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## Rule 10b-5 in the Ninth Circuit—Materiality, Scienter and Damages: *Nelson v. Serwold*

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**RULE 10b-5 IN THE NINTH CIRCUIT—MATERIALITY,  
SCIENTER AND DAMAGES: *NELSON v.*  
*SERWOLD***

I. INTRODUCTION

The Securities Exchange Act of 1934<sup>1</sup> (hereinafter the Act) was enacted to protect the general investing public by preventing unfair and inequitable practices. The Act is also designed to make control of securities transactions reasonably effective and complete.<sup>2</sup> In particular, section 10(b)<sup>3</sup> and rule 10b-5<sup>4</sup> guard against fraud in connection with the purchase or sale of any security.

The landmark case of *Ernst & Ernst v. Hochfelder*<sup>5</sup> effectively limited the scope of rule 10b-5 actions by requiring scienter as a necessary element to impose liability for damages.<sup>6</sup> The Court defined scienter as an intent to deceive, defraud or manipulate on the part of the defend-

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1. 15 U.S.C. §§ 78 (a)-(kk) (1976).

2. *Id.* § 78(b).

3. Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78(j) (1976), makes it unlawful for one "[t]o use or employ, in connection with the purchase or sale of any security . . . , 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."

4. Rule 10b-5 was promulgated by the Securities Exchange Commission pursuant to the grant of rulemaking authority in § 10(b) and provides:

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

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1978).

5. 425 U.S. 185 (1976).

6. *Hochfelder* did not decide whether scienter is a requirement in an action for injunctive relief. *Id.* at 193 n.12.

Although rule 10b-5 itself does not provide for a private cause of action, civil liability is now well established. *See, e.g.,* *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730 (1975); *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 150-54 (1972); *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 13 n.9 (1971). However, prior to *Hochfelder* there had never been agreement among the circuits as to whether scienter was a necessary element of a 10b-5 cause of action, or whether mere negligent conduct was sufficient. *See* note 55 *infra* and accompanying text.

ant.<sup>7</sup> However, it is unclear whether recklessness would satisfy the *Hochfelder* scienter requirement. The *Hochfelder* Court expressly declined to decide whether recklessness would constitute scienter sufficient for civil liability under rule 10b-5 and section 10(b).<sup>8</sup> The Ninth Circuit, however, in the recent case of *Nelson v. Serwold*<sup>9</sup> did decide that the definition of scienter included knowledge<sup>10</sup> or recklessness on the part of a defendant. It thus potentially broadened the scope of liability in 10b-5 actions. In analyzing the 10b-5 action before it, the Ninth Circuit also held that the rescissory theory<sup>11</sup> is a proper method for measuring losses in a 10b-5 action. In using this theory to give plaintiff the maximum amount recoverable, the Ninth Circuit has thus continued to focus on the defendant's wrongful conduct, rather than on the plaintiff's losses, in assessing relief.

## II. FACTS OF THE CASE

Kenneth N. Nelson (Nelson) sued defendants<sup>12</sup> on June 20, 1972 for damages for fraudulent misrepresentations made by defendants in

7. 425 U.S. at 193.

8. The *Hochfelder* definition of scienter was expressly limited to its facts. *Id.* at 193 n.12. The Court did not decide whether recklessness would constitute scienter since, in that particular case, the plaintiff premised liability on a negligence theory and acknowledged that the defendants did not engage in intentional misconduct. The Court was not, therefore, squarely presented with the recklessness question:

In this opinion the term "scienter" refers to a mental state embracing intent to deceive, manipulate, or defraud. In certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act. We need not address here the question whether, in some circumstances, reckless behavior is sufficient for civil liability under § 10(b) and Rule 10b-5.

*Id.*

9. 576 F.2d 1332 (9th Cir.), *petition for cert. filed*, 47 U.S.L.W. 3159 (U.S. Jul. 26, 1978)(No. 78-182).

10. *Hochfelder* did not specifically hold that knowledge by the defendant of the wrongful act was sufficient to satisfy the scienter standard, although the Court did "strongly suggest" that § 10(b) was directed at knowing or intentional misconduct. 425 U.S. at 197. *See also* note 82 *infra* and accompanying text.

11. *See* notes 91-96 and 103-09 *infra* and accompanying text.

12. The defendants were also sued for alleged misrepresentations in violation of rule 10b-5 in *Lanning v. Serwold*, 474 F.2d 716 (9th Cir. 1973).

The *Lanning* opinion is dated Feb. 12, 1973, prior to the opinion handed down in *Nelson*. It is interesting to note that the attorneys who represented Nelson also represented the plaintiff-appellant, Lanning. Lanning averred that he entered into an agreement in 1971 with two shareholders of Poulsbo Rural Telephone Ass'n to purchase 136 shares at \$15 per share. Rule 10b-5 was alleged to have been violated because the defendants had made false representations to the two shareholders in attempting to frustrate the proposed sale. Lanning asserted that the Serwolds wanted them to make a larger profit on the shares and so encouraged them to hold on to their shares. The Court of Appeals held that a good cause of action was stated and remanded the case to the district court.

purchasing stock from the estate of Nels Nelson, of which Nelson was an heir. The defendants, husband and wife, were directors of Poulsbo Rural Telephone Association (PRTA), a Washington corporation. They were members of a control group holding 56% of PRTA stock. This control group<sup>13</sup> took rein over the corporation to modernize it and develop it into a marketable enterprise.<sup>14</sup>

In 1962, thirty-six shares of PRTA stock were found in the estate of Nels Nelson.<sup>15</sup> Earl Korth (Korth), a Wisconsin attorney for the estate, wrote to PRTA asking for information as to the status of the stock. Serwold accepted the letter addressed to the company but did not respond in his capacity as a corporate officer. Instead, he referred the letter to his personal attorney, J. Paul Coie (Coie), who in turn responded that "we . . . may be in a position to offer \$5.00 per share."<sup>16</sup> Thereafter Korth wrote Coie showing ownership in the Nelson estate and inquiring as to whether any dividends had accrued. Korth received no response to this communique for twenty-seven months. In the interim the Nelson estate was closed, and the certificate was retained by the estate's administrator in a safe deposit box. Coie finally replied in April 1965, enclosing Serwold's personal check for \$180.00, which represented a purchase price of \$5.00 per share, and authorizing its endorsement upon surrender of the stock certificate for thirty-six shares. He stated that no dividends had ever been declared and that none were anticipated.<sup>17</sup>

Korth assumed that \$5.00 per share represented the fair market value of the stock and so informed his client.<sup>18</sup> Coie was apprised of Korth's assumption when he received a copy of the letter from Korth to the estate's administrator informing him of the latest information concerning the stock.<sup>19</sup> After further correspondence, Korth and Coie agreed in July, 1965 on a purchase price of \$6.94 per share, and Coie for-

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13. The control group consisted of the Serwolds, who held 30% of the controlling interest and, among others, J. Paul Coie, Mr. Serwold's personal attorney, who held a 10% beneficial interest.

14. 576 F.2d at 1334.

15. The stock certificate was issued to R. Norman, but was the property of Nels Nelson, deceased. *Id.*

16. *Id.* at 1335. In the defendants' Petition for Certiorari they state "Korth had requested the company to transmit his request to 'any source' that could give him the desired information." Petition For Writ of Certiorari at 19, *Nelson v. Serwold*, 576 F.2d 1332 (9th Cir. 1978). Contrary to the Ninth Circuit's implication, it does not appear unreasonable that Serwold's attorney would reply.

