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Suggested Locus of Recovery in National Exchange Violations of Rule 10b-5

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A SUGGESTED LOCUS OF RECOVERY IN NATIONAL EXCHANGE VIOLATIONS OF RULE 10b-5

SEC rule 10b-5[1] requires the insider who uses material, undisclosed corporate information for personal gain by trading in the corporation's securities to surrender his profit.[2] *SEC v. Texas Gulf Sulphur Co.*[3] is the first decision under rule 10b-5 to hold insiders liable for the return of profits gained through the use of inside information in a national exchange transaction. In reversing the lower court decision in part, the Second Circuit held that certain defendants were in violation of rule 10b-5 when, with knowledge of a favorable initial core drilling of mining property, they purchased company stock in national exchange transactions.[4] The rule has thus become a potent sanction against insider nondisclosure trading, providing a wide base of liability. But neither the rule nor *Texas Gulf Sulphur* indicates who takes or how much is taken of the surrendered profit when the trades were on a national exchange.[5] Should there be some sort of private recovery? Should derivative recovery by the corporation be allowed? Or should there be some alternative allocation?[6] The policy considera-

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1 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 (1968). The rule was issued by the SEC under the Securities Exchange Act of 1934, § 10b, 15 U.S.C. § 78j(b) (1964).

2 Kardon v. National Gypsum Co. 73 F. Supp. 798 (E.D. Pa. 1947).

3 SEC v. Texas Gulf Sulphur Co., 5 CCH FED. SEC. L. REP. ¶ 92,251 (2d Cir. Aug. 13, 1968).

4 *Id.* at 97,180-81.

5 *See* Fleischer, *Securities Trading and Corporate Information Practices: The Implications of the "Texas Gulf Sulphur" Proceeding*, 51 VA. L. REV. 1271, 1299-1300 (1965).

Texas Gulf's liability for the misrepresentation of its press release and the liability of the recipients of either stock options or insiders' tips is beyond the scope of this note.

6 Concerning the individual defendants in *Texas Gulf*, see SEC v. Texas Gulf Sulphur Co., 258 F. Supp. 262, (S.D.N.Y. 1966), *aff'd in part, rev'd in part*, 5 CCH FED. SEC. L. REP. ¶ 92,251 (2d Cir. Aug. 13, 1968):

> At least 49 private actions are now pending in this court against TGS, defendants named in the Commission's action, and others, arising out of the transactions which are the subject matter of the Commission's action. Some 16 of these are individual actions, 31 are said to be class actions, and one is a derivative action. At least 475 persons are included as plaintiffs. While many of the complaints

tions behind both the Securities Exchange Act of 1934[7] and the civil remedy created by judicial expansion of rule 10b-5[8] are relevant to the inquiry.

A. *Individual Recovery*

Under the common law majority rule, the insider has no affirmative duty of disclosure to the selling shareholder.[9] In those states which follow the minority or special circumstances rule,[10] private recovery from the insider is allowed on a theory of breach of fiduciary duty.[11] But such individual recovery for nondisclosure has been limited to cases where both privity and reliance have been proven.[12]

In cases where damages have been incurred in a face-to-face transaction, rule 10b-5 has been interpreted to provide a civil remedy.[13] Courts have used the rule to escape the strict privity requirements for individual recovery, and reliance has been readily found.[14]

The rationale for allowing private recovery in the face-to-face situation is simply not applicable to the national exchange transaction.[15]

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do not specify damages claimed, others, in the aggregate, claim compensatory damages in excess of $2,800,000 and punitive damages in excess of $77,000,000.

258 F. Supp. at 267 n.1. See also Klein, *The Extension of a Private Remedy to Defrauded Securities Investors Under SEC Rule 10b-5*, 20 U. MIAMI L. REV. 81, 110-12 (1965), for an analysis of the problem.

7 *See, e.g.*, H.R. REP. No. 1383, 73d Cong., 2d Sess. 2-5 (1934); *Hearings on Proposed Amendments to the Securities Act of 1933 and to the Securities Exchange Act of 1934 Before the House Comm. on Interstate and Foreign Commerce*, 77th Cong., 1st Sess., pt. I, at 8-30 (1942).

