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THE MEANING OF J. I. CASE CO. V. BORAK — REMEDIES AVAILABLE FOR VIOLATIONS OF PROXY RULES UNDER THE FEDERAL SECURITIES ACT*

by

Alex Elson**

THE FULL significance of *J.I. Case v. Borak*¹ was anticipated by Judge Henry J. Friendly of the Court of Appeals for the Second Circuit in his penetrating and scholarly Benjamin Cardozo lecture.² The thrust of this lecture was that the *Erie* decision,³ by uprooting the spurious uniformity of *Swift v. Tyson*⁴ and insisting that federal courts defer to the states on matters outside the states' grant of power to the nation, cleared the way for a truly uniform federal common law on issues of national concern that has developed fruitfully and will continue to grow. His prime illustration of the development of federal common law by the United States Supreme Court was the *Lincoln Mills* doctrine⁵—that Congress, by granting jurisdiction to the federal courts over suits “for violation of contracts between an employer and a labor organization representing employees in an industry affecting commerce . . . , or between any such labor organization,”⁶ gave a mandate to federal judges to fashion a body of contract law consistent with the policy of federal labor statutes and binding on all courts. Judge Friendly foresaw the development of federal common law of corporate responsibility already under way in decisions by the federal courts “implying causes of action from and filling interstices in laws administered by the SEC.”⁷ His lecture was delivered after the Seventh Circuit decision in *Borak*,⁸ but before it was affirmed by the Supreme Court. Referring to *Borak*, he stated that holdings of this character would become “of even greater importance if Congress adopts the proposal of the SEC to make various sections of the Securities and Exchange Act applicable to certain unlisted companies.”⁹ Congress subsequently adopted these proposals.¹⁰ *Borak* vindicated, if vindication was necessary, Judge Friendly's role as a prophet of things to come.

* This Article is based on a lecture delivered to the Illinois Institute for Continuing Legal Education on March 7, 1969, and to the Open Meeting of the Committee on Federal Regulation of Securities of the Section of Corporation, Banking and Business Law of the American Bar Association held in connection with its annual meeting in Dallas, Texas, on August 10, 1969.

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¹ 377 U.S. 426 (1964).

² Friendly, *In Praise of Erie—And of the New Federal Common Law*, 39 N.Y.U.L. REV. 383, 412-14 (1964).

³ *Erie R.R. v. Tompkins*, 304 U.S. 64 (1938).

⁴ 41 U.S. (16 Pet.) 1 (1842).

⁵ *Textile Workers Union v. Lincoln Mills*, 353 U.S. 448 (1957).

⁶ 29 U.S.C. § 185(c) (1965).

⁷ Friendly, *supra* note 2, at 413.

⁸ 317 F.2d 838 (7th Cir. 1963).

⁹ Friendly, *supra* note 2, at 414 n.152.

¹⁰ 78 Stat. 565 (1964), amending Securities Exchange Act of 1934, §§ 3, 12, 14, 15, 20, 23, 15 U.S.C. §§ 78(c), (l), (n), (o), (t), (w) (1963). These amendments were adopted after the United States Supreme Court decision in *Borak*.

During the twenty-year period prior to *Borak*, federal courts in a substantial number of cases had implied private rights of action under sections 6(b), 7(c), 10(b), 14(a), and 29(b) of the Securities Exchange Act of 1934.¹¹ *Borak* strongly endorsed and articulated the case for the implied cause of action, and the unanimity of the Court left no doubt as to the direction lower courts were to go. Five years have gone by since *Borak* was decided by the Supreme Court.¹² The significance of this decision in the development of securities law, and particularly in the articulation of judicial remedies for securities frauds, is the broad proposition to which this Article is addressed.

I. J. I. CASE V. BORAK

To understand the impact of *Borak* on the development of securities law it is important to view, as background, the petition and holding in this case. Plaintiff's complaint, brought as a representative class action in federal district court, has two counts. The first count, based on diversity of jurisdiction, charges violation of Wisconsin law, particularly the deprivation of pre-emptive rights of shareholders and directors' breach of duty

¹¹ 15 U.S.C. §§ 78(f), (g), (i), (n), (cc) (1964). Section 6(b) of the 1934 Act provides among other matters that the rules of a registered exchange must provide for discipline of members for willful violation of the Act or regulations issued thereunder, or for conduct in violation of equitable principles of trade. Section 7(c) of the 1934 Act prohibits, among other acts, "any member of a national securities exchange . . . directly or indirectly to extend or maintain credit or arrange for the extension or maintenance of credit to or for any customer" in contravention of rules and regulations promulgated by the Federal Reserve Board. Section 10(b) of the 1934 Act authorizes the Securities and Exchange Commission to promulgate "such rules and regulations . . . as necessary or appropriate in the public interest or for the protection of investors." Section 14(a) of the 1934 Act regulates the solicitation of proxies and authorized rule 14a-9 which ultimately became the basis for the *Borak* decision. Section 29(b), subject to certain limitations, makes contracts in violation of the 1934 Act or regulations issued thereunder, void.

