Securities Regulation -- Rule 10b-5 -- An Alternative to Scalping Palefaces Who Speak with Forked Tongues

Robert F. Price
fore the "control" language may not be interpreted as excluding propos-
als dealing with the racial policies of countries in which the issuer is
investing.

Despite the ambiguities in the new rule, it can probably be said that
it was intended to represent a liberalization of the political and social
exclusion of shareholder proposals. Aside from the question of whether
the SEC should have moved in this direction at all,\(^48\) the changes seem
to fail short of supplying a truly objective, workable guideline. It ap-
pears probable that, for the time being, the battle will shift from ques-
tions of whether a particular proposal stems from improper motives of
the shareholder or whether such improper motives dominate his inten-
tions to questions of whether the proposal is "significantly related to the
business of the issuer" or whether it is "within the issuer's control."

CHARLES E. MURPHY, JR.

Securities Regulation—Rule 10b-5—An Alternative to Scalping Pale-
faces Who Speak with Forked Tongues

To implement section 10(b) of the Securities Exchange Act of
1934,\(^1\) the Securities and Exchange Commission fashioned rule 10b-5,\(^2\)
which has become an expanding source of litigation for securities viola-

\(^1\)Section 10(b) 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 manip-
ulative or deceptive device or contrivance in contravention of such rules and regulations
as the Commission may prescribe as necessary or appropriate in the public interest or
for the protection of investors.


\(^2\)The rule provides:

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

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

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

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

tions. Although neither section 10(b) of the Exchange Act nor rule 10b-5 specifically provide for the initiation of private causes of action, the federal judiciary has interpreted the rule to afford a remedy for persons injured as a result of a 10b-5 violation. In addition to a flexible construction of rule 10b-5 permitting civil suits to be maintained by private individuals, many courts have begun to relax some of the restrictive elements of 10b-5 causes of action, which often resulted in dismissals because of the plaintiffs' failure to state a claim. Consequently, more plaintiffs suing under rule 10b-5 have been able to survive defense motions for directed verdicts and thereby enhance their prospects for favorable judgments. The remedies for violation of rule 10b-5 are not specified in the Exchange Act nor under rule 10b-5, so the courts have been faced with the problem of devising remedies for defrauded plaintiffs. In Affiliated Ute Citizens v. United States, the United States Supreme Court has solved part of the problem by formulating a rule on the issue of compensatory damages to private party sellers. This note will examine the alternative measures of damages that were available to the Court in arriving at a damage rule and will evaluate the Court's selection of a damage rule.

The Affiliated Ute case was initiated by mixed-blood Ute Indians who sought damages against the United States, the First Security Bank of Utah, and two assistant managers of the bank for alleged violation of rule 10b-5. Under a plan formulated by the mixed-blood Utes for the distribution of assets to the individual members of their group, the Ute Distribution Corporation (UDC) was formed specifically to manage

---


4Affiliated Ute Citizens v. United States, 92 S. Ct. 1456, 1472 (1972) (adoption of broad definition for materiality of misstatement and elimination of requirement of positive proof of reliance when there is a failure to disclose by one possessing such an affirmative duty); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 860 (2d Cir. 1968) (liberal construction of "in connection with" clause of rule 10b-5(e)); Texas Continental Life Ins. Co. v. Dunne, 307 F.2d 242, 249 (6th Cir. 1962) (abandonment of privity requirement).


692 S. Ct. 1456 (1972).

7Although rule 10b-5 applies to defrauded purchasers as well as to defrauded sellers, it is in the latter area that the Court has ruled on the damage issue. The scope of this note will be confined to 10b-5 actions brought by plaintiff sellers.

8The plaintiffs initiated the action, Reyos v. United States, in the United States District Court for the District of Utah, Central Division. Reyos v. United States, 431 F.2d 1337 (10th Cir. 1970).
mineral rights and unadjudicated claims against the United States under the Ute Partition Act. UDC issued ten shares of its capital stock in the name of each mixed-blood Ute, a total of 4900 shares. The assistant managers of the bank, retained as transfer agent for UDC, had developed and encouraged a market in the stock, but they failed to inform the plaintiff sellers that their shares were selling for a higher price in the market and that the managers were in a position to gain financially from the plaintiffs' sales. After a reversal by the Tenth Circuit of a generous award by the district court, the plaintiff Indians were granted a writ of certiorari by the United States Supreme Court.

