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Securities Regulation—Punitive Damages Under Section 17(a) of the Securities Act of 1933—*Globus v. Lzaw Research Serv., Inc*

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Securities Regulation—Punitive Damages Under Section 17(a) of the Securities Act of 1933—*Globus v. Law Research Serv., Inc.*¹—Law Research Service, Inc. (L.R.S.) publicly offered 100,000 shares of its common stock pursuant to Regulation A² of the Securities and Exchange Commission. The corporation, which had been in operation since 1964, offered legal research assistance to the legal profession through the use of computers. On June 5, 1963, L.R.S. and Sperry Rand entered into an exclusive five-year contract whereby Sperry Rand was to create and operate a system for the retrieval of legal citations to be made available to lawyers.

The relationship between L.R.S. and Sperry Rand did not proceed smoothly. On January 2, 1965, Sperry Rand terminated the contract, alleging that L.R.S. had failed to pay approximately \$82,000 which it owed to and which had been demanded by Sperry Rand. In response to the termination of the contract, L.R.S. commenced suit on February 23, 1965, against Sperry Rand for breach of contract and sought to compel specific performance. In the meantime, L.R.S. continued with its public offering. On March 15, 1965, it issued the required offering circular which, in reference to the Sperry Rand contract, only stated that the corporation owed \$82,000 to Sperry Rand. Nowhere did the offering circular mention the fact that Sperry Rand had terminated the contract and that L.R.S. had initiated legal proceedings. The plaintiffs, thirteen purchasers of the L.R.S. common stock, sued L.R.S., its president, and Blair & Co., its underwriter, alleging that the relevant omission from the offering circular constituted common law fraud, violated Section 17(a) of the Securities Act of 1933³ (1933 Act) and Section 10(b) of the Securities Exchange Act of 1934 (1934 Act).⁴ The United States District Court for the Southern Dis-

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

² 17 C.F.R. § 231.256 (Supp. 1959).

³ Section 17(a) provides:

It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly

(1) to employ any device, scheme, or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

Securities Act of 1933, § 17(a), 15 U.S.C. 77q (1964).

⁴ Section 10 provides:

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

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such

trict of New York found in favor of all the defendants on the common law fraud claim, but it found for the plaintiffs with regard to the actions based on both the 1933 and 1934 Acts.⁵ The jury awarded compensatory damages amounting to \$32,591.14 and punitive damages against the president of L.R.S. in the amount of \$26,812.06 and against Blair & Co. in the amount of \$13,000.00. Since the court found that there was no common law fraud and because it was bound by a prior opinion of the Second Circuit Court of Appeals denying the award of punitive damages under Section 10(b) of the 1934 Act,⁶ the award of punitive damages was based on the finding of a violation of Section 17(a) of the 1933 Act.⁷ On appeal, the United States Court of Appeals for the Second Circuit reversed as to punitive damages and HELD: Punitive damages cannot be awarded on the basis of Section 17(a) of the Securities Act of 1933.⁸

In reaching its decision the court of appeals dealt directly with the matters considered by the district court. The district court instructed the jury that it could award punitive damages if, after finding that the defendants had violated section 17(a), it could find that the defendant's conduct was so inimical to "the public interest . . . [as to] involve a high moral culpability."⁹ The district court stated the policy that punitive damages were necessary to deter wilfully deceptive conduct regarding transactions in securities.¹⁰ The court also saw a need to provide financial incentive to injured parties whose actual monetary losses were not sufficient to support the cost of a law suit.¹¹

Even though the district court was persuaded by these policy considerations, it faced a series of legal hurdles before it could rule that they be implemented. Section 28(a) of the 1934 Act specifies that damages available under the Act be limited to "actual damages."¹²

rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors. Securities Exchange Act of 1934, § 10, 15 U.S.C. § 78j (1964).

⁵ 287 F. Supp. 188 (S.D.N.Y. 1969). In the district court, the plaintiffs also sued Blair & Co. for violation of § 12(2) of the 1933 Act, 15 U.S.C. § 77l(2)(1964), and § 15(1) of the 1934 Act, 5 U.S.C. § 78o-1 (1964). There was also a cross-claim by Blair & Co. against L.R.S. because L.R.S. had agreed to indemnify Blair & Co. for any losses sustained by the latter as a result of the offering. The district court dismissed the cross-claim, holding that it would be against public policy to enter into such an agreement where Blair & Co. acted with wanton indifference to the rights of others. *Id.* at 199.