For decisions under section 14(a) of the 1934 Act, see *Dann v. Studebaker-Packard Corp.*, 288 F.2d 201 (6th Cir. 1961); *Central Foundry Co. v. Gondelman*, 166 F. Supp. 429 (S.D.N.Y. 1958); *Rosen v. Alleghany Corp.*, 133 F. Supp. 858 (S.D.N.Y. 1955); *Horwitz v. Balaban*, 112 F. Supp. 99 (S.D.N.Y. 1953); *Tate v. Sonotone*, 5 S.E.C. 310 (S.D.N.Y. 1947). See also *Mack v. Mishkin*, 172 F. Supp. 885, 889 (S.D.N.Y. 1959); *Textron v. American Woolen Co.*, 122 F. Supp. 305, 308 (D. Mass. 1954). And see *Brown v. Bullock*, 194 F. Supp. 207, 231 (S.D.N.Y.), *aff'd on other grounds*, 294 F.2d 415 (2d Cir. 1961), and *Phillips v. United Corp.*, 5 S.E.C. 445 (S.D.N.Y. 1947), where violations of the same proxy rules, made applicable by other provisions of the federal securities laws, were involved.

As to § 10(b) of the 1934 Act, see *Ellis v. Carter*, 291 F.2d 270 (9th Cir. 1961); *Matheson v. Armbrust*, 284 F.2d 670 (9th Cir.), *cert. denied*, 365 U.S. 870 (1960); *Hooper v. Mountain States Sec. Corp.*, 282 F.2d 195 (5th Cir.), *cert. denied*, 365 U.S. 814 (1960); *Reed v. Riddle Airlines*, 266 F.2d 314 (5th Cir. 1959); *Errion v. Connell*, 236 F.2d 447 (9th Cir. 1956); *Fratt v. Robinson*, 203 F.2d 627 (9th Cir. 1953); *Fischman v. Raytheon Mfg. Co.*, 188 F.2d 783 (2d Cir. 1951); *Slavin v. Germantown Fire Ins. Co.*, 174 F.2d 799 (3d Cir. 1949); *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946).

As to other sections of the 1934 Act, see *Baird v. Franklin*, 141 F.2d 238 (2d Cir.), *cert. denied*, 323 U.S. 737 (1944) (§ 6(b)); *Remar v. Clayton Sec. Corp.*, 81 F. Supp. 1014 (D. Mass. 1949) (§ 7(c)); *Geismar v. Bond & Goodwin, Inc.*, 40 F. Supp. 876 (S.D.N.Y. 1941) (§ 29(b)).

¹² 377 U.S. 426 (1964), *aff'g Borak v. J.I. Case Co.*, 317 F.2d 838 (7th Cir. 1963). Characterized as a landmark decision, the case has been cited countless times by federal district courts and courts of appeal and the Supreme Court. For law review discussions of the case, see Comment, *Private Rights from Federal Statutes: Toward a Rational Use of Borak*, 63 Nw. U.L. Rev. 454 (1968); Comment, *Private Rights and Federal Remedies: Herein of J.I. Case v. Borak*, 12 U.C.L.A.L. Rev. 1150 (1965); Note, *Violations of Proxy Rules: Private Right of Action: Retrospective Relief: J.I. Case Co. v. Borak*, 377 U.S. 426 (1964); 64 COLUM. L. REV. 1336 (1964); 50 CORN. L.Q. 370 (1965); 78 HARV. L. REV. 296 (1964). Trial on the merits of the remanded case began in June 1969, and is still in progress. Under these circumstances the merits of the case are not discussed herein.

to shareholders. The second count charges violations of the federal proxy rules¹³ promulgated under sections 14(a)¹⁴ and 10(b)¹⁵ of the Securities Exchange Act, based on section 27 jurisdiction.¹⁶ Upon plaintiff's refusal to provide security-for-costs previously ordered on the basis that the first count stated a derivative and not a representative action, and that accordingly the Wisconsin security-for-cost statute was applicable, this count was dismissed by the trial court.¹⁷ Relying on *Dann v. Studebaker*¹⁸ the court held as to the second count that its jurisdiction was limited to declaratory relief and that if plaintiff succeeded in securing declaratory judgment, further relief would await action in the Wisconsin state courts. It also held that the claim based on section 10(b) of the Securities Exchange Act was outside the scope of the order permitting plaintiff to file an amended pleading.¹⁹

The Seventh Circuit reversed,²⁰ holding that: (1) count I stated a representative cause of action for redress of rights as individual Case stockholders; (2) *Dann v. Studebaker* was wrong and that in an implied cause of action the court could grant all necessary relief, both prospective and retrospective; (3) the Wisconsin security-for-cost statute was inapplicable to federally based claims; and (4) that the section 10(b) claim had no application to the facts alleged in the complaint.

