Bad Faith Attorneys' Fees in Implied Private Rights of Action Under the Securities Exchange Act of 1934

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INTRODUCTION

The American legal system generally requires a prevailing litigant to assume the burden of paying for his own litigation connected legal services.¹ Courts, however, are not totally barred from awarding attorneys’ fees. Under court created exceptions to this rule, attorneys’ fees may be awarded to prevailing litigants. One of these exceptions, the bad faith exception, allows fee shifting in favor of a litigant whose opponent’s conduct has been reprehensible.²

Awarding fees under this exception will not be justified in every case where a party alleges bad faith conduct. For example, courts applying the bad faith exception to implied private rights of action under the Securities Exchange Act of 1934³ generally deny attorneys’ fees awards. This is because courts interpret section 28(a) the 1934 Act,⁴ a damages limitation clause, as restricting recovery to

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2. See notes 23-35 infra and accompanying text.


actual damages. As attorneys’ fees are usually not included in a damages award, courts generally interpret the section to preclude recovery of fees. Even the courts suggesting that fees might be allowed do not apply the standards for determining bad faith consistently with the application in non-securities litigation.

The purpose of this note is to analyze the approach taken to the bad faith exception in securities law cases and propose alternatives that are consistent with the exception as it is applied in non-securities litigation. This note will begin with a discussion of the exceptions to the American rule and proceed to a discussion of how the exceptions are applied in implied actions under the Securities Exchange Act of 1934. Finally, a proposed alternative standard for awarding fees under the 1934 Act will be discussed.

THE AMERICAN RULE AND ITS EXCEPTIONS

The American Rule of Attorneys’ Fees

The American rule denies fee shifting in favor of a prevailing

(a) The rights and remedies provided by this chapter shall be in addition to any and all other rights and remedies that may exist at law or in equity; but no person permitted to maintain a suit for damages under the provisions of this chapter shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of.

The problem created by this section is discussed at notes 64-80 infra and accompanying text.

5. Vaughan v. Atkinson, 369 U.S. 527, 540 (1962) (noting the “well-established rule that counsel fees may not be recovered as compensatory damages”); Rolax v. Atlantic Coast Line R.R., 186 F.2d 473, 481 (4th Cir. 1951) (“[o]rdinarily, of course, attorneys’ fees, except as fixed by statute, should not be taxed as a part of the costs recovered by the prevailing party”).

Section 28(a) limits recovery to actual damages, or what courts refer to as compensatory damages. Because attorneys’ fees are generally not included in a compensatory damages award, it is argued that they are not actual damages and therefore are precluded by § 28(a). See notes 64-80 infra and accompanying text.

6. Bailey v. Meister Brau, Inc., 535 F.2d 982, 996 (7th Cir. 1976)(the court found intentional, wanton conduct in a securities transaction which otherwise constituted bad faith within the exception; however, the court refused to award fees because the circumstances were not an exceptional situation); Kirsch Co. v. Bliss & Laughlin Indus., Inc. [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,993 (W.D. Mich. 1981) (the court found intentional and fraudulent violation of securities law reporting provisions which fell within the bad faith exception, but refused to award fees because the circumstances were not exceptional); Stevens v. Abbott, Proctor & Paine, 288 F. Supp. 838, 849 (E.D. Va. 1968)(the court found a violation of securities laws amounting to fraud and gross misconduct otherwise within the bad faith exception; however, the court said the violation did not rise to a level of vexatious conduct). See notes 83-90 infra and accompanying text. See also note 13 infra which shows that these courts applied the rule as it existed in the early stages of development.
litigant unless specifically authorized by statute or unless the parties to a suit contractually agree to shift fees. The United States Supreme Court first articulated the rule in *Arcambel v. Wiseman.* Although the Court has recognized that this principle is not completely satisfactory, it has unequivocally reaffirmed its holding. The Court has given two grounds for its adherence to this rule. First, the Court believes that it would be unfair to penalize honest litigants merely for bringing a claim or offering a defense. Second, in the Court's opinion, holding a party liable for the prevailing litigant's legal fees would unjustly deter the poor from vindicating their rights.

Notwithstanding the Court's general reluctance to award fees, it

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Within the past 60 years, legal commentators have expressed dissatisfaction with the United States' adherence to the rule. See Ehrenzweig, supra note 1; Goodhart, supra note 1; Kuenzel, supra note 1; Stoebuck, supra note 1.


has recognized exceptions which are grounded in the Court's inherent equity power, applied in its discretion.\textsuperscript{13} The two viable exceptions\textsuperscript{14} are the common fund/benefit exception\textsuperscript{15} and the bad faith exception.\textsuperscript{16}

\textit{The Common Fund/Benefit Exception}

Under the common fund/benefit exception a court may award attorneys' fees to a litigant who has created or protected a fund or benefit which affects a class of potential plaintiffs.\textsuperscript{17} The purpose of the exception is to prevent unjust enrichment to a class or corporation receiving the benefit of litigation without contributing to the costs.\textsuperscript{18} The award is premised on the positive benefit conferred by the plaintiff to an ascertainable class.\textsuperscript{19}

\begin{footnotes}
\item[13] Rolax v. Atlantic Coast Line R.R., 186 F.2d 473, 481 (4th Cir. 1951) ("[I]n a suit in equity where the taxation of such costs is essential to the doing of justice, they may be allowed in exceptional cases"). See also Sprague v. Ticonic Nat'l Bank, 307 U.S. 161, 166 (1939)("plainly, the foundation for the historic practice of granting reimbursement for the costs of litigation other than the conventional taxable costs is part of the original authority of the chancellor to do equity in a particular situation"); Guardian Trust Co. v. Kansas City S. Ry., 28 F.2d 233, 241 (8th Cir. 1928), \textit{rev'd on other grounds}, 281 U.S. 1 (1930)("The United States courts of equity at the time of their creation became endowed with the powers, including that over costs, possessed by the English Chancery Court").

\item[14] A third exception, the private attorney general exception, awarded fees to a successful litigant who enforced statutes embodying public rights. In Alyeska Pipeline Serv. Co. v. Wilderness Soc'y, 421 U.S. 240 (1975), the Supreme Court eliminated the exception, holding that absent specific statutory authority, attorneys' fees could not be awarded in federal litigation under the private attorney general exception. \textit{Id.} at 263.

For pre-Alyeska discussions of the private attorney general exception see Nussbaum, \textit{Attorney's Fees in Public Interest Litigation}, 48 N.Y.U. L. REV. 301 (1973); Note, \textit{Awarding Attorneys' Fees to the "Private Attorney General": Judicial Green Light to Private Litigation in the Public Interest}, 24 HASTINGS L.J. 733 (1973).

\item[15] \textit{See} notes 17-22 \textit{infra} and accompanying text.

\item[16] \textit{See} notes 23-35 \textit{infra} and accompanying text.