17. *Id.* See note 49 *infra*.

18. *Id.*

19. Korth wrote to the administrator of the estate stating that he assumed \$180.00 represented the fair market value for the 36 shares. A copy of the letter was sent to Coie. *Id.*

warded another Serwold check for the additional sum in exchange for the stock certificate. At that time PRTA stock had a book value of approximately \$60.00 per share.<sup>20</sup>

Shortly thereafter O.E. Serwold engaged in negotiations for the sale of the company. As a result of negotiations which began in December 1970 and culminated in 1971, PRTA agreed to an exchange of all its assets for stock in United Utilities, Inc. The shareholders of PRTA received twenty-five shares of United Stock, having a total value of \$500.00, for each share of PRTA stock.<sup>21</sup>

The plaintiff, as an heir to the Nelson estate, became aware of the PRTA transaction in 1971 and, after obtaining assignments from other relatives, brought an action for fraudulent misrepresentation in 1972. The district court held that the defendants' failure to disclose (1) the existence of the control group and (2) the group's informal long range plan to acquire a majority of the company stock in order to modernize the company for sale, constituted material omissions.<sup>22</sup> It held the defendants liable, without finding an intent to deceive,<sup>23</sup> and awarded damages based on the highest value of the shares at a reasonable time after the transaction.<sup>24</sup> Plaintiff appealed the award of damages since it was not based on a rescissory theory which would have required full disgorgement of defendants' profits. Defendants cross-appealed on the

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20. *Id.* For discussion of the relative importance of the term "book value", see notes 44-47 *infra* and accompanying text.

21. *Id.* At the time PRTA stock had a *book value* of approximately \$163.00 per share. For further discussion, see notes 44-47 *infra* and accompanying text.

22. *Id.* at 1336. A necessary element to a 10b-5 cause of action is a showing that the misrepresentations or omissions were material. For a complete discussion of this issue, see notes 29-41 *infra* and accompanying text.

23. The district court's holding predated *Hochfelder*, and the court therefore relied upon the Ninth Circuit's position as stated in *White v. Abrams*, 495 F.2d 724, 734-35 (9th Cir. 1974) that a finding of scienter was not required in order to impose liability under rule 10b-5. *Id.* at 729. See also notes 61 & 62 *infra* and accompanying text.

24. Because the district court classified the culpability of the defendants as neither deliberate nor with a "cold-blooded intent," it assessed damages which fell short of disgorging all of the defendants' profits. *Nelson v. Serwold*, No. 411-72C2, Findings and Conclusions, Conclusions of Law, No. 1 (W.D. Wash., Sept. 29, 1975).

The lack of scienter militates against the stricter rule of *Myzel v. Fields*, . . . which calls for complete disgorgement by persons who deliberately set out to cheat. Rather, the lack of scienter calls for a lesser measure of damages—more than the difference between price and market, but one still below the *Myzel* measure. The court maintained that within a reasonable time after the sale plaintiff would have discovered the material information. It concluded that December 31, 1967, just over two years after the transaction, was such a reasonable time. On that date the stock had a book value of \$83.43 per share. Accordingly, the district court awarded plaintiff \$3,003.48, plus interest and costs. 576 F.2d at 1338.

The district court was cognizant of the "insider" factors present, but because it concluded that liability under 10b-5 had been established, discussion of the insider rule of *Texas Gulf Sulphur* was unnecessary. *Nelson v. Serwold*, No. 411-72C2 (W.D. Wash., Oct. 29, 1974).

grounds that the omissions were not material and that the *Hochfelder* scienter requirement had not been satisfied.

### III. REASONING OF THE COURT

As presented on appeal, *Nelson v. Serwold*<sup>25</sup> concerns three major issues: (1) the standard by which materiality of omissions is to be judged; (2) the level of intent needed to fulfill the *Hochfelder* scienter requirement; and (3) the appropriate measure of damages in 10b-5 actions. *Nelson* is significant in that it is the Ninth Circuit's first statement in light of *Hochfelder* upon these critical issues.

#### A. Materiality of Omission

The regulatory objective of rule 10b-5 is that access to material information be enjoyed equally by all investors.<sup>26</sup> However, there exists a wide range of opinion as to the type of information which, if omitted or misrepresented, will be considered material.<sup>27</sup> Indeed, the difficult problem in 10b-5 actions has not been one of applying settled legal principles of law to particular facts, but rather of formulating the gov-

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25. 576 F.2d 1332 (9th Cir.), *cert. denied*, 99 S. Ct. 464 (1978).

26. *See, e.g.*, SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969) ("The only regulatory objective [of rule 10b-5] is that access to material information be enjoyed equally, but this objective requires nothing more than the disclosure of basic facts . . .").

27. *See, e.g.*, Sunstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977) (representations regarding financial condition of corporation and corporate merger constitute material information); Holdsworth v. Strong, 545 F.2d 687 (10th Cir. 1976), *cert. denied*, 430 U.S. 955 (1977) (statements to the effect that neither company nor its stock had any worth were material); United States v. Charnay, 537 F.2d 341 (9th Cir.), *cert. denied*, 429 U.S. 1000 (1976) (manipulation of market value of stock was material information); Marx v. Computer Sciences Corp., 507 F.2d 485 (9th Cir. 1974) (corporation's earnings forecast deemed material); Arber v. Essex Wire Corp., 490 F.2d 414 (6th Cir. 1974) (where book value of stock readily available to buyers and no evidence of secret plan by management to greatly affect stock value, no finding of material omissions since disclosure required only of existing material facts and information of unusual or extraordinary nature); Hope v. Hayden-Stone, Inc., 469 F.2d 1060 (5th Cir. 1972) (per curiam) (broker's references to father's relationship with corporation and to possible forthcoming corporate acquisition not material since not untrue and matter of public record); Chasins v. Smith, Barney & Co., 438 F.2d 1167 (2d Cir. 1970) (failure of brokerage firm to disclose that it was making a market in the securities it sold to plaintiff was material); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969) (results of drill core and existence of mine held material; materiality includes those facts which affect probable future of corporation and which affect desire of investor to buy, sell or hold securities); Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961) (representation that stock carried voice in management held to be material).

erning principles,<sup>28</sup> and the standard by which to measure materiality is still one of these unsettled principles.

There has long been a split among the circuits as to whether the proper standard for judging the materiality of omissions and/or misrepresentations should depend upon what the investor (1) would have done, (2) could have done, or (3) might have done with that information. The Second, Seventh, and Eighth Circuits have held that it is sufficient that the investor *might* have considered the information important in his investment decision.<sup>29</sup> The Third, Fifth, and Sixth Circuits, however, have insisted that it be shown that the investor *would* have considered the information important.<sup>30</sup> The Ninth Circuit has also adopted the stricter "would" criteria.<sup>31</sup>

In *Affiliated Ute Citizens v. United States*,<sup>32</sup> the United States Supreme Court defined materiality as involving those facts which the reasonable investor *could* have or *might* have considered important in making a decision to sell.<sup>33</sup> *Affiliated Ute* involved the omission of

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28. *Sunstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1044 n.15 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977).

