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Remedies for Private Parties Under Rule 10b-5

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Rule 10b-5, promulgated under Section 10(b) of the Securities Exchange Act of 1934, was designed primarily to protect buyers and sellers of securities on security exchanges from fraud. Originally viewed as a preventive measure to allow the Securities Exchange Commission to police fraudulent activities in the purchase or sale of securities on exchanges, the Rule has grown mainly through the exercise of private actions. The initial problem, whether any civil action would be allowed under 10b-5, was resolved in the affirmative early in the history of the Rule. A major persisting problem, however, is the nature of the remedies available to private litigants under 10b-5, for the Rule provides no explicit remedies.

Because of the variety of conduct proscribed by the Rule and because of the corresponding need for varying remedies, it is important to outline the general scope of the remedies and the basic kinds of relief available to plaintiffs who are successful in 10b-5 actions. Then an analysis of the development of those remedies and their application to various factual situations can be undertaken.

I. REMEDIES IN GENERAL

The scope of available remedies under 10b-5 is governed by two Supreme Court cases decided under the Securities Acts of 1933 and 1934. In Deckert v. Independence Shares Corp., the Supreme Court noted that the federal courts had been given the power to enforce the Securities Act of 1933 and stated further:

The power to enforce implies the power to make effective the right of recovery afforded by the Act. And the power to make the right of recovery effective implies the power to utilize any of the procedures or actions normally available to the litigant according to the exigencies of the particular case.

1. REMEDIES FOR PRIVATE PARTIES UNDER RULE 10b-5

Rule 10b-5, promulgated under Section 10(b) of the Securities Exchange Act of 1934, was designed primarily to protect buyers and sellers of securities on security exchanges from fraud. Originally viewed as a preventive measure to allow the Securities Exchange Commission to police fraudulent activities in the purchase or sale of securities on exchanges, the Rule has grown mainly through the exercise of private actions. The initial problem, whether any civil action would be allowed under 10b-5, was resolved in the affirmative early in the history of the Rule. A major persisting problem, however, is the nature of the remedies available to private litigants under 10b-5, for the Rule provides no explicit remedies.

Because of the variety of conduct proscribed by the Rule and because of the corresponding need for varying remedies, it is important to outline the general scope of the remedies and the basic kinds of relief available to plaintiffs who are successful in 10b-5 actions. Then an analysis of the development of those remedies and their application to various factual situations can be undertaken.

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1 17 C.F.R. § 240.10b-5 (1968).
5 Rule 10b-5 provides:
   (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.
7 311 U.S. 282 (1940).
8 Id. at 288.
This case gives the federal courts a wide area of discretion in providing remedies under the Securities Acts. The second case, *J.I. Case Co. v. Borak*, concerned itself with preemption by the Securities Acts of the states' corporation laws. The Court in effect made any state's corporation law inapplicable in certain situations involving securities when it said:

> [W]e believe that the overriding federal law applicable here [the Act of 1934] would, where the facts required, control the appropriateness of redress despite the provisions of state corporation law, for it "is not uncommon for federal courts to fashion federal law where federal rights are concerned."10

With this mandate, the federal courts have proceeded to develop their own remedies for 10b-5 violations to meet the exigencies of each case.

One important limitation on the redress available under the Rule is embodied in Section 28(a) of the 1934 Act. That provision limits damages to "actual damages." The courts have consistently interpreted this provision to disallow any punitive damages under 10b-5. One of the major purposes of this comment is to determine what the federal courts have considered "actual damages" to mean and to deduce what actual damages should mean in 10b-5 cases.

Within this broad framework for possible remedies under the Rule, courts have generally granted three kinds of relief. The three basic remedies employed by the courts in 10b-5 actions are money damages, recission of the transaction and restitution of the consideration given by the plaintiff, and the injunction.

Money damages to compensate a plaintiff for his actual damages as required by section 28(a) are generally measured by the federal out-of-pocket rule of damages. Under that rule, the plaintiff is granted money damages in an amount equal to the difference between the value of the security at the date of purchase or sale and the price paid or received on that date. The federal out-of-pocket rule is difficult to use in practice, for it requires the

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10 Id. at 434 (citation omitted).
11 Section 28(a) provides in part:
   The rights and remedies provided by this chapter shall be in addition to any and all rights and remedies that may exist at law or in equity; but no person permitted to maintain a suit for damages under the provisions of this chapter shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of.
12 Pappas v. Moss, 257 F. Supp. 345, 364 (D.N.J. 1966), rev'd on other grounds, 393 F.2d 865 (3d Cir. 1968); Meisel v. North Jersey Trust Co., 216 F. Supp. 469 (S.D.N.Y. 1963) (motion to strike granted as the claim for punitive damages in a 10b-5 action was impertinent). Cf. Globus v. Law Research Serv., Inc., 287 F. Supp. 188, 197 (S.D.N.Y. 1968) (recovery of punitive damages upheld although the jury did not distinguish whether liability was based on Rule 10b-5 or § 17(a) of the Securities Act of 1933).
determination of actual value of the security at the time of purchase or sale to permit measurement of damages.\textsuperscript{14}

In situations where the security is not widely traded, the courts are faced with a difficult problem in determining actual value for there may be no indicia of value other than intrinsic factors.\textsuperscript{15} In many instances, these intrinsic factors defy precise measurement. Even if the security is widely traded, the determination of actual value at the time of the sale may be difficult because the speculation inherent in most security purchases or sales takes place in a mass market situation where heavy volume and rapid turnover prevail. If the 10b-5 violation results in manipulation of the market price, plaintiff's selling or purchase price may not be equal to actual value. Thus, a court may have to distinguish to what extent the 10b-5 violation distorts market price as opposed to the effect of other economic factors in order to determine actual value. Moreover, many plaintiffs may buy or sell during the 10b-5 violation at different market prices and thus cause problems of consolidated suits.\textsuperscript{16}

The second basic remedy for plaintiffs deceived in a violation of 10b-5, rescission of the transaction and restitution to the plaintiff of the shares sold or the money paid for the security, is grounded in Section 29\textsuperscript{17} of the 1934 Act which makes all contracts in violation of the Act voidable. Recission and return of the securities to the seller may create important problems. For example, the defendant may entirely lose his ownership rights even though the plaintiff was willing to sell his securities if the price had been equitable. Restitution at a time many years after the fraudulent transaction may also include speculative damages because of an increase in the value of the security as a result of favorable economic factors unforeseeable when the fraud occurred. Recision and restitution may also limit the recovery of a plaintiff-buyer to the price paid for the security plus interest, for an inference may arise that he would not have bought the security at all if the true facts had been known to him.

The third remedy, injunctions by private parties, is invoked generally in derivative actions where the plaintiff is trying to prevent the initiation or continuation of some corporate activity. Derivative suits cause special problems for the application of money damages or recission and restitution after the transaction has been completed, for the transaction may cause a change of ownership or a change of corporate structure involving changes in business policy. Consequently the task of determining actual damages and applying the appropriate remedy becomes extremely complex in many derivative actions.

This comment will first examine the remedies available to buyers and sellers bringing an action to redress their injuries as a result of a 10b-5 viola-

\textsuperscript{14} The term actual value is analogous to the terms real or fair value often used by the courts. "Market value" for purposes of this comment signifies the price of a widely traded security as determined by buyers and sellers in the market place.