In its decision, the Court affirmed the Tenth Circuit's refusal to award damages under the Tort Claims Act, since the government was under no duty to the plaintiffs. However, the Court held that the managers' acts were clearly within the scope of rule 10b-5 and that the bank's liability was coextensive with that of the assistant managers. Liability was predicated upon a relaxation of the requirement of positive proof of reliance. Recognizing the right of the plaintiffs to recover under rule 10b-5, the Court turned to the damage issue and made its first ruling on damages in a private action under rule 10b-5.

One recovery award available to private party sellers is rescission or damages equivalent to rescission. By rescinding the transaction, the defrauded seller would be made whole by a recovery of the securities which were sold as a result of the defendant's misrepresentation or failure to disclose. By recovering damages equivalent to rescission, the defrauded seller would be awarded the securities' current value at the time judgment is rendered upon tender of the sale price.


16Reyos v. United States, 431 F.2d 1337 (10th Cir. 1970).

18Affiliated Ute Citizens v. United States, 402 U.S. 905 (1971). The Reyos case was consolidated with another case, which centered on the Ute Partition Act, because of the issues for Indians whose federal supervision was in the course of termination. 92 S. Ct. at 1466.


20Id. at 1470. The Court reasoned that, since there was no governmental authority over the shares of UDC stock, there could be no liability on the part of the United States for failure to restrain a sale of the stock. Each mixed-blood could sell his shares as he wished and to whom he pleased, subject only to restrictions imposed by UDC's own articles.

21Id. at 1472.

22Id.

23Id.

24Id.

25Most 10b-5 cases turn on some material misrepresentation or on some failure to disclose. Even in cases which do not turn on misrepresentation or omission, these elements are almost invariably present. 2 A. Bromberg, Securities Law: Fraud § 8.2 (1971).
When the securities which the plaintiff was fraudulently induced to sell can be returned by the defendant at the same value at which the plaintiff sold the securities, both the fraudulent and defrauded parties can be returned to the status quo ante. However, the fair value of the securities at the time of the sale may have been greater than the value of the securities at the time of judgment, and the plaintiff would be in no better position after rescission than he enjoyed after the fraudulent conduct. For example, if defendant’s fraudulent conduct induced the plaintiff to sell Security X at ten dollars per share when Security X would have been selling at fifteen dollars per share in the absence of defendant’s fraud, and if Security X were selling at ten dollars per share at the time the judgment is rendered, rescission would return the parties to the status quo ante but would deprive the plaintiff of the value he should have received for his sale. In such a case, the injury to the plaintiff would not be rectified by rescission. The same is true when the value of the securities has fallen below the value at which the plaintiff sold. Indeed, rescission would then constitute a further injury to the plaintiff. Only when the current value of the securities is greater than the value at the time of the fraudulent transaction is rescission an attractive remedy to a 10b-5 plaintiff, since it affords the plaintiff a significant speculative advantage during the period within which an action might be brought.

Authority for allowing rescission in a 10b-5 cause of action is limited. In Parker v. Baltimore Paint & Chemical Corp., the court indicated that rescission was an available remedy so long as the plaintiff offered restoration of the consideration he received unless no consideration was received or unless the consideration received was worthless. However, the plaintiff’s failure to state a claim upon which relief could be granted precluded such relief in that action. Lanza v. Drexel & Co. is also indicative of a court’s willingness to allow rescission in a 10b-5 cause of action. The court held that sellers of stock who were deceived by the buyers were entitled to rescind the transaction.