Certiorari was granted by the United States Supreme Court as to one question only: Whether section 27 of the Securities Exchange Act authorizes a federal cause of action for rescission or damages to a corporate stockholder where a consummated merger was authorized pursuant to the

¹³ SEC Reg. 14A, 17 C.F.R. §§ 240.14a-1 to -7 (1968).

¹⁴ 15 U.S.C. § 78n(a) (1964):

(a) 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 any national securities exchange or otherwise to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security . . . registered on any national securities exchange 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.

¹⁵ 15 U.S.C. § 78j(b) (1964):

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . .

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

¹⁶ 15 U.S.C. § 78aa (1964):

The district courts of the United States . . . shall have exclusive jurisdiction of violations of this chapter or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this chapter or the rules and regulations thereunder . . .

¹⁷ Wis. STAT. § 180.405 (1957) provides in part:

(4) In any action brought in the right of any foreign or domestic corporation by the holder or holders of less than 3 percent of any class of shares issued and outstanding, the defendants shall be entitled on application to the court to require the plaintiff or plaintiffs to give security for the reasonable expenses, including attorney's fees.

¹⁸ 288 F.2d 201 (6th Cir. 1961).

¹⁹ The court also entertained doubt as to whether a § 10(b) action would lie.

²⁰ 317 F.2d 838 (7th Cir. 1963). The case was taken as an interlocutory appeal under 28 U.S.C.A. § 1292(b) (1966).

use of a proxy statement allegedly containing false and misleading statements in violation of section 14(a) of the Act? The Supreme Court holding in *Borak* may be briefly summarized in three points. First, a private cause of action will be implied from a violation of duties imposed by the Securities Exchange Act. Second, a private cause of action may be brought either as a derivative or representative action on behalf of shareholders (*Howard v. Furst*²¹ was silently but definitely overruled). Third, and most important to this Article, federal courts may grant whatever relief is necessary under the circumstances, including rescission and damages, to effect the purposes of the Act (*Dann v. Studebaker* was expressly overruled²²). With relation to the scope of relief which federal courts could grant, the Supreme Court stated that:

[U]nder the circumstances here it is the duty of the courts to be alert to provide such remedies as are necessary to make effective the congressional purpose.²³

[T]he overriding federal law applicable here would, where the facts required, control the appropriateness of redress despite the provisions of state corporation law for it 'is not uncommon for federal courts to fashion federal law where federal rights are concerned' *Textile Workers v. Lincoln Mills*, 353 U.S. 448, 457 (1957).²⁴

II. APPLICATIONS OF BORAK

Standing To Sue in a Borak-Type Action. When referring to a Borak-type case, as that term is now used, we mean a private cause of action to enforce the proxy rules and regulations issued under section 14(a) of the Securities Exchange Act. While *Borak* dealt only with section 14(a), the logic of that decision by a unanimous Court makes clear that a private cause of action exists under other sections of the Act such as 6(b), 7(c), 10(b), and 29(b).²⁵ The *Borak* case takes on added significance when read in conjunction with the Supreme Court's recent decision in the *National Securities* case.²⁶ This case holds that the fraudulent purchase and sale prohibitions of section 10(b) of the Securities Exchange Act also apply to stock exchanged in a merger and that false and misleading proxy statements may constitute a violation of the provisions of section 10(b). Thus, practically speaking, cases involving mergers normally brought under section 14(a) may also be brought under section 10(b).

The *National Securities* decision is of particular significance with relation to remedies since most discussion by courts of the scope of relief in private causes of action has been in cases involving section 10(b). The Court expressly left open the question of whether there was a private cause of action for a 10(b) violation, although every court of appeals in the coun-

²¹ 238 F.2d 790 (2d Cir. 1956).

²² 377 U.S. at 434.

²³ *Id.* at 433.

²⁴ *Id.* at 434.

²⁵ See note 11 *supra*.

²⁶ *SEC v. National Sec., Inc.*, 393 U.S. 453 (1969).

try has ruled that such a remedy does exist.²⁷ The rationale of *Borak* strongly indicates that when this issue is squarely presented to the Supreme Court there will be a holding that there is a private cause of action for a violation of section 10(b).²⁸

The full scope of the *Borak* case may be obscured by the fact that the plaintiff in the case was a minority shareholder. Standing to assert a *Borak* right of action is not limited to minority shareholders. It makes no difference who is soliciting or receiving proxies if the end result is a misinformed or uninformed vote by security holders. Interference or frustration of suffrage may involve not only a direct infringement of the individual rights of the shareholder, but also may harm a corporation whose future may be determined by such a vote. The implied private cause of action belongs both to corporations and to individuals whose proxies are illegally solicited. The right thus extends to dissident or insurgent security holders, to management through direct corporate action as distinguished from derivative actions,²⁹ and to suits by one shareholder group against another.³⁰