8 *See* Myzel v. Fields, 386 F.2d 718, 735 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968); Kardon v. National Gypsum Co., 73 F. Supp. 798 (E.D. Pa. 1947).

9 H. HENN, CORPORATIONS § 240, at 378 (1961); Conant, *Duties of Disclosure of Corporate Insiders Who Purchase Shares*, 46 CORNELL L.Q. 53, 54 & n.5 (1960).

10 HENN, *supra* note 9, at 378-79.

11 Strong v. Repide, 213 U.S. 419 (1909); Janigan v. Taylor, 344 F.2d 781, 784 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965); Ruder, *Civil Liability Under Rule 10b-5: Judicial Revision of Legislative Intent?*, 57 NW. U.L. REV. 627, 662 (1963).

12 Gladstone v. Murray Co., 314 Mass. 584, 587, 50 N.E.2d 958, 960 (1945); Goodwin v. Agassiz, 283 Mass. 358, 361-63, 186 N.E. 659, 660-61 (1933); HENN, *supra* note 9, at 379. *See* Conant, *supra* note 9, at 59; Ruder, *supra* note 11, at 674-82.

13 *See* cases cited note 8 *supra*.

14 List v. Fashion Park, Inc., 340 F.2d 457, 463 (2d Cir. 1965); Cochran v. Channing Corp., 211 F. Supp. 239, 245 (S.D.N.Y. 1962); Joseph v. Farnsworth Radio & Telev. Corp., 99 F. Supp. 701, 706 (S.D.N.Y. 1951), *aff'd per curiam*, 198 F.2d 883 (2d Cir. 1952). *But see* 3 L. LOSS, SECURITIES REGULATION 1767-70 (2d ed. 1961).

15 *See, e.g.*, Cochran v. Channing Corp., 211 F. Supp. 239, 243 (S.D.N.Y. 1962). Individual investors cannot readily determine whether any of their transactions were in fact executed with insiders. In the typical situation, brokerage houses do not exchange stock certificates on a transaction basis; rather, at the end of the day totals are calculated by a clearing house and certificates are transferred on paper to the account of the net pur-

If there is no knowledge that an insider is buying, private recovery on the basis of after-acquired knowledge would amount to a windfall, since insider inactivity would not have precluded the investor's loss.[16] Such fortuitous recovery should be disallowed unless it is determined that Congress intended to implement securities policy in this manner.[17]

There would also be certain administrative problems in determining who should share in the surrendered profit, since a listed stock buffeted by rumors would be actively traded before, during and after the insider activity. Two possible alternatives could be followed: ascertainment of the specific shares which contributed to insider profit; or allowance of class recovery on the part of all who traded in the security during the period of insider activity.[18] If the former technique could be adopted practically,[19] certain sellers would receive a windfall based on the insider's wrongful use of information; the nondisclosure, after all, was equally prejudicial to the other uninformed traders who sold during that period.[20]

If class recovery were allowed, traders would be compensated for the same mistakes they would have made absent any insider activity. When the release of information would harm the corporation, insiders have the dual duty to refrain from trading *and to remain silent* concerning the corporate information.[21] Breach of the first injures neither the class nor the individual. In fact, market factors indicate that insider purchasing activity cannot adversely affect sellers who have placed sell orders at a given price, and the activity increases the price received by those selling at the market price.[22] Conversely, inactivity depresses the

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chasers. Soon even this process will be eliminated by computerized transactions. *See* 1 SEC, REPORT ON THE SPECIAL STUDY OF SECURITIES MARKETS pt. 2, at 40-42 (1963). However, some brokerage houses do offer to disclose the exact time of the transaction and the broker on the opposite side. *See* standard transaction confirmation form, Loeb, Rhoades & Co.

16 Note, *Civil Liability Under Section 10b and Rule 10b-5: A Suggestion for Replacing the Doctrine of Privity*, 74 YALE L.J. 658, 674-79 (1965).

