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Remedies Under Rule 10b-5

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REMEDIES UNDER RULE 10b-5

Nicholas R. Weiskopf*

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The Securities Exchange Act of 1934,¹ besides creating the Securities and Exchange Commission, outlining its functions and bestowing upon it essential administrative powers, affords basic safeguards for the investor in securities.

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¹ 15 U.S.C. § 78a *et seq.* (1964).

Section 10(b) of the Act is designed to curb market manipulation, misrepresentation and other fraudulent practices connected with the trading of securities.

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— . . . 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.²

In 1942, the SEC, pursuant to this section's authorization promulgated rule 10b-5.

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,

- (1) to employ any device, scheme, or artifice to defraud,
- (2) 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
- (3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.³

The rule, as construed and applied by the SEC and the federal courts, is the broadest antifraud provision in the federal securities laws.⁴ While almost all states have statutory proscriptions against fraudulent practices in the trading of securities, these provisions, as applied by state courts, are far narrower in scope than their federal counterpart.⁵ Similarly, although certain types of fraudulent acts and omissions are actionable at common law as well as under rule 10b-5, the latter serves as a far more attractive alternative, not only because it presents a re-

² *Id.* § 78j(b).

³ 17 C.F.R. § 240.10b-5 (1970).

⁴ See A. BROMBERG, *SECURITIES LAWS: FRAUD—SEC RULE 10b-5*, §§ 2.1-2.3 (1970) [hereinafter A. BROMBERG].

⁵ The antifraud provision of the American Law Institute's uniform act, which, as of 1965, was adopted in nineteen states and Puerto Rico, is patterned very closely after rule 10b-5. *UNIFORM SECURITIES ACT* § 101. Unlike the general proviso of section 17 of the Securities Act of 1933, 15 U.S.C. § 77g(a) (1964), both the uniform section and the SEC rule cover the defrauded seller as well as the defrauded purchaser of securities. However, the uniform act places highly significant restrictions upon the recovery of compensatory damages. *UNIFORM SECURITIES ACT* § 410; see also A. BROMBERG § 2.7.

laxed burden of proof,⁶ but also because the 1934 Act provides for nationwide process and contains extremely liberal jurisdiction and venue requirements.⁷

In view of all this, it is not surprising that the use of the rule as a litigational device is extremely widespread. Most cases brought to challenge fraudulent practices in the trading of securities allege violation or violations of this provision.⁸ It should be noted, however, that neither section 10 nor rule 10b-5 expressly provide for a right of civil recovery. The courts, however, have consistently held that this right must be implied.⁹

The earliest decision to this effect was *Kardon v. National Gypsum Co.*,¹⁰ where the court, influenced not only by broad considerations of statutory policy but also by the wording of the contract-voiding section of the 1934 Act,¹¹ concluded that

a statutory enactment that a contract of a certain kind shall be void almost necessarily implies a remedy in respect of it. The statute would be of little value unless a party to the contract could apply to the Courts to relieve himself of obligations under it or to escape its consequences.¹²

However, the court appeared to be most heavily influenced by the basic common-law doctrine that a person injured by acts in violation of a statute primarily enacted to protect persons in his position is entitled to recover, in tort, for the losses he has incurred.¹³

Once it was established that the existence of a private civil cause

⁶ Scienter must be proven in a common-law fraud action, whereas in most types of 10b-5 actions, it need not be alleged or proven. See generally A. BROMBERG § 8.4.

⁷ Securities Exchange Act of 1934, § 27, 15 U.S.C. § 78aa (1964).

⁸ A. BROMBERG § 2.5(6).

⁹ See L. LOSS, SECURITIES REGULATION ch. 11C(7) (abr. ed. 1961).

¹⁰ 69 F. Supp. 512 (E.D. Pa. 1946).

¹¹ Securities Exchange Act of 1934, § 29(b), 15 U.S.C. § 78cc(b) (1964):

Every contract made in violation of any provision of this title or of any rule or regulation thereunder, and every contract . . . heretofore or hereafter made the performance of which involves the violation of . . . any provision of this title or any rule or regulation thereunder, shall be void . . . as regards the rights of any person who, in violation of any such provision, rule, or regulation, shall have made or engaged in the performance of any such contract

¹² 69 F. Supp. at 514.

¹³ *Id.* at 513-14. In support of this proposition the court relied upon the RESTATEMENT OF TORTS § 286 (1934). The more recent and relaxed version of the provision which makes it optional for "[t]he court [to] . . . adopt as the standard of conduct . . . the requirements of a legislative enactment or an administrative regulation . . ." RESTATEMENT (SECOND) OF TORTS § 286 (1965); see also McClure v. Borne Chem. Co., 292 F.2d 824, 836 (3d Cir.), cert. denied, 368 U.S. 939 (1961):

The basis of the *Kardon* doctrine was the common-law tort rule, as articulated in Section 286 of the Restatement of Torts, that a private right of action may be implied from a statute in favor of those whose interests the statute was designated to protect.

of action arising out of violation of rule 10b-5 was a necessary implication, the courts set out to define the substantive scope of this provision.¹⁴ Suffice it to say that this provision has developed into the "catch-all" of the federal securities laws, a multitentacled octopus whose arms, often overlapping both the more specific provisions of these statutes and the traditional doctrines of common law, now encompass virtually any type of individual or corporate misconduct bearing on the trading of securities.

Until recently, the attention of the courts has not focused on the fashioning of remedies to be made available to the successful 10b-5 plaintiff. This state of affairs has been attributed to the fact that "[f]ew 10b-5 cases have reached the relief stage. . . . Since far more decisions have gone for plaintiffs on the existence of a cause of action, the settlement proportion has been high, but the terms are unpublished."¹⁵

The remainder of this paper digests and discusses court action to date that has been concerned with the defining of civil remedies available under rule 10b-5.

COMPENSATORY DAMAGES

The remarkably few 10b-5 decisions that focus on the calculation of compensatory damages to be received by a particular plaintiff manifest, with exceptions, an extremely flexible approach to an extremely difficult problem. If one has to formulate a general rule of damages under 10b-5, it may be stated as follows:

The *defrauded seller* is entitled to the difference between the true value of his stock at the time of sale and the amount he has been paid for this stock.

The *defrauded purchaser* is entitled to the difference between the amount he has paid for his stock and the true value of this stock at the time of purchase.

These two formulae stem from the so-called out-of-pocket measure of damages, traditionally employed in fraud cases in several states and under the federal common law. In many 10b-5 cases, however, strict application of this rule will not effectuate restoration of the status quo ante which the award of compensatory damages is generally intended

¹⁴ This phase of the development of the case law under 10b-5 is beyond the scope of this article, and has been subject to continuous law review treatment. See, e.g., Bloomenthal, *From Birnbaum to Schoenbaum: The Exchange Act and Self-Aggrandizement*, 15 N.Y.L.F. 332 (1969); Lowenfels, *The Demise of the Birnbaum Doctrine: A New Era for Rule 10b-5*, 54 VA. L. REV. 268 (1968); Note, "*Federal Corporation Law*" and 10b-5: *The Case for Codification*, 45 ST. JOHN'S L. REV. 274 (1970).

¹⁵ A. BROMBERG § 9.1.

to accomplish. This failure is almost always attributable to the out-of-pocket rule's failure to take fluctuations in the value of securities after the time of purchase or sale into account. In the ensuing discussion, we will see how a number of courts have deviated from the strict application of the rule in order to arrive at highly realistic evaluations of compensatory damages specially designed to do justice in particular cases.¹⁶

Recovery By The Defrauded Seller

(1) Material Nondisclosure and Misrepresentation — Considering Accretions in Market Value Subsequent to Tainted Transaction

The defrauded seller is typically the victim of unlawful nondisclosures or material misrepresentations that cause him to part with his stock at an artificially depressed price. To fully compensate him, a court usually must take into account subsequent accretions in the value of the securities thus transferred.

In *Reynolds v. Texas Gulf Sulphur Co.*,¹⁷ one of the many shareholder suits filed as an outgrowth of the landmark case of *SEC v. Texas Gulf Sulphur Co.*,¹⁸ plaintiffs alleged that they were induced to sell their shares by the unlawful withholding of material inside information by company personnel. On April 12, 1964, Texas Gulf, in the midst of rumors that it had made a major mineral strike in Canada, issued a press release greatly minimizing the importance of its reported findings. Four days later, it issued another release to announce a strike of staggering proportions. Of the three plaintiffs that had prevailed on the merits, two had sold their shares just after issuance of the intentionally misleading first release. The third had sold his shares just after publication of the second release, confused and disturbed by the fact that it directly contradicted the terms of the first.

