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## RULE 10b-5 AND THE GENERAL LAW AS TO DECEIT IN SECURITIES TRANSACTIONS IN MARYLAND

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The law as to deceit and fraud, or constructive fraud, in the purchase and sale of securities has been significantly changed in recent years by a mushrooming growth of federal case law interpreting and applying rule 10b-5<sup>1</sup> of the Securities and Exchange Commission. As will be shown, that rule, promulgated in 1942, gives legal force to certain obligations of fair dealing which had only moral sanction prior to its adoption.

The far-reaching nature of this development and its significance for the local bar, in Maryland and in every other state, are exemplified by the fact that at this time more than twenty cases arising under the rule, chiefly involving Maryland corporations and enterprises, are pending in the United States District Court for the District of Maryland.<sup>2</sup> In most, if not all, of these cases the issues raise both new or unsettled questions under the rule as well as a complex of questions which require a reconsideration and application of state jurisprudence in light of the federal rule.

Under the Maryland common law, as developed in past years, a plaintiff alleging fraud or deceit in a securities transaction, absent some special fiduciary relationship, was obliged in order to qualify for relief to show an intentional misrepresentation, or one made with reckless disregard of its truth or falsity;<sup>3</sup>

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1. 17 C.F.R. § 240.10b-5 (1973) [rule 10b-5 hereinafter referred to in text as "the rule"]. The rule was promulgated under section 10(b) of the Securities Exchange Act [15 U.S.C. § 78j (b) (1970)], as rule X-10b-5, on May 21, 1942, and published in the Federal Register the following day. 7 Fed. Reg. 3804 (1942). For a complete history and background of the rule see 1 A. BROMBERG, *SECURITIES LAW: FRAUD* 3-58 (1971) [hereinafter cited as A. BROMBERG].

2. Many of these cases will be referred to in the following article. A rough estimate, based on comparative population, would indicate that the national case load in this field may exceed one thousand suits.

3. *Schmidt v. Millhauser*, 212 Md. 585, 130 A.2d 572 (1957); *Cahill v. Applegarth*, 98 Md. 493, 56 A. 794 (1904).

however, broadly speaking, rule 10b-5 imposes a duty on all who have superior pertinent information, requiring them to make only truthful statements and to disclose any material information before entering into a securities transaction, whether purchase or sale.<sup>4</sup> Few, if any, of the cases decided under the common law conception will retain probative force under the new conditions governing litigation pursuant to rule 10b-5.<sup>5</sup>

The rule, however, did not spring fully developed from the heads of a few persons in charge of policy at the Commission, but was foreshadowed by both common law and statutory precedent. Earlier state and federal cases had asserted the existence of a fiduciary obligation owed by persons in control of a corporation toward other stockholders having inadequate sources of information. On the basis of fiduciary duty, a general obligation of disclosure of pertinent facts was imposed on informed and controlling stockholders if they sought to purchase from, or sell to, minority stockholders, stock or other securities of the corporation.<sup>6</sup>

The statutory precursor of rule 10b-5 was the Securities Act of 1933.<sup>7</sup> The anti-fraud provisions of that act were largely confined to the protection of buyers rather than sellers of securities,<sup>8</sup> and were particularly intended for those persons who were uninformed and unsophisticated as to securities transactions. Such persons had invested heavily in securities during the speculative period of the late 1920's, and many had lost their entire capital in the market collapse and great depression which extended from 1929 to 1932. The catastrophic effect of these speculations called

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4. 17 C.F.R. § 240.10b-5 (1973). For the wording of the rule see note 15 *infra* and accompanying text.

5. The broader duty of disclosure now recognized under the rule promises to have a more far-reaching and encompassing effect than the earlier cases on deceit.

6. See, e.g., *MacGill v. MacGill*, 135 Md. 384, 109 A. 72 (1919). See also *Clapp, A Fiduciary's Duty of Loyalty*, 3 Md. L. REV. 221, 234-35 (1939). An earlier case decided in the same year as *MacGill* recognized a similar obligation of disclosure of material facts by directors who arranged for their corporation to sell a large block of stock without advising the purchaser that they held certain obligations of the company. *McGaw v. Hoen*, 133 Md. 672, 106 A. 13 (1919).

7. 15 U.S.C. § 77a *et seq.* (1970).

8. These anti-fraud provisions are: section 11 [15 U.S.C. § 77k] which imposes liability for a materially misleading or defective registration statement; section 12(1) [15 U.S.C. § 77l(1)] which imposes liability on anyone who offers or sells a security in violation of the registration requirements of the Act; section 12(2) [15 U.S.C. § 77l(2)] which imposes liability on anyone who offers or sells a security by means of a material misstatement or omission; and, section 17(a) [15 U.S.C. § 77q] which makes unlawful any form of fraud, untruth or omission of a material fact, with respect to the sale of any securities in interstate commerce or by use of the mails. See 3 L. Loss, *Securities Regulation* 1423, 1684 (2d ed. 1961) [hereinafter cited as L. Loss].

for national legislation to prevent a recurrence, and thus led to the adoption of the Securities Act which, as stated, was couched in such terms as to protect defrauded buyers.<sup>9</sup> Chief among these provisions was section 17(a) of the Act, which declared illegal (in terms similar to those to be restated in rule 10b-5) the obtaining of money or property through the sale of securities to a buyer by means of misrepresentation of a material fact or omission to disclose a material fact;<sup>10</sup> however, neither section 17(a) nor any other provision of the Securities Act of 1933 contained a parallel provision for the protection of a seller of securities induced to make the sale by a similar misrepresentation or omission.

When the Securities Exchange Act was enacted in 1934,<sup>11</sup> the Commission was given authority to correct this imbalance. Section 10(b) of the Exchange Act authorized the Commission to adopt rules and regulations condemning the use of "any manipulative or deceptive device or contrivance . . . in connection with the *purchase or sale* of any security . . . in contravention of such rules and regulations as the Commission may prescribe."<sup>12</sup> Pursuant to this authorization, the Commission adopted rule 10b-5, which specifically applies to purchases as well as sales of securities, and appears to afford the first clear statutory basis for federal relief to a defrauded seller.<sup>13</sup> Summarizing the foregoing, protection has developed chronologically, *first*, for buyers who had been misled and could employ the Securities Act, and, *secondly*, for defrauded sellers, under the rule adopted pursuant to the later Exchange Act.<sup>14</sup>

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9. "The purpose of the [1933] Act is to protect the naive or uninformed investor and to deny recourse to the reckless or fraudulent seller of securities." *Can-Am Petroleum Co. v. Beck*, 331 F.2d 371, 373 (10th Cir. 1964).

10. 15 U.S.C. § 77q (1970). *See also* 3 L. Loss, *supra* note 8, at 1423.

11. Act of June 6, 1934, ch. 404, 48 Stat. 881 [codified at 15 U.S.C. § 78a *et seq.* (1970)].

12. 15 U.S.C. §78j(b) (1970) (emphasis added).

13. 17 C.F.R. § 240.10b-5 (1973). *See also* L. Loss, *supra* note 8, at 1427.

14. Due to this historical development the new rule was at first regarded as designed only for the protection of defrauded sellers. In this connection, the occasion of promulgation of the rule is of interest, for the particular case brought to the Commission's attention was one involving minority stockholders who were persuaded by the president of the company to sell their shares to him. *See* statement of Milton Freeman, *Conference on Codification of the Federal Securities Law*, 22 BUS. LAWYER 793, 922 (1967). The speaker was a staff attorney of the SEC in 1942, and learned of a call from the Regional Administrator in Boston, advising that the president of a company there "is going around buying up the stock of his company at \$4.00 a share, and he has been telling them that the company is doing very badly, whereas, in fact, the earnings are going to be quadrupled and will be \$2.00 a share for this coming year. Is there anything we can do about it?" *Id.* This led to a study of section 10(b) of the Exchange Act in connection with section 17 of

The rule as adopted by the Commission under section 10(b) of the Exchange Act of 1934, provides, in essence, that in connection with the purchase or sale of any security:

It shall be unlawful for any person . . . by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of a 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.<sup>15</sup>

The position of an injured seller under the new rule was particularly stressed in a much-quoted passage of Judge Leahy in the 1951 case of *Speed v. Transamerica Corp.*,<sup>16</sup> where he said:

It is unlawful for an insider, such as a majority stockholder, to purchase the stock of minority stockholders without disclosing material facts affecting the value of the stock, known to the majority stockholder by virtue of his inside position but not known to the selling minority stockholders, which information would have affected the judgment of the sellers. The duty of disclosure stems from the necessity of preventing a corporate insider from utilizing his position to take unfair advantage of the uninformed minority stockholders.<sup>17</sup>

Generally speaking, the cases under the rule fall largely into two major categories—specific wrongs against individual persons committed by those who deal directly with them, and general

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the Securities Act, and according to Mr. Freeman they "put them together" as a draft for the Commission. All the Commissioners approved the rule so drafted, without comment, except that Commissioner Sumner Pike said, "Well, we are against fraud, aren't we?" *Id.* See also 1 A. BROMBERG, *supra* note 1, at 22.6.

The Commission's official release, announcing and explaining the new rule 10b-5 [SEC Exchange Act Release No. 3230 (May 21, 1942)] stated that: "The new rule closes a loophole in the protections against fraud . . . by prohibiting individuals or companies from buying securities if they engage in fraud in their purchase."

15. 17 C.F.R. § 240.10b-5 (1973) (emphasis added). Section 240.10b-5 (2), condemning untrue statements and misleading omissions, constitutes the operative language upon which many of the litigated cases are based.

