Private Remedies Available under Rule 10b-5

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In order to achieve full and accurate disclosure in securities transactions, both Congress and the Securities Exchange Commission (SEC or Commission) have imposed numerous requirements upon issuers of securities. In particular, rule 10b-5, adopted by the Commission in 1942, attempts to curb fraudulent practices in the sale or purchase of securities. But, although the Commission has authority to institute investigatory, administrative, or injunctive proceedings under rule 10b-5, its lack of funds, manpower, and information necessitates additional pressures—private actions and remedies—to achieve full compliance. The common law action of deceit cannot fill the gap, as was seen quite early in the English House of Lords decision, Derry v. Peek. And the statutory civil liability created by Congress, while important, is limited in its coverage. Such inadequacies in enforcing legal disclosure have spurred the development of the so-called “implied liabilities.”

Implied liabilities under rule 10b-5 were first recognized judicially in Kardon v. National Gypsum Co. Although there was no express provision of the 1933 or 1934 acts which would afford relief, the federal district court stated:

The disregard of the command of a statute is a wrongful act and a tort. . . . [T]he . . . right to recover damages arising by reason of violation of a statute . . . is so fundamental and so deeply ingrained in the law that where it is not expressly denied, the intention to withhold it should appear very clearly and plainly. . . .

Apart from § 10(b), I think that the action can also be grounded upon § 29(b) of the Act which provides that contracts in violation of any provision of the Act shall be void.

The two basic premises behind the court’s holding should be empha-

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1 17 C.F.R. § 240.10b-5 (1942), pursuant to 15 U.S.C. § 78j(b) (1934). (The rule declares unlawful the employment of fraudulent schemes, the making of material misrepresentations or half-truths, or the carrying on of fraudulent practices “in connection with the purchase or sale of any security” by using interstate commerce, the mails, or a securities exchange. The SEC administrative and injunctive powers referred to are provided by § 21 of the Securities Exchange Act of 1934 (citations herein will be to the Exchange Act), 15 U.S.C. § 78u (1934). See generally Comment, 39 Yale L.J. 1120 (1930).

2 14 A.C. 337 (1889).

3 For a discussion of remedies available under the express liability provisions, see Comment, 44 Yale L.J. 456 (1935); and McCormick, DAMAGES § 122a (1935).


5 Id. at 514.
sized. First, common law has often created tort liability from certain illegal acts.\(^6\) An analysis of section 29 (b) of the Securities Exchange Act of 1934\(^7\) demonstrates a more recent and more related basis. The section expressly declares as void every contract made in violation of the act (or any rule thereunder—including rule 10b-5) and every contract whose performance would involve such a violation. Courts have extended this provision not only to render such contracts unenforceable but also to allow the injured party the right to obtain rescission and money damages.\(^8\) Moreover, in 1938 Congress amended section 29 (b) to impose a one-year and a three-year statute of limitations on actions against brokers and dealers under rules and regulations for Exchange Act section 15 (c) (1).\(^9\) Like section 10 (b), section 15 (c) - (1) does not specifically create a private cause of action. The 1938 amendment strongly implies that, with respect to these and similar sections, Congress has always assumed the existence of implied private actions.\(^10\)

Implied liability under rule 10b-5 has been consistently reaffirmed since the *Kardon* decision, even though grounds for the implication have varied.\(^11\) One rationale is the absence of any complete overlap of the express liability sections. If a plaintiff wishes to rely solely on a defendant’s innocent or negligent misstatements, he is relegated to sections 11 and 12 with their numerous procedural limitations.\(^12\) If he uses section 10 (b) to avoid those limitations, he is faced with the additional problem of alleging and proving real fraud.\(^13\) To be sure, this fraud or *scienter* requirement may be “watered-down” considerably from that necessary at common law. However, some form of *scienter* may be an essential element in order for the Commission to

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\(^6\) This concept is clearly set out in the Second Restatement of Torts at § 286:
The court may adopt as the standard of conduct of a reasonable man the requirements of a legislative enactment or administrative regulation whose purpose is found to be exclusively or in part: (a) to protect a class of persons which includes the one whose interest is invaded; (b) to protect the particular interest which is invaded; (c) to protect that interest against the kind of harm which has resulted; and (d) to protect the particular interest against the particular hazard from which the harm results.

For the leading case supporting this statutory tort doctrine, see *Bell v. Hood*, 327 U.S. 678 (1946).

\(^7\) 15 U.S.C. § 78cc (b) (1934).


\(^10\) This argument was sustained in *Geismar v. Bond & Goodwin*, Inc., 40 F. Supp. 876 (S.D.N.Y. 1941).


\(^12\) 15 U.S.C. § 48 (k), (1).

\(^13\) *Fischman v. Raytheon Mfg. Co.*, 188 F.2d 783, 786 (2d Cir. 1951).
act within its rulemaking powers under section 10(b), which speaks of "any manipulative or deceptive device or contrivance."

