoting Cort v. Ash, 422 U.S. 66 (1975)). The Court's argument denying Chris-Craft relief under rule 10b-6 emphasized that Chris-Craft came before the Court not as an ordinary shareholder but as a defeated tender offeror and as such its claim stood outside the express concern of the rule. *Id.* at 45. *Chris-Craft* is reviewed in Aranow, Einhorn & Berlstein, *supra* note 7; *1976-77 Securities Laws Developments*, 34 WASH. & LEE L. REV. 861, 950-53, 960-63 (1977).
31. Crane III, 439 F. Supp. at 954. For cases noticed by the district court, see note 51 *infra*.
32. 439 F. Supp. at 958.
33. The following statement is representative:

> *Crane* expands the anti-fraud provisions to an additional class of plaintiffs—those who are not purchasers or sellers directly engaged in a securities transaction. The effect is not to decrease the burden of proof required to establish a violation of rule 10b-5, but rather to toll the death knell of the *Birnbaum* [v. Newport Steel Corp., 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952); *see* text accompanying notes 35 & 36 *infra*] doctrine.

tal in setting the pattern of litigation between tender offer contestants that existed until the Supreme Court decided *Chris-Craft*.[34] The court of appeals' flexible interpretation of the Exchange Act enabled Crane to overcome difficult problems of establishing standing and claim relief as a victim of securities fraud. This flexibility was clearly illustrated by the manner in which the court dealt with the issue of standing—the most serious threshold obstacle to Crane's suit.

Crane's first cause of action was based on rule 10b-5. At the time of *Crane I* standing under rule 10b-5 was controlled by the rule of *Birnbaum v. Newport Steel Corp.*,[35] requiring that one be an actual purchaser or seller in the securities transaction affected by the wrongdoer to claim relief from the wrongdoer.[36] In the *Crane I* court's view the *Birnbaum* rule, which it implied had originally been concerned with establishing a causal link between the fraud perpetrated and the injury suffered,[37] was satisfied when a nonpurchaser or seller, otherwise entitled to the Act's protection,[38]

Note, *Securities Exchange Act of 1934—Antifraud Provisions Applied to Tender Offers Affected by Manipulative Practices and Nondisclosures*, 45 TUL. L. REV. 188, 195 (1970); *see, e.g.*, Recent Cases, *Securities Regulation—Standing— Defrauded Tender-Offeror May Sue Under Rule 10b-5 When Made a "Forced Seller" Under Threat of Antitrust Action*, 23 VAND. L. REV. 885 (1970); Recent Developments, *Securities Regulation—Tender Offers—Standing to Sue—Purchaser-Seller Requirement, Corporation Making a Tender Offer Has Standing Under the Securities and Exchange Act of 1934 to Seek Damages and Injunctive Relief Against Anyone Unlawfully Opposing Its Offer Despite the Fact that it Was Not Deceived in Its Own Purchases*, 15 VILL. L. REV. 1002 (1970).

34. *Crane I* was the first case to grant a tender offeror standing to sue under the antifraud provisions of the Exchange Act. Crane was granted standing to sue under rule 10b-5 because it was forced to sell its shares after losing the take-over contest. *See* note 44 and accompanying text *infra*. The decision to break new ground and grant Crane standing was consistent with the trend of expanding private rights of action to investors who suffered injury caused by fraudulent market activity. *See* cases cited note 3 *supra*.

On July 29, 1968, two months after the *Crane* litigation began, the Williams Act became effective, adding the § 14(e) antifraud provision that does not contain the purchaser-seller language of § 10(b) and rule 10b-5. *See* note 30 *supra*. The SEC had pressed for the passage of § 14(e) in that form to assure that all forms of fraudulent conduct in connection with tender offers could be challenged by private litigants. *See generally* E. ARANOW & H. EINHORN, *supra* note 14, at 116-19. After the Williams Act became law, tender offerors based their claims on both § 14(e) and § 10(b). After *Crane I* the following cases held that the tender offeror had standing to sue under the Williams Act: Missouri Portland Cement Co. v. Cargill, Inc., 498 F.2d 851 (2d Cir. 1974); Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341 (2d Cir. 1973), *rev'd*, 430 U.S. 1 (1977); Applied Digital Data Sys. Inc. v. Milgo Elec. Corp., [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,824 (S.D.N.Y. 1977); Royal Indus., Inc. v. Monogram Indus., Inc., [1976-1977 Transfer Binder] FED. SEC. L. REP. ¶ 95,863 (C.D. Cal. 1976).

35. 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952).

36. *See generally* L. LOSS, SECURITIES REGULATION 3617 (2d ed. Supp. 1969); Boone & McGowan, *Standing to Sue Under SEC Rule 10b-5*, 49 TEX. L. REV. 617, 620 (1971); Comment, *The Purchaser-Seller Limitation to SEC Rule 10b-5*, 53 CORNELL L. REV. 684, 685 (1968).

Just prior to *Crane I*, in Iroquois Indus., Inc. v. Syracuse China Corp., 417 F.2d 963 (2d Cir. 1969), the Second Circuit had denied standing to a tender offeror suing the target corporation for fraudulent practices in opposing the tender offer because the tender offeror was not a purchaser or seller under the *Birnbaum* rule.

37. 419 F.2d at 797.

