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How Big a House of Cards-Private Actions and Insiders under Rule 10b-5

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LAW NOTE

HOW BIG A HOUSE OF CARDS? Private Actions and Insiders Under Rule 10b-5.

INTRODUCTION

What has happened to Rule 10b-5 . . . always reminds me of a cartoon of . . . Mussolini dictating to his secretary, and the caption was, "Miss Baccigalupi, take a law."

Whenever I try to explain to a foreign lawyer . . . how we have developed in this country a scheme for grappling with the problems of insider preferences and so on, more and more I become increasingly ashamed, and that is the only word I can use at this sort of jurisprudence. It is awfully hard . . . to explain with a straight face how it is that this came about in this great country of ours. It is a development that, needless to say, I applaud. It was long overdue. But do we have to go on indefinitely basing this whole revolutionary change on a section of the Exchange Act that says it shall be unlawful for any person in the purchase or sale of any security to engage in any act or practice that the S.E.C. prescribes as manipulative or deceptive? How big a house of cards can we continue to build on that? This is backdoor jurisprudence with a vengeance.*

Today, the federal court interpretations of Rule 10b-5,1 promulgated by the SEC (under the authority of a federal statute, section 10b of the Securities Exchange Act)2 have become the cornerstone of a federal common law of corporations.3 Recently there has been expansive use of the rule to afford a private civil remedy for a "defrauded"4 buyer or

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4. A securities "fraud" is quite different from common law fraud. Broadly, any
seller of securities. The right to sue for either damages or rescission was not explicitly given by the statute or the rule, rather it has been implied by the courts. The dimensions of this new judicially created right of action are still developing on a case by case basis. Each court which has a securities fraud question before it, reads into the right of action under Rule 10b-5 the elements of proof, restrictions, allowable plaintiffs and defendants which it deems appropriate. Precedent from common law actions of fraud are largely disregarded, for the right to sue emanates from a federal statute. Hence the courts are free to mold, at their pleasure, the right of action and remedy. The result has been that each circuit court of appeals has interpreted the rule differently, creating a lack of uniformity and a confused area of law.

In the Securities Act of 1933, Congress declared a standard of full disclosure in the distribution of securities to the public. Congress armed itself with weapons to insure compliance with its command "Thou shalt disclose the whole truth" when preparing a registration statement—the corporate picture which is presented to the public in a public offering of securities. In addition to the criminal penalties provided by the Act, the SEC could impose certain administrative sanctions, investigate, and sue for injunctions in a federal court. Moreover, three carefully drawn statutory civil remedies were created to deter practices of nondisclosure or misrepresentation in connection with the sales of securities. The first part of this note will discuss how the "implied" remedy under Rule 10b-5 often allows a plaintiff to completely disregard the restrictions placed upon the express civil remedies made available to him by Congress in favor of a loosely defined, judicially created right of action. It will reexamine the basis of the Rule and observe the inconsistencies between the implied right of action and the express statutory remedies.

The surge of actions brought under Rule 10b-5 has
presented a dilemma which the courts have recognized in dictum if not in decision. Never before have there been so many potential plaintiffs for actions under Rule 10b-5. As the scope of what constitutes a violation of the rule broadens, accordingly, the group in which a plaintiff may be found grows. The courts have yet to place any express limits on this group. Never before have there been so many potential defendants for a Rule 10b-5 action. As the variety of ways in which a violation may occur increases, accordingly, the group of potential defendants expands. The failure of the courts to place express limitations on the rights of plaintiffs presents the possibility of the imposition of excessive, and sometimes even double liability on violators of Rule 10b-5, and may foster unnecessary litigation. The second part of this note will demonstrate this unlimited growth of potential plaintiffs and defendants by examining recent cases in the area of insider conduct. These cases, primarily involving brokers who are representative of defendants, fully illustrate the dilemmas created by the courts’ decisions.

I. Buyer’s Private Actions

At the outset it must be observed that securities are a unique commodity requiring unique regulation. Corporate securities increasingly represent a substantial part of the life savings of the average man; it is becoming quite common for an American to own a proprietary interest in one or more corporations. The restoration of public confidence in the securities market after the stock market crash of 1929 was an underlying policy of the federal securities act. Common law actions, such as deceit and rescission were generally not adequate to handle the

9. See Fleischer, supra note 3, at 1174-75.

10. The classical common law tort action for deceit was an intentional misrepresentation of a material fact which caused damage to the plaintiff who justifiably relied on it. In many jurisdictions the action has been modified in various ways. For example, some jurisdictions allow an action for negligent misrepresentation, although the persons to whom the defendant is liable is more strictly limited. See Ultramares Corp. v. Touche, 255 N.Y. 170, 174 N.E. 441 (1931) (accounting firm not liable for negligent misrepresentation to unspecified third parties whom they did not authorize the receipt of information contained in accounting statement). See W. Prosser, Law of Torts §§ 100-02 (3rd ed. 1964).

11. Simply stated, the elements for rescission are a misrepresentation of a material fact upon which the plaintiff relied. The underlying principle of the action is that a seller should not be permitted to unjustly enrich himself in the sale of an item which he misrepresents, whether innocently, negligently, or intentionally. The misrepresentation
peculiarities of securities "swindles" on a national scale. In order to fill this void Congress created civil remedies in the Securities Act which were more appropriate to securities fraud.

A. The Express Statutory Remedies

The overall purpose of the Securities Act was to protect the investing public, without unduely hampering honest business transactions. Three express civil remedies were afforded the buyer of securities.

Section 11 provides liability for a false registration statement that has become effective. It is based upon the common law action of deceit, with some significant changes. Generally, a section 11 suit requires an allegation that a registration statement contains a misrepresentation of a material fact, and that the plaintiff bought securities which were the subject of the registration statement. Further, the plaintiff must prove that the action was brought within the short statute of limitations. Specifically, the limitation is one year from the...
discovery of the misstatement or when such discovery should have been made in the exercise of reasonable diligence, with a maximum of three years after the security has been offered to the public. The investor need not prove reliance upon the false statement unless he acquired the security after one year from the date of the registration statement and the issuer had made available an earnings statement for the previous 12 months.

Section 11 holds those persons who were responsible for, participated in the preparation of, or signed the registration statement liable for, negligent misrepresentations. It also shifts the burden of proof of due care to the defendants. In effect, the statute creates a duty in the defendants to make a reasonable investigation of the facts represented in the registration statement so as to not mislead the investing public. However, there are specific defenses available to these defendants, and the allowable damages are limited and intricately defined.

Section 12(2), the general civil liability section, is essentially a modified version of the common law remedy of rescission. It allows the investor to recover the purchase price from his immediate seller for a misrepresentation of a material

23. The class of prospective defendants includes: the issuing corporation, officers who sign the registration statement, all directors, experts (e.g., accountants, engineers, appraisers), and underwriters, 15 U.S.C. § 77k(a) (1964).
24. All defendants have this affirmative defense except for the issuer. 15 U.S.C. § 77k(b)(3) (1964).
25. E.g., a defendant is immune from liability if he had properly resigned from his office prior to the effective date of the registration statement and advised the Commission of such action; another defense is that the plaintiff knew of the misleading statement. 15 U.S.C. § 77k(a), 77k(b)(1) (1964).
26. Damages may be briefly summarized as follows: Section 11(e) provides that the maximum recovery of such damages shall be the difference between the amount paid for the security (not in excess of the public offering price) and (1) the value of the security as of the time the action is brought, or (2) the price at which the security was sold in the market before suit, or (3) the price at which the security was sold in the market after suit but before judgment “if such damages shall be less than the damages representing the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and the value thereof as of the time suit was brought.” (citations omitted).
28. 3 L. Loss, supra note 8, at 1700.
29. Liability is also imposed upon those in a “control relationship” to the seller. 15 U.S.C. § 77o (1964).
fact in a sale or offer where the mails or other interstate means of communication are used. It includes, but is not limited to, securities sold pursuant to a public offering that were required to be registered. Hence a security sold from an offering circular under a Regulation A exemption could be the subject of a rescission-type section 12(2) action. While privity of contract is required, neither reliance nor scienter are part of the plaintiff's burden of proof. Upon tender of the security, a buyer may recover his consideration plus interest, less any income he received therefrom. If the buyer no longer holds the security, he may recover damages equivalent to the purchase price less the price at which he sold it. Hence, the buyer is better off using section 12(2) than the common law action of rescission.