The Ninth Circuit in Ellis v. Carter set forth several other reasons for implying liability under the rule, notwithstanding the existence of express civil liability provisions. First, judicial expansion of private remedies through implied liabilities effects Congress' dominant policy of providing "complete and effective sanctions, public and private, with respect to the duties and obligations imposed under the two acts." Second, it makes no distinction in the treatment of buyers and sellers under the Exchange Act, which apparently conforms with congressional intent. Third, it avoids judicial redrafting of the Exchange Act (1934) to include procedural provisions appearing only in the Securities Act (1933). Fourth, as between the 1933 and 1934 acts it allows the more recent legislation to control.

In addition, sections 27 and 28(a) of the 1934 act have often been mentioned in support of implied civil liability under rule 10b-5 although they do not seem to be particularly compelling bases. The former gives federal district courts jurisdiction over "violations" of the Exchange Act. The latter provides that Exchange Act remedies "shall be in addition to any and all other rights and remedies that may exist at law or in equity."

Since the tort action is implied, there is no express limitations provision governing rule 10b-5 suits. State statutes of limitations control, although when the cause of action is federal in origin, rules for

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15 291 F.2d 270, 274 (9th Cir. 1961).
16 Ibid. The court here is attempting to determine which of four possible constructions of 10b-5 is most valid. (1) No civil action to either buyer or seller since the 1933 and 1934 acts were too closely drafted to permit the inference of any private remedy in addition to those expressly provided. (2) As allowing sellers only to sue under 10b-5 and thereby limiting buyers to the express remedies of the acts. (3) As permitting buyers as well as sellers to sue without any distinction and free from the restrictions of the 1934 act. Weighing the numerous considerations involved, the court concluded that the fourth construction was "most acceptable" and as support listed the reasons found in the text.
17 Even though it assumes that Congress to some extent undid in 1934 what it carefully did in 1933.
18 The court in Osborne v. Mallory, 86 F. Supp. 869 (S.D.N.Y. 1949), relied on § 27, noting that the word "violation" encompasses both criminal and civil litigation.
tolling and commencement are dictated by federal law. If a conflict of laws problem exists, the law of the forum state prevails over that of the state in which the cause of action arose. It has been held that estoppel, waiver, and laches under state law are sound defenses in suits based on rule 10b-5. However, it has been held that state security for expense statutes do not apply to suits under rule 10b-5.

Due to the nature of the liability imposed, there is no expression of the exact remedies available in implementing the rule. Moreover, the reports do not contain many final decisions actually rendered for the plaintiffs. Thus it is difficult to gain a perspective of the courts' views on the matter.

I. POTENTIAL REMEDIES

A. DAMAGES

Despite the paucity of reported cases since Kardon, it has been well established that damages may be recovered for rule 10b-5 violations. Apparently, the first reported case going to judgment allowing recovery of damages, was Hawkins v. Merrill, Lynch, Pierce, Fenner & Bean. The suit was for failure of defendant's "agent" (whom de-
fendant knew was carrying on a brokerage business without sufficient capital) to deliver plaintiff's stock to him. The court allowed plaintiff to elect between taking the stock or cash. It is also settled that, unlike suits under section 12 of the 1933 act, suits for damages can be maintained by the buyer under section 10(b) even though he continues to have possession of the securities.30

The amount of damages recoverable in 10b-5 actions is limited by section 28(a) of the Exchange Act which provides, inter alia, "no person permitted to maintain a suit for damages under the provisions of this title 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."31 Thus, any recovery of exemplary damages in a 10(b) action is precluded. As has been pointed out, rights of action under the Exchange Act are "remedial" and not "penal" in nature.32

This "tort measure" of actual damages has been supported on the ground that it limits recovery to losses caused by the misrepresentation and prevents recovery of trading losses or depreciation caused by some fortuitous circumstance.33 An important problem with this measure of damages is that often the market value at the date of purchase was exactly the same as the purchase price because of the widespread nature of defendant's misrepresentations or concealments. This, of course, does not mean that the "actual value" was the same, but rather that one of the most accurate indicators of actual value—fair market value—becomes unavailable. The dilemma led Professor Loss to speak of actual value "not necessarily at the time of . . . purchase but perhaps in light of the issuer's subsequent history."34 This subsequent-history concept was applied in List v. Fashion Park, Inc.,35 where negotiations regarding a possible tender offer for issuer's stock were not disclosed by defendants in purchasing plaintiff's stock. The sale was made at about the market price, but recovery was sought for the difference between the sales price (eighteen dollars and fifty cents) and the tender offer price two and one-half months later (fifty dollars).

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31 Estate Counselling Serv., Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 303 F.2d 527, 533 (10th Cir. 1962), citing Smith v. Bolles, 132 U. S. 125 (1889) and a number of other cases. But see Fischman v. Raytheon Mfg. Co., 188 F.2d 786, 788 (2d Cir. 1951).
33 340 F.2d 457 (2d Cir. 1965). In this case, however, the claim itself was dismissed on the merits.
34 2 Loss at 1793.
Another interesting damages issue arises where defendant-purchaser realizes accretions which were not foreseeable at the time of transfer and are hence speculative. The court in Janigan v. Taylor distinguishes this from the defendant-seller situation, holding that "it is more appropriate to give the defrauded party [seller] the benefit even of windfalls than to let the fraudulent party keep them." It was recognized that in certain instances a result contrary to this "accounting" theory of damages might obtain, due to "extraordinary gains in the company's affairs" attributable to defendant's hard work.