Elements and Defenses of a Borak-Type Action. What are the elements of a *Borak*-type action?³¹ Regarding two elements there is no conflict of opinion: There must first be a showing that the proxy solicitations were subject to section 14(a) of the Securities Exchange Act, and second, there must be a showing of infringement of suffrage rights with relation to the transaction of materials (the inclusion of materially misleading statements or omission of materially correct statements) in violation of the proxy rules. A third element, about which there has recently developed a significant split of judicial opinion, is that the misleading proxy materials must have played a significant or causal role in the transaction. In *Borak* this question was summarily resolved by the Court's statement that the "causal relationship of the proxy material and the merger are questions of fact to be resolved at the trial."³²

In general, this element of causation has been the least clearly delineated by the courts. In *Laurenzano v. Einbender*³³ the test laid down was whether the proxy materials have a transactional function and are not randomly present in the context of the transaction. Expressed in the simplest terms, there must be a showing that "but for" the voting of the proxies secured by the misleading statement the transaction would not have been approved.³⁴

²⁷ Cases are collected in Ruder, *Texas Gulf Sulphur—The Second Round: Privity and State of Mind in Rule 10b-5 Purchase and Sale Cases*, 63 NW. U.L. REV. 423, 431 n.46 (1968).

²⁸ In this opinion I am supported by Professor Ruder, *id.* at 432.

²⁹ *Studebaker v. Gittlin*, 360 F.2d 692, 696 (2d Cir. 1965); *Goodrich Rubber Co. v. N.W. Indus.*, 406 F.2d 755 (2d Cir. 1969); *Studebaker Corp. v. Allied Prod. Corp.*, 256 F. Supp. 173 (W.D. Mich. 1966).

³⁰ *Union Pac. R.R. v. Chicago & N.W. Ry.*, 226 F. Supp. 400, 405 (N.D. Ill. 1964).

³¹ See Lockwood, *Corporate Acquisitions and Actions Under Sections 10(b) and 14 of the Securities Exchange Act of 1934*, 23 BUS. LAW. 365 (1968).

³² 377 U.S. at 431.

³³ 264 F. Supp. 356 (E.D.N.Y. 1966).

³⁴ For a definitive treatment of cases involving the "causal connection" requirement, see L. LOSS, *SECURITIES REGULATION* 2433-39 (Supp. 1969). For considered treatment of causation in a § 10(b) case, see *Globus, Inc. v. Jaroff*, 271 F. Supp. 378 (S.D.N.Y. 1967). Even where defendants controlled more than a majority of voting stock the proxies may well have a transactional function, since an unfavorable vote from minority stockholders might have caused defendants to re-

In *Mills v. Electric Autolite Co.*,³⁵ a recent decision by the Seventh Circuit, the court ruled that notwithstanding its determination that the proxy materials were misleading in omitting a material fact, no relief could be given the plaintiff until the defendants were first given an opportunity to prove the merger was fair and equitable and to satisfy the court by a preponderance of probabilities that the merger would have received a sufficient vote even if the proxy statement had not been misleading. Should the defendants successfully carry that burden, no relief could be given plaintiff.³⁶

The soundness of the *Autolite* decision is subject to serious question. The court focused its decision upon the question of whether the misleading statement and material omission caused the submission of sufficient proxies. The court recognized that this test closely parallels the common law fraud requirement of reliance on the representation and therefore stated: "Reliance by thousands of individuals, as here, can scarcely be inquired into."³⁷ Faced with the dilemma of applying a representation-and-reliance test the Seventh Circuit substituted as the appropriate test—whether or not a court could hold "by a preponderance of probabilities, that the merger would have received a sufficient vote even if the proxy statement had not been misleading in the respect found."³⁸ Such a determination would be made after receiving evidence from the defendants going to the fairness or merits of the terms of the merger. In effect, under *Autolite* the controlling factor becomes the fairness of the plan of merger. Presumably if the court finds that the plan is fair, it could then conclude that there is a greater probability that the shareholders would have voted favorably for the plan even if the proxy statement had made all material disclosures. Fairness of the plan, if established, becomes an absolute defense, even if it is conceded that the proxy statement violates section 14 and the proxy rules.

The injection of the fairness of a plan of merger as a measure of reliance or as a causal factor masks an important issue. That issue is whether there is a remedy for violation of the proxy rules even if the plan of merger is fair. Where corporate suffrage rights are violated, *Borak* contemplates some remedy. To give a wrongdoer who has obtained proxies by misleading statements another opportunity to validate a vote by showing that the merger was fair and equitable and to argue that by a "preponderance of probabilities" the merger would have received a sufficient vote even if the proxy statement was not misleading, effectively negates any remedy. In developing a federal common law in this field, courts must derive the essence thereof from statutes or clearly expressed legislative purpose. But nothing in the Securities Exchange Act, its history, or its purpose supports the *Autolite*

consider their merger plans. *Laurenzano v. Einbender*, 264 F. Supp. 356, 362 (E.D.N.Y. 1966); *Swanson v. American Consumer Indus.*, CCH FED. SEC. L. REP. ¶ 92,458 (7th Cir. Aug. 13, 1969). See also *Weber v. Bartle*, 272 F. Supp. 201, 204 (S.D.N.Y. 1967). *Contra*, *Barnett v. Anaconda Co.*, 238 F. Supp. 766 (S.D.N.Y. 1965).