⁶ *Green v. Wolf Corp.*, 406 F.2d 291 (2d Cir. 1968).

⁷ 287 F. Supp. at 191.

⁸ 418 F.2d 1276 (2d Cir. 1969). The court also affirmed the district court's holding on the indemnification issue. *Id.* at 1288. See note 5 *supra*.

⁹ 287 F. Supp. at 193.

¹⁰ *Id.* at 195.

¹¹ *Id.*

¹² Section 28(a) provides:

The rights and remedies provided by this title shall be in addition to any and all other rights and remedies that may exist at law or in equity; but no person permitted to maintain a suit for damages under the provision of this title

CASE NOTES

Furthermore, Sections 11 and 12 of the 1933 Act,¹³ when read in the light of Section 28(a), arguably evidence a congressional policy against allowing punitive damages under either Act. The lower court overcame the defendants' objections to punitive damages under section 17(a) by finding that the section 28(a) limitation specifically provides that the rights and remedies available thereunder are *in addition to* other rights and remedies, and moreover that section 28(a)'s limitation to actual damages applies only to damages available under the 1934 Act.¹⁴ Civil remedies under section 17(a) of the 1933 Act fall within the category of rights and remedies not available under the 1934 Act.

In overruling the district court, the Second Circuit Court of Appeals viewed the 1933 and 1934 Acts as a single comprehensive scheme of regulation. While the court recognized that they were two separate enactments, it concluded that the policies and interpretations of the statutes should be as consistent as possible. It stated that since the 1934 Act, which is the only basis upon which defrauded sellers of securities can obtain relief,¹⁵ prohibits punitive damages,¹⁶ it would be inconsistent to permit defrauded purchasers to be awarded punitive damages under the 1933 Act.¹⁷ The appellate court also noted that when the 1933 Act was promulgated, members of the Securities and Exchange Commission assumed that civil liability would be limited by the language of sections 11 and 12.¹⁸ Section 17(a), the court noted, was basically a criminal and injunctive section.¹⁹ While federal courts have allowed plaintiffs to maintain civil actions based on violations of the criminal sections of the securities laws,²⁰ the court of appeals doubted that the 1933 Act was intended to apply to civil actions, especially ones seeking punitive damages.²¹

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

¹³ Section 11, which imposes civil liability for filing a false registration statement, places the maximum recovery at the price at which the security was offered to the public. Securities Act of 1933, § 11(g), 15 U.S.C. § 77k(g) (1964). Section 12, which imposes civil liability for engaging in a prohibited offer or sale of a security, allows the plaintiff "to recover the consideration paid for such security with 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." Securities Act of 1933 § 12(2), 15 U.S.C. § 77l(2) (1964).

¹⁴ Securities Exchange Act of 1934, § 28(a), 15 U.S.C. § 78bb(a) (1964).

¹⁵ Id. § 10, 15 U.S.C. § 78j (1964).

¹⁶ Id. § 28(a), 15 U.S.C. § 78bb(a) (1964); cf. *Green v. Wolf Corp.*, 406 F.2d 291 (2d Cir. 1968).

¹⁷ 418 F.2d at 1286.

¹⁸ Id. at 1284.

¹⁹ Id.

²⁰ See, e.g., *Dack v. Shanman*, 227 F. Supp. 26 (S.D.N.Y. 1964); *Theile v. Shields*, 131 F. Supp. 416 (S.D.N.Y. 1955); *Osborne v. Mallory*, 86 F. Supp. 869 (S.D.N.Y. 1949) (allowing civil suits under § 17(a) of the 1933 Act). See also *Kardon v. National Gypsum Co.*, 73 F. Supp. 798 (E.D. Pa. 1947) (allowing a civil suit under § 10(b), the criminal and injunctive section of the 1934 Act).

²¹ 418 F.2d at 1284.