38. *Id.* at 795-96.

established proof of causation.[39] Under the court's analysis, Crane satisfied the rule both because "[w]hen [it] entered the securities market with its tender offer, it was entitled to the Act's protection not only against being deceived itself but also against deception of the investing public designed to prevent the public from entering into securities transactions,"[40] and because it had established that Standard's deception of the public caused it injury.[41] Crane's second cause of action was based on section 9(a)(2)[42] of the Exchange Act, which prohibits transactions creating actual or apparent active trading in a security. Standing to sue under that section is expressly dependent upon plaintiff's status as a purchaser or seller.[43] The court concluded that Crane's sale of stock on June 13, 1968, made it a seller under the Act because the sale was the "intended and inevitable" result of Standard's manipulation of the market.[44]

The passage of eight years from *Crane I* to *Crane III* led to quite different treatment of the case. The district court saw intervening Supreme Court opinions as requiring reassessment of four issues explicitly or implicitly decided by *Crane I*: the existence of an implied private right of

39. *Id.* at 797-98.

40. *Id.* at 796.

41. *Id.* at 797. The court determined that Crane's evidence was sufficient to prove that:

> Standard's extraordinary buying . . . coupled with its large secret sales off the market, inevitably distorted the market picture and deceived public investors, particularly the Air Brake shareholders. The effect of these purchases was to create the appearance of an extraordinary demand for Air Brake stock and a dramatic rise in market price, as a result of which Air Brake shareholders were deterred from tendering to Crane.

Id. at 793.

42. 15 U.S.C. § 78i(a)(2) (1970).

43. *See* note 19 *supra*.

44. 419 F.2d at 794. The court reasoned that when Standard purchased shares on April 19, it did so for the purpose of defeating Crane's tender offer and consummating the Standard merger knowing full well that, if successful, Crane would be forced to sell its interest in Air Brake because of antitrust considerations. The court likened Crane's situation to Vine's in Vine v. Beneficial Fin. Co., 374 F.2d 627 (2d Cir.), *cert. denied*, 389 U.S. 970 (1967). Vine held shares in Crown Company. Through deceptive practices Beneficial acquired 95% of Crown's shares and then effected a short-form merger. This merger left Vine and other shareholders with only the alternatives of selling the stock to Beneficial at an inadequate price or retaining their stock in a nonexistent corporation. The court held that the disappearance of Crown had converted Vine's stock into a claim for cash, *id.* at 634, and as a "forced seller" Vine was granted standing to sue under rule 10b-5, *id.* at 635.

As a final note on the question of standing the *Crane I* court added that the passage of the Williams Act "should serve to resolve any doubts about standing in the tender offer cases, even where an offeror is not, as is Crane, in the position of a forced seller." 419 F.2d at 798-99. This statement was clarified in a comment in the Second Circuit's next case involving a tender offer contest, Electronic Specialty Co. v. International Controls Corp., 409 F.2d 937 (2d Cir. 1969), the first case decided under the Williams Act. The court said: "The second prong of the [Williams Act] is § 14(e). In effect this applies Rule 10b-5 both to the offeror and to the opposition—very likely, except perhaps for any bearing it may have on the issue of standing, only a codification of existing case law." *Id.* at 940-41. For analysis of standing to sue under the Williams Act after *Chris-Craft*, see Aranow, Einhorn & Berlstein, *supra* note 7.

action under rule 10b-5 in favor of a tender offeror; a nonpurchaser's standing to sue under rule 10b-5 and section 9(a)(2); the adequacy of Crane's proof of causation;[45] and Crane's entitlement to relief.[46] With regard to the standing issues, *Crane III* applied the reasoning of *Piper v. Chris-Craft Industries, Inc.*[47] concluding that a tender offeror is merely an incidental beneficiary of the antifraud provisions of the Exchange Act and as such cannot assert an implied private right of action for damages under rule 10b-5,[48] and that because the gravamen of Crane's complaint was the lost opportunity to control, rather than losses resulting from "an improper premium exacted for [Air Brake] stock,"[49] it was not in the class of investors protected by section 9 of the Exchange Act and therefore did not have standing to sue under that section.[50]

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45. *See* note 41 and accompanying text *supra*.
46. *See* note 23 *supra*.
47. 430 U.S. 1 (1977), *discussed at* note 30 *supra*.
48. The *Chris-Craft* Court had developed this position in part by reexamining J.I. Case Co. v. Borak, 377 U.S. 426 (1964), the first case in which the Court had endorsed an implied private right of action under a provision of the Exchange Act. The reasoning of *Borak* was that private rights of action could be implied when they were shown to be a *necessary* supplement to SEC enforcement to make effective the congressional purpose underlying the Exchange Act. *Id.* at 432. According to the *Chris-Craft* reinterpretation, *Borak* held that an implied right of action is never *necessary* unless it protects the interests of individuals for whose direct benefit a provision of the Exchange Act is intended. *See* 430 U.S. at 25, 33, 41-42. The identity of those individuals is to be determined by the language of the statute, *id.* at 24, and its legislative history, *id.* at 25-26. In its examination of the Williams Act amendments to the Exchange Act, under which *Chris-Craft* sought relief (in particular, § 14(e)), the Court determined that the sole purpose of the Williams Act was the protection of public investors, *see* note 30 *supra*, and that while tender offerors were regulated by the Williams Act, they were not its beneficiaries. Applying this reasoning and extending it to a position that § 10(b) of the Exchange Act and rule 10b-5 as well as the Williams Act were for the exclusive benefit of the "public investor," the district court in *Crane III* decided that the arguments against granting standing under § 14(e) applied to Crane's claim of standing under § 10(b). 439 F. Supp. at 951-53.

