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Insiders’ Liability Under Rule 10b-5 for the Illegal Purchase of Actively Traded Securities

Civil liability for “insider trading” under SEC Rule 10b-5 may soon be greatly expanded. In the past, those claiming to have been injured by an insider’s silence were generally shareholders in closed corporations. As a result, no court has yet been faced with a private claim in a case where the insider executed his illegal transaction on a national stock exchange. But such claims are now pending. In an SEC action against the Texas Gulf Sulphur Company, the Second Circuit found that over a five-month period, eight of the company’s officials violated Rule 10b-5 by purchasing Texas Gulf stock on the open market without disclosing material information. By the date of the District Court opinion, at least forty-nine private actions had been brought to recover a total of more than $75,000,000 in damages. Unless those actions are settled, some court will soon face the difficult problem of defining the

1. 17 C.F.R. § 240.10b-5 (1942). The Rule provides:
   (a) To employ any device, scheme, or artifice to defraud,
   (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
   (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.
   In Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946), Judge Kirkpatrick held that violators were civilly liable to those for whose benefit the Rule was enacted. Since then, Rule 10b-5 has been one of the most rapidly-expanding areas of federal law.


4. SEC v. Texas Gulf Sulphur Co., 258 F. Supp. 262 (S.D.N.Y. 1966), rev’d in part, 401 F.2d 833 (2d Cir. 1968). The facts of the case were rather complicated, and a full summary would serve no useful purpose. In essence, the problem was that in November 1963 Texas Gulf personnel discovered what the Second Circuit later characterized as a “more than marginal” possibility that the land near Timmins, Ontario, contained copper, zinc and silver deposits of unprecedented size. The discovery was kept secret until April 1964 so that the company could acquire the land at minimal expense. During those five months, insiders and their “tippees” purchased considerable quantities of Texas Gulf stock on various exchanges. The SEC sued for an injunction; and as ancillary relief, it asked that the individual defendants be compelled to make restitution to those whose shares they purchased. As of this writing, the case has been remanded to the District Court for a determination of the appropriate remedies.

5. 258 F. Supp. at 267 n.1.
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proper scope of liability and measure of damages for insider trading on an active market.6

I. The Scope of Liability

The language used in some early decisions under Rule 10b-5 suggested that violators were civilly liable only to those plaintiffs who could establish privity of contract.7 This requirement seemed reasonable enough in closed-corporation cases, where it was clear that the only party who could have been injured was the person with whom the defendant dealt. But in some cases, particularly those involving listed securities, the defendants' misrepresentations reached the public at large.8 Faced with plaintiffs who clearly relied on such statements, the courts soon lost patience with the privity requirement, and by now it can safely be said that the rule has been abandoned.9 Its abandonment seems wholly proper, since privity has little to recommend it conceptually. If two plaintiffs sold for the same price at the same time, it seems manifestly unfair to deny one a remedy while permitting the other to recover, simply because the latter's stock certificates happened to be the ones delivered to the insider.10

But the absence of a privity barrier makes it necessary to develop some other means of limiting the scope of the insider's liability. Otherwise, the offending insider would become an insurer of every investor's market losses.11 This result is obviously unacceptable in theory, even

6. The following discussion makes no attempt to deal with cases involving affirmative misrepresentations. However, the suggested analysis does apply to closed-corporation, as well as market cases; and although its specific concern is with purchases by insiders, the reasoning can be extrapolated to cover cases where the insider sold as well.
10. See TAN 52 infra.
11. Comment, Civil Liability Under Section 10B and Rule 10b-5: A Suggestion for Replacing the Doctrine of Privity, 74 YALE L.J. 658, 678 (1965), notes that once privity is dropped, the absence of at least a causation requirement would mean that "there would be no a priori reason to limit the class of possible plaintiffs to one group or another since no one would have to allege a loss stemming from defendant's conduct. Any investor who suffered a loss would make as good a plaintiff as any other; any limitation such as contemporaneity with defendant's act would be wholly arbitrary."
if the amount of the insider's liability were to be somehow restricted, since it turns civil liability under the Rule into a penal, rather than a remedial device. And in practice, the courts have consistently rejected any suggestion that insiders should be treated as insurers.\textsuperscript{12}

One possible limitation would be to require the plaintiff to prove some form of reliance.\textsuperscript{13} This might be appropriate in misrepresentation cases,\textsuperscript{14} or even in cases of nondisclosure, so long as the insider dealt directly with the plaintiff. But when the insider made no representation at all and had no direct contact with the plaintiff, a strict insistence on reliance would grant him virtual immunity.\textsuperscript{16} In effect, it would mean that an insider could escape liability altogether merely by dealing through an intermediary, a result that the Supreme Court found intolerable sixty years ago in \textit{Strong v. Repide}.\textsuperscript{18}

A closer reading of the cases purporting to require reliance reveals that many courts were actually referring to the concept of causation in fact.\textsuperscript{17} It does seem proper to limit the defendant's liability to those

\textsuperscript{12} The aim of the rule . . . is to qualify, as between insiders and outsiders, the doctrine of \textit{caveat emptor}—not to establish a scheme of investors' insurance.” List v. Fashion Park, Inc., 340 F.2d 457, 463 (2d Cir. 1965), \textit{cert. denied}, 382 U.S. 811 (1965) (in support of a reliance requirement); see Myzel v. Fields, 386 F.2d 718, 744-45 n.23 (8th Cir. 1967), \textit{cert. denied}, 390 U.S. 951 (1968).

\textsuperscript{13} Cf. Rogen v. Ilikon Corp., 361 F.2d 260, 267-68 (1st Cir. 1966); Janigan v. Taylor, 344 F.2d 781, 786 (1st Cir. 1965); List v. Fashion Park, Inc., 340 F.2d 457, 462-63 (2d Cir. 1965).

\textsuperscript{14} But see W. Painter, \textit{supra} note 9, at 109-10. Professor Painter suggests that a strict reliance requirement is inappropriate even in cases of misrepresentation, since misrepresentations can affect the market price of the stock, thus injuring investors who never heard of the misstatement just as much as those who relied on it.