29. *See Chasins v. Smith, Barney & Co.*, 438 F.2d 1167, 1171 (2d Cir. 1970) (disclosure of market making role *might* have influenced plaintiff's decision to buy stock and was therefore material); *Myzel v. Fields*, 386 F.2d 718, 734 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968) (statements that corporation was on verge of bankruptcy and that stock was worthless were misleading and *might* have affected value of stock); *Kohler v. Kohler Co.*, 319 F.2d 634, 642 (7th Cir. 1963) (corporate insiders required to disclose facts of corporation's business which are unknown to outsiders and which *might* affect value of stock); *but see List v. Fashion Park, Inc.*, 340 F.2d 457, 462-63 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965) (plaintiff *would* have sold stock even if he had information that buyer was director of corporation with inside information of potential sale or merger).

30. *See Rochez Bros., Inc. v. Rhoades*, 491 F.2d 402, 408 (3d Cir. 1974) (50% owner of stock *would* attach importance to acquisition negotiations in deciding whether to sell to co-owner); *Arber v. Essex Wire Corp.*, 490 F.2d 414, 419-20 (6th Cir. 1974) (detailed knowledge of mechanism for establishing going price and book value not material since information *would* not have affected choice of action); *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579, 603-05 (5th Cir.), *cert. denied*, 419 U.S. 873 (1974) (failure to disclose stock option on proxy statement not material since not obviously important to investor and it could not be said that it *would* have been given importance in determining course of action).

31. *See Lewelling v. First Cal. Co.*, 564 F.2d 1277, 1279 (9th Cir. 1977) ("[m]ateriality of omissions is measured by . . . whether a reasonable man *would* attach importance in determining his choice of action . . ."); *Robinson v. Cupples Container Co.*, 513 F.2d 1274, 1277 (9th Cir. 1975) (reasonable investor *would* not attach importance to statement previously made but not embodied in stock exchange contract to the effect that defendant would invest in corporate acquisition); *Marx v. Computer Sciences Corp.*, 507 F.2d 485, 489 n.6 (9th Cir. 1974) (objective test for materiality is whether reasonable man *would* attach importance to misrepresentation); *Northwest Paper Corp. v. Thompson*, 421 F.2d 137, 138 (9th Cir. 1969) (*per curiam*) (recognized test for materiality is whether reasonable man *would* attach importance to certain information in determining his choice of action).

32. 406 U.S. 128 (1972).

33. *Id.* at 153-54.

facts relating to the value of the stock being sold by the plaintiffs. The plaintiff sellers, having no investor acumen, relied upon the defendant brokers for an accurate assessment of the value of the securities. The Court found the defendants liable for failing to provide information as to the fair value since this information either *could* have or *might* have influenced the plaintiffs' investment decision.<sup>34</sup>

However, the Court recently stated a different standard for materiality in *TSC Industries, Inc. v. Northway, Inc.*<sup>35</sup> Although that case was based upon a violation of a different section of the Act,<sup>36</sup> the holding depended upon a finding that certain omitted facts were material. *Northway* involved the failure of TSC Industries to state facts relating to control over its management. The Seventh Circuit in *Northway*<sup>37</sup> recognized that *Affiliated Ute* used the "might" standard in determining materiality and therefore based its finding of liability on that standard.<sup>38</sup> The Supreme Court, however, reversed the Court of Appeals since it found that the omissions in question were not "so obviously important that reasonable minds could not differ as to materiality."<sup>39</sup> The Court stated that the proper standard for materiality was the substantial likelihood that a reasonable investor *would*, rather than *might*, consider the information important in making his decision.<sup>40</sup> Although

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[T]he defendants devised a plan and induced the [plaintiffs] to dispose of their shares without disclosing to them material facts that reasonably *could* have been expected to influence their decisions to sell. . . . [F]acts withheld [are] material in the sense that a reasonable investor *might* have considered them important in the making of [his] decision. . . . (emphasis added).

34. *Id.*

35. 426 U.S. 438 (1976).

36. *Northway* involved an alleged proxy solicitation violation under 15 U.S.C. § 78n(a) (1976). The rule promulgated by the Securities Exchange Commission under that section (rule 14a-9) provides in pertinent part:

(a) No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting or other communication, written or oral, containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which *omits to state any material fact* necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading.

17 C.F.R. 240.14a-9 1978 (emphasis added). *See also* Smallwood v. Pearl Brewing Co., 489 F.2d 579 (5th Cir.), *cert. denied*, 419 U.S. 873 (1974) (analysis under § 14(a) and § 10(b) is identical).

37. 512 F.2d 324 (7th Cir. 1975).

38. *Id.* at 331-32.

39. 426 U.S. at 452-53. The Court noted that *Affiliated Ute* was not dispositive on the question of materiality since the Court's language was not used to precisely define materiality, but rather to state that positive proof of reliance is unnecessary when materiality has been established. *Id.* at 447 n.9.

40. *Id.* at 449.



*Northway* was not decided in light of rule 10b-5, at least one court has recognized the controversy raised by *Northway*.<sup>41</sup>

In *Nelson*, the district court applied the "would" standard previously adopted by the Ninth Circuit and found that the facts regarding the PRTA control group and its long range plans were materially misleading.<sup>42</sup> On appeal, however, the Ninth Circuit expressly stated that the less harsh "could" standard announced in *Affiliated Ute* was the appropriate measure by which to judge materiality.<sup>43</sup> Yet the court did not clearly distinguish the two standards since it found, on the facts before it, that the stricter "would" standard was met. By referring to the "could" standard without further discussion, the Ninth Circuit in *Nelson* not only created confusion, but added fuel to the fire regarding the proper standard by which to judge materiality.

The confusion as to what information will be considered material within the context of rule 10b-5 is exacerbated by the Ninth Circuit's use of the terms "book value" and "fair market value" in determining materiality in *Nelson*. The Court of Appeals agreed with the district court that Korth's request for information regarding the status of the shares demanded a more detailed response than that which he received, especially in light of Korth's belief that \$5.00 per share represented the fair market value of the stock and Coie's knowledge of this reliance.<sup>44</sup> According to the Ninth Circuit, this response should have included the fact that a group of shareholders had joined to acquire control of the telephone company and had plans to turn the company into a marketable commodity. The court concluded that knowledge of these facts *would* have influenced plaintiff's decision to sell.<sup>45</sup>

However, the evidence does not clearly support the court's rapid conclusion that these omissions would have in fact influenced plaintiff's decision to sell. Although the court stated that the evidence supported Korth's erroneous assumption that \$5.00 represented the fair market value, it repeatedly made references to the parallel book values of the PRTA stock.<sup>46</sup> The court failed to explain the correlation between

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41. See *Lewelling v. First Cal. Co.*, 564 F.2d 1277 (9th Cir. 1977). "[T]he Supreme Court has yet to announce a precise test for materiality under Rule 10b-5. In the Ninth Circuit, the [would] formulation controls." *Id.* at 1279 n.3.

42. 576 F.2d at 1336. See also cases cited note 31 *supra*.

43. *Id.* at 1335.

44. See note 19 *supra* and accompanying text.

45. "We find more than sufficient evidence to sustain the district court's findings . . . [and] agree with the district court's conclusion that knowledge of these facts would have influenced a reasonable investor's conduct." 576 F.2d at 1336.