Recognizing that *Chris-Craft* was "not directly analogous" to *Crane*, *id.* at 951, because *Chris-Craft* was concerned with claims under § 14(e) of the Williams Act and rule 10b-6 whereas Crane sued under rule 10b-5 and § 9(a)(2) of the Exchange Act, the court asked the parties to submit memoranda analyzing the impact of *Chris-Craft* on *Crane*. In the memoranda:

> Standard emphasized the similarity of the two cases, noting that Rule 10b-5 and § 9, relied upon by Crane here, were both among the bases for Chris-Craft's original complaint. Standard assert[ed] that the legislative history of the 1934 Act evidences no intent that these provisions would be applied to tender offers, or provide a private cause of action for a defeated offeror. According to Standard, if a statute designed to regulate tender offers—the Williams Act—does not give an offeror standing to sue for damages, it would be anomalous to derive such a right of action from statutes directed at other ends. . . .
>
> . . . .
>
> Crane, naturally, [drew] quite a different lesson from *Chris-Craft*. That decision, it . . . asserted, [did] not impair Crane's standing in this action; its holding [was] a narrow one. The broad scope of the interests designed to be protected by the 1934 Act [was] contrasted to the narrow aim of the Williams Act.
>
> Further, Crane's trial posture as both a defeated tender offeror and a defrauded seller [was] argued, with emphasis upon the *Crane I* holding that Crane had standing to sue by virtue of its position as a forced seller.

Id. at 950-51.
49. 439 F. Supp. at 953.
50. The *Crane III* court took note of the comments of the Supreme Court in *Chris-Craft*

Of the other recent Supreme Court opinions pertinent to *Crane*,[51] the district court found *Blue Chip Stamps v. Manor Drug Stores*,[52] which reaffirmed the *Birnbaum* rule,[53] especially relevant. It thought an anomaly would result if *Blue Chip*, which would bar suits against Standard under rule 10b-5 by those who did not tender their shares to Crane because of Standard's market manipulation, would nevertheless permit Crane to recover for an injury substantially derivative of the nontendering shareholders.[54] The *Crane III* court also drew attention to a portion of the *Blue Chip* opinion countenancing the *Birnbaum* rule's denial of standing to " '[investors] related to an issuer who [were not purchasers or sellers but] suffered loss in the value of their investment due to corporate or insider

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with regard to Chris-Craft's claim for damages under rule 10b-6 (which included a discussion of § 9 of the Exchange Act under which Crane was suing):

> Unlike Section 10(b), however, Section 9 provides an express cause of action for persons injured by unlawful market activities. Yet, that cause of action is framed specifically in favor of "any person who shall purchase or sell any security *at a price which was affected by such act or transaction* . . ." Congress therefore focused in Section 9 upon the amount actually paid by an investor for stock that had been the subject of manipulative activity. This is not, as we have seen, the gravamen of Chris-Craft's complaint. It seeks no recovery for an improper premium exacted for Piper stock; rather it desires compensation for its lost opportunity to control Piper. We therefore conclude that, on its claimed basis for relief, Chris-Craft cannot avail itself of Rule 10b-6.

Id. (quoting Chris-Craft, 430 U.S. at 46) (citations omitted) (emphasis supplied by *Crane III* court). The district court found the similarities between the two cases controlling. *Id.*

51. The court stated:

> *Chris-Craft* does not stand alone, it is not *sui generis*, distinguishable from all other cases because of unusual facts or esoteric points of law. Instead, it is one of several recent Supreme Court decisions which indicate that the Court is taking a hard, new look at federal jurisdiction under the securities laws. Included in this trend are *Santa Fe* [Industries v. Green, 430 U.S. 462 (1977)] . . . ; *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 . . . (1976); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 . . . (1976); and *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 . . . (1975).

Id. at 953-54.

52. 421 U.S. 723 (1975).

53. *Id.* at 755. For years standing under rule 10b-5 was limited by the rule in Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952), that a person who is merely misled into inaction—one who refrains from purchasing or selling because of another's misstatements or omissions—cannot sue for damages. *See* text accompanying notes 35 & 36 *supra*. After the announcement of the rule a number of exceptions to it were developed. *See* note 71 *infra*. The rule was severely criticized, *see, e.g.*, A. JACOBS, THE IMPACT OF RULE 10B-5 § 38.01[d] (rev. ed. 1977), and one federal circuit rejected the rule, *see* Eason v. General Motors Acceptance Corp., 490 F.2d 654 (7th Cir. 1973), *cert. denied*, 416 U.S. 960 (1974). In *Blue Chip Stamps v. Manor Drug Stores*, Blue Chip was required by an antitrust consent decree to offer a substantial number of its shares to retailers who had used the stamp service. In its offering to the retailers Blue Chip dissuaded some of the retailers from buying by means of materially misleading statements containing an overly pessimistic appraisal of its business so that the rejected shares could be offered to the public at a higher price. The Supreme Court denied standing to the retailers, reaffirming the *Birnbaum* rule and declaring an end to case-by-case erosion of the rule. The Court said there were policy advantages to the *Birnbaum* rule—protection against vexatious litigation, indeterminate liability and difficult problems of proof. 421 U.S. at 739-49.

54. 439 F. Supp. at 955.