When rescission is impossible because the defendant has resold the securities to an innocent third party, an economic equivalent of rescission affords a comparable remedy. A modification of this damage
formula was applied in Janigan v. Taylor,\(^2\) in which the court awarded to the plaintiff the defendant’s profit realized as the proximate consequence of the fraud\(^3\) even though resale of the securities was not planned at the time of the fraudulent purchase. The court did not go so far as to suggest that the defendant would be liable for a subsequent appreciation in value after his sale to an innocent third party,\(^4\) which would effectively give the plaintiff a “call” on the shares at the sale price until the statute of limitations has run against him.\(^5\) In this respect, the Janigan award is distinguishable from the “call” which would be created by an economic equivalent of rescission.

The situations in which a plaintiff might request rescission in a 10b-5 cause of action are limited, since an award of damages might be a more attractive alternative, as noted above, and since the defendant in a 10b-5 action need not have purchased the securities to be liable under the rule.\(^6\) Furthermore, a suit for rescission is subject to the equitable defenses of laches, estoppel, and waiver.\(^7\) Additionally, rescission may subject a defendant to unwarranted liability in view of the relaxation of the elements of a 10b-5 cause of action,\(^8\) and rescission gives to the plaintiff a speculative advantage he would not have enjoyed had he not sold the securities as a result of the fraud.

The most common judicial methods used to formulate 10b-5 awards for private party sellers\(^9\) have been the cover theory and the out-of-pocket theory. The cover theory results in an award representing the difference between the sale price of the stock and the amount necessary to repurchase (cover) the stock within a reasonable time after the seller has become charged with notice of the true facts about the stock.\(^0\) Under the out-of-pocket theory, the plaintiff is awarded the difference between the price he received and the real or actual value of the stock.

\(^{21}\)See note 21 supra.
at the date of sale. Both theories of recovery have been employed extensively with jurisdictional variations.

The historical development of the cover theory as a measure of damages began with the application of what has become known as the New York Rule. The United States Supreme Court adopted the New York Rule in Galligher v. Jones, in which the Court set the true and just measure of damages at the highest intermediate value of the stock between the time of conversion and a reasonable time after the owner of the stock received sufficient notice of the conversion to enable him to replace the stock. The cover theory has subsequently been applied to 10b-5 actions, such as Reynolds v. Texas Gulf Sulphur Co. The trial court applied the New York Rule to arrive at a damage formula based on the average of the highest daily price of the stock for twenty trading days after the misleading statement had been corrected. The average which the court adopted as the measure of damages was 50.75 dollars per share. The appellate court assessed the damages under the cover theory at fifty-nine dollars per share by calculating the highest value of the stock between the time disclosure was sufficient for a reasonable and diligent investor to be informed of the correction and a reasonable time thereafter during which the investor had an opportunity to decide whether or not to reinvest. Both the district and appellate courts attempted by their formulations to put the injured plaintiffs in the position they would have enjoyed if they had not sold at the time of the defendant's misleading statement.

An award based on the cover theory may be arbitrarily discriminatory in litigation arising out of a factual setting similar to Texas Gulf in which there are multiple plaintiffs. A wealthy plaintiff with surplus

---

32 The rule was initially enforced in Baker v. Drake, 53 N.Y. 211, 217 (1873), in an action brought for conversion. Valuation under the New York Rule has been subject to jurisdictional variation in applying the cover theory. Compare id. with Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90, 105 (10th Cir. 1971), cert. denied, 404 U.S. 1004 (1972).
33 129 U.S. 193 (1889). The Court adopted the rule as a compromise between an out-of-pocket rule, which would not adequately compensate a victim of conversion, and an economic equivalent of rescission, which would be too burdensome on a defendant who might have to wait several years before the action was tried.
34 Id. at 201.
36 446 F.2d at 105.
37 In this respect, the cover theory mirrors the purpose of rescission.
capital can evaluate the situation in light of the correction of the misstatement, decide that the wisest course is to reinvest, reacquire the stock within a reasonable period of time after the misstatement is rectified, and thereby take advantage of any subsequent rise in the price of the stock. On the other hand, an impecunious investor can draw the same conclusions but may be precluded from enjoying a subsequent rise in price. To illustrate, if the impecunious plaintiff sold Security Y at ten dollars per share because of some material misstatement and if the court, by applying a cover theory test for damages, determines that the plaintiff should have covered at twenty dollars per share to protect his interest in Security Y, the plaintiff will recover ten dollars per share. However, recovery will not permit the plaintiff to repurchase Security Y if, upon collecting the judgment at the conclusion of protracted litigation, Security Y is selling at thirty dollars per share.