\textsuperscript{15} Generally, intrinsic factors are those that determine the present worth of the issuing company and its potential for future growth. Cf. 1 J. Bonbright, Valuation of Property 24-29 (1937). For further discussion, see pp. 340-41 infra.

\textsuperscript{16} But see Esplin v. Hirschi, 402 F.2d 94 (10th Cir. 1968).

\textsuperscript{17} 15 U.S.C. § 78cc(b) (1964).
tion. Second, it will discuss the remedies available in actions by plaintiffs suing derivatively for the benefit of their corporation. This distinction is predicated upon the differences in relief sought by the parties in each case and upon the different considerations which determine the appropriateness of relief generally.

II. REMEDIES FOR THE INDIVIDUAL SELLER OR BUYER

A. Remedies for Plaintiff-Sellers

The courts have reached the damages question in 10b-5 actions most often in actions by plaintiff-sellers. This result is to be expected in light of the many other provisions of the Securities Acts which protect buyers from fraud.18

1. Money Damages. — Money damages are awarded to a plaintiff-seller to compensate him for the loss which he incurs by selling at a price below the securities' actual value as a result of a 10b-5 violation. In applying the federal out-of-pocket rule of damages, the courts have continually confronted a need to determine the "actual value" of the security. Because it is so difficult to determine actual value, the cases are inconsistent and the measure of damages employed is often unrealistic.

a. The Intrinsic Method of Valuation. In situations where no resale occurs and where the security is not widely traded, a major problem in determining actual value arises, for the courts do not have any indicia of value aside from intrinsic factors. In dicta, the court in Kohler v. Kohler Co.19 adopted the strict federal out-of-pocket rule where plaintiff was a seller. Although the plaintiff suggested several methods for the court to use in valuing the security the court held there had been no violation of 10b-5 and denied recovery of any damage. Although the court apparently decided that there was no deception as required by 10b-5, it noted that the plaintiff had not established any resale or other valid criteria of valuation and found that plaintiff could only prove actual value by an appraisal. Although the court does not reject the intrinsic method of valuation, the case illustrates the difficult burden which the plaintiff must bear to prove, by that method, actual value on the date of sale.

Although the court in Kohler relies on earnings as the principal indicia of value,20 other factors should be considered in the intrinsic method of valuation. These factors would be similar to those used in valuation of securities for tax purposes: the corporation's book value, earning capacity, dividend paying ability and intangible assets, the nature of the corporation's business, the general economic outlook, the economic outlook for the specific industry,

19 208 F. Supp. 808 (E.D. Wis. 1962), aff'd., 319 F.2d 634 (7th Cir. 1963).
20 208 F. Supp. at 826.
the market value of securities of comparable firms in the industry and the size of the block transferred.\textsuperscript{21}

Proving actual value at the time of the transaction by the intrinsic method puts a difficult burden on the plaintiff and the courts, for many of the influencing factors are not subject to precise measurement and the weight given each factor must vary with the valuation of different securities.\textsuperscript{22} Admittedly, this method is far from being completely accurate since all the factors are subject to error in their determination. However, a court should allow the plaintiff to use the intrinsic method of valuation where the case requires. The courts should recognize that precise, actual value cannot be found by any valuation method and should allow a reasonable approximation on the basis of expert testimony to suffice. The alternative is to deny recovery altogether even though a 10b-5 violation has occurred. This denial would seem to create greater injustice than would the risk of awarding plaintiffs too much in some cases.

b. \textit{The Resale Value Test.} In cases where there are other reliable indicia of value, most courts have not required the plaintiff to establish actual value at the date of sale by the intrinsic method, but have used other means to arrive at a satisfactory approximation of actual value. For example, in \textit{Ross v. Licht},\textsuperscript{23} the court used what may be termed the resale value test to determine actual value at the date of sale. In \textit{Ross}, plaintiffs were induced by defendants' fraud to sell their stock at a certain price, and two weeks later the defendants resold the securities at a much higher price. The court held:

\begin{quote}
Absent market value (as here), "fair value is to be determined from all the pertinent circumstances both for a reasonable time before the sale and after it. * * * If there can be no exact calculation * * * the wrongdoer cannot complain if a reasonable approximation is reached."\textsuperscript{24}
\end{quote}

The court then found that the resale price two weeks later corresponded to actual value at the time of sale and measured damages by the difference between plaintiff's selling price and defendant's resale price.

The courts have employed various procedures to measure the resale value of the securities in order to approximate actual value at the date of sale and thereby adhere to the federal out-of-pocket rule. In \textit{Kardon v. National Gypsum Co.},\textsuperscript{25} the first case allowing 10b-5 to be used by private parties, the court granted an accounting to plaintiffs, selling shareholders from whom defendants had withheld the information that the assets were to be sold to National Gypsum Company. Five days after the plaintiffs' sale, defendants consummated the contract for the sale of the assets. The actual sale was completed approximately one year after plaintiffs' sale. The accounting was

\textsuperscript{24} Id. at 410 (citation omitted).
granted to restore the plaintiffs to their “proportionate share of the profits” of the asset sale. The only appropriate way to determine the plaintiffs’ proportionate share of the profits would be to consider the sale of the assets to be a resale of the stock. Damages would then be measured by the difference between the per share proceeds of the asset sale and the per share selling price of plaintiffs multiplied by the number of shares sold by each plaintiff. The proceeds per share when the assets were sold is equivalent to a resale measure of actual value.

Similarly, in Speed v. Transamerica Corp., the court employed the liquidation value per share as resale value. In Speed, the plaintiffs alleged that the defendants, by withholding information of an impending liquidation and the increased value of the company’s inventory, had induced them to sell their shares at a price below the subsequent liquidation value. The court employed the approach of a reasonable investor’s activities if all the facts had been known and reconstructed the liquidation of the corporation. Damages were measured by what amounted to a resale value test, for the plaintiffs were given damages measured by the difference between the per share proceeds of the liquidation minus the plaintiffs’ selling price per share multiplied by the number of shares sold by each plaintiff.

These two ancillary procedures fix the actual value of the security by a resale value test when the resale is in the form of a consolidation or liquidation. Such ancillary procedures are essential to the proper measurement of damages and should be employed whenever the circumstances require.

Use of the resale test is more complicated in situations where the security is widely traded yet where market value does not reflect actual value. If, for example, defendants engaged in fraudulent market manipulation that forced market price downward, the courts would have to measure actual value by market value before the manipulation began or sometime after it ceased. In the same sense, if defendants were withholding material inside information and purchasing the shares, then market value at a reasonable time after the information became public would have to be utilized by the courts to measure damages. Market value could not reflect actual value until the material information became known to buyers and sellers in the market place. In both situations, actual value is measured by what market value would have been at the time of the sale absent a 10b-5 violation. This measure may be termed equilibrium price. The determination of equilibrium price is not an easy matter, for in many cases it is difficult to determine when the effects of the 10b-5 violation begin or when they cease to distort market price. In most cases, therefore, the courts must settle for a reasonable approximation of equilibrium price. In some cases defendant's resale in the open market will

26 Id. at 802.
28 For a criticism of the court’s approach to this liquidation see Comment, Corporations—Shareholders—Majority Liability for Improper Stock Redemption by Corporation and for Misrepresentations in Private Stock Purchases From Minority Holders, 54 Mich. L. Rev. 971 (1956).
29 Speed v. Transamerica Corp., 235 F.2d 369, 372 (3d Cir. 1956).
30 See 3 L. Loss, Securities Regulation 1630 (2d ed. 1961).
provide equilibrium price because, unless defendant's violation of the Rule forced market price upwards, the defendant would not sell until the true facts had come to light and the market price had adjusted to those facts.

c. Recovery of Speculative Damages. Aside from difficulties of ascertaining when resale prices are not tainted by the defendant's fraud, two problems arise in the use of the resale value test. First, it obviously cannot be applied in cases where there is no resale. Second, if a resale occurs, it is difficult to determine whether resale price reflects actual value at the time of plaintiff's sale if the defendant does not resell until after a significant amount of time has elapsed.

