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I. Rule 10B-5

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1975-1976 SECURITIES LAW DEVELOPMENTS

I. RULE 10b-5

A. Scienter

In recent years, confusion has arisen regarding the proper standard of culpability—scienter[1]—to be applied in actions under Rule 10b-5.[2] The courts have differed primarily on the issue of the ade-

[1] Scienter refers to the degree of culpability necessary for liability under the federal securities laws. In the securities fraud context, scienter can refer to a number of degrees of culpability. The least degree of fault is negligence, generally termed a lack of due diligence or unreasonable conduct. Batchelor v. Legg & Co., 52 F.R.D. 545, 549 (D. Md. 1971). The next higher degree is recklessness, defined as a failure or refusal to ascertain material facts when readily available. Cohen v. Franchard Corp., 478 F.2d 115, 123-24 (2d Cir.), *cert. denied*, 414 U.S. 857 (1973). The two highest degrees of culpability are knowledge and intent to defraud. *See* 2 A. BROMBERG, SECURITIES LAW: FRAUD, SEC RULE 10b-5, § 8.4 (1973) [hereinafter cited as BROMBERG]. The term does not refer to the common law meaning of conscious intent to defraud. *See, e.g.*, Globus v. Law Research Serv., Inc., 418 F.2d 1276 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970). For an historical discussion of the scienter requirement in the context of Rule 10b-5, see Bucklo, *Scienter and Rule 10b-5*, 67 Nw. U.L. REV. 562, 598-600 (1972) [hereinafter cited as Bucklo]. *See also* Kohn v. American Metal Climax, Inc., 458 F.2d 255, 312-16 (3d Cir.), *cert. denied*, 409 U.S. 874 (1972).

[2] The Seventh and Eighth Circuits have allowed recovery under Rule 10b-5 upon proof of negligence. *See, e.g.*, Hochfelder v. Ernst & Ernst, 503 F.2d 1100 (7th Cir. 1974), *rev'd*, 96 S. Ct. 1375 (1976); Vanderboom v. Sexton, 422 F.2d 1233, 1239 (8th Cir.), *cert. denied*, 400 U.S. 852 (1970). The Ninth Circuit opted for a flexible duty standard, under which negligence would sometimes constitute the appropriate scienter standard. *See* White v. Abrams, 495 F.2d 724 (9th Cir. 1974), *noted in* 32 WASH. & LEE L. REV. 99 (1975). The Second and Fifth Circuits have required proof of at least recklessness. *See, e.g.*, Sargent v. Genesco, Inc., 492 F.2d 750, 761 (5th Cir. 1974); SEC v. North Am. Research & Dev. Corp., 424 F.2d 63 (2d Cir. 1970). The Third and Fourth Circuits, although declining to determine a minimum standard, have indicated that actual knowledge would constitute sufficient scienter. *See* Carras v. Burns, 516 F.2d 251 (4th Cir. 1975); Rochez Bros. v. Rhoades, 491 F.2d 402, 407 (3d Cir. 1974). The Tenth Circuit has stated that it would require more than mere negligence to meet its scienter standard. *See* Clegg v. Conk, 507 F.2d 1351 (10th Cir. 1974), *cert. denied*, 422 U.S. 1007 (1975). Yet the Supreme Court in *Ernst & Ernst, infra* note 4, noted that few cases holding negligence sufficient involved only negligent conduct. 96 S. Ct. at 1381 n.12. *See* Smallwood v. Pearl Brewing Co., 489 F.2d 579, 606 (5th Cir.), *cert. denied*, 419 U.S. 873 (1974); Kohn v. American Metal Climax, Inc., 458 F.2d 255, 286 (3d Cir. 1972) (Adams, J., concurring); Bucklo, *supra* note 1, at 568-70 (1972).

Many commentators have stated that negligence should not constitute a sufficient culpability standard. *See* 3 L. Loss, SECURITIES REGULATION 1766 (2d ed. 1961); 6 *id.*, at 3883-90 (Supp. 1969); Bucklo, *supra* note 1, at 596-97; Ruder, *Civil Liability Under Rule 10b-5*, 57 Nw. U.L. REV. 627, 678 (1963); Note, *Civil Liability Under Section 10B and Rule 10B-5: A Suggestion for Replacing The Doctrine of Privity*, 74 YALE L.J. 658, quacy of negligence as a culpability standard.[3] The United States Supreme Court virtually resolved this issue in *Ernst & Ernst v. Hochfelder*[4] by holding that a private cause of action for damages would not lie under Rule 10b-5 absent allegations of intent to deceive, manipulate or defraud.[5] In determining that negligence is not a sufficient standard of culpability, the Court added another substantial barrier to the plaintiff's right of action under the Rule.[6] Together with *Blue Chip Stamps v. Manor Drug Stores,*[7] *Ernst & Ernst* indicates an effort by the Supreme Court to restrict the growth of Rule 10b-5 liability in recent years.

Ernst & Ernst involved a suit against an independent auditing firm for aiding and abetting securities fraud through inaction. The defendant, Ernst & Ernst, had failed to investigate the primary wrongdoer's office rule forbidding the opening of his mail. The stockholder plaintiff maintained that this "mail rule" was a material inadequacy in internal accounting controls which the defendant had a duty to investigate.[8] Ernst & Ernst's failure to investigate and report the "mail rule" allegedly aided and abetted a Rule 10b-5 violation. The district court's summary judgment in favor of Ernst & Ernst was reversed by the Seventh Circuit.[9] The circuit court reasoned that if the defendant breached a duty of inquiry and disclosure owed to the plaintiff, the latter could recover by demonstrating a causal connection between the breach and the underlying fraud.[10]

682-89 (1965); Note, *Scienter and Rule 10b-5*, 69 COLUM. L. REV. 1057, 1080-81 (1969); 82 HARV. L. REV. 938, 947 (1969). *But see* Note, *Negligent Misrepresentations Under Rule 10b-5*, 32 U. CHI. L. REV. 824, 839-44 (1965).

[3] *See* note 2 *supra*.

[4] 96 S. Ct. 1375 (1976).

[5] *Id.* at 1381.

[6] The Supreme Court also sharply limited the scope of Rule 10b-5 in Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975), upholding the Rule's purchaser-seller requirement. *See Survey of 1974 Securities Law Developments*, 32 WASH. & LEE L. REV. 719, 742-50 (1975).

[7] 421 U.S. 723 (1975).

[8] Hochfelder v. Ernst & Ernst, 503 F.2d 1100, 1109 (7th Cir. 1974), *rev'd*, 96 S. Ct. 1375 (1976).

[9] In an unreported opinion, the district court rejected Ernst & Ernst's contention that a cause of action for aiding-abetting a securities fraud could not be maintained under § 10(b) and Rule 10b-5 merely on allegations of negligence. It concluded, however, that there was no genuine issue of material fact with respect to whether Ernst & Ernst had conducted its audits in accordance with generally accepted auditing standards. Civ. No. 71 C 454 (N.D. Ill. Aug. 1, 1973).

[10] 503 F.2d at 1104. In support of this holding, the Seventh Circuit cited its decision in Hochfelder v. Midwest Stock Exch., 503 F.2d 364 (7th Cir.), *cert. denied*, 419 U.S. 875 (1974), where it detailed the elements necessary to establish a claim under

In overturning the Seventh Circuit decision, the Supreme Court first addressed an argument concerning the language of § 10(b) of the 1934 Act,[11] upon which Rule 10b-5[12] is based. The Securities Exchange Commission in its amicus curiae brief maintained that the words "manipulative or deceptive" in conjunction with the "device or contrivance" language were not particularly enlightening in determining the scienter standard intended by Congress. To support this contention, the SEC cited the overall congressional purpose in the 1933 and 1934 Acts to protect investors from false and deceptive practices that might injure them.[13] In view of this purpose and because the effect upon investors would be the same regardless of whether the fraudulent conduct is negligent or intentional, the SEC concluded that Congress must have meant to bar all such conduct.

Rule 10b-5 based on a defendant's aiding and abetting a securities fraud solely by inaction. In such a case, the plaintiff must show "that the party charged with aiding and abetting had knowledge of or, but for the breach of a duty of inquiry, should have had knowledge of the fraud, and that possessing such knowledge the party failed to act due to an improper motive or breach of a duty of disclosure." *Id.* at 374. In *Ernst & Ernst*, the court explained that these elements constituted a flexible standard of liability which should be amplified according to the peculiarities of each case. 503 F.2d at 1104.

[11] 15 U.S.C. § 78j (1970). Section 10 makes it:

> unlawful for any person . . . (b) [t]o use or employ, in connection with the purchase or sale of any security . . . 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.

Id.

[12] SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (1975), provides:

> Employment of manipulative and deceptive devices. 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,
>
> (1) to employ any device, scheme, or artifice to defraud,
>
> (2) 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
>
> (3) 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.

Id.

[13] 96 S. Ct. at 1383. *See* Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972); Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 11-12 (1971); J. I. Case Co. v. Borak, 377 U.S. 426, 432-33 (1964). *See also* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 195 (1963).

The Court was not persuaded by this effect-oriented approach, however, finding that the statutory language clearly reflected congressional intent to proscribe only knowing, intentional misconduct designed to deceive investors.[14] Moreover, the Court noted that this approach, applied to its fullest extent, would impose liability for wholly faultless conduct.

The SEC also argued that because § 10(b) is not by its terms explicitly restricted to willful, knowing or purposeful conduct, it should not be construed in all cases to require more than negligence as a precondition for civil liability.[15] The Court refuted this argument, recognizing that in each instance where Congress created express civil liability in the securities laws, it clearly specified whether recovery was premised upon knowing or intentional conduct, negligence, or mere mistake.[16] Additionally, each of the express civil remedies in the 1933 Act allowing recovery for negligent conduct[17] is subject to important procedural restrictions not applicable under § 10(b).[18] The Court determined that permitting a negligence standard for § 10(b) actions would nullify the effectiveness of the carefully drawn procedural restrictions on the express actions granted elsewhere in the securities laws. In the Court's opinion, to allow such circumvention would be contrary to congressional intent.[19]

The majority likewise rejected a flexible construction of § 10(b)

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[14] 96 S. Ct. at 1383-84. *See* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 868 (2d Cir. 1968) (Friendly, J., concurring), *cert. denied*, 394 U.S. 976 (1969); Loss, *Summary Remarks*, 30 BUS. LAW. 163, 165 (1975). *See also* Kohn v. American Metal Climax, Inc., 458 F.2d 255, 280 (3d Cir. 1972) (Adams, J., concurring).

[15] The SEC contrasted § 10(b) with § 9 of the1934 Act, 15 U.S.C. § 78i (1970), which explicitly requires intentional conduct, 15 U.S.C. § 78i(e) (1970).

[16] 96 S. Ct. at 1384. *See* §§ 11, 12 and 15 of the 1933 Act, 15 U.S.C. §§ 77k, *l*, o (1970), and §§ 9, 18 and 20 of the 1934 Act, 15 U.S.C. §§ 78i, r, t (1970). Section 11, for example, expressly recognizes a cause of action premised on negligent behavior by an expert in preparing registration statements.

[17] Sections 11, 12(2) and 15, 15 U.S.C. §§ 77k, *l*, o (1970). Each of the provisions of the 1934 Act that expressly creates civil liability, *see* note 21 *infra*, requires a higher degree of culpability than negligence.

[18] For example, § 11(e) of the 1933 Act, 15 U.S.C. § 77k(e) (1970), authorizes the court to require a plaintiff bringing a suit under §§ 11, 12(2) or 15 thereof to post a bond for costs. *Id.* Section 13, 15 U.S.C. § 77m (1970), imposes a one-year statute of limitations from the time the violation was or should have been discovered. *Id.*

[19] 96 S. Ct. at 1384. *See* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 867-68 (2d Cir. 1967) (Friendly, J., concurring), *cert. denied*, 394 U.S. 976 (1969); Fischman v. Raytheon Mfg. Co., 188 F.2d 783, 786-87 (2d Cir. 1951); Rosenberg v. Globe Aircraft Corp., 80 F. Supp. 123, 124 (E.D. Pa. 1948); R. JENNINGS & H. MARSH, SECURITIES REGULATION 1070-74 (3d ed. 1972); 3 L. LOSS, SECURITIES REGULATION 1787-88 (2d ed. 1961).

under the pretext of effectuating the securities laws' remedial purposes.[20] The Court recognized that Congress, in seeking to accomplish broad remedial goals, did not uniformly adopt a negligence standard even as to express civil remedies.[21] Instead, it fashioned standards of culpability on a section-by-section basis. Since the Court had already determined that the language of § 10(b) did not contemplate a negligence standard, the "remedial purpose" argument could not stand.