Furthermore, in light of the liberalization of the “in connection with” clause of Rule 10b-5(c) and in light of the uncertainty of the scienter requirement as an element of a 10b-5 cause of action, the cover theory may subject a defendant to unwarranted liability.

A number of federal courts have recognized the out-of-pocket theory as an accurate measure of damages for 10b-5 violations. The out-of-pocket theory relieves the court of the speculative task of assessing the seller’s intentions regarding the disposition of the securities at some time subsequent to his actual sale. Likewise, the theory dispenses with the necessity to determine a reasonable period of time in which the seller would have, should have, or could have reinvested. More significantly, it places a limit on the liability of the defendant.

Despite these advantages, the out-of-pocket theory minimizes the deterrent quality of the Securities Exchange Act of 1934 and erodes the congressional purpose of achieving “a high standard of business ethics in the securities industry.” The out-of-pocket theory is, by itself, not sufficient to deter fraudulent conduct when the defendant retains the possibility of considerable gain from his misconduct. A fraudulent purchase at ten dollars per share of Security Z, which has an “actual value” of fifteen dollars per share, enables the wrongdoer to

---

30See note 4 supra.
retain any profit he may have realized as a result of a rise in the market price above fifteen dollars per share. To allow him to profit by his wrongdoing offends not only the congressional intent in the field of securities regulation but also basic equity principles.

It seems that the United States Supreme Court was cognizant of the advantages and disadvantages of the various damage theories when it made its initial ruling on damages in the Affiliated Ute case. The Court's measure of damages was the difference between the fair value of all the seller received and the fair value of what he would have received on the date of the sale had there been no fraudulent conduct, except that when the defendant received more than the seller's actual loss, damages are the amount of the defendant's profit.

In the Affiliated Ute case, the Court basically applied an out-of-pocket rule in arriving at the appropriate damages. However, the Court's damage rule is not limited only to this case or to a case with the same factual pattern. The Court's alternative damage formula encompasses all fact situations in which the defrauded seller can prove a 10b-5 violation. The rule need not be restricted to face-to-face transactions in insignificant markets; it is especially appropriate for securities listed on major exchanges, because a fair value is more easily determined by substantial trading after the misstatement or failure to disclose has been rectified.

By fashioning such a flexible damage rule, the Court has interpreted section 28(a) of the Securities Exchange Act of 1934 broadly.
enough to include an equitable remedy and thereby to effectuate the
deterrent value of the Act by requiring the wrongdoer to "disgorge his
fraudulent enrichment";\textsuperscript{49} yet, at the same time, the Court's interpreta-
tion of section 28(a) is not so broad as to subject defendants, as a group,
to unwarranted liability.

Because of the liberalization of the elements of a 10b-5 cause of
action,\textsuperscript{50} the class of potential defendants from whom an injured plaintiff
may recover is broader than the class of defendants from whom an
injured plaintiff may recover in a common law action. Moreover, be-
cause of the extremely liberal jurisdiction and venue requirements of the
Securities Exchange Act of 1934, the class of potential defendants in a
10b-5 action is more accessible than the class of potential defendants in
a common law action. For these reasons, it seems appropriate that the
Court limit the measure of damages in a 10b-5 cause of action. Such a
limitation does not preclude a plaintiff from pursuing an action at law
or in equity if the remedy he seeks is excluded in a 10b-5 action,\textsuperscript{51}
provided the plaintiff satisfies the more stringent elements of such a
claim.

In \textit{Affiliated Ute}, the Court has spoken in an area in need of
clarification, and by its ruling has paved the way for uniform, equitable
recovery in 10b-5 actions.

\textbf{ROBERT F. PRICE}


\textsuperscript{49} See note 4 supra.

\textsuperscript{50} See note 46 supra.

\textsuperscript{51} See note 46 supra.