Section 12(1), the third civil liability section, imposes almost absolute liability for improper registration and is similar to section 12(2) in the relief granted.

Although Congress enacted new civil remedies which were more liberal than the common law forms of recovery, they counterbalanced these remedies with procedural impediments. The intricate features of section 11 make this observation all the more evident. While sections 11 and 12(2) place the burden of due care on the defendants and delete some of the common law elements of proof required for rescission or deceit, certain restrictions upon recovery are imposed which amount to a

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31. There are two exceptions to the privity requirement—controlling persons, and possibly aiders and abettors. 3 L. Loss, supra note 8, at 1704, 1712-20.
32. Id. at 1702, 1704.
34. Id.
35. For example, buyer need not prove that he relied on the misstatement; if he no longer owned the security, he could still recover damages, and the privity requirement was relaxed. 3 L. Loss, supra note 8, at 1702-04.

But, there were several disadvantages to the use of section 12(2). The defendant-seller had an affirmative defense which was not available at common law rescission—that he did not know or in the exercise of reasonable care could not have known of the untruth or omission; the buyer must prove "materiality," even for intentional misstatements or omissions of the defendant, also not required at common law rescission; use of interstate facilities or mail used in connection with the fraud must be proved by the buyer. This last requirement would often be the buyer’s nemesis, relegating him to his state remedies. Id. at 1704, 1705.
37. 3 L. Loss, supra note 8, at 1693.
separate code of procedure. In section 11 several defenses are specified. Damages are limited and specific in both sections 11 and 12. The plaintiff must allege that he brought his section 11 or section 12 suit within the short period allowed by statute. The trial judge now is given the discretionary power to require a bond from either the plaintiff or defendant. If the litigant's suit is without merit, the security can be used as liability against him to pay for his adversary's costs of the suit, including reasonable attorney's fees. Generally, these statutes provide the investor with a less difficult cause of action and a federal forum. Prospective defendants (the issuers, underwriters, brokers, directors, etc.) on the other hand are accommodated with not only the procedural safeguards mentioned above, but also a fair warning as to what conduct is forbidden.

The civil liability sections seem to afford a certain degree of predictability—a jurisprudential virtue. Prior to 1949, there was general agreement that the express civil liability sections provided exclusive relief for the defrauded buyer. However, the courts have permitted recovery for the buyer by implying liability for violation of the substantially similar section 17(a) of the Securities Act and Rule 10b-5.

39. The statute of limitations, paraphrased in the text at note 24, applies to both § 11 and § 12(2). The limitation for § 12(1) is somewhat different. 15 U.S.C. § 77m (1964). See H. Soward, supra note 17, at § 9.05.
40. 15 U.S.C. § 77k(e) (1964). This provision is made applicable also to actions under section 12. 3 L. Loss, supra note 8, at 1727, 1836-42.
41. Id.
42. However, quaere how predictable will the courts be in view of the interpretation given to the section 11 defense of a reasonable investigation in Escott v. BarChris Constr. Corp., 283 F. Supp. 643 (S.D.N.Y. 1968) (all defendants were held liable for a misleading registration statement, including one "outside" director who had been with the corporation for less than a month). See Heller, Comment BarChris: A Dialogue on a Bad Case Making Hard Law, 57 Geo. L.J. 221 (1968); Note, BarChris, Due Diligence Refined, 68 Colum. L.J. 1411 (1968); 45 Notre Dame Lawyer 123 (1968); Note, 47 Texas L. Rev. 162 (1968).
43. In 1949 for the first time an implied right of action for a buyer was permitted in Osborne v. Mallory, 86 F. Supp. 869 (S.D.N.Y. 1949).
45. Prior to 1949 section 17(a) of the Securities Act [15 U.S.C. § 77q(a) (1964)] "had unvaryingly been regarded only as the basis for criminal and injunctive proceedings under section 20 [15 U.S.C. § 77t (1964)] of the 1933 Act and administrative
B. The Kardon Doctrine—Implied Liability for the Defrauded Seller

While the disclosure procedures in the Securities Act appear to provide adequate relief to a buyer, no corresponding protection is afforded to defrauded sellers. The primary purpose of the SEC in promulgating Rule 10b-5, which outlawed a broad range of deceptive conduct, was to close this gap. Although the proceedings against broker-dealers under section 15 [15 U.S.C. § 78o (1964)] of the 1934 Act, supra note 44, at 1034 (footnotes omitted).

Buyers tend to use Rule 10b-5 more than section 17 because of the wealth of case law on the former. But, after Globus v. Law Research Service Inc., 287 F. Supp. 188 (S.D.N.Y. 1968) this may no longer be true, as punitive damages are available under section 17(a) but not Rule 10b-5. Regardless, anything said of Rule 10b-5 would generally be applicable to a section 17(a) suit.

46. Section 17(a) of the Securities Act makes it unlawful in the offer of securities by mail or interstate means:

(1) to employ any devise, scheme, or artifice to defraud, or
(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
(3) to engage in any transaction, practice or course of business which operates or would operate as a fraud or deceit upon the purchaser.


In 1942 the SEC adopted Rule 10b-5 under the authority of § 10b of the Exchange Act which said:

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 . . . [t]o 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 (emphasis added).


As one writer observed:

Rule 10b-5, with minor changes and one major change, simply repeated section 17(a) of the 1933 Act. The major change, and the one which motivated the adoption of the rule, was the application of those protections to the sellers of securities as well as the buyers.

Sommer, supra note 44, at 1033-34 (footnotes omitted).

Rule 10b-5 reads:

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

(a) To employ any device, scheme or artifice to defraud,
(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading or
Exchange Act contains express provisions for civil liability,\textsuperscript{47} Rule 10b-5 does not expressly authorize private actions by sellers. It was not difficult, however, for the court in \textit{Kardon v. National Gypsum Co.}\textsuperscript{48} to deduce from the rule a right for a defrauded \textit{seller} of stock to sue the buyer. The action was brought by two former directors (father and son) of a closed corporation against two other directors (brothers). The brothers allegedly conspired to induce the father and son to sell their shares to the brothers by fraudulently representing that no negotiations were pending for the sale of the assets of the corporation when in fact there had been. The securities were not the subject of a public offering, nor was a stock broker used.

Judge Kirpatrick justified the implied action from Rule 10b-5, upon two theories. The first ground was a statutory tort theory, contained in the Restatement of Torts § 286 (1934). The court announced that a violation of a legislative enactment by doing a prohibited act or by failing to do a required act rendered the actor liable for invading the interests of another\textsuperscript{49}—provided that:

(a) the intent of the enactment is exclusively or in part to protect an interest of the other as an individual; and
(b) the interest invaded is one which the enactment is intended to protect . . . .\textsuperscript{50}

The alternative rationale was a void contract theory. Section 29(b) of the Exchange Act\textsuperscript{51} provided that contracts in violation of any provision of the act shall be void. The court observed that this provision would be of little value unless an action for damages, as well as rescission, was allowed.\textsuperscript{52} The remedy awarded in \textit{Kardon} was “an accounting to ascertain and restore to the plaintiffs their proportionate share of profits, if any.”\textsuperscript{53}

Finding a right to sue the defendants in \textit{Kardon} appears

\textsuperscript{47} 17 C.F.R. § 240.10b-5 (1968) (emphasis added).
\textsuperscript{48} 15 U.S.C. §§ 78i(e), 78p(b), 78r(a) (1964).
\textsuperscript{50} 69 F. Supp. at 513.
\textsuperscript{51} RESTATEMENTS OF TORTS § 286 (1934).
\textsuperscript{52} 15 U.S.C. § 78cc(b) (1964).
equitable when limited to the facts of the case. The complaint alleged a conspiracy to purchase fraudulently the shareholder’s stock for less than its true value. The Rule 10b-5 action allowed the sellers, who were not otherwise covered by an express civil liability provision, a forum in a federal court with interstate service of process and an advantageous venue requirement. Further, the difficult elements of proof for rescission or deceit at common law were parried by using Rule 10b-5 as a basis for a judge-made version of the common law actions.