The appellate court also disagreed with the lower court's determination that punitive damages are desirable for the efficient enforcement and deterrent effect which the securities laws envision. Violators of section 17(a) can be fined up to \$5,000 and sentenced to prison for up to five years.²² The Securities and Exchange Commission may also suspend or expel violators or suspend trading in a stock.²³ The court of appeals felt that these deterrents, along with compensatory damages, were sufficient to discourage violations of section 17(a).²⁴ The court also observed that awarding punitive damages, especially where there are thousands of people who might have suffered losses, would cause an overwhelming burden which could financially ruin defendants.²⁵

The court of appeals' basic argument was that buyers and sellers of securities should be treated equally and, since sellers under Section 10(b) of the 1934 Act could not recover punitive damages, then buyers also should not be allowed punitive damages under Section 17(a) of the 1933 Act. As authority for allowing recovery under section 10(b), the court cited *Green v. Wolf Corp.*,²⁶ and *Meisel v. North Jersey Trust Co.*²⁷ In *Green* the plaintiff brought an action for compensatory damages under section 10(b) alleging the use of untrue and misleading statements in a registration statement. He also sought punitive damages, but this latter claim was denied. The court stated that the section 28(a) language, "no person . . . shall recover . . . a total amount in excess of his actual damages,"²⁸ is clear—only actual damages can be recovered under the Securities and Exchange Act of 1934.²⁹ The court pointed out that punitive damages are not needed as a deterrent,³⁰ that the resulting possibility of cumulative harm would be staggering,³¹ and that the 1934 Act also has criminal sanctions for violation.³²

In *Meisel* the same issue was in dispute—whether punitive damages could be awarded under section 10(b). As in *Green*, the court dismissed this issue with little discussion, saying that section 28(a) of the 1934 Act made it clear that punitive damages could not be awarded.³³

The Second Circuit's interpretation of section 28(a) as excluding punitive damages may be questioned. Section 28(a) states that remedies available under the 1934 Exchange Act are in addition to all

²² Securities Act of 1933, § 24, 15 U.S.C. § 77x (1964).

²³ Id. § 20(b), 15 U.S.C. § 77t (1964).

²⁴ 418 F.2d at 1285.

²⁵ Id.

²⁶ 406 F.2d 291 (2d Cir. 1968).

²⁷ 216 F. Supp. 469 (S.D.N.Y. 1963).

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

²⁹ 406 F.2d at 303.

³⁰ Id.

³¹ Id.

³² Securities Exchange Act of 1934, § 32, 15 U.S.C. § 78ff (1964).

³³ 216 F. Supp. 469 (S.D.N.Y. 1963).

other existing rights and remedies.³⁴ It also provides that "no person permitted to maintain a suit for damages *under the provisions of this title*" shall recover more than actual damages.³⁵ (Emphasis added.) The right to sue for damages for a violation of section 10(b) however, is based on the general tort theory that the violation of a criminal statute provides a basis for civil liability. It is not one granted by the statute; thus it is arguable that punitive damages should be allowed under section 10(b).

The *Globus* court's denial of punitive damages under section 10(b) is in conflict with the rule applied by courts in other circuits. In *Hecht v. Harris, Upham & Co.*,³⁶ the District Court for the Northern District of California said that under certain circumstances punitive damages could be awarded in a suit brought under section 10(b). The *Hecht* court looked to the special language of section 28(a) limiting recovery to actual damages in causes of action "permitted" by the Act, and pointed out that there were several sections of the Act which specifically "permitted" civil causes of action.³⁷ The court then concluded that section 28(a)'s limitation to actual damages applies only to those causes of action which are specifically provided for by the 1934 Act. While the court in *Hecht* felt that punitive damages were not necessary on the facts in that particular case, it did state, contrary to the interpretation of the Second Circuit, that punitive damages could have been recovered under section 10(b). The reasoning in *Hecht* also was followed in *deHaas v. Empire Petroleum Co.*,³⁸ where the District Court for the District of Colorado stated that an action for damages under section 10(b) is not "permitted" by the Act, in the sense of being created by it, but rather is grounded in the common law of torts.

Assuming the correctness of the Second Circuit's ruling that section 28(a) precludes the awarding of punitive damages in any civil action based on the 1934 Act, it still must be shown that section 28(a) applies also to the 1933 Act. The *Globus* court treated both Acts as one, but failed to discuss the fact that applicability of Section 28(a) of the 1934 Act is specifically limited to "the provisions of the title."³⁹ The pivotal rationale for the Second Circuit Court of Appeals' view that section 28(a) applied to the 1933 Act was that the civil liability sections of the Act specifically limit the amount that could be recovered.⁴⁰ However, the suit in *Globus* was not based on these civil

³⁴ Securities Exchange Act of 1934, § 28(a), 15 U.S.C. § 78bb(a) (1964); see note 12 supra.