17 *Id.* at 679.

18 *See generally* SEC v. Texas Gulf Sulphur Co., 258 F. Supp. 262, 267 n.1 (S.D.N.Y. 1966), *aff'd in part, rev'd in part*, 5 CCH FED. L. REP. ¶ 92,251 (2d Cir. Aug. 13, 1968); Klein, *supra* note 6, at 111.

19 For a discussion of the reasons for this choice, such as the seller's reliance on silence, see Fleischer, *supra* note 5, at 1298.

20 Note, *supra* note 16, at 675-76.

21 *See* Henkel, *Codification—Civil Liability Under the Federal Securities Laws*, 22 BUS. LAW. 866 (1967); R. JENNINGS & H. MARSH, SECURITIES REGULATIONS 958 (2d ed. 1968); Note, *supra* note 16, at 675.

22 Address by Mr. Jack M. Whitney, II, ABA Comm. on Fed. Reg. of Securities, Aug. 11, 1965, *reprinted in* 21 BUS. LAW. 193 (1965). *But see* Fleischer, *supra* note 5, at 1296-98.

sales price received by those trading at the market price, and does not guarantee that the sell orders at fixed prices will remain unexecuted until the favorable information is released.

The magnitude of the potential administrative problem is staggering under the first solution since judicial proceedings would be required for an investor to determine whether he actually sold to the insider.[23] Confirmation of such a sale would be entirely fortuitous with no degree of predictability. Although less cumbersome to administer, the class action has the inherent disadvantage of spreading the recovery so thin (especially in a heavily traded stock) that the remedy becomes nearly worthless to the individual.[24] The problem of determining the extent of the class remains. Should it include only those who sold on the day or hour of insider purchase, or should it include those who sold during the full period of nondisclosure?[25]

If private recovery of the insider's national exchange profits were allowed under rule 10b-5, several related problems would arise. Where the seller immediately reinvests the sale proceeds at a profit, will recovery be mitigated? If mitigation is held applicable, upon whom should the burden of proof fall? Finally, will the insider be faced with liability greater than the amount of his profit if the paper profit is greater than his realized profit?

Since Congress has chosen the policy of forcing the insider to surrender his profits in order to preserve the integrity of the securities markets,[26] disposition of the surrendered profit should serve the same purpose. Individual windfall recoveries do not serve the purpose of preserving market integrity.

B. *Corporate Recovery*

Congressional policy in enacting section 16b of the Securities Exchange Act of 1934[27] was to allow corporate recovery of short-swing

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23 This difficulty would be surmounted if the SEC is permitted, as in *Texas Gulf Sulphur*, to demand restitution on behalf of defrauded investors who are not parties to the litigation. This procedure may be open to attack. Fleischer, *supra* note 5, at 1297 n.126.

24 The class action becomes less unattractive if the SEC bears the expense of investigation and litigates on behalf of the notified parties who decide not to opt out. *See* 3 Loss, *supra* note 14, at 1824.

25 *See generally id.* at 1819-1924. *See also* note 15 *supra.*

26 *See* Cochran v. Channing Corp., 211 F. Supp. 239, 243 (S.D.N.Y. 1962); Speed v. Transamerica Corp., 99 F. Supp. 808 (D. Del. 1951). *See generally* Ruder, *supra* note 11.

27 Section 16(b) reads as follows:

> For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an ex-

insider profits in order to curb potential abuse of market integrity.[28] If an officer, director, or beneficial owner of ten percent or more of the corporation's stock sells shares within six months of purchase, the profit is recoverable by the corporation in a derivative action under section 16b.[29] Only the holding period need be shown; intent and use of inside information are immaterial. On the other hand, because stock acquisition programs of a long-term nature are favored,[30] the rule 10b-5 sanction requires proof of the use of material, undisclosed information in making the purchase.