The underlying basis for a right of action implied from Rule 10b-5 has not been elucidated by the courts since Kardon. If any rationale is offered, most courts adopt the statutory tort theory.\(^5\) It appears that the courts need the tort theory to justify the inclusion of defendants who are not in privity of contract with the plaintiff.\(^5\) Hence, the void contract theory would not provide the justification for an action where something more than rescission is sought.\(^6\)

C. Ellis v. Carter—Implied Liability for the Defrauded Buyer

Once the door was opened to the defrauded seller for a judicially created private right of action in Kardon, the buyer was quick to seize upon it and ask for parity. Indeed, it would be difficult for a court to deny the plaintiff-buyer such a right in

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\(^5\) A. Bromberg, supra note 3, at § 2.4(1)(a).

\(^5\) E. Gadsby, 11A BUSINESS ORGANIZATIONS. SECURITIES REGULATION, THE FEDERAL SECURITIES EXCHANGE ACT OF 1934, at § 5.03(1)(a).

\(^6\) The Supreme Court in J.J. Case Co. v. Borak, 377 U.S. 426 (1964), did not clarify what the basis was for implied liability when it determined there was such a right of action for a violation of the proxy rules of the Exchange Act. The Supreme Court’s explanation for implied liability was that it was "the duty of the courts to be alert to provide such remedies as are necessary to make effective the Congressional purposes." Id. at 433. There is some speculation that the Supreme Court would probably uphold implied liability under Rule 10b-5 if it were presented with the issue, based on the result of the Borak case. A.B.A. National Institute, "The BarChris Case: Prospectus Liability." 24 BUS. LAWYER 523, 567 (Ruder) (1969). Professor Loss observed,

The opinion, as I read it, doesn’t say very much except that private rights of action will be implied when they are necessary to the achievement of the statutory objective.

In short, if I may say so with great respect, the Supreme Court in Borak reached the right result not for the wrong reason but for no reason at all. Surely the Court did not so much as breathe the one doctrine that most of us thought was at the bottom of all this development of implied private rights, namely, the doctrine in tort law that certain crimes are torts.

Id. at 532 (Loss).
light of the wording of Rule 10b-5: "It shall be unlawful for any person . . . [to do the prohibited acts] in connection with the purchase or sale of any security." If a court bases implied liability upon the intent of Congress, then the inclusion of the words "or sale" would clearly indicate that Congress likewise intended that the buyer should reap a benefit from the Rule. However, if the buyer is allowed a Rule 10b-5 action, there arises the problem of what to do with the restrictions which Congress had placed as a condition for obtaining relief in the express civil liability sections.

Ellis v. Carter illustrates the dilemma. The case involved an alleged oral communication by Carter, chairman of the board of Republic Pictures Corporation, to Ellis, representing that the sale of a certain number of shares would carry with it a voice in the management of the corporation, which in fact it did not. Although Ellis had an express remedy available to him in section 12(2), he based his amended complaint solely upon Rule 10b-5. The court was faced with the decision of whether or not Ellis should be allowed to use the judicially created remedy under Rule 10b-5, thereby avoiding the restrictions of section 12(2). In considering this anomalous situation the court saw four possible alternatives.

The first alternative was to disallow a civil action to either buyer or seller under 10b-5. This was the state of affairs between 1942, when the Rule was promulgated, and 1946, when the Kardon decision was rendered. One reason in support of this choice was that the Securities and Exchange Acts were too closely drafted in point of time to permit an implied remedy in addition to the ones expressly made available in sections 11 and 12 of the Securities Act and sections 9(e), 16(b), and 18(a) of the Exchange Act. However, this left the defrauded seller with no civil remedy under either act. The court felt that this was an untenable position because it seemed inconsistent with the overall purpose of the Acts, and unfairly drew a distinction between the buyer and seller.

The second possible solution espoused in Ellis was to permit sellers but not buyers to sue under the Rule. Two courts had
previously adopted this position in *Rosenberg v. Globe Aircraft Corporation*60 and *Montague v. Electronic Corporation of America*.61 In *Rosenberg* the same judge who decided *Kardon* denied the buyer an implied right to sue under Rule 10b-5 when relief under section 11 of the Securities Act was available to him. The court in *Rosenberg* reasoned that the Securities and Exchange Acts were *in pari materia* and must be construed together in order to have a consistent whole. Congress carefully measured the relief it intended to give the buyer in sections 11 and 12. It counterbalanced the relatively easy-to-prove actions with an intricate system of defenses and restrictions. If a buyer were allowed to plead an action under Rule 10b-5 when he had an express remedy available, he would avoid the restrictions which Congress had placed as a condition for obtaining relief. Certainly Congress did not intend to casually nullify these restrictions when it enacted section 10b of the Exchange Act.62

The court in *Montague* reached the same conclusion via a different rationale. It applied the rule of statutory construction that if there is a general and a specific statute covering the same situation, the specific will govern. Section 11 was a specific civil remedy, while Rule 10b-5 was a general provision outlawing a great variety of misconduct. Therefore, the specific remedy afforded was deemed the exclusive means of relief. Thus *Montague* refused to permit the plaintiff-buyer to avoid an undertaking of $15,000 by merely pleading a cause of action under Rule 10b-5.63

To these arguments *Ellis* responded that Rule 10b-5 was expressly made applicable to buyers as well as sellers. There is no good reason, declared the court, why Congress would want to restrict buyers to the limited remedies of the Securities Act while giving sellers unrestricted civil remedies under Rule 10b-5.64

The third choice posed by *Ellis* was to permit both buyers and sellers to sue under Rule 10b-5, but to make the restrictions of the Securities Act applicable to the buyer. Although this would avoid the anomaly of giving the buyer a less restricted

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62. 80 F. Supp. at 124.
63. 76 F. Supp. at 936.
64. 291 F.2d at 273.
remedy under Rule 10b-5 than he had under the Securities Act, it would in effect give him no right under the Exchange Act, leaving an unexplained distinction between buyers and sellers. No courts have followed this alternative.

The fourth choice, which was adopted by Ellis, was to permit both buyers and sellers to sue under the Rule, free of the restrictions of the Securities Act. The court explained:

While it assumes that Congress in 1934 undid what it carefully did in 1933, it avoids judicial rewriting of the 1934 act to include procedural provisions which appear only in the 1933 act. As between two acts which deal with the problem, it permits the most recent enactment to govern.65

The procedural safeguards for a section 12(2) suit which Ellis would avoid by pleading a Rule 10b-5 action were: (1) the allegation that he did not know of the untruth or omission himself; (2) the defendant’s affirmative defense of lack of knowledge that the statement was untrue or misleading; (3) the short statute of limitations of section 13 (under an implied action the State statute of limitations is used); and (4) the discretionary undertaking allowed the trial court under section 11(e) was not applicable. Although the rationale used in Rosenberg and Montague has found favor with many writers, the weight of authority is with Ellis thus granting the buyer relief under the Kardon doctrine, as an additional remedy.66

D. The Added Ingredient of Fraud

Although Ellis cited Fischman v. Raytheon Manufacturing Co.67 as authority for permitting a buyer to use the Kardon