The classic 10b-5 case applying the disgorgement rationale is Speed v. Transamerica Corp. There the court carried out a self-termed "reconstructed liquidation" by imposing the most probable result absent the misrepresentation culminating in what it considered to be a restitutional measure of damages. It treated the transaction as if the corporation had done what it properly could have done (call in the Class A stock, redeemable and convertible preferred) and then as if all Class A shareholders had done what they would have done, with proper disclosure as to the appreciated value of the corporation’s tobacco inventory (convert to Class B common). It then awarded damages on the basis of dividing the recomputed number of Class B shares into the value of the corporation’s assets at time of liquidation.

B. Rescission

Since section 29 (b) of the Exchange Act declares that any contract made in violation of the Exchange Act, or any rule thereunder, is void, rescission is available under rule 10b-5 if the parties are in privity. Whether plaintiff selects a suit for damages or for rescission will generally depend upon whether the stock’s present value or its actual value at the time of sale is more divergent from the sales price.

In 1956 the Ninth Circuit, in Errion v. Connell, affirmed a district court decision which had, in an extremely complicated fact situation, cancelled a number of the moving instruments involved, in an attempt to reinstate the parties. The result was, in effect, a rescission,
although the court never so designated it. In *Crist v. United Underwriters, Ltd.*, rescission was likewise sought by the purchasers of securities.

There are, however, certain conditions which must be met by one bringing a rescission suit. Since it is grounded in equity, a plaintiff seeking rescission must not have "unclean hands." It has been so held in a case alleging a champertous agreement to bring the lawsuit in order to harass defendant and coerce him into selling his stock. In addition, it may be necessary for plaintiff to tender into the court any property received by him from the defendant. The tender requirement is supported to some extent in the recent case of *Parker v. Baltimore Paint & Chem. Corp.* There, in a suit for rescission of issuer's sale of securities to defendant brought by the trustee in bankruptcy, it was held that there must be an offer of restoration of the value received before any such suit can succeed. On the other hand, the traditional rule in equity was that the defrauded party need not restore, or offer to restore, the consideration received before bringing his rescission suit, since in equity the contract is not terminated by the act of the party but by the decree of the court.

It is possible that a suit requesting a rescission measure of damages might be permitted in certain situations. Stocks may be fungible goods. If the security in question is readily available on the open market, there would seem to be nothing to prevent the plaintiff from restoring to the defendant sufficient cash to purchase these securities on the date of judgment rather than restoring the stock itself. In this manner he might be able to profit by selling out early (in effect, a type of short sale).

Although clearly an available remedy, rescission (or a rescission measure of damages) may frequently lead to unjust results and speculation, particularly where suit is brought long after the transaction in question. The basic premise that the plaintiff would have retained his stock (or refrained from purchasing) up to the date suit was instituted if the favorable or unfavorable information had been disclosed, seems not always to be a warranted assumption.

The complaint in *SEC v. Texas Gulf Sulphur Co.* introduces a

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43 There were also "damages" but only because defendant's manipulations made them necessary in order to make plaintiff whole.
44 343 F.2d 902 (10th Cir. 1965).
46 2 Loss at 1672.
47 244 F. Supp. 267 (D. Colo. 1965).
48 The court apparently grounded its holding on the fact that Colorado law so required.
49 MCCLINTOCK, EQUITY 231 (2d ed. 1948).
50 See 2 Loss at 1793.
new twist on rescission.\textsuperscript{11} Here, the Commission is itself seeking a court order directing defendant-purchasers "to offer rescission" to their respective sellers. This would, of course, place the burden on those defendants to determine the identities of and seek out their respective privies.

C. Accounting

In addition to the basic remedies of damages and rescission, it has been clear, since \textit{Kardon}, that an accounting is available in certain circumstances. The \textit{Kardon} decision indicated that to obtain such accounting no profit need be shown but only a duty of disclosure and its breach.\textsuperscript{2}

It is well to note some of the situations in which an accounting has been found proper. The Third Circuit allowed a suit for an accounting in \textit{McClure v. Borne Chem. Co.},\textsuperscript{8} where conspiracy, manipulative devices, and issuance of stock for inadequate consideration were alleged. In \textit{Kane v. Central Am. Mining \\& Oil, Inc.},\textsuperscript{44} an accounting was granted for money which had been misappropriated in connection with an issuance of the corporation's stock. In the recent case of \textit{Hoover v. Allen}\textsuperscript{65} plaintiffs sought, \textit{inter alia}, an accounting (1) for company assets used solely for defendants' benefit and (2) for company losses due to failure to register as an investment company and failure to liquidate and waste of corporate assets.\textsuperscript{67} In \textit{Kardon} the court permitted an accounting to ascertain and restore to plaintiffs their proportionate shares of the profits, if any, from defendants' sale of substantially all of the corporate assets.\textsuperscript{67}