If a great deal of time elapses between plaintiff's sale and defendant's resale, and if the court uses that resale price as actual value at the time of plaintiff's sale, speculative damages unrelated to the 10b-5 violation may be recovered. In the reasoning of Janigan v. Taylor, the resale measure of actual value is distorted by a lapse of time, and the federal out-of-pocket rule loses its identity. In Janigan plaintiffs had been induced by fraud to sell their stock to the defendant in 1955 for $40,000, and the defendant resold the stock two years later for $700,000 after he had managed the corporation for the interim. Suit was brought in 1958. Having found a violation of Rule 10b-5, the court implicitly rejected the out-of-pocket rule and the need to determine actual value at the date of sale by holding

future accretions (sic) not foreseeable at the time of the transfer even on the true facts, and hence speculative, are subject to another factor, viz., that they accrued to the fraudulent party. It may, as in the case at bar, be entirely speculative whether, had plaintiffs not sold, the series of fortunate occurrences would have happened in the same way, and to their same profit. However, there can be no speculation but that the defendant actually made the profit, and, once it is found that he acquired the property by fraud, that the profit was the proximate consequence of the fraud, whether foreseeable or not. It is more appropriate to give the defrauded party the benefit even of windfalls than to let the fraudulent party keep them. . . . [T] is simple equity that a wrongdoer should disgorge his fraudulent enrichment.

It is submitted that this disgorgement of profits theory is inappropriate to measure damages in 10b-5 actions. By the court's admission in Janigan, the disgorgement theory grants to the defendant speculative recovery—damages that do not result from defendant's 10b-5 violation. Such damages are not actual damages as a result of a violation of 10b-5 nor are they even benefit of the bargain damages. Recovery of speculative damages is based on a quasi-unjust enrichment theory that becomes penal in nature. This theory of recovery is contrary to section 28(a), which limits damages to

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31 344 F.2d 781 (1st Cir.), cert. denied, 382 U.S. 879 (1965).
32 Id. at 786.
33 See 3 L. Loss, Securities Regulation 1793 (2d ed. 1961).
actual damages, and to the view that punitive or exemplary damages are not recoverable in 10b-5 actions.\(^{34}\)

The resale value measure of damages should be used only when it produces a result consistent with the federal out-of-pocket rule.\(^{35}\) Therefore, when the resale occurs many years after plaintiff’s sale, the resale price should only be used to measure the actual value at the time of the 10b-5 violation in rare circumstances if at all. The disgorgement theory of Janigan apparently gives the plaintiff the benefit of an irrebuttable presumption that he would not have sold during the time elapsed had he known the true facts. But the mere fact that plaintiff sold the security to the defendant should indicate that the plaintiff was willing to sell at an equitable price. In determining damages, the courts should either require the plaintiff to prove that he would not have sold the security during the time elapsed if the true facts had been known to him, or at least allow defendant to prove that plaintiff would have sold at an equitable price or at some time before defendant’s resale. If it is found that plaintiff would not have sold during the time elapsed, then the actual value of the security to him at the date of sale is equal to defendant’s resale price, for the future accretions would have accrued to him had it not been for the 10b-5 violation. If it is found that plaintiff would have sold the security at an earlier time or that at a certain point the defendant’s own expertise caused the increase in value, the actual value at that point should be used to determine damages.\(^{36}\) This method may require the courts to use the intrinsic method of valuation in situations where there is no accurate market or resale price measure, but the problems involved in the intrinsic method should not lead the courts to employ the disgorgement theory suggested by Janigan.

d. Resale at a Loss. There is a second justification for employing the resale measure of actual value in a manner consistent with the out-of-pocket rule as suggested above. If by violation of 10b-5 defendant had induced plaintiff to sell, the plaintiff should be allowed to show damage even if defendant had resold at a loss. The loss suffered by defendant may be a result of his mismanagement or of a sudden drop in the market. The application of the resale value test in these situations deprives plaintiff of recovery of his actual damages from the 10b-5 violation.

36 Myzel v. Fields, 386 F.2d 718 (8th Cir. 1967), cert. denied, 390 U.S. 951 (1968), presents a close analogy to this suggested procedure. The court in Myzel would require the defendant to disgorge future accretions only if the plaintiff can show that he would have retained the stock if there had been full disclosure. 386 F.2d at 749. The court upheld the district court’s instruction that left to the jury the question of whether or not the plaintiff would have sold. The district court had the benefit of defendant’s resale five years later, but instructed the jury that damages should be measured by the highest of (1) the difference between selling price and the actual value of the security when sold, or (2) the difference between selling price and the higher price at which plaintiff would have sold if there had been complete disclosure or (3) the difference between selling price and the value of the stock after a reasonable time, if the jury found that plaintiffs would not have sold until that time if there had been complete disclosure. 386 F.2d at 744-45.
2. Rescission and Restitution.—Once the recovery of speculative damages is allowed by a disgorgement of profits theory, that theory can be applied to allow restitution in cases where many years have elapsed from the time of plaintiff's sale. The case of Baumel v. Rosen provides an example of restitution based on reasoning like that which supports the recovery of speculative profits combined with the traditional rationale for equitable restitution. Each of the plaintiffs in Baumel was induced by fraud to sell 500 shares of a company's stock for $10,000 in 1959. Some six years later the plaintiffs brought an action for restitution. After holding that section 28(a) operates only to prevent double recovery, the court noted that a defendant should disgorge his fraudulent enrichment. The court proceeded to allow equitable restitution.

It reasoned:

[E]quity will act when the fixing of damages presents unusual difficulties in their measurement, or where the uncertainty of correct measurement will potentially result in great injustice to either of the parties.

The court thereupon required the defendant to return the present equivalent of 500 shares to each of the plaintiffs with the stipulation that plaintiffs each return the $10,000 which they had received in 1959 plus interest. As a result of events which occurred after the plaintiffs' sales, the present equivalent of the 500 shares on the date of judgment, as found by the court, was 69,200 shares with a market value of approximately $563,000. Thus, each plaintiff, in the court's estimation, was damaged by $563,000 (minus $10,000 plus interest), and each plaintiff was returned to his position of substantial ownership in a company of proven worth despite his earlier sale.