In evaluating damages, the court reasoned that plaintiffs had to be permitted a reasonable time in which to discover the fraud com-

¹⁶ Not every court has shown this flexibility. See, e.g., *Kohler v. Kohler Co.*, 208 F. Supp. 808 (E.D. Wis. 1962), *aff'd*, 319 F.2d 634 (7th Cir. 1963), where the court, after finding for the defendant on the merits, remarked:

"Actual damages" are to be computed under the federal "out of pocket" rule applied in fraud actions, i.e., the difference between the price received by the plaintiff and the real or actual value of the stock at the date of the sale. Under this rule, a plaintiff is entitled to recover what he has lost by the sale but may not recover any actual or potential gain that was received by the defendants. *Id.* at 825 (emphasis added).

¹⁷ 309 F. Supp. 548 (C.D. Utah 1970).

¹⁸ 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969); see generally Note, *Texas Gulf Sulphur: Expanding Concepts of Corporate Disclosure Under SEC Rule 10b-5*, 43 ST. JOHN'S L. REV. 655, 685 (1969).

plained of and replace their stock, through purchase on the open market, if they so desired.

The variety of situations in which a 10(b) or 10b-5 violation may be found makes it difficult to formulate a comprehensive rule of damages. . . . It seems to this court that the true and just measure of damages in these cases should be, with some qualification, what long ago came to be called the New York Rule. Of necessity, it was unthinkable that the common-law rule in trover for the conversion of ordinary chattels, *i.e.*, fair market value at time of conversion should be applied in the case of corporate shares with rapidly changing values. So the rule evolved that the measure of damages in stock transactions is the highest intermediate value reached by the stock between the time of the wrongful act complained of and a reasonable time after the injured party received, or should have received notice of it, a time within which he has a reasonable opportunity to replace the stock.¹⁹

Furthermore, the court concluded that a few days was not sufficient for a duly diligent seller to discover the type of fraud complained of, nor for the New York market to reflect the true value of the Texas Gulf shares they had sold. Instead, the average of the highest daily market price of these shares over a period of twenty trading days immediately after issuance of the April 16th release announcing the major strike minus the per share price received by plaintiffs, multiplied by the number of shares sold by each of the plaintiffs was the formula adopted by the court to calculate their respective damages.

Where, as in *Reynolds*, the defrauded seller is deprived of profits that are a reflection of a major piece of good news concerning the corporation's operations, it is logical for the court to consider upward fluctuations in the market value of the securities sold that reflect full disclosure of this information to the investing public.²⁰ Where insider nondisclosures and misrepresentations are of a far broader type, depriving the defrauded seller of information concerning the corporation's overall greatly improved business outlook and growth potential, the courts are sometimes willing to look far beyond relatively immediate accretions in a stock's value in calculating damages.

¹⁹ 309 F. Supp. at 562-63. As justification for this liberal approach, the court relied on the RESTATEMENT OF RESTITUTION:

Where the subject matter is of fluctuating value, and where the person deprived of it might have secured a higher amount for it had he not been so deprived, justice to him may require that the measure of recovery be more than the value at the time of deprivation.

RESTATEMENT OF RESTITUTION § 151, comment *c* (1937).

²⁰ The *Kohler* case provides a good discussion of the difficulties presented when a stock has no ascertainable market value on which to base an evaluation of damages. See 208 F. Supp. at 811-16.

For instance, in the recent Eighth Circuit case of *Myzel v. Fields*,²¹ defendant insiders purchased stock from the various plaintiffs on the basis of misrepresentations and nondisclosure of their corporation's significantly improved sales and profits picture. As the stock in question was not publicly traded, the market value of the shares sold was not readily ascertainable. The Court of Appeals, reasoning that plaintiffs were entitled to full restoration of the status quo ante, approved the following jury charge issued by the trial court on the question of damages:

1. At the very least, plaintiffs should recover "out of pocket" damages — the difference between the actual value of their shares at the time of sale and the purchase price.
2. If plaintiffs, upon full disclosure, would have demanded and received a higher price for their shares, they should recover the difference between this higher price and the actual purchase price.
3. If plaintiffs, upon full disclosure, would have refused to sell their shares, the jury could consider not only the true value of their shares at the time of sale, taking into account the corporation's subsequent prosperity, but also actual "subsequent increases in the value of the stock over . . . a reasonable period," at the end of which, presumably, plaintiffs would have sold their shares even had they not been approached by defendants. Recovery would then be calculated as the difference between this higher price and the actual purchase price.²²

Especially significant about this extremely flexible approach in calculating damages is that it is left for the jury to surmise what each seller's probable actions in selling or retaining his stock would have been but for the nondisclosures and misrepresentations complained of. Despite this possible shortcoming, however, the prospects for plaintiffs receiving equitable treatment were far better than had the jury been required to stick to a strict out-of-pocket method of evaluating damages.

(2) Material Nondisclosure and Misrepresentation — The "What Might Have Been" Approach — "Windfalls" to Defrauded Sellers

The case of *Speed v. Transamerica Corp.*²³ is an even stronger indication of a court's willingness to speculate on *what would have been* the probable investment action taken by defrauded sellers but for the fraudulent omissions and misrepresentations that induced them to part

²¹ 386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968).

²² *Id.* at 744-45.

²³ 135 F. Supp. 176 (D. Del. 1955), *modified*, 235 F.2d 369 (3d Cir. 1956).

with their stock. Plaintiffs were minority shareholders in a subsidiary of the defendant corporation who sold their shares pursuant to a written offer which grossly underestimated the value of the subsidiary's inventory and gave a misleading gloomy sales and profits picture. Ascribed to the parent-defendant corporation was an undisclosed scheme to liquidate its subsidiary and realize the greatly increased and as yet unpublicized true value of its tobacco inventory.

The court found that defendants had violated 10b-5 and, in so doing, had breached their fiduciary obligations owed by them as majority shareholders to the plaintiffs, who were former Class *A* and Class *B* shareholders in the subsidiary. The court proceeded to reconstruct both the challenged sales and the subsequent liquidation. First, the court reasoned that Class *A* and Class *B* shareholders should be treated the same, since the former, as victims of an illegal call surrounded by material nondisclosures, had been deprived of participation in the liquidation and would undoubtedly have elected to convert their shares on a one-to-one basis for Class *B* stock, an alternate option given to those not interested in taking advantage of the call. Next, the court rejected defendants' contention that Class *B* shareholders were not entitled to damages in excess of the difference between the market value of their shares and the consideration received:

[o]n a "what might have been" or a "reconstructed liquidation," assuming a valid call and full disclosure of facts as to values, all stock owned or formerly owned by plaintiffs shall be considered as "B" stock. All stock owned by defendant shall be also so considered. All shares of plaintiffs and those acquired by defendant shall be divided into the value of the assets at the time of liquidation. This is the rule of recovery.²⁴

The "what might have been" approach taken by Chief Judge Leahy in *Speed* has, on occasion, produced a windfall for the defrauded seller that could not have been entirely anticipated by even a fully informed shareholder at the time of sale. In *Janigan v. Taylor*,²⁵ defrauded sellers brought a class action challenging their sale to the president of their corporation of virtually all of the company's outstanding stock for \$40,000. The court found that defendant, on the day of sale at a directors' meeting, had consciously and falsely represented that the condition of the company had not materially changed in past months, when in fact its future profits picture had greatly improved. Two years later, defendant sold these shares for \$700,000. The First Circuit

²⁴ *Id.* at 194.

²⁵ 344 F.2d 781 (1st Cir.), cert. denied, 382 U.S. 879 (1965).

held that plaintiffs were entitled to defendant's profit, in essence creating a constructive trust to cover the two-year period between the challenged purchase and subsequent resale. After indicating that defrauded purchasers are not generally entitled to more than "the difference between the real value of the property at the date of its sale . . . and the price paid for it," the court continued:

On the other hand, if the property is not bought from, but sold to the fraudulent party, future accretions not foreseeable at the time of the transfer even on the true facts, and hence speculative, are subject to another factor, *viz.*, that they accrued to the fraudulent party. It may, as in the case at bar, be entirely speculative whether, had plaintiffs not sold, the series of fortunate occurrences would have happened in the same way, and to their same profit. However, there can be no speculation but that the defendant actually made the profit and, once it found that he acquired the property by fraud, that the profit was the proximate consequence of the fraud, whether foreseeable or not. It is more appropriate to give the defrauded party the benefit of windfalls than to let the fraudulent party keep them.²⁶

(3) Material Nondisclosure and Misrepresentation — Recovery of Defrauding Purchaser's Profits on Resale Contemplated at Time of Tainted Transaction

Where, unlike in *Janigan*, the defrauding purchaser enjoys the profits from a relatively immediate resale contemplated at the time of the challenged purchase, the defrauded seller stands an even better chance of recovering these profits as his damages because the resale price may be deemed the true value of the shares at the time of the challenged purchase, thus negating the inference that an award of an undeserved "windfall" has been made.