65. Id. at 274.
66. See A. Bromberg, supra note 3, at § 2.4(2). An occasional attempt is made by a district court to deny a 10b-5 action when an express remedy is provided the plaintiff in the Securities Act. E.g., Jordan Bldg. Corp. v. Doyle, O’Connor & Co., 282 F. Supp. 87 (N.D. Ill. 1967) (buyer denied a 10b-5 action when section 12(2) of the Securities Act was available to him). But the attempt was in vain as the Seventh Circuit fell in line with the weight of authority, reversing the decision. Jordan Bldg. Corp. v. Doyle, O’Connor & Co., 401 F.2d 47 (7th Cir. 1968) (based on Congressional intent, the express remedies and implied 10b-5 action are cumulative, not mutually exclusive). This rationale appears questionable when the result of some cases allows the plaintiff to subvert the express intent of Congress by riding roughshod over the restrictions. E.g., Dack v. Shannon, 227 F. Supp. 26 (S.D.N.Y. 1964) (buyer slept on his rights for three years and was barred by a section 12 action, but was allowed to plead an implied section 17(a) action by using the New York six year statute of limitations).
67. 188 F.2d 783 (2d Cir. 1951).
doctrine, it overlooked that holding as a fifth possible alternative. The plaintiffs in *Fischman* were preferred and common shareholders who allegedly were fraudulently misled by material contained in a registration statement only for the sale of the preferred stock. The district court dismissed the action as to the common shareholders because (1) the prospectus was only for preferred shares and therefore they had no section 11 action, and (2) section 11 specifically gave a new remedy for a specific type of misconduct for which the common shareholders were not in the class protected. Therefore, Rule 10b-5 could not be used to include them by implication. The Second Circuit Court of Appeals reversed, giving the common shareholders an implied right to sue under Rule 10b-5, primarily for the same reason stated in *Kardon*. That is, the common shareholders would otherwise be without a federal remedy.

It should be noted, however, that the common shareholders did have an express remedy available to them under section 12(2) of the Securities Act. That the court did not explain why a Rule 10b-5 action should be given in addition to what was provided by Congress, was probably due to poor advocacy.

The court in *Fischman* found that there was no conflict in the overall statutory scheme by making the *Kardon* doctrine available to the buyer when a misrepresentation was intentional. According to the court, section 11 was aimed at negligent misrepresentations. "[W]hen, to conduct actionable under § 11 of the 1933 Act, there is added the ingredient of fraud, then that conduct becomes actionable under § 10b of the 1934 Act and the Rule [for] any defrauded person, whether or not he could maintain a suit under § 11 of the 1933 Act."

The inherent weakness in *Fischman* is that Rule 10b-5 does not on its face limit the outlawed conduct to intentional misrepresentations. Note that Rule 10b-5(a) speaks in terms of a "device, scheme or artifice to defraud." Rule 10b-5(c) speaks in

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69. See 188 F.2d at 787.
70. See 3 L. Loss, *supra* note 8, at 1783 n.335.
71. 188 F.2d at 787 (footnotes omitted). Likewise the court in dictum observed that a suit under section 17 of the Securities Act was free of the restrictions of a section 11 suit, provided the plaintiff adds allegations of fraud. *Id.* at 787 n.2. This started a trend of using section 17(a) and Rule 10b-5 interchangeably.
terms of an "act, practice, or course of business which operates or would operate as a fraud or deceit."\footnote{73} However Rule 10b-5(b) does not appear to require knowledge of a misstatement as a requisite to finding a violation:

[It shall be unlawful] to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statement made, in light of the circumstances under which they were made, not misleading . . . \footnote{74}

Though presently unrealized, the vast potential for civil liability lurks in subparagraph (b) of Rule 10b-5.\footnote{75} Based on its express wording, a negligent misrepresentation may be actionable. Some courts, following the lead of Ellis, take the rule at face value and require no proof of "scienter."\footnote{76} Other courts favor the Fischman theory of requiring that the plaintiff prove some form of knowledge, at least a reckless disregard of the facts from which knowledge of the misleading statement could be imputed.\footnote{77} These courts "read into" subparagraph (b) the ingredient of fraud,\footnote{78} otherwise, it would be ultra vires of the authority granted the SEC by section 10b of the Exchange Act.\footnote{79} Such an interpretation permits a court to resolve the anomalies posed by Ellis under the pretense of fulfilling the overall purpose of the two acts. Where only negligent misrepresentations are alleged, the express civil liability provisions would be the buyer's exclusive remedy.\footnote{80} Where intentional misrepresentations are alleged the plaintiff would have the option of choosing the express or the implied right of action.\footnote{81} This bit of judicial restraint on the Rule 10b-5 action at least lends some symmetry to the statutory scheme of the federal securities acts, and thus gives some meaning to the restrictions of the Securities Act.

\footnote{73} Id.
\footnote{74} Id.
\footnote{75} See A.B.A. National Institute, supra note 56, at 613, 614 (Kaplan).
\footnote{76} For the split of authority, see A. Bromberg, supra note 3, at §§ 2.4(2), 2.6(1); E. Gadsby, supra note 55, at § 5.03[1][d].
\footnote{77} Trussell v. United Underwriters, Ltd., 228 F. Supp. 757, 772 (D. Colo. 1964); 3 L. Loss, supra note 8, at 1766.
\footnote{79} See note 77 supra.
\footnote{81} Id.
E. Punitive Damages

In 1968 a new anomaly was added to the list that the courts had already created. In *Globus v. Law Research Service, Inc.* punitive damages were allowed against the president of the issuing company and its underwriter, where a Regulation A exemption from the registration requirement of section 5 had been utilized. The plaintiffs, 13 purchasers of common stock in Law Research, alleged that they had bought the speculative stock in reliance on the description in the offering circular of a key contract with the nationally known Sperry Rand Corporation. The contract was obviously an attractive feature to an investor, as Sperry Rand was to perform vital services for Law Research. The offering circular failed to disclose the fact that Sperry Rand terminated the contract and that Law Research had commenced a suit against them for performance. Because the president had knowledge of these facts and failed to disclose them in the offering circular, punitive damages were assessed against him. His conduct perpetrated a gross fraud upon the public. Since knowledge of the lawsuit was imputed to the corporate underwriter, it was held liable as an aider and abettor of the fraud. Punitive damages were justified on two grounds: (1) as a deterrent against one who had deliberately and wantonly engaged in a far-flung fraudulent scheme, systematically conducted for profit, and (2) as an effective remedy for those who had only a small claim for compensatory damages.

Clearly, the Exchange Act does not allow punitive damages. But the plaintiffs wisely claimed relief under both Rule 10b-5 of the Exchange Act and section 17(a) of the Securities Act. The court reasoned that because the Securities Act did not prohibit punitive damages, then apparently Congress intended to permit them.

*Globus* failed to specify whether state or federal law supplies the standard for imposing punitive damages. If federal law is used, it would provide a uniform standard. However, if state law

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82. 287 F. Supp. 188 (S.D.N.Y. 1968).
84. 287 F. Supp. at 194, 195.
is used within a federal structure, a legal morass would result from the variations of conduct deemed sufficiently blameworthy to award punitive damages. However, by implication, the law of the State would probably be controlling if Globus is followed elsewhere, because a New York case regarding punitive damages was consistently cited throughout the opinion.

Globus reaches the apex of unexplained anomalies by giving the buyer a distinct advantage over the defrauded seller who may only sue under the Exchange Act. Remember that prior to the Kardon doctrine it was assumed that the buyer had no implied right of action under section 17(a), and it was only through the express wording of Rule 10b-5 that the defrauded buyer was given parity. Now the buyer has been afforded an even greater advantage by suing under section 17(a). Globus is now on appeal to the Second Circuit Court of Appeals. It is unlikely that it will be reversed. The courts have not been concerned with the entire statutory scheme of the federal securities acts, failing to look at them as one statute. Each court seems to create new law which it believes is appropriate for the particular case before it. Globus is an excellent example. The probable impact of the case on future section 11 actions is uncertain, but it clearly provided incentive for a buyer to plead under Rule 10b-5 in lieu of or in addition to a section 11 action.