³⁵ 403 F.2d 429 (7th Cir. 1968), cert. granted, 394 U.S. 971 (1969).

³⁶ 403 F.2d at 436.

³⁷ *Id.* at 436 n.10.

³⁸ *Id.* at 436.

holding. The decision in fact runs counter to the congressional purpose to protect investors in their corporate suffrage rights.

The claimed "fairness of the plan of merger" was rejected as a defense in *Gerstle v. Gamble-Skogmo, Inc.*³⁹ The proxy statement in that case justified the exchange of stock on comparative market values of the securities of the merging company when in fact the liquidating value of the assets of the acquired company would have required that a substantially higher price be paid to the shareholders of the acquired company. The district court said:

The plaintiffs in this case were prevented from exercising their right to decide whether to gamble and speculate upon the profits to be received from the sale of the remaining properties and to diversify the proceeds The purpose of § 14(a) was to prevent such frustration of stockholders (H.R. Rep. No. 1383, 73d Cong., 2d Sess. 13, 14). The exercise of this right cannot be defeated by the mere promulgation of a fair plan in a merger proceeding. Nor can the remedy of restitution be defeated by such a defense.⁴⁰

The court in *Gamble-Skogmo* discussed at length the element of reliance as causation in a *Borak*-type case. It concluded that to require stockholders by direct proof to establish sufficient reliance to validate a causal connection, would be to impose a prohibitive burden of proof in a publicly held corporation. The court placed the burden on the defendant to show absence of "either reliance or causation on the part of the stockholders voting for the merger."⁴¹ It concluded that causation may be inferred from the totality of the circumstances.

From its opinion, it seems that the *Autolite* court was concerned about the remedy—a fear that judgment for plaintiff would have resulted in setting aside the merger, even though the merger might have been in the best interest of the shareholders. I submit that there was another alternative to the very restrictive, and I believe unsound, precondition to relief laid down in *Autolite*. That alternative would have been to await determination by the trial court as to the remedy and to review that determination in the light of its findings. The trial court is not compelled to order rescission or dissolution—some remedies serving a deterrence objective can be shaped by the trial court. For example, the *Gamble-Skogmo* court, after trial, ordered an accounting and restitution.⁴²

Remedies in Borak-Type Cases—General Considerations. What are the remedies available in a *Borak*-type case, assuming plaintiff is able to establish the elements of a cause of action? Perhaps it would serve some purpose to view the matter of remedies in its broadest terms.

³⁹ CCH FED. SEC. L. REP. ¶ 92,367 (S.D.N.Y. Mar. 20, 1969).

⁴⁰ *Id.* at 97,750.

⁴¹ *Id.* at 97,748.

⁴² *Id.* at 97,753. The decision by the Fifth Circuit Court of Appeals in the *Eastside Church of Christ v. National Plan, Inc.*, 391 F.2d 357 (5th Cir. 1968), is also of interest. In that case the defendant failed to register in compliance with section 15(a)(1) of the Securities Exchange Act of 1934. The court held the transaction could be voided under § 29(b), that the plaintiffs need only show they were "in the class of persons whose interest the Act was designed to protect." They were not required to show harm suffered by failure to register. *Id.* at 362.

Borak and *National Securities* in substance direct the federal courts, in the handling of private causes of action, to carry out the broad objectives of security statutes. The trend of decisions since *Borak* indicates that the courts will insist on standards of conduct consistent with the objectives of the statutes, and are prepared to encourage strong remedies to foreclose activities which defeat or frustrate these objectives. When I speak of courts, I am neither referring to all judges nor to all decisions. Although I know of no statistical study of outcomes of securities cases, I suspect a box-score would favor the defendant.⁴³ What I do refer to is the dominant trend of court decisions. The critics of this trend of opinions have a different basic approach. They look at the body of federal regulation and point to a pattern of regulation derived from the express language of the statutes. They claim that, taken as a whole, the remedies therein specified should be adequate, and that in any event Congress did not intend to go further.⁴⁴ On the other hand, significant decisions of the courts place emphasis on the broad purpose of the relevant statutes—the protection of investors. It is that stated purpose which provides the rationale for *Borak* and other landmark decisions.