\textsuperscript{15} Professor Painter notes that the concept of “reliance” when applied to cases of nondisclosure that involve dealings on an exchange or over-the-counter market is incongruous; the investor “relies” only on his general impression of the financial condition of the corporation gleaned from its published reports, or he relies on the general tendency of market quotations to reflect the results of such reports; he does not rely on the “omission of an individual whose identity is unknown to him.” W. Painter, \textit{supra} note 9, at 109.

For that reason, one commentator argues that “focusing on reliance rather than causation prevents an accurate analysis of the nature of plaintiff's harm and its causal relationship with defendant's conduct.” Comment, \textit{supra} note 11, at 674; see Bronnberg \textsection{} 8.1, at 194-95.

\textsuperscript{16} 213 U.S. 419 (1909). There the Court held that because of the “special facts”—apparently consisting in the defendant insider's dominant position in the corporation, which gave him exclusive access to the information in question—he was liable to the seller despite the fact that he concealed his identity by purchasing through a straw man.

In List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir. 1965), the court cited \textit{Strong} for the proposition that an insider can be liable even though he made no affirmative representation at all, stating that “[s]urely we would suppose that Rule 10b-5 is as stringent in this respect as the federal common law rule which preceded it.”

\textsuperscript{17} The reliance test ordinarily permits the court to determine whether or not there was a causal nexus between the defendant's conduct and the plaintiff's loss. But reliance and causation will at times point in different directions, since either can exist without the other. See Comment, supra note 11, at 672; W. Painter, \textit{supra} note 9, at 103-12. When they do work at cross-purposes, courts ordinarily look to causation, even though some may continue to use the term “reliance.” See note 36 infra.
Injuries which, but for his illegal conduct, would never have been suffered. Any broader liability would be inconsistent with the policies thought to justify the imposition of civil liability in the first place.

Courts have developed three major rationales for the existence of a private right of action under the Rule. Two of them, the "tort" and "policy" rationales, clearly preclude liability for injuries that the defendant's conduct cannot be shown to have caused. The third, the "voidability" rationale, is less clear; but insofar as it does conflict with the first two, its application cannot be justified on any rational theory of remedies.

A. The Tort and Policy Rationales

The most frequently cited rationale for civil liability under the Rule is the "tort" doctrine. It derives from the common-law rule that the violation of a criminal statute is tortious if (1) it results in an injury of the sort that the statute was intended to prevent, and (2) the injury was suffered by a member of the class that the statute was supposed to protect. The doctrine is based, not on the premise that the legislature must have intended a private right of recovery, but rather...
on the theory that "the right is so fundamental and so deeply ingrained in the law that where it is not expressly denied the intention to withhold it should appear very clearly and plainly."  

If liability is based on the tort doctrine, the doctrine itself restricts the insider's liability to those losses that he actually caused. Section 286 of the first Restatement of Torts, the provision relied on by virtually every court that has employed the doctrine, states explicitly that the violator of a criminal enactment is civilly liable for the invasion of another's interests only if "the violation is a legal cause of the invasion."  

The "policy" rationale is much broader. It assumes that the courts are charged with the duty of making remedial legislation like the securities laws fully effective by supplying any necessary remedy that Congress may have overlooked.  

Although foreshadowed by lower court opinions, the doctrine was first articulated by the Supreme Court in J. I. Case Co. v. Borak. There the Court held that a private action lies under Section 14(a) of the Securities Exchange Act for injuries suffered as a result of reliance on misleading proxy statements. Quoting Bell v. Hood, the Court said that "[i]t is for the federal courts 'to adjust their remedies so as to grant the necessary relief' when federally secured rights are invaded.

Even if the tort doctrine is abandoned in favor of the broad policy rationale of Borak, causation in fact should still have to be alleged. Under the latter rationale, the only real justification for civil liability is that an injury resulting from illegal conduct would otherwise go unremedied. If a court holds the defendant liable for an injury that did not in fact result from his offense, the court is exceeding its authority and in effect assessing criminal penalties without legislative guidance. Borak may have authorized the judiciary to supply necessary remedies, but a "remedy" in the absence of a loss caused by the wrongdoer is

24. Restatement of Torts § 286(d) (1939). Section 9, Comment b, states that "In order that a particular act or omission may be the legal cause of an invasion of another's interest, the act or omission must [inter alia] be a substantial factor in bringing about the harm ...."  
It should also be noted that at common law deceit was not even actionable unless the plaintiff could allege actual damages. 1 F. Harper & F. James, The Law of Torts § 7.15, at 590-91 (1956); Frosser, supra note 18, at 747-48.  
25. See Bromberg § 2.4(1)(d), at 33-34.  
26. E.g., Ellis v. Carter, 291 F.2d 270, 274 (9th Cir. 1961); Pratt v. Robinson, 203 F.2d 627, 632 (9th Cir. 1953); cf. Baird v. Franklin, 141 F.2d 238, 244-45 (2d Cir. 1944) (Clark, J., dissenting on another point).  
29. 377 U.S. at 433.
simply a fine, levied in a particularly pernicious ex post facto manner.

Section 28(a) of the Securities Exchange Act itself provides that "no person permitted to maintain a suit for damages under the provisions of this chapter shall recover . . . a total amount in excess of his actual damages on account of the act complained of." Two recent cases have questioned the section's applicability to implied actions under the Rule, on the theory that the right of action arises from common law, rather than under the provisions of the Act. But the prevailing opinion seems to be that Section 28(a) does apply. If so, "on account of the act complained of" might reasonably be interpreted as restricting recovery to plaintiffs whose asserted injuries were demonstrably caused "by the act complained of."

B. Causation in the Context of Insider Trading

In past cases, sellers have experienced relatively little difficulty in convincing the trier of fact that their losses were in fact caused by the insider's offense. But their burdens were lightened considerably by a fundamental misconception on the part of most courts as to what "causation in fact" means in the context of insider trading.