It is submitted that the Baumel decision reached a more inequitable result by invoking equitable restitution than it would have reached had it undertaken the "unusual difficulties" and "uncertainties" of measuring damages. Baumel, like Janigan, gives plaintiff the benefit of an irrebuttable presumption that under the disgorgement theory he would not have sold during the time elapsed. As discussed above, this disgorgement theory is inappropriate in 10b-5 actions. Not only does restitution in effect give plaintiff extremely speculative damages in cases like Baumel, but it deprives defendant of his ownership rights in a company which he has apparently guided to success. Although it may be argued that harsh results like those in Baumel serve as deterrents to violations of 10b-5, some practical limitations on restitution are necessary to prevent the recovery of speculative damages and to prevent

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38 Baumel relies on avoidance of a contract induced by deceit as an equitable principle. 283 F. Supp. 146. Other courts have relied on § 29(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78cc(b), which voids the contract as a matter of law. E.g., Myzel v. Fields, 386 F.2d 718, 742 (8th Cir. 1967), cert. denied, 390 U.S. 951 (1968). Reliance on § 29 permits a court to grant restitutionary damages in an action at law before a jury. Restitution is normally an equitable remedy, but restitution may be granted in an action at law if the underlying contract is set aside as a matter of law. See Myzel v. Fields, supra.
corporate upheavals through inordinate redistribution of corporate securities at a point many years after a 10b-5 violation.

This view draws strength from the landmark case of SEC v. Texas Gulf Sulpher Co. In that case the Securities and Exchange Commission sought restitution on behalf of all sellers during a period when insiders purchased securities on the basis of inside information. The Second Circuit not only established a duty of insiders either to disclose any material inside information or to refrain from buying, but also held that lack of due diligence of the corporation was sufficient to sustain an action for injunctive relief under 10b-5. If these standards are applicable to actions by sellers in private actions, then the recovery of speculative damages will be avoided only where the 10b-5 violation is discovered shortly after the transactions and the utmost judicial expediency is used to reach a decision.

Even where the utmost expediency is employed, restitution should be granted only where the transaction takes place on a face-to-face basis. In situations where the security is widely traded, as in Texas Gulf, insiders purchase only a limited number of shares while many thousands of other sales may occur. Thus, no matter how quickly the action is brought, it would be impossible to determine which sellers among all who sold during the period of the 10b-5 violation should receive the limited number of shares available for restitution. Privity cannot be considered a relevant test in market situations since all trades are through intermediaries. Privity and other methods of determining which sellers should get restitution would leave the selection to pure chance and might exclude some plaintiffs who were actually injured.

Conceivably, a court could grant restitution to those plaintiffs who can prove that they relied on defendant's statements and prove also that they would not have sold during the period had they known the true facts. If the standard of proof of these facts is made too difficult, very few plaintiffs will recover. If the standard of proof is made too easy, many plaintiffs will be allowed recovery. In either case it is unlikely that the plaintiffs granted restitution will match the number of shares available to be returned. The alternative, that all sellers during the period when defendants made purchases in violation of 10b-5 receive shares, is improper and unrealistic because the corporation would have to issue new shares.

In light of these factors, restitution is inappropriate in market situations similar to Texas Gulf. Restitution should be available only in cases where

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40 401 F.2d 833 (2d Cir. 1968), rev’g in part and aff’d in part 258 F. Supp. 262 (S.D.N.Y. 1966).
41 For a discussion of the propriety of this action by the SEC see Comment, Private Remedies Available Under Rule 10b-5, 20 Sw. L.J. 620, 629-31 (1966).
42 401 F.2d at 848.
43 Id. at 863.
44 But see id. at 864-69 (where some of the concurring justices voiced hesitation to apply the rules set out in the decision to actions by private parties).
45 The only feasible remedy in cases like Texas Gulf, if the courts are to allow all sellers to recover, is a combination of money damages and shares. Even this solution, however, could be used only if none of the plaintiffs could show that they would have held the stock indefinitely if full disclosure had been made.

The submitted formulation for relief in situations like Texas Gulf is as follows:
all the selling shareholders who relied on the 10b-5 violation are identifiable and where the defendant retains the shares. This situation arises most commonly in tender offer situations.\textsuperscript{46}

It is submitted, therefore, that both money damages and restitution to the seller should be governed by a reasonable out-of-pocket rule to value the securities and to determine the damages or number of shares to be returned to the seller. Although this rule would involve the intrinsic method of valuation in situations where no resale occurs a reasonable time after plaintiff’s sale and a determination of equilibrium price in open market situations, this task is not so difficult as to justify the alternative, the awarding of speculative damages.

B. Remedies for the Plaintiff-Buyer

An initial distinction should be made with respect to buyers’ remedies under 10b-5. Two procedures are available to shareholders under Rule 10b-5. One is a suit by a buyer who has been induced by fraud to purchase the security and who seeks to redress his own injury. The second is a derivative

\textbf{1. Remedies for the Plaintiff-Buyer}

(1) Require restitution to a receiver of the shares still held by the insiders which were purchased during the period.

(2) Require the payment of damages by insiders who have resold as measured by the equilibrium price after the market adjusts to the announcement of the previously withheld information minus the price which the insiders paid.

(3) Compute the remaining damages payable by the defendants as follows: Let \( E \) = equilibrium price; let \( T \) = the total number of shares sold by all sellers during the period of the violation; let \( M \) = the total amount received by all sellers as a result of all sales during that period; let \( S \) = the total number of shares held by the receiver; let \( R \) = the total amount of damages already paid to the receiver by those defendants who resold; let \( P \) = market price on the date of the judgment. The total damages that would have to be paid, if any, over and above the return of the shares and the damages already paid by those who resold would be found by solving the following equation for \( X \):

\[
(T \times E) - M = (S \times P) + R + X
\]

(4) To compute the number of securities which should be returned to each individual seller: let \( N \) = number of shares sold by the individual seller during the period of the violation; let \( T \) = the total number of shares sold by all sellers during the period of the violation; let \( S \) = the total number of shares held by the receiver. Each plaintiff would receive a proportionate number of shares found by solving the following formula for \( Y \):

\[
Y = \frac{S}{T} \times N
\]

(5) The remainder of each seller’s total damage recovery, or the amount of money each seller must tender back to the receiver to be entitled to restitution of shares, would be determined by solving the following equation for \( Z \). If \( Z \) is a positive figure, the individual seller should receive additional damages in that amount. If \( Z \) is a negative figure, the seller should return that amount to the receiver before he is entitled to restitution of the shares. Let all the letters equal what they equalled in (3) and (4) above.

\[
(E \times N) - F = (P \times Y) + Z
\]

(6) A method of apportioning fractional shares could be devised, or if an equitable means cannot be agreed upon, the divided shares could be sold by the receiver and the proceeds divided among all sellers who were entitled to fractional shares. All shares or money remaining in the hands of the receiver after all sellers have received their damage award should be returned to each defendant who tendered shares to the receiver in proportion to his original outlay for securities bought during the period.

\textsuperscript{46} A tender offer is generally a public offer made to the shareholders of a corporation which states that the offeror will pay a stipulated price for all shares tendered to him by a certain date.
action by a shareholder who has not been induced by fraud to purchase but who seeks to redress any diminution of the value of his shares or to protect his ownership rights because of a 10b-5 violation inducing the corporation to buy or sell. This section is concerned only with the former. Derivative suits, because of the special situations which they present, are dealt with separately in the next section.

