The Role of Scienter and the Need to Limit Damages in Rule 10b-5 Actions--The Texas Gulf Sulphur Litigation

J. Kent Dunlap
University of Kentucky

Follow this and additional works at: https://uknowledge.uky.edu/klj
Part of the Jurisprudence Commons, and the Securities Law Commons
Right click to open a feedback form in a new tab to let us know how this document benefits you.

Recommended Citation
Available at: https://uknowledge.uky.edu/klj/vol59/iss4/7

This Note is brought to you for free and open access by the Law Journals at UKnowledge. It has been accepted for inclusion in Kentucky Law Journal by an authorized editor of UKnowledge. For more information, please contact UKnowledges@lsv.uky.edu.
Notes

THE ROLE OF SCIENTER AND THE NEED TO LIMIT DAMAGES IN RULE 10b-5 ACTIONS—
THE TEXAS GULF SULPHUR LITIGATION

One of the most complex and baffling areas of securities law is Section 10b of the Securities Exchange Act of 1934\(^1\) and controversial Rule 10b-5\(^2\) promulgated under it. This statute and rule deal with fraudulent and misleading practices in connection with the purchase or sale of securities. Since the Rule has been frequently used in cases involving small, closely held corporations, it is important that lawyers with corporate clients have some knowledge of 10b-5 jurisprudence.

A primary reason for the confusion surrounding 10b-5 litigation is that three distinct types of plaintiffs—the Securities and Exchange Commission [hereinafter SEC], private parties, and the corporation—are allowed to bring an action under the Rule. Although each type of plaintiff must frame his action within the same 10b-5 language, each has a unique reason for seeking relief. The SEC is concerned with protecting the public from violations of the securities laws and its primary remedy is an injunction. In contrast, the private party usually seeks monetary damages as compensation for the loss he suffered from the defendant's deception.

When one of the defendants is a public issue corporation, an additional consideration arises. Because of the many daily transactions in the stock of such a company, a corporation could become liable for a monstrous judgment if its conduct fell within the Rule's prohibition. Payment of the judgment would come from the assets of the company which means that the innocent stockholder would be ultimately the source of recovery. One case, which will be discussed at length subsequently, used a theory of liability which could result in damages of over 30 million dollars against the particular corporation if all potential plaintiffs were to bring suit. Due to this possibility of extensive liability, the development of a limiting doctrine seems necessary.

When the plaintiff is a corporation the same problem of unlimited liability exists if a public issue corporation is one of the defendants. Frequently, however, the corporate action takes the form of a minority

---

stockholder's derivative suit against the controlling interests of the company. When this occurs the danger arises that the complaint will essentially consist of allegations of bad business judgment and corporate waste against the insiders. Although Congress may have intended Section 10b to encompass a broad remedy, it is doubtful that it intended the federal courts to concern themselves with the business decisions of corporations. Since these cases do not seem to fall within the purpose of the Rule, a need arises to distinguish them from the other 10b-5 cases.

Because of the differences between each type of plaintiff, it is necessary to analyze 10b-5 cases with regard to which party is bringing the action. This article will examine the requirement of scienter\(^3\) as it affects each plaintiff in his efforts to prevail under the Rule. The need to limit damages in the private action will be discussed and the offered solution will be to require scienter and establish an alternative remedy of restitution in situations where the defendant has made a wrongful profit without deceitful intent. Due to the complex nature of the subject matter this note will begin by tracing the development of 10b-5 jurisprudence and then examine the rule of scienter in relation to each of the different types of plaintiffs.

I. 10b-5 Jurisprudence Becomes Perplexing

The stock market crash of 1929 and the Great Depression which followed served as a catalyst in the realignment of many economic facets of American life. One of the significant changes was the establishment of federal regulation in the securities industry. During the depths of the depression people were shaken by the disclosure that a few insiders in some of America's most respected corporations had escaped financial ruin through transactions based on knowledge not available to the general public.\(^4\) As a result of these disclosures, Congress passed the Securities Act of 1933\(^5\) and the Securities Exchange

---

\(^3\) Black's Law Dictionary 1512 (4th ed. 1968) defines scienter as "the defendant's previous knowledge of the cause which led to the injury complained of, or rather his previous knowledge of a state of facts which it was his duty to guard against, and his omission to do which has led to the injury complained of." Thus scienter is a broad term which connotes a knowing awareness of the wrongful activity. Frequently courts discuss the scienter issue in terms of whether proof of fraud is required. However, fraud, in its tort sense, requires proof of an intentional misrepresentation. See W. Prosser, The Law Of Torts § 100 (3d ed. 1964). Since scienter includes intentional nondisclosures its scope is considerably broader than a mere intent to defraud.


Act of 1934.6 Briefly, this legislation was designed to protect the investor, maintain integrity and honesty in the securities market, and curb "unnecessary, unwise, and destructive speculation." One of the practices prohibited by this legislation was the use of manipulative and deceptive devices in regard to security transactions. This prohibition was articulated by Section 10b of the 1934 Act as follows:

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 rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Eight years later the Securities and Exchange Commission exercised its rule making power9 and established the now famous Rule 10b-510 which provides as follows:

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 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.

For the first several years after the Rule was promulgated, few significant issues were raised under it. This peaceful situation was not to last, however, and soon the federal courts were asked such difficult questions as whether the Rule created a private right of action, whether a corporation could sue under the Rule, whether scienter was necessary to establish liability, and many other questions of a similarly complicated nature. When courts turned to the Rule to decide these issues, they discovered its general language provided

9 PAINTER, supra note 4, at 19.
little direction as to its specific requirements. Moreover, the legislative history of Section 10b proved so incomplete that a determination of congressional intent became a matter of conjecture. Due to this lack of guidance, the judiciary was forced to rely on its own sense of justice and fairness to determine the outcome of each case. As a result, 10b-5 jurisprudence has grown on a case by case basis in the same tradition as the common law.

Generally, the courts have assigned an expansive, liberal construction to the Rule. This trend was begun when it was decided that private parties had a right of action, later the Rule was further enlarged to include corporations within its protection. These decisions, along with the Securities and Exchange Commission's statutory right to sue, created a situation whereby three distinct types of plaintiffs could frame their suit under 10b-5. Because of the different motivation of each party and the need to limit actions by private and corporate litigants, the courts should have developed distinct legal principles for each action. Unfortunately this has not occurred due to several factors. The most obvious reason is that all three parties were bringing their actions under the same statute and rule. Once a court had decided a particular issue there was a natural tendency to carry over this interpretation into other areas of 10b-5 jurisprudence. Moreover, since the law developed on a case by case basis, the courts were never presented with an overview of the whole field of 10b-5 litigation. Compounding the judiciary's problems was the fact that the Supreme Court has considered only one 10b-5 case, which merely discussed a single minor point of law. Due to the Supreme Court's

12 Marsh, What Lies Ahead Under Rule 10b-5?, 24 Bus. Law. 69, 73, 74 (1968). Prof. Marsh cites three factors which he believes caused the courts to interpret 10b-5 broadly:
   (1) An increase in federalization and centralization
   (2) Greater judicial activism
   (3) The unwillingness or inability of states to enact fair and balanced laws protecting persons involved in securities transactions.
16 SEC v. National Securities, Inc., 393 U.S. 453 (1969). In this case the Commission sought relief for violation of 10b-5 in connection with a merger of Producers Life Insurance Co. into a subsidiary of National Securities, Inc. Shareholder approval of the merger was obtained through proxy material containing alleged misrepresentations and omissions.