\item[17] The Supreme Court first used the exception in Trustees v. Greenough, 105 U.S. 527 (1882), a suit involving a creditor of a trust. The Court held that when a litigant salvages assets (i.e., creates, increases or protects a fund) for the benefit of a class of which he is a member, the fund may be charged with all necessary expenses incurred in achieving the result. \textit{Id.} at 530.

\item[18] In Hall v. Cole, 412 U.S. 1 (1973) the Supreme Court rationalized that "to allow the others to obtain full benefit from the plaintiff's efforts without contributing equally to the litigation expenses would be to enrich the others unjustly at the plaintiff's expense." \textit{Id.} at 5-6. \textit{See Note, Recovery of Attorneys' Fees: Exceptions to the American Rule}, 25 DRAKE L. REV. 717, 729 (1976); Note, \textit{Rule 10b-5, supra} note 1 at 326; Comment, \textit{Exceptions to the Rule, supra} note 1 at 573.

\item[19] F.D. Rich Co. v. United States \textit{ex rel.} Industrial Lumber Co., 417 U.S. 116, 128-30 (1974) ("[w]e have long recognized that 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
This exception, when used in securities litigation, is generally applied in class actions and derivative suits. The rationale for awarding fees is based on equitable principles. Because class or corporate representatives, by bringing a successful action, have conferred a benefit upon all the members of a class or corporation, they should in fairness be relieved of the financial burden incurred. Recent court decisions indicate courts are willing to award fees to a prevailing plaintiff who confers a substantial benefit even absent his protection of a monetary fund from which fees could be paid.

The Bad Faith Exception

The bad faith exception allows a court to award attorneys' fees to a successful litigant when his opponent acted in a vexatious or wanton manner or for oppressive reasons. Because fees may be awarded to a prevailing defendant as well as to a prevailing plaintiff, the exception may also deter frivolous litigation and prevent injustice to innocent litigants. Courts have viewed the awarding
of bad faith fees as both a form of punitive and compensatory damages.

The exception employs a standard based on a litigant's conduct itself and the time that the conduct occurred, in order to determine whether fees are justified. A litigant who either obstinately refuses to recognize or intentionally evades a clear legal duty exhibits sufficient bad faith to allow an award of fees. A court may justify an award of fees when bad faith occurs either during the litigation and affects the litigation process, or when bad faith occurs prior to the litigation and induces the plaintiff to bring the cause of action.

Courts have awarded bad faith fees for several types of bad faith conduct occurring during non-securities litigation. For example, awards have been made in favor of a defendant where the plaintiff filed a groundless suit, and in favor of a plaintiff where the defendant asserted a baseless defense. In addition, fees have been

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*Exceptions to the Rule, supra note 1 at 573. See Natural Resources Defense Council, Inc. v. EPA, 484 F.2d 1351, 1333 (1st Cir. 1973).*

25. *Hall v. Cole*, 412 U.S. 1, 5 (1973). Most courts citing *Hall* fail to recognize that the case was decided under the common fund/benefit exception, and that the Court's statements regarding the punitive nature of bad faith fees are dicta. The statements, therefore, should not carry the weight of authority that has been attributed to them.

26. In *Guardian Trust Co. v. Kansas City S. Ry.*, 28 F.2d 233, 240 (8th Cir. 1928), rev'd on other grounds, 281 U.S. 1 (1930), one of the early cases recognizing the bad faith exception, the Eighth Circuit found that the court's equity power to award fees was the same as that of the English Chancery Court's. *Id.* at 241. See note 24 *supra*. Professor McCormick commenting on this decision said that "[It] may be the benchmark of a new and salutary doctrine in the federal courts that in equity the chancellor... may in his discretion award counsel fees and expenses as costs against the losing party..." McCormick, *Counsel Fees and Other Expenses of Litigation as an Element of Damages*, 15 MINN. L. REV. 619, 625-26 (1931). The "benchmark" noted by Professor McCormick was recognized by the Supreme Court in *Sprague v. Ticonic Nat'l Bank*, 307 U.S. 161 (1939). See note 13 *supra*. More recently the court in *In re National Student Mktg. Litig.*, 78 F.R.D. 726, 728 n.3 (D.D.C. 1978) stated that bad faith fee awards are "compensatory, through recovery by an injured party of expenses incurred due to the other party's harassing and vexatious litigation tactics [citations omitted]." See also *Wright v. Jackson*, 522 F.2d 955, 958 (4th Cir. 1975). But see note 5 *supra*; *Hall v. Cole*, 412 U.S. 1, 5 (1973) (bad faith fees are essentially punitive damages).

27. See notes 29-33 *infra* and accompanying text.


29. See, e.g., *Browning Debenture Holders' Comm. v. DASA Corp.*, 560 F.2d 1078, 1088 (2nd Cir. 1977) (the defense must be wholly without color); *Gates v. Collier*, 70 F.R.D. 341, 343 (N.D. Miss. 1976) (defendants' refusal to admit culpability and stipulate facts in the face of evidence indicating defendants' clear liability, which was brought out at evidentiary hearings, forced the plaintiff to engage in extensive discovery not otherwise required); *Baas v. Elliot*, 71 F.R.D. 658, 694 (E.D.N.Y. 1976) (defendant's reversal of position mid-litigation was a frivolous, self-defeating invocation of federal procedure).
charged against parties offering unnecessary motions and using pleadings to disrupt the litigation process.\textsuperscript{8} Each of these situations, of course, involved more than a mere finding of facts against a party.\textsuperscript{9} The courts in these cases found an obstinate refusal to recognize an indisputable legal right or an intentional evasion of a clear legal duty.\textsuperscript{10}

Bad faith fees may also be awarded for conduct occurring prior to commencement of the litigation. Specifically, courts have shifted fees where a defendant obstinately refused to recognize his duty under well established law,\textsuperscript{11} where a defendant exhibited a long