Unlike the plaintiff-seller, the plaintiff-buyer is protected by other provisions of the Securities Acts, and these provisions may govern situations that also could be considered violations of 10b-5. Nevertheless, plaintiff-buyers apparently have the same two basic remedies as plaintiff-sellers in 10b-5 actions: rescission and money damages.

1. **Rescission.**—Rescission for the buyer is a relatively straightforward remedy because it does not raise the problem of speculative damages present in the case of returning the securities to the seller. The plaintiff-buyer is merely attempting to get his money back. Plaintiff-buyer would seek rescission where future growth of the stock is unlikely after his purchase, or at any time when market value is less than price paid. Recovery in a rescission action would be the amount paid for the security plus interest and other expenses attributable to defendant’s fraud. Moreover, the plaintiff would have to return the securities to the defendant.

2. **Money Damages.**—The recovery of money damages (other than those allowable under a rescission measure) is questionable, for few reported cases have reached this question under 10b-5. Their dearth is due to the extensive provisions of the Securities Act of 1933 which protect buyers induced by fraud or misrepresentations in their purchase of a security. In cases where plaintiff has been induced to purchase by a violation of 10b-5 and where the plaintiff later resells at a loss, the measure of damage might be the difference between price paid and resale price. However, if a long period of time elapses between purchase and resale, the decline in market value may be due to economic factors unrelated to the fraud. The court should, therefore,

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50 The question was reached in Esplin v. Hirschi, Current CCH Fed. Sec. L. Rep. § 92,276 (10th Cir. Sept. 30, 1968). It is submitted, however, that the court in *Esplin* made a technical error in the time which it used to measure damages. See pp. 349-50 and note 54 infra.

51 See notes 18 and 47 supra.

52 A similar measure is provided for in § 11 of the Securities Act of 1933, 15 U.S.C. § 77k(e) (1964):

The suit . . . may be to recover such damages as shall represent the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and . . . (2) the price at which such security shall have been disposed of in the market before suit . . .

348
REMEDIES UNDER RULE 10b-5

adopt an equilibrium price or the intrinsic method of valuation in order to give effect to the out-of-pocket rule where the circumstances of the case require.

a. Unrealized Gains. In situations where the plaintiff has not resold and does not desire rescission, the correct application of the federal out-of-pocket rule is important. The courts have continually refused to grant plaintiff-buyers expected but unrealized gains. Expected but unrealized gains are gains which the plaintiff expected in the security because of the facts represented to him by the defendant. In other words, the plaintiff is attempting to recover damage as measured by the difference between the price paid and the hypothetical value of the security at some future time if the facts given him by defendant had been true. Thus, plaintiff attempts to prove what the value should have been at some time after his purchase if the facts given him by the defendant had been true. The possibility of future gain in value is speculative and, therefore, should be excluded by the out-of-pocket rule. The proper application of the federal out-of-pocket rule does not include expected but unrealized gains. The measure of damages under the out-of-pocket rule is the difference between price paid and actual value at the time of plaintiff's purchase. The crux of the difference is that in expected but unrealized gains the plaintiff is trying to recover on the basis of expected value, not on the basis of actual value as required by the federal out-of-pocket rule. Thus, for plaintiff to recover under the federal out-of-pocket rule, actual value must be less than the price paid. This rule excludes the recovery of expected but unrealized gains which the courts have rightfully rejected as entirely speculative.

b. Increase in Value Despite Fraud. The courts must distinguish the proper application of the federal out-of-pocket rule from expected but unrealized gains if they are to enforce effectively the provisions of 10b-5. The importance of actual value is illustrated by the error made by one court which held that damages should be measured by the difference between price paid and the market value at the time of the discovery of the fraud. This measure is open to two immediate criticisms. First, it may include speculative damages if a long period has elapsed between the fraudulently induced purchase and the discovery of the fraud. Second, if market value exceeds price paid at the time of the discovery of the 10b-5 violation, no recovery would be allowed. This latter result may seem logical at first glance, but in certain situations it abrogates the function of the federal out-of-pocket rule. This abrogation may be illustrated by the following hypothetical.

Assume defendants, in violation of 10b-5, misrepresent that their Uranium Company has a certain amount of earnings, assets and so on. Relying

54 Esplin v. Hirschi, 402 F.2d 94, 104-05, (10th Cir. 1968). In this case, if damages had been measured on the date of sale rather than on the date the fraud was discovered, plaintiffs would not have been entitled to any damages because the jury found that the value of the security on the date of purchase was equal to the purchase price.
on these representations, the plaintiff purchases 100 shares of Uranium Company stock at $100 per share in the reasonable belief that this is the actual value of the shares at the time. Besides ambitious goals, defendants have nothing but a certificate of incorporation, a charter, a board of directors and officers. Assume further that through some extremely fortuitous circumstances the defendants make a major uranium discovery soon after plaintiff's purchase. Later, because of this discovery, defendants are able to acquire assets and receive $150 per share by going public on the American Stock Exchange.

Plaintiff, who by the exercise of reasonable care could not have discovered the fraud any earlier, discovers the fraud shortly after the securities are placed on the exchange and brings an action under 10b-5 relying on the out-of-pocket rule of damages to reduce his cost basis. Plaintiff has evidence that on the day of his purchase three other uranium companies in the same position as defendants could ask only $10 per share for their securities.

Plaintiff would be allowed to recover only if a court were to allow him to show actual value (by the intrinsic method of valuation) at the date on which he purchased the stock and only if the court were to disregard market value on subsequent days. It is doubtful that any court would grant recovery in this situation even though a violation of 10b-5 occurred, a difference between actual value and price paid existed, and the defendant profited by a $90 reduction in cost of capital. The problem is one of basic assumption. As pointed out earlier, some courts apparently create a presumption that a plaintiff-seller would not have sold at all had he known the true facts. A parallel presumption might exist that plaintiff-buyer would not have purchased at all had he known the true facts, and thus that the only appropriate remedy is a return to the status quo through rescission and return of the purchase price. The facts in many cases (including the above hypothetical) indicate that plaintiff would have bought the security, albeit at a lower price, even if the true facts had been known to him. A plaintiff should be allowed to prove that he would have bought the security even if he had known the true facts. A contrary rule forces the plaintiff to choose between retention of his stock despite the fraud surrounding his purchase and return of his stock as a prerequisite to redressing a wrong done to him.

c. Retention of the Security by Plaintiff. One final problem remains in the recovery of money damages by a plaintiff-buyer. Because Section 12 of the Securities Act of 1933 may apply, it is questionable that a buyer may both hold his securities and sue for money damages. It is likely that Section 12 of the 1933 Act, which concerns material misstatements in prospectuses or oral communications, may govern some cases that could fall under 10b-5. If this is the case, then the plaintiff-buyer possibly would be limited by that provision to price paid plus interest upon the tender of the security to the defendant.

57 Cf. id. at 124-25. Section 12 of the Securities Act of 1933 provides in part:
[A purchaser may sue] to recover the consideration paid for such security with

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There is, however, authority for the proposition that a plaintiff-buyer may hold the security and proceed under 10b-5. In Pfeffer v. Cressaty, the court held an action under Section 12 of the 1933 Act was inappropriate because plaintiff desired to hold the security, but the court allowed an action under 10b-5. Although the court did not pass on the damages question, it is submitted that the plaintiff should be allowed to recover the difference between his purchase price and the actual value on the date of sale. In terms of the Uranium Company hypothetical, plaintiff should be allowed to hold the security and reduce his cost basis by the difference between price paid ($100) and actual value at the date of purchase ($10).