One case has already held that when "the added ingredient of fraud" is present in a misleading registration statement (which would normally be actionable only under sections 11 or 12) then an implied action would lie under Rule 10b-5. Whether Rule 10b-5 can be plead in lieu of section 11 for the negligent preparation of a registration statement eventually will be decided in the Ninth Circuit where "scienter" is not required for a Rule 10b-5 action (following Ellis precedent). This will be the supreme test of backdoor jurisprudence: Will the courts circumvent what the draftsmen of the federal securities law so carefully prescribed in limiting the civil liability sections?

87. See text accompanying note 44 supra.
89. See Henkel, Codification—Civil Liability Under the Federal Securities Laws, 22 Bus. LAWYER 866 (1967). Professor Jennings indicates that Montague should be followed in refusing to permit a plaintiff to bypass section 11 in favor of Rule 10b-5. Id. at 878. Professor Loss states that "until the Supreme Court says otherwise—that section 11
Undoubtedly, the recent cases of Escott v. BarChris Construction Corp. and Globus reflect judicial concern with the contemporary lax attitude in preparing a registration statement or a "junior registration" (offering circular) required by a Regulation A exemption. Certainly protection of the purchasing public can be achieved only by impressing upon promoters of public offerings their responsibility to disclose the whole truth when placing before the public a document which purports to fairly represent a corporation's past performance. But "it must be recognized that the general welfare of the country depends upon a viable and vigorous business community." The uncertainty of who is liable for what under Rule 10b-5 may well have an adverse effect on the viability of the entire securities field. The anomalies that have developed with the application of the Kardon doctrine to the buyer make it evident that a reconstruction of Rule 10b-5 is essential in order to restore some semblance of order and consistency to the federal securities law. The burden should fall upon the SEC, to whom Congress has delegated the authority, to promulgate rules which would meet the complex problems in this area.

II. Insider's Conduct

A. Is It Really All That Bad

Before discussing the extent of liability for insider trading, it is appropriate to point out that such conduct is not uniformly condemned. While admittedly the trend of comment is the other way, one argument in support of that practice is found in Henry

\footnote{90. 283 F. Supp. 643 (S.D.N.Y. 1968) (in a section 11 suit, varying standards of reasonableness of investigation of facts put into the registration statement were imposed on the underwriters, directors, officers and experts, depending on how close they were to the facts).

91. In an investigation of the securities market by the SEC in 1963, it was discovered that many of the newer, inexperienced underwriters undertook no investigation prior to sponsoring a new issue. S.E.C., REPORT OF SPECIAL STUDY OF SECURITIES MARKET OF THE SECURITIES AND EXCHANGE COMMISSION, H.R. Doc. No. 95, Part I, 88th Cong., 1st Sess. 513 (1963). See also, A.B.A. National Institute, supra note 56, at 554.

92. Ruder, supra note 3, at 208.

93. See A. Bromberg, supra note 3, at § 2.3; Henkel, supra note 89, at 871.

94. See note 47 supra.}
G. Manne's *In Defense of Insider Trader*. Professor Manne insists that the courts and commentators have taken too narrow a view of what is more than a mere legal problem, but is in fact a legal-economic dilemma going to the very heart of the system of corporate capitalism. Manne's analysis revolves around such basic questions as: who really gains and loses from insider trading; what are the long run consequences of disallowing insider trading; and can such trading feasibly be prevented? Manne concludes not only that the market is rarely significantly affected by insider trading, but that the average investor, whom the SEC assertedly seeks to protect, is generally unaffected by it. The speculator or trader to whom the SEC is less solicitous is normally the one dealing with the insider, and therefore is the party usually affected.  

While Manne's advocacy of insider trading is not conclusively persuasive, (he fails to expressly challenge the pervasive belief that all investors should have equal access to knowledge of material facts) he does present the contrary viewpoint of a practice that has been summarily declared to be undesirable. As Professor Manne states:

In the entire literature on insider trading there does not exist one careful analysis of the subject. . . . [M]ost lawyers do not have the skills to develop a careful economic analysis . . . . The tone of the debate has remained essentially moralistic and question begging. Logic has been totally lost to emotion.

Further, even if the undesirability of the practice is conceded, the authors are not persuaded that the effect of this practice warrants establishing such far-reaching liability as found today. The call is heard from writers and the courts that the investor is in need of protection. But as Professor Manne asks,

96. Id. at 114, 115. Manne reaches this conclusion from the premise that traders do not act on so-called fundamental factors, but rather on recent changes in the price of a security.
97. While not expressly rejecting this belief, Manne argues that in fact inside trading is the only way to adequately compensate the entrepreneur. While admittedly this is at the expense of some investor, that is not to say the investor was injured by the transaction. Arguably this is no different than compensation in salary comprising part of the cost of goods sold and thereby being passed on to a consumer.
99. *But see* San Diego Union, March 9, 1969, at H-11, col. 1. Some suggest
is the impact of insider trading really that significant? In terms of dollars or number of shares traded the actual effect insider trading has on either the market or private investors is questionable. Courts apparently prefer to view investors as “admittedly fully informed” purchasers of a company’s stock. A more reasonable and practical assumption would seem to be that the investor knows there are people in the market with knowledge superior to his, some due to their positions as insiders; he then enters into transactions assuming that degree of risk. Regardless of whether insider trading is really undesirable, or whether its effect is de minimus, a practical analysis of today’s problem must start from the assumption of the courts, that such a practice is undesirable, harmful and should be eliminated.

B. Plaintiffs and Defendants Without Limit

The scope of the private right of action under Rule 10b-5 has been expanded purely on a case by case basis. As pointed out earlier, it began with Kardon.100 There have been subsequent inconsistencies in the decisions, even within the Second Circuit itself.101 While there are some standard explanations given for these inconsistencies, careful reading of the cases raises questions as to the validity of them.102

The varying views of the elements of an action under Rule 10b-5, some of which were discussed previously in relation to buyers’ actions, are a full study in themselves.103 In insider cases the complete absence of any privity requirement or other limiting factor for bringing an action under the Kardon doctrine has opened a Pandora’s box of plaintiffs. While there are some

100. See text accompanying note 48 supra.
101. 3 L. Loss, supra note 8, at 1767-69.
102. A good example of this is found in Judge Frank’s dissent in Joseph v. Farnsworth Radio & Television Corp., 99 F. Supp. 701 (S.D.N.Y. 1951) aff’d per curiam, 198 F.2d 883 (2d Cir. 1952). Judge Frank seeks to restrict the applicability of the decision in Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir. 1952), by pointing out that in Birnbaum neither party was a buyer or seller. A cursory reading of the decision however, will reveal that the court made its decision, requiring some semblance of privity to bring an action under Rule 10b-5, based purely on what they considered to be the express legislative intent at the time of promulgation of the rule.
103. See note 10 supra.
disturbing ramifications to this prospect alone, some recent decisions have further increased the list of potential defendants. One of the most alarming and far-reaching cases is the controversial SEC v. Texas Gulf Sulphur Co.\footnote{104} The holding of the Second Circuit in Texas Gulf Sulphur has been examined and re-examined, and written about extensively. To be sure the end is not in sight. For the purposes of this discussion a summary of how the court substantially expanded the liability of insiders in the area of nondisclosure is pertinent.

First, the court expanded the definition of what constitutes a material fact that must be disclosed. This is found in the court's version of the test of materiality that rejects a "conservative investor" rule which by its nature had limited "material" to a more reliable degree of information\footnote{105} (i.e. a conservative investor would tend to disregard more speculative information). Second, there was an expanded definition of who is an insider. Now it is unnecessary to be in any class in particular (e.g. corporate officer); you need only possess the type of information that is deemed to be material.\footnote{106} Third, the court imposed a duty on an insider not only to make a public disclosure, but also to delay trading for an even longer period to allow the information disclosed to be absorbed by the public.\footnote{107} Finally, it was held that "tipping" is a violation as well as trading, if disclosure is not made. A "tipping" violation relates not only to the liability of the tippor, but also to the tippee who subsequently participates in a transaction.\footnote{108}

The results of the expanded boundaries of liability under the Texas Gulf Sulphur decision are: (1) creation of a greater number of people who may become defendants in the categories of either insiders, tippors or tippees; (2) dissemination of more information the use of which may cause one of these defendants to be liable; and (3) the making of heretofore non-culpable conduct with regard to this information a new basis for liability.