16. 99 F. Supp. 808 (D. Del. 1951).

17. *Id.* at 828-29. Among the cases which have quoted this passage was Judge Winter's district court opinion in *Baumel v. Rosen*, 283 F. Supp. 128, 139 (D. Md. 1968), *aff'd as to liability*, 412 F.2d 571 (4th Cir. 1969). Judge Winter is now one of the circuit judges on the Court of Appeals for the Fourth Circuit.

wrongs against a whole class of investors, usually in a public company, who have bought or sold securities without significant information which management should have disclosed publicly. The latter type of case, typified by *SEC v. Texas Gulf Sulphur Co.*,<sup>18</sup> is peculiarly adapted to litigation of national scale in the federal courts, and is beyond the scope of this article.<sup>19</sup> In addition, the history, similarity and differences between the various regulatory provisions and principles, which has been touched upon in the foregoing discussion, has been examined fully in leading treatises.<sup>20</sup> For these reasons the following discussion will be limited to cases involving what a leading writer has called "direct personal dealings,"<sup>21</sup> and emphasis will be placed on decisions of federal cases arising within the Fourth Circuit, as well as Maryland cases dealing with the points of Maryland law applicable in this general field.

#### COMMON LAW AND EQUITABLE PRINCIPLES

Historically, the state common law or equitable principles regulating securities dealings began with the recognition of a right of rescission in equity to the injured party, either buyer or seller, when the transaction was induced by material misrepresentations.<sup>22</sup> In this early period, however, an injured party who sought to recover damages at law for his injury was faced with the

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18. 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969), *noted in* 82 HARV. L. REV. 938 (1969).

19. For a discussion and treatment of this broader area see Wiesen, *Disclosure of Inside Information—Materiality and Texas Gulf Sulphur*, 28 MD. L. REV. 189 (1968). See also Bahlman, *Rule 10b-5, The Case for its Full Acceptance as Federal Corporation Law*, 37 U. CIN. L. REV. 727 (1968); Comment, *SEC Rule 10b-5: A Recent Profile*, 13 WM. & MARY L. REV. 860 (1972).

20. 3 L. LOSS, *supra* note 8, at 1430-48, 1623-1796; 1 A. BROMBERG, *supra* note 1, at 57-58, 83-88.2. See also *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 193-95 (1963); *Hooper v. Mountain States Sec. Co.*, 282 F.2d 195, 201 (5th Cir. 1960), *cert. denied*, 365 U.S. 814 (1961). See generally Annot., 7 A.L.R.3d 500 (1966); Annot., 84 A.L.R. 615 (1933).

21. 1 A. BROMBERG, *supra* note 1, at 67-88.1. Most of these cases involve dealings between the seller and the purchaser, but a minority have presented similar questions between one of these parties and a broker. See, e.g., *Johns Hopkins Univ. v. Hutton*, 297 F. Supp. 1165 (D. Md. 1968), *aff'd in part*, 422 F.2d 1124 (4th Cir. 1970).

22. In Maryland, relief in equity from a contract induced by a misrepresentation (involving not a securities transaction but a mortgage), even if the representation was not known to be false, began at least as early as 1833, with *Joice v. Taylor*, 6 G. & J. 54 (Md. 1833). A number of cases have applied the same principle in securities dealings. See, e.g., *Shulton, Inc. v. Rubin*, 239 Md. 669, 212 A.2d 476 (1965); *Sears v. Barker*, 155 Md. 323, 141 A. 908 (1928); *Findlay v. Baltimore Trust & Guar. Co.*, 97 Md. 716, 55 A. 379 (1903); *Negley v. Hagerstown Mfg., Mining & Land Improvement Co.*, 86 Md. 692, 39 A. 506 (1898).

established legal principle that no recovery could be obtained unless the defendant had been guilty of intentional deceit or what was termed "fraud".<sup>23</sup>

In the rescission cases, in equity, there has long been a tendency to relax the requirement of *scienter* on the part of the defendant, and in the relatively recent case of *Shulton, Inc. v. Rubin*<sup>24</sup> rescission was again allowed without proof that the defendant intended to mislead the injured party. However, it was not until 1957 that the Maryland Court of Appeals, in *Schmidt v. Millhauser*,<sup>25</sup> extended the common law fraud action to allow damages at law for misrepresentations shown to have been made not intentionally but with "reckless disregard of truth." Thus it has been established that the victim of a misrepresentation so made has the option of rescission in equity, or of suit for damages at law;<sup>26</sup> but the proof required as to the defendant's guilty or reckless state of mind may still be involved in some doubt.

In the cases involving fiduciary duty of controlling persons in a corporation, who sell to or buy from the minority, as previously indicated,<sup>27</sup> a different principle has repeatedly been recognized. The principle was clearly enunciated as early as 1909 in the opinion of Justice Peckham for the Supreme Court in *Strong v. Repide*.<sup>28</sup> This case was an appeal from the Supreme Court of the Philippine Islands, and the United States Supreme Court held that the chief executive officer and director of a company, who also owned three-fourths of its stock, violated his fiduciary duty in buying the plaintiff's stock without disclosing his pending negotiations to sell the company's lands to the United States government for a price representing a value for the stock many times the price which he had paid. The Court held that his conduct violated provisions of the Philippine Civil Code, but commented that "[t]his is the rule of the common law also,"<sup>29</sup> and continued:

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23. *Donnelly v. Baltimore Trust & Guar. Co.*, 102 Md. 1, 61 A. 301 (1905); *Cahill v. Applegarth*, 98 Md. 493, 56 A. 794 (1904). This rule appears not to have been relaxed until the case of *Schmidt v. Millhauser*, 212 Md. 585, 130 A.2d 572 (1957).

24. 239 Md. 669, 212 A.2d 476 (1965).

25. 212 Md. 585, 130 A.2d 572 (1957).

26. Recovery either at law or equity both *normally* require a misrepresentation in the form of an *untrue statement*. A mere *omission* to reveal known facts is ordinarily not enough; however, as will be shown, when the omission is by one who stands in a fiduciary position then that omission may be sufficient for a cause of action. See *MacGill v. MacGill*, 135 Md. 384, 109 A. 72 (1919).

27. See notes 3-5 *supra* and accompanying text.

28. 213 U.S. 419 (1909).

29. *Id.* at 430.

[B]ut in both cases it is based upon the proposition that, under all the circumstances of the case, it was the duty of the party who obtained the consent, [of the plaintiff to the sale] acting in good faith, to have disclosed the facts which he concealed. . . . In such cases concealment is equivalent to misrepresentation.<sup>30</sup>

In the same vein, but without citing *Strong*, the Court of Appeals of Maryland in 1919 rendered two decisions based on a similar view of the responsibility of controlling stockholders and directors who purchase, or cause their corporation to acquire, the stock of a minority holder or holders; or who sell, or cause the corporation to sell, shares of its stock to others, in each case without disclosing material and significant facts known to them. In the first case, *McGaw v. Hoen*,<sup>31</sup> the controlling directors held certain outstanding "due bills" or notes of the company and arranged for it to sell a large block of stock to an outsider without disclosing the existence of these notes. The purchaser, on discovering the facts, obtained a decree enjoining the enforcement of the notes, which was approved by the Court of Appeals.<sup>32</sup>

The second case, *MacGill v. MacGill*,<sup>33</sup> involved a scheme by which the controlling stockholders and directors proposed and recommended to the minority stockholders that they convert their common stock into preferred stock. This was done without informing the minority that the company had become prosperous due to war conditions and that the common stock was worth substantially more than the preferred. The court had no difficulty in setting aside this plan because of the fiduciary relation of the defendants to the minority. The court's citations and reasoning establish its position that the directors violated a fiduciary obligation similar to that which they owed to the corporation itself.<sup>34</sup>

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30. *Id.*

31. 133 Md. 672, 106 A. 13 (1919).

32. The court's opinion, by Chief Justice Boyd, says: "[I]t can not be doubted that Messrs. McGaw and Harlow were in equity and justice under obligation to make known to the purchaser the fact that they held such certificates and claimed to be entitled to be paid for them." *Id.* at 680, 106 A. at 16.

33. 135 Md. 384, 109 A. 72 (1919).

34. Roger Clapp, discussing this case in his article, *A Fiduciary's Duty of Loyalty*, 3 MD. L. REV. 221 (1939), describes *MacGill* as "an *a fortiori* case for the application of these principles. Directors of a corporation and the owners of a majority of its stock, who induced minority stockholders to exchange their common stock for preferred stock without disclosing that the corporation had earned large profits and would pay correspondingly large dividends on the common stock, were held to have violated their fiduciary duty." *Id.* at 234-35.