C. Conclusions on Remedies of Individuals

It is apparent from the foregoing discussion that the measure of damages in 10b-5 actions should be governed by the federal out-of-pocket rule of damages for both buyer and seller. The determination of actual value is the critical factor in applying the rule, for actual value can be determined only from the circumstances of each particular case. In 10b-5 actions by sellers, plaintiff should be required to prove the actual value of that security to the plaintiff by any reasonable means including appraisal of intrinsic factors or by a resale value test. Rescission and restitution of the shares to the plaintiff-seller must be limited to only a few situations where speculative damages will not be recovered and where the sellers who relied on the misrepresentation are identifiable. Where the plaintiff-buyer still has the securities, on the other hand, rescission and restitution should be supplemented by an opportunity to hold the security and redress the wrong done to him by recovery of money damages.

This approach is necessary not only to counteract the speculative nature of the purchase and sale of securities and the consequent problem of speculative damages, but also to provide effective enforcement of Rule 10b-5. Application of the federal out-of-pocket rule in the manner discussed above will equalize the remedies and the enforcement of 10b-5 between buyer and seller.

III. SHAREHOLDERS' DERIVATIVE ACTIONS TO PREVENT OR REDRESS THE PURCHASE OR SALE OF SECURITIES BY THEIR CORPORATION

Plaintiffs, through a derivative suit, may utilize Rule 10b-5 to prevent or redress actions by their corporation which involve a purchase or sale of securities. The decision in Birnbaum v. Newport Steel Corp. places important limitations on actions by shareholders under 10b-5 and, indeed, parts of the opinion create a strong inference that non-selling shareholders have no action at all under 10b-5. The actual holding in Birnbaum is that Rule 10b-5 was directed solely at that type of misrepresentation or fraudulent interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

59 193 F.2d 461 (2d Cir.), cert. denied, 343 U.S. 956 (1952).
60 Id. at 463-64.
practice usually associated with the sale or purchase of securities
rather than at fraudulent mismanagement of corporate affairs, and
that Rule X-10b-5 extended protection only to the defrauded pur-
chaser or seller.01

The line of demarcation between a 10b-5 violation and fraudulent mismanage-
ment is not always clear. The purpose of this section is to examine some
situations where 10b-5 actions have been allowed and to determine whether
effective remedies are available to meet these situations.

In the examination of remedies where the corporation's activities are
closely tied to the claim for relief, it is helpful to classify the actions in two
sections. The first includes actions to prevent the inception or continuance of
corporate activities or activities by third parties that affect the plaintiff
shareholders' corporation. The second section examines actions for redress
after the transaction or activity has been consummated. Such a distinction
is significant because the substantive requirements for relief and the problem
of remedy application differ between the two.

A. Preventive Relief

The primary remedy sought to prevent corporate security transactions
is the injunction, which may be granted before the transaction begins or while
it is taking place. The leading case for injunctive relief under 10b-5 is Ruckle
v. Rota Am. Corp.02 In Ruckle, plaintiff, a director of the defendant corpo-
ration, sued derivatively to enjoin an issuance of treasury stock which had been
approved by a majority of the directors. Plaintiff alleged that the defendant
directors of the corporation had, by withholding certain information from the
entire board, induced the majority of the directors to postpone a stockholders'
meeting and to issue the treasury stock. The defendant directors intended
to issue these securities to the president of the company who could then resell
or vote the shares as he saw fit. Plaintiff further alleged that defendants' pur-
pose in withholding this information in violation of 10b-5 was solely to protect
the defendants' ownership rights (from an apparent takeover by plaintiff and
others) and thus the issuance of the stock would harm the corporation.

The court upheld plaintiff's theory that a corporation could be defrauded
by a majority of the directors, that the impending issuance by the corporation
constituted a sale under 10b-5 and that a preliminary injunction should be
issued to enjoin the issuance pending trial on the merits. This reasoning allows
shareholders to bring suit when their corporation is, or is about to become a
seller of securities, even though the individual plaintiff is not a seller. Similar
reasoning would allow shareholders to sue when the corporation is about to
purchase the securities.

Although the Ruckle court does not explicitly mention any test for the
propriety of a preliminary injunction, other courts have required the plaintiff
to satisfy the traditional requirements of equity. The preliminary injunction
is an extraordinary equitable remedy granted on the basis of the courts'

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01 Id. at 464.
02 339 F.2d 24 (2d Cir. 1964).
REMEDIES UNDER RULE 10b-5

discretion. The plaintiff must show that there is no adequate remedy at law, for only if compensatory damages are inadequate will plaintiff be able to show irreparable harm that justifies invoking equity jurisdiction. The plaintiff must also show that there is some likelihood that he can show a 10b-5 violation at a subsequent trial on the merits. Determination of plaintiff's likelihood of success is particularly within the discretion of the court, but it is certainly important that the 10b-5 violation be clear from the facts alleged.

In Symington Wayne Corp. v. Dresser Indus., Inc., the plaintiff corporation was denied a preliminary injunction to prevent the corporate defendant's announcement of a tender offer to purchase plaintiff corporation's shares. The court denied an injunction because it felt that there was little likelihood that the plaintiff could establish a material misrepresentation at trial on the merits. The court noted, moreover, that the plaintiff failed to show that it would suffer irreparable injury if the tender offer was carried out, since plaintiff could restrain the voting of the shares after the transfer was completed.

The decision in Symington illustrates a practical difficulty which plaintiffs must face in the attempt to demonstrate irreparable injury. The court implicitly recognized that tender offers are geared to prevailing market conditions and the current financial status of both companies, and further that any delay of the tender offer may force renegotiation or termination of the tender offer because of changing economic conditions. Any such delay would greatly prejudice the defendant and other stockholders in the plaintiff corporation who wished to take advantage of the tender offer if no violation of 10b-5 were found at a subsequent trial on the merits. However, in its desire to avoid these problems, the court overlooked the complexity of the remedy problem if the transaction were allowed to continue and a 10b-5 violation did in fact occur. Money damages would be inadequate relief because the merger would have already taken effect and the shift of ownership would be completed. Although preventing the shares from being voted by a later injunction may prevent the takeover, granting restitution if a 10b-5 violation were found would raise the problem of speculative damages or might even be impossible if the defendant had resold the shares to a good faith purchaser.

A balance of these equities is found in Puharich v. Borders Electronics Co. The court granted a preliminary injunction requiring that the shares

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64 See J. Pomeroy, Equity Jurisprudence § 1338 (students' ed. 1907).
65 Unicon Management Corp. v. Koppers Co., 366 F.2d 199, 204-05 (2d Cir. 1966).
67 383 F.2d 840 (2d Cir. 1967).
69 See authorities cited note 68 supra.
already tendered and any shares tendered in the future be kept in escrow. The court also restrained the defendants from calling any stockholders meeting until a trial on the merits was concluded. The solution reached in *Puharich* is correct because it allows the parties to complete the mechanics of the tender offer, but prevents the shares from being distributed or controlled by the defendant until a decision on the merits is reached. This result greatly simplifies the task for the court if a 10b-5 violation is subsequently found, for the court can require the shares to be delivered back to the sellers from escrow and thereby prevent the management takeover and prevent any problems arising from resale by the defendants. The defendants also are protected because the mechanics of the tender offer are allowed to continue, and, if no 10b-5 violation is found, the shares can be released to the defendants and the takeover effected.