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\item 31. In Runyon v. McCrory, 427 U.S. 160, 182-86 (1976) the Supreme Court used a standard of "mere findings of fact against a party" as a standard for determining whether or not to award bad faith fees for conduct during the litigation. In the case, which involved alleged racial discrimination in a private school, the plaintiffs asserted that the sole purpose of the defendant's denial of the allegations was to prolong the litigation and was in bad faith. The Court reasoned that in any case in which facts are disputed a court must decide that one version is inaccurate. It would be untenable to conclude from such a denial that a litigant acted in bad faith.
\item The Supreme Court's pronouncement that a mere finding of facts against a party is insufficient to justify fees under the bad faith exception, is as far as the Court has come in stating a standard for determining bad faith. Earlier cases refer only to interests of justice as the applicable standard. Alyeska Pipeline Serv. Co. v. Wilderness Soc'y, 421 U.S. 240, 262 (1975); Hall v. Cole, 412 U.S. 1, 6 (1973); Sprague v. Ticonic Nat'l Bank, 307 U.S. 161, 167 (1930).
\item Lower federal courts applying the bad faith exception allude to the stringent standards for applying the bad faith exception. The courts, however, never define the stringent standard and it is unclear whether they are applying interests of justice as a standard or a new standard. For example, in Bond v. Stanton, 528 F.2d 688 (7th Cir.), cert. granted, 426 U.S. 905, vacated, 429 U.S. 973 (1976), on remand, 555 F.2d 172 (7th Cir. 1977), cert. denied, 438 U.S. 916 (1978), the plaintiff sued state officials for noncompliance with the Social Security Act. Throughout the litigation the defendant "continually asserted compliance with the HEW requirements in the face of documentary evidence to the contrary." \textit{Id.} at 690. The court stated that the evidence amply supported a finding of bad faith and that "stringent as the standards for establishing bad faith may be . . . they were more than satisfied by the facts before [it]." \textit{Id.}
\item 32. See notes 28-31 supra.
\item 33. In Vaughan v. Atkinson, 369 U.S. 527 (1962) a sailor underwent medical treatment. He requested reimbursement for maintenance and medical expenses under the admiralty laws. The owner of the vessel on which he served refused the claim. The Supreme Court reversed the circuit court's denial of attorneys' fees. The Court said that "maintenance and cure is designed to provide a seaman with food and lodging when he becomes sick . . . in the ship's service; and it extends during the period when he is incapacitated to do a seaman's work and continues until he reaches maximum medical recovery." \textit{Id.} at 531. The Court awarded fees as damages due to the obstinate refusal of the shipowner to pay sums
standing pattern of evasion and obstruction of Supreme Court mandates, and where a defendant forced a plaintiff to institute suit regarding an issue decided against the same defendant in a previous case.

**Availability of Attorneys’ Fees in Implied Private Rights of Action**

**Implied Private Rights of Action under the Securities Exchange Act of 1934**

Although various sections of the 1934 Act either require or pro-
hibit certain conduct, several of these sections do not expressly state that any person may be liable to another for violations of these provisions. As a result, it is unclear on the face of the statute whether an individual damaged by a violation of these provisions has standing to sue.

Recognizing the necessity for private enforcement of these statutes, the Supreme Court in *J.I. Case Co. v. Borak* implied a private right of action under section 14(a) of the Securities Exchange Act of 1934. The Court stated that the underlying policy for allowing the private right of action is to provide remedies effectuating the congressional purpose underlying the 1934 Act. That purpose is protection of the national public interest through regulation and control of the securities exchanges, explicitly stated in section 2 of the 1934 Act. Using this purpose as a basis for its decision, the Supreme Court stated that where a federal statute gives a general right to sue and where legal rights have been invaded, the federal courts may use any available remedy to correct the harm done.

The Court’s rationale has been used to imply a private right of action for damages under sections 10(b), 14(a), and 13(d) of

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38. *Id.* at 433. Recently, in *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11 (1979), the Court denied a private damage remedy in a suit based on § 206 of the Investment Advisors Act of 1940, 15 U.S.C. § 80b-6 (1976). This may indicate a trend in restricting the expansion of implied private actions.

39. SEA § 2, 15 U.S.C. § 78b (1976) states that the purpose of the Securities Exchange Act of 1934 is “to impose requirements necessary to make ... regulation and control reasonably complete and effective, in order to protect interstate commerce, the national credit ... and to insure the maintenance of fair and honest markets in [securities] ... transactions.”


41. 15 U.S.C. § 78j(b) (1976) states:

   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
the 1934 Act. Section 10(b) makes it unlawful to use in connection with the purchase or sale of any security any manipulative device or contrivance in contravention of rules prescribed by the Securities Exchange Commission.\(^4\) Rule 10b-5, promulgated under section 10(b), specifically prohibits the use of any manipulative device to defraud, and the use of untrue statements or misstatements of material facts.\(^5\) Ordinarily, an individual plaintiff unable to meet the requirements for a derivative suit or class action under section 10(b) may bring suit in his own behalf.\(^6\) Generally, courts limit regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

42. 15 U.S.C. § 78n(a) (1976) provides:
   It shall be unlawful for any person, by the use of the mails or by any means or instrumentality of interstate commerce or of any facility of a national securities exchange or otherwise, 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, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted security) registered pursuant to section 78l of this title.

43. 15 U.S.C. § 78m(d) (1976) states that:
   Any person who, after acquiring directly or indirectly the beneficial ownership of any equity security of a class which is registered pursuant to section 78l of this title, or any equity security of an insurance company which would have been required to be so registered except for the exemption contained in section 78g(2)(G) of this title or any equity security issued by a closed-end investment company registered under the Investment Company Act of 1940; is directly or indirectly the beneficial owner of more than 5 per centum of such class shall, within ten days after such acquisition, send to the issuer of the security at its principal executive office, by registered or certified mail, send to each exchange where the security is traded, and file with the Commission, a statement containing such of the following information, and such additional information, as the Commission may by rules and regulations prescribe as necessary or appropriate in the public interest or for the protection of investors.

44. See note 41 supra.

45. 17 C.F.R. § 240.10b-5 (1981) states:
   It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
   
   (a) To employ any device, scheme, or artifice to defraud,
   
   (b) To make any untrue statement of a material fact or to omit to state a material 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.

46. An individual plaintiff bringing suit under the securities laws must still meet the standing requirements of the 1934 Act. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 732, reh'g denied, 423 U.S. 884 (1975) (standing to bring a private damage action under SEC rule 10b-5 is limited to actual "purchasers" or "sellers" of securities); Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6, 13-14 (1971), (citing Shell v. Hensley, 430 F.2d 819, 827 (5th Cir. 1970)) ("When a person who is dealing with a corporation in a securi-
ties transaction denies the corporation's directors access to material information known to him, the corporation is disabled from availing itself of an informed judgment on the part of its board. . . . In this situation the private right of action recognized under Rule 10b-5 is available as a remedy. . . .”); Jordan Bldg. Corp. v. Doyle, O'Connor & Co., 401 F.2d 47, 50 (7th Cir. 1968) (“a private right of action exists under § 10(b) whether plaintiff is a buyer or a seller”); cf. Ohaski v. Verit Indus., 536 F.2d 849, 852 (9th Cir.), cert. denied, 429 U.S. 1004 (1976)(plaintiff must allege that his purchase or sale was the result of the defendant's fraudulent activities); G & M, Inc. v. Newborn, 488 F.2d 742, 745 (9th Cir. 1973)(a plaintiff may sue a person not a party to a sale where that person made misrepresentations on which plaintiff relied); Herpich v. Wallace, 430 F.2d 792, 803 (5th Cir. 1970)(plaintiffs who fail to claim they or members of their class purchased or sold securities in connection with the alleged manipulation do not have standing to sue); Surowitz v. Hilton Hotels Corp., 342 F.2d 596, 604 (7th Cir.), rev'd, 383 U.S. 363,reh'g denied, 384 U.S. 915 (1965)(any cause of action under § 17(a) of the Securities Act of 1933 is a right of the person injured); Lorber v. Beebe, 407 F. Supp. 279, 285 (S.D.N.Y. 1976)(in order to sue under § 11 of the Securities Act of 1933 the plaintiff must prove that the stock he purchased was issued pursuant to a false registration statement); Osadchy v. Gans, 436 F. Supp. 677, 685 (D.N.J. 1977)(“Federal securities law protects individuals damaged through the sale or purchase of securities when the sale was made in reasonable reliance on the misrepresentations of defendants”).