The defendants argued that the McCarran-Ferguson Act, which forbids federal intervention into state regulation of the insurance field, barred the Commission's suit. Furthermore, the defendants contended that solicitation of proxies

(Continued on next page)
lack of leadership, the lower federal courts have been forced to try to anticipate the highest court's position by analogizing 10b-5 actions to other federal securities provisions which the Supreme Court has construed.

Besides failing to develop a comprehensive system of specific legal principles, the courts were sometimes unable to fully develop the narrow issues which were presented by the cases. One reason for this was the fact that so many 10b-5 cases arose on motions to dismiss for failure to state a claim. The courts usually interpreted these complaints liberally since the sole issue was whether the plaintiff would be allowed to bring his action. Upon sustaining the claim, the case was usually settled out of court and the judiciary was thereby denied the opportunity to pass on the end results. If the courts had had the benefit of seeing the effects of their holdings, 10b-5 jurisprudence would probably be much clearer today. Additionally, in the field of private litigation under the Rule, many of the cases involved private, closely-held corporations which therefore eliminated the limiting consideration of the innocent shareholder of the public issue corporation.

Finally, the courts have tended to avoid establishing strict criteria to allow themselves much greater flexibility in reaching their decisions. The history of the buyer-seller requirement illustrates this point. Originally it was required that a private party be a buyer or seller of securities before he could bring an action under the Rule.

(footnote continued from preceding page)

did not constitute a "purchase or sale" of securities and therefore § 10b and the Rule were inapplicable.

Speaking for the majority, Justice Marshall held that the McCarran-Ferguson Act did not bar the Commission's suit and that the proxy solicitation fell within the bounds of the Rule. In reaching this latter conclusion Marshall reasoned that if the scheme had worked the shareholders of Producers would have lost their shareholder status in that company in exchange for a similar status in the new company. Therefore, the effect of a successful merger would be a "purchase" by former Producers shareholders of stock in the new company. On this point Harlan dissented, arguing that only the issue of the McCarran-Ferguson Act was properly before the court. He contended that since any decision by the Supreme Court construing the Rule would be of great importance, the 10b-5 issue should be avoided until all sides of the question could be fully argued.

For the Supreme Court's first foray into the morass of 10b-5 litigation, this decision was disappointing. The opinion merely added another exception to the buyer-seller requirement without analyzing in depth the underlying theory behind this requirement. Justice Harlan was correct in approaching 10b-5 with caution, but if the court is too cautious it may never be able to assert the leadership necessary to alleviate the confusion surrounding the Rule.

17 Marsh, supra note 12, at 74. The author claims that the Supreme Court is the most logical candidate to restore order and predictability to 10b-5 cases. He concludes however, that the Court has neither the inclination nor the ability to perform such a task.

but subsequent decisions riddled this requirement with exceptions.\textsuperscript{19}

Because of the broad effect courts have been willing to give 10b-5, they have drawn fire from numerous persons.\textsuperscript{20} One unidentified writer summed up his feelings in an \textit{Ode to 10b-5} which reads as follows:

\begin{quote}
Can any man a prophet be
When dealing with the SEC?
Officer, lawyer, director beware
10b-5 is everywhere.

Even though the facts seem small,
You must disclose, you must tell all,
Now that you've done your very best,
A market bust may cause arrest.

Cause and effect don't seem to be
Important to all, but they ought to be.
There's no need to rely or even read,
The material test is all they need.

The state of the law is clear as can be,
Don't sell or buy a security.
Don't offer to merge or utter a word,
Unless you're prepared for liability transferred.

You may own a yacht, a house by the sea,
But you'll not have them long if you clash with 10b.\textsuperscript{21}
\end{quote}

It would be a hopeless task for one note to effectively cover all the issues which have arisen under the Rule. Therefore, such important issues as the buyer-seller requirement,\textsuperscript{22} definitions of insider,\textsuperscript{23}

\textsuperscript{19} SEC v. National Securities Inc., 393 U.S. 453 (1969); Mutual Shares Corp. v. Genesco, 384 F.2d 540 (2d Cir. 1967) (not necessary to be a buyer or seller in suits for injunctions); Vine v. Beneficial Finance Co., 374 F.2d 627 (2d Cir. 1967), \textit{cert. denied}, 389 U.S. 970 (1967) (short form merger qualified as a sale since the stockholder was forced to turn in his shares or receive nothing); Commerce Reporting Co. v. Puretec Inc., 290 F. Supp. 715 (S.D.N.Y. 1968) (an abortive purchaser was considered a "purchaser" for the purpose of the Rule).


\textsuperscript{22} Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir. 1952), \textit{cert. denied}, 343 U.S. 956 (1952); \textit{See also} cases cited at note 19 \textit{supra}; Note, 53 Cornell L. Rev. 684 (1968).

\textsuperscript{23} SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968); Matter of Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961) (An insider was defined as one who has "access directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone.").
and materiality,\textsuperscript{24} requirements of privity\textsuperscript{25} and reliance\textsuperscript{26} and liability for nondisclosure\textsuperscript{27} will not be discussed at length. As previously mentioned, the main focus of this article will be the role of scienter in 10b-5 cases and damages against a public issue corporation.

II. \textsc{Action by the SEC}

A. Injunction

As indicated in the introduction, the SEC could seek an injunction under Section 21(e) of the 1934 Act when it appeared that "any person is engaged or about to engage in any acts or practices, which constitute or will constitute a violation of the provisions of this chapter, or of any rule or regulation thereunder."\textsuperscript{28} This remedy is widely utilized by the Commission as indicated by the fact that it had obtained 1,614 injunctions against 5,022 defendants as of June 30, 1969.\textsuperscript{29} Because SEC injunctions are creatures of statutes, all that had to be established is what the statute required, without reference to proof of irreparable injury or the inadequacy of other remedies as in the usual suit for injunctions.\textsuperscript{30}

Besides lessening the requirements for an injunction by statute, the courts further extended its application by discarding scienter as a necessary element. This elimination was established by the Supreme Court in \textit{SEC v. Capital Gains Research Bureaus}\textsuperscript{31} where it interpreted the Investment Advisor's Act of 1940\textsuperscript{32} which was analogous to SEC actions under the Rule. In that case, Mr. Justice Goldberg dis-
tighstished sharply between damage proceedings and injunctions by saying:

It is true that at common law intent and injury have been deemed essential elements in a damage suit between parties to an arm's-length transaction. But this is not such an action. This is a suit for a preliminary injunction in which the relief sought is, as the dissenting judges below characterized it, the "mild prophylactic," requiring a fiduciary to disclose to his clients, not all his security holdings, but only his dealings in recommended securities just before and after the issuance of his recommendations.