List v. Fashion Park, Inc. furnishes an illustration. There the plaintiff claimed that insiders had purchased his stock without disclosing an impending sale of the corporation's assets. The District Court found for the defendants, citing two alternative grounds. First, it held that the information withheld was not material, since negotiations for the asset sale had barely begun when defendants purchased

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As an alternative possibility, Baumel suggested that the section might be interpreted "as simply precluding double recovery for common law fraud and violation of federal law." 285 F. Supp. at 145; accord, 3 L. Loss, Securities Regulation 1474 n.103 (2d ed. 1961). But even if that interpretation is correct, the same considerations that militate against double recoveries would seem to preclude even a single recovery when the defendant's offense was not the cause in fact of the asserted injury.

32. See, e.g., Myzel v. Fields, 386 F.2d 718, 748 (8th Cir. 1967); Estate Counseling Service v. Merrill Lynch, Pierce, Fenner and Smith, Inc., 303 F.2d 527, 553 (10th Cir. 1962); Kohler v. Kohler Co., 208 F. Supp. 808, 825 (E.D. Wis. 1962), aff'd, 319 F.2d 634 (7th Cir. 1963).

33. But see Bromberg § 8.7(1), at 213 n.59, where the author notes that "on account of" is a relatively loose connective; Congress might easily have written "caused by" instead.

Some courts have suggested that the section's only function is to prohibit punitive damages. E.g., Myzel v. Fields, 386 F.2d 718, 748 (8th Cir. 1967). However, any liability for injuries not caused is arguably "punitive."

plaintiff's stock. Second, it held that plaintiff was too sophisticated an investor to have relied on defendant's disclosure. The Second Circuit affirmed, but it rejected the lower court's interpretation of the reliance requirement. Instead, it proposed that

[the proper test is whether the plaintiff would have been influenced to act differently than he did act if the defendant had disclosed to him the undisclosed fact... This test preserves the common law parallel between "reliance" and "materiality," differing as it does from the definition of "materiality" under Rule 10b-5 solely by substituting the individual plaintiff for the reasonable man.\(^{35}\)

As a test of causation in fact, which, in context, it clearly purported to be,\(^{36}\) the List formula is misleading in the extreme. But the courts, and even a number of commentators, have accepted it without question,\(^{37}\) and it seems destined to create serious problems when an active-market case arises.

The formula's basic defect is its implicit assumption that insiders are subject to an unconditional duty of disclosure. Because of that assumption, the critical question is thought to be whether or not, had disclosure been made, the plaintiff would still have sold for the price he received. But in fact, as the Second Circuit itself has since recognized, if an insider stays out of the market and refrains from recommending his company's stock to others, he retains what appears to be an absolute right to keep material information secret.\(^{38}\) This right derives from the language of the Rule itself. The "manipulative and deceptive devices" listed in the Rule's three numbered clauses are illegal only if practiced...
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"in connection with the purchase or sale of [a] security." The courts have interpreted the "in connection with" requirement liberally, particularly in cases where the defendant was accused of making a positive misrepresentation, but no court has ever held that the Rule was violated by mere failure to disclose when neither the insider nor any party privy to the insider bought or sold a security.

The fact that an insider ordinarily retains the option of silence means that what the court should have been asking in List was whether the plaintiff would have sold if defendants had refrained from trading, not whether he would have sold if defendants had disclosed. Assuming that defendants had in fact violated the Rule, the plaintiff should have been able to recover only if, but for the defendants' willingness to purchase, he would have retained his stock until news of the asset sale

39. The placement of the "in connection with" clause at the end of 10b-5(c) might seem to indicate that the practices prohibited by the first two clauses need not meet that test. However, no court has yet made such a suggestion; and if the Rule were to be so construed, it might well be ultra vires.

40. See Sprayregen v. Livingston Oil Co., CCH Fed. Sec. L. Rep. 92,272 (S.D.N.Y. 1968). There the defendants delivered an allegedly misleading speech to a group of security analysts, hoping to induce them to recommend their employer's securities. The court held that it was unnecessary to allege that the misleading speech was delivered for the purpose of improving defendants' own market position, so long as plaintiffs did allege reliance. See also Miller v. Bargain City, U.S.A., 229 F. Supp. 33 (E.D. Pa. 1964) (decision on whether or not the "in connection with" requirement was satisfied where defendants filed allegedly misleading reports with the SEC, without engaging in any transactions themselves, would have been premature on motion to dismiss).

In SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 860-62 (1968), the Second Circuit held that good faith and an absence of corporate advantage were no defense to an SEC injunction action if the corporation had failed to exercise due diligence in preparing an important press release. However, it found it unnecessary to decide whether such a negligent failure would ground an action for damages. Id. at 853; accord, Heit v. Weitzen, 402 F.2d 909 (2d Cir. 1968), petition for cert. filed, 37 U.S.L.W. 9120 (U.S. Jan. 2, 1969) (No. 894).

41. But see Fischer v. Kletz, 266 F. Supp. 180 (S.D.N.Y. 1967). There one of the defendants was an accounting firm which the plaintiffs accused of having remained silent after discovering that its client's last annual report was materially misleading. The court refused to decide on motion whether or not the "in connection with" requirement was satisfied in the absence of any obvious gain. However, it was also alleged that the firm had encouraged its employer to distribute uncertified interim reports after discovering the crucial error, and the court treated the case in part, at least, as one where the defendant aided and abetted the primary violation of the employer. But here, too, as in Miller v. Bargain City, U.S.A., 229 F. Supp. 33 (E.D. Pa. 1964), there was no specific allegation that the primary defendants were buying or selling securities.

In theory, it might seem arbitrary to condition liability on whether an insider (or a tippee) actually bought or sold stock. Investors can be harmed by any failure to make immediate disclosure of material information; and insiders can cause considerable damage by malicious or negligent delay, whether or not they themselves profit from it.

But secrecy is essential to the proper exploitation of most innovations and discoveries. Texas Gulf is a ready example. If the "in connection with" requirement is found to have been satisfied without insider trading, as such, the door is open to judicial scrutiny of every corporate decision to keep something secret. The resulting exposure, even if limited to the possibility of an injunction, could exert undesirable pressure on managers making decisions that should be purely matters of business judgment. The retention of a trading requirement lets corporate officers make business decisions without fear of judicial second-guessing, so long as they remain silent and stay out of the market.
became public. If he would have sold before that date anyway, the insiders' offense bore no causal relationship to his loss.