³⁵ Id.

³⁶ 283 F. Supp. 417 (N.D. Cal. 1968).

³⁷ See, e.g., Securities Exchange Act of 1934, §§ 9(e), 16(b), 18, 15 U.S.C. §§ 78i(e), 78p(b), 78r (1964).

³⁸ 302 F. Supp. 647 (D. Colo. 1969).

³⁹ Securities Exchange Act of 1934, § 28(a), 15 U.S.C. § 78bb(a) (1964); see text of § 28 at note 12 supra.

⁴⁰ Securities Act of 1933, §§ 11g, 12(2), 15 U.S.C. §§ 77k(g), 77l(2) (1964).

liability sections. Furthermore, the lack of any all encompassing provision in the 1933 Act similar to that of section 28(a) would seem to imply that punitive damages are not precluded from all sections of the 1933 Act.

The Second Circuit, prior to the *Globus* decision, had not raised any policy barriers to punitive damages when the actionable wrong involved securities. Actually, in dicta the court has spoken to the contrary. In the *Green* case the court noted that "punitive damages are permitted under the Securities Act of 1933 . . ." ⁴¹ Similarly, in *Gann v. Bernz-Omatic Corp.*, ⁴² a case based on section 10(b), the defendant seller moved to strike the plaintiff's plea for punitive damages on the ground that section 28(a) prohibited such recovery. The District Court for the Southern District of New York said, however, that aside from the federal claim, the plaintiff's complaint stated a claim under state law for fraud and deceit over which the federal court had pendent jurisdiction. ⁴³ The court held that if the plaintiffs established their state claim, they could receive punitive damages if certain standards of willfulness were met. ⁴⁴ Thus, the *Gann* holding and the *Green* dicta illustrate that, prior to *Globus*, punitive damages for securities violations were recognized by the second circuit. It is submitted that the policy of *Gann* allowing punitive damages for securities violations should be followed in a civil action based on Section 17(a) of the 1933 Act.

Persuasive arguments have been marshalled contending that it is improper to allow any kind of civil remedy on the basis of section 17(a). ⁴⁵ Since Sections 11 and 12 of the 1933 Act provide remedies for civil liabilities, it has been suggested that these are the only civil remedies which should be available. Commissioner Landis of the Federal Trade Commission, who helped draft the 1933 Act, stated:

The suggestion has been made on occasion that civil liabilities arise from a violation of Section 17, the first subsection of which makes unlawful the circulation of falsehoods and untruths in connection with the sale of a security in interstate commerce or through the mails. But a reading of this section in the light of the entire Act leaves no doubt but that violations of its provisions give rise only to a liability to be restrained by injunctive action or, if willfully done, to a liability to be punished criminally. ⁴⁶

Most courts, however, including the *Globus* court, have held that section 17(a) provides the basis for a civil remedy. This holding is based upon the generally accepted assumption that a criminal statute

⁴¹ 406 F.2d at 303.

⁴² 262 F. Supp. 301 (S.D.N.Y. 1966).

⁴³ *Id.* at 304.

⁴⁴ *Id.* at 302, 304.

⁴⁵ 3 L. Loss, *Securities Regulation* 1785-88 (2d ed. 1961).

⁴⁶ Landis, *Liability Sections of Securities Act*, 18 *Am. Accountant* 330, 331 (1933).

establishes a standard of conduct, deviation from which constitutes negligence.⁴⁷ Because such statutes legislatively alter the existing standards of conduct, they should be interpreted as recognizing civil, as well as criminal liability. The court's willingness to accept civil suits based on section 17(a) is illustrated in *Dack v. Shanman*.⁴⁸ In this case, the plaintiffs sued under Sections 12 and 17(a) of the 1933 Act. The District Court for the Southern District of New York dismissed the claim based on section 12 because the one-year statute of limitations had run, but it did not dismiss the almost identical claim based on section 17(a) because, it held, this common law action was governed by the New York six-year statute of limitations.⁴⁹

If civil remedies based on deviations from the standards of conduct prescribed by section 17(a) are available, it must be determined whether punitive as well as actual damages should be awarded thereunder. Since, as discussed above, the section is ambiguous to the extent that different courts have interpreted it as both allowing and disallowing punitive damages, it would seem that the proper determination should turn upon what policies section 17(a) seeks to effect, and whether the use of punitive damages can be helpful in implementing those policies.