The content of common law fraud has not remained static as the courts below seem to have assumed. It has varied, for example, with the nature of the relief sought, the relationship between the parties, and the merchandise in issue. It is not necessary in a suit for equitable or prophylactic relief to establish all the elements required in a suit for monetary damages.33

This elimination of the scienter requirement was followed by the Second Circuit in the now famous Texas Gulf Sulphur case.34 In that case the SEC brought an action for an injunction and damages against Texas Gulf Sulphur and nine insiders. Since the damages were sought under the Commission's auxiliary power, which will be examined subsequently, only the factual setting relating to the injunction will be discussed here. Texas Gulf Sulphur had made extensive copper and zinc discoveries in Northern Canada and rumors of this large strike had begun to circulate throughout Canada and the United States which caused a rise in the company's stock prices.35 On April 12, 1964, Texas Gulf Sulphur issued a press release playing down the recent discoveries which caused stock prices to drop.36 Four days later the company announced the discovery of at least 25 million tons of ore.37 The SEC subsequently brought an action to enjoin the defendants from issuing further misleading statements. The trial court found that the issuing of the April 12th press release was not in violation of the Rule because it was not issued for the purpose of benefiting the corporation, there was no evidence that any insider used the release to his personal advantage and it was not "misleading or deceptive" on the basis of the facts then known.38 The Second Circuit reversed the lower court's findings saying that the proper test was whether the release was misleading because of the company's

34 SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968).
35 Id. at 843-45.
36 Id. at 845-46.
37 Id. at 846.
lack of due diligence. As to whether proof of scienter was necessary, Judge Waterman, who wrote the majority opinion, seemed to feel that neither SEC actions nor private actions required such proof.

Whether the case before us is treated solely as an SEC enforcement proceeding or as a private action, proof of a specific intent to defraud is unnecessary.

However, Judge Friendly, who concurred in the result, pointed out his concern over finding damages against a corporation for a negligent misrepresentation.

The consequences of holding that negligence in the drafting of a press release such as that of April 12, 1964, may impose civil liability on the corporation are frightening. As has been well said, of a situation where time pressures and consequent risks were less, "One source of perplexity as to the appropriate bounds of the civil remedy for misleading filings is that any remedy imposed against the issuer itself is indirectly imposed on all holders of the common stock, usually the most important segment of the total category of investors intended to be protected."

On remand, Judge Bonsal of the Southern District of New York determined that the press release was misleading, and that there was a lack of due diligence on the part of Texas Gulf Sulphur in drafting it. He decided that an injunction against the company was unnecessary, however, because of the "once in a lifetime" nature of the circumstances. Of the seven individual defendants, Judge Bonsal found that four of them had violated the Rule only because the test of materiality had been expanded (they had purchased shares before the April 12th press release) and another was no longer associated with the company. For these reasons an injunction was denied against these defendants. As to the two defendants who had purchased stock just before the April 16th announcement, he found that their action was wrongful even under the previous case law, and therefore enjoined them.

From the foregoing, it seems clear that courts will not entertain the defense of lack of scienter in SEC enforcement proceedings. The fairness of this result is verified when the interests of the SEC and

---

40 Id. at 854 (footnote omitted).
41 Id. at 866-67 (citations omitted).
43 Id. at 86.
44 Id. at 88.
45 Id. at 90.
defendant are analyzed. Since an injunction will lie only if a defendant has already violated the Rule or a violation is imminent, the injunction serves as an excellent method to put the defendant on notice of the seriousness of his actions. To require the Commission to prove scienter would seem to unduly burden the SEC in its efforts to enforce the securities laws.

B. Ancillary Relief

Although the Securities Exchange Act of 1934 authorized the SEC to seek injunctive relief to enforce the securities laws, nowhere was the Commission empowered to obtain money damages.48 The courts, however, have held that when an injunction has been sought under Section 21e, they may use their inherent power to grant all the equitable relief necessary under the circumstances.49 The judiciary predicted its power to grant such relief on Section 27 of the Act50 which states:

The district courts of the United States . . . shall have exclusive jurisdiction of violations of this chapter or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this chapter or the rules and regulations thereunder.

Until recently the precedent for granting the Commission money damages stemmed from two sources. The first source was a few cases in which the courts, under their ancilliary powers, granted the SEC's request for appointment of a receiver.51 The other source was based on instances where courts had granted similar relief to other federal agencies under analogous statutes.52 Since neither of these authorities were directly in point, it was not until Texas Gulf Sulphur that the right of the SEC to seek damages was clearly established. There, in addition to injunctive relief, the Commission asked for rescission and restitution with the recovery to the sellers who actually sold their shares to the individual defendants.53 The trial court found that, although the drilling was commenced on November 8, 1963, the drilling results were not "material" until April 9, 1964.54 For this reason,

49 Id. at 946.
51 Comment, supra note 48, at 946.
those insiders who made their purchases before that date were not liable. Of the nine individual defendants only two were found to be in violation of the Rule because they had purchased their shares immediately before the April 16th announcement which had disclosed the extent of the ore strike.\textsuperscript{55} On appeal, the Second Circuit chose to adopt a more liberal "reasonable investor" test for materiality\textsuperscript{56} and found liability as to those insiders who purchased their shares after the preliminary drilling results indicated a substantial strike.\textsuperscript{57} The court did not distinguish the injunction portion of the suit from the damages portion in holding that scienter was not required for either. This elimination of the scienter requirement for damages was reasonable because the damages which were sought were wrongful profits derived from insider trading. Since the defendants' dealings were illegal, it should not have been necessary to prove an evil intent before they were ordered to give up their profits.

On remand to determine the proper remedies, the SEC abandoned its first approach which asked for rescission and restitution for the benefit of those sellers who actually sold their shares to insiders. Undoubtedly, two considerations influenced the SEC in changing its approach. The first was the difficulty in tracing the stock purchases,\textsuperscript{58} and second, was the initiation of numerous private suits\textsuperscript{59} which indicated that the private investor who sold to an insider did not need the Commission to protect his rights. As an alternative to its original approach, the SEC asked that the defendants be required to disgorge any profits they had made from the wrongful trading in Texas Gulf Sulphur securities. Judge Bonsal granted the Commission's request and adopted its formula for assessing damages which was as follows:

In applying the formula, the SEC proposes that the amount to be paid by each defendant would be the difference between the mean average price of TGS common stock on the New York Stock Exchange on April 17, 1964, which has been stipulated by the parties to be 40%, and the purchase price of their shares, and in the case of calls, the aggregate of the purchase price and the cost of exercise, with interest from April 17, 1964, at the New York legal rate.

The payment would be made to TGS to be held in escrow in an interest-bearing account for a period of three or more years, subject to disposition in such manner as the court might direct upon application by the SEC or other interested person or on the

\textsuperscript{55} Id. at 296.
\textsuperscript{56} SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968).
\textsuperscript{57} Id. at 847-57.
court's own motion. At the end of the period any money remaining undisposed of would become the property of TGS. 60

The reason for making the damages payment to Texas Gulf Sulphur to be held in escrow was undoubtedly to help the company pay off the numerous claims by private parties which had been filed. Because of the extensive use of the private action by investors, it remains to be seen how frequently the SEC will invoke the court's ancillary powers and request damages. Certainly today the investor needs little help from the SEC in enforcing his rights under Rule 10b-5. Perhaps if the Commission had anticipated the landslide of private litigation in the Texas Gulf Sulphur case, it would have foregone its request for damages. If, however, the courts adopt the theory which is urged in this article and limit plaintiffs to either damages which were intentionally caused, or to recovery of wrongful profits from defendants who lacked the requisite scienter, then a damage action by the SEC could become significant. Under this theory there would be many cases where the damages which would be recoverable by private parties could also be recovered by the SEC. In these cases, allowing the Commission to seek damages could enable all the claim to be consolidated into one action, which would greatly simplify procedure since the multiplicity of suits arising under the same circumstances would be eliminated.

In retrospect, the development of ancillary relief is still too recent to make an accurate prediction as to its impact on 10b-5 jurisprudence. However, as long as the private plaintiff is given an extensive remedy under the Rule, a damage action by the SEC appears to have limited utility.