Hence, in *Kardon*, two shareholders that had sold a combined half interest in a close corporation to its two remaining shareholders alleged that, at the time of sale, the defendants had already arranged for the sale of the corporation at a substantial profit without disclosing these plans. The court found for plaintiffs, with the proper remedial relief in this situation consisting of "an accounting to ascertain and restore to the plaintiffs their proportionate share of the profits, if any."²⁷

The *Kardon* approach was followed recently in *Ross v. Licht*,²⁸ a suit by defrauded sellers against corporate insiders to whom they had

²⁶ *Id.* at 786.

²⁷ 73 F. Supp. 798, 801-02 (E.D. Pa. 1947).

²⁸ 263 F. Supp. 395 (S.D.N.Y. 1967).

sold their stock for \$120 per share. Subsequently they learned that defendants had undisclosed information at the time of the challenged transactions, of purchase proposals set at a minimum of \$300 per share. The court reasoned that plaintiffs were entitled to damages based on the "fair value" of their shares at the time of sale. It further reasoned that, particularly where no market value could be established for these shares at the time of the challenged transactions, this "true value" had to be calculated on the basis of circumstances existing for a reasonable time prior to and subsequent to the sale. The court, using a \$300 "true value" figure equal to the purchase price of these shares in a private placement that took place two weeks after the fraudulent purchases, awarded damages of \$180 per share.²⁹

(4) Private Placement Price as a Measure of "True Value"

While the court in *Ross* was willing to accept a private placement resale price as a measure of "true value" in its calculation of damages, there is firm indication in *Pappas v. Moss*,³⁰ that a court will not automatically accept a private placement price as such a measure, particularly if the facts suggest unlawful self-dealing by corporate officers. In *Pappas*, shareholders brought a derivative action on behalf of the seller-corporation against its officers and directors to challenge the private placement of its shares at \$6 each, while public trading was at approximately \$13 per share. Defendants had actively participated in the placement, fraudulently claiming that interested outside investors had insisted on their doing so.

In its assessment of damages, the court permitted a "reasonable discount" of 20 percent, once convinced that a genuine need for a placement had existed, stating:

The expert testimony set forth a wide range of permissive discount which, under the facts here, is neither very helpful nor highly persuasive. I have concluded that a reasonable discount, under all the facts and circumstances of this case, was 20%. The measure of damages is the difference between the total price paid at 20% discount of the average market price on the date of the respective purchases.³¹

²⁹ Interestingly enough, shortly after the challenged purchases, the shares involved in *Ross* had become almost worthless. The court relied upon this factor in its denial of prejudgment interest. *Id.* at 411-12.

³⁰ 257 F. Supp. 345 (D.N.J. 1966), *rev'd and remanded*, 393 F.2d 865 (3d Cir. 1968). The reversal was necessary for a reconsideration of the common-law court and clarification of the measure of damages.

³¹ *Id.* at 364.

Recovery By The Defrauded Purchaser

(1) Material Nondisclosure and Misrepresentation — Considering Decreases in Market Value Subsequent to Tainted Transaction

Typically, a successful 10b-5 plaintiff-purchaser has been fraudulently induced into acquiring stock that has subsequently declined in value. In these circumstances, plaintiff will ordinarily seek to rescind the sale in order to recover his purchase price upon restoration of the stock to the defrauding seller.³²

The defrauded purchaser will not seek rescission if, for any reason, he desires to retain the securities he has acquired. A sharp decline in the value of the consideration paid by the purchaser may also cause him to elect to affirm the challenged transaction and sue for damages. Finally, the purchaser will have to seek damages if, for any reason, rescission is unavailable to him.

Digression from strict application of the out-of-pocket measure of damages is less frequently called for in defrauded purchaser cases than in defrauded seller cases. Generally, only when a seller is defrauded, does the defendant retain the securities transferred pursuant to the challenged transaction, sometimes reaping a profit that the court orders paid over to the seller on some sort of constructive trust basis. Nevertheless, the courts, where necessary, have shown considerable flexibility in setting a defrauded purchaser's damages.

In *Esplin v. Hirschi*,³³ an award of damages to a defrauded purchaser was affirmed despite the fact that the trial jury had found that the stock in question, at the time of the challenge sale, was valued at the price plaintiff had paid for it. Refusing strict application of the out-of-pocket rule, which would have precluded an award of damages, the court reasoned that a plaintiff should recover an amount equal to the subsequent decrease in the value of the stock purchased, especially when the decrease is due to material factors not adequately disclosed at the time of sale. The *Esplin* holding may alternately be stated as follows: The defrauded purchaser, where stock he acquires declines in value, may recover the difference between the purchase price and the value of his stock at the time seller's fraud is, or should, with due diligence, be discovered.³⁴

³² *E.g.*, *Stevens v. Vowell*, 343 F.2d 374 (10th Cir. 1965); *Matheson v. Armbrust*, 284 F.2d 670 (9th Cir. 1960). See discussion of rescission commencing at 751 *infra*.

³³ 402 F.2d 94 (10th Cir. 1968).

³⁴ As might be expected, the defrauded purchaser, as well as the defrauded seller, may generally recover outlays incidental to the challenged transaction. See, *e.g.*, *Sackett v.*

(2) Material Nondisclosure and Misrepresentation — The "What Might Have Been" Approach

*Gottlieb v. Sandia American Corp.*³⁵ again illustrates the willingness of a court to consider downward fluctuations in the value of shares received by a defrauded purchaser in evaluating his damages. In this recent case, ex-shareholders of the World Wide Bowling Corporation brought suit to challenge their company's acquisition by Sandia, contending that the underlying exchange of stock and debentures had been induced by the latter's fraudulent omissions and misrepresentations. The court, after finding that rescission was unavailable because of "the acts of the defendants in spinning off and subsequently relinquishing their ownership interest in the former World Wide assets,"³⁶ set out to evaluate the damages to which plaintiffs were entitled.

First, the court rejected strict application of the out-of-pocket rule as both impractical — it would be extremely difficult to evaluate the value of either World Wide or Sandia securities at the time of the exchange — and unfair to plaintiffs — the Sandia securities received by them had declined sharply in value following the exchange and were virtually untradeable, leaving no practical means of unloading the newly acquired stock upon discovery of the fraud.

An application of the so-called "rescission measure of damages" was ruled out since such a measurement, being equal to the "present market value of the consideration received," would have put the burden of subsequent decreases in the value of Sandia stock squarely on the defendants. The court reasoned that this measure of damages would call for equally speculative evaluations and that, in any event, its application was far more suited to a case involving a defrauding purchaser as defendant — one who has received "an unexpected or unwarranted windfall" due to accretions in the worth of securities fraudulently acquired by him.

Finally, after pointing to the fact that "strict application of the remedies previously considered was rendered difficult or impracticable

Beaman, 399 F.2d 884, 891 (9th Cir. 1968), *discussed at* note 74 and accompanying text *infra*. Similarly, amounts realized by the purchaser on his stock are sometimes deducted from his damages where subsequent decreases in the value of his stock are taken into account. For example, in *Esplin*, the court subtracted dividends received by plaintiff from his award. In many cases, an appropriate item of relief is prejudgment interest on the damages incurred, which the court, in its discretion, may award. Such relief is usually denied if it will work an extreme hardship upon the defendant. *See, e.g.,* *Speed v. Trans-america Corp.*, 235 F.2d 369 (3d Cir. 1956).

³⁵ 304 F. Supp. 980 (E.D. Pa. 1969).

³⁶ *Id.* at 990.

by the fraudulent conduct of the defendants,"³⁷ the court decided to create its own hybrid remedy to deal with the unusual set of facts and circumstances before it. Plaintiffs would restore to defendants those Sandia securities, now greatly reduced in value, received by them pursuant to the challenged exchange. In return, plaintiffs would receive from defendants, with interest, a pro rata share of the monetary equivalent of all World Wide securities transferred to Sandia; the value of these securities to be determined, insofar as practicable, as of the time of the exchange. In effect, the court had ordered a quasi-rescission of the challenged transaction, with restitution to be made through cash payment. Justifying its decree on a "what would have been" basis, an approach used in some of the defrauded seller cases previously discussed, the court concluded:

Regardless of how this adjustment is formally characterized, we think it will as effectively as is now possible restore the parties to the position they would have been in had there been no fraud in the first place: The plaintiffs will have the monetary equivalent of their bowling business as if they had sold it for a fair price at the time of the exchange . . . with fair interest to the present. The defendants on the other hand will have the stock which they gave to the plaintiffs in connection with the transaction so that they will be treated as if World Wide had known all of the facts and rejected the Sandia offer.³⁸

PUNITIVE DAMAGES

The Cases

(1) The Majority Rule

The great weight of case authority points against the award of punitive damages in 10b-5 suits. Indeed, the language of the Securities Exchange Act lends itself to this interpretation.