[trading] . . . which violate[d] Rule 10b-5' "[55] in support of barring Crane because "Crane itself [could] be compared to [this] class of potential plaintiffs."[56] In the final portion of its opinion, using the fact that *Blue Chip* expressed concern about the problems of proving causation and damages in securities fraud cases as a springboard, the district court launched an attack on Crane's proof of these elements.[57] Crane had tried to show that Standard's market manipulation had caused its tender offer to fail, thus leading to a failure in its take-over bid and a substantial diminution of the value of its investment in Air Brake.[58] On the basis of the evidence presented, however, the court held that even if Crane had standing it had not proved that it had suffered any specific injury caused by Standard and therefore it was entitled to no relief.[59]

On each of the four issues decided in *Crane III*—existence of a private right of action, standing to sue, causation and damages—the district court could have decided for Crane, notwithstanding the recent Supreme Court decisions. *Chris-Craft*'s "narrow holding" that "a tender offeror, suing in its capacity as a takeover bidder, does not have standing to sue [at law] for damages under § 14(e)"[60] left open the question whether a tender offeror could sue in equity for injunctive relief.[61] The Court's approval of Judge Friendly's statement in *Electronic Specialty Co. v. International Controls*

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55. *Id.* (quoting Blue Chip, 421 U.S. at 738). Plaintiffs in *Birnbaum* were of this class. *Birnbaum* involved a suit against the directors of Newport Steel Corporation, who, in their official capacity, turned down a merger plan with Follansbee Steel Corporation. The president then sold his controlling share of stock to Wilport Company at an above-market price. Plaintiffs, minority shareholders, sought recovery for the "control premium" the president exacted from Wilport (plaintiffs would have shared in the value of the control premium if the merger with Follansbee had been approved).

56. *Id.* at 955. Under the rationale of *Crane I*, Crane did not belong in this class because it was the intended target of Standard's fraudulent activity and was forced to sell its shares because of the activity. *See* note 44 and accompanying text *supra*.

57. 439 F. Supp. at 955.

58. *See id.* at 956-57. In support of its position Crane offered evidence that on April 19 there was an attractive spread between the value of the Crane offer and the market price of Air Brake stock. In addition, it presented expert testimony that but for the sudden rise in price caused by Standard's manipulation its offer would have succeeded. *Id.* Standard, on the other hand, presented its own experts who testified that Crane's offer was not so attractive because there was a possibility that shareholders tendering to Crane would face capital gains tax, whereas, if the merger went through, shareholders could exchange their stock for Standard stock, equal in value to the Crane offer, and not be taxed. *Id.* at 957.

On April 19, 1968, Standard must not have been convinced of this position; it took a half million dollar trading loss on that day to defeat Crane's "unattractive" offer. *Id.* at 947.

59. *Id.* at 958.

60. 430 U.S. at 42 n.28.

61. "We intimate no view upon whether as a general proposition a suit in equity for injunctive relief, as distinguished from an action for damages, would lie in favor of a tender offeror under either § 14(e) or Rule 10b-6." *Id.* at 47 n.33. Aranow, Einhorn and Berlstein express their belief that injunctive relief should be available to tender offerors. Aranow, Einhorn & Berlstein, *supra* note 7, at 1760-61.

Corp.[62] that "in corporate control contests the stage of preliminary injunctive relief, rather than post-contest lawsuits, 'is the time when relief can best be given' "[63] would seem to indicate that a tender offeror does have such a right. Crane began its suit by seeking preliminary injunctive relief but was denied such relief by the district court.[64] In *Crane I* the court of appeals ruled that this denial had been error and remanded the case to the district court to grant such relief as might equitably be required,[65] including damages.[66] In so doing, as the court of appeals explained in *Crane II*, it did not convert the suit from one in equity to an action at law for damages.[67] As on remand the district court would have had the power to order divestiture, the court of appeals had mentioned damages as an alternative, "less onerous *equitable* remedy against Standard than what the district court had the power to decree."[68] If *Chris-Craft* left open a tender offeror's right to seek preliminary injunctive relief, it arguably also left open an offeror's (Crane's) right to appeal the wrongful denial of preliminary relief and the right of a court subsequently to grant retrospective equitable relief.[69]

62. 409 F.2d 937 (2d Cir. 1969), *discussed in* note 44 *supra*.

63. 430 U.S. at 41-42 (quoting Electronic Specialty Co. v. International Controls Corp., 409 F.2d at 947).

64. *See* text accompanying notes 20-22 *supra*.

65. 419 F.2d at 804.

66. *Id.* at 803-04.

67. 490 F.2d at 342.

68. *Id.* at 340 (emphasis added). The court of appeals stated that the power to award damages was within the district court's equitable "clean-up" jurisdiction. *Id.* Under the "clean-up" doctrine a court of equity has authority to accord full relief in any case within its cognizance even though giving such relief might mean redressing injuries for which there is an adequate remedy at law. *See* D. DOBBS, HANDBOOK ON THE LAW OF REMEDIES § 2.7, at 83-84 (1973).

The Second Circuit compared the action it had taken to that taken in two prior cases decided by the Supreme Court:

> [T]he *Borak* Court approved a ruling . . . that, in a suit in equity to enjoin unlawful proxy solicitation under § 14(a) of the Securities Exchange Act with respect to a merger since consummated, a district court "has jurisdiction under Section 27 to award damages or such other retrospective relief to the plaintiff as the merits of the controversy may require.". . . In Mills v. Electric Auto-Lite Co. . . . the Court reaffirmed the right of a district court to award damages where a merger had been consummated in the face of a pending equity suit alleging a misleading proxy solicitation.