III. Private Action

Today the right of a private party to sue under the Rule is clearly established. The first case to decide this issue was Kardon v. National Gypsum Company 61 and this result has been sustained by numerous

61 73 F. Supp. 798 (E.D. Penn. 1947). In this case Judge Kirkpatrick found that a private right of action existed under Rule 10b-5 for two reasons. First he reasoned that since Section 29(b) of the Securities Exchange Act declared that any contract in violation of any provision of the Act shall be void, it necessarily followed that a remedy must be implied along with it. Without this implied remedy the statute would be of little consequence since a party could not relieve himself of obligations under it or escape its consequences.

The second theory advanced by Judge Kirkpatrick, the so-called "statutory tort theory" was undoubtedly the more significant of the two theories in the development of 10b-5 jurisprudence. He reasoned that § 10b and the Rule created a duty to behave within the expressed standard of conduct. Therefore it followed that an individual who disregarded the command of the statute committed a tort.
lower federal courts. In addition, the Supreme Court in *J. I. Case Company v. Borak* held that Section 14a of the 1934 Act concerning misleading proxy solicitations created a private remedy and by analogy this holding can be applied to 10b-5 actions.

With the decision that 10b-5 created a private right, it was inevitable that the courts would have to decide what role scienter would play in these cases. For the purpose of this discussion, those decisions which have indicated that scienter is required will be analyzed separately from those that have not.

A. Decisions Requiring Scienter

The first case to consider the role of scienter in a private action under the Rule was *Fischman v. Raytheon Manufacturing Company.* In that case the common stockholders brought an action under 10b-5 alleging that they were persuaded to buy stock in the defendant corporation by misstatements and omissions in a prospectus covering only preferred stock. The district court dismissed their claim, reasoning that since their action was based on allegedly false statements in a prospectus, Section 11 of the Securities Act of 1933 constituted their exclusive remedy. Since relief under that Section was limited to buyers purchasing the stock issue covered by the prospectus, the court held that the plaintiffs had failed to state a cause of action. The Second Circuit reversed and stated:

... when, to conduct actionable under § 11 of the 1933 Act, there is added the ingredient of fraud, then that conduct becomes action-able under § 10b of the 1934 Act and the Rule, ... 

Unfortunately, the court did not elaborate on what it meant by "ingredient of fraud."

The rationale of *Fischman* was followed by a New York federal district court in *Weber v. C.M.P. Corporation,* and the test was articulated as "knowledge of the falsity of the alleged untrue state-

---

62 377 U.S. 426 (1964). In this case the Supreme Court was faced with the issue of whether § 14(a) and the Rule 14a-9 concerning misleading proxy solicitations created a private remedy. The court disregarded the statutory tort theory and instead based its opinion allowing the private suit on the broad remedial purpose of the Rule. Thus when the Supreme Court finally decides whether 10b-5 creates a private remedy, it may sustain the action by relying on the broad remedial purpose of the Rule rather than the statutory tort theory.

63 188 F.2d 783 (2d Cir. 1951).


65 Fischman v. Raytheon Mfg. Co., 188 F.2d 783, 787 (2d Cir. 1951) (emphasis added).

Outside of several New York district court decisions which followed Fischman, only one court outside the Second Circuit has taken a similar position. In Trussell v. Underwriters, the federal district court of Colorado held that two of the plaintiffs' claims were insufficient since they did not allege that the misstatements were made "knowingly or intentionally." It added, however, that a representation made with reckless disregard of truth or falsity would satisfy this requirement. A year later this same court reaffirmed its position in Parker v. Baltimore Paint and Chemical Corporation, despite a seemingly binding opinion by the Tenth Circuit indicating that proof of common law fraud was unnecessary under Section 10b and the Rule. The court merely avoided the higher court's precedent by characterizing that portion of the decision which eliminated scienter as dictum.

B. Decisions Eliminating Scienter

The first significant case to hold that scienter was not required by Rule 10b-5 was Ellis v. Carter. In that case a plaintiff-buyer sought to recover damages caused by allegedly fraudulent misrepresentations. The defendants resisted the action by arguing that 10b-5 offered no right of recovery to defrauded buyers. The court rejected this defense and stated that a showing of common law fraud was not essential to establish a cause of action under the Rule. In eliminating scienter as a requirement, the court used language which implied that proof of a "mere misstatement or omission" was all that was necessary to establish liability. Under this interpretation even innocent, nonnegligent misstatements or omissions would be actionable under the Rule.

The Tenth Circuit adopted the Ellis approach in Stevens v.

---

67 Id. at 323.
70 Id. at 773.
71 Id. at 772.
72 244 F. Supp. 267 (D. Colo. 1965).
73 Stevens v. Vowell, 348 F.2d 374 (10th Cir. 1965).
75 291 F.2d 270 (9th Cir. 1961).
76 In this case the plaintiff claimed that the defendants sold him 10,000 shares of Republic Picture Corporation by fraudulently representing that the stock carried with it a voice in the management. Upon buying in, the plaintiff was excluded from any say in the management of the company.
77 Ellis v. Carter, 291 F.2d 270, 274 (9th Cir. 1961).
Vowell,\textsuperscript{78} a case in which the defendants' behavior was particularly outrageous.\textsuperscript{79} In this case the court eliminated the requirement of scienter by saying:

It is not necessary to allege or prove common law fraud to make out a case under the statute and rule. It is only necessary to prove one of the prohibited actions such as the material misstatement of fact or the omission to state a material fact.\textsuperscript{80}

Since this language fails to distinguish between material misstatements and omissions which are negligently made and those which are made innocently, it could be argued that under the Stevens approach defendants are held to a strict liability. The value of this case as precedent, however, is dubious since in Parker a district court circumvented this portion of the opinion by characterizing it as dictum.

Although the Seventh and Eighth Circuits looked upon Ellis with favor in dicta,\textsuperscript{81} the only case in which the decision can be said to have been based directly on Ellis is Hendricks v. Flato Realty Investments.\textsuperscript{82} In that case the district judge relied on Ellis to reject a motion to dismiss for failure to allege scienter and simply stated that he felt it was the most "logical approach."\textsuperscript{83}

The more recent cases have been careful to exclude innocent misrepresentation or omission from 10b-5 protection. In Drake v. Thor Power Tool Company,\textsuperscript{84} the plaintiff alleged that he had purchased securities in reliance on false figures in Thor's financial statements. The district judge discussed Ellis and stated that under that case "even due care is no defense to an action under Rule 10b-5."\textsuperscript{85} Had the court followed this approach the plaintiff could have recovered by only proving that the statements were material and false. The court, however, rejected strict liability and held that only intentional or negligent misrepresentations were in the ambit of the Rule.\textsuperscript{86}

The Eighth Circuit, which had previously looked upon Ellis favorably,\textsuperscript{87} altered its approach somewhat in City National Bank v. Vander-
boom. In this case the court rejected strict liability and held that a defendant would not be liable under the Rule unless his "misrepresentation or nondisclosure was made with scienter or from a lack of due diligence."

Although some cases have articulated the test in terms of strict liability, for misrepresentation or omissions, no faultless defendant has ever been held to have violated 10b-5. In both Ellis and Stevens the courts were faced with intentional misrepresentations and recovery could have been sustained in an interpretation requiring scienter. It appears that in cases eliminating scienter as a requirement, the more reprehensible the conduct of the defendant is, the broader the reading of 10b-5 will be. When the courts have to squarely face the issue of whether innocent defendants can be held liable, they will probably follow the example of the district judge in Drake and require that at least negligence be proved.