The Court also scrutinized the legislative history of the 1934 Act to ascertain congressional intent on the negligence issue. Although the history contained no explicit discussion of the intended scope of § 10(b), one statement made by a spokesman for the drafters of § 10(b) evinced that the section was to enable the SEC "to deal with new manipulative devices."[22] The Court expressed doubt "that any lawyer, legislative draftsman or legislator would use these words if the intent was to create liability for merely negligent acts or omissions."[23]

The majority found further support for its conclusion in the legislative reports. Although the reports did not directly address the scope or function of § 10(b), they did indicate that liability would not result from specific manipulative practices which did not involve intent to defraud.[24] The Court interpreted this as indicating congressional reluctance to impose a lesser standard under § 10(b).[25]

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[20] 96 S. Ct. at 1384. *See* Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972), *quoting* SEC v. Capital Gains Research Bureau, Inc. 375 U.S. 180, 186 (1963).

[21] 96 S. Ct. at 1384. In some circumstances, Congress did create express liability predicated upon a failure to exercise reasonable care. *See, e.g.*, § 11(b)(3)(B) of the 1933 Act, 15 U.S.C. § 77k(b)(3)(B) (1970) (liability of experts for misleading statements in portions of registration statements for which they are responsible). Elsewhere, however, good faith is an absolute defense. *See, e.g.*, § 18 of the 1934 Act, 15 U.S.C. § 78r (1970) (misleading statements in any document filed pursuant to 1934 Act). In a third set of circumstances, Congress created strict liability. *See, e.g.*, § 11(a) of the 1933 Act, 15 U.S.C. § 77k(a) (1970).

[22] This description was made by Thomas G. Corcoran in the Hearings on H.R. 7852 and H.R. 8720 before the House Comm. on Interstate and Foreign Commerce, 73d Cong., 2d Sess. 115 (1934).

[23] 96 S. Ct. at 1385.

[24] *See* S. REP. No. 792, 73d Cong., 2d Sess. 6 (1934). The Report addressed certain practices which required express prohibition, such as "wash sales," and "matched orders," 15 U.S.C. § 78i(a)(1) (1970), and other practices like option grants and security price stabilization, which were left to regulation by the SEC. Even in the discussion of the latter type of practice, no indication could be found that liability was to attach without intent to defraud. Moreover, with respect to the specified practices, the Report indicated that private actions for damages would exist only when the defendant did not act in good faith. S. REP. No. 792, 73d Cong., 2d Sess. 11-12 (1934). *See* H. REP. No. 1838, 73d Cong. 2d Sess. 10-11, 20-21 (1934).

[25] 96 S. Ct. at 1386.

The final argument posed by the SEC was that subsections (2) and (3) of Rule 10b-5[26] could be read as proscribing any type of material misstatement or omission and any course of conduct which would defraud investors. The Court responded by holding that the scope of the Rule could not exceed the power granted the SEC by Congress under § 10(b). Since § 10(b) speaks specifically in terms of manipulation and deception and of implementing devices and contrivances—commonly understood terminology of intentional wrongdoings—and since its history reflects no more expansive intent, the Court was unwilling to extend the scope of the Rule to include negligent conduct.[27]

Despite an extensive examination of statutory language and history, *Ernst & Ernst* does not completely resolve the issue of scienter in Rule 10b-5 litigation. First, the Court specifically refused to address the issue of whether reckless behavior is sufficient for civil liability under § 10(b) and Rule 10b-5.[28] This may be significant, because in some cases the difference between standards of negligence and recklessness is slight.[29] Indeed, the failure of the accountant in *Ernst & Ernst* to discover the "mail rule" may constitute a reckless violation as well as a negligent one. In light of the Court's recent reluctance to broaden the class of plaintiffs in Rule 10b-5 litigation,[30]

[26] *See* note 12 *supra*.

[27] 96 S. Ct. at 1391. The Court was also unwilling to extend the class of potential plaintiffs in Rule 10b-5 litigation, an inevitable result under a holding approving a negligence standard. Such a holding would extend the hazards of rendering expert advice under the securities laws to new frontiers and raise serious policy questions not yet addressed by Congress. 96 S. Ct. at 1391 n.33.

[28] 96 S. Ct. at 1381 n.12. *See* note 1 *supra*.

[29] The reckless disregard standard was recently applied by a district court in the Second Circuit in Herzfeld v. Laventhol, Krekstein, Horwath & Horwath, 378 F. Supp. 112 (S.D.N.Y. 1974). *Herzfeld* involved a qualified auditor's report of a corporation that was misleading to investors. *Id.* at 125. In creating a test for liability, the court stated that the culpability standard for failure to discover omissions or misrepresentations was willful, deliberate or reckless disregard for the truth. This standard includes failure or refusal to discover and report material facts when readily available and when there is reason to believe they exist. *See* Cohen v. Franchard Corp., 478 F.2d 115, 123 (2d Cir.), *cert. denied*, 414 U.S. 857 (1973). While the *Herzfeld* court's knowledge standard included liability for a reckless failure to discover fraudulent conduct, and is thus distinguishable from negligence, the application of such a standard to circumstances involving independent auditors may reach negligence. This recklessness, or inquiry-notice, standard is important for an accountant who will be aware of many material facts. If he should ignore even one of them, such as the "mail rule" in *Ernst & Ernst*, then arguably there is a reckless violation. Under such circumstances, the distinction between recklessness and negligence virtually disappears.

[30] 96 S. Ct. at 1391 n.33; Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 747-48 (1975).

however, the future vitality of the recklessness standard is questionable. To be successful, a plaintiff suing under a recklessness theory[31] would have to convince the court that recklessness more closely resembles knowing, intentional conduct than negligence.[32]

Moreover, the Court discussed neither the propriety of civil liability for aiding-abetting under § 10(b) and Rule 10b-5,[33] nor the distinction between active and passive aiding-abetting. Yet in view of the holding that an intent to deceive, manipulate or defraud is required for civil liability under the section and the rule,[35] the Court likely intended all such violations, primary and secondary, active and passive, to be within the scope of the decision. Thus, no matter what type of violation is involved, liability under § 10(b) and Rule 10b-5 will not be imposed without a showing of more than negligent conduct.[36]

Finally, the Court did not consider whether knowing, intentional conduct is a necessary element in an action for injunctive relief under § 10(b) and Rule 10b-5.[37] Since most private parties seek monetary damages rather than injunctive relief in federal antifraud litigation, the policy underlying *Ernst & Ernst* which limits the class of Rule 10b-5 plaintiffs[38] seems inapplicable. Therefore, the validity of negligence allegations in suits for injunctive relief remains an open question.[39]

Although the Court left certain questions unanswered by its decision in *Ernst & Ernst*, it nonetheless imposed a significant obstacle

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[31] *See* notes 1 & 29 *supra*.

[32] *See* Herzfeld v. Laventhol, Krekstein, Horwath & Horwath, 378 F. Supp. 112, 126 (S.D.N.Y. 1974).

[33] 96 S. Ct. at 1380 n.7. *See generally*, Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy,* In Pari Delicto, *Indemnification and Contribution,* 120 U. PA. L. REV. 597, 620-45 (1972). The Court also refused to discuss the elements necessary to establish a cause of action for aiding-abetting. *Id.*

[34] *See* Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy,* In Pari Delicto, *Indemnification and Contribution,* 120 U. PA. L. REV. 597, 641-46 (1972).

[35] 96 S. Ct. at 1381.

[36] By its choice of *Ernst & Ernst* as the factual vehicle for its anti-negligence holding, the Court indicated that liability for passive aiding-abetting would require more than negligence.

[37] 96 S. Ct. at 1381 n.12. *Cf.* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963).

[38] *See* note 30 *supra*.

[39] The Supreme Court also ignored the injunctive relief exception to Rule 10b-5's purchaser-seller requirement in its recent decision upholding that requirement. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975). *See* SEC v. National Sec., Inc., 393 U.S. 453, 465-68 (1969); SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 193 (1963); Mutual Shares Corp. v. Genesco, Inc., 384 F.2d 540 (2d Cir. 1967). *But cf.* Rondeau v. Mosinee Paper Corp., 422 U.S. 49 (1975).

before securities fraud claimants. This limitation seems justified in light of the policy of investor protection behind federal securities law. If other elements of proof, such as privity and reliance, were eliminated or relaxed, investors injured through negligent misconduct would have less difficulty in recovering damages. However, elimination of the intentional conduct requirement and substitution of a negligence test in private actions might well cause unwarranted injury to innocent shareholders, who must ultimately pay for corporate mistakes.[40]

B. Aiding-Abetting

Secondary liability, imposed upon those who aid and abet primary securities law violators, is another aspect of Rule 10b-5 that has received recent judicial attention.[41] Aiding-abetting normally requires intent to further a scheme to defraud, or knowledge of such a scheme—scienter,[42] combined with substantial assistance[43] to the pri-

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[40] *See* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 866-67 (2d Cir. 1968) (Friendly, J., concurring), *cert. denied*, 394 U.S. 976 (1969). Bucklo, *supra* note 1, at 596-97 (1972).

[41] *See generally* Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy,* In Pari Delicto, *Indemnification and Contribution*, 120 U. PA. L. REV. 597 (1972) [hereinafter cited as Ruder]; *see also* Lowenfels, *Expanding Responsibilities of Securities Lawyers: An Analysis of the New Trend in Standard of Care and Priorities of Duties*, 74 COLUM. L. REV. 412 (1974).

[42] Scienter refers to the degree of culpability necessary for liability under the securities laws. In the securities fraud context, scienter has referred to a number of degrees of culpability. The least degree of fault has been negligence, generally termed a lack of due diligence or unreasonable conduct. Batchelor v. Legg & Co., 52 F.R.D. 545, 549 (D. Md. 1971). In light of the Supreme Court ruling in *Ernst & Ernst v. Hochfelder*, *supra* note 4, negligence no longer suffices to constitute scienter. The next higher degree is recklessness, defined as a failure or refusal to ascertain material facts when readily available. Cohen v. Franchard Corp., 478 F.2d 115, 123 (2d Cir.), *cert. denied*, 414 U.S. 857 (1973). The validity of this culpability standard is unclear after *Ernst & Ernst*. *See* 96 S. Ct. at 1381 n.12. The two highest degrees of culpability are knowledge and intent to defraud. *See* 2 A. BROMBERG, SECURITIES LAW: FRAUD, SEC RULE 10b-5 § 8.4 (1973). The term does not refer to the common law meaning of conscious intent to defraud. *See, e.g.*, Globus v. Law Research Serv., Inc., 418 F.2d 1276 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970). For a good historical discussion of the scienter requirement in the 10b-5 context, see Bucklo, *Scienter and Rule 10b-5*, 67 NW. U.L. REV. 562, 598 (1972).

[43] Substantial assistance may be given by active participation in the scheme. *See, e.g.*, Rosen v. Dick, [1974-75 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,786 (S.D.N.Y. Sept. 3, 1974); Brennan v. Midwestern United Life Ins. Co., 286 F. Supp. 702, 728 (N.D. Ind. 1968), *aff'd*, 417 F.2d 147, 154-55 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970). It may also include mere inaction if the secondary defendant is one upon whom the securities laws impose special duties. *See* Lanza v. Drexel & Co., 479

mary wrongdoer.[44] In private actions, courts have generally imposed secondary liability upon proof of actual knowledge of the fraudulent scheme.[45] Not until recently, however, have courts distinguished between active and passive assistance in establishing standards of culpability in private actions.[46] In *Woodward v. Metro Bank*,[47] the Fifth Circuit examined this distinction as it relates to the scienter requirement.

The plaintiff cosigned a 90-day note, secured in part by the pledge of her stock. The defendant bank gave this stock to a corporation under the control of the primary wrongdoer, Starnes. Through misrepresentations and failure to disclose material information about the poor financial condition of the corporation he controlled, Starnes had induced the plaintiff to cosign the note and pledge a certificate of deposit against the debt owed defendant bank by the corporation. In her Rule 10b-5 action, the plaintiff alleged that the bank had aided and abetted the primary violator by failing to disclose the material facts regarding the corporation's financial status and thereby furthered the scheme to defraud.[48] The court refused to hold the bank secondarily liable, noting that "Rule 10b-5 was not designed to be the ethical Ten Commandments for all securities transactions."[49] It reasoned that although investor protection is of major importance under the Rule, expanding 10b-5 liability to cover all loan accommodation arrangements would impair the maintenance of a vigorous business community.