The court in *MacGill* quoted at length from *Cumberland Coal & Iron Co. v. Parish*,



Thus, the court expanded the principle of the director's fiduciary duty to include an identical obligation to the uninformed individual stockholders from whom material information was withheld. In the *MacGill* case the deception practiced on the minority stockholders was no doubt beneficial to the corporation and its majority stockholders; yet the court held that the fiduciary duty to the injured minority, which had been violated by the controlling parties, outweighed any conflicting fiduciary duty owed to the corporation which they controlled.<sup>35</sup>

A comparison of the *McGaw* and *MacGill* cases with the opinion of the Supreme Court in *Strong v. Repide* indicates that all three support the view that a director or directors who are in a position of control in their corporation must disclose pertinent facts to a buyer or seller with whom they deal individually. While *MacGill* would seemingly place Maryland in the group of states which recognize a fiduciary duty owed by a director to an individual stockholder in such a situation, the Supreme Court in *Strong* outlined "special facts" which would compel disclosure even if, in the ordinary case, a director as such would not ordinarily owe such a duty. The special facts so stated in Mr. Justice Peckham's opinion were: the director who failed to make disclosure "owned three-fourths" of the corporation's stock; he was administrator general of the company, with large powers; as such, he was engaged in the negotiations which finally led to the sale of the company's lands at a price which very greatly enhanced the value of the stock; the negotiations were for the sale of the whole of the

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42 Md. 598 (1875). There, a successful complaint had been filed by the corporation itself, and the court had said that the defendant director "bore an important fiduciary relation to the company, as well as one of trust and confidence in the general control and management of its affairs. . . . such directors or managers being in fact trustees and agents of the bodies represented by them." 135 Md. at 393-94, 109 A. at 75, quoting *Cumberland Coal & Iron Co. v. Parish*, 42 Md. 598, 604-05 (1875). Having quoted this statement, the *MacGill* court went on to say, "[t]he facts alleged are sufficient, in our opinion, to bring the defendants fully within the principles announced by this Court in the cases . . . ." 135 Md. at 394, 109 A. at 75.

35. These two cases, *McGaw* and *MacGill*, have never been questioned by the Court of Appeals. However, a statement by Judge Grason in a 1946 case, *Llewellyn v. Queen City Dairy, Inc.*, 187 Md. 49, 48 A.2d 322 (1946), which was not necessary to the decision, expresses doubt as to the existence of a general fiduciary duty owed by a director to an individual stockholder. While not mentioning *MacGill*, the court cites with approval cases in other states holding that the mere director-stockholder relationship does not impose a fiduciary duty on the director when he purchases a stockholder's stock, in the absence of "fraud or concealment," which Judge Grason found not to exist in the case before him. *Id.* at 60, 48 A.2d at 327. In the same year, however, the court, in *Ross Transport, Inc. v. Crothers*, 185 Md. 573, 45 A.2d 267 (1946), holding that a sale of company stock to directors should be voided, discussed and approved the fiduciary cases, including *MacGill*.

property of the company; no one knew as well as he the exact condition of such negotiations, the probability of the sale of the lands to the government and the probable price that might be obtained on such sale; and, the lands were the only valuable asset owned by the company.<sup>36</sup>

In view of the Maryland cases, as set forth, and the considerations stated by the Supreme Court in *Strong*, a carefully delineated touchstone is presented to the Maryland practitioner for advising as to the duty of a controlling stockholder-director, in Maryland, to disclose facts known to him when he proposes to purchase stock of a minority or sell securities of the company to a minority. Whether these rules would apply in a case involving a non-controlling stockholder-director, however, may still be open to some question.

These conditions exist in the body of Maryland case law, apart from federal rule 10b-5 and the Maryland Securities Act.<sup>37</sup> In view of the fiduciary duty recognized in these cases, and the burden of proof imposed upon a fiduciary to justify the fairness of his conduct,<sup>38</sup> the litigant may find that a count in his complaint based on the general state law may have equal value with a count directly based on rule 10b-5, at least as regards the issue of liability.

An increasing number of state courts now support the view that a fiduciary obligation of full disclosure rests on a director who purchases stock of his corporation from minority stockholders.<sup>39</sup> The states taking this view are Georgia, Kansas, Idaho, Iowa, Maryland and New York.<sup>40</sup>

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36. 213 U.S. at 431-32.

37. MD. ANN. CODE art. 32A, § 13 *et seq.* (1971).

38. See *Parish v. Maryland & Va. Milk Producers Ass'n, Inc.*, 250 Md. 24, 101-02, 242 A.2d 512, 555 (1968), repeated in second appeal after trial on the merits, 261 Md. 618, 695, 277 A.2d 19, 55, *cert. denied*, 404 U.S. 940 (1971) (releasee, being in confidential relation, "cannot escape from the burden of proving . . . the absence of fraud, undue influence or over-reaching and the releasor's knowledge of all relevant facts"). See also *Cummings v. United Artists Theatre Circuit*, 237 Md. 1, 24, 204 A.2d 795, 807 (1964); *Indurated Concrete Corp. v. Abbott*, 195 Md. 496, 504, 74 A.2d 17, 20 (1950) ("the onus of proof . . . [is] . . . upon him [the fiduciary] to establish the perfect fairness, adequacy, and equity of the transaction").

39. The principle appears to be stated broadly on the basis of a fiduciary duty imposed on *all* directors purchasing from minority stockholders; however, in several of the cases the defendant-director was in fact a "controlling" person.

40. See, e.g., *Oliver v. Oliver*, 118 Ga. 362, 45 S.E. 232 (1903); *Weatherby v. Weatherby Lumber Co.*, 94 Idaho 504, 492 P.2d 43 (1972); *Dawson v. National Life Ins. Co.*, 176 Iowa 362, 157 N.W. 929 (1916), *approved and followed in*, *Berger v. Amana Society*, 253 Iowa 378, 111 N.W.2d 753 (1962); *Stewart v. Harris*, 69 Kan. 498, 77 P. 277 (1904); *Falk v. Hoffman*, 233 N.Y. 199, 135 N.E. 243 (1922); *Sautter v. Fulmer*, 258 N.Y. 107, 179 N.E.

In summation, Maryland clearly appears to be one of the states in which at least *controlling* stockholder-directors and probably *all* directors have an established common law or equitable duty to disclose pertinent facts before buying stock from minority stockholders who are ignorant of such facts.<sup>41</sup> If the controlling parties proceed without making such disclosure, the case law indicates that a substantial burden of proof as to the fairness of the transaction is imposed on them, and the transaction, if challenged, cannot stand unless they affirmatively establish its complete fairness.

### THE MARYLAND SECURITIES ACT

In 1962, long after rule 10b-5 was adopted but before its use in litigation became widespread, the Maryland Securities Act was enacted.<sup>42</sup> Section 13 of this act contains a general pronouncement in virtually the same language as the rule,<sup>43</sup> that it shall be unlawful:

. . . in connection with the offer, sale, or purchase of any security, directly or indirectly: (1) to employ any device,

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311 (1932). A sixth state taking this position is, of course, Maryland, as shown previously in this section.

41. To what extent liability will be imposed on insiders other than controlling shareholders is unsettled in Maryland. Professor Loss recognizes that the holding of the cases cited in note 40 *supra*, as to the fiduciary duty owed by a mere non-controlling director to a stockholder (with which Maryland appears to agree in the *MacGill* case), is a minority rule, but he makes this comment:

In actual results the old "majority" rule [under which officers and directors have a fiduciary obligation only to the corporation and to the stockholders in their dealings with or on behalf of the corporation] has substantially merged into the "special circumstances" doctrine [of *Strong v. Repide*] which in turn is scarcely distinguishable from the so-called "minority" rule. . . . It seems fair to conclude from all this that the so-called "majority" view is gradually giving way to the generally growing feeling of responsibility of corporate insiders—the development of a status of "trusteeship" in a non-technical sense.

3 L. Loss, *supra* note 8, at 1447-1448, referring also to his previous discussion at 1 L. Loss, *supra* note 8, at 17-18.

An interesting dictum of Chief Judge Parker of the Fourth Circuit Court of Appeals in *Brown v. Eastern States Corp.*, 181 F.2d 26 (4th Cir. 1950), includes the following statement:

The president and directors occupied a fiduciary relationship towards the stockholders, and for them to put forward a plan under which the assets of the corporation would be used in the purchase of stock in a way which would so greatly profit one of their number, would be difficult to justify under any principles of law or equity with which we are familiar.

*Id.* at 29.

42. Ch. 1, [1962] Md. Laws 3 [codified at MD. ANN. CODE art. 32A, § 13 *et seq.* (1971)].

43. See note 15 *supra* and accompanying text.

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 are 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.<sup>44</sup>

The virtual identity between this language and the language of rule 10b-5 is apparent; and it has been stated by the first Maryland Securities Commissioner, Decatur H. Miller, that this section of the Act "is a substantially verbatim copy of Rule 10b-5 under the Securities Exchange Act of 1934 and consequently inherits a long line of judicial and administrative precedent."<sup>45</sup> It may be asserted without contradiction that the "long line of precedent" supports a private right of action to anyone injured by these proscribed acts. While the federal rule 10b-5 has no specific provision granting a right of action to the injured party, the federal courts have consistently held that its substantive provisions demand and require that such a right of action be recognized, equally on behalf of an injured buyer or an injured seller of securities.<sup>46</sup> The principal ground given for recognition of a civil liability is called "statutory tort." The Restatement of Torts takes the position that a person injured by violation of a statute enacted for the benefit of persons in his position is entitled to recover his damages.<sup>47</sup>

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44. MD. ANN. CODE art. 32A, § 13 (1971).

45. Miller, *A Prospectus on the Maryland Securities Act*, 23 MD. L. REV. 289, 294 (1963).

46. A large number of cases assert that the rule implies a right of civil recovery for violations, beginning with *Speed v. Transamerica Corp.*, 71 F. Supp. 457 (D. Del. 1947), 99 F. Supp. 808 (D. Del. 1951), *aff'd*, 235 F.2d 369 (3d Cir. 1956). *See, e.g.*, *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6 (1971), *noted in*, 1972 DUKE L.J. 465; *Fischmann v. Raytheon Mfg. Co.*, 188 F.2d 783 (2d Cir. 1951); *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946). *See also* 3 L. LOSS, *SUPRA* note 8, at 1763 nn.260-61, supplemented in 6 L. LOSS, *SECURITIES REGULATION* 3871 (Supp. 1969); *Annot.*, 37 A.L.R.2d 649 (1954); *Ruder, Civil Liability under Rule 10b-5: Judicial Revision of Legislative Intent*, 57 NW. U.L. REV. 627 (1964).