D. Traditional Equitable Remedies

Professor Loss, in considering relief available under rule 10b-5, states, "In appropriate circumstances it seems clear that the plaintiff should also be able to seek a receivership or any other of the tradi-

\textsuperscript{51} Civil No. 1182/1965, S.D.N.Y., complaint filed April 19, 1961. See CCH Fed. Sec. L. Rep. \textsuperscript{5} 91,520. See also note 74 \textit{infra}.
\textsuperscript{52} \textit{Kardon v. National Gypsum Co.}, 73 F. Supp. 798, 801-02 (E.D. Pa. 1947). See also 2 \textit{Loss} at 1794.
\textsuperscript{53} 292 F.2d 824 (3d Cir. 1961).
\textsuperscript{55} 241 F. Supp. 213 (S.D.N.Y. 1965).
\textsuperscript{57} The agreement to sell had been finalized before and in anticipation of defendant's purchase of the other 50\textperthousand stock interest of plaintiffs, but was never revealed to plaintiffs.
tional equitable remedies." This passage was relied upon in Speed v. Transamerica Corp. in support of its "reconstructed liquidation" remedy, which was the first solid holding granting equitable relief.

An important case in this area of ancillary relief is Deckert v. Independence Shares Corp. The private relief sought included an accounting, appointment of a receiver, an injunction, and a return of plaintiff's payments (i.e., rescission). Justice Murphy, in upholding the district court's denial of a motion to dismiss the bill for failure to state a cause of action, gave the views of a unanimous Court:

We think the Securities Act does not restrict purchasers seeking relief under its provisions to a money judgment. On the contrary, the Act as a whole indicates an intention to establish a statutory right which the litigant may enforce in designated courts by such legal or equitable actions or procedures as would normally be available to him. . . . The power to enforce [which is expressly given specified courts] implies the power to make effective the right of recovery afforded by the Act. And the power to make the right of recovery effective implies the power to utilize any of the procedures or actions normally available to the litigant according to the exigencies of the particular case. Although Deckert was a Securities Act section 12(2) case, its rationale should hold true under the other civil liability sections of both the 1933 and 1934 acts.

Plaintiff, in the recent case of Voege v. American Sumatra Tobacco Corp. brought suit under rule 10b-5 seeking several types of equitable relief. Although not deciding the relief to which plaintiff was entitled, the court stated, "Where federally secured rights have been invaded and a federal statute provides for a general right to sue for that invasion, a federal court may use any available remedy to make good the wrong done." However, in Crist v. United Underwriters, Ltd. the court disallowed writs of attachment and garnishment, reasoning that under Colorado law, such remedies are only available in contract suits, whereas it is well-settled that rule 10b-5 suits are in tort.

Some of the traditional equitable remedies which may be available

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88 2 Loss at 1795.
90 311 U.S. 282 (1940).
91 Id. at 287-88.
92 Professor Loss, in referring to the above-quoted language of Deckert, remarks: "Everything Justice Murphy said applies equally in principle to §§ 11 and 12(1) of the 1933 act as well as all the other civil liability express and implied, under the S.E.C. statutes." 2 Loss at 1807.
94 Id. at 376. (Emphasis added.) J. I. Case Co. v. Borah, 377 U.S. 426, 433 (1964) is cited.
95 343 F.2d 902 (9th Cir. 1965).
under section 10(b) are the following: injunction, appointment of a receiver, subrogation, imposition of a constructive trust on the proceeds of resale by defendant, imposition of a lien on specific property of defendant to secure restitution, compelling defendant to make good his representations (e.g., reformation), detention of defendant (who is threatening to flee) under a writ of ne exeat, and issuance of a creditor's bill (to discover concealed assets, reach equitable assets, or set aside fraudulent conveyances).

Although one district court has held an injunction to be available there appears to be no valid reason for denying such relief. The injunction has been sustained in the two other major areas of implied liability, the proxy rules and the Investment Company Act; and the United States Supreme Court has upheld the right to private injunctive relief under section 12(2) of the 1933 act. In 1961 the Third Circuit approved a private injunction complaint based on rule 10b-5, as did the Second Circuit in 1964, though the ultimate outcomes in those cases are not reported. A similar complaint, seeking both an injunction against carrying out a registration of securities and a cancellation of stock issued by the corporation to certain of its insiders, was sustained in the recent case of Kane v. Central Am. Mining & Oil, Inc.

E. Restitution

The most questionable remedy thus far litigated is raised by two currently pending suits, the more highly publicized being SEC v. Texas Gulf Sulphur Co. The remedy sought is "restitution," and