Upon examining prior aiding-abetting cases, the court considered

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F.2d 1277, 1302-03 (2d Cir. 1973). *See also* Pettit v. American Stock Exch., 217 F. Supp. 21 (S.D.N.Y. 1963).

[44] *See* Rosen v. Dick, [1974-75 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,786 (S.D.N.Y. Sept. 3, 1974); Brennan v. Midwestern United Life Ins. Co., 259 F. Supp. 673, 681-82 (N.D. Ind. 1966), 286 F. Supp. 702, 728 (N.D. Ind. 1968), *aff'd*, 417 F.2d 147, 154-55 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970); Ruder, *supra* note 41, at 620.

Aiding-abetting differs from primary liability because it involves a lesser degree of participation or importance of the acts performed. *See* 2 BROMBERG, *supra* note 1, § 8.5 (515) (1973). *See, e.g.*, SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1097 (2d Cir. 1972).

[45] *See* Lanza v. Drexel & Co., 479 F.2d 1277, 1302-03 (2d Cir. 1973).

[46] *See* Hochfelder v. Midwest Stock Exch., 503 F.2d 364, 375 (7th Cir.), *cert. denied*, 419 U.S. 875 (1974) (negligence standard for active aiding-abetting); Hochfelder v. Ernst & Ernst, 503 F.2d 1100, 1114 (7th Cir. 1974), *rev'd*, 96 S. Ct. 1375 (1976) (negligence standard for inactive aiding-abetting).

[47] 522 F.2d 84 (5th Cir. 1975).

[48] *Id.* at 89.

[49] *Id.* at 91.

the holding in *SEC v. Coffey*,[50] in reaching a solution most applicable to the facts before it. In *Coffey*, the Sixth Circuit required that the aider-abettor first be aware that his conduct was part of an overall improper activity, and second, that the aider-abettor have knowingly and substantially assisted the violation.[51]

The *Woodward* court found the first element of *Coffey* dependent upon the business expectations of the parties. If the alleged aider-abettor conducts what appears to be an ordinary business transaction, *Woodward* would require more evidence of his complicity. For example, if securities fraud were perpetrated in the sale of shares of common stock, it would be difficult for an aider-abettor of that fraud to claim innocence once it was shown that he knew of the general sales activity. However, where a commercial transaction appears ordinary on its face, the alleged aider-abettor may be unaware of any improper activity.[52] In such a case, liability would likely be imposed

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[50] 493 F.2d 1304 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975). *See Survey of 1974 Securities Law Developments*, 32 WASH. & LEE L. REV. 719, 754-64 (1975). In *Coffey*, the Sixth Circuit found that a person may be held liable as an aider-abettor only if some other party has committed a securities law violation; if the accused party has general awareness that his role was part of an overall activity that is improper; and if the alleged aider-abettor knowingly and substantially assisted the violation. 493 F.2d at 1316. *See* 2 BROMBERG, *supra* note 1, § 8.5 (582) (1971).

The test in Landy v. FDIC, 486 F.2d 139 (3d Cir. 1973), *cert. denied*, 416 U.S. 960 (1974), is similar, but there the court refers to "an independent wrong" rather than a securities law violation, and knowledge of the wrong's existence rather than awareness of a role in improper activity. *See* Ruder, *supra* note 41, at 630. *Landy* also lacks the "knowing" requirement for the substantial assistance element. The first two requirements of *Landy* appear to be over-inclusive and seem to lose sight of the necessary connection to the securities laws. The existence of a "wrong" could be known without an awareness of one's role in the scheme. The *Woodward* court noted this and recognized that it is the knowledge of participation in the fraud that is the issue. 522 F.2d at 95.

[51] 493 F.2d at 1316. The *Woodward* court held that the scienter requirement scales upward as the activity is more remote and thus found the knowing and substantial assistance to be properly required. 522 F.2d at 95.

Professor Ruder has suggested that the secondary defendant must know of the illegal act and render positive assistance to the primary wrongdoers. Ruder, *supra* note 41, at 600. Professor Bromberg states that the law still lacks a meaningful definition of aiding-abetting, but he also notes that one fairly common and important thread in the judicial verbalizations, which is taken from the RESTATEMENT OF TORTS, is that the aider-abettor's conduct must be "substantial." BROMBERG, *supra* note 1, § 8.5 (530) (1974). The RESTATEMENT provision Bromberg refers to requires knowledge of another's breach of duty and substantial assistance or encouragement. RESTATEMENT OF TORTS § 877 (1939).

[52] 522 F.2d at 95. Such lack of awareness may be the result of independent commercial assumptions. For example, if the document were questionably like a loan, the

only if a court found a special duty of inquiry and public disclosure upon the particular type of party, such as an insider,[53] controlling person,[54] accountant[55] or broker.[56] Absent such a duty, the *Woodward* holding requires some knowledge of impropriety before imposing secondary liability under Rule 10b-5.[57]

The Fifth Circuit also stated that the extent to which mere silence or inaction by the defendant could fulfill the requirement of "knowing, substantial assistance"—the second element of the *Coffey* test[58]—depended upon the nature of the duty owed by the alleged aider-abettor to the other parties to the transaction. The Sixth Circuit in *Coffey* suggested that courts impose liability only where the silence of the alleged aider-abettor was consciously intended to aid the securities law violation.[59]

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court indicated reluctance to impose upon the bank a duty to investigate and to disclose any impropriety to the plaintiff cosigner. *Id.* The bank in effect is entitled to assume that the transaction is free of fraud. Thus, the Fifth Circuit expressed its unwillingness to make the bank an insurer of every loan transaction it handled. *Cf.* Grimes, Hooper & Messer, Inc. v. Pierce, 519 F.2d 1089 (9th Cir. 1975) (bank not liable under Rule 10b-5 for supplying credit reference which did not indicate defendant's poor financial condition).

[53] *See, e.g.*, SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

[54] *See* § 20 of the 1934 Act, 15 U.S.C. § 78k (1970).

[55] *See* § 18 of the 1934 Act, 15 U.S.C. § 78r (1970). *But cf.* Gold v. DCL Inc., [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,036 (S.D.N.Y. June 29, 1973) (accounting firm that neither rendered any certification nor invited public to rely on its financial judgment was under no duty to disclose publicly that issuer's earnings statement was misleading or incomplete).

[56] *See, e.g.*, Clement A. Evans & Co. v. McAlpine, 434 F.2d 100 (5th Cir. 1970), *cert. denied*, 402 U.S. 988 (1971).

[57] Kerbs v. Fall River Indus., Inc., 502 F.2d 731, 740 (10th Cir. 1974); BROMBERG, *supra* note 1, § 8.5 (582) (1974); Ruder, *supra* note 41, at 630-31. Indeed, the court held that even remote parties must not only be aware of their roles, but should also know when and to what degree they are furthering the fraud. 522 F.2d at 95.

[58] The standards courts have used for measuring culpability by silence have varied. Some declare without qualification that silence and inaction alone can create liability for aiding-abetting. *See* Kerbs v. Fall River Indus., Inc., 502 F.2d 731, 740 (10th Cir. 1974); Fischer v. New York Stock Exch., CCH FED. SEC. L. REP. ¶ 95,416 (S.D.N.Y. Jan. 16, 1976); Green v. Jonhop, 358 F. Supp. 413, 419 (D. Ore. 1973); Anderson v. Francis I. duPont & Co., 291 F. Supp. 705, 709 (D. Minn. 1968). *See also* Brennan v. Midwestern United Life Ins. Co., 417 F.2d 147, 154-55 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970). *But see* Ernst & Ernst v. Hochfelder, 96 S. Ct. 1375 (1976).

Other courts have flatly rejected the notion that inaction alone is sufficient. *See* Landy v. FDIC, 486 F.2d 139, 161-62 (3d Cir. 1973), *cert. denied*, 416 U.S. 960 (1974); Wessel v. Buhler, 437 F.2d 279, 283 (9th Cir. 1971); Ruder, *supra* note 41, at 642-44.

[59] 493 F.2d at 1317. *See* Rochez Bros. v. Rhoades, CCH FED. SEC. L. REP. ¶ 95,313 (3d Cir. Sept. 29, 1975).

In devising its culpability standard, the *Woodward* court combined this language with that in *Strong v. France*,[60] which held that liability for silence or inaction arises only if a duty to disclose exists.[61] Consequently, *Woodward* held that absent a duty of disclosure, an alleged aider-abettor should be held liable only if scienter of the high "conscious intent" variety can be proved. If some special duty of disclosure exists,[62] however, then liability is possible with a lesser degree of scienter.[63] In a case involving both silence/inaction and affirmative assistance, the degree of knowledge required was held to depend upon the ordinariness of the assisting activity in the alleged fraudulent transaction;[64] the court would infer the knowledge needed for aiding-abetting liability only if the pertinent transaction was atypical or lacked business justification.[65]

Thus, the Fifth Circuit in *Woodward* adopted with slight modification the culpability standard implied by the Sixth Circuit in *Coffey*. Significantly, *Woodward* applied this standard to a private action, whereas the *Coffey* court considered it only in terms of an enforcement suit for injunctive relief. Nevertheless, the Fifth Circuit was not willing to follow the decision in *Hochfelder v. Midwest Stock Exchange*[66] holding active aider-abettors liable under a negligence standard.[67] Without specifically considering the issue of purely active aiding-abetting, the *Woodward* court indicated that some special duty of inquiry or disclosure would be required before it adopted a standard lower than knowing, intentional conduct. As to inactive aiding-abetting, however, the Fifth Circuit is in agreement with

[60] 474 F.2d 747 (9th Cir. 1973).

[61] *Id.* at 752.

[62] *See* text accompanying notes 53-56 *supra*.

[63] 522 F.2d at 97. However, *Ernst & Ernst* has indicated that the degree of scienter may not go below a standard of recklessness. 96 S. Ct. at 1381 n.12. *Cf.* City Nat'l Bank v. Vanderboom, 422 F.2d 221 (8th Cir.), *cert. denied*, 399 U.S. 905 (1970); *accord*, Vohs v. Dickson, 495 F.2d 607, 621-22 (5th Cir. 1974); Clement A. Evans & Co. v. McAlpine, 434 F.2d 100, 103 (5th Cir. 1970), *cert. denied*, 402 U.S. 988 (1971).

[64] 522 F.2d at 97. *See* H. L. Federman & Co. v. Greenberg, CCH FED. SEC. L. REP. ¶ 95,380 (S.D.N.Y. Dec. 8, 1975). *Cf.* Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972) (no special duty for ordinary function of transfer agent).

[65] In addition, substantiality of the assistance was found to be a prerequisite to liability in every instance. 522 F.2d at 97. *See Landy, supra* note 50, at 163; BROMBERG, *supra* note 1, § 8.5 (530) (1974).

[66] 583 F.2d 364 (7th Cir.), *cert. denied*, 419 U.S. 875 (1974). *Midwest Stock Exchange* involved claims of aiding-abetting resulting from negligent supervision of a securities broker and the subsequent failure to detect his fraudulent operations.

[67] The negligence standard is no longer valid in light of the recent *Ernst & Ernst* decision by the Supreme Court, *supra* note 4.

Midwest Stock Exchange; where inaction is involved, the plaintiff must prove that the defendant knew, or but for a breach of his duty of inquiry and disclosure, would have known of the fraud.[68]

These holdings are consonant with the Supreme Court ruling in *Ernst & Ernst v. Hochfelder*[69] that negligence is not a proper standard of culpability for aiding-abetting, whether of the active or passive variety.[70] The Fifth Circuit in *Woodward* was willing to lower the scienter requirement if the law imposed a special duty upon the defendant, as in *Ernst & Ernst*, but not below a recklessness standard—the equivalent of knowledge.[71] The standard imposed by the Fifth Circuit also resembles the "flexible duty" standard used by the Ninth Circuit which allows recklessness as a culpability standard only when the securities laws impose a high standard of conduct upon the defendant.[72] The modification added by *Woodward*, that the degree of knowledge required depends upon the conventionality of the pertinent commercial transaction, has actually been an implied element of other decisions.[73]

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[68] *Id.* at 374. *See* Fischer v. New York Stock Exch., CCH FED. SEC. L. REP. ¶ 95,416 (S.D.N.Y. Jan. 15, 1976) (scienter sufficiently pleaded if plaintiff alleged Exchange knew or should have known lenders unaware of nondisclosed facts—duty to disclose).