In sustaining actions for injunctions before the transaction is completed, therefore, the courts balance irreparable harm threatened plaintiff and his likelihood of eventual success with the prejudice which the injunction will cause the defendant. In light of the possible complexity of the remedy problem after the transaction has occurred, the courts should establish equitable means for restraining the transaction, for the plaintiff will generally be irreparably injured if his ownership rights are endangered. Thus, the courts should be liberal in the application of the likelihood-of-success test where preliminary injunctions are sought to prevent corporate takeovers, but should allow the mechanics of the transaction to be carried out by ancillary procedures similar to an escrow agreement. The measure, adequacy and application of money damages or restitution cause difficult problems in derivative suits. Prophylactic relief provides the best way to avoid these problems.

**B. Redress of Completed Transactions**

The discussion of remedies in this section is based almost entirely on extrapolation, for no reported case has reached a final decision on the damages question in a derivative action where the transaction has already occurred. This extrapolation requires application of the concepts of money damages and restitution developed earlier to cases where special problems arise because the transaction involving the securities has already occurred. Some of these problems relate to standing to sue, others relate to a 10b-5 violation that is only a part of a broader scheme of fraudulent mismanagement, and others relate to providing an adequate remedy. The purpose of this section is to examine some of the more difficult problems of remedy application in cases where transactions closely tied to corporate activities have already occurred.

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plaintiff alleged misrepresentations in the written agreements between the companies in violation of 10b-5. The agreement related to an acquisition by the defendant of a controlling interest in the plaintiff's corporation. Plaintiffs further alleged that the takeover was solely for tax purposes which would result in injury to the corporation and its shareholders. *Puharich v. Borders Electronics Co.,* Current CCH Fed. Sec. L. Rep. ¶ 92,141 (S.D.N.Y. Jan. 24, 1968).

72 Comment, The Expanding Uses of Rule 10b-5, 10 B.C. Ind. & Com. L. Rev. 313 (1968).

1. The Intertwining of Corporate Mismanagement.—The intertwining of 10b-5 violations and corporate mismanagement is occasioned by decisions holding that directors may be liable under 10b-5 if they induce their corporation to issue securities to third parties or to buy from third parties. At this point the cases come into the area of mismanagement of corporate affairs, and the problems of adequate relief become complex. Unfortunately, none of the cases in the area has yet met the post-transaction remedial problem head on.

The corporation may, for example, bring an action against former directors. In *New Park Mining Co. v. Cranmer* the plaintiff corporation brought such an action against three former directors and officers alleging that the defendants had induced the corporation to purchase properties with a value far less than that which the defendants had represented by issuing an excessive number of securities. The complaint also alleged a wrongful expenditure of cash for certain services. The court allowed the 10b-5 action despite the fact that the transaction may have involved a larger scheme of mismanagement and despite the fact that the defendants were apparently not the only people who had received the shares.

If it is assumed that plaintiffs in *New Park* were able to prove a violation of 10b-5, it is obvious that certain complexities would arise in the determination of the appropriate measure of recovery. Damages in this case would have to be determined by the federal out-of-pocket rule—the difference between the value of the shares issued and the value of the properties or consideration received. But if the securities were not widely traded, the court would be faced not only with the valuation of the securities given but with the valuation of the properties received by the corporation. In many cases, both would have to be determined by the intrinsic method of valuation.

*New Park* raises a second problem concerning the damages allowable under 10b-5. A strict application of the federal out-of-pocket rule would allow recovery for cash outlays only if they are related to the transfer of the securities. The broader the scope of the fraudulent mismanagement, the more difficult it becomes to determine which damages result from the 10b-5 violation in the transfer of the securities and which result from breaches of fiduciary duty. It is submitted that a court should resolve all the questions involved in the particular case where a 10b-5 violation has occurred, even though litigation concerning breach of fiduciary duty alone is not actionable under 10b-5.

2. Double Recovery.—Aside from the problem of the intertwining of 10b-5 violations and breaches of fiduciary duty which pervades most derivative actions against directors where a transfer of securities is involved, there are certain cases where a derivative action is improper even where a 10b-5

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75 Id. at 266.
76 See Estate Counseling Serv., Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc. 303 F.2d 527, 533 (10th Cir. 1962).
77 See O'Neil v. Maytag, 339 F.2d 764, 767-68 (2d Cir. 1964).
violation is proved. A derivative action is improper when it would result in double recovery or would prevent those persons who were actually injured from being compensated. The problem of double recovery is well illustrated by Mutual Shares Corp. v. Genesco, Inc. In Mutual Shares, plaintiffs were minority shareholders in Kress Corporation and alleged that the defendant, Genesco, had made fraudulent representations to Kress shareholders to effect a tender offer. Plaintiffs were apparently not shareholders of Kress at the time of the tender offer and consequently were not members of the class to which the offer was directed, nor did they sell their shares. Plaintiffs alleged further that since the termination of the tender offer the defendant had manipulated the market price of Kress shares downward to force the remaining shareholders to sell.

The court sustained an injunction to prevent the continuance of the market manipulation, but would not sustain an action by plaintiffs individually or derivatively for the corporation's benefit as a result of the allegedly fraudulent tender offer. The court reasoned that, because the plaintiffs had not sold as a result of the allegedly fraudulent tender offer, they would be unable to prove that they had been induced by fraud to sell or that they had suffered any loss.

This result reflects the proper interpretation of 10b-5 in outside tender offer situations. The relief for non-selling shareholders should be limited to protection from market manipulation because until they do sell they receive no injury. In the same sense, a derivative suit for damages is inappropriate because there is only a potential for injury to the corporation if the new owners breach their fiduciary duties. The selling shareholders, therefore, are the only parties injured within the contemplation of 10b-5. To allow a derivative suit by non-sellers would result in double recovery if the injured parties, the sellers, were allowed an action. The problem of double recovery will arise in any case where the corporation itself was not the buyer or seller.

79 But see Diamond v. Oreamuno, 29 App. Div. 2d 285, 287 N.Y.S.2d 300 (Sup. Ct. 1968). In a common law derivative suit for breach of fiduciary duty, the corporation was allowed recovery of damages where the defendant directors had sold their securities on the basis of inside information that the company's earnings were going to drop. Allowing recovery by the corporation in this situation prevents recovery by the persons buying those shares, the persons actually injured, or results in double recovery if a subsequent action by the buyers is allowed against the defendants. The payment of damages to the corporation is improper because the corporation suffered no injury by the defendants' sale of stock. The only injury to the corporation was the decline in earnings. The only justification for this result is that the corporation may eventually be liable for the misrepresentations of its directors or officers. There was no indication in Diamond that any potential corporate liability existed.

80 384 F.2d 540 (2d Cir. 1967).

81 Id. at 546-47 where the court reasoned that plaintiffs, because they were injured by the activity, had the same power as the SEC to prevent manipulation.

82 Id. at 546.

83 But see Vine v. Beneficial Fin. Co., 374 F.2d 627 (2d Cir. 1967), where plaintiff who had not yet sold was allowed to bring a 10b-5 action because his corporation had merged into another by a "short-form" merger agreement. This merger would soon force the plaintiff either to sell or exchange his stock.