C. Damages Against a Corporate Defendant

The cases which have just been discussed indicate the conflicting and confusing positions of courts on the role of scienter in private actions under the Rule. However, in actions to assess damages against a public issue corporation these cases may be dubious precedents. All but two of the cases which have just been examined arose on motions to dismiss for failure to state a claim. Because of this, the courts did not have to consider the extent of potential liability. In the future, courts may be more hesitant to speak on matters which they have not fully considered. In Heit v. Weitzen the Second Circuit was asked to dismiss a complaint on the grounds that it failed to allege scienter. The court wisely avoided the issue by saying:

There is no occasion for us to enter this thicket now as we pass only upon the legal sufficiency of the complaints to allege a

---

38 422 F.2d 221 (8th Cir. 1970).
39 Id. at 230.
40 See the fact pattern of each case, supra notes 76 & 79.
41 In Stevens v. Vowell, 343 F.2d 874 (10th Cir. 1965), the plaintiff had received a judgment and in City National Bank v. Vanderboom, 422 F.2d 221 (8th Cir. 1970), the 10b-5 issue was raised on an unsuccessful counterclaim. Because of this the trial court dismissed the complaint on the ground that the fraudulent scheme was aimed at the government and not purchasers of stock. Because of this the district judge felt the complaint did not satisfy the "in connection with the purchase or sale of any securities" requirement of 10b-5. The Second Circuit reversed, holding that it was foreseeable that investors would rely on the false information and that "ulterior motive" was irrelevant.
claim for relief. This each of the complaints fairly does. The charge that defendants knew or should have known adequately alleges actual knowledge of the falsity of the statements, and alternatively, negligence or lack of diligence in failing to ascertain the true facts.\footnote{Id. at 914.}

Because courts have not had the opportunity to consider the role of scienter simultaneously with the issue of damages, the outcome of this situation remains an open question. Ultimately it is likely that this issue will be settled by the private litigation surrounding the Texas Gulf Sulphur case. The major private suit arising from this case is presently pending in the Southern District Court of New York. In that case, a class action was brought against Texas Gulf Sulphur representing all the investors who had been damaged by the company's nondisclosure and misleading press release. Although a final decision has not been reached, Judge Bonsal has issued a preliminary ruling in which he granted a summary judgment in favor of TGS against all plaintiffs who sold their stock before March 27, 1964.\footnote{Astor v. Texas Gulf Sulphur Co., 306 F. Supp. 1333, 1338-39 (S.D.N.Y. 1969).} He based his decision on the fact that before March 27th the company was on a land acquisition program and therefore news of the discovery had to remain secret.

Although the bulk of the litigation surrounding Texas Gulf Sulphur has occurred in the Second Circuit, one district court outside that circuit has rendered a decision in a private action against the corporation. In Reynolds v. Texas Gulf Sulphur\footnote{309 F. Supp. 548 (D.Utah 1970).} four plaintiffs brought an action in the Utah federal district court alleging that they had sold their TGS stock because of the defendant's nondisclosure and misleading April 12th press release. The plaintiffs sold their stock on the following dates: Karlson—Dec. 11, 1963, Reynolds—April 21, 1964, Stout—April 21, 1964, and Mitchell—April 17, 1964 and April 23, 1964. On April 16, 1964 the company fully disclosed the large extent of the strike. The district judge dismissed the claim of the plaintiff who sold on Dec. 11, 1963 since the company was on a land acquisition program which would have been thwarted by a disclosure of the strike.\footnote{Id. at 558-59.} Thus, on this point, the decision agreed with Judge Bonsal's preliminary ruling that business considerations justified the initial nondisclosure of the discovery.

As to the other three complainants, however, it was a different story. Each plaintiff testified that he had been induced to sell his
shares by a misleading press release of April 12th despite the fact that most of the sales came after the April 16th announcement disclosing the ore strike. The district judge held that the April 12th press release was “misleading, intentionally deceptive, inaccurate and knowingly deficient in material facts pertaining to the results of the drilling.” Since the plaintiffs had relied on the release, he concluded, the corporation was liable for damages.

In ascertaining the extent of damages the court developed a unique formula. It began its determination by saying the plaintiffs should receive the “fair value” of the property which they had transferred. Principles of restitution and conversion were cited to support this proposition. The court found the “fair value” by taking the average of all of the highest market prices on the 20 trading days preceding the April 16th announcement. The average was $50.75. To determine his damages, each plaintiff subtracted his selling price from $50.75, (this ascertained his damage per share), and then multiplied by the number of shares he had sold. Between the three claimants the damages totaled $21,702.25 plus interest from the date the shares were sold.

This case presented a different approach to the Texas Gulf Sulphur case in several respects. For one, the district judge characterized the April 12th press release as intentionally misleading which contrasted with the implication of Judge Friendly that the deception stemmed from negligence. Since the violation was declared intentional, Reynolds did not decide whether negligence alone would satisfy the requirements of the Rule. Another surprise was the finding of liability for sales which were consummated several days after the company had made a full disclosure. Thus under the Reynolds approach, once a misrepresentation has been made, the accumulation of potential damage actions does not necessarily cease upon correction of the mistake.

Perhaps the most significant aspect of the Reynolds case, however, is the position on damages. The use of the restitution and conversion principles to establish the nature of damages appears to be clearly inappropriate. The remedy of restitution is designed to prevent unjust

97 Id. at 562.
98 Id. at 564-65.
99 Id. at 565.
100 SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 866-67 (2d Cir. 1968).
101 In SEC v. Texas Gulf Sulphur Co., 312 F. Supp. 77, 93 (S.D.N.Y. 1970), Judge Bonsal adopted the SEC formula for damages which set April 17th as the date from which damages could be measured; Ruder, supra note 20, at 429. In his article on potential damages under the Rule, which was written before Reynolds, Prof. Ruder omitted even considering that liability might be extended beyond the disclosure date.
enrichment and the measure of recovery is not the plaintiff's damage but the benefit secured or reaped by the defendant at the expense of the plaintiff. Since TGS did not purchase the plaintiff's shares, it received no benefit from the sale and should not be liable to them under a theory of restitution. In conversion, the defendant must have exercised dominion or control over the plaintiff's property so as to require a "forced sale" to the defendants. Although the wrongdoer is required to pay "fair value" for the converted property he does retain possession of that property and thereby the harsh aspect of the remedy is mitigated. In Reynolds, since Texas Gulf Sulphur had never acquired the plaintiff's shares, compelling it to pay the fair value of the stock would force the company to pay for something it never possessed. Because the plaintiff's shares did not number among the corporation's assets the mitigating aspect of a true conversion case is not present and the affect of the remedy is extremely harsh. For these reasons, the underlying theories on which the "fair value" formula was based seem to be inapplicable.

Undoubtedly the most amazing feature of the Reynolds opinion was the extent of potential liability for which the corporation could become responsible. To reiterate, the court held that investors who relied on the April 12th press release and sold their shares for less than its fair value ($50.75) could recover from the company the difference between their selling price and its fair value. If the closing price on the New York Stock Exchange is taken as an approximate average for each trading day, then it is revealed that between April 12th through April 27th (11 trading days) the prices received for TGS shares were substantially below the $50.75 fair value price. The chart reproduced below demonstrates the monstrous liability which would occur by applying the Reynolds formula to all potential plaintiffs trading on the New York Stock Exchange.