[69] 96 S. Ct. 1375 (1976). *See* section on *scienter supra.*

[70] *See* 96 S. Ct. at 1381.

[71] Since the Supreme Court in *Ernst & Ernst* did not address the validity of the recklessness standard, *id.* at 1381 n.12, it is arguably still valid. This standard was applied by a district court in the Second Circuit in Herzfeld v. Laventhol, Krekstein, Horwath & Horwath, 378 F. Supp. 112 (S.D.N.Y. 1974). *Herzfeld* involved a qualified auditor's corporation report that was misleading to investors. *Id.* at 125. In creating its test for liability—whether the report represented a fair and true financial picture—the court stated that the culpability standard for failure to discover omissions or misrepresentations was willful, deliberate or reckless disregard for the truth. This standard includes failure or refusal to discover and convey material facts when readily available and when there is reason to believe they exist. *See* Cohen v. Franchard Corp., 478 F.2d 115, 123 (2d Cir.), *cert. denied*, 414 U.S. 857 (1973). Thus, the difference between a negligence and recklessness or inquiry-notice standard may often be marginal. For example, the failure of the accountant in *Ernst & Ernst* to discover the "mail rule" would seem to constitute a reckless violation as well as a negligent one.

[72] *See* White v. Abrams, 495 F.2d 724, 736 (9th Cir. 1974); Note, *The Development of a Flexible Duty Standard of Liability Under SEC Rule* 10b-5, 32 WASH. & LEE L. REV. 99 (1975).

[73] In determining duties of inquiry and disclosure, the courts have almost certainly considered the nature of the transaction involved. For example, in *Ernst & Ernst* the Seventh Circuit imposed a negligence standard upon the defendant independent auditing firm because the "mail rule" was a material inadequacy and not sufficiently conventional to escape defendant's duty of inquiry.

Another example is found in Clement A. Evans & Co. v. McAlpine, 434 F.2d 100 (5th Cir. 1970), in which the court found that a duty of inquiry upon a stock brokerage

In *Woodward*, the Fifth Circuit was unwilling to extend the scope of Rule 10b-5 liability to parties remotely involved in the actual fraud.[74] Thus, it refused to hold aider-abettors, either active or inactive, to a negligence standard of culpability. Such a determination is consonant with the policies underlying federal securities laws of providing investor protection without imposing crushing financial liability upon violators.[75] To impose liability upon those who merely know of fraudulent conduct but have no separate duty to act or upon those who assist in fraudulent conduct without knowing that the conduct is unlawful would unfairly extend liability to many persons whose primary businesses are unrelated to the securities markets.[76]

By declaring the culpability standard to be a function of the legal duties imposed upon the defendants and the conventionality of the commercial transaction involved, the Fifth Circuit has placed reasonable and effective limits upon secondary liability under Rule 10b-5. Since imposition of a recklessness standard will normally include those defendants who would also be held liable under the broader negligence standard,[77] the former standard appears better suited as a limitation. Inflexible imposition of a negligence standard would render the securities laws "amorphous snares for guilty and innocent alike."[78]

C. *Purchaser-Seller Requirement*

Courts have limited the class of plaintiffs suing under Rule 10b-5[79] to those alleging fraudulent activity in connection with the purchase or sale of securities.[80] This purchaser-seller requirement was first formulated in *Birnbaum v. Newport Steel Corp.*,[81] and is more

firm was breached by the broker's continuing to accept its customer's personal checks after prior checks had been dishonored for insufficient funds. Normally, such an irregularity required the customer's trading account to be frozen for a period of 90 days.

[74] The court did note, however, that its decision was not intended to exempt all bank-associated notes from Rule 10b-5 coverage. Under different facts, demonstrating awareness of complicity and substantial assistance, it would hold a bank to account. 522 F.2d at 100.

[75] *See* Cobine, *Elements of Liability and Actual Damages in Rule 10b-5 Actions*, 1972 U. ILL. L.F. 651, 651-52.

[76] Ruder, *supra* note 41, at 646. *See* note 59 *supra*.

[77] *See* note 71 *supra*.

[78] 522 F.2d at 97.

[79] 17 C.F.R. § 240.10b-5 (1975).

[80] *Id.* This same language appears in § 10(b) of the Securities Exchange Act, 15 U.S.C. § 78j(b) (1970).

[81] 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952).

commonly known as the *Birnbaum* Rule. Courts began to erode *Birnbaum* by creating exceptions to the Rule in circumstances involving forced sales resulting from short form mergers,[82] aborted purchases and sales,[83] de facto sales,[84] private injunctive actions,[85] and

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[82] Forced sales involve plaintiffs who have neither bought nor sold, but who nonetheless have been granted standing under Rule 10b-5 because defendant's fraudulent conduct will force him to sell in the future. *See, e.g.*, Vine v. Beneficial Fin. Co., 374 F.2d 627 (2d Cir.), *cert. denied*, 389 U.S. 970 (1967).

[83] This term refers to plaintiffs who have neither bought nor sold because of defendant's fraud. *See, e.g.*, A.T. Brod & Co. v. Perlow, 375 F.2d 393 (2d Cir. 1967).

[84] This term includes those with beneficial interests in a security who are otherwise barred from seeking Rule 10b-5 relief because they do not hold the legal title. *See, e.g.*, James v. Gerber Prods. Co., 483 F.2d 944 (6th Cir. 1973).

Thomas v. Roblin Indus., Inc., 520 F.2d 1393 (3d Cir. 1975), was a post-*Blue Chip* case involving a plaintiff who apparently sought Rule 10b-5 standing under the de facto seller exception. Plaintiff was the trustee in bankruptcy of Erie Forge & Steel Corp. (Erie); defendant (Roblin Indus.) was the former majority stockholder of Erie. Plaintiff sought to recover the amount Roblin had received from the public sale of its Erie stock after Erie had filed for bankruptcy. Roblin had allegedly sold the stock publicly when it had inside information regarding recent financial losses. Plaintiff claimed a beneficial interest in this stock because Roblin as controlling shareholder had a fiduciary duty to the corporation not to sell for its own benefit based on confidential information acquired through its fiduciary position. *See* Brophy v. Cities Serv. Co., 31 Del. Ch. 241, 70 A.2d 5 (1949); Diamond v. Oreamuno, 24 N.Y.2d 494, 301 N.Y.S.2d 78, 248 N.E.2d 910 (1969).

The court held that the trustee lacked standing to sue under Rule 10b-5 because neither the trustee nor the secured creditors he represented had complained of a transaction in which any of them was a buyer or seller of Erie's securities. 520 F.2d at 1396. The court cited *Blue Chip* for its basic affirmance of the *Birnbaum* Rule without discussing the de facto seller exception. Yet it seems that this exception applies. Although the trustee did not hold the legal title to the stock, he had a beneficial interest in retaining the assets of Erie after it had filed for bankruptcy. Arguably, Erie's assets included the stock held by the controlling party (Roblin) in light of the fiduciary duty set out in *Diamond* and *Brophy, supra.* Because of the fiduciary duty set forth in these cases, Roblin could be considered a type of trustee similar to those in the other de facto seller cases, James v. Gerber Prods. Co., 483 F.2d 944 (6th Cir. 1973), and Heyman v. Heyman, 356 F. Supp. 958 (S.D.N.Y. 1973). *See also* Cambridge Capital Corp. v. Northwestern Nat'l Bank, 350 F. Supp. 829 (D. Minn. 1972).

The court found the *Diamond* and *Brophy* principle inapplicable because the allegedly inside information regarding Erie's current financial status was not sufficiently material. Thus, the fiduciary duty did not exist in this case, and the court did not need to consider the present validity of the de facto seller exception. If the information had been material, the Third Circuit would have been obligated to analyze *Blue Chip* more thoroughly.

The Supreme Court's decision in *Blue Chip*, however, may have effectively ended the vitality of the de facto seller standing. The Court stated that shareholders, *creditors and others related to an issuer* who suffered loss in the value of their investment due to fraudulent corporate or insider activity would be barred by *Birnbaum*. 421 U.S. at 738. Moreover, the emphasis throughout *Blue Chip* that one must meet corporate antifraud derivative suits.[86] The Seventh Circuit rejected the *Birnbaum* Rule entirely.[87] Recently, however, in *Blue Chip Stamps v. Manor Drug Stores*,[88] the Supreme Court reaffirmed the validity of a strict purchaser-seller requirement. Although the Court indicated that nonpurchasers and nonsellers will be barred from maintaining private damage actions under Rule 10b-5, the question remains as to whether any of the judicially-created exceptions to the *Birnbaum* Rule survived the decision.[89] Since *Blue Chip*, courts have explicitly dealt only with the derivative action[90] and private injunctive relief exceptions.[91] The derivative action exception is still acknowledged, but decisions conflict over the validity of the private injunctive relief exception. Other recent decisions, not specifically addressing the established exceptions, have rigidly applied the *Birnbaum* Rule in a variety of contexts to exclude claimants not strictly purchasers or sellers of securities.[92]

Derivative Suits and Private Injunctive Relief

In *Wright v. Heizer Corp.*,[93] an Illinois district court upheld the validity of the derivative suit exception. The plaintiffs in *Wright* sued derivatively on behalf of International Digisonics Corporations (IDC), which had sold the securities in question, alleging a series of Rule 10b-5 violations between IDC and the defendant, Heizer Corporations. Although the plaintiffs neither purchased nor sold the securi-

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the statutory definitions of purchaser and seller (*e.g.*, 15 U.S.C. § 78c (13-14) (1970)) militates against further tolerance of de facto seller standing.

[85] *See, e.g.*, Mutual Shares Corp. v. Genesco, Inc., 384 F.2d 540 (2d Cir. 1967).

[86] A derivative action involves a suit by a shareholder to enforce a cause of action on behalf of the corporation. Courts have allowed derivative suits in the Rule 10b-5 context if the corporation on whose behalf suit was brought was a purchaser or seller of securities. *See, e.g.*, Herpich v. Wallace, 430 F.2d 792, 803-04 (5th Cir. 1970).

[87] *See* Eason v. General Motors Acceptance Corp., 490 F.2d 654 (7th Cir. 1973), *cert. denied*, 416 U.S. 960 (1974), *noted in* 31 WASH. & LEE L. REV. 757 (1974).

[88] 421 U.S. 723 (1975). *See* Gallagher, *10b-5 After Blue Chip Stamps: How Stands the Judicial Oak?*, 80 DICK. L. REV. 1 (1975); *Survey of 1974 Securities Law Developments*, 32 WASH. & LEE L. REV. 719, 742-50 (1975).

[89] In reaching its decision in *Blue Chip*, the Supreme Court did not directly address any of the exceptions to *Birnbaum*.

[90] *See* Wright v. Heizer Corp., CCH FED. SEC. L. REP. ¶ 95,399 (N.D. Ill. Dec. 3, 1975).

[91] *See* Davis v. Davis, 526 F.2d 1286 (5th Cir. 1976).

[92] *But cf.* Daniel v. International Bhd. of Teamsters, CCH FED. SEC. L. REP. ¶ 95,453 (N.D. Ill. Mar. 1, 1976) (entry into involuntary, noncontributory pension plan held to constitute sale of security for Rule 10b-5 purposes).

[93] CCH FED. SEC. L. REP. ¶ 95,399 (N.D. Ill. Dec. 3, 1975).

ties, the court held that the *Birnbaum* Rule, as rearticulated in *Blue Chip*, did not prohibit this action,[94] since maintenance of Rule 10b-5 derivative suits merely requires purchaser or seller status by the corporation.[95]

The *Wright* court also considered the impact of the *Blue Chip* decision upon actions for injunctive relief. It noted that the Supreme Court's limitation in *Blue Chip* was merely applicable to actions for money damages.[96] Furthermore, the policy arguments in *Blue Chip* supporting the *Birnbaum* Rule were keyed to apprehensions of "strike" or *in terrorem* actions for money damages by stockholders or offerees who neither sell nor buy due to inaccurate reports on the future of the company involved.[97] Nonetheless, the *Wright* court refused to distinguish between actions at law and in equity, holding that the *Blue Chip* limitations should apply to all private Rule 10b-5 actions, regardless of the type of relief requested.[98]

Although the *Wright* court suggested that the private injunctive relief exception is no longer valid, the Fifth Circuit in *Davis v. Davis*[99]

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[94] *Id.* at 99,048.