47. The amount of recovery is usually determined under the out-of-pocket rule. For cases demonstrating the out-of-pocket rule, see Harris v. American Inv. Co., 523 F.2d 220, 224-25 (8th Cir. 1975), cert. denied, 423 U.S. 1054 (1976)(the measure of damages in a § 10(b) and rule 10b-5 action is the out-of-pocket rule borrowed from the tort action of deceit); Rochez Bros., Inc. v. Rhoades, 491 F.2d 402, 416 (3d Cir.), on remand, 390 F. Supp. 470 (W.D. Pa. 1974), aff'd in part, 527 F.2d 880 (3d Cir.), cause remanded in part, 527 F.2d 891 (3d Cir.), cert. denied, 425 U.S. 993 (1975)(a defrauded purchaser of securities in a § 10(b), rule 10b-5 action may recover the greater of the sale price of stock in the fraudulent transaction less its fair market value at that time, or the amount of buyer's profit on resale); Fershtman v. Schectman, 450 F.2d 1357, 1361 (2d Cir. 1971)(“a buyer defrauded in violation of the securities laws is 'entitled to recover only the excess of what he paid over the value of what he got' . . . ”); Ingenito v. Bermez Corp., 441 F. Supp. 525, 544 (S.D.N.Y. 1977)(“A buyer's recovery for a fraudulent securities transaction is limited to . . . the excess of what he paid over what he got”); Beecher v. Able, 435 F. Supp. 397, 412 (S.D.N.Y. 1977)(damages for violation of rule 10b-5 are measured by looking at value received at time of purchase); Hickman v. Groesbeck, 389 F. Supp. 769, 779 (D. Utah 1974)(actual damages are measured by the out-of-pocket rule for rule 10b-5 securities actions); Johns Hopkins Univ. v. Hutton, 326 F. Supp. 250, 262 (D. Md. 1971), supplemented, 343 F. Supp. 245 (D. Md. 1972), aff'd in part and rev'd in part, 488 F.2d 912 (4th Cir. 1973), cert. denied, 416 U.S. 916 (1974)(damages recovery in a § 10(b) action is measured by plaintiff's out-of-pocket loss); Chaney v. Western States Title Ins. Co., 292 F. Supp. 376, 377 (D. Utah 1968)(federal courts determining damages under the Securities Exchange Act generally follow the out-of-pocket rule); BaumeI v. Rosen, 283 F. Supp. 128, 147 (D. Md. 1968), aff'd in part and rev'd in part, 412 F.2d 571 (4th Cir. 1969), cert. denied, 396 U.S. 1037 (1970)(general rule of recovery in a § 10(b) action is the difference between value on date of return and highest value which plaintiffs were deprived of ownership, with interest). However, consequential damages have been awarded. Foster v. Financial Technology Inc., 517 F.2d 1068, 1071 (9th Cir. 1975)(consequential damages are recoverable in a rule 10b-5 action where plaintiff can prove with reasonable certainty that the damages were the result of the defendant's violation); Madigan, Inc. v. Goodman, 498 F.2d 233, 238 (7th Cir. 1974)(where plaintiff can establish a causal connection between fraud and expenses, consequential damages may be recovered). See notes 64-70 infra and accompanying text.
Section 14(a) makes it unlawful for any person to solicit proxies in violation of rules and regulations established by the Securities Exchange Commission. As in section 10(b), courts imply a private right of action, allowing individuals to bring suit under that section.\textsuperscript{48} Ordinarily, the individual plaintiff recovers only actual damages.\textsuperscript{49}

Finally, section 13(d) of the 1934 Act requires the owner of five percent or more of any class of a corporation's registered securities to file certain information with the Securities Exchange Commission within ten days after acquiring the five percent share. The purpose of this section is to provide full disclosure of corporate equity ownership when a person seeks to acquire a substantial block of equity securities.\textsuperscript{50} The intended beneficiaries of the section are the private investors of the corporation.\textsuperscript{51} Nevertheless, only a few courts allow a private right of action. Under this section, where a private right of action is implied, courts have limited recovery to injunctive relief.\textsuperscript{52}

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\textsuperscript{49} Many § 14(a) cases, however, involve derivative suits requesting injunctions to prevent corporate action. In these cases damages are not an appropriate remedy, and injunctive relief is granted. See, e.g., Bastian v. Lakefront Realty Corp., 581 F.2d 685 (7th Cir. 1979); Chris-Craft Indus., Inc. v. Independent Stockholders Comm., 354 F. Supp. 885 (D. Del. 1973); Twentieth Century Fox Film Corp. v. Lewis, 334 F. Supp. 1398 (D.C.N.Y. 1971).
\textsuperscript{50} Where an individual plaintiff can prove, however, that he relied to his detriment on the proxy and incurred monetary loss, courts award damages. See J.I. Case Co. v. Borak, 377 U.S. 426, 432 (1964).
\textsuperscript{52} Courts have allowed a private right of action under § 13(d) in Dan River, Inc. v. Unitex Ltd., 624 F.2d 1216 (4th Cir. 1980); General Aircraft Corp. v. Lampert, 556 F.2d 90 (1st Cir. 1977); Crane Co. v. Harsco Corp., 511 F. Supp. 294 (D. Del. 1981); Kirsch Co. v. Bliss & Laughlin Indus., Inc. 495 F. Supp. 488 (W.D. Mich. 1980).
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Attorneys' Fees for Bad Faith Conduct in Implied Private Rights of Action under the Securities Exchange Act of 1934

In Mills v. Electric Auto-Lite Co., the Supreme Court discussed the availability of attorneys' fees under the exceptions to the American rule. The decision is important because of the Court's statements regarding recovery of attorneys' fees in implied actions under the 1934 Act.

In Mills the plaintiffs filed a derivative suit under section 14(a). They alleged that the corporation's management used false proxy statements to obtain approval of a corporate merger. The Supreme Court remanded the case to the district court for a determination of proper relief but granted an interim award of fees under the common fund exception. The Court held that provisions in the 1934 Act specifically allowing attorneys' fees should not be read as a denial of the courts' power to award fees under other sections of the 1934 Act. The Court supported this conclusion by drawing an analogy between its power to award fees and its power to create an implied right of action. Recognizing that its inherent power to imply a private right of action was not limited by the express statutory provisions granting private enforcement, the Court reasoned that its inherent power to award attorneys' fees should similarly not be limited by the express statutory provisions.