490 F.2d at 340 (citations omitted) (quoting J.I. Case v. Borak, 317 F.2d 838, 849 (7th Cir. 1963), *aff'd*, 377 U.S. 426 (1964)).

69. In *Chris-Craft* the Supreme Court took note that the court of appeals had given injunctive relief. 430 U.S. at 47. The Court held that the injunction against Bangor Punta, one of the tender offerors, should not have been granted, saying

> Chris-Craft prior to the trial on liability expressly waived any claim to injunctive relief. The case was tried . . . exclusively as a suit for damages. . . . Under these circumstances, our holding that Chris-Craft does not have a cause of action for damages under § 14(e) or Rule 10b-6 renders that injunction inappropriate, premised as it was upon the permissible award of damages.

Id. Crane does not fall within the rationale of this holding. In *Crane* there was no express waiver of injunctive relief. Crane III, 439 F. Supp. at 947. In dissent in *Chris-Craft*, Justice Stevens argued that Chris-Craft's right to injunctive relief should not have been decided

On the issue of standing, *Blue Chip* reaffirmed the *Birnbaum* rule, putting an end to "case by case erosion of the rule."[70] Apparently, however, *Blue Chip* did not affect the exceptions to the *Birnbaum* rule recognized at the time it was announced.[71] The most widely accepted exception to the *Birnbaum* rule was the "forced seller" exception of *Vine v. Beneficial Finance Co.*[72] In *Crane I* the court of appeals granted standing to Crane relying on this theory.[73] If *Blue Chip* did not affect the exceptions to the *Birnbaum* rule, then it had no application to *Crane III*. Accordingly, Crane had a strong argument that it did indeed have standing under rule 10b-5.

On the issue of causation, the district court could have found for Crane on the basis of *Mills v. Electric Auto-Lite Co.*[74] and *Affiliated Ute Citizens v. United States*.[75] Defendant in *Mills* successfully solicited proxies for a merger using a proxy statement that failed to disclose material information. Plaintiff was not required to prove that the solicitation would have failed but for the nondisclosure; rather, the Supreme Court held it sufficient that plaintiff had shown that the defective proxy solicitation was an "essential link in the accomplishment of the transaction."[76] *Affiliated Ute*, also dealing with a problem of causation in a nondisclosure case, held:

> Under the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them im-

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because it was not raised in the appeal briefs and the Court's action in setting aside the recovery of damages "does not logically support the conclusion that there should be no remedy whatsoever for violations which the Court assumes, *arguendo*, were properly proved." 430 U.S. at 70 (Stevens, J., dissenting).

70. 421 U.S. at 755.

71. Five principal exceptions to the *Birnbaum* rule had developed prior to *Blue Chip*: the injunctive relief exception, *see, e.g.*, Mutual Shares Corp. v. Genesco, Inc., 384 F.2d 540 (2d Cir. 1967); the forced seller exception, *see, e.g.*, Vine v. Beneficial Fin. Co., 374 F.2d 627 (2d Cir.), *cert. denied*, 389 U.S. 970 (1967), *discussed in* note 44 *supra*; the derivative action exception, *see, e.g.*, Herpich v. Wallace, 430 F.2d 792 (5th Cir. 1970); the aborted transaction exception, *see, e.g.*, Walling v. Beverly Enterprises, 476 F.2d 393 (9th Cir. 1973); and the de facto seller exception, *see, e.g.*, James v. Gerber Prods. Co., 483 F.2d 944 (6th Cir. 1973). Since *Blue Chip*, several cases have granted standing to plaintiffs under these exceptions to the *Birnbaum* rule. *See, e.g.*, Horst v. W.T. Cabe & Co., [1977] FED. SEC. L. REP. (CCH) ¶ 96,213 (S.D.N.Y. Oct. 31, 1977) (aborted transaction); Singer v. Magnavox Co., [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,830 (D. Del. 1977) (forced seller); Klamberg v. Roth, [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,747 (S.D.N.Y. 1976) (de facto seller). Several commentators have also argued that the exceptions are generally still valid. *See* Gallager, *10b-5 After Blue Chip Stamps: How Stands the Judicial Oak?*, 80 DICK. L. REV. 1 (1975); *1976-1977 Securities Laws Developments*, *supra* note 30, at 893-97; Note, *Standing Under Rule 10b-5 After Blue Chip Stamps*, 75 MICH. L. REV. 413, 431-44 (1976).

72. 374 F.2d 627 (2d Cir.), *cert. denied*, 389 U.S. 970 (1967), *discussed in* note 44 *supra*.

73. *See* note 44 and accompanying text *supra*.

74. 396 U.S. 375 (1970).

75. 406 U.S. 128 (1972).

76. 396 U.S. at 385.

> portant in the making of this decision. . . . This obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact.[77]

On the basis of these cases, the district court could have held either that Standard's April 19 fraudulent stock transactions were an essential link in, and therefore the cause of, the defeat of Crane's tender offer or that Standard failed to disclose a material fact to Air Brake shareholders on April 19 and therefore caused them not to tender their shares to Crane, thus resulting in the defeat of Crane's tender offer.[78]

Even if Crane failed to prove that Standard caused specific injury for which the court could fashion a remedy it would not necessarily follow (as it did implicitly in the court's opinion in *Crane III*[79]) that Crane was entitled to no relief. The Supreme Court anticipated that eventuality in *Mills* and said that plaintiffs would still be entitled to attorneys' fees and reasonable expenses to repay the cost of establishing the Exchange Act violation.[80] Crane could in equity have been granted this same minimal relief.[81]

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77. 406 U.S. at 153-54 (citations omitted).