46. The court noted that when the counter offer of \$6.94 per share was made to Korth, the book value of the PRTA stock was approximately \$60.00 per share. *Id.* at 1335. Also, at the

book value and fair market value,<sup>47</sup> even though book value may be a factor in determining the value of stock in a closely held corporation.<sup>48</sup> It can be argued that the parties involved struck a fair bargain. Korth probably realized that Serwold was closely connected with the corporation because the check mailed to Korth was Serwold's personal check. Korth even may have known that Serwold was a director of PRTA. The opinion is silent on these matters. Also, the court failed to state the facts upon which it relied in the determination of the market value of the PRTA stock at the time plaintiff sold his stock. Since market value takes the future worth of the securities into consideration, a decision in the lower court that \$5.00 was the fair value could greatly affect subsequent findings. For instance, because the omitted information regarding the control group and its plans might not have affected plaintiff's decision to sell, the court might not have been as willing to find the omissions material.

Without further guidance from the court, however, it must be assumed that \$5.00 per share was not far from the fair market value; otherwise, the representation as to the value of the securities would have been deemed a material misrepresentation. Neither court held that the offering price of \$5.00 per share was such a material misrepresentation. In addition, the court maintained that Coie's statements with respect to the lack of declared dividends were not material misrepresentations.<sup>49</sup> However, the court considered all the disclosures as a

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time PRTA exchanged its assets for United Utilities, Inc. stock, the shareholder received a value of \$500.00 per share; again the court stated that the book value of the PRTA stock was approximately \$163.00 per share. *Id.* at 1335. Additionally, the court used the \$60.00 book value of the PRTA stock minus the \$5.00 per share received in computing the losses to the plaintiff. *Id.* at 1339 n.4.

47. The district court calculated book value as the stockholders' equity divided by the number of PRTA's issued and outstanding shares of stock. However, it was pressed to use the book value as the appropriate fair market value due to the lack of sales of PRTA stock during the years 1965-1971. It is possible that the Court of Appeals adopted this approach.

48. *See, e.g.,* *Righter v. United States*, 439 F.2d 1204 (Ct. Cl. 1971) (book value is a factor in determining fair market value of closely held stock, but is of lesser importance than earnings and dividends records).

49. In response to Korth's request as to the status of the shares, Coie responded that no dividends had ever been declared and that none were anticipated because of mortgage commitments. Also, Coie stated that there had never been a surplus from which dividends could have been declared. Apparently, these representations were not found to be material because the information would not influence a sale based on the \$5.00 per share figure. It should also be noted that, unlike stock dividends, information as to a group's plan to develop a company into a saleable commodity is special information of the kind which cannot be found on the public record. *See* note 27 *supra* and accompanying text.

whole.<sup>50</sup> As a result, while the original offer of \$180.00 may have been a fair price for the shares transferred between willing parties, the additional knowledge of a pending sale of the company was found to be information which would affect an investor's decision to sell. Korth did not accept the first offer for the shares. He initially inquired as to the stock's status, and then pursued the matter by asking about dividends. Obviously, he was attempting to acquire pertinent information upon which to base a decision to sell. The court's holding that the information concerning the PRTA control group and its development plans was material, therefore seems correct when one considers the transaction as a whole, since materiality not only affects the investment value of the stock, but, more importantly, affects an investor's decision whether to sell such stock at all.

### B. *Scienter*

"Scienter" has been defined in a variety of ways in 10b-5 actions, including "conscious fault,"<sup>51</sup> "wilfull or reckless disregard for the truth,"<sup>52</sup> and "lack of diligence, constructive fraud, or unreasonable or negligent conduct."<sup>53</sup> Unlike negligence, the concept underlying scienter is a culpable mental state. Rule 10b-5 does not delineate what mental state of the defendant must be established by the plaintiff to impose liability.<sup>54</sup> As a result, prior to 1976, there had never been com-

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50. 576 F.2d at 1336. Rule 10b-5 requires that the statements or omissions in question be considered in light of the surrounding circumstances in order to determine whether they are material. See note 4 *supra*. See also *St. Louis Union Trust Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 562 F.2d 1040 (8th Cir. 1977), *cert. denied*, 435 U.S. 925 (1978) (company's plan not material in circumstances); *Holdsworth v. Strong*, 545 F.2d 687 (10th Cir. 1976), *cert. denied*, 430 U.S. 955 (1977) (parties to the action were close friends in a relationship of trust and confidence; there were excessive loans to defendant's law firm and family; under these circumstances statements that defendant company was unable to pay dividends on preferred shares amounted to material misrepresentations); *Great Western Bank & Trust v. Kotz*, 532 F.2d 1252 (9th Cir. 1976) (*per curiam*) (courts should construe details of act in light of context); *Robinson v. Cupples Container Co.*, 513 F.2d 1274 (9th Cir. 1975) (representations must be viewed in light of the relationship of the parties, the context in which the statement was made, the experience and bargaining position of the investor and the nature of the transaction as well as the character of the underlying fact); *Marx v. Computer Sciences Corp.*, 507 F.2d 485 (9th Cir. 1974) (in light of great importance attached to an earnings forecast, corporation's knowledge that investors would rely heavily thereon and disparity between the parties in access to information by which to judge accuracy of the forecast, information was material).

51. *Clegg v. Conk*, 507 F.2d 1351, 1361-62, 1363 (10th Cir. 1974), *cert. denied*, 422 U.S. 1007 (1975).

52. *Lanza v. Drexel & Co.*, 479 F.2d 1277, 1306 (2d Cir. 1973) (*en banc*).

53. *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 855 (2d Cir. 1968) (*en banc*), *cert. denied sub nom. Coates v. SEC*, 394 U.S. 976 (1969).

54. See note 4 *supra*.

plete agreement among the circuits whether "scienter" was needed in order to hold a defendant liable in a 10b-5 action.<sup>55</sup>

In 1976, the United States Supreme Court settled the controversy when it decided *Ernst & Ernst v. Hochfelder*.<sup>56</sup> *Hochfelder* made it clear that it was not the intent of Congress in formulating section 10(b) to hold a wrongdoer liable for merely negligent acts.<sup>57</sup> The Court reasoned that section 10(b) only proscribed intentional and wilfull conduct since the section's words "manipulative" and "deceptive" implied that something more than negligence was a prerequisite for imposing liability.<sup>58</sup> The Court therefore held that scienter was essential to a successful 10b-5 action. It defined scienter as being "a mental state embracing an intent to deceive, manipulate, or defraud."<sup>59</sup> Although the Court indicated that in certain areas of the law recklessness is also considered to be a form of intentional conduct for some acts, it declined to decide the question of whether recklessness or knowledge was sufficient to impose liability on a defendant in a 10b-5 action.<sup>60</sup>