The difference in approach may be explained to some extent by the fact that the cases that come before the courts frequently are shockers, sometimes involving blatant and raw kinds of fraud. If one does nothing more than read the *Wall Street Journal* regularly he cannot help but be impressed by the substantial number of cases involving both small and large corporations and individuals of wealth and social position involved in questionable conduct. I do not mean to downgrade the great majority of securities traders who adhere to ethical standards. But the securities markets are still markets of speculation. They still hold out prospects for great profits made in a short time. Human nature being what it is, the urge to get rich quick or to enhance one's riches in a hurry, is an important factor. The ruthless, no-holds-barred attitude is best exemplified by the tactics used in the recent rash of take-over attempts, both successful and unsuccessful. The standards of conduct which have been and are likely to be developed by the courts will continue to be at variance with the mores of the market place. Ostensibly these standards will be derived from the statutes. They will continue to reflect the concern for the consequences or lack of restraint in securities transactions, particularly during this period of national history when so many millions of Americans have invested in securities. My reason for dwelling on court attitudes is my conviction that the remedies developed by the courts for violation of judicially established standards of conduct will reflect these attitudes.

⁴³ For box-score on 10b-5 cases, see Comment, *Rule 10b-5 Corporate Mismanagement Cases: Who Must Deceive Whom?*, 63 Nw. U.L. REV. 477, 495-98 (1968).

⁴⁴ Cohen, "Truth in Securities" Revisited, 79 HARV. L. REV. 1340 (1966); Ruder, *Texas Gulf Sulphur—The Second Round: Privity and State of Mind in Rule 10b-5 Purchase and Sale Cases*, 63 Nw. U.L. REV. 423 (1968); Ruder, *Pitfalls in the Development of a Federal Law of Corporations by Implication Through Rule 10b-5*, 59 Nw. U.L. REV. 185 (1964).

Securities Exchange Act Limitations in Private Causes of Action. There are five sections of the Securities Exchange Act of 1934 which provide for remedies in private causes of action: sections 9(e),⁴⁵ 16(b),⁴⁶ 18(a),⁴⁷ 28(a),⁴⁸ and 29(b).⁴⁹ The question arises as to whether in implied causes of actions, such as *Borak*-type cases, the remedies are limited to those specified in the 1934 Act. The problem comes into better focus by considering the court decisions of section 10(b) cases which deny or give effect to the section 28(a) limitation on recovery to actual damages.⁵⁰ The most recent case in this regard is *Green v. Wolf Corp.*⁵¹ There the Second Circuit sustained a district court ruling striking from a section 10(b) complaint a claim for punitive damages. The court recognized that punitive damages are permitted under the 1933 Securities Act, but stated that the 1933 Act did not contain language similar to section 28(a) of the 1934 Securities Exchange Act. The Second Circuit's principal rationale was that punitive damages can be justified only as retribution or as a deterrent measure, but that punitive damages are not needed as a deterrent in section 10(b) cases since liability for actual damages may be very substantial. The purpose of retribution would not be served by imposing punitive damages against a publicly held corporation, then, because a heavy burden would fall on all stockholders.

The decisions against the imposition of punitive damages are difficult to reconcile with decisions allowing a rescissional measure of damages which may return to plaintiff not only his original investment but also a substantial windfall. Nor can these decisions be reconciled with the *Borak* and *National Securities* holdings that federal courts have broad discretion in shaping the relief necessary and can specifically grant rescission—a remedy not specified in any of the provisions of the 1934 Act.

⁴⁵ 15 U.S.C. § 78i(e) (1964) provides that a willful violator of prohibitions against manipulation of securities prices is liable to any purchaser or seller of such affected securities; security for costs is provided; and the time span for enforcing liability is within one year after discovery of facts constituting the violation and within three years after such violation.

⁴⁶ 15 U.S.C. § 78p(b) (1964) provides that the issuer of stock, or any owner of security of issue (if issuer fails to bring suit within 60 days after request) may sue for short-swing profits of insider; statute of limitations commences two years after the date the profit was realized.

⁴⁷ 15 U.S.C. § 78r(a) (1964) provides a cause of action for damages accruing to any person relying on a false and misleading application, report, or document or any undertaking in a registration statement, for purchases or sales of securities; security for costs is provided, and the statute of limitations is the same here as for § 9(e).

⁴⁸ 15 U.S.C. § 78bb(a) (1964) provides in part:

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.

⁴⁹ 15 U.S.C. § 78cc(b) (1964) provides that contracts made in violation of the 1934 Act are void under certain circumstances.

⁵⁰ *Meisel v. North Jersey Trust Co.*, 216 F. Supp. 469 (S.D.N.Y. 1963); *Kohler v. Kohler*, 208 F. Supp. 808 (E.D. Wis. 1962), *aff'd*, 319 F.2d 634 (7th Cir. 1963) (§ 28(a) limits recovery to actual damages and bars punitive damages). *Contra*, *Myzel v. Fields*, 386 F.2d 718, 747-48 (8th Cir. 1967); *Janigan v. Taylor*, 344 F.2d 781, 786-87 (1st Cir. 1965); *Hecht v. Harris, Upham & Co.*, 283 F. Supp. 417, 444-45 (N.D. Cal. 1968); *Baumel v. Rosen*, 283 F. Supp. 128 (D. Md. 1968) (rescissional damages are not barred by § 28(a)).

⁵¹ CCH FED. SEC. L. REP. ¶ 92,321 (2d Cir. Dec. 9, 1968).