On ten of the eleven trading days Texas Gulf Sulphur was among the ten most actively traded stocks on the New York Stock Exchange. By subtracting the average price from $50.75 the damages per share are determined and when this figure is multiplied by the number of shares traded it is found the company's potential liability is $30,978,554.

103 Id. at 88-84.
104 It must be kept in mind that these figures reflect only the transactions on the New York Stock Exchange. Since undoubtedly numerous TGS securities were traded on other exchanges liability will be even greater than the computed figure. Moreover, interest charges have not been figured in this calculation although interest was granted in Reynolds. The illustrated totals were compiled from the Wall Street Journal.
Had a liability of this extent been assessed in 1964, which is when the cause of action arose, the judgment would have amounted to approximately 23 percent of the total shareholder's equity.\(^{106}\) In addition to the huge potential liability to which the corporation was subjected, the district court made it extremely easy for a plaintiff to qualify as an investor who relied on the misleading information. In Reynolds, one plaintiff could not even recall where he had heard the misrepresentation.\(^{107}\) Therefore, in cases in which the misleading nature of a corporate announcement is revealed to the public, numerous buyers or sellers of its securities will undoubtedly be able to convince themselves that they were motivated to buy or sell by the rumor which had been invidiously circulated by the company, while in reality the announcement will have had little to do with the transaction.

The Reynolds case illustrates the need for judicial restraint when assessing the damages of a few plaintiffs against a public issue corporation. If several parties are allowed to recover against the company, class actions representing thousands of investors would undoubtedly be initiated giving rise to a potentially enormous judgment. Since private actions such as Reynolds are essentially suits between innocent parties—the misled investor and the shareholders—care must be taken to protect the interests of both to the greatest extent possible.

### D. An Alternative to Unlimited Liability

When considering the degree to which liability should be extended in private 10b-5 actions, it is important to distinguish between these

---


cases and tort actions in which the corporation is sued vicariously. A corporation can foresee liability for the torts of its employees and it can purchase insurance to cover these situations. By purchasing insurance it thereby distributes the loss to the general public. On the other hand, it is impossible for a corporation to treat liability imposed by 10b-5 as a mere cost of doing business. For one thing, the situations are often unique and therefore difficult to foresee. In the Texas Gulf Sulphur case for instance, Judge Bonsal aptly characterized the nature of the circumstances which led to the violation as "once in a lifetime." Furthermore, even if the damages could be foreseen no insurance company would assume a risk for which there was no ceiling as to damages. For these reasons private actions under the Rule present a unique problem and the judiciary is in the unenviable position of having to decide in some cases which of two innocent parties will bear the loss for misstatements or omissions by a corporation.

In order to limit the liability in the private action, it is the position of this Note that scienter should be required. By limiting damages in this way, the corporations would still be deterred from intentional violation of the Rule and the injured investor would be compensated for his loss. On the other hand, the assets of the corporation would be safe from mere negligent violations of the Rule which would protect the innocent shareholder from diminution of his investment. Thus, by requiring scienter, the courts could protect the interests of both the investor and the shareholder. In situations such as Reynolds, where deciding whether the defendant possessed the requisite scienter is difficult, the court should consider the potential liability of the corporation if it finds scienter.

In addition to requiring scienter in private 10b-5 actions, an alternative remedy of restitution should be utilized in cases where benefits have inured to the corporation or insiders through an unintentional violation of the Rule. Restitution is designed to avert unjust enrichment and is uniquely applicable to these cases because proof of scienter is unnecessary. Since the measure of damages is the defendant's gain, this remedy can be used to retrieve wrongful gains stemming from unintentional violations without jeopardizing the general assets of the corporation. Where restitution is used to recover wrongful benefits received by the corporation or insiders, recovery should be distributed equally to all injured investors rather

---

110 RESTATEMENT OF RESTITUTION § 28 (1935).
than to only those who had specific dealings with the wrongdoer. This would eliminate the difficult problem of tracing and prevent the situation where some investors would receive full recovery while others would receive nothing due to purely fortuitous circumstances.

In situations where the corporation has corrected misleading information, liability should not be extended past the date which the corrected information could reasonably be disseminated to the public. If an investor claims justifiable reliance on public statements in his securities trading then it is not unreasonable to expect him to be informed of the latest information. By not extending liability beyond this point, the corporation would be encouraged to correct public misrepresentations since such corrections would terminate further liability. Furthermore, courts would be spared the impossible task of determining whether the plaintiff relied on the misleading statement before hearing of the correction.

Some might argue that if plaintiffs are limited to damages caused by intentional violations of the Rule or to a recovery of benefits inuring to the corporation or insiders the law would then unduly limit the recovery of the misled investor. However, one of the primary purposes of the law is to strike a balance between competing interests in order to maximize justice in each given situation. If the injured investor is allowed full recovery under all circumstances, then his interest would prevail in every instance and the interest of the shareholder would always be disregarded. Thus the affect of full recovery by the investor in all situations could create as much inequity as before the Rule was promulgated. Hopefully as the courts become deeper embroiled in the Texas Gulf Sulphur litigation this will become more apparent.

Whether these proposals are ever incorporated into 10b-5 jurisprudence is a matter of pure conjecture at present. The issue of scienter in regard to the private action is in such a muddled state that it will probably take a decision by the Supreme Court to clear it up. The remedy of restitution has not yet been utilized in 10b-5 cases; since most decisions have gone the plaintiffs way, the establishment of an alternative theory of recovery has been unnecessary. However, if recovery is limited to violations of 10b-5 involving scienter, then restitution could become highly significant.

IV. CORPORATE RIGHT OF ACTION

Since the corporation was the last party to receive the right to sue under Rule 10b-5, the courts have not yet fully developed the applicable principles in this form of action. The judiciary has seldom
discussed the role of scienter in the corporate cases so its ultimate impact on 10b-5 jurisprudence remains nebulous. Nevertheless, this section will examine the circumstances in which a corporate action may arise and attempt to determine the role which scienter seems to play.

It becomes apparent upon reviewing the corporate cases that often the nature of these actions is essentially the same as the private action, differing only in that a corporation, rather than an individual, is the plaintiff. This results from the simple fact that corporations can undertake the same investment programs as individuals and therefore are as likely to be injured by 10b-5 violations as private parties. Undoubtedly if a list were made of all the investors who relied on the misleading press release of Texas Gulf Sulphur, a number of corporations would be included. In these situations where the complexion of the corporate action is substantially identical with the private action the same problems arise. Where the defendant is a public issue corporation there is a danger of diluting the innocent shareholder's equity regardless of whether the plaintiff is a corporation or a private investor. Therefore it is the position of this Note that the corporate plaintiff should be limited to damages involving scienter in the same manner as the private party. Moreover, an alternative remedy of restitution should be established to recover benefits inuring to the defendants.