Prior to *Hochfelder* the Ninth Circuit's position had been stated in

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55. See, e.g., *White v. Abrams*, 495 F.2d 724, 730 (9th Cir. 1974) (holding negligence sufficient under a "flexible duty" standard); *Myzel v. Fields*, 386 F.2d 718, 734-35 (8th Cir. 1967), cert. denied, 390 U.S. 951 (1968) (proof of scienter and conscious wrongdoing not required in 10b-5 actions); *Stevens v. Vowell*, 343 F.2d 374, 379-80 (10th Cir. 1965) (not necessary to allege or prove common law fraud; showing of material misstatement or omission sufficient); *Kohler v. Kohler Co.*, 319 F.2d 634, 637 (7th Cir. 1963) (knowledge of falsity not required); *Royal Air Properties, Inc. v. Smith*, 312 F.2d 210, 212 (9th Cir. 1962) (establishment of material facts sufficient to constitute prima facie case); *Ellis v. Carter*, 291 F.2d 270, 274 (9th Cir. 1961) (common law fraud need not be shown). But see, e.g., *Carras v. Burns*, 516 F.2d 251, 256 (4th Cir. 1975) (sufficient mental state if defendant knew statement misleading or knew of facts which would have shown it to be misleading); *Clegg v. Conk*, 507 F.2d 1351, 1361-62 (10th Cir. 1974), cert. denied, 422 U.S. 1007 (1975) (some form of scienter needed); *Rochez Bros., Inc. v. Rhoades*, 491 F.2d 402, 407-08 (3d Cir. 1974), cert. denied, 425 U.S. 993 (1976) (in nondisclosure case, scienter requirement satisfied where defendant had knowledge of information because defendant under a duty to disclose all material facts); *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579, 606 (5th Cir.), cert. denied, 419 U.S. 873 (1974) (some culpability beyond mere negligence required); *Lanza v. Drexel & Co.*, 479 F.2d 1277, 1306 (2d Cir. 1973) (en banc) (willful or reckless disregard for the truth required); *Katz v. Realty Equities Corp.*, 406 F. Supp. 802, 805 (S.D.N.Y. 1976) (actual knowledge or reckless disregard for truth is prerequisite).

56. 425 U.S. 185 (1976).

57. *Id.* at 199.

58. *Id.*

59. *Id.* at 193 n.12.

60. *Id.* The Court was not faced with deciding whether recklessness constituted scienter since the facts of *Hochfelder* did not demand it. Knowledge has traditionally been thought of as satisfying the scienter requirement by any definition. However, although the *Hochfelder* Court made reference to the fact that knowing conduct was equated with intentional conduct, it did not include the knowledge standard within its definition. See notes 8 & 10 *supra* and accompanying text.

*White v. Abrams*,<sup>61</sup> which held that scienter was not an essential element of a 10b-5 action. In *White*, the court set out a "flexible duty" standard which, contrary to *Hochfelder*, allowed negligence as a ground for holding a defendant liable.<sup>62</sup> Other circuits, however, had insisted that negligence did not further the purpose of rule 10b-5 and accordingly required the stricter standard of scienter. But even as to those circuits which required a finding of scienter there had been no unanimity as to its definition.<sup>63</sup>

Since the district court opinion in *Nelson* predated *Hochfelder*, the court relied upon the standard enunciated in *White* for the requisite mental state of a defendant in a 10b-5 action. It also cited in its opinion the Eighth Circuit case of *Myzel v. Fields*,<sup>64</sup> which held that negligence was a sufficient basis for the imposition of liability in a 10b-5 action.<sup>65</sup> The district court found in Nelson's favor without classifying defendants' actions as intentional.<sup>66</sup> The district court defined scienter as a cold-blooded or deliberate intent on the part of a defendant and did not find that the Serwolds acted with such state of mind. The court did, however, find that the defendants had acted more than negligently.<sup>67</sup>

The Ninth Circuit Court of Appeals was forced to decide the case in light of the ruling in *Hochfelder*.<sup>68</sup> It concluded that the omissions by defendants were committed either knowingly or recklessly.<sup>69</sup> The

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61. 495 F.2d 724 (9th Cir. 1974).

62. *Id.* at 730-34. The "flexible duty" standard provides that the duty imposed upon the defendant be determined after examining factors such as the access to information or the existence of special relationships which may impose some affirmative duty. This sliding scale approach is a subjective test which does not preclude finding negligence as sufficient for the imposition of liability. *See also* Crocker-Citizens Nat'l Bank v. Control Metals, Corp., 566 F.2d 631, 636 n.2 (9th Cir. 1977) (*Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) not inconsistent with the flexible duty standard except as to liability for mere negligence). *But cf.* Arthur Young & Co. v. United States Dist. Ct., 549 F.2d 686, 695-96 (9th Cir.), *cert. denied*, 434 U.S. 829 (1977) (questioning the validity of the standard in light of *Hochfelder*).

63. *See, e.g.*, notes 51-53 *supra* and accompanying text.

64. 386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968).

65. Plaintiffs in *Myzel* were induced to sell their closed corporation stock to the defendants without being told of increased sales and profits and the identity of the controlling purchasers. The court found that the defendants had deliberately set out to cheat the plaintiffs. *Id.* at 733.

66. 576 F.2d at 1337.

67. *Id.*

68. The district court's Findings of Fact and Conclusions of Law were filed on September 29, 1975. *Hochfelder* was decided March 30, 1976 and the *Nelson* appeal was heard April 3, 1978.

69. 576 F.2d at 1334, 1338.

Serwolds, as part of a control group that took an active part in the modernization of the Poulosbo Telephone Company, were aware of the plan to sell the company and were informed of the steady and significant increases in earnings and book value of the shares.<sup>70</sup> Serwold's attorney, Coie, who was also a member of the control group, had actual knowledge of plaintiff's assumption that \$5.00 per share represented the fair market value of the stock.<sup>71</sup> The *Nelson* court maintained that the failure of the defendants to inform plaintiff of the existing control group and of the group's long range, albeit indefinite, plans was done either with knowledge, or in the alternative, recklessly.<sup>72</sup> The Ninth Circuit assumed that the result below was not based upon a negligence theory since the district court "never used the word negligence or any of its derivatives."<sup>73</sup> This non-specificity left room for the Ninth Circuit to characterize the omissions as those made recklessly or knowingly.<sup>74</sup>

The court did not define what it considered "knowing conduct" to be. In the securities field, one author has stated that behavior is knowing if one acts on a belief that the investor may be misled by the omission or misrepresentation,<sup>75</sup> whereas reckless behavior has generally been defined as "acts in conscious disregard of, or indifference to, the risk that [the investor] will be misled."<sup>76</sup> However, the *Nelson* court alluded several times to a different meaning. In its initial statement the court declared that the defendants acted knowingly.<sup>77</sup> When addressing itself to the scienter requirement the court discussed the knowledge standard set forth in *Hochfelder*. The majority in *Hochfelder* had stated that the language of section 10(b) "strongly suggests" knowing or intentional misconduct, implying that knowing behavior was intended by Congress to sustain liability.<sup>78</sup> The *Nelson* court then found that the defendants acted "with knowledge" of the omitted information.<sup>79</sup>

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70. *Id.* at 1337-38.

71. *Id.* at 1338. See also note 19 *supra* and accompanying text.

72. *Id.* at 1337-38.

73. *Id.*

74. "The evidence supports a finding of recklessness . . . [which] would also be consistent with the district court's findings." *Id.* at 1338.

75. See, e.g., Ruder, *Texas Gulf Sulphur—The Second Round: Privity and State of Mind in Rule 10b-5 Purchase and Sales Cases*, 63 NW. L. REV. 423, 436 (1968).

76. *Id.*

77. 576 F.2d at 1334.

78. 425 U.S. 185, 197 (1976).