47. *See* 1 A. BROMBERG, *SUPRA* note 1, at 29-30, citing RESTATEMENT OF TORTS § 286 (1934). Two other grounds upon which civil liability has been based are: the "void contract" theory, that the 1934 Act itself grants a private right of action under § 29(b), which provides that "[e]very contract made in violation [of the statute or any rule thereunder] . . . shall be void." 15 U.S.C. § 78cc (b) (1970); and, the theory expressed in *J.I. Case Co. v. Borak*, 377 U.S. 426 (1964), that the language "for the protection of investors" which appears in § 14(a) of the 1934 Act implies "the availability of judicial relief where necessary to achieve that result." *Id.* at 432. Thus, where federally secured rights are invaded, the federal courts may "adjust their remedies so as to grant the necessary relief." *Id.* at 433.

This ground of statutory tort would be equally applicable to the Maryland Securities Act but for the provision of section 34 of the Act which, while preserving "any other rights or remedies that may exist at law or in equity,"<sup>48</sup> states that "this act does not create any cause of action not specified."<sup>49</sup> The Maryland Act specifically grants a right of action to an injured buyer but omits any reference to an action by an injured seller.<sup>50</sup> Section 34 of the Maryland Securities Act, in asserting that the Act "does not create any cause of action not specified," appears to run counter to the supposed general intention to adopt rule 10b-5 as to intrastate transactions, together with the established interpretation of the rule that it *does* create a right of action, by implication, in favor of an injured seller as well as an injured buyer. If section 34 is applied literally, it follows that a fundamental distinction and difference must be recognized as between the rights of an injured seller under the federal law and his corresponding rights under the state law. It would seem that the Court of Appeals of Maryland would seek to avoid this distinction if possible, by relying upon the overriding general policy to grant correlative rights as to securities transactions to sellers as well as to buyers, but until the question has been raised and decided, or an amendment made to the Securities Act, no categorical answer can be given to this question.

What is clear, however, is that section 34 does provide that the specific rights and remedies granted by the Act "are in addition to any other rights or remedies that may exist at law or in equity." This would preserve the right of an injured seller under proper circumstances to seek redress pursuant to the principles

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48. MD. ANN. CODE art. 32A, § 34(h) (1971).

49. *Id.*

50. MD. ANN. CODE art. 32A, § 34(a)(2) (1971). Section 34 of the Maryland Securities Act was adopted from the Uniform Securities Act, which contained no civil liability against buyers. The draftsmen of the Uniform Act felt that there was:

[N]o clear need to create any *civil liability* against buyers as distinct from sellers. Although the lower federal courts have uniformly implied a civil cause of action against fraudulent buyers under the SEC rule, the federal courts when applying federal law do not have at their disposal all of the common-law and equitable remedies of deceit and rescission which are available to the state courts without benefit of statute. In the area of civil liability, moreover, it seems not only unnecessary but unwise to disturb the general jurisprudence which has been developing with reference, for example, to the obligation of corporate insiders to make affirmative disclosure when purchasing from existing stockholders. On the other hand, the general law is not adequate to deal with flagrant cases of fraud by buyers on a *criminal* level, and there can of course, be no public action for an *injunction* against such practices without specific statutory authority.

Draftsmen's Comment, Uniform Securities Act § 101.

set forth in *MacGill v. MacGill*,<sup>51</sup> recognizing a fiduciary duty of a controlling stockholder-director to disclose pertinent information to a minority shareholder before purchase from that shareholder.

#### RULE 10B-5

##### *Requirements for Federal Jurisdiction*

Federal jurisdiction in 10b-5 cases rests upon the assertion of a claim based upon federal law. The rule requires that the wrongful acts of the defendant must be committed "in connection with the purchase or sale of a security" and that some "means or instrumentality of interstate commerce" be used.<sup>52</sup>

The cases have interpreted these requirements broadly. Jurisdiction usually rests on the use of the mails<sup>53</sup> or of the telephone service,<sup>54</sup> and such use need not include the transmission of the alleged untrue or misleading statements.<sup>55</sup> For example, it appears to be sufficient if the use of these interstate facilities is reasonably called for in connection with the development of the transaction, or any aspect of the transfer of the securities, or payments or releases incident to the consummation of the transaction.<sup>56</sup> In addition, while at one time there was a conflict in the cases as to whether local telephone calls were sufficient on which to predicate jurisdiction, this point seems now to be affirmatively established by the current weight of authority, the reasoning of the courts being that the entire telephone service is an interstate facility which is being used, whether or not the particular calls shown did in fact cross state lines.<sup>57</sup> It would be a rare transaction indeed if all aspects of a sale of securities could be carried out with no use of the mails or of telephone service.

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51. 135 Md. 384, 109 A. 72 (1919).

52. The other listed means for a violation are the use of the mails or any national securities exchange.

53. The mails need only be used incidentally. See *Hooper v. Mountain States Sec. Corp.*, 282 F.2d 195 (5th Cir. 1960), cert. denied, 365 U.S. 814 (1961); *Northern Trust Co. v. Essaness Theatres Corp.*, 103 F. Supp. 954 (N.D. Ill. 1952). See also 3 L. Loss, *supra* note 8, at 1522-25.

54. See 3 L. Loss, *supra* note 8, at 1522-25.

55. *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6 (1971); *Levin v. Marder*, 343 F. Supp. 1050 (W.D. Pa. 1972). See also 2 A. BROMBERG, *supra* note 1, at 245.

56. See 2 A. BROMBERG, *supra* note 1, at 245 n.5.

57. See *Myzel v. Fields*, 386 F.2d 718 (8th Cir. 1967), cert. denied, 390 U.S. 951 (1968); *Levin v. Marder*, 343 F. Supp. 1050 (W.D. Pa. 1972); *Ingraffia v. Belle Meade Hosp.*, 319 F. Supp. 537 (E.D. La. 1970); *Esplanade, Inc. v. Maryland Land & Inv. Co.*, Civ. No. 19092 (D. Md. Apr. 19, 1968). But see *Burke v. Triple A Mach. Shop, Inc.*, 438 F.2d 978 (9th Cir. 1971).

Even if the case, as based on rule 10b-5, is not established upon trial, the applicable state law, whether statutory or based on the course of decision, may recognize a cause of action arising from the same facts. Federal courts have pendent jurisdiction of state law claims arising out of the same facts as 10b-5 or other federal claims.<sup>58</sup> It follows that a violation of the state law, if it exists, should be pleaded in the complaint filed in the federal court. Accordingly, it is often alleged, in a 10b-5 case, that the acts complained of were: violative of rule 10b-5; violative of section 13 (or a similar section of the applicable state securities act); and if, special facts exist such as a fiduciary or confidential relationship, violative of legal or equitable principles recognized by the applicable state law.<sup>59</sup> All of these matters can thus be brought before the federal court in a single proceeding, while the state court could exercise no jurisdiction over the federal claim.<sup>60</sup>

### *Materiality, Reliance and Scienter*

Ordinarily the plaintiff in litigation brought under rule 10b-5 must show a purchase or sale of a security induced in part by a material misrepresentation, or by the non-disclosure of material information known to the defendant in order to establish his case.<sup>61</sup> The burden of proof rests on the complainant as to these

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58. See *United Mine Workers v. Gibbs*, 383 U.S. 715 (1966); *Hurn v. Oursler*, 289 U.S. 238 (1933). See also Annot., 5 A.L.R.3d 1040, 1115-20 (1966); Lowenfels, *Pendent Jurisdiction and the Federal Securities Acts*, 67 COLUM. L. REV. 1018 (1967); Mills, *Pendent Jurisdiction and Extraterritorial Service Under the Federal Securities Laws*, 70 COLUM. L. REV. 423 (1970).

59. See, e.g., *Schine v. Schine*, 250 F. Supp. 822 (S.D.N.Y.), *appeal dismissed*, 367 F.2d 685 (2d Cir. 1966), in which claims under the state law were included in the complaint.

60. Under section 27 of the Securities Exchange Act of 1934, exclusive jurisdiction with respect to matters regulated under section 10(b) of the Act is conferred on the federal courts. The ultimate in legal confusion and frustration will be realized if a complainant, supposing his case to be impregnable under state law, seeks first a remedy in the state court, only to find that that tribunal disagrees with him; then he files an action in the federal court under rule 10b-5, and is met with defenses of res adjudicata and collateral estoppel. See Note, *Effect of Prior Nonfederal Proceedings on Exclusive Federal Jurisdiction Over Section 10(b)*, 46 N.Y.U.L. Rev. 936 (1971).

61. Several leading decisions have said that it is necessary only to prove . . . one of the prohibited actions, such as a material misstatement of fact or the omission of a material fact. However, this seems to be an oversimplification. A more balanced view, better reflective of the current of decision, is that recovery requires, in addition, proof of an injury in some significant way connected with the violation. 2 A. BROMBERG, *supra* note 1, at 223 (footnotes omitted).