Even though the court asked the wrong question in List, it probably reached the right result. For under the suggested test, proof of causation would still be relatively easy in closed-corporation cases and in cases where the insider actively solicited the sale. But where the stock in question was highly liquid and the seller spoke only to his broker, his burden of proof is formidable.

The problem is not, as some commentators have suggested, that no one can be harmed by insider trading on a stock exchange. Investors as a class are always harmed by insider trading. The real problem is that in stock exchange cases the injured parties are likely to be unidentifiable: there is usually no way of knowing who would have held the stock at the time of disclosure had the insider not entered the market.

If investors all made their decisions to buy or sell without reference to the price of the stock, the only people who could legitimately claim to have been injured by insider purchases would be those buyers who were forced to pay a marginally higher price by competition from the insiders. But most investors do look at a stock's price before selling, and if an insider's purchases were solely responsible for a rise in the stock's price to the level at which an investor intended to sell, the insider in a very real sense caused the sale. In practice, this means

42. See Comment, supra note 11, at 675-76, 679; Whitney, Section [sic] 10b-5: From Cady, Roberts to Texas Gulf: Matters of Disclosure, 21 Bus. LAW. 193, 201-05 (1965); cf. H. MANNE, INSIDER TRADING AND THE STOCK MARKET ch. 7 (1966); BROMBERG § 8.7(2), at 217.

43. Comment, Insider Trading Without Disclosure—Theory of Liability, 28 Ohio St. L.J. 472, 477 (1967), notes that whenever insider trading takes place, "the aggregate quantity of good securities owned by investors is diminished, or the quantity of losing stock in the hands of investors is increased."

44. See Whitney, supra note 42, at 201.


Nonetheless, even if a frustrated purchaser can sue under the Rule, the problems of proving that he would in fact have bought but for the insider's offense are such that his rights are of theoretical interest only. Like the seller, he has to prove that the insider's transaction had a measurable effect on the market and that he reacted to that effect. The task is difficult enough for a seller; but for a buyer, proof of reaction would be virtually impossible.
that private recoveries in active-market cases, although infrequent, may occur when sellers can show that (1) the insider's purchases had a measurable effect on the market, and (2) they sold when they did as a direct result of that effect.

Yet when the stock in question was the subject of heavy trading during the relevant period, it would probably be impossible for a seller to establish causation.\footnote{46} The result is admittedly incongruous. A realistic causation in fact requirement, without which no rational limitation on the scope of the insider's liability is possible, has the effect of denying recovery to the very class that the Securities Exchange Act was specifically designed to protect: investors trading on national stock exchanges. Commentators have suggested that this result might be avoided by appropriate presumptions—for example, a presumption that any sale executed during the approximate period in which insiders were buying was caused by the insiders.\footnote{47} But no presumption could make it substantially easier for a seller to recover without being grossly contrary to fact and thus eliminating the rationality of the causation in fact test.

C. Causation and the Voidability Doctrine

The third major rationale for civil liability under the Rule is the "voidability" theory. Section 29(b) of the Securities Exchange Act provides:

\begin{quote}
Every contract made in violation of any provision of this chapter or any rule or regulation thereunder . . . shall be void (1) as regards the rights of any person who, in violation of any such provision, rule or regulation, shall have made or engaged in the performance of any such contract, and (2) as regards the rights of any person who, not being a party to such contract, shall have acquired any rights thereunder with actual knowledge of the facts by reason of which the making or performance of any such contract was in violation of any such provision, rule or regulation.\footnote{48}
\end{quote}

Taken literally, it gives any person capable of showing that his shares were the ones purchased by the insider an unconditional option to avoid the contract of sale and demand restitution,\footnote{49} while those un-

\footnote{46} Cf. Bromberg § 8.7(2), at 216. Professor Bromberg concludes that a strict insistence on causation would in most instances immunize insiders from civil liability entirely, and for that reason suggests that some "middle ground" must be found; but he makes no serious attempt at proposing one. Id. at 220.
\footnote{47} See, e.g., Bromberg § 8.7(2), at 219 & n.87. But see note 11 supra.
\footnote{49} See 3 L. Loss, supra note 31, at 1793. Read literally, the section characterizes
able to do so are relegated to an implied action and subjected to the burden of proving causation in fact.

Ordinarily the discrimination is innocuous. A seller will usually be unable to recover under Section 29(b) unless he could have shown causation in fact, for in order to avoid the contract he has to establish that it was “made in violation of” Rule 10b-5. In misrepresentation cases, that should mean that the seller has to prove he relied on the buyer’s misstatement. And even in nondisclosure cases, so long as the stock in question was closely held, its lack of liquidity would ordinarily make it unlikely that the seller would have sold anyway if the insider had not wanted to buy. But in active-market cases, the literal language of Section 29(b) lets sellers demand restitution when the insider’s offense bore no causal relationship at all to the sale. Bromberg notes that “[t]hose in unwitting privity with the buyers have no greater claim than others trading about the same time,” yet those who traded at about the same time neither have nor should have any claim at all unless they can establish that the insider actually caused their sales.

Irrational as Section 29(b) may seem when juxtaposed with the rules governing implied actions, there appears to be no really satisfactory way of avoiding its application. One possibility would be to interpret it as a statutory analogue to the common-law rule that contracts tainted by fraud in the inducement are voidable. It would

 contracts in violation of SEC rules as “void.” In practice, however, the courts have interpreted it as rendering them voidable only, at the option of the “defrauded” party, The Greater Iowa Corp. v. McLendon, 378 F.2d 783, 792 (8th Cir. 1967); Royal Air Properties, Inc. v. Smith, 312 F.2d 210, 213 (9th Cir. 1962).