78. This reasoning was advanced by Crane in *Crane III*. 439 F. Supp. at 956 n.4. The district court replied that even though there may be a presumption of reliance when it is logical to presume that reliance in fact existed, "[t]he proof submitted by Crane makes this Court doubt that such a presumption is necessarily logical." *Id.* In addition, the court cited Justice Blackmun's concurring opinion in *Chris-Craft*, 430 U.S. at 48, which had rejected the majority's position that a tender offeror lacked standing to sue under § 14(e) but had said that Chris-Craft should be denied relief because of insufficient proof of causation. The district court in *Crane III* said its problem in finding causation was "akin to" Justice Blackmun's in *Chris-Craft*:

> "It is not enough for the offeror to prove that the competitor's violations caused the shareholders of the target corporation to act in a certain way. In addition, the offeror must show that the shareholders' reactions to the misstatements or omissions caused the injury for which it demands remuneration. Even though the *Mills-Affiliated Ute Citizens* presumption satisfies the requirement for proof of the first element of causation, the absence of any evidence that the violations might have altered the outcome of the contest for control would leave me unable to hold that the securities law violations caused the disappointed contestant's ultimate injury—its failure to acquire control of the target corporation."

439 F. Supp. at 956 n.4 (quoting Chris-Craft, 430 U.S. at 51 (Blackmun, J., concurring)). But if the presumption satisfies the requirement of proof that investors acted in a certain way, in *Crane* that they failed to tender their shares, it would logically follow that this caused the tender offer to fail.

79. *See* text accompanying note 59 *supra*.

80. 396 U.S. at 392-97.

81. The "American rule" governing the award of attorneys' fees in litigation in the federal courts is that attorneys' fees "are not ordinarily recoverable in the absence of a statute or enforceable contract providing therefor." Fleischman Distilling Corp. v. Maier Brewing Co., 386 U.S. 714, 717 (1967). There are two exceptions to this rule—attorneys' fees may be awarded "where a successful litigant has conferred a substantial benefit on a class of persons and the court's shifting of fees operates to spread the cost proportionately among the members of the benefited class," F.D. Rich Co. v. United States *ex rel.* Industrial Lumber Co., 417 U.S. 116, 129-30 (1974), or "to a successful party when his opponent has acted in bad faith, vexatiously, wantonly or for oppressive reasons," *id.* at 129. *See also* Alyeska Pipeline Serv. Co. v. Wilderness Soc'y, 421 U.S. 240, 257-59 (1975). *Mills* came under the first exception. The court held that when plaintiffs established a violation of the proxy rules they restored fair and

Despite the availability, and perhaps even the attraction, of these alternative grounds for decision, it appears that the district court reached the proper result in light of the present posture of the securities laws. The arguments made for Crane's position are supportable, but they reflect policy considerations and directions of another era of judicial decisionmaking. In its recent opinions, the Supreme Court has not sought through technical argumentation to stir the waters of securities fraud litigation, but rather has sought through policy offensive to reverse the flow. To follow the leadership of the nation's highest tribunal, judges must not simply understand new legal doctrines applicable to securities fraud litigation, they must learn a new way of thinking about the role of the judiciary in handling the cases. Judges were once admonished that the federal securities laws should be interpreted " 'not technically and restrictively, but flexibly to effectuate . . . [their broad] remedial purposes' ";[82] by implication, the statutes are now to be read narrowly[83] and judges are to guard against case by case

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informed corporate suffrage, which was a substantial service to the corporation and its shareholders. To charge defendant corporation (all the shareholders) with attorneys' fees was "to impose them on the class that ha[d] benefited from them." 396 U.S. at 396-97. *Crane* would fall under the second exception. Standard's bad faith stock transactions made it necessary for Crane to undergo litigation to recover the value of its investment; in such circumstances the burden of attorneys' fees should be shifted to Standard. The power of a court to award attorneys' fees to a successful rule 10b-5 litigant under the bad faith exception was recognized in Ernst & Ernst v. Hochfelder, 425 U.S. 185, 210-11 n.30 (1976). The award of attorneys' fees in *Crane* would be further justified by the express provision of § 9(e), 15 U.S.C. § 78i(e) (1970), allowing recovery of attorneys' fees by a party injured by a § 9(a)(2) violation.

82. Affiliated Ute Citizens v. United States, 406 U.S. at 151 (quoting SEC v. Capital Gains Research Bureau, 375 U.S. 180, 195 (1963)). *See also* Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 12 (1971); Tcherepnin v. Knight, 389 U.S. 332, 336 (1967).

83. Of the recent "restrictive" opinions, three, Santa Fe Indus. v. Green, 430 U.S. 462 (1977); Piper v. Chris-Craft Indus., Inc., 430 U.S. 1 (1977); and Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), turned on narrowing constructions of the language of the Exchange Act. In *Hochfelder* the Supreme Court held that a private cause of action for damages would not lie under § 10(b) and rule 10b-5 in the absence of any allegation of "scienter," *i.e.*, intent to deceive, manipulate or defraud on the defendant's part. *Id.* at 199-214. The Court reached this conclusion on the basis of the language of the statute saying that "[t]he use of the word 'manipulative' . . . is virtually a term of art," *id.* at 199, its reading of the legislative history, *id.* at 201-06, its observation that in other sections in which Congress created express civil liability for acts of negligence it had no trouble specifying its purpose, *id.* at 206-11, and its determination that the administrative history of the Exchange Act indicated that when the SEC adopted rule 10b-5 the rule was intended to apply to activities that involved scienter, *id.* at 212-14.