An exception may be suggested to Professor Bromberg's statement, that is, the case in which the defendant occupies a fiduciary position with respect to the plaintiff and has made a profit on the property purchased from his beneficiary. In such a case the plaintiff

essential matters.<sup>62</sup>

Other elements, frequently discussed in the cases, are "reliance" and "scienter." An increasing number of decisions appear to hold that, if "materiality" of the misrepresentation or of the omitted fact is shown, this may supply any requirement of proving reliance, and the recent Supreme Court decision in *Affiliated Ute Citizens v. United States*,<sup>63</sup> dealing with nondisclosure of a material fact, appears to have settled the law in favor of this view. The Court there said:

Under the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision . . . [citing *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 384 (1970) and other authorities] . . . This obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact.<sup>64</sup>

As far as proof of the defendant's *scienter*, or guilty state of mind, is concerned,<sup>65</sup> it is questionable whether the weight of modern authority supports such a requirement, at least if the word bears any resemblance to the state of mind required to shown common law fraud. In his treatise, Bromberg, after some two hundred pages discussing *scienter*, reaches no firm conclusion, except that actual knowledge by the defendant of the material fact not disclosed is enough *scienter* for liability in these cases.<sup>66</sup> Cases that have been decided in the United States District Court for the District of Maryland appear to reject any requirement of guilty intent but seem to require actual knowledge

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might be unable to show a direct loss to himself, but the defendant, by his wrongdoing, has made a profit on plaintiff's property which it is unconscionable for him to retain. See *Garner v. Boyd*, 330 F. Supp. 22, 26 (N.D. Tex. 1970), *aff'd*, 447 F.2d 1373 (5th Cir. 1971). As to following a trust res improperly acquired from the beneficiary by the fiduciary see *MacBryde v. Burnett*, 132 F.2d 898 (4th Cir. 1942). See also Notes 119-28 *infra* and accompanying text.

62. Under Maryland law, where the defendant stood in a fiduciary or confidential relationship to the complainant the burden appears to rest on the fiduciary to establish the complete fairness of the transaction. See note 38 *supra* and accompanying text.

63. 406 U.S. 128 (1972) (the *Reynos Case*).

64. *Id.* at 153-54.

65. There are many different meanings of the word as used in the cases, ranging from intentional deceit to negligence. For a discussion of this semantic confusion see 2 A. BROMBERG, *supra* note 1, at 204.102-104.

66. 2 A. BROMBERG, *supra* note 1, at 204.137. See 2 A. BROMBERG, *id.* at 204.11-.260.



of the omitted fact, or negligent conduct of the defendant (something less than common law fraud).<sup>67</sup>

### *Material Facts Requiring Disclosure*

A particularly significant inquiry in evaluating any 10b-5 complaint or potential complaint is to ascertain what facts and what undisclosed facts have been deemed material in the reported cases. The existence and extent of the obligation of a fiduciary under state law to disclose material facts is consistent with the obligation of a control person under rule 10b-5 to make similar disclosures. Each of these regulatory principles, therefore, lends support to the other, and they are independently and severally enforceable by the federal court in a single action pleading the non-disclosure.<sup>68</sup> A review of a number of decided cases involving non-disclosure may assist in developing certain classes of significant non-disclosures which have been deemed to be actionable, and the following discussion attempts to classify these.

If the securities being purchased by controlling parties or "insiders" have a market value not readily known to the other party, this must be disclosed by such purchasers.<sup>69</sup> If, however, the securities have no market value, significant factors bearing on the fair value of such securities must be revealed.<sup>70</sup> In all cases,

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67. See *Batchelor v. Legg & Co.*, 52 F.R.D. 545, 549 (D. Md. 1971); *Johns Hopkins Univ. v. Hutton*, 297 F. Supp. 1165, 1219-20 (D. Md. 1968), *aff'd in part*, 422 F.2d 1124 (4th Cir. 1970); *Baumel v. Rosen*, 283 F. Supp. 128, 140 (D. Md. 1968), *aff'd as to liability*, 412 F.2d 571 (4th Cir. 1969).

68. See *Kardon v. National Gypsum Co.*, 83 F. Supp. 613 (E.D. Pa. 1947), upholding a complaint both as based on fiduciary duty and as claiming under rule 10b-5. Both grounds are also asserted in *Schine v. Schine*, 250 F. Supp. 822 (S.D.N.Y.), *appeal dismissed*, 367 F.2d 685 (2d Cir. 1966), which is still pending in the United States District Court for the Southern District of New York. In *Schine* the court said that "the prime thrust of their [the plaintiffs'] charges is that the defendants failed to disclose material facts which, as controlling stockholders, they were under a duty to disclose, both under common law principles and by virtue of statutory command." *Id.* at 826. In *Kohler v. Kohler Co.*, 319 F.2d 634 (7th Cir. 1963), while the court decided that the plaintiff under the particular circumstances was not entitled to relief, it said that section 10(b) and rule 10b-5 are "intended to create a form of fiduciary relationship between so-called corporate 'insiders' and 'outsiders' with whom they deal in company securities, which places upon the insider duties more exacting than mere abstention from what generally is thought to be fraudulent practices." *Id.* at 637. An interesting discussion of the interdependence of a breach of fiduciary duty by insiders and violation of rule 10b-5 by the same action will be found in 1 A. BROMBERG, *supra* note 1, at 83-88.1.

69. See *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972), where the purchasers recognized the obligation to make such disclosure, but represented that the value was lower than what the Court later found to be the true value.

70. In the case of *In re Ward La France Truck Corp.*, 13 S.E.C. 373 (1943), the SEC determined that there had been a violation of the rule, where two officers of a

recent financial statements available to the insiders would ordinarily be included in the required disclosure.<sup>71</sup>

In a negotiation or discussion with outside parties in anticipation of a sale of the company, its assets or its securities, or a merger, involving valuation, these developments would appear to constitute material information to which a minority stockholder would be entitled, even if the negotiation or discussion never reached the stage of agreement.<sup>72</sup> If the negotiations develop evidence of a value higher than that proposed by the insiders, no ground can be perceived for excluding such evidence and it would have convincing probative force.

Several of the cases have stressed the need of disclosure of any significant recent developments as to the company, and especially plans for disposition of the business or a material change in its operations. Thus, in *Speed v. Transamerica Corp.*,<sup>73</sup> the insiders (a controlling parent corporation), finding that the company's inventory of tobacco had greatly increased in value due to a shortage of tobacco and had a cash value substantially greater than the valuation carried on its books, developed a program to buy in minority stock at slightly more than its market value (the market being thin). The remaining stockholders, including the parent, would then realize a profit on the tobacco inventory by the sale of the inventory and liquidation of the subsidiary company. The court not only condemned the non-disclosures, but took the position that the offer of the parent company to buy in the stock of the subsidiary was, due to its fiduciary position, a representation that the offering price was fair. Because of the facts known to the controlling stockholder, its action constituted

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company arranged for it to buy certain shares at from three to six dollars per share when they hoped to sell controlling stock for many times that amount, and proposed to have the company liquidated for an amount which would yield the other stockholders twenty-five dollars a share. All of these matters, the Commission determined, should have been disclosed. Stockholders who had sold received a settlement of over \$165,000. See 3 L. Loss, *supra* note 8, at 1457 n.46.

71. Cases in which such statements and complete financial information were not furnished, but were regarded as material include: *Janigan v. Taylor*, 344 F.2d 781 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965); *Ross v. Licht*, 263 F. Supp. 395 (S.D.N.Y. 1967); *Schine v. Schine*, 250 F. Supp. 822, 254 F. Supp. 986 (S.D.N.Y. 1966); *Speed v. Transamerica Corp.*, 99 F. Supp. 808 (D. Del. 1951); *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946) (on motion to dismiss complaint), 73 F. Supp. 798 (E.D. Pa. 1947) (on the merits), 83 F. Supp. 613 (E.D. Pa. 1947) (on requests for additional findings).

72. See 1 A. BROMBERG, *supra* note 1, at 69-72, stating that "[t]he archetypal 10b-5 case is the purchase by one group in a closed corporation of the interest of another, without disclosing negotiations for sale or other disposition of the issuer's assets or its securities at a higher price." *Id.* at 70 (footnote omitted).

73. 99 F. Supp. 808 (D. Del. 1951).

an affirmative, false and fraudulent representation.<sup>74</sup>

In *Janigan v. Taylor*,<sup>75</sup> the Court of Appeals for the First Circuit stressed the fact that the company's condition was substantially improving and that its orders and backlog were greatly increased. The importance of these non-disclosed but favorable facts was emphasized by the president's answering an inquiry by stating that things were "about the same." While ordinarily statements of expectations as to future gains to be made by the company are not favored, in *Janigan* favorable projections based on "observed trends" would, according to the court, have been in order and the offering of projections based on the facts observed would have been proper for the stockholders to whom the insiders were making their offers of purchase.<sup>76</sup>

In several cases the courts have regarded a negotiation for sale of the company, its assets or a substantial block of its stock, as sufficiently material to require disclosure.<sup>77</sup> However, there is an initial point of negotiation at which disclosure is not required. In *List v. Fashion Park, Inc.*,<sup>78</sup> where relief was denied on the facts, the court concluded that at the critical time when the purchase of stock was made negotiations for the sale of the business had not begun. The facts disclosed that nothing more had happened but the passing of a directors' resolution to seek a sale and the assertion by a union leader that a buyer was interested.

As to the time when the materiality of the negotiation, as involving the need of disclosure, should be assessed, the following

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74. *Id.* at 849.

75. 344 F.2d 781 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965).

76. It would also appear that in *Janigan* the books had been "juggled" by repricing the inventory and deferring posting of some sales from December to January, which reduced income of the prior fiscal year. Other cases have commented on errors in statements. *See, e.g.,* Royal Air Properties, Inc. v. Smith, 312 F.2d 210 (9th Cir. 1962) (where land cost was not taken into account in an income projection); Dauphin Corp. v. Redwall Corp., 201 F. Supp. 466 (D. Del. 1962) (where the court found an error in overvaluation of properties).