69 Goldsmith v. Western & So. Life Ins. Co., 5 S.E.C. 795 (N.D. Ohio 1948) held this remedy to be exclusively in the Commission.
74 Civil No. 1182/1965, S.D.N.Y., complaint filed April 19, 1965. The other is SEC v. Golconda Mining Co., Civil No. 1312/1965 S.D.N.Y., complaint filed May 19, 1965. See generally Note, 79 Harv. L. Rev. 676 (1966). Note that the court in Texas Gulf Sulphur has recently come down with a decision in this case, but in the court's words, "All parties agreed that the trial should first be had on whether defendant . . . had violated Section 10(b) and Rule 10b-5 reserving for later hearing the issue of the remedy to be applied in the event such violations are found." CCH Fed. Sec. L. Rep. (S.D.N.Y. 1966). The SEC, displeased with the district court holding, has appealed to the Second Circuit. See Wall Street Journal, Sept. 8, 1966, p. 4, col. 3.
the question is whether the SEC, as relief ancillary to its injunction suit for violations of rule 10b-5, can recover property on behalf of private parties injured by these violations. This is an unprecedented attempt on the part of the SEC, although several other administrative agencies have sought similar powers in the past. In *Porter v. Warner Holding Co.*, the OPA administrator sought restitution ancillary to its injunction of prior overcharges made in violation of the Emergency Price Control Act of 1952. The relief was on behalf of tenants who had not previously recovered in private suits. The Supreme Court held that, in light of the public interest involved in the enforcement of the act, such relief was within the equitable powers of the court. In *Mitchell v. Robert De Mario Jewelry, Inc.*, the Court clarified its position somewhat in a similar question under the Fair Labor Standards Act. It held that an administrator could employ the restitution device if he could show it to be necessary to the effectuation of the legislative policy, i.e., in the public interest.

These cases differ somewhat from the *Texas Gulf Sulphur* situation, however, in their degree of effect on the public interest. In the previous cases the injured parties maintained close relationships with the violators, making them hard put to bring suit in their own behalf. Moreover, making sure of full monetary recovery was essential to effective enforcement of the legislative purposes for those acts. Neither of these statements can be made with regard to the SEC.

Nevertheless, there are some redeeming characteristics of this method of restitution. This mechanism makes recovery of small claims practical and provides for a simple and efficient handling of all claims. It makes possible the employment of high-calibre attorneys and tends to minimize inconsistent judgments under the same basic set of facts. Whether there is sufficient public interest to support the remedy, in light of the availability of a class action, remains to be seen.

It has been pointed out that allowing suits by the Commissioner seeking restitution would prejudice the injured parties' rights in two ways—by preventing any probability of extrajudicial settlement and by denying the availability of a jury trial. From the defendant's point

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76 There is one instance in which the SEC sought to impound the receipts of illegal sales. However, after the complaint had been upheld, a consent decree was entered. SEC v. Robert Collier & Co., 76 F.2d 939 (2d Cir. 1935).
77 328 U.S. 395 (1946).
78 Section 205(a), 56 Stat. 33 (1942).
79 328 U.S. 395, 400 (1946); See also United States v. Moore, 340 U.S. 616 (1911).
82 Note that in United States v. Parkinson, 240 F.2d 918, 920 (9th Cir. 1966), the court, in denying restitution as ancillary relief to an injunction under the Food, Drug, and Cosmetic Act, distinguishes *Warner* on the basis of its dealing with wartime legislation.
of view there also might be some unfairness. He would be held responsible for profits realized by someone else (his "tippee"), unmitigated by any right of contribution from the tippee. Regarding unfairness, it is interesting that courts of equity have traditionally employed this type of remedy in certain circumstances. "W[here the plaintiff has been induced by defendant's fraud to enter into a transaction with a third person who did not know of the fraud, so that the transaction cannot be rescinded, equity may compel the defendant to make his representations good, if he can do so." 8

Another obstacle to be overcome is the contention that it is solely a legislative function to provide such an extreme measure. It is interesting to note that recent studies of the securities market carried out in Canada 86 and England, 87 though coming up with different suggested revisions, were in accord in their recognition that changes should be effected by the legislature. In fact, the Ontario Attorney General's Committee arrived at a Texas Gulf Sulphur-type remedy: "In order to provide the effective remedy which we feel is necessary a governmental agency should have the right to bring the action if the company fails to do so within a reasonable time. The Ontario Securities Commission is the logical agency to assume this responsibility." 88

Finally, the restitution remedy, if adopted, would pose a multitude of procedural problems. For example: Who are entitled to restitution? What duty do they have to come forward? What proof must they be required to show to establish that they are entitled to relief? What effect will an unsuccessful SEC suit for restitution in their behalf have on a subsequent individual action by one of them? 89

The restitution power could be extremely effective, especially when coupled with the power to appoint a receiver, and it may be that the SEC is the "logical agency." Conversely, it may be that a specific legislative authorization is called for, assuming that there is sufficient public interest in the remedy. 90

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84 Shea v. Ungar, CCH Fed. Sec. L. Rep. § 91, 518 (S.D.N.Y. 1965) (no right of contribution by a joint violator under § 10(b)).
87 Board of Trade, Report of the Law Committee (1962), the "Jenkins Report," which reviewed in detail the English Companies Act, the Presentation of Fraud Act, and the Registration of Business Names Act.
88 See Note 86 supra.
89 See Note, 29 Harv. L. Rev. 616 (1966). For a discussion of the privity problem encountered in more conventional suits see notes 126-35 infra and accompanying text.
90 Note that at the present time the Commission is often able to obtain restitution informally through warnings of possible criminal prosecutions. See 2 Loss at 1824 n. 469.
II. CLASS ACTIONS

Closely akin to the remedies issue is the question of whether a class action may be brought. Of the three former varieties of class action, only the "spurious" was generally available for use under the securities statutes. For many years this type of suit has been permitted under the 1933 and 1934 acts, even though as an alternative individuals might have recovered separate judgments, and even though each member of the class would have damages of a different amount.