55. The plaintiffs in Mills desired to set aside a corporate merger which the shareholders approved based on false proxy statements. The Court found the statements materially misleading and in violation of SEA § 14(a), 15 U.S.C. § 78n(a) and rule 14a-9, 17 C.F.R. § 240.14a-9, because minority shareholder approval was required to acquire the two-thirds majority needed to pass the merger. The proxies stated Auto-Lite's board's approval but failed to state that the merging corporation owned 50% of Auto-Lite common stock and that Auto-Lite's directors were controlled by the merging corporation.

56. Mills v. Electric Auto-Lite Co., 396 U.S. 375, 390 (1970) (citing Smolowe v. Delendo, 136 F.2d 231, 241 (2d Cir. 1943)). The Second Circuit determined that congressional silence did not evidence intent to deny courts the power to award fees under sections of the 1934 Act which do not mention fees. The sections which specifically provide for attorneys' fees "merely enforce an additional penalty against the wrongdoer." Id.

57. Mills v. Electric Auto-Lite Co., 396 U.S. 375, 390-91 (1970) analogizes between a court's power to imply private actions and award attorneys' fees. The Court stated that "the specific provisions [of the 1934 Act, allowing attorneys' fees] should not be read as denying to the courts the power to award counsel fees in suits under other sections of the Act . . . any more than the express creation by those sections of private liabilities negates the possibility of an implied right of action under § 14(a)." Id.
awarding attorneys' fees. This holding is consistent with earlier cases in which the Court implied a private right of action, because ability to imply both a private right of action and to award attorneys’ fees serves the remedial purposes of the 1934 Act.66

Moreover, the Mills decision demonstrated an even more liberal approach to attorneys' fees than had previously existed under the common law. Under the common benefit exception, if the representative party conferred a benefit on a class of persons, each member of this class would pay a proportion of the attorneys’ fees.59 The Court applied a combined common fund/benefit exception, and extended this exception beyond its common law application. The Court held that plaintiffs' showing that they had conferred a substantial benefit on a corporation brought the case within the exception, requiring the defendant corporation to pay the fees.

The Mills decision, expanding the common fund/benefit exception, indicates the Supreme Court's liberal attitude toward attorneys' fees. Hall v. Cole,60 decided three years after Mills, is consistent with this liberal attitude. In Hall, plaintiffs brought suit pursuant to an express statutory cause of action under the Labor-Management Reporting and Disclosure Act. The Supreme Court awarded fees to the plaintiffs under the expanded common fund/benefit rationale recognized in Mills. In addition, the Court discussed the propriety of awarding fees for bad faith conduct. Because the evidence failed to show any bad faith conduct however, the Court refused to award bad faith attorneys' fees. Nevertheless, the Court recognized that even under an explicit statutory scheme, courts have the power to award fees under the bad faith exception, when overriding considerations such as furthering congressional purpose indicate a need to do so.61

The overriding considerations referred to in Hall are most often present in implied actions under the 1934 Act.62 Absent awards of

58. See notes 36-43 supra and accompanying text.
59. See note 19 supra and accompanying text.
60. 412 U.S. 1 (1973).
62. Overriding considerations as a basis for awarding fees has never been specifically defined by the courts using the term. The phrase, used interchangeably with “exceptional situation” and “specific circumstances,” is based on a subjective determination by the court that the facts of the case justify awarding attorneys’ fees. In the context of the bad faith exception it is a determination that a litigant’s conduct has reached an indefinite level sufficient to award fees.
attorneys' fees for bad faith conduct, the remedial purposes of the 1934 Act would not be achieved. This is due to the tremendous expense imposed on a private litigant bringing an implied action, which is aggravated by the opponent's bad faith. Often, the plaintiff's attorneys' fees exceed the court's award of damages. Thus, refusing to award attorneys' fees under the exception would encourage a defendant to indulge in bad faith conduct because a plaintiff would be deterred from filing suit by the disproportionate costs of the litigation.

The *Mills* and *Hall* decisions indicate the Court's willingness to provide a solution to the problem faced by the plaintiff unable to afford the cost of litigating his rights. Allowing bad faith fees where a potential defendant has exhibited bad faith conduct encourages the prospective plaintiff to pursue his rights, because he can recover his costs if circumstances bring his suit within the exception. It also discourages potential defendants from pursuing a course of wilful and wanton conduct by providing injured investors with effective redress for costs incurred as the result of such conduct. Thus, by awarding fees under the bad faith exception, the remedial purposes of the 1934 Act are effectuated and congressional intent is served.

**Section 28(a) as a Bar to Bad Faith Attorneys' Fees**

Notwithstanding the Supreme Court's apparent willingness to award bad faith attorneys' fees, lower courts have denied fees, relying on section 28(a) of the 1934 Act which limits recovery under the Act to actual damages. In *Straub v. Vaisman & Co.*, the Third Circuit denied fees, basing its decision on section 28(a), the *Mills* decision, and the more recent Supreme Court decision in *Ernst & Ernst v. Hochfelder*.

In *Straub*, the plaintiffs brought an implied private action under section 10(b) and rule 10b-5, where they had purchased stock based on fraudulent recommendations of the defendant. The dis-

63. As an example, in *Straub v. Vaisman & Co.*, 540 F.2d 591 (3d Cir. 1976), the damage award totalled $38,875.00 and the attorneys' fees amounted to $47,808.42. Id. at 594-95. See, e.g., Note, *Attorney's Fees as an Element of Costs: The Copyright Experience*, 4 Ga. L. Rev. 571, 588 (1970).


65. 540 F.2d 591 (3d Cir. 1976).

66. 425 U.S. 185, 185 (1976), reh'g denied, 425 U.S. 986 (1976) (a private cause of action will not lie under § 10(b) and rule 10b-5 absent an allegation of "scienter," i.e., intent to deceive, manipulate or defraud).
district court, finding that the defendant’s conduct was wilful, wanton and reprehensible, awarded attorneys’ fees under the bad faith exception. The Third Circuit reversed the award of fees, holding that section 28(a) barred bad faith fees based on conduct occurring prior to the litigation. As previously discussed, courts generally construe section 28(a) as limiting recovery for securities law violations to actual damages. Therefore, the circuit court reasoned, punitive damages as well may not be awarded under section 28(a). The Straub court reasoned that bad faith attorneys’ fees for conduct occurring prior to the litigation are essentially punitive damages and, therefore, bad faith attorneys’ fees were barred by the section.

In reversing the fee award, the Straub court used flawed reasoning. Bad faith attorneys’ fees are not punitive damages. The purpose of awarding such fees is to fully compensate the plaintiff for being forced to litigate a well established right. Thus, awarding fees for an opponent’s bad faith conduct does not amount to awarding punitive damages and does not violate section 28(a) of

67. Straub v. Vaisman & Co., 540 F.2d 591, 594-95 (3d Cir. 1976). The defendant securities dealer gave advice concerning stock purchases to foreign investors. The plaintiff investors relied on false statements to purchase stock which defendant knew was a poor investment. The court found that given the defendants’ position of trust in the handling of discretionary securities accounts its breach was reprehensible.