An example of the similarity between many corporate actions and private actions is the comparison between Hooper v. Mountain States Securities Corporation,\(^\text{111}\) which was the first case to extend 10b-5 protection to corporations, and Errion v. Connell,\(^\text{112}\) which was a private action. In Hooper, a trustee in bankruptcy brought an action for the corporation against certain outside interests who had fraudulently induced the company to exchange its shares for allegedly worthless consideration. The court held that the broad purpose behind the Rule indicated an intent to include "a person who parts with stock owned by him as the result of fraudulent practices wrought on him by his purchaser."\(^\text{113}\) Moreover, within the meaning of the Rule a "person" included a corporation and its issuance of shares was a "sale."\(^\text{114}\) In Errion, an eighty-year-old widow was persuaded to trade stock and real estate worth $124,000 for 125 acres of Oregon tidelands. The defendants had fraudulently represented the values of

\(^{111\text{ }}\)282 F.2d 195 (5th Cir. 1960).
\(^{112\text{ }}\)286 F.2d 447 (9th Cir. 1956).
\(^{113\text{ }}\)Hooper v. Mountain States Securities Corp., 282 F.2d 195, 202 (5th Cir. 1960).
\(^{114\text{ }}\)Id. at 200-08,
the tidelands at $150,000 when in actuality it was only worth $12,500. The Ninth Circuit held that Section 10b gave it jurisdiction over the whole transaction even though some of the property which the plaintiff transferred consisted of nonsecurities. Once this jurisdictional issue was decided the court had no hesitancy in affirming a substantial judgment against the defendants for a violation of 10b-5. Thus in both cases the plaintiff was fraudulently induced to trade his valuable securities for inadequate consideration and was allowed to recover under the Rule.

There is one instance, however, where the corporate action is substantially different from the private action. This is the situation where a shareholder has brought a derivative suit against the controlling interests of the corporation. Needless to say most of the reported corporate plaintiff cases are of this nature. Due to the uniqueness of the 10b-5 derivative suit, the remainder of this section on the corporate action will be devoted solely to this form of action.

In these derivative suits there is seldom concern about harming the innocent shareholders of a corporate defendant. There is, however, another consideration which must be taken into account when dealing with these cases. Since these actions are usually initiated by minority shareholders, some of the cases have involved, essentially, disagreements over the business affairs of the company. Since in 1934 Congress rejected a federal licensing provision for corporations which would have regulated all intracorporate activity, an extension of federal law into day to day corporate affairs would seem to contravene congressional intent. Therefore the courts have been careful to exclude complaints of negligent mismanagement, corporate waste and breach of fiduciary duty from 10b-5 protection.

When the results of the derivative suits are examined it becomes apparent that liability is not forthcoming unless scienter is proved. This stems from the fact that 10b-5 does not cover the daily management of the corporation. In order to sustain an action under the Rule, the corporation must usually prove a fraudulent or deceptive scheme by insiders to take advantage of their positions to benefit themselves. As soon as the allegations drift outside the area of fraud, the suit invariably becomes a case of negligence and corporate waste relating to the business decisions of the company and hence falls outside 10b-5 protection.

---

115 Errion v. Connell, 236 F.2d 447, 451 (9th Cir. 1956).
116 Id. at 455.
Illustrative of the judiciary's refusal to bring disputes over corporate business decisions within the Rule's dominion are *Lester v. Preco Industries*,\(^{118}\) and *Carliner v. Fair Lanes*.\(^{119}\) In *Lester*, the plaintiff complained of numerous incidences of corporate mismanagement which occurred after the corporation had allegedly issued false statements to spur the sale of its stock. The court dismissed the claim finding that the essence of the allegations was negligent mismanagement. The judge explained that these incidents did not fall within the bounds of 10b-5 by saying:

> Every one of these allegations is a typical, common law charge of breach of fiduciary duty in the management of a corporation, and is not normally covered by the securities laws. The sale of the securities is only incidental to a major mismanagement issue. Each item complained of occurred after the filing of the registration statement and the issuance of the prospectus and the sale of the stock.\(^{120}\)

In *Carliner*, a shareholder of Fair Lanes brought an action against the controlling interests of the corporation. The complaint alleged that the defendants had violated 10b-5 by agreeing to repurchase stock owned by one of the insiders at its market value. It was alleged that the repurchase was not in the best interests of the corporation even though the price was admittedly fair and the transaction was not deceitful. The court dismissed the complaint and indicated that such transactions were outside the Rule using the following language:

> Despite the general principle that Courts will not ordinarily inquire into questions of business judgment by corporate directors, this Court would hold, if the question were before it, that the complaint in this case alleges a sufficient breach of the fiduciary duty owed by the directors of the corporation under State law to require defendants to answer to a complaint based upon State law. But no jurisdiction based upon diversity of citizenship is claimed or exists in the instant case. To sustain jurisdiction under section 10b of the Securities Exchange Act of 1934 plaintiff must allege facts amounting to deception. . . \(^{121}\)

Needless to say, it is not always easy to distinguish between fraudulent or deceptive schemes and other forms of mismanagement. In order to examine the relevant factors involved in making this determination three contrasting cases in the Second Circuit will be discussed.

---

In *Ruckle v. Roto American Corporation*,¹²² it was alleged that a majority of the board of directors withheld financial statements from others at the meetings to enable them to buy treasury stock of the corporation at an arbitrarily set low price to ensure their control of the company. Despite the fact that the minority interests on the board could not have prevented the transaction if the facts had been disclosed, the Second Circuit held that the plaintiff stated a cause of action for injunctive relief under the Rule and characterized the nondisclosure as "fraud" upon the corporation.¹²³

Within weeks the same court was faced with *O'Neill v. Maytag*,¹²⁴ where a stockholder in National Airlines complained of an exchange of stock between National and Pan American Airways, in which the value of the Pan Am shares given up by National was in excess of the value of the National shares received. It was alleged that the unfavorable ratio represented a premium paid by the defendant board of directors to eliminate the threat those shares posed to their control of National. The exchange had been ordered by the Civil Aeronautics Board due to its findings that cross-ownership of domestic airlines was not in the public interest.¹²⁵ The court held that a breach of "general fiduciary duties where the breach does not involve deception" did not fall within the bounds of Rule 10b-5.¹²⁶ The court, therefore, implied that the whole board could not deceive the corporation.

In order to reconcile these two cases it is necessary to examine what the court perceived to be the underlying nature of the action. In *Ruckle* it was alleged that there was a scheme by insiders to purchase securities at an arbitrarily set low price to maintain control of the company. Under the circumstances the court had no trouble characterizing the plan as fraudulent and therefore within the bounds of 10b-5. On the other hand, in *O'Neill* the court felt that while the premium paid by National may have amounted to a breach of the defendant's "general fiduciary duty," it did not constitute "deception" and therefore was outside the protection of the Rule. Although not emphasized, perhaps a significant reason for the court's decision was the fact that the stock exchange was motivated by the order of the Civil Aeronautics Board. The controversy stemmed from a disagreement over the way in which this exchange was carried out. For the court to have adjudicated this matter it would have had to inquire

¹²² 339 F.2d 24 (2d Cir. 1964).
¹²³ Id. at 27.
¹²⁴ 339 F.2d 764 (2d Cir. 1964).
¹²⁵ Id. at 766.
¹²⁶ Id. at 767.
into the business considerations which the defendant board of directors weighed in reaching its decision. This the court was not willing to do.