III. THE NATURE OF AVAILABLE REMEDIES IN PRIVATE ACTIONS

The Securities Exchange Act of 1934 is silent as to remedies in private actions brought under sections 14(a) and 10(b). Courts have applied a substantial battery of remedies which lend themselves to discussion in two categories—premerger and postmerger.

Premerger Remedies. The injunctive remedy has been used extensively by the courts as a way of granting therapeutic relief. The courts have freely granted injunctions prior to consummation of the transaction for a variety of purposes: to postpone shareholder meetings,⁵² to require supplementation or correction of proxy materials with reservation of jurisdiction to oversee solicitation of proxies,⁵³ to enjoin a state court action and restrain the use of stockholders' authorizations to obtain inspection of stockholder's list where obtained without compliance with the proxy rules,⁵⁴ and to enjoin use of proxies obtained by false or misleading materials.⁵⁵ Injunctive relief before a merger is a feasible remedy when the plaintiff is a corporation or a substantial group of shareholders. In the typical suit by a minority shareholder, the requirement of posting bond exposes the shareholder to financial risk most minority shareholders cannot assume. Hence, in most of these cases no such injunctive relief is sought. Here is an area for judicial innovation. In the interest of effective justice, premerger relief should be encouraged. Early termination of litigation clearly benefits the corporations involved, their shareholders, and overburdened courts. The mandate of *Borak* to devise effective relief would justify a court, satisfied that a sufficient showing has been made to warrant the issuance of a preliminary injunction, in requiring only a nominal bond.

Postmerger or Retrospective Relief. As stated before, most discussion concerning remedies has occurred in section 10(b) cases. Within these decisions, most courts have held that a rescission or return to the *status quo ante* would be ordered when the defendant has not disposed of the securities, or as an alternative courts have allowed a rescissional measure of damages, including accretions to value.⁵⁶ *National Securities* established the appropriateness of rescission as a remedy.⁵⁷ Recently great anxiety has been expressed concerning the great potential liability for damages in non-privy situations.⁵⁸ This anxiety has led to suggestions that the remedy

⁵² *Henwood v. SEC*, 298 F.2d 641 (9th Cir.), *cert. denied*, 371 U.S. 814 (1962); *Studebaker Corp. v. Allied Prods.*, 256 F. Supp. 173 (W.D. Mich. 1966); *Union Pac. R.R. v. Chicago & N.W. Ry.*, 226 F. Supp. 400 (N.D. Ill. 1964).

⁵³ *Studebaker Corp. v. Allied Prods.*, 256 F. Supp. 173 (W.D. Mich. 1966).

⁵⁴ *Studebaker v. Gittlin*, 360 F.2d 692 (2d Cir. 1966).

⁵⁵ *Union Pac. R.R. v. Chicago & N.W. Ry.*, 226 F. Supp. 400, 414 (N.D. Ill. 1964); *Willoughby v. Port*, 182 F. Supp. 496 (S.D.N.Y.), *modified and aff'd*, 277 F.2d 149 (2d Cir. 1960); *SEC v. May*, 134 F. Supp. 247 (S.D.N.Y. 1955), *aff'd*, 229 F.2d 123 (2d Cir. 1956).

⁵⁶ As stated in *Janigan v. Taylor*, 344 F.2d 781 (1st Cir. 1965), "It is more appropriate to give the defrauded party the benefit of windfalls than to let the fraudulent party keep them." *Id.* at 786, cited with approval in *Myzel v. Fields*, 386 F.2d 718, 747 (8th Cir. 1967).

⁵⁷ See note 26 *supra*, and accompanying text.

⁵⁸ *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 864-69 (2d Cir. 1968) (Friendly, J., concurring); Knauss, *Disclosure Requirements—Changing Concepts of Liability*, 24 *Bus. Law.* 43,

be severely limited in such cases. I do not suggest that this anxiety is misplaced, but I think it does not take into account the broad discretion which lies in the trial courts, and in general the good judgment which may be anticipated on the part of our trial court judges. I would suggest that it is idle to attempt to formulate, in the abstract, restrictive principles for such cases. If restrictions are developed, they should be developed on a case-by-case basis. In the end, I have confidence in the outcome of this traditional process.

One conclusion that emerges from my review of section 14(a) cases, particularly concerning mergers or acquisitions, is that generalizations concerning retrospective relief do not provide much help, and reported decisions throw little light on the subject. The bulk of cases are usually settled after the trial court holds that the complaint states a cause of action and after some discovery has occurred. The settlements which have been made employ a variety of remedies which are somewhat suggestive. If any generalization can be made, I think it fair to say that the broad objective of the plaintiff is to secure a return to the *status quo ante* or, if this is not possible, that the corporation or the class of shareholders represented be made whole again. Since the relief must be custom-made to meet the necessities of the case, the array of remedies available include declaratory judgment, damages, accounting, restitution, rescission, mandatory and prohibitory injunctive relief.