The rights and remedies provided by this title 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 title shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of *actual damages* on account of the act complained of.³⁹

It is on the basis of this "actual damages" provision, which, when broadly construed, outlaws the recovery of exemplary damages in suits brought under the 1934 Act, that several courts have held that such

³⁷ *Id.* at 991.

³⁸ *Id.* at 991-92.

³⁹ Securities Exchange Act of 1934, § 28(a), 15 U.S.C. § 78bb(a) (1964).

damages are not available to the successful 10b-5 plaintiff. The Second Circuit placed great reliance on section 28(a) in its recent decision in *Green v. Wolf Corp.*⁴⁰ In this case, the plaintiffs appealed the striking of that portion of their class action complaint that requested punitive damages for defendants' alleged violation of rule 10b-5. In approving this action by the district court, the Second Circuit summarized and refuted the three basic arguments customarily set forth in favor of the award of punitive damages in 10b-5 suits.

First, to the argument that section 28(a) was solely intended to prevent multiple recoveries through the bringing of both federal and state suits based on the same alleged fraudulent conduct,⁴¹ the court responded that such a limited construction was not warranted when the Exchange Act was read so as to effectuate its broad purposes. The vagueness of this response was attributed to the absence of any meaningful legislative history surrounding the section's adoption.⁴²

Second, to the argument that the right to civil recovery under 10b-5 is implied on the basis of a common-law statutory-tort theory and that such an action is not "a suit for damages under the provisions of this [Act]" as contemplated by section 28(a), the court somewhat indirectly responded: "We have gone far beyond the limits of the common law in imposing liability under 10b-5 and thus may not import all the other aspects of common law fraud without scrutiny."⁴³

Third, to the argument that punitive damages are permitted under the Securities Act of 1933⁴⁴ and that the 1934 Act should be read *in pari materia*, the court noted that the fact that the 1933 Act does not contain language similar to that in section 28(a) shows that "Congress might well have intended to impose different liabilities under each of the two Acts," perhaps so as to encourage registration under the 1934 Act by having it carry lighter penalties.⁴⁵ Interestingly enough, the Second Circuit, shortly after deciding *Green*, held in *Globus v. Law Research Service, Inc.*⁴⁶ that a district court award of punitive damages under section 17(a) of the 1933 Act⁴⁷ was also improper.

⁴⁰ 406 F.2d 291 (2d Cir. 1968), *cert. denied*, 395 U.S. 977 (1969).

⁴¹ See *Hecht v. Harris, Upham & Co.*, 283 F. Supp. 417, 444 (N.D. Cal. 1968).

⁴² 406 F.2d at 302-03.

⁴³ *Id.* at 303.

⁴⁴ Cf. *Nagel v. Prescott & Co.*, 36 F.R.D. 445 (N.D. Ohio 1964) (denial of a motion to strike interrogatories as rejection of contention that punitive damages are not available under the 1933 Act).

⁴⁵ 406 F.2d at 303.

⁴⁶ 418 F.2d 1276 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970).

⁴⁷ 15 U.S.C. § 77g(a) (1964). This section is the most general anti-fraud provision in the Act.

There are several other decisions which are in accord with *Green*, denying recovery of punitive damages in a successful 10b-5 suit. The Eighth Circuit, in the *Myzel* case held, with little discussion, that the recovery of such damages is precluded by the aforementioned "actual damages" restriction contained in section 28(a) of the 1934 Act. Finally, still on the appellate level, the Second Circuit, in *Globus*, reaffirmed its position in *Green*, holding that section 28(a) effectively precluded the recovery of punitive damages in 10b-5 suits.⁴⁸

(2) The Minority Rule

A few recent district court cases, decided in the face of considerable contrary precedent, either hold or indicate in dictum that punitive damages may be awarded in a rule 10b-5 action. In *de Haas v. Empire Petroleum Co.*,⁴⁹ defendants sought to vacate a punitive jury award of \$5000 based upon a violation of 10b-5. The district court upheld this award, holding that such damages "are allowable . . . where aggravated *scienter* is clearly shown by the facts."⁵⁰

The court expressly refused to follow the contrary holding in *Green*, reasoning that the section 28(a) "actual damages" limitation applied "only to claims which are expressly or impliedly created by the Act itself."⁵¹ Furthermore, 10b-5 claims are grounded purely in tort law and, accordingly, fall outside this category. Because some element of *scienter* is needed to make out a rule 10b-5 violation, such a violation could be likened to "the commission of an intentional tort from which punitive damages flow depending on the circumstances."⁵²

While the *de Haas* award of punitive damages was recently overturned by the Tenth Circuit, dicta may be found in other district court decisions that support its initial holding. Despite this reversal of the one 10b-5 case in which punitive damages were actually awarded, these dicta suggest policy considerations that may ultimately serve as bases for judicially carved out exceptions to what must now be accepted as the prevailing rule that punitive damages are not available in a 10b-5 action.

⁴⁸ Several district court cases also bar the recovery of exemplary damages in 10b-5 actions. See, e.g., *Pappas v. Moss*, 257 F. Supp. 345, 364 (D.N.J. 1966), *rev'd and remanded*, 393 F.2d 865 (3d Cir. 1968); *Meisel v. North Jersey Trust Co.*, 216 F. Supp. 469 (S.D.N.Y. 1963); *Mills v. Sarjem Corp.*, 133 F. Supp. 753 (D.N.J. 1955); see also *Reynolds v. Texas Gulf Sulphur Co.*, 309 F. Supp. 548, 564 (C.D. Utah 1970); *Klein v. Spear*, 306 F. Supp. 743, 748 (S.D.N.Y. 1969).

⁴⁹ 302 F. Supp. 647 (D. Colo. 1969), *rev'd*, CCH FED. SEC. L. REP. ¶ 92, 898 (10th Cir. Dec. 22, 1970).

⁵⁰ *Id.* at 649.

⁵¹ *Id.*

⁵² *Id.*

The *de Haas* lower court opinion cites with approval *Hecht v. Harris, Upham & Co.*,⁵³ which states that punitive damages may be awarded in an appropriate 10b-5 case. In *Hecht*, however, the court refused to award such damages as a matter of discretion. Two factors influenced this choice. First, the court, in its discretion, had already awarded substantial prejudgment interest to the plaintiff. Second, defendants, as a result of their misconduct, faced NASD disciplinary proceedings.

Finally, in *Stevens v. Abbott*,⁵⁴ the court, while denying punitive damages under a 10b-5 claim, likewise treated the question of their availability as a matter of discretion.⁵⁵ Citing *Hecht*, the court based its denial of exemplary damages on two factors. First, plaintiff had received adequate compensatory damages and should not be "unduly enriched." Second, judging from defendants' "prior impeccable reputation," such an award was not needed to deter similar future conduct on their part.

Surrounding Policy Considerations

The decision by the great majority of the courts not to award punitive damages in 10b-5 cases is basically a sound one.⁵⁶ A combination of policy and practical considerations, not wholly set forth by the courts in their opinions, may be advanced in support of this position:

(1) As the Second Circuit argued in *Green*, an award of punitive damages against the typical corporate defendant will lead to inequities insofar as "the heavy burden would ultimately fall on all the stockholders, including mere innocent pawns."⁵⁷ In *de Haas*, the one 10b-5 case in which exemplary damages were actually awarded by a district court, both an individual and corporate defendant were named. It is interesting to note that the court in this case awarded these damages only against the individual defendant.⁵⁸

(2) Punitive damages are sometimes awarded to fully compensate the plaintiff who has suffered serious injury not susceptible of monetary evaluation. The typical 10b-5 plaintiff, upon prevailing on the merits, is in a position to establish his monetary losses. As a result,

⁵³ 283 F. Supp. 417 (N.D. Cal. 1968).

⁵⁴ 288 F. Supp. 836 (E.D. Va. 1968).

⁵⁵ *Id.* at 848.

⁵⁶ The availability of punitive damages under 10b-5 has been the subject of considerable discussion in the past year. The subject has been treated in: Note, *Punitive Damages as a Remedy for a Violation of Rule 10b-5*, 55 CORNELL L. REV. 646 (1970).

⁵⁷ 406 F.2d at 303.

⁵⁸ 302 F. Supp. at 648; see also the *Globus* case, 418 F.2d at 1286 n.10.