\footnotesize{\bibliographystyle{chicago}
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104. 401 F.2d 833 (2d Cir. 1968).
105. Id. at 849.
106. Id. at 848.
107. Id. at 853, 854. Coates v. S.E.C. 401 F.2d 833 (2d Cir. 1968) petition for cert. filed, 37 U.S.L.W. 3255 (U.S. Jan. 3, 1969) (No. 897). Director Coates is contending that there is no such duty to wait, and further that Rule 10b-5 does not provide an ascertainable standard of conduct as required by the Fifth Amendment.
108. 401 F.2d at 853.}
C. Recent Cases of Insider Trading and Failure to Disclose

Bearing in mind the wide realm of potential plaintiffs and growing number of potential defendants, a look at current actions begins to show the disturbing result if the theories are carried to their logical end. There are numerous dilemmas posed by recent cases. The scope of this discussion, however, will be limited to the need to restrict the number of plaintiffs who could bring an action under Rule 10b-5.

One such action by the SEC under Rule 10b-5 was against a registered broker-dealer, Merrill, Lynch, Pierce, Fenner & Smith, Inc. Merrill Lynch was charged with providing selected customers with information about the future earnings of Douglas Aircraft Co. which allowed the selected customers to sell and sell short to their own gain. Merrill Lynch acquired this information by virtue of its position as managing underwriter for a proposed offering by Douglas of convertible subordinated debentures. Merrill Lynch waived public hearing and submitted an offer of settlement to the Commission which was ultimately accepted.

The bases claimed for the action brought against Merrill Lynch were the principles set forth in *In re Cady, Roberts & Co.* and *SEC v. Texas Gulf Sulphur Co.* The Commission

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109. It is arguable that these decisions may result in the broker no longer being able to serve the dual function of underwriter and broker. The broker's duties to his customers will conflict directly with his duties to fully disclose or abstain.

A similar and perhaps more distressing dilemma is that of the express trustee administering investments under a trust instrument. When he receives pertinent information, not yet disseminated to the market, from a broker or underwriter—is he not bound by his duty as trustee to use this information instantly in administering the trust? At the same time, he is certainly a tippee for the purposes of Rule 10b-5 and as such faces possible liability for performing his duties as trustee.


112. The sanctions offered by Merrill Lynch and agreed to by the S.E.C. were the suspension of activities of Merrill Lynch's New York Institutional Sales Office for 21 days, the suspension of activities of its West Coast Underwriting Office for 15 days, the censure of various Merrill Lynch executives and dissociation of some of those same executives for periods of from 21 to 60 days. CCH Fed. Sec. L. Rep. ¶ 77,629 at 83,351.

113. 40 S.E.C. 907, 911. The Commission in *Cady, Roberts* found a traditional duty to disclose material information imposed on corporate insiders. This duty comes into play when those with whom the insiders are dealing do not have this information
noted from their holding in *Cady, Roberts* that such advance information could not be utilized, and further concluded that the information was intended to be available only for a corporate purpose, not for anyone's personal benefit, because of the inherent unfairness to the uninformed remainder of the investing community. The Commission relied on the "disclose or abstain" guidelines set forth in *Cady, Roberts*, and the court's holding in *Texas Gulf Sulphur* that tipping of information to another for use in a securities transaction is a violation. The Commission maintained that the foregoing principles prohibited disclosure of the information by Merrill Lynch to selected persons, particularly in view of the fact that at the same time Merrill Lynch was effecting purchases of Douglas stock for other less favored customers.

Hearings presently being conducted by the SEC involving selected customers of Merrill Lynch (several institutional investors) promise to yield the first specific ruling on the extent to which a "tippee" may act on information received from an insider. Likewise, this may shed some light on the extent to which the tippor is liable for the actions of the tippee. The institutional investors are defending their conduct on a theory of dubious promise, that the information they were given was too inaccurate to qualify as "material." Since the test of materiality laid down by the *Texas Gulf Sulphur* decision rested on probable effect of the information rather than its accuracy, this approach seems desperate. The institutional investors also claimed that their actions were not the result of receiving the inside information, but were dictated by other factors such as the fact that Douglas' lower earnings had been rumored on Wall Street for three weeks before the public announcement. These factors will require a

which would affect their investment judgment. Not only did the Commission find the insider's failure to disclose a violation of anti-fraud provisions, but went further and found that if disclosure would be improper or unrealistic under the circumstances, the alternative is to forego the transaction.

114. 401 F.2d 833.
115. 40 S.E.C. at 911.
116. 401 F.2d at 852, 853.
119. See text accompanying note 105 supra.
difficult resolution of conflicting facts by the court involved, or an expansion of the "tippee's" duty to the extent of the real insider's duty (disclose or abstain). It is unlikely that the Commission would expect or even desire that the tippee disclose publicly information, the validity or accuracy of which he would be unable to ascertain. If that were so, the tippee would, and may, be left with the choice of abstain or violate. As will be seen, the Commission has no compunctions about placing parties in that position.121

A further aspect of the problem is typified by a suit recently filed in the U.S. District Court in Denver, by Financial Industrial Fund Inc., a Denver-based mutual fund, against Merrill Lynch and McDonnell Douglas Corporation.122 This case also grows out of the SEC action against Merrill Lynch. The fund claims a loss of just under $2 million on shares of Douglas stock purchased from Merrill Lynch as a result of "touting meetings" at which a favorable earnings picture was portrayed.123 Financial is charging the defendants with aiding and abetting violations of Section 10(b) of the Exchange Act and Rule 10b-5 in that, while the purchases were being effected, Merrill Lynch failed to disclose that Douglas in fact anticipated little or no profits. While handling the purchases for Financial, Merrill Lynch had advised other customers of the poor earnings prospects for Douglas enabling those customers to sell and sell short to their own gain. This is the first suit by a mutual fund arising out of the action against Merrill Lynch, although a number of private individual suits have been filed on charges that the tipping schemes to which they were not privy caused them losses. This case as well as the others mentioned, is based upon the theory discussed in Texas Gulf Sulphur—liability of the tippor for the profits made by the tippee.124

A further ramification of the action against Merrill Lynch is found in an unobtrusive footnote to the SEC's release regarding

123. Id. Financial claims to have purchased through Merrill Lynch 80,000 shares of Douglas stock on June 22 and 23, 1966 at approximately $89 a share. It sold the 80,000 shares from July 1 through 8, 1966 at an average price of $65 a share, sustaining a total loss of $1,969,226.00.
the settlement offer. The SEC stated that even if Merrill Lynch had disclosed to all of its customers, there still would have been a violation. If that had been done, all of Merrill Lynch’s customers would have had an unfair advantage over the remainder of the investing public. This is consistent with the theory of the cases thus far; but if Financial Industrial Fund is allowed to recover, such a judgment, in view of that footnote, could create a precedent for recovery by every person who bought Douglas during the period in question. It is here that a distinction between granting these persons a cause of action and, going further, allowing them a remedy of damages becomes critical.

Another expansion of enforcement under Rule 10b-5 is the SEC action recently settled involving Blyth & Company. This action was brought against Blyth for purchasing government securities with the benefit of inside information. The Blyth case is particularly important for two reasons. First, it is an affirmation of the principle set forth in Cady, Roberts, that when disclosure is improper or impossible, the insider must abstain from trading. Secondly, and more significant, it held that the anti-fraud provisions of Rule 10b-5 are applicable to government securities. The court found that the legal principles of Cady, Roberts, Texas Gulf Sulphur and Merrill Lynch were applicable to government securities as well as to all non-exempt securities. The information that the insiders possessed in Blyth was secret government information that could not be disclosed. This hard line by the SEC is indicative of what their attitude is likely to be toward the institutional investor-defendants in Merrill Lynch.