68. See note 4 supra.


71. See Richey, Attorney’s Fees: A Two Pronged Problem, 11 TRIAL 59 (1975); and note 26 supra.
the 1934 Act.\textsuperscript{72}

The Straub court supported its holding by relying on Mills and Hochfelder. The court cited Mills for the principle that counsel fees cannot be awarded as an item of damages unless specifically authorized under a statute.\textsuperscript{78} It cited a Hochfelder footnote as authority for the proposition that a court's power to award fees under section 10(b) is "sharply circumscribed."\textsuperscript{74}

The Straub court's interpretation of both cases is questionable. First, the statement attributed to Mills is contrary to the Supreme Court's statements regarding attorneys' fees.\textsuperscript{78} In addition, the Mills court, through its analogy between the power of the court to imply actions and to award attorneys' fees, has advocated a broad application of the exceptions to the American rule.\textsuperscript{78} Further, the expansion of the common fund/benefit exception to award fees to accomplish justice, as demonstrated in Mills, argues in favor of the availability of bad faith attorneys' fees.

Second, the court erred in relying on the Hochfelder footnote. Hochfelder involved a determination of the elements of liability in a section 10(b) and rule 10b-5 action, not the availability of fees.\textsuperscript{77}

\textsuperscript{72} The dissenting judge in Straub also reached the conclusion that awarding bad faith attorneys' fees does not amount to awarding punitive damages. Ignoring § 28(a), the judge relied on the statement in Hall v. Cole, 412 U.S. 1 (1975) that bad faith fees may be awarded for "actions that led to the lawsuit." \textit{Id.} at 15. The dissent argued that the defendant's fraud was wanton, wilful and reprehensible, and stated that an award of fees would be in conformity with the equitable nature of the proceedings. Straub v. Vaisman & Co., 540 F.2d 591, 601 (3d Cir. 1976).


\textsuperscript{74} Straub v. Vaisman & Co., 540 F.2d 591, 599 (3d Cir. 1976) (citing Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976)). The footnote states in part:

One of [the] purposes [of amending § 11(e) to include attorneys' fees recovery] was to deter actions brought solely for their potential settlement value. . . . [citations omitted]. This deterrent is lacking in the § 10b context, in which a district court's power to award attorneys' fees is sharply circumscribed. See Alyeska Pipeline Service Co. v. Wilderness Society, 421 U.S. 240 . . . ("bad faith" requirement).

\textit{Id.} at 210 n.30.

\textsuperscript{75} \textit{See} notes 54-58 \textit{supra} and accompanying text.

\textsuperscript{76} \textit{Id.}

\textsuperscript{77} In its discussion of civil liability in the other sections of the Securities Exchange Act of 1934, the Hochfelder Court noted the limitations placed on the actions in which negligent conduct constituted liability. The sections based on negligence contain shortened statutes of limitation and various other procedural restrictions not evident in § 10(b). The Court pointed out that if the same standard of conduct were allowed in § 10b suits plaintiffs could avoid the procedural limitations of some sections by bringing actions under § 10(b) and yet have no greater burden of proof. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 206-11 (1976).
Although the Straub court correctly cited the Hochfelder footnote as limiting the availability of attorneys' fees under section 10(b), it failed to realize that the Court was not referring to any additional limitations to the bad faith exception. The Court was merely pointing out that because fraud, not negligence, was the gravamen of a 10b-5 action, more than a factual finding of fraud would be necessary to show a party acted in bad faith. The court's power to award fees under section 10(b) and rule 10b-5 is therefore limited, but only to the extent it would be in any type of litigation requiring proof of fraud as a specific element of the offense.

Notwithstanding the apparent problems with the Straub decision, courts in subsequent cases have cited Straub as authority for denying fees. Although the language of the decisions in these cases follows Straub, the results of the cases and the reasoning employed indicate dissatisfaction with the Straub rationale. Thus, the better

78. The plaintiff in a § 10(b) or rule 10b-5 suit is already limited in his award because of his burden of proof. He must prove that the statements made were false or misleading, and that they were material, or that there was a manipulative device. In addition, the elements of fraud and scienter must be proven.

79. This point is raised in Note, Rule 10b-5, supra note 1 at 341.

80. In Wright v. Heizer Corp., 503 F. Supp. 802 (N.D. Ill. 1980), the court found sufficient bad faith conduct during the litigation to award bad faith fees, and therefore, did not have to determine whether § 28(a) precluded bad faith fees. The plaintiff corporation, International Digisonics Corp., (“IDC”) needed funds to fill its capital requirements. Heizer Corp. agreed to provide funds in exchange for IDC stock. In a series of four transactions, Heizer provided funds for which it received stock and stock warrants. It also elected three members to IDC’s board of directors. IDC was unable to repay any of the loans. This gave Heizer the right to exercise its warrants. Upon exercise, Heizer would control more than 87% of IDC’s stock. The plaintiff shareholders instituted suit after the fourth transaction, alleging § 10(b) and rule 10b-5 violations by Heizer. The stockholders alleged that Heizer received stock valued unreasonably low, and that the stock warrants were priced below value, both of which defrauded the shareholders.

During the litigation, a fifth transaction occurred. IDC, still badly in need of funds, agreed to pledge to Heizer 100% of the stock of its wholly owned subsidiary. In exchange, Heizer agreed not to demand payments on notes already outstanding. Wright v. Heizer Corp., 411 F. Supp. 23, 30 (N.D. Ill. 1975). When this transaction occurred, Heizer Corp. controlled IDC’s board of directors, having elected five of the five members. The plaintiffs amended their complaint to include this fifth transaction, alleging fraud under rule 10b-5.

The court, consistent with Straub, awarded bad faith fees for conduct during the litigation. This is because the fifth transaction which occurred after the suit had been filed, “contained elements directly related to the litigation process.” Wright v. Heizer Corp. 503 F. Supp. 802, 814 (N.D. Ill. 1980). First, it protected Heizer from the outcome of the litigation. One of the defendant's witnesses admitted that Heizer intended to protect itself from any damages award against it. In obtaining the subsidiary, Heizer would be able to pay the award without dipping into its own funds.

Second, the transaction was a “device to discourage . . . a nuisance suit.” The court determined that the transaction was equivalent to a frivolous defense because its purpose was to harrass the plaintiff and delay his recovery. Id. at 814. See notes 28-31 supra and accom-
position would seem to be that bad faith attorneys' fees are recoverable in implied actions arising from the Securities Exchange Act of 1934.