10b-5 recoveries tend to be quite high.⁵⁹ It can further be argued from this that punitive damages are not needed in the 10b-5 area either as an incentive to wronged investors to bring suit or as an added deterrent to those who would violate its proscriptions. Frequently, plaintiffs may share ordinarily burdensome litigation expenses by bringing a class action.

(3) Rule 10b-5 suits are generally multi-plaintiff proceedings which often lead to a multiplicity of subsequent related suits. Permitting each plaintiff, in each suit, to recover punitive damages from the same defendant or group of defendants would lead to liability far beyond the degree of fault, this, on the unlikely assumption that the defendant or defendants would be able to pay such vast amounts.

(4) Punitive damages are traditionally awarded only against defendants guilty of intentional and malicious misconduct. Often, misconduct adjudged to be a 10b-5 violation is not of this type.⁶⁰ Where defendants alleged misconduct does manifest the type of "aggravated scienter" on which the court in *de Haas* predicated its award of punitive damages,⁶¹ it will fall within the more restricted traditional boundaries of common-law fraud. If the conduct of defendant on which a common-law fraud cause of action may be predicated brings him within the jurisdiction of a state whose courts do award punitive damages to the victims of intentionally fraudulent misconduct, plaintiff should follow the litigation strategy outlined immediately below.

Joinder of Common-Law Fraud and Rule 10b-5 Claims — Recovery of Punitive Damages

Under the doctrine of pendent jurisdiction as set forth in the landmark Supreme Court case of *Hurn v. Oursler*,⁶² a federal court entertaining a *bona fide* federal claim will usually also assume jurisdiction of all related state law claims arising out of the same transaction or series of transactions on which the federal claim is predicated. Hence, it is a fairly common practice, when bringing suit under rule 10b-5, to include in the complaint claims under state law for fraud and deceit grounded on the same basic factual allegations set forth in support of the federal claim. If plaintiff succeeds in proving these common-law claims, he may also succeed in recovering punitive damages.

⁵⁹ *Id.*

⁶⁰ See, e.g., *Ellis v. Carter*, 291 F.2d 270 (9th Cir. 1961); see generally 82 HARV. L. REV. 951, 957 (1969).

⁶¹ 302 F. Supp. at 649.

⁶² 289 U.S. 238 (1933).

In *Gann v. Bernzomatic Corp.*,⁶³ defendants moved to strike from plaintiffs' prayer for relief their request for punitive damages. The complaint set forth both a 10b-5 claim and related common-law claims. In denying this motion, the court reasoned:

Assuming that [punitive damages may not be recovered in an action under the Exchange Act], defendants overlook the fact that . . . the present amended complaint states a claim under state law for fraud and deceit, a claim of which this court has pendent jurisdiction. *If plaintiffs establish their claim, they may be entitled to punitive damages under New York Law . . .*⁶⁴

This approach was followed by the district court in *Globus v. Law Research Service, Inc.*,⁶⁵ a shareholders' action asserting violations of both section 17(a) of the 1933 Act and section 10(b) of the 1934 Act. These claims were joined with a common-law fraud count alleging violation of New York law. In consideration of the question of whether resort to relief under the Exchange Act precludes recovery of all but actual damages, the court noted that "[w]hile the contention is an interesting one, defendants' position cannot succeed because it overlooks the first clause of section 28(a). . ."⁶⁶ The court's recognition of the non-exclusive remedial nature of the Exchange Act provision permitted the following conclusion: "Among the other remedies available to . . . plaintiffs is a common law deceit action . . . with [its] possibilit[y] of punitive damages."⁶⁷

In both *Gann* and *Globus*, the courts indicate, at least indirectly through cross-reference to state decisions, that they will follow state law not only in passing up on the legal sufficiency of the common-law fraud count joined to a claim or claims under the federal securities law, but also in determining whether punitive damages should be awarded pursuant to this count.⁶⁸

⁶³ 262 F. Supp. 301 (S.D.N.Y. 1966).

⁶⁴ *Id.* at 304 (emphasis added).

⁶⁵ 287 F. Supp. 188 (S.D.N.Y. 1968), *aff'd in part and rev'd in part*, 418 F.2d 1276 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970). On appeal, the Second Circuit reversed the Southern District's determination that punitive damages are available under section 17(a) of the 1933 Act. Because the jury found defendants not liable on the common-law fraud count, the Second Circuit did not pass on the district court's holding that section 28(a) does not prohibit recovery of punitive damages in an action for common-law fraud joined to an action based on the 1934 Act.

⁶⁶ 287 F. Supp. at 196.

⁶⁷ *Id.*

⁶⁸ Both decisions cite *Walker v. Sheldon*, 10 N.Y.2d 401, 179 N.E.2d 497, 223 N.Y.S.2d 488, (1961), which held that recovery of punitive damages may be had in a fraud case only when the alleged misconduct is part of a scheme to defraud the public generally rather than solely a particular plaintiff. This New York "public injury" requirement was incorporated in the trial judge's jury charge in *Globus*: "The test is whether there

RESCISSION

In *J. I. Case Co. v. Borak*,⁶⁹ a section 14 case involving a stockholder challenge to a consummated merger allegedly effected through the use of false and misleading proxy materials, the United States Supreme Court dealt specifically with the availability of rescission as a remedy under the Exchange Act, stating that

[i]t is for the federal courts "to adjust their remedies so as to grant the necessary relief" where federally secured rights are invaded Section 27 (of the Exchange Act) grants the District Courts jurisdiction "of all suits in equity and actions at law brought to enforce any liability or duty created by this title" In passing on almost identical language found in the Securities Act of 1933, *the Court found the words entirely sufficient to fashion a remedy to rescind a fraudulent sale, secure restitution and even to enforce the right to restitution against a third party holding assets of the vendor.*⁷⁰

Language found in section 29(b) of the Exchange Act to the effect that "[e]very contract made in violation of any provision of this title or of any rule or regulation thereunder . . . shall be void" may well be the ultimate justification for awarding rescission of stock transactions materially tainted by violation of rule 10b-5. The courts, however, have not construed these words as a statutory mandate, but rather as a basis for rendering such transactions voidable at the option of the innocent parties thereto under appropriate circumstances.⁷¹ The award of rescission in an Exchange Act case, as at common law, is purely within the discretion of the trial court. The request for rescission in an Exchange Act case is subject to the traditional equitable defenses of waiver, laches and estoppel.⁷²

Basic Investor Transactions

In the straightforward cash or stock transaction, a defrauded seller or purchaser will normally seek compensatory damages under 10b-5

is high moral culpability or such gross fraud and deceit *upon the public* . . ." 287 F. Supp. at 193 (emphasis added). *See also* Dupont Galleries, Inc. v. International Magne-Tape, Ltd., 300 F. Supp. 1179 (S.D.N.Y. 1969); holding that, in a common-law fraud action, a federal court must follow applicable state law to determine the availability of punitive damages. Under New York law, such damages are not available in an ordinary fraud case. Accordingly, suit must be dismissed for failure to meet the "amount in controversy" standard required for federal diversity jurisdiction.

⁶⁹ 377 U.S. 426 (1964).

⁷⁰ *Id.* at 433, citing *Deckert v. Independence Shares Corp.*, 311 U.S. 282 (1940) (emphasis added).

⁷¹ *See, e.g.*, *Royal Air Properties, Inc. v. Smith*, 312 F.2d 210, 213 (9th Cir. 1962), *aff'd on remand*, 333 F.2d 568 (1964).

⁷² *Id.*; *see also* *Walpert v. Bart*, 280 F. Supp. 1006 (D. Md. 1967).

rather than equitable relief. An award of such damages, particularly where measured so as to take into account fluctuations in market value after the challenged purchase or sale, generally serves as the simplest way of restoring the status quo ante. Nevertheless, ample case authority exists for the proposition that the defrauded seller or purchaser may, at his option, seek rescission in lieu of such damages.

(1) The Defrauded Purchaser

It is generally recognized that a defrauded purchaser seeking relief under 10b-5 may, upon discovery of the fraud or misrepresentation complained of, either choose to affirm the transaction and sue for damages or seek to cancel the contract of sale so as to recover the purchase price upon restoration of the securities acquired in the tainted transaction. The Ninth Circuit in *Sackett v. Beaman*⁷³ recently stated that a defrauded purchaser can request either "cancellation of the contract of sale" or "damages under what may be called an out-of-pocket rule, namely, the difference between the real value of the property purchased at the date of its sale . . . and the price paid for it, together with interest and associated outlays by the purchaser."⁷⁴

A grant of rescission to a defrauded purchaser will lead to his recovery of whatever consideration he has paid for his stock less any dividends or capital distributions received by him during his period of ownership.⁷⁵

Where securities purchased in a tainted transaction are worthless at the time of sale, the recovery of damages and the award of rescission will produce identical results — recovery of the full purchase price by the defrauded purchaser.⁷⁶ Where, however, securities so purchased do not become worthless until after the time of sale, it will be to the advantage of the defrauded purchaser, particularly when bringing suit in a jurisdiction applying a strict out-of-pocket measure of damages, to seek rescission rather than monetary relief. However, the defrauded purchaser that waits for a long period of time after discovery of the fraud before seeking rescission may be precluded by certain equitable defenses from gaining the relief he seeks.⁷⁷

In *Royal Air Properties, Inc. v. Smith*,⁷⁸ another Ninth Circuit

⁷³ 399 F.2d 884 (9th Cir. 1968).