77. *See* Levin v. Marder, 343 F. Supp. 1050 (W.D. Pa. 1972) (where one offer was disclosed but an earlier proposal which might have been better was not disclosed); Ross v. Licht, 263 F. Supp. 395 (S.D.N.Y. 1967) (where plaintiffs were considering sale to insiders at \$120 per share but the insider-defendants were having discussions as to possible private sale at \$300, to be followed by a possible public offering at \$600); Schine v. Schine, 250 F. Supp. 822 (S.D.N.Y. 1966) (where there were several negotiations but not all were disclosed); Speed v. Transamerica Corp., 99 F. Supp. 808 (D. Del. 1951) (where the insiders knew, but did not disclose that the corporation's tobacco inventory, a major asset, had an increased cash value several times its cost or book value, and the insiders were considering plans for realizing on this higher value).

78. 227 F. Supp. 906 (S.D.N.Y. 1964), *aff'd*, 340 F.2d 457 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965).

problems arise. If the relation of the parties is such that a duty of disclosure of material facts may exist, when does such a duty arise, and does the duty continue until settlement and delivery of the stock to the insider, or is the duty measured solely by knowledge acquired by him at or prior to the time when the parties committed themselves to the sale? One case in the Court of Appeals for the Second Circuit, which seemingly decides this question, is *Radiation Dynamics, Inc. v. Goldmuntz*.<sup>79</sup> In the district court the judge allowed the case to go to the jury, which decided in favor of the defendants.<sup>80</sup> The plaintiff appealed, complaining of the judge's charge, and on appeal the decision was affirmed. The appellate court expressed the view that the duty of disclosure ended when the seller and buyer had committed themselves by agreement to the sale, and therefore the duty did not continue as to subsequent negotiations and facts learned by the buyer thereafter.<sup>81</sup> No other appellate case, at this writing, appears to have considered and decided this question, and Professor Bromberg has suggested, in discussing the effect of a release by the plaintiff, that there is "an opportunity for falseness or omission at the closing as a result of intervening developments."<sup>82</sup> In fact, in the earlier decision of *Schine v. Schine*<sup>83</sup> the District Court for the Southern District of New York considered the facts known by the insider-buyer up to the time of settlement, in sustaining a complaint.

Conceivably *Schine* may be distinguishable from *Radiation Dynamics*. Due to the relation of the parties, an imperative obligation of disclosure, including a strong fiduciary duty, existed in

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79. 464 F.2d 876 (2d Cir. 1972).

80. 323 F. Supp. 1097 (S.D.N.Y. 1971).

81. It may be suggested that, since federal jurisdiction may be first acquired or triggered by use of interstate facilities at the time of and in connection with the settlement, it requires a very fine point of distinction to hold that the duty of disclosure under the rule had terminated at the earlier date when an agreement or commitment was reached as to the sale and purchase contract.

82. 1 A. BROMBERG, *supra* note 1, at 288.1-.2.

A delayed closing typical of formal agreements, permits postcontractual investigation and evaluation that further tends to disprove reliance on undisclosed information. But representations and warranties are customarily recited to be true at the closing as well as the making of the contract, and thus present an opportunity for falseness or omission at the closing as a result of intervening developments. Even without specification of truth at the closing, it is arguable that the sale is still being made at this point, which must thus be currently free from misrepresentation or omission. In other words, disclosure may be a continuing obligation through the closing.

*Id.*

83. 250 F. Supp. 822 (S.D.N.Y. 1966).

the earlier district court case of *Schine*. In *Radiation Dynamics*, however, the facts showed a weak or non-existent fiduciary duty of the insider-purchasers to the plaintiff (RDI), which actually acquired its stock after it had contracted to make the first of the resales of which it complained. It was apparent to all parties that RDI not only was not a previous stockholder but intended to realize on the stock, by resale or obtaining a large cash loan, immediately after acquiring it. Thus, there was no history of a director-stockholder relationship, nor any confidential basis on which a typical fiduciary obligation could be predicated.

What law there is in Maryland would indicate that the duty of disclosure continues until settlement;<sup>84</sup> and, due to the inescapable fiduciary duty of a controlling person buying from an outsider stockholder, he has a continuing obligation to establish the complete fairness of the transaction. Since equity deals with substance rather than form, this would seemingly include a continuing obligation of disclosure until the sale is fully consummated, and possibly even thereafter until existing negotiations for resale or other disposition have been consummated or terminated.

### *Defenses to Suit*

A number of defenses to a 10b-5 suit have been raised in the cases. These may be generally classified as follows: general legal defenses (including laches, limitations, waiver and estoppel); releases (including release of prior dispute or litigation); and, plaintiff's asserted lack of diligence.

Certain general comments may be made on the subject of defenses. First, the relationship of the parties may be of particular significance in the application of these asserted defenses. For

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84. Maryland law appears to present a liberality as to extension of the period of required disclosure; that is, evidence appears to be admissible of facts occurring after the injured party has been induced to enter into a contract with the defendant but prior to ultimate settlement under the contract. See *Summons v. State*, 156 Md. 382, 144 A. 497 (1929), a case involving conviction for obtaining money by false pretenses. The court there said:

Where a party has been induced by false pretences to enter into a contract, the party who has so procured the party's agreement to the contract cannot have excluded the evidence of his subsequent misrepresentations, whereby he completes the original fraud upon his victim by securing the full fruit of the fraud.

*Id.* at 385, 144 A. at 499. The theory supporting this position in the securities context is that if the contract was voidable for misrepresentation or equivalent non-disclosure at the time when it was signed by the parties, any further dealings between them which induced the actual settlement or payment should likewise be viewed as subject to the continued requirement of full disclosure, at least by a party occupying a fiduciary position.

example, if the alleged wrongdoer owed a fiduciary duty to the plaintiff, his conduct must be measured in the light of this responsibility, and the burden of proof as to issues involving the respective conduct of the parties may be shifted from the plaintiff to the defendant. Indeed, under the Maryland law the defendant may be required to establish the complete fairness of the questioned transaction.<sup>85</sup> The plaintiff's duty in such a case would be correspondingly diminished. If the plaintiff has suffered no measurable injury as a result of the defendant's alleged violation of duty, it is highly questionable whether, in the ordinary case, even nominal relief could be obtained, with the exception of cases involving a profit realized by the defendant through breach of fiduciary duty. Similarly, causation of the injury would appear to be an essential part of the plaintiff's case; thus, if the defendant is charged with non-disclosure of a material fact, and the plaintiff knew the fact, he would ordinarily not be entitled to relief.<sup>86</sup>

In the case of such defenses as limitations and laches, the period of statutory limitations, or of reasonable time before bringing suit, would ordinarily not begin running until knowledge, or at least ground for suspicion, has been brought to the attention of the plaintiff. In the usual action based on rule 10b-5, the most closely analogous state statute of limitations is customarily applied, since there is no directly applicable federal statute.<sup>87</sup> The present section 34(e)<sup>88</sup> of the Maryland Securities Act would be

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85. See notes 27-41 *supra* and accompanying text.

86. Causation of the injury is sometimes referred to as "reliance"; in non-disclosure cases "reliance" seems to have been eliminated as a requirement of the plaintiff's case by the Supreme Court's decision in *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972).

87. *Janigan v. Taylor*, 344 F.2d 781, 783-84 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965); *Batchelor v. Legg & Co.*, 52 F.R.D. 553, 558 (D. Md. 1971); *Baumel v. Rosen*, 283 F. Supp. 128 (D. Md. 1968), *aff'd as to liability without discussion of this point*, 412 F.2d 571 (4th Cir. 1969), *cert. denied*, 396 U.S. 1037 (1970). See also *Johns Hopkins Univ. v. Hutton*, 326 F. Supp. 250, 261 (D. Md. 1971) (which also discusses time limitation on asking for rescission). See generally *Schulman, Statutes of Limitations In 10b-5 Actions: Complication Added to Confusion*, 13 WAYNE L. REV. 635 (1967).

In *Johns Hopkins Univ. v. Hutton*, the complainant alleged that the facts constituted a violation of rule 10b-5 as well as other provisions of the Securities Act of 1933 which carry specific limitation provisions. The plaintiff obtained a summary judgement based on these other claims [297 F. Supp. 1165 (D. Md. 1968)] but the judgement was reversed and the case was sent back since the appeals court found that there was a substantial question for trial as to whether the specific limitation period should be applied [422 F.2d 1126 (4th Cir. 1970)]. On re-trial plaintiff again obtained a summary judgment, based this time on rule 10b-5 [326 F. Supp. 250 (D. Md. 1971)], and a second appeal was taken, which has been argued but not yet decided.