79. "It appears that the defendants' omissions were, at the very least, with knowledge. They knew of the control group, the outstanding, but still indefinite plans to sell . . . and the steady and significant increases in earning . . ." 576 F.2d at 1337-38 (citation omitted).

That the defendants had knowledge of the control group and its plans is undisputed. However, to assert that the defendants acted knowingly, with a state of mind to conceal what they knew in order to mislead the plaintiff, is quite different. Once the court determined that the information omitted was material, it was required to determine whether the omissions were withheld with the intent to mislead. It appears that because the defendants were found to have had knowledge of the material information, the court assumed that failure to divulge such information indicated an intent to mislead. Even if the omissions were material, they may not have been withheld either knowingly or recklessly. If the defendants gave a fair offer for the stock, then it would be reasonable to find that the additional information was withheld with a good faith belief that the decision to sell would not be affected. The court imputed a culpable state of mind to the defendants merely because they had knowledge of certain information and failed to impart that information to the plaintiff.

By this analysis, the Ninth Circuit held that knowing behavior was sufficient under *Hochfelder* for the imposition of liability.<sup>80</sup> In effect, it reviewed the evidence and made findings which allowed the district court's holding to fall within the *Hochfelder* rule. Even though the Ninth Circuit did not clearly find that defendants acted with the belief that plaintiff might have been misled by the nondisclosure of the material information, its inclusion of knowledge within the scienter definition is not a significant expansion.

The more difficult question is whether the *Hochfelder* scienter definition should be expanded to include recklessness. The Ninth Circuit recognized that *Hochfelder* had left this question open, and it proceeded to answer the question in the affirmative by concluding that liability should be premised on knowing *or* reckless behavior. It stated that "the district court could have found Coie reckless in his evaluation of the 'status' of the stock, and imputed that recklessness to the defendants."<sup>81</sup> When the Ninth Circuit held that a finding of recklessness is sufficient to impose liability, it was not the first circuit to do so. Several other circuits have held, both prior to and after *Hochfelder*, that recklessness was either sufficient or necessary for the imposition of liability in a 10b-5 action.<sup>82</sup>

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80. *Id.* at 1337, 1338.

81. *Id.* at 1338.

82. *See, e.g.,* Sunstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1039-40 (7th Cir.) (en banc), *cert. denied*, 434 U.S. 875 (1977) (intentional or reckless test correct); Dupuy v. Dupuy, 551 F.2d 1005, 1020 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977) (*Hochfelder* standard is at least recklessness); Bailey v. Meister Brau, Inc., 535 F.2d 982, 993 (7th Cir. 1976) (gross

The court in *Nelson* believed that reckless behavior was intended by Congress to support 10b-5 liability.<sup>83</sup> The *Nelson* court found that the purpose of the rule would be accomplished only by including recklessness within the *Hochfelder* requirement and thus giving a broad interpretation of scienter. The Securities Exchange Commission itself has also argued for an expansive reading of section 10(b) to effect the overall congressional purpose of protecting investors against injury from false and deceptive practices.<sup>84</sup> The Commission enacted rule 10b-5 specifically to eliminate all manipulative and deceptive methods in the sale of securities.<sup>85</sup> Also, to protect investors from fraud and to encourage the widest possible dissemination of accurate information, the Supreme Court has repeatedly insisted that courts construe the rules "not technically and restrictively, but flexibly in order to effectuate [their] remedial purpose[s]."<sup>86</sup>

*Nelson* involved material omissions rather than affirmative misrepresentations. Finding knowing conduct by implication in order to satisfy the requisite degree of culpability is therefore noteworthy. The result is, that those with information are required not only to make accurate statements, but to disclose such information or risk 10b-5 liability. The mere possession of material information could itself fulfill the scienter requirement since some form of intent to mislead can be inferred from that possession. At first blush this requirement seems to be harsh. However, in light of the policy to encourage full disclosure of information to investors, the standard for material omissions should be no different than that for material misrepresentations. The nondisclosure of

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negligence and wanton ignorance of situation); *City Nat'l Bank v. Vanderboom*, 422 F.2d 221, 229-30 (8th Cir.), cert. denied, 399 U.S. 905 (1970) (proof of scienter not required). *But cf. Sanders v. John Nuveen & Co.*, 554 F.2d 790, 793 (7th Cir. 1977) ("definition of 'reckless behavior' should not be a liberal one lest any discernible distinction between scienter and negligence be obliterated"). *See also* Bucklo, *The Supreme Court Attempts to Define Scienter Under Rule 10b-5*; *Ernst & Ernst v. Hochfelder*, 29 STAN. L. REV. 213, 235 (1977) (the great bulk of decisions and the more influential scholarly comments have argued that recklessness should suffice) [hereinafter cited as Bucklo].

83. 576 F.2d at 1337.

84. *See* *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197-98 (1976).

85. *See* *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977). *See also* *Kardon v. National Gypsum Co.*, 73 F. Supp. 798, 800 (E.D. Pa. 1947) (private cause of action under 10b-5 held to serve purpose of rule).

86. *See, e.g.,* *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 151 (1972); *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 12 (1971); *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963). *Accord, Dessler v. Ashton*, 408 F. Supp. 1174, 1176 (S.D.N.Y. 1975), *aff'd*, 573 F.2d 1289 (2d Cir. 1977). *See also* Bucklo, *supra* note 82.



information can be as harmful to an enlightened investment decision as affirmative misrepresentations.

By its terse treatment, the Ninth Circuit has not provided any clear guidelines by which to evaluate knowing or reckless conduct. In stretching the scienter meaning, the court must have been anxious to resolve the issue left unanswered by *Hochfelder*. But it should have waited for a factual situation which would have provided a firmer basis for its position. The Ninth Circuit here has strained to find facts to fit the outcome. After the confusion, the court emerges with what appears to be an unavoidable result; namely, that recklessness is a form of scienter. The effectiveness of *Nelson* is diluted because of this lack of forthrightness.

### C. The Remedy

Relatively few cases based on a 10b-5 violation have been presented on appeal with respect to the appropriate remedy. One reason for this is that plaintiffs infrequently prove all the elements of the claim for relief so the court rarely reaches the question of damages.<sup>87</sup> In cases where the court has examined the issue of damages, the plaintiff seller has often received the difference between the actual price paid and the amount defendant should have paid at the time of the sale had there been no fraudulent conduct.<sup>88</sup>

*Affiliated Ute Citizens v. United States*<sup>89</sup> is the leading case on the measure of damages for defrauded sellers in 10b-5 actions. There Justice Blackmun stated for the seven members of the Court:<sup>90</sup>

[T]he correct measure of damages . . . is the difference between the fair

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87. *E.g.*, *Nelson v. Serwold*, 576 F.2d 1332, 1338 (9th Cir.), *cert. denied*, 99 S. Ct. 464 (1978).