Several years after Ruckle and O'Neill, the Second Circuit was called on to decide the complex case of Schoenbaum v. Firstbrook. In that case Acquitaine Company acquired control of Banff Oil Ltd. and placed three nominees on Banff's eight member board of directors. Shortly thereafter, Acquitaine and Banff entered into a partnership agreement under which Banff would explore for oil in Canada sharing the costs and ownership rights with Acquitaine. On December 11, 1964, the Banff board of directors voted to offer 500,000 shares of Banff treasury stock to Acquitaine at the then market price of $1.35 per share, supposedly to finance Banff's share of the exploration expenses. It was alleged however that Banff only needed $77,500 for this purpose. The purchase was approved by Acquitaine on January 5, 1965, announced to the public on January 26, 1965, and actually consummated by delivery of the stock on March 16, 1965. The discovery of oil, however, had previously been made on February 6, 1965. In November, 1965, Paribas Corporation, an investment banking corporation, negotiated a purchase of 270,000 shares at $7.30 a share, the then current price on the Toronto Stock Exchange. However, once the public announcement of the oil discovery was disclosed in 1966, Banff stock traded at prices as high as $18 a share.

Subsequently, a Banff shareholder brought a derivative action against Acquitaine, Banff's board of directors and Paribas alleging that they had taken advantage of their controlling position. The trial court granted the defendants motion for summary judgment holding that the court lacked jurisdiction over the subject matter due to the foreign nature of the corporations and that a cause of action could not be maintained where affirmative deception of the decision-making body had not been alleged. On appeal before a three judge panel, the jurisdictional finding was reversed, but the court affirmed the district court's ruling that a cause of action under the Rule was not stated.

127 405 F.2d 215 (2d Cir. 1968) (en banc).
128 Id. at 217.
129 Schoenbaum v. Firstbrook, 405 F.2d 200, 204-05 (2d Cir. 1968) (panel).
130 Schoenbaum v. Firstbrook, 405 F.2d 215, 217-18 (2d Cir. 1968) (en banc).
131 Id. at 218.
132 Schoenbaum v. Firstbrook, 405 F.2d 200, 205 (2d Cir. 1968) (panel).
133 Id. at 205.
134 Schoenbaum v. Firstbrook, 405 F.2d 215, 218 (2d Cir. 1968) (en banc).
136 Id. at 393, 396.
137 Schoenbaum v. Firstbrook, 405 F.2d 200, 218-14 (2d Cir. 1968) (panel).
On rehearing en banc, the court reversed as to Acquitaine and the Banff board of directors and affirmed as to Paribas.138 Speaking for the majority, Judge Hays stated that no action existed against Paribas since the negotiations for the purchase of the stock were at "arms length" and it was not in a position to influence the judgment of the Banff directors.139 With regard to Acquitaine and the Banff directors, however, Judge Hays concluded that a cause of action had been stated against them under 10b-5. He seemed to rest his opinion on two grounds. First, that an improper use of "controlling influence" to effect a stock transfer for "wholly inadequate consideration" constituted a violation of subdivision (3) of the Rule which outlawed practices operating as a "fraud or deceit."140 Second, if the allegations were true, Acquitaine and the Banff directors would be "guilty of deceiving the stockholders of Banff."141 Apparently forgotten was the implication of O'Neill that a whole board of directors could not deceive the corporation.

The defendants attempted to justify the sale to Acquitaine by arguing that the sale was entered into before the results of the oil exploration were known. Judge Hays countered this argument by saying it was uncertain whether a binding contract existed before the discovery was made and therefore "further investigation" was necessary.142 Moreover, the argument that the sale was a business necessity was negated by the fact that only $77,500 was spent for exploration while the sale amounted to $675,000.143 Therefore, this case involved much more than a controversy over the business decisions of the company or negligent mismanagement. Rather, at issue was whether the defendants would be allowed to siphon off profits from the corporation they controlled.

By holding that improper exercise of "controlling influence" to effect an unfair purchase of stock ran afoul of the Rule, Schoenbaum substantially enlarged the scope of 10b-5 since deception did not seem to be necessary to constitute a violation. Under this new "fraud or deceit" theory the emphasis was placed on whether the controlling interests used their influence to effect an unfair sale of corporate securities to themselves rather than if the corporation was mislead through misrepresentations or nondisclosures. The refusal of the court to distinguish between simple power plays by controlling

138 Schoenbaum v. Firstbrook, 405 F.2d 215, 219 (2d Cir. 1968) (en banc).
139 Id. at 219.
140 Id. at 219-20.
141 Id. at 220.
142 Id. at 220.
143 Id. at 218.
interests and deceptive schemes by those interests was reasonable since both activities accomplish the same purpose. In order to achieve this result oriented approach the court avoided a strict construction of the Rule's language. This straining of the 10b-5 language reflected the federal judiciary's lack of confidence in the adequacy of state law to protect the rights of minority shareholders.

The Schoenbaum case indicates that the scienter requirement of the derivative suit is not necessarily limited to an intent to defraud in its narrow common law sense since misrepresentation by the defendant is not required. Instead, the Rule only requires that the controlling interests intentionally misuse their position to reap wrongful benefits through securities transactions with the corporation. Therefore, the scienter requirement is satisfied once this wrongful scheme is proven, regardless of whether the controlling interests used misrepresentation or deception to accomplish their purpose.

The derivative cases which have just been cited illustrate that, as a practical matter, proof of intentional wrongdoing is necessary even though the courts have not formally stated that these cases require scienter. The situations in which scienter is lacking invariably involve various forms of negligent mismanagement which fall outside the bounds of 10b-5. By requiring proof of an intentional scheme, the courts have effectively established reasonable boundaries in the 10b-5 derivative suit.

V. CONCLUSION

By allowing three different parties—the SEC, private parties and the corporation—to bring an action under the Rule, the courts inadvertently made 10b-5 jurisprudence perplexing. Each party sought to utilize this remedy for his own purpose and a need therefore arose to analyze each type of action in light of the interests and goals of the parties.

The SEC needed a flexible remedy to enable it to protect the public from violations of the Rule. This flexible remedy would be greatly curtailed if scienter were required. Moreover, no desirable social policy would be accomplished by such a requirement. Therefore the courts were wise in not requiring scienter in these cases.

The private party sought redress for the injuries he sustained as the result of the defendant's violation of the Rule. Frequently the plaintiff's loss corresponded exactly with the defendant's gain and full recovery could be granted without fear of injury to innocent parties. In some cases involving public issue corporations, however, the plaintiff's loss far exceeded the gain received by the corporation or
insiders. To grant full relief in these cases would work a great
detriment to the innocent shareholder since his equity in the corpora-
tion would be diluted. The private actions which discuss the role of
scienter are conflicting and the role which it will ultimately play is
uncertain. It is the position of this Note that scienter should be
required in these cases and an alternative remedy of restitution
should be established in order to effect a reasonable compromise be-
tween the injured investor and the shareholder.

The corporation sought recovery for injuries it had sustained by
the defendant’s violation of the Rule. In some cases, the nature of
the corporate action was similar to the private action and the same
problem of unlimited liability presented. Therefore, it was the
position of this Note that in these cases the corporate plaintiff should
also be required to prove scienter or proceed under the alternative
theory of restitution. There was, however, one instance where the
corporate action was completely different from the rest of 10b-5
jurisprudence. This was the 10b-5 derivative suit. When a scheme
was shown to exist by the controlling interests to wrongfully extract
benefits from the company through stock transfers, the derivative
suit was generally allowed. The opposite result was reached in
negligent mismanagement cases since these cases fell outside the
bounds of Rule 10b-5. Thus in effect, courts interpreted a scienter
requirement into the derivative action.

Hopefully, the courts in the future will focus on the differences of
each type of action so that clear, sound law can be developed.

J. Kent Dunlap