88. MD. ANN. CODE art. 32A, § 34(e) (1971).

the applicable statute in Maryland.<sup>89</sup> This section has a limitation period of one year after discovery of the untrue statement or omission, or after such discovery should have been made by the exercise of reasonable diligence, but not more than three years after the contract of sale.<sup>90</sup>

Likewise, the expiration of a reasonable period after discovery of the fraud, or of key facts leading to such discovery, would ordinarily call for the application of laches.<sup>91</sup> The established Maryland rule on laches, however, has consistently required a change of position by the defendant as well as passage of time, to invoke the doctrine.<sup>92</sup> The federal rule appears to be similar.<sup>93</sup>

A special application of the standard of diligence to the plaintiff's conduct lies in the field of limitations and laches. The case of *Holmberg v. Armbrecht*,<sup>94</sup> decided by the Supreme Court in 1946, established that where a state statute of limitations would ordinarily be applied to the enforcement of a federal right in equity, the federal court will not bar the suit due to mere lapse of time and that "where a plaintiff has been injured by fraud and 'remains in ignorance of it without any fault or want of diligence or care on his part, the bar of the statute does not begin to run until the fraud is discovered. . . .'"<sup>95</sup> This principle has been regularly applied in suits in equity based on violations of rule 10b-5, which does not contain or refer to any specific limitation period, and the "equitable doctrine is read into every federal statute of limitation."<sup>96</sup> Dealing with laches, the Supreme Court also said:

Equity eschews mechanical rules; it depends on flexibility. Equity has acted on the principle that 'laches is not like limitation, a mere matter of time; but principally a question of the inequity of permitting the claim to be enforced—an inequity founded upon some change in the condition or relations of the property or the parties.' . . . And so, a suit in

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89. See *Batchelor v. Legg & Co.*, 52 F.R.D. 553 (D. Md. 1971), applying Maryland's prior two year statute of limitations.

90. MD. ANN. CODE art. 32A, § 34(e) (1971).

91. *Holmberg v. Armbrecht*, 327 U.S. 392 (1946).

92. *Arundel Supply Corp. v. Carson*, 265 Md. 371, 289 A.2d 585 (1972).

93. See *Holmberg v. Armbrecht*, 327 U.S. 392 (1946); *Baumel v. Rosen*, 283 F. Supp. 128 (D. Md. 1968), *aff'd*, 412 F.2d 571 (4th Cir. 1969). See generally Comment, *Applicability of Waiver, Estoppel, and Laches Defenses to Private Suits Under the Securities Act and S.E.C. Rule 10b-5*, 73 YALE L.J. 1477 (1964).

94. 327 U.S. 392 (1946).

95. *Id.* at 397.

96. *Id.*

equity may lie though a comparable cause of action at law would be barred.<sup>97</sup>

In *Royal Air Properties, Inc. v. Smith*<sup>98</sup> possible defenses of laches, waiver and estoppel were recognized. The plaintiff was a substantial investor and became president of the company but complained of an earlier income projection which ignored land costs; he also complained of non-disclosure of the company's dispute with a former president. The defenses were, however, not sustained on trial and the plaintiff recovered.<sup>99</sup> In another case a defense of unclean hands was sustained. The plaintiff was a tippee who sought recovery from those who had made a further profit under prompting of the same tip. He was found by the court to be *in pari delicto*.<sup>100</sup>

In *Clement A. Evans & Co. v. McAlpine*,<sup>101</sup> the plaintiff, a broker, sued another brokerage house for falsely recommending a customer as a good credit risk, claiming that it suffered large losses by accepting checks of the customer in extensive stock market transactions. The facts established that the plaintiff had accepted checks on this recommendation previously, and the customer had defaulted, but after delay had cured the default. This, according to the court, relieved the defendant of any possible liability, since the plaintiff had again accepted checks after this experience. The loss was therefore due in large part to the plaintiff's own conduct.

A leading case in the Fourth Circuit, *Baumel v. Rosen*,<sup>102</sup> held that the remedy of rescission can be lost through delay in making demand. While the plaintiff must act promptly after discovery of the fraud in order to preserve his full right of rescission, the burden rests on the defendant to prove plaintiff's knowledge and the timing of such knowledge.<sup>103</sup>

Assuming that there is no fiduciary relationship, it would seem that ordinarily a release entered into with full knowledge of the facts would be enforced. Where, however, a release is obtained without full disclosure of material facts known to the defendant,

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97. *Id.* at 396.

98. 312 F.2d 210 (9th Cir. 1962). The court there recognized that the defenses of laches, waiver and estoppel were permissible under section 10(b) of the Securities Exchange Act of 1934, and remanded the case for further proceedings.

99. *Royal Air Properties, Inc. v. Smith*, 333 F.2d 568 (9th Cir. 1964), affirming the district court's decision on re-trial.

100. *Kuehnart v. Texstar Corp.*, 412 F.2d 700 (5th Cir. 1969).

101. 434 F.2d 100 (5th Cir. 1970).

102. 412 F.2d 571 (4th Cir.), *cert. denied*, 396 U.S. 1037 (1969).

103. *See Johns Hopkins Univ. v. Hutton*, 343 F. Supp. 245, 259-61 (D. Md. 1972).



it is difficult to perceive why it should defeat an action otherwise maintainable under the rule.<sup>104</sup> In a case in which the releasee occupies a fiduciary position to the releasor, the release can be sustained under Maryland law only if the releasor had "knowledge of all relevant facts," and the releasee has the burden of establishing "the perfect fairness, adequacy and equity" of the transaction.<sup>105</sup>

The effect of section 29(a) of the Exchange Act, invalidating any waiver of rights under the Act,<sup>106</sup> has been the subject of numerous decisions, including several as to the validity of releases and arbitration clauses.<sup>107</sup> In *Schine v. Schine*,<sup>108</sup> a long-continued proceeding in the District Court for the Southern District of New York, the court sustained a complaint which disclosed and sought to avoid a detailed form of release and recital signed by the plaintiff. The district court in that case made the following comment: "It would be at least highly anomalous . . . to hold under § 29(a) that a party, without knowing the facts, could effectively bar himself by a release from suing for fraud in the transaction of which the release was part."<sup>109</sup>

Unlike the defenses of limitations and laches, discussed previously, which placed a certain obligation on the plaintiff to investigate and bring an action within a reasonable period of time after the discovery of the fraud, there is no requirement placed upon the plaintiff that he search out possible fraud before entering into the transaction. Quite the opposite is true; no reported case to date has held that the defrauded party must, at his peril, investigate whether the defendant has violated the standard set forth in rule 10b-5 (or section 13 of the Maryland Securities Act), absent any indication that there may have been such a violation. The United States District Court for the District of Maryland, in a case involving a recognized fiduciary obligation of the defendant to the plaintiff, has held that the burden of disclosure and explanation must necessarily rest upon the defendant under the express terms of the rule as well as the uniform holdings of the courts.<sup>110</sup>

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104. *Rogen v. Ilikon Corp.*, 361 F.2d 260, 268 (1st Cir. 1966) (*semble*).

105. See note 38 *supra*.

106. 15 U.S.C. § 78cc (a) (1970). This subsection provides: "Any condition, stipulation, or provision binding any person to waive compliance with any provision of [the statute or regulations thereunder] . . . shall be void." *Id.*

107. See 3 L. Loss, *supra* note 8, at 1812-17, supplemented in 6 L. Loss, SECURITIES REGULATION 3932-38 (Supp. 1969).

108. 254 F. Supp. 986 (S.D.N.Y. 1966).

109. *Id.* at 988.

110. *Johns Hopkins Univ. v. Hutton*, 343 F. Supp. 245, 259 (D. Md. 1972). There

It should be noted, however, that where the defrauded party is put on notice as to any facts which are "calculated to excite inquiry," the courts have said that the plaintiff cannot go forward with the transaction without further investigation and later claim to have been defrauded.<sup>111</sup> Where, however, there has been no such fact brought to the attention of the plaintiff prior to entering into the transaction, the courts have not placed an affirmative burden upon the plaintiff to search out possible fraud.

### *Measure of Damages*

The accounting to which an injured buyer is entitled by way of damages is relatively simple. If he acts promptly on discovery and tenders the securities purchased, he is ordinarily entitled to rescission and recovery of the full purchase price.<sup>112</sup> This appears to constitute a ceiling on the damages which an injured buyer may receive. If rescission is not permitted, or if the buyer retains the securities purchased, his recovery is the amount by which his payment for the securities exceeded their then value.<sup>113</sup> In other words, the injured buyer is entitled to be "made whole" but can recover no profit on the transaction.

The damages recoverable by an injured seller are, in the

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Judge Kaufman cites *Pence v. Langdon*, 99 U.S. 578 (1878), for his conclusion that the burden of proof on this aspect of the case rests upon the defendant.

111. *Clement A. Evans & Co. v. McAlpine*, 434 F.2d 100 (5th Cir. 1970), *cert. denied*, 402 U.S. 988 (1971). In *Kohler v. Kohler Co.*, 319 F.2d 634 (7th Cir. 1963), a case which enunciates many of the principles set forth herein, the Seventh Circuit analyzed the non-disclosures of which the plaintiff complained and the statements given or made accessible to him as a former director active in management, and concluded that no material facts were kept from him. But it also emphasized that the "plaintiff was intent on selling his stock [ten percent of a large national manufacturing company] in as short a time as possible" and that the "sale was accomplished . . . in less than three weeks—an abbreviated period directly attributable to the near-urgent negotiation timetable set by plaintiff." *Id.* at 638.

*City Nat'l Bank v. Vanderboom*, 422 F.2d 221 (8th Cir.), *cert. denied*, 399 U.S. 905 (1970), involved a 10b-5 counterclaim against a plaintiff bank which had no connection with the purchase and sale but had loaned money to the counterclaiming investors who, as the court found, had access to "all the books and records" of the corporation in question. The court treated the investors as insiders and denied the claim on several grounds, citing its earlier and leading case of *Myzel v. Fields*, 386 F.2d 718 (8th Cir. 1967), for the conclusion that "there is no duty to disclose information to one who reasonably should already be aware of it. Nor is there the necessity for one insider to 'search out details' for another insider." 422 F.2d at 231.