A discussion of some illustrative situations may be of some help in analyzing the nature of available remedies. First, let us consider the case of self-dealing by officers or directors, such as the sale of corporate stock below actual value to directors or the grant of stock options or excessively high salaries in employment contracts made as a part of a merger plan. The relief in this case does not require that the merger be set aside, and the court is therefore presented with alternatives which do not involve drastic consequences. The most direct remedy in the case of self-dealing is an injunctive order which would direct cancellation of either the stock issued or the stock options and award damages for any benefits received thereunder in excess of the amounts paid for such stock or stock options. In the case of an employment contract, the terms of the contract can be voided or by injunctive order the court can direct that the terms of the contract be changed to eliminate the self-serving aspects.

A more difficult problem is presented when the securities of the corporation acquired in a merger or sale of assets have been grossly overpriced or the shareholders of the acquired company have been grossly underpaid. In this case the most effective remedy would be rescission or return to the *status quo ante*. Under *Borak* and the *National Securities* case, rescission can be ordered if the court finds that course of action desirable, necessary, and otherwise lawful. But there are, of course, practical problems in rescission. The complexities of securities litigation and the fact that they are

56-61 (1968) (suggesting alternative remedies); Painter, *Inside Information: Growing Pains for the Development of Federal Corporation Law Under Rule 10b-5*, 65 COLUM. L. REV. 1361 (1965); Ruder, *Texas Gulf Sulphur—The Second Round: Privity and State of Mind in Rule 10b-5 Purchase and Sale Cases*, 63 N.W. U.L. REV. 423 (1968).

thoroughly defended may result in a trial of the issues years after the consummation of the merger. For example, the decision in *Borak* was handed down more than seven years after the merger and the remanded case is still pending; the *National Securities* case was decided three and one-half years after the merger and still has to be tried on remand. Restoring the *status quo ante* after such a lapse of time may be an impossible task since the acquired company has lost its identity, its employees, its good will, and for all practical purposes it no longer exists.

Another situation which arises in section 14(a) cases involves the sale of corporate assets for inadequate consideration to a potentially insurgent group, or when an asset is purchased from an insurgent group at an excessive price, and the underlying objective of such sale or purchase is to maintain management control. In such a case rescission of the transaction can be ordered without jeopardizing the interests of the shareholders. If rescission is not possible because the assets have been sold, the court can assess damages on a rescissionary basis against both the insiders and the insurgent group in order that such damages be paid to the corporation. The court will not order rescission, and should not order rescission, where the impact will be adverse to the interest of the shareholders. It is highly unlikely that the deterrent effect of rescission will take precedence in a court's mind over the economic interest of all shareholders, including those represented by the plaintiff.

There are, however, alternatives to a rescission. In *Gamble-Skogmo* the court, concluding that the shareholders of the acquired corporation were underpaid for their shares, ordered an accounting and restitution. It held that the restitutional basis of recovery is the value of the property at the time the sale was consummated or a higher value at a subsequent time if the value of the property has thereafter fluctuated or additions have been made thereto.⁵⁹

Where an excessive price is paid and the interests of the shareholders in the acquiring company have been accordingly diluted, the court can meet this situation by an injunctive order directing that additional shares be issued to the shareholders of the acquiring company. A variety of devices of a similar character are available and have been used in settlement cases. A second alternative is an award of damages against the directors or insiders responsible for the fraud, payable to the corporation in derivative cases or to the defrauded class of shareholders in representative cases.

My final illustrative situation is the sale of a controlling interest as part of a merger plan when the merger serves no corporate purpose and the primary purpose is to enable the controlling shareholder to sell his stock on an over-priced basis to the acquiring corporation. Here, possible remedies include (1) rescission, (2) award of damages in favor of the minority shareholders of the acquired corporation, or (3) an award of damages in favor of the surviving corporation equal to the difference between the price paid the controlling shareholders and that paid to other shareholders,

⁵⁹ CCH FED. SEC. L. REP. ¶ 92,367, at 97,750 (S.D.N.Y. Mar. 20, 1969).

presumably offsetting to some extent the dilution of the interests of the minority shareholders of the acquired corporation. In the latter case, the award of damages should be coupled with an injunction directing the issuance of additional stock to the minority shareholders of the acquired corporation to compensate for the dilution of their interest in the merged corporation. In all cases where wrongdoing has been shown to have been established the court may, in addition to the remedies I have mentioned, order the wrongdoers to pay the cost of the litigation, including attorney's fees.

IV. CONCLUSION

At this stage in the development of the private cause of action, except for the measure of damages in section 10(b) cases and the clear-cut decisions of the Supreme Court that rescission may be an appropriate remedy, there is not a great deal of decisional material from which one can generalize a well-defined set of principles applicable to the shaping of relief in *Borak*-type cases. The mandate of the Supreme Court is, however, indisputable. It is the duty of the courts to be alert to provide such remedies as are necessary to make effective the congressional purpose. In time, the ingenuity of judges and lawyers will provide the grist for the scholars' mills.