A recent action by the SEC against Great American Industries, Inc. goes further than any previous case. Violations

126. See note 121 supra.
128. The S.E.C. found that from January 1964 to November 1967, Blyth’s government bond department received advance information about the terms of new Government financings. This was possible under the Federal Government’s procedure, since revised, of giving advance notice of terms such as interest rates and maturity dates to the Federal Reserve System. The information was given to Bythe by an employee of the Federal Reserve Bank of Philadelphia.
of Section 13(a)\textsuperscript{130} and Rule 13a-11\textsuperscript{131} and Rule 10b-5 were charged by the Commission. The violations resulted from press releases issued by Great American which were substantially inaccurate and required public correction. Great American had acquired options on certain mining properties. The press releases concerning this acquisition were found deficient by the SEC because of gross inaccuracies in describing when the mines could be put into production, and the failure of Great American to disclose that two-thirds of the purchase price of the property was to be passed on by the sellers to intermediaries in the form of finder’s fees. The latter circumstance is of most concern here.

The court in basing its ruling as to the non-disclosure on Texas Gulf Sulphur, found no trouble applying its principles. They held that reasonable traders in stock very likely would have re-evaluated the worth of the property as well as the judgment of those who bought it, if they had known that two-thirds of the price was going to “finders.” There would seem to be little argument with that conclusion as far as it goes. The Second Circuit Court of Appeals, however, has again demonstrated its mastery of the art of circuitous reasoning in dealing with the sellers of the property. Judge Friendly recognized that to read Rule 10b-5 as imposing an affirmative duty on one who had no special relationship to a seller or buyer of securities “would be occupying new ground and would require most careful consideration.”\textsuperscript{132} He further stated that due to the unsatisfactory record available to the court that they “were loathe” to do so. However, upon determining that the partial statements were misleading, he referred to the Restatement of Torts and found there was a breach of the duty to disclose. Considering this breach to constitute common law fraud in connection with the purchase of securities, he found 10b-5 “plainly applicable.”\textsuperscript{133} Whatever the rationale or explanation, Rule 10b-5 was held to have been violated when the sellers of the property failed to publicly disclose the substantial amount of the proceeds that were to be passed on to the finders.\textsuperscript{134}

\textsuperscript{130} 15 U.S.C. 78m(a) (1964).
\textsuperscript{131} 17 C.F.R. § 240.13a-11 (1968).
\textsuperscript{132} CCH Fed. Sec. L. Rep. *92,325 at 97,541.
\textsuperscript{133} Restatement of Torts § 24.551(2)(b) (Tent. Draft No. 12, 1966). This is a deceit provision relating to disclosure in a business transaction. Yet here neither party to the transaction was dissatisfied, and the court still used this as a wedge to accomplish that which they said one paragraph earlier they could not do.
\textsuperscript{134} See Errion v. Connell, 236 F.2d 447 (9th Cir. 1956), not relied upon by the
Both Judge Kaufman and Judge Hays in concurring opinions place great emphasis on the potential spread of damage to others, due to the fact that the purchase price was paid in securities.\textsuperscript{135} Their misgivings may be valid.\textsuperscript{136} However, Judge Kaufman distinguishes such a transaction from one on a cash basis by noting that only the buyer and seller in a cash transaction are injured by a fraud. This is an oversimplification. People could decide to buy or sell a stock on the basis of a $3.6 million acquisition of property for cash as easily as where the consideration was stock.

Since the distinction between stock and cash transaction is not as clear as the Second Circuit considers it, it is questionable whether the transaction was within the class intended to be regulated by Rule 10b-5. Both parties to the sale were apparently satisfied, yet both were penalized. There was not any actual purchase or sale of stock to which the SEC could point to find injury. Is this really a failure to disclose "in connection with" the purchase or sale of a security?

A unique and disconcerting aspect of this case is that it in effect makes Rule 10b-5 a means by which a federal agency can "protect" the stockholders of a corporation from what it considers to be "questionable business judgment."\textsuperscript{7} Regardless of the soundness of the decision, this case has created a further category of potential defendants: (1) the seller who is paid in stock and does not properly disclose the intended use of his proceeds, and (2) the buyer who does not disclose what he also knows in that regard. The result prompted Judge Moore, in dissent, to say, "The SEC has advanced '1984' by at least 15 years and casts the ominous shadow of Big Brother over the desk of every executive and over the tables around which directors gather."\textsuperscript{137} While not everyone may feel as strongly as Judge Moore, this decision will cause comment for some time to come.

\textsuperscript{135} CCH Fed. Sec. L. Rep. \textsuperscript{136} Judge Kaufman's views are valid to an extent, but seem too broad to give an accurate analysis of the problem. It could, for example, be true that a stock payment would have a more direct effect on the market. But the mere fact of stock being involved in a transaction is probably the most tenuous ground yet for invoking Rule 10b-5. It seems that protection of the parties to the transaction is merely incidental or collateral to the S.E.C.'s action.

\textsuperscript{137} CCH Fed. Sec. L. Rep. \textsuperscript{138} at 97,542, 97,543.
Careful analysis of the relationships in these cases, considered in the context of the preceding discussion of buyer's actions, reveals the possibility of extraordinary potential liability. In commenting on Texas Gulf Sulphur, Professor Robert L. Knauss concluded that if any seller was entitled to a remedy, all sellers of Texas Gulf stock during this period were entitled to a remedy.\textsuperscript{138} It could as easily be concluded that if the object of the Exchange Act is to protect investors, there also should be a remedy for the non-transactors, those investors who would have purchased Texas Gulf stock had they known the inside information.\textsuperscript{139} Professor Loss finds a "lovely question" in the problem presented in Texas Gulf Sulphur as to the tippor's liability.\textsuperscript{140} How are the tippee's profits to be determined, and is the tippor liable to those to whom the tippee is liable?

D. The Problem

The scope of liability is readily apparent if such liability is extended to include all allegedly injured participants in an open market transaction. The magnitude of this potential liability can be seen by an examination of the categories of parties now subject to a Rule 10b-5 action. A defendant in such an action could conceivably be an:

(1) inside-buyer  
(2) insider-seller  
(3) insider-tippor  
(4) insider-tippee  
(5) insider—who did not disclose  
(6) insider—who partially discloses  
(7) outsider—dealing with a corporation

It is possible that an action could be brought under Rule 10b-5 by those who are:

(1) buyers from insiders  
(2) sellers to insiders  
(3) buyers on the open market  
(4) sellers on the open market

\textsuperscript{139} Contra Birnbaum v. Newport Steel Corp., 193 F.2d 461, 464 (2d Cir. 1951).
\textsuperscript{140} A.B.A. National Institute, supra note 56, at 534.
(5) buyers from tippees
   (a) against either the tippor or the tippee
(6) sellers to tippees
   (a) against either the tippor or the tippee

While this is a substantial array of parties under Rule 10b-5, there is no indication that the end is in sight. The extreme case would seem to be where a plaintiff who bought or sold a security from a non-insider, who had no special knowledge, tries to recover damages from a non-disclosing insider with whom he has never dealt. The problems are the same whether the plaintiff seeks full damages or mere restitution. An action under Rule 10b-5 for non-disclosure of a material fact has at this point no express limit. Anyone could allege that he would have acted differently had he known the information, and as a result contend that he was injured. There are a multitude of unanswered questions under these new definitions and potential violations, each a study in itself. The crucial question has been raised by a director of Texas Gulf Sulphur: does Rule 10b-5 provide an ascertainable standard of conduct as required by the Fifth Amendment?\textsuperscript{141} It is questionable. Under present law, there exists an almost unlimited field for plaintiffs. It is clear that limitations of some type are in order. This would seem to be a proper legislative function, but until such action is taken the courts which have created the problems now must resolve them. The judiciary must determine how they are to prevent insider trading on the strength of undisclosed material information, and yet do so in a logical and equitable manner.

There would appear to be nothing objectionable about the specific actions brought by the SEC to enjoin or impose other administrative sanctions. Likewise private actions where there is a privity relationship of some type seem fair and proper.