The option is unconditional in the sense that proof of sale appears to be the only legal requisite for rescission. However, it can be lost by laches, waiver and estoppel. Royal Air Properties, Inc. v. Smith, supra, at 213-14; cf. Strailey v. Universal Uranium & Milling Corp., 289 F.2d 370 (9th Cir. 1961). And the remedy, as distinguished from the right itself, can be barred by the running of the applicable statute of limitations. Myzel v. Fields, 386 F.2d 718, 742 (8th Cir. 1967), cert. denied, 390 U.S. 951 (1968); Royal Air Properties, Inc. v. Smith, supra, at 214.

50. The alternative—voiding all transactions whether or not the other party was affected by the misrepresentation—could be justified only as a penalty. Arguably, the section operates as a penalty anyway in nondisclosure cases, but that result, unlike the alternative noted above, is apparently compelled by the plain language of the statute. In misrepresentation cases, its language is loose enough to give the court a choice.

51. It might be thought that the “actual damages” rule of Section 28(a) bars any recovery, even under Section 29(b), by plaintiffs unable to establish causation in fact. However, even if Section 28(a) does govern implied actions, a matter of some doubt, see p. 869 & note 31 supra, plaintiffs suing under Section 29(b) are demanding restitution, not maintaining “a suit for damages,” and that would seem to render the former section inapplicable on its face. See Bromberg § 8.7(1), at 213 n.59.

52. Bromberg § 8.7(2), at 218.

53. See Restatement of Contracts § 476(1) (1932).
then be appropriate to require that the plaintiff show that his sale was in fact induced by the insider's "fraud"—i.e., his presence in the market during a period of nondisclosure. The problem with that interpretation is that the language of the statute contains no warrant for it. Purchases by insiders in possession of undisclosed material information are certainly "in violation of" Rule 10b-5, irrespective of whether they actually hurt anyone.54

Admittedly, the mechanical problems of matching transactions executed on an active exchange may be such that the possibility of frequent windfall recoveries under Section 29(b) is more theoretical than real.55 Still, so long as civil liability under the Rule is supposed to be remedial rather than penal, the section will remain an unfortunate anomaly, and one that should be excised in any future overhaul of the Act.

II. Measure of Damages

The burden of showing that a sale was in fact caused by an insider's illegal market activity is so formidable that a discussion of the damages to which successful plaintiffs are entitled may seem to be of academic interest only. Nonetheless, unusual cases do arise, and parts of the following analysis are relevant to all insider trading cases, not just to active-market situations.

A. The Insider's Maximum Liability

Under present law, the extent of an insider's potential liability can be grossly disproportionate to the magnitude of his offense.56 If the courts extend the List formula to stock exchange cases, every investor who sold the relevant stock between the inception of insider trading and the date of disclosure would be a potential plaintiff. All that List requires is a finding that the plaintiff would have acted differently if the insider had made full disclosure. That means that if the in-

54. See Myzel v. Fields, 386 F.2d 718, 742 (1967). Another possible means of avoiding the literal application of Section 29(b) would be to read "contracts" as meaning "executory contracts," thus limiting the "voidability" doctrine to those few cases in which the fraud is discovered before the sale is completed, on the theory that the legislature was endorsing the common-law rule that a knowing party to an illegal contract has no right to enforce it. See Restatement of Contracts § 598 (1932). However, any such endorsement would have been supererogatory, and the legislature could easily have said "executory" if that was what it meant.
55. See Fleischer, supra note 40, at 1297 n.126.
56. This assumes that the magnitude of the offense is measured by the number of shares purchased or the amount of the insider's net profit.
formation withheld was in fact material, the insider's liability is virtually a foregone conclusion.57

Some commentators have suggested that an insider's potential liability is so "frightening,"58 especially in comparison with the culpability of his offense, that in stock exchange cases, at least, private plaintiffs as a class should be allowed to recover no more than an amount equal to the insider's "profits."59 But any such limitation on the insider's liability would create serious definitional problems. Since the beginning of civil liability under the Rule, courts have insisted that gain is no prerequisite for liability.60 As long as that doctrine continues to be applied in "non-market" cases, questions will arise as to which category the case at hand should be placed in.

57. The only possible defense would be to plead that even though a reasonable investor would have changed his mind, the plaintiff would not have. The prospects for success with an argument like that are dim.

Painter, who appears to accept the List test, is forced to admit that "there seems to be no rational means of deciding who, among those trading through the vastly impersonal medium of an exchange or over-the-counter market, should recover and who should not." Painter, supra note 5, at 112. As a result, he concludes that [the boundless scope of potential liability, by a class action or otherwise, is] enough to make the whole question of civil liability in this area controversial. For failing to disclose relevant information during the course of a single transaction in which he purchased a limited number of shares, an insider could become virtually an insurer of the future losses suffered by all who sold at about the same time. If several purchases were made, the extent of liability on a per share basis would correspond with the volume of trading during the period in question. If Section 16(b) has been criticized as being 'arbitrary' and 'penal,' an application of Section 10(b) in the manner suggested above would be nothing short of confiscatory.

58. Id. 111; see, e.g., Bromberg § 8.7(2), at 220.
59. Id. 218, 220 n.92 (noting, however, that in "very willful instances" liability might properly be measured by the losses suffered by individual investors). Bromberg asserts that "[t]he net loss [to investors as a class] is, of course, equal to the violators' gain or profit and coincides with a fiduciary measure of damages." Bromberg § 8.7(2), at 218. Then, however, he adds in a footnote that "[i]n theory the calculation would be easy: the difference between the prices paid . . . by the violators, and what they would have been with disclosure and without misstatement." Id. at 218 n.98.

The two statements are contradictory. If a fiduciary measure of damages were applied, the insider would be stripped of any profits made by virtue of the illegal purchase. This would mean that if the shares increased in value after disclosure, the insider would be liable for the increase. Alternatively, if he sold after disclosure and invested the proceeds in another stock, a court of equity could decree an accounting and apply equitable tracing. Obviously the "gain or profit" thus measured would approximate the net loss to investors as a class (see p. 877 & note 63 infra) only on the dubious assumption that those who would otherwise have been holding the insider's shares on the date of disclosure would subsequently have made the same investment decisions as the insider.