Both the remedy of corporate recovery and the sanction of profit surrender serve the purpose of preserving market integrity. Profit surrender eliminates the unfair advantage of the insider vis-à-vis the investor with regard to corporate information. Corporate recovery of surrendered profit encourages investment because those who remain shareholders are benefited, and those who sold are not harmed; meanwhile the courts and exchanges are spared the administrative turmoil caused by individual sellers seeking recovery. The remedy chosen by Congress under section 16b appears to be the appropriate one in most rule 10b-5 insider nondisclosure actions.

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empted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection.

48 Stat. 896 (1934), 15 U.S.C. § 78p(b) (1964). The omission of express mention of corporate recovery in § 10(b), in view of its inclusion in § 16(b), does not necessarily mean that such a remedy should be denied. *No remedy* is expressly provided by § 10(b) or rule 10b-5; individual recovery is a judicially created remedy. *See* Kardon v. National Gypsum Co., 73 F. Supp. 798, 802-03 (E.D. Pa. 1947). In the appropriate case, and *Texas Gulf Sulphur* fits the description, the courts, therefore, should be free to utilize a congressionally approved remedy such as corporate recovery.

28 *See Hearings on Stock Exchange Practices Before the Senate Comm. on Banking and Currency*, 73d Cong., 1st Sess. (1934) (21 vols.).

29 *See* Lowenfels, *Section 16b: A New Trend in Regulating Insider Trading*, 54 CORNELL L. REV. 45 (1968).

30 *See generally* NEW YORK STOCK EXCHANGE, THE CORPORATE DIRECTOR AND THE INVESTING PUBLIC 11 (1965); Henkel, *supra* note 21.

In addition to congressional approval of corporate recovery in a section 16b situation, there are strong arguments by analogy to state law that the corporation whose shares are involved in wrongful insider trading should receive the profit. Fiduciary principles dictate that when an agent profits by using inside information concerning the affairs of his principal, his profit should go to the principal.[31] Corporate recovery of insider profits on a national exchange transaction based on the breach of fiduciary duty was allowed in *Brophy v. Cities Service Co.*[32] There the defendant was a corporate employee who bought company stock with knowledge that the plaintiff-corporation was to initiate a buying program in its own shares. The court held that a cause of action is stated when it is alleged that an employee in a fiduciary position used confidential information to his own profit. Although the holding was based on the special circumstance that the company was interested in the purchase of its own stock, the court significantly noted in dictum that it is not necessary for the plaintiff-corporation to allege financial loss to maintain the action.[33] The allegation is unnecessary because public policy requires that the employee be held accountable to his corporation for profits gained through the breach of fiduciary duty.[34]

A recent New York decision, *Diamond v. Oreamuno*,[35] allowed corporate recovery in a derivative action against a director who purchased shares on a national exchange. Applying New York law, the court found inside information a corporate asset, holding that the trading in securities was only a vehicle by which such a corporate asset could be converted.[36] Whether corporate recovery of national exchange profits under rule 10b-5 is based on breach of fiduciary duty or on conversion of a corporate asset,[37] the result would be in keeping with the policy of section 16b.[38] Such recovery is preferable to private re-

31 HENN, *supra* note 9, at 566; H. MANNE, INSIDER TRADING AND THE STOCK MARKET 19 (1966).

32 31 Del. Ch. 241, 70 A.2d 5 (Ch. 1949).

33 *Id.* at 243, 70 A.2d at 7.

34 *Id.*

35 29 App. Div. 2d 285, 287 N.Y.S.2d 300 (1st Dep't 1968).

36 *Id.* at 288, 287 N.Y.S.2d at 303-04. *See* Conant, *supra* note 9, *cited in Diamond*, in which Conant eight years previously advocated the "corporate asset" theory.

37 Conversion of a corporate asset would be the broader basis of liability since recovery would not be limited to actions against an insider, but would be available against anyone who has converted the asset. Liability of those receiving tips would be more readily established under this theory.