⁷⁴ *Id.* at 891; *see also* *Esplin v. Hirschi*, 402 F.2d 94 (10th Cir. 1968).

⁷⁵ *See, e.g., Esplin v. Hirschi*, 402 F.2d at 105; *Stephens v. Vowell*, 343 F.2d 374 (10th Cir. 1965).

⁷⁶ *See, e.g., Matheson v. Armbrust*, 284 F.2d 670 (9th Cir. 1960).

⁷⁷ *See* *Estate Counseling Serv., Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 303 F.2d 527, 532 (10th Cir. 1962), *discussed at* note 93 and accompanying text *infra*.

⁷⁸ 312 F.2d 210 (9th Cir. 1962).

case, a defrauded purchaser sought to recover his full \$50,000 investment in a real estate corporation that had been liquidated before he brought suit. The trial court refused to consider the equitable defenses of laches and estoppel interposed by defendants in response to the purchaser's request for rescission. The Ninth Circuit remanded the case, stating:

Since the buyer can elect to retain his investment, we see no reason why he can not waive his statutory right to rescind or be estopped from asserting such right The purpose of the Securities Exchange Act is to protect the innocent investor, not one who loses his innocence and then waits to see how his investment turns out before he decides to invoke the provisions of the Act.⁷⁹

The court's conclusion that laches and the related equitable defenses of waiver and estoppel apply to a request for rescission in a 10b-5 suit was largely inferred from the non-existence of an applicable federal statute of limitations. On remand, the trial court disallowed the equitable defenses pleaded by defendant, after giving full consideration to their applicability to the facts of the case.⁸⁰

(2) The Defrauded Seller

Rescission is also available to the defrauded seller in a 10b-5 suit. In *Parker v. Baltimore Paint & Chemical Corp.*,⁸¹ an action by the trustee of a debtor corporation in reorganization to rescind the sale to defendant of all the corporation's stock in its formerly totally owned subsidiary, the court held that rescission would be awarded upon plaintiff's showing that restoration or an offer to restore the consideration received had been made. A similar result was reached in *Lanza v. Drexel & Co.*,⁸² involving defrauded sellers who had transferred all the stock in their family-owned corporation in exchange for stock in the BarChris Corporation. The court awarded plaintiffs \$100,000 in damages, the amount paid by them prior to the judgment to BarChris' bankruptcy trustee to regain their stock.

Just as it will be to the very possible advantage of the defrauded purchaser to seek rescission rather than damages when the stock he holds has decreased in value, converse logic dictates that it will be to the advantage of the defrauded seller to seek rescission in lieu of dam-

⁷⁹ *Id.* at 213-14.

⁸⁰ The award to the plaintiff of his full purchase price was subsequently affirmed by the Ninth Circuit. 333 F.2d 568 (9th Cir. 1964).

⁸¹ 244 F. Supp. 267 (D. Colo. 1965).

⁸² [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,826 (S.D.N.Y. Oct. 9, 1970).

ages when the stock he has parted with has increased in value, as is often the case. While several courts have permitted the defrauded seller to recover this increased value in damages on a constructive trust approach,⁸³ others have refused to apply anything other than a strict out-of-pocket measure.⁸⁴ Certainly, in these out-of-pocket jurisdictions, the defrauded purchaser should seek rescission, remaining conscious of the fact that an undue delay after discovery of the fraud in requesting this relief may lead to the successful interposition of equitable defenses by the defendant.

Corporate Combinations

Many transfers of stock take place in the context of corporate combinations — mergers and consolidations. In these situations, particularly where the defrauded party is a seller of securities who has acquired grossly overvaluated corporate assets in return, the award of monetary damages may well prove to be an inadequate form of relief. Often, this inadequacy will be attributable to either the inability of the defrauding purchaser to pay a large amount of damages or the unwillingness of the defrauded seller to be saddled with a floundering corporate acquisition.

While, as previously noted, not too many 10b-5 cases have reached the relief stage in litigation, there are several in which rescission of a merger or consolidation has been sought.⁸⁵ In only a few of these cases does the court actually award rescission or indicate a firm willingness to do so.

For example, in the *Lanza* case, the Southern District Court in New York held that plaintiffs were entitled to the return of all the stock in their formerly owned family corporation. This corporation had been acquired by the since bankrupt BarChris Corporation in return for its stock. However, prior to this judgment, plaintiffs had already reacquired their stock from BarChris' bankruptcy trustee. Hence, the court's judgment only lent judicial sanction to the already accomplished undoing of a corporate combination.

⁸³ See, e.g., *Janigan v. Taylor*, 344 F.2d 781 (1st Cir.), cert. denied, 382 U.S. 879 (1965).

⁸⁴ See, e.g., *Kohler v. Kohler Co.*, 208 F. Supp. 808, 825 (E.D. Wis. 1962), aff'd, 319 F.2d 634 (7th Cir. 1963).

⁸⁵ See, e.g., *Mills v. Electric Autolite Co.*, 403 F.2d 429 (7th Cir. 1968), vacated, 396 U.S. 375 (1970); *Matheson v. Armbrust*, 284 F.2d 670 (9th Cir. 1960); *Lanza v. Drexel*, [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,826 (S.D.N.Y. Oct. 9, 1970); *de Haas v. Empire Petroleum Co.*, 300 F. Supp. 834 (D. Colo. 1969); *Berman v. Thompson*, 45 F.R.D. 342 (N.D. Ill. 1968), vacated, 312 F. Supp. 1031 (N.D. Ill. 1970); *Walpert v. Bart*, 280 F. Supp. 1006 (D. Md. 1967); *Knauff v. Utah Constr. & Mining Co.*, 277 F. Supp. 564 (D. Wyo. 1967); *Richland v. Crandall*, 262 F. Supp. 538 (S.D.N.Y. 1967); *Parker v. Baltimore Paint & Chem. Corp.*, 244 F. Supp. 267 (D. Colo. 1965).

In the *Parker* case, the court indicated a willingness to rescind defendant's acquisition of a formerly totally owned subsidiary of a debtor corporation in reorganization, as represented by plaintiff-trustee, but only if and when plaintiff was able to plead and prove that adequate restoration or a firm offer thereof had been made.

In *Matheson v. Armbrust*,⁸⁶ the Ninth Circuit granted rescission of plaintiff's acquisition of a closely-held corporation, ordering the return to him of his full purchase price. Similarly, in *Bowman & Bourdon, Inc. v. Rohr*,⁸⁷ plaintiff, who had purchased all the stock in defendants' closely-held corporation, allegedly on the basis of material inaccuracies in its inventory figures, claimed violations of both the 1933 Act and rule 10b-5. Rescission of the entire transaction was sought, requesting damages in the alternative. The court noted in dictum that "[r]escission is a normal remedy in such cases and is appropriate here."⁸⁸

Few Exchange Act cases actually focus on the wisdom of ordering rescission of a corporate combination. Nevertheless, a number of factors a court is likely to consider in determining the appropriateness of awarding rescission of a corporate combination to a successful 10b-5 plaintiff emerges from a reading of these cases and others decided at common law.

(1) Laches

In *Walpert v. Bart*,⁸⁹ a shareholder sought to challenge his corporation's acquisition of a new subsidiary. Although the suit, brought fifty days after consummation of the acquisition, was primarily dismissed for failure to state a claim under section 14 of the Exchange Act, the court also pointed out some of the obstacles to effectuating rescission, indicating that application of the doctrine of laches alone would have precluded such an award:

[L]aches is appropriate here for two reasons. First, the plaintiff should have at least let [it be known] . . . that he opposed the merger and that he was having the proxy statement studied for its legality. But even more important than that, he should have informed [his corporation] . . . as soon as he planned to take legal action rather than waiting until he took it.⁹⁰

The Ninth Circuit in the *Royal Air Properties* case, also noted that the

⁸⁶ 284 F.2d 670 (9th Cir. 1960).

⁸⁷ 296 F. Supp. 847 (D. Mass. 1969).

⁸⁸ *Id.* at 852.

⁸⁹ 280 F. Supp. 1006 (D. Md. 1967).