However, it is critical to distinguish attempts by individuals to recover (either damages or in restitution) for violations that affect investors only in a general way, when the plaintiffs have not dealt with any insider. This occurs most frequently in the area of open market transactions on an exchange or in formal over the counter transactions. The court in \textit{Texas Gulf Sulphur}\textsuperscript{142}

\textsuperscript{141} See note 10 \textit{supra}.
\textsuperscript{142} 401 F.2d at 868.
and *Great American Industries*\(^{143}\) was clearly concerned with the potential private actions for damages.

There are numerous objections, relating mainly to mechanics, to any approach granting rescission and restitution, or damages to open market transactors who bought or sold the security involved. There are great difficulties in tracing certificates through the clearing house\(^{44}\) and these difficulties are complicated by the activities of a specialist. Even once the certificates have been traced, little more has been accomplished than to give a windfall to persons whose certificates ended up with the defendants involved or vice versa if the plaintiff is a buyer. Such a remedy would be little more than arbitrary and would clearly be subject to criticism, justifiably leveled, for failing to insure that the proper party is compensated.

### E. A Recommendation

With the privity requirement in an action based on the *Kardon* doctrine eliminated, and not likely to be returned, a different type of limitation is required. The previously discussed problems surface in cases of violations involving securities traded on a stock exchange or on the formal over the counter market, where all investors have an interest and are affected in a general way. Here is where a limitation on private recoveries is needed, without precluding recovery *merely* because the transaction occurred on the open market. An adequate remedy would allow no recoveries by open market transactors except in special circumstances.

1) **Restitution**—To cover the vast majority of cases, a restitutionary remedy of disgorgement of profits to the corporation should be available to the SEC or to individuals. This is no more than what is presently available in actions under Section 16(b).\(^{145}\) Such a remedy was recently allowed in *Diamond v. Oreamuno*\(^{146}\) on a

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144. This fact and the arbitrary result are highlighted by the recently developed problem of securities thefts on a large scale. The situation has been aggravated by the paper-jam in brokerage houses. The reports of amounts of losses are sparse due to relucence on the part of securities industry and law enforcement officials, but include estimates of up to \$50 million in stolen securities circulating in the underworld. San Diego Union, March 9, 1969, at 1, col. 1 (home ed.).
claim of conversion of corporate property (inside information) in an open market transaction involving insider trading and a failure to disclose. Justification for returning the profits to the corporation arguably can be found in the resulting injury to the interest the corporation has in maintaining a good image and hence a good trading market for its securities. Publicized insider trading activities detract from this desired image.

2) Special Circumstances—An equitable solution would not require that trading on the open market constitute a complete bar to recovery of damages. In those open market transaction cases where "clear and convincing proof" of related personal dealings with nondisclosing insiders (e.g. where the broker effecting the purchase had knowledge of the material fact involved) can be shown, then damages rather than disgorgement would be proper. This would allow recovery in those cases where most would agree it is needed, while a high standard of proof would preclude the undesirable windfall effect.

The above approach would discourage the misuse of inside information in that either alternative remedy removes the incentive of profit. What it does not do is subject the insider, who, arguably, is blameless, to excessive or double liability. It does not turn the courtroom into an arena in which an individual might recoup losses suffered due to his own error in judgment. Likewise the denial of a private action under the above special circumstances would not be inconsistent with the existing decisions, and perhaps not even be objectionable to the SEC.

147. An incentive for the bringing of actions for disgorgement of profits was recently demonstrated in the case of Blau v. Brown, CCH Fed. Sec. L. Rep. * 92,263 (S.D.N.Y. 1968), where attorneys were allowed 20% of short-swing profits recovered in a section 16(b) action as a reasonable fee.


149. In Diamond v. Oreamuno the court stated, "... [They] may conceivably be sued by the purchasers of their stock for culpable failure to disclose material information, and ... may incur double liability if the suits should be brought and prove successful. ..." 29 App. Div. 2d 285, 287 N.Y.S.2d 300, 305 (Sup. Ct. App. Div. 1968) (emphasis added).

150. It is quite possible this may not be inconsistent even with the desires of the S.E.C. Irving M. Pollack, Director, Division of Trading and Markets, S.E.C., stated that "we at the Commission look upon the Texas Gulf prayer for relief as requesting an equitable remedy of divestiture of profits rather than as the assertion of somebody's private right of action." Practising Law Institute, Disclosure Requirements of Public Companies and Insiders 290 (1967). The courts have expressly stated their concern over potential private actions. 401 F.2d at 868; CCH Fed. Sec. L. Rep. * 92,325, at 97,543.
The SEC could still bring its own actions, seeking injunctions for example. Moreover, the courts in reaching their decisions would not have to be concerned with the far-reaching effect of their decision on private litigation flowing from the SEC action.151

E. Summation

It appears that a reevaluation of Rule 10b-5 is in order. One thing is clear in all recent actions by the SEC—there has been no evaluation per se of what, if any, actual damage to individuals has occurred. Plainly it is as absurd to argue that no investor has been damaged as it is to argue that every investor connected with a security transaction involving a nondisclosing insider has been damaged. Even if a disclosure were made, not everyone would attach the same significance to it. It has been suggested that the insider’s disclosure may distort the prospective value of the securities.152 It is entirely possible that excessive reliance would be placed on an insider’s information.

The growth of liabilities under Rule 10b-5 has been a “bootstrap” operation. Each case has been justified by the one before it, all going back to Texas Gulf Sulphur. It is time to step back and examine these developments anew, in light of analyses such as those suggested by Professor Manne. Is the attack on insider conduct preventing actual public harm, or are the attacks initiated merely because the conduct seems morally reprehensible or unfair to the individual purchaser or seller?

A great amount of disagreement has been said to exist between the Nixon administration and the SEC due to the administration’s dissatisfaction with the practices of the Commission. This conflict is evident from statements and conduct on both sides.153 The dispute has overtones which go

151. For a similar but more restrictive remedy, see the suggestion in Knauss, supra note 138, at 57.
153. NEWSWEEK, Nov. 11, 1968, at 54, discusses the now famous letter from President Nixon to investment men condemning “heavy handed regulatory schemes.” It has been reported that President Nixon is considering “watch-dog committees” over certain federal agencies including the S.E.C. Significant also is the bringing of the action against Blyth, note 121 supra, on the very eve of President Nixon’s inauguration.
154. P-H LAWYER’S WEEKLY REPORT, § 2 (March 17, 1969). The report considers President Nixon’s appointment of Hamer Budge as Chairman of the S.E.C. as a sign that he is not going to reverse the direction of the S.E.C. Mr. Budge has supported most of the recent S.E.C. activity.
beyond mere disagreement over the use of Rule 10b-5 and run to basic political philosophies. A collision between the views seems unavoidable. It is hoped that the outcome will be constructive, and will bring an end to the case-by-case disorder that has characterized this area of the law for over twenty years. A limitation on private actions would be the first step in the right direction. Subsequent thought and analysis should lead to a reconsideration of the proper use of the federal securities law and a return to reasonableness.

III. CONCLUSION

Rule 10b-5 has become a judicially expanded remedy that has grown from an innocuous theory of liability as stated in *Kardon* to what is now the cornerstone of a federal common law of corporations. The remedy has been defined by the courts without uniformity. Its uncertainties and vagaries have resulted from conflicts between political-social philosophies and conflicts between the need for protection against stock swindles and the fear of unlimited liability bringing a flood of litigation.

The arguments for having the express remedies of the Securities Act as exclusive ones in federal courts, and the need for reasonable limitations on insider liability related to open market transactions are valid in theory. But for the practicing attorney, they are not yet persuasive arguments for a client who in some undefined degree was "morally" or "legally" culpable. They are valid limitations for the legislature to consider if and when the confusion which surrounds these implied civil remedies is eliminated by a recodification as is earnestly urged. Meanwhile, the legal community will suffer from the unpredictability that abounds under the symbol 10b-5.

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