38 *But see* Blau v. Lehman, 368 U.S. 403 (1962), in which the Court, narrowly reading the statute, refused to expand the applicability of the § 16(b) sanction. This does not necessarily preclude the use of the § 16(b) remedy in the framework of rule 10b-5.

covery without the elements of privity, reliance, causation, or even demonstrable financial loss.[39]

There are, however, possible abuses inhering in corporate recovery under rule 10b-5. First, the insider may benefit from his own wrong. For example, if he is a substantial stockholder, corporate recovery will be to his benefit. Second, director profit-making might be looked upon favorably by the closely held corporation unconcerned with its public image; the director of such a corporation may not be deterred by the chance of being caught if his illicit profit is merely deposited in corporate coffers. This potential for abuse is, nevertheless, no greater than under section 16b, and where such abuse occurs, an alternative remedy would be appropriate.

C. *Alternative Remedy*

An alternative to corporate recovery should be adopted on a clear showing of abuse of recovery provisions.[40] In such a case the corporation should not be allowed recovery, and sanctions such as fines and removal (either temporary or permanent) from national exchange listing should be imposed. One proposal which deserves congressional scrutiny is that insider profits should be used to help pay for SEC investigations of securities abuses.[41] A comprehensive national securities indemnity fund, administered in a manner similar to Federal Deposit Insurance in the banking field, should also be considered. If individual investors are defrauded and pre-*Texas Gulf Sulphur* federal securities laws provide a right to recovery, the indemnity fund would reimburse the investors for damages uncollectable after judgment. Rights to the judgment would be assigned to the SEC which would, if possible, en-

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39 Conant, *supra* note 9. *See* 80 HARV. L. REV. 468, 475-76 (1966). *Cf.* 2 SEC, REPORT ON THE SPECIAL STUDY OF SECURITIES MARKETS pt. 3, at 96 (1963).

40 The antifraud sanctions of rule 10b-5 should provide a basis for preventing corporate abuse of the recovery provisions. The more closely held the corporation, the greater is the danger of abuse of corporate recovery. A point must be delineated beyond which a corporation becomes so closely held that corporate recovery of insider profits would be antithetical to federal securities law policies.

When a corporation, by purchasing its own shares over national exchanges, favors one group of shareholders over another, the newly enacted § 13(e)1 of the Securities Exchange Act of 1934, Pub. L. No. 90-439 (July 29, 1968), 82 Stat. 454, U.S. CODE CONG. & AD. NEWS 2769 (1968), should provide an appropriate remedy.

41 Such an alternative should also be available in cases of § 16(b) abuse. This alternative will not necessarily foster a marked increase in SEC activity for two reasons. First, the fund would not necessarily be large. Second, political considerations would prevent the Commission from using such a provision to stifle legitimate corporate activities. Fears of SEC domination of a controlled market would be allayed by the strong political pressures available to counteract overaggressive administrative tendencies.

force it for the benefit of the fund at a later date. Investor confidence in national securities markets would certainly be bolstered by the creation of such a fund.

CONCLUSION

Unless Congress acts to clarify the duties of insiders, courts will probably expand the interpretation of rule 10b-5 to control insider disclosure responsibilities and trading practices.[42] An expansion of rule 10b-5 sanctions, as in *Texas Gulf Sulphur*, magnifies the problem of dispensing the recovery. And the need for established standards for insider trading is matched by the need for established standards for recovery.

The examples of section 16b and of well reasoned common law decisions should be followed to award the profit in most situations to the corporation. However, there are situations in which corporate recovery of profits would be unjustified; the courts should then have the alternative of awarding the full amount to an indemnity fund to be administered by the SEC. Such a fund could be used for a variety of purposes in keeping with the legislative intent to maintain public confidence in the securities market.

Of course, *Texas Gulf Sulphur* may signal the beginning of the end of judicial expansion of rule 10b-5. If the nondisclosure remedy is expanded to afford a private recovery in the national exchange transaction, the resulting judicial and administrative chaos may force congressional evaluation of the rule.

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42 *See* NEW YORK STOCK EXCHANGE, THE CORPORATE DIRECTOR AND THE INVESTING PUBLIC 45 (1965).