Professor Loss emphasizes that class actions offer several advantages. They may tend to permit small investors to obtain more competent counsel than they could retain individually. And filing of the suit may toll the statute of limitations, allowing other class members additional time in which to appeal. Moreover, the suit cannot be settled or dismissed without court approval. Of course, an important practical advantage of a class action is the extra leverage it gives for settlement.

Since Speed v. Transamerica Corp. and Fischman v. Raytheon Mfg. Co., class actions have often been permitted under rule 10b-5. In Speed, Judge Leahy, who had previously denied the class action, subsequently sustained it upon an amended complaint which added an allegation of preexistent intent to liquidate the appreciated tobacco inventory. In Fischman the court sustained a complaint brought on behalf of all past and present preferred and common stockholders of the defendant corporation "who may intervene and become plaintiffs herein." The Third Circuit also allowed such a suit in McClure v. Borne Chem. Co. in 1961, and a number of other courts have permitted them recently.

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81 See, however, the amended rule 23, effective July 1, 1966, which abolishes the distinctions between types of class action and provides a uniform class action.
82 Loss at 1826.
84 2 Loss at 1822-23.
85 See Fed. R. Civ. P. 21(c) (old rule).
87 188 F.2d 783 (2d Cir. 1951).
88 5 F.R.D. 56 (D. Del. 1945).
89 Id. at 792.
90 292 F.2d 824 (1d Cir. 1961).
III. DERIVATIVE SUITS

The derivative suit, traditionally considered "an internal corporate matter governed exclusively by state law,"\textsuperscript{102} first appeared in a rule 10b-5 context, in dictum, in \textit{Slavin v. Germantown Fire Ins. Co.}\textsuperscript{103} Although the remedy was held to be individual and not derivative, the court remarked: "[I]f there was a scheme which actually resulted in harm to the corporation and which was effectuated in violation of the provisions of Section 10(b) of the Securities Exchange Act, we have no doubt that the corporation could prosecute the action for redress; or that in the proper case, a derivative suit may be brought on its behalf."\textsuperscript{104}

Later, in \textit{Hooper v. Mountain States Sec. Corp.},\textsuperscript{105} an issuance of stock was held a "sale," and a valid cause of action was granted where spurious assets were received by the corporation from an "outsider" in the exchange. The rationale was further developed in \textit{Ruckle v. Roto Am. Corp.}\textsuperscript{106} where the court decided that a corporation could be "defrauded" if a majority of the board of directors, in causing it to issue shares, did not disclose their intentions or the company's financial condition to the other directors. \textit{Birnbaum v. Newport Steel Corp.},\textsuperscript{107} which decided that a corporation could be "defrauded" if a majority of its directors,\textsuperscript{108} so that a derivative suit is possible. To deny relief

\textsuperscript{103}174 F.2d 799 (3d Cir. 1949). A derivative suit had been sustained in the earlier case of \textit{Stella v. Kaiser}, 82 F. Supp. 301 (S.D.N.Y. 1948); however, violations of both §§ 9(a) and 10(b) of the Exchange Act had been alleged, and the court mentioned and based its holding upon only the former.
\textsuperscript{104}\textit{id.} at 805-06.
\textsuperscript{105}282 F.2d 195 (1st Cir. 1960).
\textsuperscript{106}159 F.2d 24 (2d Cir. 1964).
\textsuperscript{108}Id. at 464.
\textsuperscript{109}Id. at 463. Note that the basis of the court's decision was the fact that plaintiff was neither a purchaser nor seller of securities; therefore, the suit was not within rule 10b-5 (see note 121 \textit{infra} and accompanying text). Further, the court felt that the fact that § 16(b) dealt quite specifically with the fiduciary duties of corporate insiders, indicated a lack of broad congressional intent under § 10(b).
\textsuperscript{110}Analogous to embezzlement and conflict of interest cases in which this has been held possible.
solely because a director rather than an outsider committed the fraud would emasculate the federal securities law, and it is no answer to generalize with such statements as “federal securities law is not concerned with corporate mismanagement or breaches of fiduciary duties.” It is clear, however, that any breach of fiduciary duty must in some way involve a purchase or sale of securities before rule 10b-5 can apply, and “a suit certainly could not be brought under the Rule simply for a misappropriation of corporate funds by an officer of the corporation.”

The court in *Ruckle* relied upon a broad dictum volunteered in *McClure v. Borne Chem. Co.* that a rule 10b-5 derivative suit against directors for causing the corporation to issue its own stock for inadequate consideration (or to redeem or purchase it at an excessive price) may be maintained. The Second Circuit in *O’Neill v. Maytag* felt that this statement was an overgeneralization, holding that the element of deception must also be proved. This latter holding was recently reinforced by a decision rejecting the rule 10b-5 count in a derivative suit. The petition was deemed fatally defective in failing to allege that plaintiff was injured and that the directors took advantage of the alleged potential manipulative device.