88. *See, e.g.*, *Harris v. American Investment Co.*, 523 F.2d 220, 225 n.4 (8th Cir. 1975) (en banc), *cert. denied*, 423 U.S. 1054 (1976). *See generally* 6 L. LOSS, SECURITIES REGULATION, 3922-23 (Supp. 1969). *Nelson* involves a plaintiff seller who was defrauded in a face-to-face transaction. The measure of damages in other situations has considerations which are not present in *Nelson*. For instance, the potential draconian liability that plagued *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228 (2d Cir. 1974) does not affect the decision in *Nelson*, since that case involved a defrauded buyer in an over-the-counter transaction. The potential for tremendous liability to all investors who purchased in the open market during the applicable period is a factor which, right or wrong, has a tendency to affect a judge's decision not only as to liability, but also as to the measure of damages. *See generally* Note, *The Measure of Damages in Rule 10b-5 Cases Involving Actively Traded Securities*, 26 STAN L. REV. 371 (1974).

89. 406 U.S. 128 (1972).

90. Two justices, Powell and Rehnquist, did not participate in the opinion. Although Justice Douglas dissented in part with respect to the United States' waiver of sovereign immunity, he joined in the Court's opinion and judgment as to the application of the theory.

value of all that the . . . seller received and the fair value of what he would have received had there been no fraudulent conduct, . . . except for the situation where the defendant received more than the seller's actual loss. In the latter case damages are the amount of the defendant's profit.<sup>91</sup>

This measure of damages is based upon a contractual setting and plaintiff is made whole by forcing defendant to relinquish all gains.

This rescissory theory computes the difference between the value of the stock as of the date of the sale and the value as of the date the wrongdoer was under a present duty to return the stock. This duty accrues at the date of judgment, although courts generally employ an earlier post-transaction date.<sup>92</sup> True rescission calls for a cancellation of the bargain and a return of the parties to the status quo ante the sale.<sup>93</sup> There are, however, several situations where this theory cannot be literally applied. If it is impractical to return the stock, such as when it has been profitably disposed of or retired, and true rescission is therefore impossible, this theory provides that the equivalent value of the stock at the time of disposal or judgment is the proper measure of plaintiff's losses.<sup>94</sup> Alternatively, if the stock has declined in value or has been sold by the wrongdoer at a loss, the plaintiff may then seek to recover the difference between the price paid and the actual value at the date of the sale.<sup>95</sup> In other words, depending upon the circumstances, the plaintiff should be given either the defendant's profits or plaintiff's losses, whichever is greater. Because the day of judgment may be years away from the time of the sale, rescissory relief may include future accretions not foreseeable at the time of the original transfer. This theory, then, awards the plaintiff all of defendant's profits, whether foreseeable or not.<sup>96</sup> As a result, it not only provides full com-

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91. 406 U.S. at 155 (citations omitted).

92. See generally Bucklo, *supra* note 82.

93. See, e.g., Myzel v. Fields, 386 F.2d 718, 742 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968) (if the contract is void, then plaintiff is entitled to restitution of what he sold).

94. *Id.* at 742-45 (plaintiffs prayed for either rescission or money damages; since the stock was no longer available and return in specie was therefore impossible, the equivalent monetary value was the proper amount of judgment).

95. These are "out-of-pocket" damages. This theory is discussed at notes 97-102 *infra* and accompanying text.

96. The possible exception to this rule occurs where special or unique efforts on the part of the defendant contributed greatly to the stock's increase in value. In this instance, increases in value attributed to defendant's special efforts will not be subject to recovery by plaintiff. See, e.g., Janigan v. Taylor, 344 F.2d 781, 787 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965). Also, consequential damages arising from fraud may be awarded to the plaintiff. Garnatz v. Stifel, Nicolaus & Co., 559 F.2d 1357, 1360 (8th Cir. 1977), *cert. denied*, 435 U.S. 951 (1978).

pensation for injury to plaintiff, but also serves to remove any incentive for engaging in wrongful conduct.

There are, however, other remedies which have been considered by the courts in 10b-5 actions. The one most often used as an alternative to the rescissory theory is commonly designated as the "out-of-pocket" theory. The out-of-pocket theory allows recovery of the difference between the fair market value of the securities at the date of the sale and the purchase price.<sup>97</sup> It is based upon the tort of deceit, rather than a contract theory, and enforces a primary purpose of the private right of action under rule 10b-5, *i.e.*, to compensate for damages caused by fraudulent acts. Unlike the rescissory theory, the out-of-pocket theory restricts the amount for which the defendant may be liable and therefore supports the premise that Congress did not intend anyone to be an insurer against false or misleading statements.<sup>98</sup>

The out-of-pocket theory was discussed in the Ninth Circuit case of *Green v. Occidental Petroleum Corp.*<sup>99</sup> Defendants had engaged in an unlawful scheme that violated section 10(b) and rule 10b-5. Improper accounting practices and exaggerated press releases resulted in an artificially inflated price of defendant's stock. As a result of the wrongful acts, plaintiff, among others who relied upon the misrepresentations and reports, alleged that she was damaged when she purchased the stock.<sup>100</sup> The out-of-pocket theory was advanced since it measures the difference between the purchase price and the value of the stock at the date of purchase. In *Green*, that difference represented the extent to which the purchaser plaintiff had been required to invest greater than otherwise would have been necessary. Also, as pointed out by Judge Sneed in a concurring opinion, the theory was appropriate since the corporate defendant itself never received the inflated purchase price and therefore realized no "ill-gotten" gains.<sup>101</sup> To permit recovery in an amount other than the difference between the fair market value of the securities and the purchase price would have been to unduly burden the defendant with losses which it neither caused nor for which it assumed responsibility.<sup>102</sup> However, this measure of damages is not a

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97. *See, e.g.*, *Kohler v. Kohler Co.*, 319 F.2d 634 (7th Cir. 1963).

98. *See, e.g.*, *White v. Abrams*, 495 F.2d 724, 728 (9th Cir. 1974) (citing *Kohn v. American Metal Climax, Inc.*, 458 F.2d 255, 280 (3d Cir.) (Adams, J. concurring & dissenting), *cert. denied*, 409 U.S. 874 (1972)).

99. 541 F.2d 1335, 1346 (9th Cir. 1976) (*per curiam*) (Sneed, J., concurring in part & concurring in the result in part).

100. *Id.* at 1338.

101. *Id.* at 1341-42 n.2 (Sneed, J. concurring).

102. *Id.* at 1343 (Sneed, J. concurring). *Green* was brought as a class action and the

talisman. Often the evil perpetrated is not merely an inflated purchase price, but the fact that plaintiff was induced to buy without full disclosure. As a result, only the rescissory measure could remedy this evil since it could recover the wrongdoer's profits as well as the plaintiff's losses.

The plaintiff in *Garnatz v. Stifel, Nicolaus & Co.*<sup>103</sup> was induced to buy bonds and the court applied the rescissory measure for the remedy. The defendants were found to have violated rule 10b-5 since they made untrue representations as to the risk-free nature of the bonds which they were recommending to plaintiff for investment. The material misrepresentations, however, resulted only in plaintiff purchasing the bonds at the then fair market value.<sup>104</sup> If the out-of-pocket theory had been applied, plaintiff would have recovered nothing, since the market value of the bonds on the date of purchase was the same as the value which plaintiff paid. The Eighth Circuit held, therefore, that the rescissory theory was the proper means of compensating plaintiff for the wrong perpetrated upon him. According to the court, the fact that plaintiff purchased the bonds *at all* was the gravamen of the action.<sup>105</sup> The court returned the parties to the status quo by requiring the defendants to bear the risk of the investment and awarding plaintiff the losses he suffered. The court reasoned that plaintiff's losses stemming from the decline in value of the bonds were a consequence of defendants' fraud; any losses attributable to market forces should be borne by the wrongdoer.<sup>106</sup>

The rescissory theory is more effective than the out-of-pocket theory in deterring wrongful conduct because it substitutes the philosophy of caveat emptor with that of full disclosure. The courts have employed both theories for the measure of losses, depending upon the nature of the violation. However, the court's choice of either the out-of-pocket or rescissory theory also reflects the individual court's philosophy as to the

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corporate defendant was also potentially liable to all other investors who purchased Occidental's stock in the open market. *See* note 88 *supra*.