⁹⁰ *Id.* at 1017.

related defenses of waiver and estoppel, are available to the 10b-5 defendant against whom equitable relief has been requested.

(2) Estoppel

Almost totally interrelated with the concept of laches is the doctrine of estoppel which may be applied to preclude an award of rescission when the request therefore is untimely and the defendant has so changed his financial position during the delay that restoration of the status quo ante would be impossible or unduly harsh. In the *Walpert* case, indicating that plaintiff's delay in requesting rescission was alone sufficient justification for denying such relief, the court explained that

[t]he plaintiff . . . has lulled third parties, who have purchased the stock on the open market, into thinking that the action would not be contested. Further he has allowed [his corporation] . . . to undertake a course of action that would be exceedingly difficult to untangle.⁹¹

It is important to note that the court is concerned with the justifiable reliance placed on plaintiff's temporary inaction by innocent third-party transferees as well as with that shown by the corporate defendant. Where the 10b-5 defendant has pumped considerable capital into a corporate acquisition made pursuant to the challenged transaction, a court, quite understandably, will be less willing to grant rescission.

(3) Waiver

Waiver of the right to elect to rescind may be found on the basis of plaintiff's unreasonable delay in notifying defendant of his intent to rescind or on the basis of plaintiff's filing suit for damages without, at the same time, requesting rescission as an alternate (and perhaps preferred) form of relief. Where plaintiff is the acquiring party in a challenged corporate combination, waiver may also be found on the basis of conduct taken by it with respect to its new acquisition.

[a] Delay

The *Royal Air Properties* case vividly illustrates the fact that courts are unlikely to be sympathetic to 10b-5 plaintiffs who delay the bringing of suit until subsequent fluctuations in market value of the securities sold or acquired dictates that a suit for rescission will yield a greater recovery than a suit for out-of-pocket damages — “[s]ince the buyer can elect to retain his investment, we see no reason why he can not waive his statutory right to rescind”⁹²

⁹¹ *Id.*

⁹² 312 F.2d at 213.

[b] Request for Monetary Relief

At least one court has indicated that an election by a 10b-5 plaintiff to rescind is binding upon him, even though he subsequently desires to affirm the challenged transaction because of an unanticipated fluctuation in the value of the securities he has purchased or sold pursuant thereto.⁹³ The converse of this proposition might well be adopted by a court in an appropriate case.

[c] Affirmation of Challenged Acquisition

The acquiring plaintiff in a challenged corporate acquisition, even after announcing his intention to rescind, must be mindful of the possibility that his continued operation of the acquired company pending the outcome of litigation may be interpreted as an affirmation or ratification of the transaction.⁹⁴ The law does not require a plaintiff seeking rescission to refrain from continuing the normal operation of its newly acquired corporate assets. Such action is often necessary to preserve the assets to be returned to defendant pursuant to restoration of the status quo ante.⁹⁵ Waiver of the right to rescind through affirmation of the challenged transaction will be found only on the basis of actions performed that are "inconsistent with the claim of repudiation,"⁹⁶ such as the thorough integration of newly acquired corporate assets into the plaintiff's former corporate structure.

(4) Mechanical Feasibility

Rescission is awarded only at the discretion of the trial court. Often the primary consideration behind a court's refusal to grant rescission is the fact that restoration of the status quo ante will be extremely difficult or impossible to effectuate.

A court of equity does, however, enjoy extreme flexibility in fashioning a rescission. It may order partial rescission, restoration or restitution in kind, or supervision of the carrying out of its decree by a court-appointed master or referee. This flexibility is illustrated by the Eighth Circuit's approach in *Omaha Hardwood Lumber Co. v. J. H. Phipps Lumber Co.*,⁹⁷ a non-Exchange Act suit brought to cancel the sale of a manufacturing plant:

⁹³ *Estate Counseling Serv., Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 303 F.2d 527, 532 (10th Cir. 1962).

⁹⁴ See generally S. WILLISTON, *CONTRACTS* § 1527 (3d ed. 1970).

⁹⁵ See generally 13 Am. Jur. 2d *Fraud & Deceit* § 210 (1964).

⁹⁶ *Weigel v. Cook*, 237 N.Y. 136, 140, 142 N.E. 444, 445 (1923); see also *Wickre v. Allen*, 58 Wash. 2d 770, 364 P.2d 911 (1961); *Bariel v. Tuinstra*, 45 Wash. 2d 533, 276 P.2d 569 (1954).

⁹⁷ 135 F.2d 3 (8th Cir. 1943).

The general principle that cancellation will not be granted unless the other party can be placed in status quo must, of necessity, be given a practical and somewhat flexible application to the circumstances of each particular case. The degree to which a literal restoration of the status quo will be required as a condition of cancellation depends largely upon the nature of the subject matter, the circumstances of the transaction, the measure of the parties' respective legal and moral responsibility for the confronting situation, and the equitableness of the judicial result that it is possible to achieve. As it is commonly expressed, cancellation will be denied if the granting thereof will leave the plaintiff with any unconscionable advantage, or if the defendant cannot be substantially restored to his former position, under all the circumstances of the case. . . . But, as with other equitable principles, the fundamental test necessarily is whether, on the whole situation, justice in the particular case will more nearly and practically be achieved by the granting or by the denial of cancellation.⁹⁸

Nevertheless, despite manifesting this flexibility, courts have traditionally refused to award rescission where either plaintiff's restoration or defendant's restitution is difficult to effectuate and an award of compensatory damages will largely remedy the injury incurred. Let us consider three possible obstacles to the effectuation of rescission of a corporate combination tainted by a violation of rule 10b-5.

[a] Acquisition of Securities by Bona Fide Third-Party Purchaser

A bona fide purchaser of securities takes them free of adverse claims.⁹⁹ Where a corporate combination, as is often the case, is accompanied by a transfer of shares representing ownership of the corporate assets acquired or the consideration for same, and these shares are subsequently sold to bona fide third-party purchaser, rescission of the combination becomes impossible unless the court is willing to permit restoration or restitution in kind. The latter possibility is likely to arise only when shares paid as consideration for a corporate acquisition are freely traded and available on a recognized stock exchange.

In the *Gottlieb* case, ex-shareholders of the World Wide Bowling Corporation alleged that the company's acquisition by Sandia, accomplished through an exchange of stock and debentures, was induced by material omissions and misrepresentations in violation of 10b-5. The court, although fully cognizant of the fact that monetary relief would not fully compensate plaintiffs, still ruled out the possibility of complete rescission because of Sandia's subsequent transfer of its newly

⁹⁸ *Id.* at 8.

⁹⁹ N.Y. UNIFORM COMMERCIAL CODE § 8-301(2).

acquired World Wide stock, stating: "At the same time, a remedy of strict rescission has been made impossible by the acts of the defendants in spinning off and subsequently relinquishing their ownership interest in the former World Wide assets" ¹⁰⁰

A 10b-5 plaintiff desiring rescission of a corporate combination pursuant to which the defendant has acquired transferable securities should immediately move to temporarily enjoin the defendant's transfer of these shares pending determination on the merits of his case. ¹⁰¹

[b] Integration of Acquired Corporate Assets

Rescission may become exceedingly difficult or even impossible to effectuate once corporate assets acquired pursuant to a tainted transaction are merged with the other assets of the acquiring company. Pointing to the inadvisability of awarding rescission in such circumstances, the court in *Walpert* noted that "[t]he plaintiff . . . [by refusing to take prompt action] has allowed [his corporation] . . . to undertake a course of action that would be exceedingly difficult to untangle." ¹⁰²

In *May v. Midwest Refining Co.*, ¹⁰³ a non-Exchange Act case, the First Circuit approved the district court's refusal to award rescission in a suit brought by a former minority shareholder of a corporation that had been dissolved after the sale of its assets to another corporation to challenge this acquisition, stating that

the District Court had power to decline to grant rescission . . . , and we see no reason to quarrel with the court below for exercising that power under the somewhat peculiar circumstances of the case at bar.

But that does not mean, as the plaintiff seems to argue, that equitable relief is denied because of the proportionately small number of shares which he owns. It means that the nature and extent of the properties and assets sold by the Midwest Refining Company to the defendants, and the commingling by the defendants of those properties and assets with others either formerly owned or later acquired by them, are proper elements for consideration in determining whether or not it would be equitable to rescind the sale. ¹⁰⁴

¹⁰⁰ 304 F. Supp. at 990.

¹⁰¹ See *Greater Continental Corp. v. Schechter*, 304 F. Supp. 325 (S.D.N.Y. 1969); see also *Hamilton Watch Co. v. Benrus Watch Co.*, 206 F.2d 738 (2d Cir. 1953); N.Y. UNIFORM COMMERCIAL CODE § 8-315(3) which provides that "[t]he right to obtain or reclaim possession of a security may be specifically enforced and its transfer enjoined and the security impounded pending the litigation."