112. See *Stevens v. Vowell*, 343 F.2d 374 (10th Cir. 1965); *Royal Air Properties, Inc. v. Smith*, 333 F.2d 568 (9th Cir. 1964). See also *Janigan v. Taylor*, 344 F.2d 781 (1st Cir.) (dictum), *cert. denied*, 382 U.S. 879 (1965). The general discussion of damages in this case was approved by the Supreme Court in *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972).

113. See *Janigan v. Taylor*, 344 F.2d 781 (1st Cir.), *cert. denied*, 382 U.S. 872 (1965).

usual case where the other party has made a profit on the securities purchased, subject to a different principle, and may involve complex calculations due to the presumed breach of fiduciary duty on the part of the insider-purchaser. The essence of the rule is that the so-called fraudulent party is not permitted to retain the profits which he has made through the wrongful acquisition of the plaintiff's securities. Such profit is recoverable in full by the plaintiff.<sup>114</sup>

This rule of damages was adopted by the Fourth Circuit in *Baumel v. Rosen*.<sup>115</sup> In that case, however, the court carefully considered the facts as to discovery of the fraud by the plaintiff and determined that additional profits accruing to the defendant after the plaintiff knew that he had been defrauded should not be recoverable, as the right to full rescission had been lost by delay for an unreasonable time after such discovery. The damages as finally determined and awarded included the increase in market value of the securities to that date but not thereafter.<sup>116</sup>

Further questions as to rescissional damages recoverable by a defrauded plaintiff-seller may be presented in cases involving unusual facts. For example, if the fraudulent purchaser has commingled the securities purchased with other securities owned by him, and has sold the package as an entirety, what effect would this have on the recovery by the plaintiff?<sup>117</sup> In several cases the plaintiff has obtained relief in the form of a decree for an accounting without an immediate determination of the amount of damages to be awarded.<sup>118</sup> It is suggested that in complex cases such

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114. *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972), where the Court approved and adopted the rules stated in *Janigan v. Taylor*, 344 F.2d 781 (1st Cir.), *cert. denied*, 382 U.S. 872 (1965). The Supreme Court stated the damage rule in the following language:

The correct measure of damages . . . is the difference between the fair 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.*

406 U.S. at 155 (emphasis added).

115. 412 F.2d 571 (4th Cir.), *cert. denied*, 396 U.S. 1037 (1969).

116. Whether the Supreme Court would approve this limitation on its rule, which would in fact permit the defrauding party to retain a substantial part of his wrongful gain, appears to be open to argument in future litigation reaching the Court.

117. See notes 119-28 *infra* and accompanying text.

118. See, e.g., *Kane v. Central Am. Mineral & Oil, Inc.*, 235 F. Supp. 559 (S.D.N.Y. 1964); *Kardon v. National Gypsum Co.*, 73 F. Supp. 798 (E.D. Pa. 1947). In *Speed v. Transamerica Corp.*, 135 F. Supp. 176 (D. Del. 1955), the damages were determined in a separate hearing nearly four years after liability had been ruled to exist.

a procedure might result in a more equitable solution than an attempt to fix the damages at the trial on the question of liability.

### Valuation Problems

The broad principle has been previously stated that a seller injured by violation of rule 10b-5 is, in general, entitled to recover from the buyer the entire profit made by him on the securities wrongfully acquired from the plaintiff. It is now intended to explore briefly the question whether principles of tracing trust funds misappropriated by a fiduciary are applicable in such a case. No case decided under rule 10b-5 appears to have considered this question and it must therefore be dealt with from the standpoints of analogy, and of consideration of the reasoning of the courts expressed in the so-called tracing cases.

The general equitable doctrine of tracing trust funds is well recognized in Maryland and has been applied in a number of cases, both state and federal. A statement in *Englar v. Offutt*,<sup>119</sup> quoted by Chief Judge Parker of the Fourth Circuit in *MacBryde v. Burnett*,<sup>120</sup> states the rule broadly in this language: "[I]f a trustee or fiduciary mixes trust funds with his own, the whole will be treated as trust property, except so far as he may be able to distinguish what is his from that which belongs to the trust. . . ." <sup>121</sup>

The fiduciary duty of controlling persons in a corporation, under Maryland law, has been explored generally, and the point has been suggested that directors and officers, who are also *controlling stockholders*, are by the present general weight of authority recognized to be fiduciaries in their relationship to minority stockholders. Such directors, even if not in a controlling position, are seemingly, by the Maryland court, and by a number of other state courts, regarded as owing a fiduciary duty to individual stockholders with whom they deal in the purchase or sale of stock of the corporation.

In *MacBryde* the Fourth Circuit had before it an appeal from a decision of the United States District Court for the District of Maryland which considered the question whether the trustee had been guilty of a breach of trust, invoking the rules applicable to tracing of misapplied trust funds in altered form. While both courts found that the trustee had not violated the fiduciary stan-

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119. 70 Md. 78, 16 A. 497 (1889).

120. 132 F.2d 898 (4th Cir. 1942).

121. *Id.* at 900.

dard in the acts charged, the Fourth Circuit's opinion carefully analyzed the doctrine of tracing under the Maryland law. It stated:

It is well settled that, if trust funds are mingled with personal funds of a trustee, the whole is impressed with a trust until separation of the trust property can be made, and that the trust is entitled to a proportionate part of the profits realized by the trustee in dealing with the fund in which the trust funds are mingled. And it is not necessary in asserting the rights of the cestui que trust that the trust funds be specifically traced. It is sufficient that they have been used by the trustee to augment a fund upon which profits have been realized.<sup>122</sup>

In *Corbett v. Hospelhorn*,<sup>123</sup> the Court of Appeals of Maryland stated that where a trustee by wrongful disposition of trust property acquires other property, the beneficiary is entitled to enforce a constructive trust on the property so acquired by the trustee.<sup>124</sup> The broad scope of the doctrine as recognized in Maryland is stated in *Thomas C. Basshor Co. v. Carrington*,<sup>125</sup> a 1906 decision, that the doctrine permitting trust property to be followed and recovered in equity is applicable in all cases of a fiduciary relationship or quasi-trust.<sup>126</sup>

If, therefore, it is recognized, as it must be, that under applicable Maryland law one who violates his fiduciary responsibility (as well as the applicable rule 10b-5) in acquiring securities of a minority stockholder in his corporation, holds these securities in trust, it seems difficult to discern any ground for failure to apply the established remedies in such cases called the tracing of trust funds. The general principles for application of these rules appear to be met, and the juridical statements which have been quoted indicate no ground for excepting the 10b-5 cases from full application of the doctrine.<sup>127</sup>

In *Weatherby v. Weatherby Lumber Co.*,<sup>128</sup> decided in 1972

122. *Id.*

123. 172 Md. 257, 191 A. 691 (1937).

124. *Id.* at 275, 191 A. at 699.

125. 104 Md. 606, 65 A. 360 (1906).

126. *Id.* at 629-30, 65 A. at 362-63.

127. The author acknowledges that because of the pendency of litigation by his firm in which these questions may be involved, he cannot claim a totally disinterested impartiality for the opinion here expressed; however, the aforementioned notwithstanding, it is strongly felt that this is a correct statement of the law.

128. 94 Idaho 504, 492 P.2d 43 (1972).

by the Idaho Supreme Court, a somewhat similar tracing problem developed, although the case was decided entirely under state law and with no reference to rule 10b-5. By state law Idaho had in earlier cases recognized a fiduciary duty of a controlling stockholder, who was the president of his corporation, toward other stockholders. In *Weatherby*, the president of the Weatherby Company bought the stock of certain minority holders without disclosing a pending but not finalized offer of an outside corporation to purchase the entire company, together with another company which the president owned solely, for a lump sum price. The court held that the president was liable to the minority for the profit he made on their stock (for a proper apportionment of the total purchase price which he received). This appears to be a direct application of the principles governing the tracing of trust funds.

A further question was presented in *Weatherby* as to apportionment of the purchase price, since the allocation on the books of the companies was claimed by the plaintiffs to have been unfairly made on the basis of incorrect book values. The appeals court held that the plaintiffs were entitled to a supplementary hearing on damages to have the respective book values revised, if it could be shown that they were not computed in accordance with the actual facts and proper accounting principles.

### CONCLUSION

In a general review of the scope of the anti-fraud provisions found in securities law one immediately recognizes a similarity between the rules developed in the state common law cases, which stress fiduciary obligations of controlling stockholders, and those developed in federal cases relying upon rule 10b-5. In connection with this similarity the federal courts have developed a relative freedom to apply both state law and federal statutory remedies for the solution of securities related problems. With these observations in mind several concluding comments on the area of securities law may be ventured.

First, the development and application of rule 10b-5 cuts across and overshadows, in cases where it is applicable, the duties, obligations and remedies which have developed in the state common law cases, particularly those dealing with the effect of fiduciary obligations. However, the common law actions should not be ignored. Both the increased burden of proof placed upon a fiduciary to justify the fairness of his conduct and the remedies available to a defrauded party through the common law should be kept in mind when a securities fraud suit is initiated.

Secondly, complementing rule 10b-5, and supplementing the common law fraud actions, are the state securities acts. These state laws should, as far as possible, be assimilated to those protections available under rule 10b-5. This should be done so that the same legal principles may be applied regardless of the amounts involved and where the suit is initiated. With this goal in mind, it is immediately recognized and recommended that section 34 of the Maryland Securities Act be amended to provide a civil remedy for injured sellers of securities as well as injured buyers.

The long-stated aim of the anti-fraud securities laws and rules, to equalize the bargaining power of the parties to securities transactions, can perhaps never be fully realized; however, this remains a goal toward which the courts, the regulatory and legislative bodies, legal students and the bar can persistently devote their joint efforts.