Plaintiffs in *Green* challenged the fairness of the terms of a short-form merger. The Supreme Court relegated plaintiffs to "whatever remedy is created by state law," 430 U.S. at 478, and said that the concern of rule 10b-5 was full disclosure and that "once full . . . disclosure has occurred, the fairness of the terms of the transaction is at most a tangential concern of the statute," *id.* The Court added that "[a]bsent a clear indication of congressional intent, we are reluctant to federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden." *Id.* at 479.

Chris-Craft studied the legislative history of the Williams Act to determine the *main purpose* of the statute and denied plaintiffs' right of action as not based upon that purpose. *See* note 30 and accompanying text *supra*.

erosion of established rules.[84] Once judges were encouraged to be "alert to provide such remedies as are necessary to make effective the congressional purposes";[85] now judges are instructed to be on their guard against vexatious litigation[86] and the dangers of indeterminate liability.[87] Once it was proposed that the federal securities laws were a pervasive scheme of regulation intended to secure fair markets for all investors; it now appears judges are to regard them as a limited, somewhat tentative effort[88] to regulate the securities markets for the benefit of public investors.[89]

Many reservations have been expressed about this abrupt change of the judicial mind. The sharpest and most telling criticism has come from within the Supreme Court itself. Mr. Justice Blackmun, in dissent in *Blue Chip*, argued that the majority had let certain policy considerations—namely, guarding against vexatious litigation and avoiding difficult procedural issues—dominate its thinking and had evaded fundamental issues of substance.[90] The salient issue in the case, said Blackmun, was the fact that plaintiff had raised "disturbing claims of fraud."[91] The majority in rendering their decision, paid no heed to the unremedied wrong but rather devoted their attention to worries about the possible motives of potential

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84. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. at 755.
85. J.I. Case v. Borak, 377 U.S. 426, 433 (1964).
86. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. at 739-49.
87. *Id.* at 739-41.
88. In the majority opinion in Santa Fe Indus. v. Green, 430 U.S. 462, 477-80 (1977), it was argued that rule 10b-5 is only concerned with disclosure and that once there is disclosure federal courts should have no concern for fairness. This holding emasculates subsections (a) and (c) of rule 10b-5, 17 C.F.R. § 240.10b-5(a), (c) (1977), which prohibit any device, scheme, or artifice to defraud, or conduct that operates as a fraud or deceit upon, any person in connection with the purchase or sale of any security. The Court feared, however, that if the federal judiciary got into questions of fairness

> [t]he result would be to bring within the Rule a wide variety of corporate conduct traditionally left to state regulation. . . . Federal courts applying a "federal fiduciary principle" under Rule 10b-5 could be expected to depart from state fiduciary standards at least to the extent necessary to ensure uniformity within the federal system.

430 U.S. at 478-79. The Court added: "There may well be a need for uniform federal fiduciary standards to govern mergers such as that challenged in this complaint. But those standards should not be supplied by judicial extension of § 10(b) and Rule 10b-5 'to cover the corporate universe.'" *Id.* at 479-80 (quoting Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 633, 700 (1974), which expressed concern about the low standards for corporate conduct in the Delaware corporation law; it is ironic that his article was quoted in support of lower standards under federal law).

The majority opinion in *Green* countered the view expressed by various commentators that decisions under the antifraud provisions of the Exchange Act constituted a body of substantive federal corporate law. *See, e.g.*, Jacobs, *The Role of the Securities Exchange Act Rule 10b-5 in the Regulation of Corporate Mismanagement*, 59 CORNELL L. REV. 27 (1973); Painter, *Inside Information: Growing Pains for the Development of Federal Corporate Law under Rule 10b-5*, 65 COLUM. L. REV. 1361 (1965).

89. *See generally* Piper v. Chris-Craft Indus., Inc., 430 U.S. at 30-40.
90. 421 U.S. at 761-71 (Blackmun, J., dissenting).
91. *Id.* at 762 (Blackmun, J., dissenting).

plaintiffs[92] and the problem that proof of causation might depend on "oral testimony."[93] He concluded:

> The facts of this case, if proved and accepted by the factfinder, surely are within the conduct that Congress intended to ban. Whether this particular plaintiff . . . will be able to carry the burdens of proving fraud and of proving reliance and damage . . . is a matter that should not be left to speculations of "policy" of the kind now advanced in this forum so far removed from witnesses and evidence.
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> . . . I am uneasy about the type of precedent the present decision establishes. Policy considerations can be applied and utilized in like fashion in other situations. The acceptance of this decisional route in this case may well come back to haunt us . . . I would decide the case to fulfill the broad purpose that the language of the statutes and the legislative history dictate . . . .[94]

Mr. Justice Stevens, in dissent in *Chris-Craft*, criticized the majority for focusing on the narrow intent of ensuring enforcement of the securities laws to protect the "public investor" and being oblivious to the fact that this could only be accomplished by ensuring enforcement of the laws on behalf of all investors who had an interest in the integrity of the securities market.[95] Stevens forcefully argued that in *Chris-Craft* the majority had excluded from the class of plaintiffs those most interested in and most capable of ensuring effective enforcement—the tender offeror itself.[96]

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92. Certainly, this Court must be aware of the realities of life, but it is unwarranted for the Court to take a form of attenuated judicial notice of the motivations that defense counsel may have in settling a case, or of the difficulties that a plaintiff may have in proving his claim.