PROBLEMS IN DETERMINING BAD FAITH

Because of the heavy burden of proof required under some sections of the 1934 Act, courts have difficulty determining when bad faith exists. If courts applied the standards applicable to non-securities cases in securities litigation, potentially all plaintiffs bringing suit could receive an award of bad faith attorneys' fees, because proof of fraud, traditionally an element of bad faith is often needed to prove a violation of the securities laws. The courts' re-

panying text. Further, the transaction rendered any recovery meaningless, because Heizer fully protected its own funds by obtaining IDC's subsidiary in order to pay potential damages.

Although the facts in this case allowed the court to use the Straub rule, the substance of the transaction could have been labeled conduct forming the cause of action. The court found the pledge of IDC's subsidiary to be fraud on the shareholders. It forced the plaintiffs to expend time and effort in continuing a lawsuit to vindicate established rights of full disclosure in all corporate transactions.

By labeling conduct as occurring during the litigation, the court avoided discussion of § 28(a). Had the court determined that the conduct in the fifth transaction constituted a violation of the securities laws it would have faced two problems. First, it would have had to justify fees despite § 28(a) and Straub. Second, the court would have had to explain why the conduct in the fourth transaction was not bad enough to award fees but the conduct in the fifth transaction was bad enough to warrant fees. By sidestepping § 28(a), the court could award bad faith fees yet remain consistent with Straub.

Similarly, in Huddleston v. Herman & MacLean, 640 F.2d 534 (5th Cir. 1981), cert. granted, 50 U.S.L.W. 3797 (April 4, 1982) (No. 81-680), the court expressed a view in keeping with Heizer. In Huddleston the plaintiff shareholders instituted a suit against accountants who prepared the balance sheet for the corporation's prospectus. The trial court found the balance sheet materially misleading. "The defendant's conduct... [was found to be] so extreme as to be a form of intentional conduct or behavior equivalent to an intent to deceive, manipulate or defraud." Id. at 545. The Fifth Circuit determined that this conduct had nothing to do with the litigation proceedings. Id. at 559. In accordance with Straub, the court denied plaintiff's request for bad faith attorneys' fees.

The Huddleston court recognized that § 28(a) limits recovery to actual damages, but never stated that the section precludes attorneys' fees. The court based its denial of fees on the trial court's finding that no bad faith conduct occurred during the litigation. The Huddleston court avoided the problem of determining whether defendant's conduct prior to the litigation justified bad faith fees by remanding for a new trial. The remand was the result of the Fifth Circuit's finding that the trial judge failed to include jury instructions regarding two essential elements of a rule 10b-5 claim, i.e., causation and reliance, without proof of which no rule 10b-5 violation can be found. The court, however, indicated that it may have considered the possibility of awarding fees for defendant's conduct notwithstanding Straub. The court cited a recent commentary highly critical of Straub's restrictive interpretation of the bad faith exception. Id. at 559 (citing Note, Rule 10b-5, supra note 1 at 338-42).

81. In Wright v. Heizer Corp., 503 F. Supp. 802 (N.D. Ill. 1980), the court expressed concern for this problem. "If proof of such recklessness alone were enough to constitute bad
luctance to award fees in actions requiring a specific showing of fraud has extended to suits arising under sections requiring a lesser burden of proof, so that even where defendant's conduct is clearly within the bad faith exception and the danger of awarding fees to all potential plaintiffs is not present, fees are denied.\textsuperscript{82}

**Problems in Applying the Standards**

Recent cases demonstrate the problems courts have in applying the bad faith exception. In *Stevens v. Abbott, Proctor & Paine*,\textsuperscript{83} the district court found that the defendant violated section 10(b) and rule 10b-5 by engaging in manipulative, deceptive and fraudulent conduct.\textsuperscript{84} The defendant broker, grossly indifferent to his

faith sufficient to justify an award of attorneys' fees, every derivative plaintiff prevailing in a rule 10b-5 cause of action would be entitled to attorneys fees." \textit{Id.} at 813.

Currently, courts are not in agreement as to whether proof of recklessness is sufficient to support liability under rule 10b-5. In *Franke v. Midwestern Oklahoma Dev. Auth.*, 428 F. Supp. 719 (W.D. Okla. 1976), the court in dictum defined the kind of recklessness that could constitute scienter.

In the context of an omissions case, reckless conduct may be defined as a highly unreasonable omission, involving not merely simple, or even inexcusable, negligence, but an extreme departure from the standards of ordinary care and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it. \textit{Id.} at 725. Accord, *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 44 (2d Cir.), \textit{cert. denied}, 439 U.S. 1039 (1978); *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1044 (7th Cir.), \textit{cert. denied}, 434 U.S. 875 (1977); *recklessness can support an action for fraud or deceit at common law; therefore, it would be inappropriate to construe rule 10b-5 to require a stricter standard than common law*; *Sanders v. John Nuveen & Co.*, 554 F.2d 790 (7th Cir. 1977) (agreeing with *Sundstrand* but adding that any definition of recklessness should not be a liberal one lest any discernible distinction between scienter and negligence be obliterated). Cf. *McLean v. Alexander*, 599 F.2d 1190, 1197 (3d Cir. 1979); *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017, 1024 n.2 (6th Cir. 1979); *Nelson v. Serwold*, 576 F.2d 1332, 1337 (9th Cir.), \textit{cert. denied}, 439 U.S. 970 (1978).


84. \textit{Id.} at 848. The case involved alleged "churning" by the defendants. Churning, which is specifically prohibited by rule 15c1-7, 17 C.F.R. \$ 240.15c1-7, involves broker-dealer acts
duty to the customer, had used a customer's investment account to generate commissions.85 Nevertheless, the court found that this conduct did not rise to the level of cases involving "groundless, oppressive, vexatious conduct"86 in which federal courts award fees.

In Bailey v. Meister Brau, Inc.,87 the court refused to assess fees against the defendant corporation for section 10(b) and rule 10b-5 violations although the defendant was held to have been "blinded by a conflict of interest" and to have wantonly ignored the unfairness of the transaction.88 The court denied the claim for attorneys' fees because the conduct was not an exceptional situation reflecting wilful and persistent defiance of the law.89 These cases demonstrate the court's difficulty in applying the standards for awarding bad faith attorneys' fees. Both Stevens and Bailey are examples of proven violations of law which would justify an award of fees in a non-securities case. In Stevens the violation involved gross misconduct and in Bailey the defendant acted wantonly. The courts in both cases indicated that in order for bad faith fees to be awarded, the defendant's conduct must be more than gross or wilful and wanton. The conduct and surrounding circumstances would have to constitute an exceptional situation.90 This finding is contrary to the current position taken in non-secur-

86. Id. at 849. See, e.g., Chaney v. Western States Title Ins. Co., 292 F. Supp. 376 (D. Utah 1968) where the jury found for the plaintiff on federal securities and common law fraud claims. The court, however, refused to award fees because no extraordinary circumstances warranted an award. The court also recognized that § 28(a) could bar attorneys' fees. Id. at 379 n.16(a). Accord, Fey v. Walston & Co., 493 F.2d 1036 (7th Cir. 1974). The case did not present "'overriding considerations of justice' . . . nor . . . fall within the limited exceptions to the contrary general rule." Id. at 1056. See note 62 supra and 90 infra.
87. 535 F.2d 982 (7th Cir. 1976).
88. Id. at 993.
89. Id. See note 60 supra.
90. See note 62 supra.
ities litigation that proof of a violation of established law justifies fees.