103. 559 F.2d 1357 (8th Cir. 1977), *cert. denied*, 435 U.S. 951 (1978).

104. *Id.* at 1359-60.

105. *Id.* The plaintiff was not a sophisticated trader but characteristically the average, individual investor. He purchased the bonds late in 1972 and the fraud became apparent in August, 1974. *Id.*

106. *Id.* at 1361. The court listened to defendant's argument that the out-of-pocket theory as articulated by Judge Sneed in *Green v. Occidental Petroleum Corp.*, 541 F.2d 1335, 1342 (9th Cir. 1976) (concurring opinion), was applicable since the plaintiff should not recover for losses due to the market forces. However, the court decided that the rescissory theory was the appropriate measure because defendants should be held liable for their wrongful concealment of the risks attendant to the transaction.

purpose of rule 10b-5. The earlier cases involving 10b-5 awards adopted the attitude that the buyer should be aware of the risks inherent in the securities market due to its speculative nature, and thus encouraged investor diligence as a means of promoting efficiency in the market. The out-of-pocket theory was appropriate to implement this outlook since it provided compensation for wrongful conduct while also limiting amounts due to loss of expectancy. But the trend over the years has been for courts to protect the investor from misrepresentations and nondisclosures by focusing on the culpable conduct of the defendant and by requiring full disgorgement of profits resulting from that conduct. The courts have thus adopted a more punitive approach to rule 10b-5 liability by removing all incentive to engage in wrongful activity.

In 1965, the First Circuit articulated this view in *Janigan v. Taylor*.<sup>107</sup> "It is more appropriate to give the defrauded party the benefit even of windfalls than to let the fraudulent party keep them . . . . [I]t is simple equity that a wrongdoer should disgorge his fraudulent enrichment."<sup>108</sup> The rescissory theory allows for recovery of losses due to market forces. This, in effect, makes the defendant an insurer of his conduct since he may be forced to compensate plaintiff for more than the actual losses sustained by the plaintiff. The rationale underlying this theory is that the ill-gotten gains which accrue to the defendant justify a shifting of the risk of loss from the plaintiff to the defendant.<sup>109</sup>

This is the theme of *Nelson v. Serwold*.<sup>110</sup> The Ninth Circuit in *Nelson* acknowledged that the law on the appropriate remedy in 10b-5 actions was still in its formative stage and therefore unsettled. However, it chose to follow the trend of disgorging the wrongdoer's profits rather than merely compensating plaintiff for losses.<sup>111</sup> It would have

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107. 344 F.2d 781 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965).

108. *Id.* at 786.

109. *E.g.*, *Garnatz v. Stifel, Nicolaus & Co.*, 559 F.2d 1357 (8th Cir. 1977), *cert. denied*, 435 U.S. 951 (1978). Discussed at notes 103-06 *supra* and accompanying text.

110. 576 F.2d 1332 (9th Cir.), *cert. denied*, 99 S. Ct. 464 (1978).

111. In *Nelson*, the district court judge found that defendants had not deliberately concealed the material information. He applied the flexible duty standard of *White v. Abrams*, 495 F.2d 724 (9th Cir. 1974), finding a technical violation of rule 10b-5, but found that the defendants lacked scienter. This lack of scienter required an award of less than complete disgorgement. The judge, relying primarily upon *Myzel v. Fields*, 386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968), believed that only when the fraud involved was "apparent and extensive" should disgorgement of future profits be applied. Also, the exchange with United Utilities, Inc. took place six and one-half years after the sale in question. According to the district court, no decision yet has required a defendant to disgorge profits earned more than two years after the original transfer. Additionally, the district judge be-

been possible for the *Nelson* court to apply the out-of-pocket theory in assessing damages. Assuming the fair market value of the PRTA stock was \$60.00 per share, the plaintiff could have been given the difference between that amount and the price paid of \$6.94 per share.<sup>112</sup> Proponents of this method might contend that this compensatory amount is all that plaintiff actually suffered, and hence all that he should receive. However, the Ninth Circuit reasoned that the defendants should not benefit from their wrongdoing. The exchange with United Utilities, Inc. was for \$500.00 per share. Application of the out-of-pocket theory would still have left the wrongdoers with a profit of \$440.00 per share. The Ninth Circuit, adopting the *Janigan v. Taylor*<sup>113</sup> rationale, awarded plaintiff all of the defendant's profits from the transaction, emphasizing that those who knowingly or recklessly fail to disclose all material information should not benefit by their wrongful nondisclosures.

*Nelson* does not imply that the rescissory theory will always be applied when assessing damages. However, in situations where a plaintiff *seller* is defrauded in a face-to-face transaction, as in *Nelson*, the rescissory theory should be applied to better serve the purposes of section 10(b) and rule 10b-5. In light of the *Hochfelder* scienter requirement, by which negligence will no longer suffice to hold a defendant liable, it is not unjust to require a defendant to give up all gains which were obtained as a result of the wrongdoing.

#### IV. CONCLUSION

The Ninth Circuit continues in its broad and flexible interpretation of rule 10b-5. Even within the rule set by *Hochfelder*, excluding negligence as a basis for liability, the court has construed the exclusion narrowly by interpreting the intent requirement to include recklessness or knowledge. In sum, although scienter has been defined in a variety of ways, it should include within its ambit reckless or knowing misconduct. Courts must be given this flexibility in interpreting rule 10b-5 to better implement the intention of Congress in protecting investors from unfair and inequitable practices. With this governing principle established, however, there stands the invitation to the courts to engage in

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lieved that the defendants' own personal efforts contributed to the increase in stock value and that profits of that nature should not be subject to recovery by the seller plaintiff.

112. The court determined that the loss to plaintiff was \$60.00 less the \$5.00 received. *Id.* at 1339 n.4. However, the plaintiff actually received \$6.94 per share. *Id.* at 1335. See also note 46 *supra* and accompanying text.

113. 344 F.2d 781 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965).

the common battle of applying the particular facts of the case to the standard. As has been the case with scienter, there may emerge as many different definitions of "reckless" as there are circuits.

The Ninth Circuit has continued the current trend in allowing plaintiff sellers to recover defendant's profits rather than limiting damages to plaintiff's actual losses, thus enforcing dual purposes of the Act—those of encouraging full disclosure and of protecting investors from fraud. In all probability this approach of disgorging the defendant's profits, even to the extent of giving plaintiff a windfall, will not always be applied and the courts will continue to wrestle with the proper measure of damages in cases where plaintiffs are many in number and the transaction is in the open market. Ultimately, the outcome of each case will continue to depend upon its individual facts. *Nelson v. Serwold* does not provide a definitive solution to the question of the measure of damages. It merely establishes that the rescissory theory may be applied when appropriate.

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