If, on the other hand, the deceit measure suggested in the footnote were applied, some parity would be achieved, since the insider's paper profits do approximate the paper losses of investors as a class. But see p. 889-90 infra.

Since the difference between "market" and "non-market" cases is merely one of degree, turning on how actively the particular stock was traded, close cases could be decided only by an arbitrary determination of whether or not the defendant's potential liability was "frightening" enough to justify applying the limitation.

Even under the test of causation suggested above, the insider's potential liability can vastly exceed the amount of his illegal profits. When an insider purchases stock in an active market, the extent of the resulting injury to investors will not necessarily be determined by the number of shares he bought. If he buys enough stock to affect the quoted price, the magnitude of the resulting damage will depend solely on the market's reaction to the change. For example, the management of a mutual fund might have decided early in April 1964 to liquidate ten thousand shares of Texas Gulf as soon as the price reached thirty-five. If Texas Gulf reached thirty-five on April 15, the day before the Timmins discovery was disclosed, solely because an insider had purchased five hundred shares that morning, the fund could legitimately charge the insider with responsibility for the sale of all ten thousand.

But under the suggested test, the problem of disproportionate liability is largely theoretical. Although the insider's potential liability still exceeds the amount of his gains, the plaintiff's problems of proof are such that the potentiality would rarely, if ever, be realized.

A limitation on the insider's maximum liability might be thought to be justified by the fact that in any case where the insider caused the sale of more shares than he bought, the sellers' losses were partially balanced by the profits realized by innocent buyers, who purchased only because the insider's offense had the effect of increasing the supply of shares on the market. But those who gained are unidentifiable; and even if they could be identified, it seems highly unlikely that any seller could recover from them. Someone has to bear the consequent loss; and the insider, whose wrongdoing caused it in the first place, seems by far the most appropriate candidate.

In short, if a realistic causation in fact test is applied, there seems

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61. The prices used here are fictional.
62. This assumes that the fund would have revalued Texas Gulf once it learned of the Timmins discovery and waited at least until the market digested the news before selling. If it would have sold at thirty-five anyway, obviously the insider bore no responsibility for the fund's failure to profit from disclosure.
63. The case of the mutual fund furnishes an example. If the insider purchased only five hundred shares, his offense had the effect of shifting the profits on ninety-five hundred from the fund to other innocent investors.
to be no real justification, theoretical or practical, for limiting an insider's potential liability to the amount of his profits.

B. The Plaintiff's Maximum Recovery

In the few cases involving insider purchases that have reached the relief stage, courts have been more interested in depriving defendants of ill-gotten gains than in compensating sellers for credible losses. The only consistent pattern emerging from the case law is that regardless of circumstances, the insider will be deprived of an amount equal to or exceeding any "profit" he might have made.

1. The Case Law

Speed v. Transamerica Corp. was the first case in which the problem of damages was given any detailed consideration. Transamerica, the owner of a majority of the voting stock of Axton-Fisher Tobacco Company, made a tender offer to the minority without disclosing that Axton-Fisher's tobacco inventory had been grossly undervalued in the last annual report and that Transamerica planned to liquidate the enterprise in the near future. Most of them accepted. On the date of liquidation, warehouse receipts for the tobacco in storage were distributed to Transamerica and the few minority holdouts. The latter sold their receipts shortly thereafter to a buyer that Transamerica found for them, but Transamerica held on to its own receipts and eventually sold at an even greater profit.

The stockholders who had accepted Transamerica's tender offer brought suit under Rule 10b-5. The court held that a disinterested board of directors would have disclosed the value of the inventory and the liquidation plans, and that plaintiffs would never have accepted the offer in that event. Having lost on the issue of liability, Transamerica argued that damages should be measured under the "deceit" or "out-of-pocket" rule, by calculating the difference between the price paid by Transamerica and "the value of the stock at the time when the fraud occurred, presuming a public knowledge of the additional value of the inventory and of the fact of imminent liquidation." Evidence was introduced to show that the stock's value at the time of the fraud, even presuming full disclosure, would have been considerably less than the amount Transamerica eventually received for


65. 135 F. Supp. at 191.
the tobacco, but the court rejected the suggested measure entirely\(^{66}\) and purported to rely instead on the principles of Section 151 of the *Restatement of Restitution*.\(^{67}\) As a result, the plaintiffs found themselves in an even better position than that of the stockholders who had refused Transamerica’s offer.

Had plaintiffs received their warehouse receipts upon the liquidation . . . , it is impossible to say whether they would have accepted the offer which defendant arranged for the other public stockholders, or whether they would, as did defendant, have held them for a better price. The Restatement . . . considers that the defrauded party is “entitled to be put in substantially the position [in which] he would have been had there not been the deprivation” and it then goes on to recognize that “this may result in granting to him an amount equal to the highest value reached by the subject matter within a reasonable time after the tortious conduct.” What this highest value became within a reasonable time after the liquidation does not appear in this record. Nevertheless, within what I consider a reasonable time defendant itself sold the warehouse receipts at a substantially higher price than that received by the public stockholders. In the circumstances, it would, I think, be a curious decision of an appellate court which specified that the damages payable to the defrauded party were to be measured in value at the time of the liquidation when plaintiffs were by the act of the defendant deprived of the opportunity to gamble on future prices, and to permit the tortfeasor itself, who deprived them of that right, to take the gamble successfully and to retain the proceeds which resulted from it.\(^{68}\)

In dictum, the court went even further, stating that if Transamerica had profitably invested the proceeds from the sale of tobacco attributable to plaintiff’s shares, the plaintiffs would have been entitled to a proportionate share of the investment as well.\(^{69}\)

Although the court claimed to be following the *Restatement*, it drastically reduced the plaintiff’s burden of proof. Under the *Restatement*, the plaintiff could claim the value of the property at a date

### Notes

66. The court’s rejection seemed to be in part on theoretical grounds, and in part a reflection of its doubt as to the strength of the defendant’s evidence.