[95] In a derivative action the corporation is universally recognized as the real party plaintiff. *See* Herpich v. Wallace, 430 F.2d 792 (5th Cir. 1970); Shell v. Hensley, 430 F.2d 819 (5th Cir. 1970); Dolin v. Vipont Mining Co., 384 F. Supp. 1255 (E.D. Pa. 1974).

[96] CCH FED. SEC. L. REP. ¶ 95,399 at 99,049. *See* 421 U.S. at 727. The court in *Wright* also recognized that the purchaser-seller rule imposes no limitation on the standing of the SEC to bring actions for injunctive relief under Rule 10b-5. *See* 421 U.S. at 751 n.14; SEC v. National Sec., Inc., 393 U.S. 453 (1969). Moreover, the *Blue Chip* Court failed to discuss or disapprove of several prior cases declining to apply the strictures of *Birnbaum* to private Rule 10b-5 actions requesting solely equitable relief. *See* Vincent v. Moench, 473 F.2d 430, 434-35 (10th Cir. 1973); Kahan v. Rosenstiel, 424 F.2d 161, 173 (3d Cir.), *cert. denied*, 398 U.S. 950 (1970); Mutual Shares Corp. v. Genesco, Inc., 384 F.2d 540, 546-47 (2d Cir. 1967). However, it should be noted that although the SEC need not be a purchaser or seller to seek injunctive relief, it must show fraud in connection with a purchase or sale to obtain an injunction under Rule 10b-5.

[97] CCH FED. SEC. L. REP. ¶ 95,399 at 99,049-50.

[98] *Id.* at 99,050. The court quoted with approval the language of the Supreme Court in *Blue Chip* holding that shareholders and others related to an issuer who suffer loss in the value of their investment due to fraudulent activity in connection with the purchase or sale of securities will be denied standing under Rule 10b-5. 421 U.S. at 737, 738.

[99] 526 F.2d 1286 (5th Cir. 1976). Another post-*Blue Chip* case supporting the continued validity of the injunctive relief exception was Harriman v. E. I. duPont de Nemours & Co., CCH FED. SEC. L. REP. ¶ 95,386 (D. Del. Dec. 23, 1975). The plaintiffs in *Harriman* were shareholders of duPont who brought a derivative action challenging the corporation's merger with an investment company under Rule 10b-5. Because the court found that duPont was a purchaser and seller of securities, the plaintiffs had no problem in satisfying the *Birnbaum* Rule in their derivative suit. The court considered

disagreed. There, the plaintiffs alleged a scheme which involved defendants' refusal to honor certain contracts to purchase plaintiff's shares at the contract price and their denial of all financial resources in order to force the plaintiff to sell the shares to defendants at a grossly inadequate price. The court avoided discussion of the forced-seller exception to *Birnbaum*, which would clearly include the plaintiff, and instead recognized the plaintiff as a seller by virtue of his contracts to sell stock.[100]

The Fifth Circuit also considered significant the difference between plaintiff's suit for injunctive relief and suits for monetary relief. It concluded that a strict purchaser-seller requirement is not as critical in suits for injunctive relief as it is when damages are sought.[101] Although this conclusion is only dictum in *Davis* because plaintiff was a seller by definition, the Fifth Circuit indicated that had plaintiff not been a statutory seller, he still could have pressed his claim for injunctive relief.

The United States Supreme Court has taken various positions on the viability of the private injunctive relief exception after *Blue Chip*.

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in dictum, however, the necessity of the *Birnbaum* Rule in an injunctive Rule 10b-5 context, since the Supreme Court in *Blue Chip* did not address *Birnbaum's* applicability to suits seeking injunctive relief. It concluded that prior cases dispensing with *Birnbaum* and requiring only a causal nexus between the alleged violation and the pleader's injuries were still good law after *Blue Chip*. CCH FED. SEC. L. REP. ¶ 95,386 at 98,939. *See* Kahan v. Rosenstiel, 424 F.2d 161 (3d Cir.), *cert. denied*, 398 U.S. 950 (1970); Britt v. Cyril Bath Co., 417 F.2d 433, 436 (6th Cir. 1969); Mutual Shares Corp. v. Genesco, Inc., 384 F.2d 540, 546 (3d Cir. 1967).

[100] A contract to buy or sell securities is expressly defined by § 3(a) of the 1934 Act as a purchase or sale of securities for the purpose of that Act, 15 U.S.C. § 78c(2) (1970). The Supreme Court in *Blue Chip* explicitly recognized that if one is granted purchaser or seller status by some definitional provision of the 1934 Act, he shall not be denied standing to bring a Rule 10b-5 action. 421 U.S. at 750.

The Fifth Circuit also dealt with the definition of a sale to determine Rule 10b-5 standing in Spector v. LQ Motor Inns, Inc., 517 F.2d 278 (5th Cir. 1975), *cert. denied*, 96 S. Ct. 786 (1976). The plaintiff received stock which had been registered in his wife's name in connection with a divorce property settlement. Plaintiff sold this stock back to the issuer upon assurances that the stock would not be offered to the public. Shortly thereafter, the issuer fraudulently transferred the stock to the newly-formed defendant corporation whose stock was sold publicly. The court had no trouble in labelling the plaintiff's contract of sale with the issuer as a "sale" transaction within the meaning of the 1934 Act. *See* 15 U.S.C. § 78c(a)(14) (1970).

[101] A number of pre-*Blue Chip* decisions have suggested that a plaintiff's claim for injunctive relief is not necessarily controlled by his purchaser-seller status. *See* Sargent v. Genesco, Inc., 492 F.2d 750, 760 (5th Cir. 1974); Herpich v. Wallace, 430 F.2d 792 (5th Cir. 1970); Mutual Shares Corp. v. Genesco, Inc., 384 F.2d 540, 546 (2d Cir. 1967); O'Neill v. Maytag, 339 F.2d 764, 768 (2d Cir. 1964); Hoover v. Allen, 241 F. Supp. 213, 227 (S.D.N.Y. 1965).

Arguments supporting its continued validity include the Court's holding in *SEC v. National Securities, Inc.*[102] that the purchaser-seller rule imposed no bar to SEC standing to bring actions for injunctive relief under Rule 10b-5.[103] The Supreme Court also noted in *SEC v. Capital Gains Research Bureau, Inc.*,[104] that it is not necessary in suits for equitable or prophylactic relief to establish all the elements—such as intent to injure and actual injury—required in a suit for monetary damages.[105] Taken together, these considerations suggest that the *Birnbaum* Rule should likewise impose no standing limitations in actions for private injunctive relief.

Conversely, the Supreme Court recently held in *Rondeau v. Mosinee Paper Corp.*[106] that private injunctive relief under § 13 of the 1934 Act[107] required a showing of irreparable harm. Also, the possibility of adverse injunctive relief may be more of a threat to businesses than potential monetary liability, and therefore, wield more force in settlement negotiations.[108] Thus, the policy considerations against vexatious litigation cited in *Blue Chip* may similarly apply in private actions requesting injunctive relief.[109] Nor would exclusion of nonpur-

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[102] 393 U.S. 453 (1969).

[103] *Id.* at 465-68.

[104] 375 U.S. 180 (1963).

[105] *Id.* at 193. This statement was used by the Second Circuit to support the private injunctive relief exception in Mutual Shares Corp. v. Genesco, Inc., 384 F.2d 540 (2d Cir. 1967).

[106] 422 U.S. 49 (1975).

[107] 15 U.S.C. § 78m (1970).

[108] *See* Gallagher, *10b-5 After Blue Chip Stamps: How Stands the Judicial Oak?*, 80 DICK. L. REV. 1, 40 (1975).

[109] *Id.* The Fifth Circuit recently was asked to address the *Birnbaum* Rule as it applied to those who seek only declaratory relief in a Rule 10b-5 context. In Lutgert v. Vanderbilt Bank, 508 F.2d 1035 (5th Cir. 1975), the court rejected plaintiff's attempt to attach significance to the fact that he was requesting declaratory relief rather than monetary damages. The court recognized in Smallwood v. Pearl Brewing Co., 489 F.2d 579 (5th Cir.), *cert. denied*, 419 U.S. 873 (1974), that some courts had relaxed the *Birnbaum* requirement for actions seeking injunctive relief. *Id.* at 589 n.8. *See* Kahan v. Rosenstiel, 424 F.2d 161, 173 (3d Cir.), *cert. denied*, 398 U.S. 950 (1970); General Time Corp. v. Talley Indus., Inc., 403 F.2d 159 (2d Cir.), *cert. denied*, 393 U.S. 1026 (1968); Mutual Shares Corp. v. Genesco, Inc., 384 F.2d 540, 546 (2d Cir. 1967); Ruckle v. Roto Am. Corp., 339 F.2d 24 (2d Cir. 1964). *But see* Thomas v. Duralite Co., 524 F.2d 577, 590 (3d Cir. 1975) (no relaxation of *Birnbaum* Rule where securities law violations completed by time of suit requesting only declaratory relief). The court stated that the rationale behind the leniency afforded injunctive relief suits was to prevent deception which if carried to its fruition, would provide plaintiff standing to sue for damages. The reasoning for granting standing to nonpurchasers and nonsellers seeking only declaratory relief would be essentially the same as that for injunctive relief. Consequently, the same considerations regarding the post-*Blue Chip* validity of

chasers and nonsellers from injunctive relief under Rule 10b-5 necessarily leave these parties remediless in light of protection afforded by state securities laws.[110] Consequently, rejection of this exception would be more consistent with the holding of *Blue Chip*. Because of the countervailing considerations, however, another Supreme Court decision may be required to resolve this issue conclusively.

Aborted Purchaser/Seller[111]

The aborted seller exception has also been considered in the *Blue Chip* aftermath. In *Thompson v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*,[112] an Oklahoma district court granted summary judgment against a plaintiff investor who had brought suit under § 10(b)[113] alleging that he was induced by misrepresentations to retain stock that was declining in value.[114] The court cited with approval the

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the injunctive relief exception should apply to suits for declaratory relief. *See* text accompanying notes 102-110 *supra* and *infra*.

[110] State courts may grant broader protection from securities fraud than is available under Rule 10b-5. *Compare* Diamond v. Oreamuno, 24 N.Y.2d 494, 301 N.Y.S. 2d 78, 248 N.E.2d 910 (1969) (corporation that neither bought nor sold has cause of action against officers, directors for insider trading) *with* Haberman v. Murchison, 468 F.2d 1305 (2d Cir. 1972) (same facts, no cause of action under Rule 10b-5).

[111] The term "aborted purchaser or seller" refers to plaintiffs who because of defendant's fraud, have neither purchased nor sold. *See, e.g.*, Goodman v. H. Hentz & Co., 265 F. Supp. 440 (N.D. Ill. 1967).

[112] CCH FED. SEC. L. REP. ¶ 95,383 (W.D. Okla. Sept. 23, 1975).

[113] 15 U.S.C. § 78j(b) (1970).

[114] The aborted seller exception received further consideration in another pre-*Blue Chip* case, Angelakis v. Churchill Management Corp., CCH FED. SEC. L. REP. ¶ 95,285 (N.D. Cal. June 6, 1975). The plaintiff was a client of defendant investment adviser, Churchill Management. Plaintiff urged standing under the aborted seller exception, claiming he sought to enter into a security transaction as a seller, but that the transaction was aborted as a result of defendant's fraud. Specifically, plaintiff claimed that he wished to sell all of his securities but did not do so because Churchill had represented to him that the company would take plaintiff's account as it was, and that it was unnecessary for him to liquidate his portfolio. *Id.* at 98,463. The court refused to grant standing, holding that the alleged fraud was not directly connected with the plaintiff's inability to sell his securities. Rather, the court found that the allegedly fraudulent activity was in connection with the mismanagement of plaintiff's account not directly involving a purchase or sale. Because there was no fraud upon which to base plaintiff's status as an aborted seller, the exception was found inapposite.