The use of punitive damages in addition to penal sanctions and actual damages has been severely criticized.⁵⁰ It has been said that where there is a multiplicity of plaintiffs bringing suits, the defendant would be forced to pay an unconscionable amount in the form of punitive damages.⁵¹ But this argument fails to take into account that most courts allow evidence of the defendant's financial position in order to ascertain a fair measure of punitive damages.⁵² In line with this policy, courts should, and probably would, initially charge the jury to make the following findings of fact: (1) whether there was any violation of Section 17(a) of the Act, (2) if so, the extent of the actual damages suffered by the plaintiffs, and (3) whether the violation of section 17(a) was willful. If the jury finds a willful violation, it would then have to determine whether to award punitive damages and, if so, in what amount. However, prior to being sent back with this question the defendant would be afforded the opportunity to present evidence as to any prior punitive damages awarded against him and his general financial situation. This information would allow juries to reach rational and fair judgments as to punitive damages.

The use of punitive damages under section 17(a) also has been criticized as tending to encourage a multiplicity of suits, with each plaintiff striving to commence his suit first so as to receive an award

⁴⁷ W. Prosser, *Law of Torts* 191-93 (3d ed. 1964).

⁴⁸ 227 F. Supp. 26 (S.D.N.Y. 1964).

⁴⁹ *Id.* at 30.

⁵⁰ Note, 82 Harv. L. Rev. 951 (1969); Note 54 Va. L. Rev. 1560 (1969).

⁵¹ Note, 82 Harv. L. Rev. 951, 957 (1969).

⁵² W. Prosser, *supra* note 47 at 14.

of punitive damages before the defendant's resources are depleted.⁵³ This encouragement to bring suit, however, is not an entirely undesirable goal because many violations causing small, individual financial losses to numerous plaintiffs might otherwise not be worth the expense of court proceedings to a single plaintiff. Moreover, if the primary purposes of punitive damages are to punish and to deter the wrongdoer, the fact that the first few plaintiffs might recover punitive damages while the others may not would not affect the accomplishment of that purpose. The additional compensation given to the initial plaintiff is merely a windfall.⁵⁴ The plaintiff's claim for punitive damages should be based upon the fact that potential wrongdoers should be deterred, and that the defendant's conduct warrants punishment rather than that the plaintiff is entitled to additional compensation.

It should be kept in mind that punitive damages would not be awarded merely on the finding that material information was omitted or misstated in a registration statement or prospectus. Juries would be instructed, after hearing evidence about the defendant's financial position and prior punitive damages, to award punitive damages only if the defendant's conduct was wilful and wanton, or, as the district court said in *Globus*, indicated "a high moral culpability."⁵⁵ This would be a stricter test than the "willfulness test"⁵⁶ of the 1933 Act on which simple actual damages may be based. Thus, the award of punitive damages for securities violations, if limited as suggested above, would increase the protection available to the buying public.

MARK P. HARMON

Products Liability—Statute of Limitations—Application of the Contract Statute of Limitations to a Cause of Action for Strict Liability in Tort—*Mendel v. Pittsburgh Plate Glass Co.*¹—In October, 1958 defendant Pittsburgh Plate Glass Company installed a glass door at the front entrance to the Rochester, New York building of the Central Trust Company. The Plaintiff, Cecile Mendel, alleged that on October 29, 1965, while walking through the door, it struck her causing her to fall and suffer personal injuries. In 1967 the plaintiff and her husband initiated an action against the Pittsburgh Plate Glass Company in which they alleged that a fault in the door caused the injuries.² Recovery was sought both on the theories of tort and contract.

⁵³ Note, 82 Harv. L. Rev. 951, 957 (1969).

⁵⁴ Comment, Exemplary Damages in the Law of Torts, 70 Harv. L. Rev. 517, 525 (1957).

⁵⁵ 287 F. Supp. at 193.

⁵⁶ Securities Act of 1933, § 24, 15 U.S.C. § 77yyy (1964).

¹ 25 N.Y.2d 340, 253 N.E.2d 207, 305 N.Y.S.2d 490 (1969).

² The plaintiff and her husband also initiated an action against the owners of the building, the Central Trust Company.