The appropriate action where a tender offer by an outsider has been completed would be a class action by all sellers subscribing to the tender offer and seeking rescission of the transaction along with restitution as governed by the limitations discussed earlier. On the other hand, sellers could be given money damages measured by the out of pocket rule if a great deal of time had elapsed or if their only objection was the deflated value at which they had been induced to sell. If some sellers wanted restitution while others wanted money damages, the court could rely on the test of a reasonable investor under all the circumstances to determine which remedy is proper for the class. The court could, if it were feasible under the circumstances of the case, give either remedy according to the desire of each individual plaintiff.

3. The Corporation as a Buyer or Seller.—A shareholder may bring a derivative action for damages to the corporation if the corporation was induced by a 10b-5 violation to issue or purchase its own securities or to purchase other securities. Such cases avoid the problem of double recovery encountered in outside tender offer situations as in Mutual Shares above. The corporation itself in the situations discussed hereafter is the purchaser or seller of securities and is thus the party who suffers injury.

One of the few cases that has considered the damages question in a derivative suit is Pappas v. Moss. In that case a derivative action was brought by several minority stockholders who alleged that all the directors had defrauded the corporation by issuing unregistered securities to themselves at an unreasonable discount price. The district court found a violation of 10b-5 because the defendants' conduct was made illegal under Rule 10b-6 and because that Rule should be incorporated into 10b-5. Without explaining its basis for measuring the reasonableness of the discount, the court found that 20 percent of market price was a reasonable discount. It then assessed damages against each director equivalent to the difference between 80 percent of market value on the date of the various purchases and the price which they had actually paid.

On appeal, however, the circuit court reversed. It disagreed with the district court's interpretation of 10b-5 and remanded the case to the district court for resolution of all relevant questions including damages. The appellate court did not settle the damage issue but noted that the district court had not explained its measurement of a reasonable discount. The circuit court questioned the use of market value and indicated that the "fair value" of the stock at the "critical dates" was the relevant factor "in resolving several issues." It is submitted that, if a 10b-5 violation is found on remand in Pappas, the corporation is a defrauded seller and should be allowed the same

For a discussion of the use of the class action device, see A. Bromberg, Securities Law: Fraud—SEC Rule 10b-5 § 11.6 (1968).


17 C.F.R. 240.10b-6 (1968).


Discount prices are commonly utilized to provide incentives for management to take a proprietary interest in the corporation.


Pappas v. Moss, 393 F.2d 865, 870 (3d Cir. 1968).
recovery applicable to individual sellers. Damages should be measured by
the difference between actual value and selling price received. The only
logical method of determining actual value in *Pappas* is to calculate the
reasonable discount from market price on the date of the decision and to em-
ploy that figure as actual value. As an alternative remedy, the corporation
should be able to rescind the transaction and have the shares returned if the cir-
cumstances require.

4. *Money Damages or Restitution.*—In the foregoing cases in this section, the
basic remedy discussed is money damages. In many derivative actions, how-
ever, the actual concern of the plaintiff is the change in ownership which results
when his corporation issues or purchases its own shares. For example, the
increased ownership achieved by the defendants, not their financial enrich-
ment, may have been the actual concern of the plaintiffs in *Pappas*. The
more difficult cases of changes in ownership arise in acquisitions, mergers or
consolidations. In *Simon v. New Haven Board & Carton Co.*, the court
allowed a derivative action under 10b-5 in which plaintiff alleged that, be-
cause certain directors falsified reports and proxy statements, the shareholders
approved the issuance of securities with a value $2,000,000 higher than the
value of the corporations acquired. It should be noted that as a result of the
transfer, one director's ownership increased from 33 percent to 76 percent. Although the question of damages was never reached, money damages would
merely force the defendants who took part in the fraud to pay an equitable
price for the shares. Plaintiffs' actual concern was that the ownership and con-
trol acquired by the defendant be nullified by rescission of the transaction
and return of the shares. Rescission and restitution would avoid the problems
of valuation which arise if money damages are sought and would prevent the
change in ownership. In most cases, therefore, rescission and restitution would
afford a more satisfactory remedy to the plaintiffs and would be easier for the
court to apply than would money damages. There are, however, certain prob-
lems with restitution. One is the speculative damages problem discussed earlier
which arises if a great deal of time elapses between the transaction and the
court's decision. The second problem is that in mergers by stock acquisitions
not all the shares go to the defendants. Even if the defendant directors are on
the boards of both companies involved in the transaction, it is questionable
whether the entire transaction is voidable so as to allow restitution of the
shares from those who have no notice of the fraud or misrepresentation.

However, plaintiffs could argue that the plaintiff corporation had issued shares
as a result of the fraud of the other corporation, for the knowledge of the direc-
tors' guilt of the 10b-5 violation is imputed to the other directors and thus to
the entire corporation. If this argument could be supported, then rescission
and restitution would be proper because the shareholders of the fraudulent
corporation acted as an entity, not as individuals.

The more difficult situation arises where the defendant directors were not
directors in the other corporation in the acquisition but simply substantial
shareholders who would benefit from the transfer.\textsuperscript{95} Here, if a 10b-5 violation is established, plaintiff should be able to require restitution from the defendant as the circumstances of the particular case allow. Plaintiff would have two arguments to void the entire transaction. One argument would be that the directors of the other corporation knew or should have known that the terms of the transfer were a result of misinformation and that thereby the other corporation became a party to the fraud. The second argument would be a constructive trust theory that the shareholders should not be allowed unjust enrichment as a result of the defendants' fraud.\textsuperscript{96} The success of both of these arguments is questionable. Furthermore, the numerous resales that would occur if the security is widely traded make it even more questionable that effective restitution of all the shares could ever be accomplished in these cases. Thus, where an action is brought against directors when they are the only wrongdoing participants in the transaction, it is likely that recovery could come only from them.

IX. CONCLUSION

Because of the widening variety of conduct proscribed by Rule 10b-5, it is important to restrict damages under the Rule to the federal out-of-pocket rule of damages. Money damages in both individual and derivative actions should be limited to the difference between actual value to the plaintiff at the date of sale and the price paid or received. Actual value cannot be measured at some arbitrary time or by some arbitrary standard, but must be measured in the light of all the circumstances of the particular case for a determination of plaintiff's actual damages as a result of the 10b-5 violation.

For the purposes of limiting speculative damages and of compensating plaintiff for his actual damages, restitution of the securities should be considered an extraordinary remedy not to be employed unless there is a clear showing that it is appropriate under the circumstances.

For avoidance of the complexities of damage recovery under 10b-5, the prophylactic remedial structure under the Rule must be expanded. Injunctive relief can avoid the possible inadequacies and inconsistencies now hindering effective enforcement of the Rule. Injunctive relief avoids the unrealistic measurement of money damages and the uneven application of rescission and restitution. The proper use of injunctive relief could free those remedies for their own appropriate use.

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\textsuperscript{95} See Cohen v. Colvin, 266 F. Supp. 677 (S.D.N.Y. 1967), where the court held that there was no action under 10b-5. Plaintiffs alleged that in competition with their own corporation the defendant directors were purchasing shares of another corporation.

\textsuperscript{96} See Restatement of Restitution § 167 (1936).