Another case, decided before *Blue Chip*, that dealt with somewhat similar allegations was Pollak v. Eastman Dillon, [1974-75 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,987 (S.D.N.Y. Feb. 18, 1975). Plaintiff had merely claimed that he retained stock during the period of an alleged Rule 10b-5 violation. This was clearly insufficient under *Birnbaum* and other Second Circuit cases to confer Rule 10b-5 standing. *See* Greenstein v. Paul, 400 F.2d 580 (2d Cir. 1968); Mutual Shares Corp. v. Genesco, Inc., language in *Blue Chip* which denied standing to actual shareholders of an issuer who chose not to sell because of an unduly rosy representation.[115] It also recognized that permitting a right of action under § 10(b) and Rule 10b-5 merely because the plaintiff is a security holder would encourage spurious and vexatious litigation.[116] Moreover, absent the *Birnbaum* Rule, bystanders to the securities marketing process could await developments without risk, claiming that inaccuracies in disclosure caused nonselling in a falling market.[117] Since such situations were precisely the target of *Blue Chip*, the court denied plaintiff standing under § 10(b).[118]

The "In Connection With" Requirement[119]

Several recent cases have addressed the *Birnbaum* requirement that there be a connection between the alleged fraud and the securities purchase or sale. In *Myers v. American Leisure Time Enterprises,*

384 F.2d 540 (2d Cir. 1967); Feldman v. Hanley, 59 F.R.D. 299 (S.D.N.Y. 1973); Hirsch v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 311 F. Supp. 1283 (S.D.N.Y. 1970). This outcome is consonant with the *Blue Chip* decision, which would deny standing under Rule 10b-5 even to shareholders who *could* allege that their failure to sell was due to defendant's failure to disclose unfavorable information. 421 U.S. at 737-38.

At any rate, the aborted seller exception no longer appears to have much vitality in view of *Blue Chip*. The majority in *Blue Chip* discussed and rejected the "functional equivalency of a contract" reasoning employed by the court of appeals. *See* Manor Drug Stores v. Blue Chip Stamps, 492 F.2d 136, 142 (9th Cir. 1973), *rev'd*, 421 U.S. 723 (1975). Thus, the aborted purchaser-seller doctrine has been limited to plaintiffs who were at least parties to a breached contract for the purchase or sale of securities.

[115] CCH FED. SEC. L. REP. ¶ 95,383 at 98,909, *quoting* 421 U.S. at 737-38.

[116] CCH FED. SEC. L. REP. ¶ 95,383 at 98,909.

[117] *Id.* at 98,910, *quoting* 421 U.S. at 747.

[118] The court also considered the validity of plaintiff's claim under § 17(a) of the 1933 Act, 15 U.S.C. § 77q(a) (1970), involving fraudulent interstate transactions in the offer or sale of securities. There is still some doubt as to whether § 17(a) affords a private cause of action. *See* Newman v. Prior, 518 F.2d 97 (4th Cir. 1975) (holding yes); Crowell v. Pittsburgh & Lake Erie R.R. Co., 373 F. Supp. 1303, 1311 (E.D. Pa. 1974) (holding yes). *But see* Reid v. Mann, 381 F. Supp. 525, 528 (N.D. Ill. 1974) (holding no cause of action afforded). Other courts have refrained from resolving the issue in cases where claims were also asserted under the 1934 Act. *See, e.g.*, Schaefer v. First Nat'l Bank, 509 F.2d 1287, 1293 (7th Cir. 1975); Unicorn Field, Inc. v. Cannon Group, Inc., 60 F.R.D. 217, 224 (S.D.N.Y. 1973). The Supreme Court in *Blue Chip* also failed to express an opinion on the issue. 421 U.S. at 734 n.6. The *Thompson* court nonetheless declined to grant plaintiff standing because no purchase or sale was involved in the alleged fraud. To allow plaintiff standing under § 17(a) in this situation would be to stretch the flexibility of the provision beyond bounds. CCH FED. SEC. L. REP. ¶ 95,383 at 98,910.

[119] *See also* note 114 *supra*, discussing Angelakis v. Churchill Management Corp., CCH FED. SEC. L. REP. ¶ 95,285 (N.D. Cal. June 6, 1975).

Inc.,[120] the court followed the *Blue Chip* holding by refusing to grant standing to shareholders claiming damages foı alleged misrepresentations made by directors of an issuing company in violation of § 10(b). The claims arose from defendant's purchase of stock at a premium, followed by the election of three new directors and the appointment by the board of directors of a new president and chief executive officer. Because the plaintiffs, having been shareholders of the issuer prior to the violations, did not allege that they had bought or sold any stock in connection with the claimed violation, the court dismissed the § 10(b) claim for failure to satisfy the *Birnbaum* Rule.[121]

In addition, the court indicated that it would not allow the plaintiffs to circumvent the *Birnbaum* Rule by suing under a different section of the 1934 Act. Specifically, the court applied the principles of *Blue Chip* and *Birnbaum* to dismiss plaintiffs' claim based on a § 13(d)[122] reporting violation. Section 18[123] was held to bar the plaintiffs' § 13(d) claim by its requirement that a person who makes a false or misleading statement shall be liable for damages only to those who bought or sold securities in reliance upon and at a price affected by such statement. The court rejected plaintiffs' contention that § 13(d) grants an implied private right of action regardless of their status as purchasers or sellers. Courts have found such private rights of action on behalf of issuers[124] and shareholders[125] under § 13(d), but only in cases involving purely injunctive relief.[126] To allow damages suits

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[120] CCH FED. SEC. L. REP. ¶ 95,286 (S.D.N.Y. Aug. 18, 1975).

[121] Plaintiffs in effect alleged that the mere retention of their stock gave them standing to sue under § 10(b) and Rule 10b-5. This allegation has always been found insufficient to meet the purchaser-seller requirement. *See* Greenstein v. Paul, 400 F.2d 580 (2d Cir. 1968); Mutual Shares Corp. v. Genesco, Inc., 384 F.2d 540 (2d Cir. 1967); Feldman v. Hanley, 59 F.R.D. 299 (S.D.N.Y. 1973); Hirsch v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 311 F. Supp. 1283 (S.D.N.Y. 1970).

[122] 15 U.S.C. § 78m(d) (1970). Section 13(d) requires the filing of certain reports by those who acquire directly or indirectly the beneficial ownership of more than 5% of a class of a registered equity security.

[123] 15 U.S.C. § 78r (1970).

[124] *See* GAF Corp. v. Milstein, 453 F.2d 709 (2d Cir. 1971), *cert. denied*, 406 U.S. 910 (1972).

[125] *See* Scott v. Multi-Amp Corp., 386 F. Supp. 44 (D.N.J. 1974).

[126] Although there is no authority restricting standing in suits under § 13(d) to plaintiffs who are purchasers or sellers, such a holding is a logical extension of the Supreme Court's decision in *Blue Chip*. To allow one who is neither a purchaser nor seller to circumvent the *Birnbaum* Rule by suing under § 13(d) would undoubtedly result in the same "vexatious litigation" that the Court cited as the reason for limiting Rule 10b-5 standing. *See* 421 U.S. at 739-44.

The court appeared to apply this rationale in rejecting plaintiffs' final contention that their complaint stated a cause of action for injunctive relief. It noted that even if based merely on one's status as a security holder would permit plaintiffs to circumvent the *Birnbaum* Rule simply by casting their complaint to include alleged violations of § 13(d). This is contrary to the intent of the *Blue Chip* decision.[127]

Another recent decision addressing the "in connection with" requirement was *Bio-Medical Sciences, Inc. v. Weinstein.*[128] In *Weinstein*, plaintiff issuer brought a Rule 10b-5 action against its chief executive officer alleging he had defrauded purchasers of plaintiff's securities. The plaintiff alleged that as a result of this conduct and consequent litigation, it suffered numerous disadvantages and substantial damages. The court found that the loss suffered by the plaintiff was not "in connection with" the sale of the securities in question because the loss was not suffered directly on account of the sale itself.[129] The court chose this narrow construction of the "in connec-

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plaintiff's contention were true, it must fail for lack of a showing of irreparable harm absent injunctive relief. *See* Rondeau v. Mosinee Paper Corp., 422 U.S. 49 (1975).

[127] Although a plaintiff may not be able to circumvent *Birnbaum* under § 13(d), courts may not likewise apply the same reasoning to limit standing in a tender offer suit. In McCloskey v. Epko Shoes, Inc., 391 F. Supp. 1279 (E.D. Pa. 1975) (a pre-*Blue Chip* case), the court refused to extend *Birnbaum* to bar standing to a plaintiff challenging the validity of a tender offer. The overriding purpose of § 14(e) was found to be the protection of the investor. *See* H. K. Porter Co. v. Nicholson File Co., 482 F.2d 421 (1st Cir. 1973); Ronson Corp. v. Liquifin Aktiengesellschaft, 370 F. Supp. 597 (D.N.J.), *aff'd*, 497 F.2d 394 (3d Cir. 1974). The court determined that a strict application of the *Birnbaum* Rule would be clearly contrary to this legislative purpose. Section 14(e) does not contain the words "purchase or sale" as does § 10(b), and this may indicate that one of the goals of § 14(e) was to eliminate the purchase and sale requirement in the tender offer context. *See* Electronic Specialty Co. v. International Controls Corp., 409 F.2d 937 (2d Cir. 1969); Note, *Cash Tender Offers*, 83 HARV. L. REV. 377 (1969). The court further determined that the relaxation of *Birnbaum* would apply to § 14(e) suits for damages as well as injunctive relief. This too is amply supportable. *See* H. K. Porter Co. v. Nicholson File Co., 482 F.2d 421 (1st Cir. 1973); Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341 (2d Cir.), *cert. denied*, 414 U.S. 910 (1973); Dyer v. Eastern Trust & Banking Co., 336 F. Supp. 890 (D. Me. 1971). Nor does it appear the court was incorrect in allowing possible injunctive relief although the tender offers had been completed. *See* Crane Co. v. Westinghouse Air Brake Co., 419 F.2d 787 (2d Cir. 1969), *cert. denied*, 400 U.S. 822 (1970).

[128] CCH FED. SEC. L. REP. ¶ 95,445 (S.D.N.Y. Feb. 18, 1976).

[129] The court in *Wright v. Heizer Corp.*, note 93 *supra*, also considered the "in connection with" requirement. The plaintiffs had complained of injury to themselves as investors or holders of IDC securities purchased prior to the alleged violations and maintained that this status sufficed to give them standing to sue under Rule 10b-5. This argument was based upon Eason v. General Motors Acceptance Corp., 490 F.2d 654 (7th Cir. 1973), *cert. denied*, 416 U.S. 960 (1974), in which plaintiff was granted standing to bring a Rule 10b-5 suit based on his guarantee of an obligation which was an integral part of a tripartite security transaction. Plaintiff was an investor in the company whose stock was fraudulently sold. *See* Superintendent of Ins. v. Bankers

tion with" requirement as being the one most consistent with *Blue Chip*.[130] Although the court admitted that the *Blue Chip* holding was actually irrelevant to the facts of this case, it nonetheless interpreted the opinion as indicating a reluctance to expand the ambit of Rule 10b-5 liability.

The court indicated that the great difficulty in assessing damages was another reason for limiting the "in connection with" concept. Because the defendant officer in *Weinstein* sought to benefit himself by enhancing the assets of the plaintiff and thereby increasing the value of its shares, the court would have to begin assessment with the question of whether the plaintiff could have survived at all but for the defendant's actions. Unlike other cases sustaining Rule 10b-5 liability,[131] the court would be unable simply to compare the amount the corporation received with the amount it should have received in computing the harm resulting from the sale. The Court in *Blue Chip* noted the dangers of imposing "liability in an indeterminate amount for an indeterminate time."[132] The same considerations apply in lim-

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Life & Cas. Co., 404 U.S. 6, 10, 12-13 (1971). The *Wright* court noted that while Eason's role as an investor undoubtedly motivated him to give his guarantee, it was incidental to the undertaking he sought to avoid. CCH FED. SEC. L. REP. ¶ 95,399 at 99,049. Thus, the court rejected the *Wright* plaintiffs' standing argument, concluding that the *Eason* investor rationale should not survive *Blue Chip* because of an insufficient connection with the purchase and sale of securities. *See* 421 U.S. at 737, 738.

[130] CCH FED. SEC. L. REP. ¶ 99,399 at 99,237. This interpretation is consistent with other cases in which an issuer sued its officers or directors on Rule 10b-5 counts. *See* International Controls Corp. v. Vesco, 490 F.2d 1334 (2d Cir.), *cert. denied*, 417 U.S. 932 (1974); Shell v. Hensley, 430 F.2d 819 (5th Cir. 1970); Ruckle v. Roto Am. Corp., 339 F.2d 24 (2d Cir. 1964); Hooper v. Mountain States Sec. Corp., 282 F.2d 195 (5th Cir. 1960): Hoover v. Allen, 241 F. Supp. 213 (S.D.N.Y. 1965); Kane v. Central Am. Mining & Oil, Inc., 235 F. Supp. 559 (S.D.N.Y. 1964); New Park Mining Co. v. Cranmer, 225 F. Supp. 261 (S.D.N.Y. 1963).