A solution exists for courts in securities litigation having difficulty defining conduct for awarding bad faith fees consistent with the definition applied in non-securities litigation. Slight modification of standards applicable in non-securities litigation to fit the issues determined in a securities litigation would allow consistency of the bad faith exception on a broad scale but afford ready adaption to securities cases.

A Proposal for Standards for Awarding Bad Faith Attorneys' Fees in Implied Private Actions Under the 1934 Act

In order to develop a rule for bad faith fee awards, the several types of securities violations must initially be identified and a separate analysis developed for each, because conduct required for securities violations varies under each implied action. The 1934 Act contains provisions which recognize liability for conduct ranging from a mere violation of statute to varying degrees of fraud. For example, a violation of section 13(d) may incur liability for failing to comply with its reporting provisions. At the other extreme, a suit under section 10(b) and rule 10b-5 requires not only proof of fraud, but a specific showing of scienter. Because the burden of proof placed on a plaintiff varies with the violation, the proof required to obtain bad faith fees should also vary with the violation.

Although securities fraud actions are most often brought under both section 10(b) and rule 10b-5, the proposed standard for determining whether bad faith fees are available is based on rule 10b-5. This proposed standard requires a two-prong analysis based on the type of violation committed. Where a defendant has used a manipulative device, a court should award bad faith fees to any plaintiff who can prove that the device has previously been found to violate the rule. The second prong of the rule 10b-5 analysis would be

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91. See notes 43, 50-53 supra and accompanying text.
92. See note 66 supra and accompanying text.
93. Certain types of conduct have been enumerated as manipulative. Some common schemes include rigged prices, furnishing false financial statements, wash sales and matched orders. Wash sales are transactions involving no change in beneficial interest and matched orders are those purchases/sales made with the knowledge that a substantially equal order at the same time and price will be made by the same or different person for the purchase/sale of the security.

Other examples of manipulative devices which are commonly attempted are agreements to buy up, or corner, the entire supply or a major portion of a security. Contracts to effect this kind of manipulation are not enforceable. Pegging a security is also an unlawful prac-
used where the violation was based on defendant's omission or misstatement of material fact. As in the manipulative device analysis, the plaintiff alleging misstatement or omission must also establish that the alleged misconduct has been found in violation of the 1934 Act. Meeting bad faith standards for this violation may be more difficult than showing bad faith in cases involving a manipulative device, because the determination of materiality is an objective test which must be determined by the facts of the case.

Dividing rule 10b-5 into two parts gives courts a framework for considering whether bad faith fees should be awarded. Notwithstanding the other elements of proof in a rule 10b-5 violation, the plaintiff must raise an issue of either manipulation or materiality. The availability of precedent determines whether the court can award fees for the defendant's alleged violation of a clear legal duty. Moreover, requiring the party moving for fees to support his position with precedent gives that party the burden of proof. This
is desirable in that the moving party should not be able to recover his counsels' fees unless he has met the burden of proving both the defendant's violation and bad faith conduct.

In contrast to rule 10b-5, under section 13(d) the plaintiff need not prove fraud in order to prove a violation. The section allows recovery for mere violation. If the plaintiff additionally proves fraud, he should be entitled to recover bad faith fees because the defendant's conduct, not only violated the statute but was proven to be intentional.

This same standard would also apply to violations of rules promulgated under section 14(a). For example, rule 14a-9 establishes a quality standard for proxy material. Courts generally agree that negligence is the proper standard of liability for a rule 14a-9 violation. Under the proposed section 13(d) standard a plaintiff able to prove more than a negligent omission or misstatement of material fact, i.e., scienter, would be entitled to an award of bad faith fees. Although this proposed rule appears to conflict with the standard applicable to materiality in rule 10b-5 violations, it does not. Section 14(a) applies only to proxy material, whereas rule 10b-5 applies to a broader range of information. This limited application reduces the broad range of material information subjected to a rule 10b-5 violation, and therefore allows an easier de-

95. See notes 42, 48-49 supra and accompanying text.
96. Rule 14a-9, 17 C.F.R. § 240.14a-9 (1981) states:
   (a) No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting or other communication, written or oral, containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading.
   (b) The fact that a proxy statement, form of proxy or other soliciting material has been filed with or examined by the Commission shall not be deemed a finding by the Commission that such material is accurate or complete or not false or misleading, or that the Commission has passed upon the merits of or approved any statement contained therein or any matter to be acted upon by security holders.
   No representation contrary to the foregoing shall be made.
termination of what information is material. Once this decision is made, fee shifting under the bad faith exception would be proper if the defendant’s conduct amounted to more than a negligent violation.

Finally, the proposed standards for rule 10b-5 and section 13(d) violations should apply to other implied private actions where appropriate. The rule 10b-5 standard could be used where the plaintiff’s burden of proof includes fraud and scienter. The standard proposed for section 13(d) could apply where the defendant’s liability is established by a mere violation, but the plaintiff proves that the conduct was fraudulent.

In sections where fraud is an element of the cause of action but the burden of proof is not equal to that of a rule 10b-5 action, which requires scienter, a third standard should apply. Similar to rule 10b-5 cases, the plaintiff must establish by precedent that the violation is fraudulent. If the plaintiff meets this burden and proves a violation of established law, there should be a basis for awarding bad faith fees. Lack of precedent could preclude the plaintiff from recovering bad faith fees if the plaintiff, however, can prove conduct beyond mere fraud, i.e., scienter, he should be able to recover bad faith attorneys’ fees. Unless this extra step in the burden of proof is met courts, would confront the problem of awarding bad faith fees to every successful litigant proving fraud.98

**Conclusion**

This proposal provides a better system for awarding bad faith attorneys’ fees than that currently used by the courts. By instituting the proposed standards for allowing recovery, courts would be furthering the purpose of the Securities Exchange Act of 1934. First, awarding bad faith fees for bad faith conduct gives litigants a realistically effective cause of action. The possible recovery of counsels’ fees encourages a hesitant litigant to pursue his claim. In addition, requiring defendants to pay plaintiff’s counsel fees may deter the defendant from bad faith conduct. Thus, the remedial purpose of the Securities Exchange Act of 1934 would be better served by providing complete compensatory recovery in implied private actions. The implied action itself is the result of the court’s power to promote the intended purpose of the Securities Exchange Act.98

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98. See note 81 supra.
Act. Awarding bad faith attorneys' fees further effectuates this purpose by encouraging the litigant to pursue his claim.

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