Id. at 770 (Blackmun, J., dissenting).

93. [T]he greater portion of the Court's opinion is devoted to its discussion of the "danger of vexatiousness" . . . that accompanies litigation under Rule 10b-5 and that is said to be "different in degree and in kind from that which accompanies litigation in general." It speaks of harm from the "very pendency of the lawsuit," . . . something like the recognized dilemma of the physician sued for malpractice; of the "disruption of normal business activities which may accompany a lawsuit" . . . and of "proof . . . which depend[s] almost entirely on oral testimony," . . . as if all these were unknown to lawsuits taking place in America's courthouses every day. In turning to and being influenced by these "policy considerations," . . . the Court, in my view, unfortunately mires itself in speculation and conjecture not usually seen in its opinions. In order to support an interpretation that obviously narrows a provision of the securities laws designed to be a "catch-all," the Court takes alarm at the "practical difficulties," . . . that would follow the removal of *Birnbaum*'s barrier.

Id. at 769-70 (Blackmun, J., dissenting).

94. *Id.* at 770-71 (Blackmun, J., dissenting).

95. [P]rotection of tender offerors is not only consistent with protection of shareholders. It is also indispensable to protecting shareholders. Individual shareholders often lack the capacity to litigate these cases effectively. Few indeed could afford to pursue the course Chris-Craft has taken of hiring counsel with experience in complex litigation of this kind to litigate through a preliminary injunction, discovery, trial on liability, another trial on damages, three appeals to the Second Circuit, including an en banc, and three petitions to this Court. Thus, the most realistic deterrent to fraud on shareholders is a damage suit brought by the opposition in the tender contest.

430 U.S. at 68 (Stevens, J., dissenting).

96. If a private remedy must be applied to ensure full compliance with the statute, the

The criticisms of Justices Blackmun and Stevens can be applied to *Crane*. The factual situation presented to the district court was that on April 19 Standard willfully perpetrated a fraud on the shareholders of Air Brake for the purpose of defeating Crane's tender offer. The substantive question raised by the facts was whether, under either section 9(a)(2) or rule 10b-5, Crane was entitled to the protection of the Exchange Act and could, therefore, sue to recover for the injury it suffered as a result of the fraud. To deny that Crane had such a right *on substantive grounds* the *Crane III* court would have had to refute the holding of *Crane I* that Crane was "entitled to the Act's protection not only against being deceived itself, but also against the deception of the investing public designed to prevent the public from entering into securities transactions."[97] But *Crane III* finessed the substantive issue by invoking the standing requirement of the *Birnbaum* rule. It is doubly ironic that *Blue Chip*, which had resurrected the *Birnbaum* rule to guard against vexatious litigation and then had applied the rule in a suit bearing none of the indicia of vexatious litigation, would be applied in *Crane*, a suit similarly devoid of such indicia. *Crane III* also avoided the substantive issue by relying on the stare decisis effect of *Chris-Craft* even though *Chris-Craft* involved different sections of the Exchange Act. In applying *Chris-Craft* to *Crane* the *Crane III* court did not seriously question whether tender offerors were excluded from the protection of section 10(b) as they were from the narrower section 14(e) as interpreted by the majority in *Chris-Craft*. As a result, *Crane III* was able to achieve the same result as *Chris-Craft*—denying standing to the party most interested in and capable of enforcing the Exchange Act and permitting the defendant to achieve control of a corporation by the use of fraudulent means expressly proscribed by that Act. In the last portion of the district court's opinion, concerning proof of causation, Crane was ostensibly assumed to have standing to sue. But even there the substantive issue was not faced squarely because Crane was only granted second-class standing: it did not have the benefit of the presumption of causation to which, as plaintiff in a nondisclosure case, it would normally be entitled.[98]

The result in *Crane* and the results it presages are unsettling. The new rules permit violators of securities laws to escape liability and deny relief to their innocent victims. By so favoring defendants the Supreme Court has not

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> remedy must be available to the litigants who are most vitally interested in effective enforcement. . . . Once one recognizes that Congress intended to rely heavily on private litigation as a method of implementing the statute, it seems equally clear that Congress would not exclude the persons most interested in effective enforcement from the class authorized to enforce the new law.

Id. at 61-62 (Stevens, J., dissenting).

97. 419 F.2d at 797.

98. *See* note 78 and text accompanying notes 74-78 *supra*.

restored equilibrium in the administration of justice. It has only, as demonstrated in *Crane III*, restricted the ability of the federal judiciary to deal with substantive issues of fraud. The recent decisions may have the effect of exposing the limitations of the existing securities laws and expediting the adoption of more comprehensive federal legislation,[99] but the movement to develop new federal legislation should not delay the effort to restore in judicial interpretation of the Exchange Act primary concern both for dealing with substantive issues of fraud and for fulfillment of the Act's broad remedial purposes.[100]

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99. For commentary on proposed federal corporate law, see Cary, *supra* note 88, at 701-05; Loss, *The American Law Institute's Federal Securities Code Project*, 25 BUS. LAW. 27 (1969); Schwartz, *An Introduction to Symposium, Federal Chartering of Corporations*, 61 GEO. L.J. 71 (1972).

100. *Crane III* is currently on appeal to the Second Circuit. Telephone conversation with Mr. Peter J. McKenna, attorney for plaintiff, New York, New York (Jan. 31, 1978).