In *Vesco*, for example, a Rule 10b-5 claim by an issuer was sustained on an allegation that the issuer had been induced by defendant directors improvidently to dispose of some of its stock holdings by way of a dividend in kind. The Second Circuit wrestled with the problem of whether such a dividend in kind could be deemed a "sale." Having answered that question affirmatively, the court had no trouble in holding that defendants would be liable on a showing that the issuer had received inadequate consideration for the assets it had thus been induced to "sell."

Conversely, in *Hoover v. Allen, supra*, a case involving the *purchase* of its own stock by a corporation at an artifically *depressed* price, the court found no violation of Rule 10b-5 because the corporation could not have been injured by the purchase itself, despite an allegation that the defendant's motive for depressing the price had been to assist them in a fraudulent scheme of manipulating corporate control.

[131] *See* note 130 *supra*.

[132] 421 U.S. at 748, *quoting* Ultramares Corp. v. Touche, 255 N.Y. 170, 179-80, 174 N.E. 441, 444 (1931).

iting the "in connection with" aspect of *Birnbaum*. Thus, the court's application of *Blue Chip* to the "in connection with" issue seems proper.

D. Damages

The purpose of Rule 10b-5 is to protect investors, to insure equality of information between buyers and sellers, and to protect the integrity of the securities market.[133] An ideal Rule 10b-5 damage rationale would provide a plaintiff with adequate compensation for economic losses resulting from a defendant's violation of Rule 10b-5 without unduly burdening the defendant. This position, combined with a judicial flexibility which adapts remedies to the circumstances of each case, would best carry out the purposes of Rule 10b-5. Investors would be compensated for losses caused by violations of the Rule, violations would be made unprofitable and hence discouraged, and protective litigation would be encouraged.[134]

In attempting to achieve an ideal damage award, courts have devised a number of different measures. The most common measure is the out-of-pocket theory, which permits recovery of the difference between the fair market value of the securities at the time of the fraudulent transfer and the actual consideration paid.[135] Another measure is the rescission theory,[136] under which the securities are returned to the seller. This measure reaches essentially the same result as the out-of-pocket theory, because increases in the values of the securities during the period between the sale and the remedy inure to the defrauded seller.[137] The Supreme Court has modified these theories to provide a third measure—the difference between

[133] In the words of the Supreme Court, § 10(b) "is not limited to preserving the integrity of the securities markets . . . though that purpose is included. Section 10(b) must be read flexibly, not technically and restrictively." Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 12 (1971) (citation omitted).

[134] Cobine, *Elements of Liability and Actual Damages in Rule 10b-5 Actions*, 1972 U. ILL. L.F. 651, 651-52.

[135] Ross v. Licht, 263 F. Supp. 395, 410 (S.D.N.Y. 1967). The fair value of the security is usually computed on the date of the transaction. When the security is seldom traded, however, subsequent sales which more accurately reflect the true values will be used to measure the plaintiff's loss. *Id.*

[136] *See, e.g.*, Myzel v. Fields, 386 F.2d 718, 743 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968); Janigan v. Taylor, 344 F.2d 781, 786 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965).

[137] *See* Janigan v. Taylor, 344 F.2d 781, 786 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965); Baumel v. Rosen, 283 F. Supp. 128, 145 (D. Md. 1968), *modified*, 412 F.2d 571 (4th Cir. 1969), *cert. denied*, 396 U.S. 1037 (1970).

what the seller received and the fair value of what he would have received had there been no fraudulent conduct. If the defendant received more than the defrauded seller's actual loss, damages would be the amount of the defendant's profit.[138] Fourth, courts now provide plaintiff-purchasers with consequential damages upon establishing a causal nexus with the underlying fraud.[139] These damages would include expenses legitimately attributable to the defendant's fraudulent conduct.[140] Finally, damages may be awarded a defrauded seller based on the amount it would cost him to reinvest in the same security within a reasonable time after discovery of the fraud.[141] This is known as the "cover" theory.

In recent attempts to effectuate investor protection and fraud deterrence without financially destroying defendants, courts have reconsidered certain damages measures. Specifically, these policy considerations have been treated in the context of burdens of proof in consequential damages, mitigation of damages, and the date of valuation and defendant's special efforts regarding out-of-pocket losses.

Although the most common measure of damages in Rule 10b-5 cases—the out-of-pocket theory—usually amounts to the difference between what the seller received for his stock and what he would have received had there been no fraudulent conduct,[142] one important exception exists: if the defendant received more on resale than the latter amount, then the award is the amount of the defendant's profit over and above what he had paid to the plaintiff. In that situation, the profit is considered a proximate consequence but must be limited to

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[138] *See* Affiliated Ute Citizens v. United States, 406 U.S. 128, 155 (1972), *citing* Janigan v. Taylor, 344 F.2d 781, 786 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965). *Affiliated Ute* applied this measure to sellers only, but the Second Circuit in Zeller v. Bogue Elec. Mfg. Corp., 476 F.2d 795 (2d Cir.), *cert. denied*, 414 U.S. 908 (1973), would apply to it purchasers also, granting them profits from their purchase proceeds if such proceeds could be traced with any certainty. *Id.* at 802 n.10.

[139] *See* Madigan, Inc. v. Goodman, 498 F.2d 233, 238 (7th Cir. 1974); Zeller v. Bogue Elec. Mfg. Corp., 476 F.2d 795, 803 (2d Cir.), *cert. denied*, 414 U.S. 908 (1973); *Survey of 1974 Securities Law Developments*, 32 WASH. & LEE L. REV. 719, 767-69 (1975).

[140] *See* Janigan v. Taylor, 344 F.2d 781, 786 (1st Cir.), *cert. denied*, 382 U.S. 789 (1965), *quoting* Sigafus v. Porter, 179 U.S. 116, 125 (1900).

[141] *See* Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90, 104-06 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971); Fridrich v. Bradford, [1974-75 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,723 (M.D. Tenn. 1974).

[142] Thomas v. Duralite Co., 524 F.2d 577, 586 (3d Cir. 1975).

the amount not due to the defendant's own special efforts after the fraud occurred.[143]

In *Thomas v. Duralite Co.*,[144] the Third Circuit considered the issue of the defendant's special efforts in fashioning a damages award. The plaintiff in *Thomas* was a former shareholder of Duralite who sued the corporation and two of its officers to recover losses resulting from misrepresentations made in connection with Duralite's repurchase of his stock. In reviewing the damages award of the district court,[145] the Third Circuit held that the individual defendants were not properly credited with the results of their special efforts and talents on behalf of the corporation.[146] The court held that the district court's damages award, constituting the difference between what plaintiff received and what defendants received for the stock when the Duralite purchase was negotiated, should be reconsidered on remand. It indicated that the defendants' profit figure should be decreased by the amount of such profit properly creditable to their efforts in enhancing the corporation's value.

The court stated that the theory of damages permitting windfall profits does not depend solely upon the premise that but for the fraud the injured party would have realized such gains.[147] In addition, the defendant should not be allowed to keep profits made through the use of fraudulently acquired assets.[148] This doctrine has definite limita-

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143 *See* Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972); Rochez Bros. v. Rhoades, 491 F.2d 402, 412 (2d Cir. 1974) (no allowance for defendant's special efforts because efforts not made after purchase of plaintiff's stock); Janigan v. Taylor, 344 F.2d 781 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965); 3 A. BROMBERG, SECURITIES LAW: FRAUD, SEC RULE 10b-5 § 9.1 (1971).

144 524 F.2d 577 (3d Cir. 1975).

145 Thomas v. Duralite Co., 386 F. Supp. 698 (D.N.J. 1974). The district court imposed liability upon the two individual defendants, stripping them of all windfall profits which they received. *Id.* at 727.

146 Specifically, the defendants had financially revitalized Duralite, thereby increasing its value to the company which eventually purchased Duralite. Defendant's managerial efforts had been the primary factor inducing this purchase which in turn made the Duralite stock more valuable than when the plaintiff had sold it.

147 524 F.2d at 589. *See* Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972). There, the Supreme Court, in an effort to chill executive fraud and chicanery, adopted a judge-made alternative damages rule which went beyond merely compensating a defrauded party to the extent of his loss, but also deprived the perpetrator of the fraud of all fraudulently incurred gain. As a result, not only would the victim be made whole but the guilty party would derive no undue benefit, windfall or otherwise, from the product of his fraud.

148 *See* Zeller v. Bogue Elec. Mfg. Corp., 476 F.2d 795 (2d Cir.), *cert. denied*, 414 U.S. 908 (1973); Janigan v. Taylor, 344 F.2d 781 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965).

tions,[149] however, and no court has ever applied this approach to assess damages for an indefinite time in the future. Thus the court, in addition to recognizing the special efforts limitation, placed a time limitation on damage awards. Because of the difficulty in determining precisely when the defendants' special efforts began to affect the rise in values of plaintiff's stock, the court refused to apply strictly the windfall profits theory.

By modifying the lower court's strict application of the windfall profits theory, the Third Circuit effected a more equitable assessment of damages.[150] Although the court refused to impose a financial burden in excess of the defendants' wrongful conduct, the deterrent effect[151] upon future violators was probably not undermined. An im-

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[149] *See* Cobine, *Elements of Liability and Actual Damages in Rule 10b-5 Actions*, 1972 U. ILL. L.F. 651, 677 n.122; Note, *Rule 10b-5: The Rejection of the* Birnbaum *Doctrine by* Eason v. General Motors Acceptance Corp. *and the Need for a New Limitation on Damages*, 1974 DUKE L.J. 610.

[150] The Third Circuit also ordered that the assessment of prejudgment interest be reconsidered. It noted that interest is not recoverable merely as compensation for money withheld but rather, in response to fairness considerations. 524 F.2d at 589. *See* Blau v. Lehman, 368 U.S. 403 (1962).

In addition, the Third Circuit vacated the lower court judgment against Duralite for compensatory damages. 524 F.2d at 586. It recognized that the individual defendants had acted solely for their own personal benefit, and that the plaintiff was aware of this. Furthermore, Duralite had not bought Thomas' shares. The court found the doctrine of respondeat superior inapplicable to the present case. *Id.* In *Thomas* any judgment payable by the corporate defendant would be at the expense of innocent members of the public who held shares in the corporation which had later acquired Duralite. This result would be patently unfair, and thus, the circuit court appeared to be correct in imposing liability solely upon the individual defendants. *See* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 867 (2d Cir. 1968) (Friendly, J., concurring); Cohen, *"Truth in Securities" Revisited*, 79 HARV. L. REV. 1340, 1370 (1966). *But cf.* Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 516 F.2d 172 (2d Cir. 1975), *cert. granted*, 44 U.S.L.W. 3558-59 (U.S. Apr. 6, 1976) (No. 75-355) ($25.8 million damages awarded against corporation for § 14(e) violation).

[151] The deterrent effect also played a major role in a case involving indemnification and contribution, Odette v. Shearson, Hammill & Co., 394 F. Supp. 946 (S.D.N.Y. 1975). The case involved a brokerage company which was the named defendant in actions for alleged violations of federal antifraud securities laws. In connection with those actions, the company filed third-party complaints against a bank for indemnification and contribution as to any amounts for which the company may be held liable. The court denied Shearson indemnification, noting that this should be done whether Shearson's conduct involved actual knowledge of violations, reckless disregard of the truth or mere negligence. Thus, the court reaffirmed the rule prohibiting indemnity among joint wrongdoers as set out in Globus v. Law Research Serv., Inc., 418 F.2d 1276, 1288 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970), and rejected the comparative fault standard proposed by some commentators. *See, e.g.*, Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy,* In Pari Delicto,

position of sweeping liability in *Thomas* would have amounted to an assessment of punitive damages, which has been prohibited in the past.[152]

Nevertheless, federal courts have increasingly recognized the buyer's right to consequential damages[153] where it can be proven with reasonable certainty that such damages were caused by the defendant's Rule 10b-5 violation.[154] In *Foster v. Financial Technology, Inc.*,[155] the plaintiffs had bought franchises from defendant corporation's subsidiary and had agreed to sign releases of claims against the corporation upon nonperformance of the franchise agreement. They were to receive the stock of another company in exchange for signing the releases. Upon nondelivery of the stock, the plaintiffs

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Indemnification, and Contribution, 120 U. PA. L. REV. 597, 658 (1972).