In *Kane v. Central Am. Mining & Oil, Inc.*, a petition filed by stockholders on behalf of the corporation seeking, *inter alia*, return of stock issued to defendants (officers, directors and majority stockholders of the corporation) was sustained as stating a cause of action. On the other hand, a derivative action is not available for injuries to shareholders in their individual capacities. “[C]ontrol acquired as part of a fraudulent scheme, of itself, is not an injury to the corporation within the meaning of section 10(b) of the 1934 Act upon which a derivative action can be based.” In *Defiance Indus. Inc. v. Galdi*, shareholders suing derivatively sought damages for injury to
the good name, credit, and reputation of the corporation. However, the rule 10b-5 petition was held unsupportable by the court since the attempted measure of damages was the decline in market value of the shareholders' shares. By the same token, if the corporation had been the party injured under section 10(b), "a shareholder of that corporation had standing to sue only on a derivative basis."

The availability of a rule 10b-5 derivative suit is of great importance to the shareholder because of the several advantages which it offers over a state court derivative suit. These include the availability of nationwide service of process and immunity from state security for expense statutes. In addition, it circumscribes the restrictions which state legislatures and courts carefully impose upon the derivative action vis à vis an individual direct action.

IV. WHO MAY BE A PLAINTIFF?

The primary gap intended to be filled by section 10(b) was allowing defrauded sellers of securities to recover their losses, and this is precisely the situation in which the court in Kardon first implied civil liability. Nevertheless, since Fischman v. Raytheon Mfg. Co. it has been established that defrauded purchasers could also utilize the section, notwithstanding the availability of other sections to purchasers of securities. The only proof required is: (1) some purchase or sale of a security; (2) some fraud or material misstatement in connection therewith; and (3) use of the mails or some interstate or stock exchange facility. "The other elements of common law deceit—rela-

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121 See JENNINGS & MARSH, SECURITIES REGULATION 857 (1963); a more expanded discussion of those same advantages in Lowenfels, Rule 10b-5 and the Stockholder's Derivative Action, 18 VAND. L. REV. 893 (1965).
122 188 F.2d 783 (2d Cir. 1951). In Roston v. Bergman, CCH FED. SEC. L. REP. ¶ 91,659, at 91,432 (S.D.N.Y. Mar. 21, 1966), the court says, "The great weight of more recent authority establishes that when, to conduct actionable under § 11 of the 1933 Act, there is added the ingredient of fraud, then that conduct becomes actionable under § 10(b) of the 1934 Act . . . [by] any defrauded person, whether or not he could maintain a suit under § 11 of the 1933 Act." See also Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961); Matheson v. Arnbrust, 284 F.2d 670 (9th Cir. 1960); Dauphin Corp. v. Redwall Corp., 201 F. Supp. 466, 468-69 (D. Del. 1962); Osborne v. Mallory, 86 F. Supp. 869, 879 (S.D.N.Y. 1949).
123 E.g., §§ 11 and 12 of the 1933 Act.
124 Note that the fraud or misstatement need not itself pass through these channels (Boone v. Baugh, 308 F.2d 711 (8th Cir. 1962) (dictum); Errion v. Connell, 236 F.2d 447 (9th Cir. 1956); Fratt v. Robinson, 203 F.2d 627 (9th Cir. 1953)) and that it has been held that Congress did not intend § 10(b) to cover an intrastate telephone communication even though the particular telephone lines are also used for interstate calls [Roston v. Althern Color Research, Inc., 218 F. Supp. 473 (E.D. Pa. 1963) holding that Congress has not regulated this situation, not that it could not. Contra, Nemitz v. Cunny, 221 F. Supp. 711 (N.D. Ill. 1963)].
An important and much litigated question is whether the plaintiff in a rule 10b-5 action must have been in privity of contract with the defendant. The leading case imposing this restriction is *Joseph v. Farnsworth Radio & Television Corp.*, where the plaintiffs bought their stock after defendants had successfully disposed of theirs. The district court opinion, approved on appeal, stated the requirement as being a "semblance of privity between the vendor and purchaser of the security." A comment on the case quoted at length by Judge Frank in his dissent on appeal, may explain what the court meant by "some semblance of privity." It noted that no privity was necessary in actions for fraud and that *Peek v. Gurney* required only that plaintiff be within the class of persons whom defendant intended to defraud. The tendency in the United States has been to liberalize the *Peek* rule, predicated upon reasonable foreseeability of reliance rather than actual intent to defraud. Moreover, under the legislative history of the Exchange Act, the *Peek* class of plaintiffs appears broadened. In *Texas Continental Life Ins. Co. v. Bankers Bond Co., Inc.* the court refused to adopt the *Joseph* semblance of privity concept, adopting the position that the purpose of the legislation indicates that no privity requirement was intended. The holding was expressly affirmed on appeal, the court reasoning


123 *Joseph v. Farnsworth Radio & Television Corp.*, 99 F. Supp. 701, 706 (S.D.N.Y. 1951). There was no allegation of reliance in that case, and the district judge expressly reserved judgment on the question of whether sufficient privity would exist with reliance present. See Comment, 32 Texas L. Rev. 197, 209 (1953), predicting that a purchase from a third party in reliance on defendant's misrepresentations would be sufficient "semblance of privity."