¹⁰² 280 F. Supp. at 1017.

¹⁰³ 121 F.2d 431 (1st Cir. 1941), cert. denied, 314 U.S. 668 (1942).

¹⁰⁴ *Id.* at 438. In the course of its opinion, the court quoted the following language of the trial court with approval:

With all interested parties in court, and the plaintiff making a complaint in-

To prevent the "scrambling" of newly acquired corporate assets by defendant, prompt action on the part of the plaintiff seeking rescission is necessary. Where the plaintiff is the acquiring party, he must remain mindful that failure to segregate acquired assets will not only render rescission mechanically difficult to effectuate but may also constitute a waiver of his right to rescind.¹⁰⁵

[c] Dissolution of Seller Corporation

Acquisition agreements often provide for dissolution of the corporation whose assets are to be transferred to the acquiring corporation. Dissolution is generally accompanied by a pro rata distribution to the acquired corporation's former shareholders of the consideration paid by the acquiring corporation. The feasibility of effectuating rescission against a recently dissolved corporation and its former shareholders depends upon several important considerations.

(i) Suit Against Dissolved Corporation

A federal court will honor the right to bring suit against a dissolved corporation where this right is established by the law of the incorporating state.¹⁰⁶ Many states have such provisions. For example, the Delaware Corporation Law provides:

All corporations, whether they expire by their own limitation or are otherwise dissolved, shall nevertheless be continued for the term of three years from such expiration or dissolution or for such longer period as the Court of Chancery shall in its discretion direct, bodies corporate for the purpose of prosecuting and defending suits, whether civil, criminal or administrative, by or against them¹⁰⁷

The section goes on to toll expiration of this three-year period upon the commencement of suit by or against the dissolved corporation.

Once the right to bring timely suit against a dissolved corporation

volving the value of his holdings, which the defendants are willing to satisfy, it does not seem reasonable to use such a difficult, clumsy and harsh method of redress as that urged by the plaintiff, if any other can be found that is simple and efficacious as well as just and equitable, . . . and to attempt to grant relief by annulling this sale made six years ago and restoring such a vast amount and diversity of property as an oil company of this size must have owned, is wholly impracticable. What counsel refers to as an "eighty million dollar egg" of that character cannot be unscrambled and the expense and time involved in trying to do so would be so great as to amount to a denial of justice.

Id. at 436-37.

¹⁰⁵ See notes 94-96 and accompanying text *supra*.

¹⁰⁶ See, e.g., *United States v. P.F. Collier & Son*, 208 F.2d 936, 937 (7th Cir. 1953) (applying the Delaware statute); see also *Chicago Title & Trust Co. v. Wilcox Bldg. Corp.*, 302 U.S. 120, 124-25 (1937).

¹⁰⁷ DEL. CODE ANN. tit. 8, § 278 (1967).

is established, additional obstacles must be met before rescission in the aforescribed type of 10b-5 suit may be effectuated.

(ii) Resurrection of Dissolved Corporation

Restoration by plaintiff of the assets acquired pursuant to the challenged acquisition will require resurrection of the dissolved corporation. The power of a federal court, possessing full equity powers, to resurrect a dissolved corporation for the purpose of effectuating rescission, while infrequently exercised, has long been recognized. In *Jones v. Missouri-Edison Co.*,¹⁰⁸ plaintiff, a former shareholder of a company dissolved pursuant to the challenged, acquisition, sought rescission thereof. The court indicated that

[t]here is in the bill, it is true, a prayer that the agreement of consolidation be set aside, and that the property of the Edison Company be restored to it [T]he Edison Company was not so irrevocably dissolved that its rehabilitation is beyond the power of a court of chancery. Its dissolution was wrought by the transfer, by means of the contract and act of consolidation, of its franchises, powers and property to the new corporation. That transfer, that act and that contract were voidable A court of equity has plenary powers to set them all aside and to restore to the Edison Company all its franchises, powers, and property, if action so drastic becomes necessary in order to secure to them adequate relief.¹⁰⁹

(iii) Compelling Restitution by Former Shareholders

The substantive basis for asserting a right to rescission against the former shareholders of a dissolved corporation rests on a constructive trust impressed upon the assets of the corporation that has been distributed to them. This constructive trust runs in favor of creditors of and claimants against the dissolved corporation.¹¹⁰

Several cases indicate that in a suit requesting rescission of a transaction against a subsequently dissolved corporation, its former shareholders are indispensable parties insofar as restitution will have to be effectuated out of assets already distributed to them.¹¹¹ An argument

¹⁰⁸ 144 F. 765 (8th Cir. 1906).

¹⁰⁹ *Id.* at 776-77.

¹¹⁰ See, e.g., *Christian v. Texas Gas & Power Corp.*, 14 F.R.D. 80 (N.D. Tex. 1952) (applying Delaware law); see also *Hawkings v. Glenn*, 131 U.S. 319 (1889).

¹¹¹ *Mansfield Hardwood Lumber Co. v. Johnson*, 263 F.2d 748 (5th Cir. 1959); see also *Chiodo v. General Waterworks Corp.*, 380 F.2d 860 (10th Cir. 1967); *Tucker v. National Linen Serv. Corp.*, 200 F.2d 858 (5th Cir. 1953). A contrary argument may be made on the basis of cases indicating that a judgment on the merits against a dissolved corporation may be enforced in a subsequent proceeding against its former shareholders. See, e.g., *Hancock Nat'l Bank v. Farnum*, 176 U.S. 640 (1900) (judgment against dissolved corporation in State X entitled to full faith and credit in State Y even though the share-

can be made that in personam jurisdiction over former shareholders in a 10b-5 suit may be based on section 27 of the Exchange Act which provides for nationwide jurisdiction and service not only with respect to all violations of the 1934 Act but also with respect to "actions . . . brought to enforce any liability or duty created" by that Act.¹¹²

If, for any reason, in personam jurisdiction cannot be obtained over certain former shareholders of the dissolved corporation, the possibility of obtaining in rem jurisdiction over them for purposes of compelling restitution still exists. Section 57 of the Judicial Code provides:

In an action in a district court to enforce any lien upon or claim to, or to remove any incumbrance or lien or cloud upon the title to, real or personal property within the district, where any defendant cannot be served within the State, or does not voluntarily appear, the court may order the absent defendant to appear or plead by a day certain. . . . If an absent defendant does not appear or plead within the time allowed, the court may proceed as if the absent defendant had been served with process within the State, but any adjudication shall, as regards the absent defendant without appearance, effect only the property which is the subject of the action. When a part of the property is within another district, but within the same state, such action may be brought in either district.¹¹³

Various case authorities, when pieced together, support the proposition that section 57 may be used in combination with a state provision fixing the situs of stock ownership for purposes of suit to obtain in rem jurisdiction over former shareholders that must be joined in a suit against the dissolved corporation for the purpose of effectuating rescission. In *Doherty v. McDowell*,¹¹⁴ a suit brought in Maine some fifty years ago by New York plaintiffs against Pennsylvania and Texas defendants to quiet title to stock in a Maine corporation allegedly acquired by them through fraud, the court, relying on Maine statutory provisions, held that the locus of this stock, for purposes of suit under section 57, was in Maine and refused to sustain a challenge to its in rem jurisdiction over defendants. Despite the fact that there have been

holders were not parties to the State X action). As a practical matter, plaintiff will want to join former shareholders in its suit against their dissolved corporation wherever possible, so as to avoid their transfer of distributed corporate assets to bona fide transferees before judgment is obtained against the dissolved corporation.

¹¹² 15 U.S.C. § 78aa (1964).

¹¹³ 28 U.S.C. § 1655 (1964).

¹¹⁴ 276 F. 728 (D. Me. 1921).

holdings to the contrary,¹¹⁵ it was further held in *Doherty* that under section 57, plaintiffs could sue to "establish a claim" to certain shares of stock and that plaintiffs did not have to establish either title to or a lien on this stock as a precondition to seeking to compel its return in a suit pursuant to this provision.

CONCLUSION

The courts have yet to fully consider many questions concerning the remedies available under rule 10b-5. Judicial treatment of almost all questions falling under this broad rubric, including the more basic ones that have arisen and been considered quite often, has been marked by a surprising degree of flexibility. It is for these reasons that the effective handling of even the relatively routine 10b-5 case requires both the skill and imagination of the artful litigator.

¹¹⁵ See, e.g., *Maya Corp. v. Smith*, 32 F.2d 350 (D. Del. 1929); see also *Wilhelm v. Consolidated Oil Corp.*, 84 F.2d 739 (10th Cir. 1936).