67. There is a certain incongruity in an argument which speaks of undenied testimony given in behalf of the defendant when the experience of the defendant itself, perhaps in the exercise of rare good judgment, perhaps as a result of good fortune, or again, perhaps for a variety of reasons, is itself the effective denial of the testimony of its own witnesses, in that it was able to cash in for itself afterwards several times the value which its witnesses gave as of the dates when the fraud was committed.

68. See pp. 886-87 infra.

69. Id. at 196.
subsequent to the fraud only if he could "prove" that he probably would have sold it at that time.\textsuperscript{70} In \textit{Speed}, however, the court admitted that it was impossible to predict whether or not plaintiffs would have accepted the offer arranged for the other stockholders, and still gave them the benefit of the doubt.

Almost ten years later, the First Circuit reached an identical result in \textit{Janigan v. Taylor}.\textsuperscript{71} Janigan, the manager of a closed corporation, bought up virtually all of its shares for $20.00 each without disclosing that the business was beginning to look profitable. Two years later, he sold out for $300.00 per share. The sellers sued for an accounting. Janigan argued that there was no way of knowing whether or not they would have held on to the stock for as long as he did, to which the District Court replied:

There is no merit in defendant's oft-repeated contention that the accounting remedy necessarily involves the court's dealing with the conjectural proposition what would plaintiffs have done had the facts been known to them. On the contrary, I rule that because Janigan's fraud was successfully perpetrated on the plaintiffs and because he achieved his desired purpose of terminating their ownership . . . , he cannot now be heard to say that plaintiffs are to be penalized because they are unable to show what course they would have followed with reference to the stock at a time after they had parted with ownership of it as a result of his successful perpetration of a deliberate fraud on them.\textsuperscript{72}

In affirming, the First Circuit took substantially the same position but appeared to be more concerned with the unjust enrichment of the defendant than the injury to the plaintiff. It admitted that in cases where the defendant was a seller rather than a buyer, the correct measure of damages was the out-of-pocket rule, but flatly declined to employ that rule in an insider-purchase case.

\textit{[If] the property is not bought from, but sold to, the fraudulent party, future accretions not foreseeable at the time of the transfer even on the true facts, and hence speculative, are subject to another factor, viz., that they accrued to the fraudulent party. It may, as in the case at bar, be entirely speculative whether, had plaintiffs not sold, the series of fortunate occurrences would have happened in the same way, and to their same profit. However, there can be no speculation but that defendant actually made the profit and, once it is found that he acquired the property by fraud,}

\textsuperscript{70} See pp. 886-87 infra.
\textsuperscript{71} 344 F.2d 781 (1st Cir. 1965).
that the profit was the proximate consequence of the fraud, whether foreseeable or not. It is more appropriate to give the defrauded party the benefit even of windfalls than to let the fraudulent party keep them. . . . We may accept defendant's position that there was no fiduciary relationship and that he was dealing at arm's length. Nonetheless, it is simple equity that a wrongdoer should disgorge his fraudulent enrichment.73

Thus Janigan made explicit what was only suggested in Speed: even though a plaintiff is unable to establish that he would have made the same profit as the insider, the insider still has to surrender that profit to the plaintiff.74

Two recent cases have modified the position taken in Speed and Janigan. In Myzel v. Fields,75 on facts similar to those in Janigan,76 the district judge instructed the jury that the minimum amount recoverable would be the difference between the price paid by the defendants and the “actual value” of the stock at the time of the fraud, which could be determined by considering “all the circumstances,” including the corporation's subsequent history. If the jury found that plaintiffs would still have sold when they did, but at a higher price, had defendants made full disclosure,77 then plaintiffs were entitled to the difference between that higher price and the actual sale price. If, on the other hand, the plaintiffs would probably have retained their stock as an investment, the jury was to award the difference between the value of the stock at the end of a “reasonable period” and the sale price. The only guidelines in determining what period was “reasonable” were the limiting principles that (1) the Act was not intended to “provide investors with an insurance policy against market changes,” and (2) violators should nonetheless not be allowed to profit from their wrongdoing.78

The jury awarded considerably less than it might have, and the Eighth Circuit affirmed without trying to reconstruct its thought processes.79 The court made no attempt to develop a generally applicable theory of damages for insider purchase cases. Instead, it was

73. 344 F.2d at 786.
74. Fleischer, supra note 37, at 1997-98, cites Janigan as support for the proposition that “a primary purpose of rule 10b-5 is to deter improper insider trading,” and that the SEC may therefore properly demand full disgorgement in an enforcement proceeding like Texas Gulf.
75. 386 F.2d 718 (8th Cir. 1967), cert. denied, 390 U.S. 951 (1968).
76. Defendant insiders purchased stock from plaintiffs, minority shareholders, without disclosing favorable business developments. They also made positive misrepresentations to some of the plaintiffs.
77. The court apparently assumed that the List test of causation was appropriate.
78. 386 F.2d at 744-45 n.23.
79. Id. at 743.
content to find precedent in the common law for each of the District Court’s instructions. The result was confusing in the extreme. At one point, the court stated that the contract of sale was void ab initio by virtue of Section 29(b), and that since the shares were no longer in existence, the plaintiffs were entitled to “recisional damages.”

At another, it quoted Janigan with approval. Yet the instructions it upheld limited the maximum recovery to the value of the stock within a reasonable time after the fraud, whereas Janigan’s accounting, or the “recisional damages” suggested by Section 29(b), would presumably have given plaintiffs an amount equal to the stock’s value at the time of the judgment. Elsewhere, however, the court noted that the proper measure of damages would vary from case to case, and it cited Section 151 of the Restatement for the proposition that restitutionary damages are available only when the plaintiff can prove that he would have sold the property at the relevant time. In any event, Myzel’s authority as precedent is limited, since the court implied strongly that its decision might have been different on slightly variant facts.