124 Comment, 4 Stan. L. Rev. 308 (1952).


127 This intent to cause reliance on the fraudulent misrepresentation is included in § 531 of the *Restatement of Torts*.

128 "[A]ny person who . . . induces transaction in a security by means of false or misleading statements . . . shall be liable in damages to those who have bought or sold the security at prices affected by such . . . statements." S. Rep. No. 792, 73d Cong. 2d Sess. 12 (1934).

that a contrary decision would encourage evasion of the statutory policy. The court did acknowledge the necessity of an intent to defraud (Peek v. Gurney), but it allowed such intent to be evidenced by the objective acts of the defendants. Perhaps this will be the nature of any future privity requirement that may survive.

A much more difficult question, when material information is being concealed, is whether all purchasers or sellers through a stock exchange at or near the time of concealment should be able to recover without showing a connection between their sales and corresponding purchases by specific defendants. At this point the reliance factor becomes very important, for it is, at most, conjectural whether plaintiff would have retained his shares (or refrained from buying) had he been aware of the information—and if so, for what period of time.

Whether proof of reliance is even necessary in suits under rule 10b-5 is far from settled. The primary case supporting the reliance requirement is List v. Fashion Park, Inc., where recovery was denied because the plaintiff, who had initiated the negotiations, was interested only in realizing his five-point paper profit and would have sold even though full disclosure had been made by the defendant. An article by William H. Painter notes that there was really no causation of the injury by the defendant’s concealment and no evidence of an intent to hold down the market price in order for the defendant to acquire cheap stock. The author advocates a complete abolition of the reliance requirement in nondisclosure cases involving transactions on an exchange or over-the-counter market, where he feels the reliance concept to be incongruous. Noting that the con-
cept is often stretched beyond recognition, he would allow all who sold "at about the same time that the defendant was purchasing" to recover regardless of their reasons for selling. It is doubtful, however, that the reliance requirement, so well-established at common law, will be abandoned under rule 10b-5.

Even though all other requirements have been met, an injured party may be unable to utilize rule 10b-5 because he is simply not within the class of persons intended to be protected by the rule. For example, in Rogers v. Crown Stove Works, where a pledgor of stock sought to enjoin foreclosure sale of the stock on grounds that the defendant was making misrepresentations in advertising the sale and that the plaintiff would, as a result, be injured, it was held that no cause of action under section 10(b) had been asserted. The opposite result was reached, however, in Opper v. Hancock Sec. Corp., where the broker was held liable under section 10(b) for selling his own stock while misrepresenting that he actively sought to sell the plaintiff's stock. Possibly this situation is more within the spirit of the statute than the pledge situation, since it involves a normal sale in the course of the securities business, where the sole purpose of the agency arrangement is to sell the stock.

V. CONCLUSION

It can fairly be said that the plaintiff under the "Kardon Rule 10b-5" has or may have available a wide variety of remedies, greatly exceeding those of the traditional common law. The availability of "restitution," the role of the SEC in civil liability matters, and the insider's responsibility for his "tippee" are important unanswered questions in this area which may be resolved in the Texas Gulf Sulphur controversy. Undoubtedly, the final outcome will be a long time in the judicial mill, but perhaps that period and the concommit-

145 See Painter, note 140 supra at 1378, "[I]t seems unrealistic and slightly arbitrary to allow recovery to those who (1) sold because of the misstatement, or (2) sold because of the drop in price caused by the misstatement, and to deny recovery to those who, although selling for other reasons, suffered similar harm because of the defendant's conduct."
146 Prosser, TORTS § 103 (3d ed. 1964)
148 The court also noted that even if plaintiff bid in at the foreclosure sale he would be an informed investor.
ant publicity will allow protracted consideration of any further extensions of the scope of rule 10b-5.

It is also clear that a number of variables and uncertainties still exist within the broad framework of the rule. It is somewhat inimical to the precise scheme of the express liabilities sections of the acts that an all-encompassing section from which liability is merely inferred should interpose its obscurities in such an important segment of our economy.

Even in *Texas Gulf Sulphur* the SEC has not sought the full measure of its potential authority under a liberal interpretation of this very broad statute and rule. However, perhaps Congress may now see the interpretation which its statute is being given, particularly in light of the effects upon its more explicit statutes. Perhaps it will recognize the undesirable factors which have accompanied the rule as interpreted (at least by the SEC). Such factors would include, among others, localized statutes of limitation, uncertainty respecting elements of proof (reliance, causation, privity, scienter) and extent of damages (at what point would plaintiff have bought or sold), and a possible placing of the burden on defendant to seek out those whom he somehow injured.

In addition, it is possible that we shall witness a determination, either by the courts or Congress itself, that the issue of the "logical agency" for the assertion of private rights under rule 10b-5 should be decided by the legislature and not by unilateral assumption by the SEC. In any event, it may be said with little hesitancy that the repercussions of this current activity will not slip by unnoticed.