Although the *Odette* court barred Shearson from indemnification, it did state that contribution may be available to it from the bank should it establish joint liability at trial. The court found that the same deterrent policy which required that an underwriter not be permitted to shift its entire liability to another through indemnification also mandated that tortfeasors other than the underwriter not be allowed to escape liability for damages. *See* Globus, Inc. v. Law Research Serv., Inc., 318 F. Supp. 955 (S.D.N.Y. 1970), *aff'd*, 422 F.2d 1346 (2d Cir.), *cert. denied*, 404 U.S. 941 (1971). Although this holding goes against the traditional American no-contribution rule, *see* Union Stock Yards Co. v. Chicago, B. & Q.R.R., 196 U.S. 217 (1905), it makes sense in the securities fraud context. Application of the no-contribution rule would result in the denial of contribution between all defendants in securities law cases, and this would violate the intent of Congress in this area. *See* § 11(f) of the 1933 Act, 15 U.S.C. § 77k(f) (1970), and §§ 9(e), 18(b) of the 1934 Act, 15 U.S.C. §§ 78i(e), 78r(b) (1970).

[152] *See* deHaas v. Empire Petroleum Co., 435 F.2d 1223, 1232 (10th Cir. 1970); Green v. Wolf Corp., 406 F.2d 291 (2d Cir. 1968), *cert. denied*, 395 U.S. 977 (1969). Indeed, § 28(a) of the 1934 Act, 15 U.S.C. § 78bb(a) (1970), may be read as prohibiting punitive damages. Moreover, specific recovery provisions of the 1934 Act limit relief to the consideration paid by the claimant. Section 11(e), 15 U.S.C. § 77k(e) (1970) (registration statement liability), § 12(2), 15 U.S.C. § 77*l*(2) (1970) (prospectus liability). Nor does there appear to be any indication that Congress intended imposition of such damages by the securities acts. *See* deHaas v. Empire Petroleum Co., *supra* at 1230, Green v. Wolf Corp., *supra* at 303.

Nonetheless, punitive damages are permissible under state laws. Under the doctrine of pendent jurisdiction, punitive damages for fraud are recoverable in federal courts on state law claims when those laws allow such damages. Flaks v. Koegel, 504 F.2d 702 (2d Cir. 1974); Coffee v. Permian Corp., 474 F.2d 1040, 1044 (5th Cir.), *cert. denied*, 412 U.S. 920 (1973); Young v. Taylor, 466 F.2d 1329, 1338 (10th Cir. 1972).

[153] For a discussion of consequential damages and recent cases dealing with them, see *Survey of 1974 Securities Law Developments*, 32 WASH. & LEE L. REV. 719, 767-69 (1975).

[154] *See* Madigan, Inc. v. Goodman, 498 F.2d 233, 238-40 (7th Cir. 1974); Zeller v. Bogue Elec. Mfg. Corp., 476 F.2d 795, 802-03 (2d Cir.), *cert. denied*, 414 U.S. 908 (1973); *accord*, RESTATEMENT (SECOND) OF TORTS § 549(1)(b) (Tent. Draft No. 11, 1965).

[155] 517 F.2d 1068 (9th Cir. 1975).

brought suit against the parent corporation and its officers for failure to register the sale of the stock to be delivered under § 5 of the 1933 Act[156] and for certain misrepresentations under Rule 10b-5.[157] The court held that if plaintiffs could prove their Rule 10b-5 claim they would be able to recover consequential damages. It reasoned that when the plaintiffs entered into the settlement agreement, they had monetary claims against the subsidiary. Because the defendant had also induced the plaintiffs to forego suing upon their claims for two and a half months in the settlement agreement, the court determined that the plaintiffs may have suffered a compensable loss if they could have realized more than they ultimately did on the claims.[158]

To establish consequential damages under the *Foster* analysis, the plaintiffs would have to prove: first, that defendant's misrepresentations violated Rule 10b-5; second, that but for these misrepresentations, plaintiffs would have brought suit on their claim against the subsidiary at the earlier date; and third, that any losses plaintiffs incurred were a reasonably foreseeable consequence of these misrepresentations.[159] These damages do not necessarily include the full difference between what the plaintiffs would have realized on their claim had they asserted it promptly and what they ultimately received in the bankruptcy proceeding. Instead, they are limited by the familiar mitigation of damages principle to what they would have realized had the plaintiffs acted upon their claim when they first learned of the fraud.[160] Thus, at the point where a reasonable man, either because of the breach or the discovery of the fraud, would have taken action to protect himself from further depreciation in the value of the claim, the chain of causation would be cut, and plaintiffs should not be awarded damages for subsequent losses.[161]

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[156] 15 U.S.C. § 77e (1970). Section 5 requires registration statements for a security if it is to be sold through the mail or any other instrument of interstate commerce.

[157] 517 F.2d at 1071.

[158] *Id.* at 1072. Such opportunity-lost damages are similar to those incurred in *Zeller*, *supra* note 138, in which, because of a Rule 10b-5 violation, a corporation lost the extra profits it would have earned had it reinvested its excess funds in its own operation instead of using them to purchase securities from the defendant. 476 F.2d at 803. *See* Madigan, Inc. v. Goodman, 498 F.2d 233, 238-39 (7th Cir. 1974). *Cf.* Affiliated Ute Citizens v. United States, 406 U.S. 128, 154-55 (1972).

[159] 517 F.2d at 1072.

[160] *See, e.g.*, Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90, 103 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971); Esplin v. Hirschi, 402 F.2d 94, 104-05 (10th Cir. 1968). The court recognized that plaintiffs were not asserting a breach of contract claim but stated that the reasonable conduct standard applies in determining the amount of the plaintiff's loss for which defendants should be held responsible. 517 F.2d at 1072.

[161] The Ninth Circuit considered and rejected defendant's argument that because

Conceivably, the plaintiffs may have difficulty in meeting the three-part test established by the court to prove consequential damages, particularly the foreseeability element. Yet the requirement that the plaintiff mitigate his losses prevents imposition of an undue burden upon defendants.[162] By carefully limiting the possibility of recovering consequential damages, the Ninth Circuit has implemented the purposes behind the federal securities laws and Rule 10b-5.[163]

Another case dealing with the mitigation concept was *Harris v. American Investment Co.*[164] The plaintiff, a shareholder in the defendant company, alleged that he was the victim of an ongoing scheme of misrepresentation and fraudulent concealment of information in violation of Rule 10b-5. He further alleged that this scheme caused him to suffer damages by inducing him to hold the stock beyond the time in which he could have recouped his initial outlay.

The Eighth Circuit noted that the normal measure of damages in such actions was plaintiff's actual pecuniary out-of-pocket loss rather than his loss of bargain.[165] The usual time at which damages under

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the plaintiffs failed to execute the releases and subsequently submitted their claims in the bankruptcy proceedings, they should be precluded from recovery damages. This notion of election of remedies apparently assumed that the remedies of rescission and consequential damages for losses suffered prior to that rescission are inconsistent. *See* RESTATEMENT (SECOND) OF TORTS § 549(1)(b), Comment *e* (Tent. Draft No. 11, 1965). Under this argument, the plaintiffs upon learning of the fraud would face the dilemma of seeking rescission and thereby waiving their right to recover consequential damages, or not seeking rescission, which might subject them to further, uncompensated losses. Thus, the court's conclusion—that the plaintiffs' prosecution of their claims against the corporation was the reasonable conduct required to prevent suffering further loss—seems proper.

[162] *See* Cobine, *Elements of Liability and Actual Damages in Rule 10b-5 Actions*, 1972 U. ILL. L.F. 651. The court further limited the plaintiffs' recovery by deducting that sum compensating them for the risk that their claims would drop in value over the 75-day forbearance period. This was done to prevent plaintiffs from receiving a double recovery. 517 F.2d at 1072.

[163] *See* note 134 *supra*.

[164] 523 F.2d 220 (8th Cir. 1975), *cert. denied*, 96 S. Ct. 784 (1976).

[165] 523 F.2d at 225. *See* Madigan, Inc. v. Goodman, 498 F.2d 233, 239 (7th Cir. 1974); Wolf v. Frank, 477 F.2d 467, 478-79 (5th Cir.), *cert. denied*, 414 U.S. 975 (1973); Estate Counseling Serv., Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 303 F.2d 527, 533 (10th Cir. 1962). *But see* Ohio Drill & Tool Co. v. Johnson, 498 F.2d 186, 190-91 (6th Cir. 1974); Zeller v. Bogue Elec. Mfg. Corp., 476 F.2d 795, 801-03 (2d Cir.), *cert. denied*, 414 U.S. 908 (1973); *see generally* 6 L. LOSS, SECURITIES REGULATION 3922-23 (Supp. 1969); Note, *The Measure of Damages in Rule 10b-5 Cases Involving Actively Traded Securities*, 26 STAN. L. REV. 371, 383-85 (1974); Note, *Measurement of Damages in Private Actions Under Rule 10b-5*, 1968 WASH. U.L.Q. 165, 172. *See also* W. PROSSER, LAW OF TORTS § 100 at 733-34 (4th ed. 1971).

the out-of-pocket rule are ascertained is the date of purchase.[166] However, the court refused to apply the date of purchase measurement in this case because of the difficulty in determining the actual worth of the securities.[167] Since the misrepresentation allegedly affected the market price of the securities, the court found that a more apt time measurement would be the date of discovery of the fraud.[168] This holding is logical, because only when the public discovers the fraud can the market reflect the true value of the stock unaffected by the defendant's alleged fraud.

The court also held that defrauded buyers of securities may maintain an action for damages though continuing to hold the securities.[169] Thus, it found that the plaintiff was under no duty to sell his stock in the defendant before maintaining a Rule 10b-5 action or to mitigate his damages.[170] Presumably, where one has bought securities for long-term investment, it would be inappropriate to apply a rule re-

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[166] Janigan v. Taylor, 344 F.2d 781 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965). The First Circuit stated:

> [T]he damages are to be reckoned solely by the difference between the real value of the property at the date of its sale to the plaintiffs and the price paid for it, with interest from that date, and, in addition, such outlays as were legitimately attributable to the defendant's conduct, but not damages covering the expected fruits of an unrealized speculation.

Id. at 786. *Accord*, Occidental Life Ins. Co. v. Pat Ryan & Associates, 496 F.2d 1255, 1264-65 (4th Cir.), *cert. denied*, 419 U.S. 1023 (1974); Gottlieb v. Sandia Am. Corp., 304 F. Supp. 980, 991 (E.D. Pa. 1969), *aff'd in part & rev'd in part on other grounds*, 452 F.2d 510 (3d Cir.), *cert. denied*, 404 U.S. 938 (1971).

[167] It should be noted that the typical fact situation in cases applying the date of purchase measurement involves an alleged fraudulent concealment or misrepresentation by a seller directed only at the buyer-plaintiff rather than the public at large. Hence, the actual worth of the securities at the time of the purchase by the plaintiff is easily determinable. *See* Ross v. Licht, 263 F. Supp. 395, 410 (S.D.N.Y. 1967).

[168] 523 F.2d at 226. *See* RESTATEMENT OF TORTS § 549, comment c at 30-32 (Tent. Draft No. 11, 1965). The general rule for applying this time measurement is when defendant's conduct is alleged to have caused an artificial market of long duration. *See, e.g.*, Esplin v. Hirschi, 402 F.2d 94, 104-05 (10th Cir. 1968), *cert. denied*, 394 U.S. 928 (1969); *see also* Chasins v. Smith, Barney & Co., 306 F. Supp. 177, 178 (S.D.N.Y. 1969).

[169] 523 F.2d at 227. *See* Sackett v. Beaman, 399 F.2d 884, 891 (9th Cir. 1968); Johns Hopkins Univ. v. Hutton, 326 F. Supp. 250, 262 (D. Md. 1971), *aff'd in part & rev'd in part on other grounds*, 488 F.2d 912 (4th Cir. 1973), *cert. denied*, 416 U.S. 916 (1974); Pfeffer v. Cressaty, 223 F. Supp. 756, 758 (S.D.N.Y. 1963).

[170] At common law, a defrauded purchaser of securities was under no duty to sell them prior to maintaining an action for deceit, but could hold them for investment purposes if he chose. *See, e.g.*, Hindman v. First Nat'l Bank, 112 F. 931, 935-36 (6th Cir.), *cert. denied*, 186 U.S. 483 (1902).