In Baumel v. Rosen, defendants were the controlling stockholders and managers of Gulf American Land Company. In 1959, when the corporation’s shares were still closely held, they persuaded plaintiffs to sell their minority interests by intimating that the business was less than sound and concealing material facts. Plaintiffs, presumably hoping for a liberal interpretation of Section 151, asked for restitution of the stock plus damages in an amount equal to the difference between the stock’s value on the date of judgment and the highest value it had reached since the date of the sale. Defendants argued for an out-of-pocket measure, which, according to the court, would have resulted in no recovery at all, since the plaintiffs had failed to

80. Id. at 741-42.
81. Id. at 747.
82. Id. at 743.
83. Id.
84. Id. at 749:

Although the trial court fashioned and submitted to the jury a remedy for the particular facts, we fail to see any prejudice to appellants. The damages given essentially reflect a proper measure of damages for deceit based upon an unknown fluctuating value of stock of a closed corporation under the particular circumstances surrounding the case. The trial court was faced with great difficulty in instructing upon these issues and did an excellent job. His approach on instructions was fair to the appellants under the circumstances prevailing.

(Emphasis in original.)
Introduce evidence regarding the "fair value" of the stock at the time of the sale.\textsuperscript{86}

Taking an intermediate position, the court ordered that the stock be restored (or that defendants pay money damages in an amount sufficient to let plaintiffs replace the stock themselves by purchasing on the market)\textsuperscript{87} on the ground that any other decision might result in "great injustice,"\textsuperscript{88} but it denied plaintiffs any additional damages:

Had plaintiffs elected to press their optional right to money damages, rather than the specific return of personal property, plaintiffs would have been entitled to money damages at least for accretions in value within a reasonable time after they discovered or had reason to know of defendants' tortious conduct [citing the Restatement of Torts] \ldots{}, or to its highest value reached within a reasonable time after the tortious conduct [citing the Restatement of Restitution]. \ldots{} The Court does not believe that plaintiffs are entitled to both, especially where plaintiffs offered no evidence to show that they would have sold their stock when it reached its highest value \ldots{}.\textsuperscript{89}

Viewed purely as a remedial decision, \textit{Baumel} could be justified only on the dubious theory that the court felt it safe to assume plaintiffs would have retained their stock from 1959 to 1968.\textsuperscript{90} A much more likely explanation is that here, as in \textit{Speed} and \textit{Janigan}, the court used civil liability to punish the insider. It took special note of the fact that defendants' fraud was "wilful," like the fraud in \textit{Janigan},\textsuperscript{91} and implied that one of the circumstances justifying a restitutionary measure was that defendants still held the stock and had not changed their position materially since the time of the fraud.\textsuperscript{92}

But the courts are far from unanimous. In \textit{Kohler v. Kohler Co.},\textsuperscript{93} the court took the position that the plaintiff's recovery should be

\textsuperscript{86} Id. at 144.
\textsuperscript{87} The corporation went public shortly after plaintiffs sold, and its stock was listed on the American Stock Exchange. Plaintiffs had each sold 500 shares at $20.00 per share, or a total of $10,000 each. The stock subsequently split 34.6 for 1 and 4 for 1, so that by the time of the decision, each 500-share block had turned into 69,200 shares. Shortly before that time, Gulf American was selling at $8\frac{1}{2}, so total damages apparently amounted to more than $1,000,000.
\textsuperscript{88} 283 F. Supp. at 146.
\textsuperscript{89} Id. at 147.
\textsuperscript{90} See note 109 infra.
\textsuperscript{91} 283 F. Supp. at 144.
\textsuperscript{92} Id. at 147.
\textsuperscript{93} 208 F. Supp. 808 (E.D. Wis. 1962), aff'd, 319 F.2d 634 (7th Cir. 1963). The District Court's comments on damages were explicitly disapproved in \textit{Myzel} and \textit{Baumel}. 386 F.2d 718, 749 (1968); 283 F. Supp. 129, 145 (D. Md. 1968).
limited to his "actual damages," as measured by the out-of-pocket rule. There, the plaintiff had voluntarily offered to sell his stock to the corporation. In order to help him set a reasonable price, the company's officers furnished him with information on its past earnings and those of its competitors. He sold, and later, dissatisfied with his bargain, brought suit under the Rule, charging that the information had contained material misstatements and omissions. The district court found for defendants on the merits, but it noted that

[p]laintiff could not recover damages in this action even if defendants had violated their statutory or common-law duties of disclosure. Section 28 of the Securities Exchange Act . . . limits recovery to "actual damages on account of the act complained of" "Actual damages" are to be computed under the federal "out-of-pocket" rule applied in fraud actions, i.e., the difference between the price received by the plaintiff and the real or actual value of the stock at the date of the sale. Under this rule, a plaintiff is entitled to recover what he has lost by the sale but may not recover any actual or potential gain that was received by the defendants.94

The court's reasoning was that even if plaintiff were right and the information furnished by the corporation was in fact misleading, the difficulty of appraising the stock was such that it would have been pure speculation to say that the price received was less than its "real value."

Judge Wyatt of the Southern District of New York followed the Kohler rule in Ross v. Licht.95 There the insiders had purchased plaintiffs' stock for $120.00 per share without disclosing plans for a public offering at $600.00. Shortly after the purchase but before the offering, they sold similar shares to some friends for $300.00. Perhaps influenced by the fact that the corporation had gone into bankruptcy by the time the suit was brought, thus wiping out any profits defendants might have made,96 the judge applied an out-of-pocket measure. But he observed that "[a]bsent market value (as here), 'fair value' is to be determined from all the pertinent circumstances both for a reasonable time before the sale and after it."97 The evidence indicated that book value at the time of the sale was $204.20, but the court awarded damages based on a fair value of $300.00, on the theory that the price paid by friends of the insiders less than two weeks after

94. 208 F. Supp. at 825.
96. Id. at 411-12.
97. Id. at 410.
the sale could not have been greatly in excess of the value at the time of the sale.98

In none of these cases did the court develop a measure of damages that could honestly be characterized as remedial. In Speed, Janigan and Baumel, civil liability was clearly used as a penal device. This does violence to the basic purpose of civil liability,99 and it seems particularly inappropriate when the Securities Exchange Act provides specifically for criminal penalties100 and the SEC claims the authority to compel disgorgement in an enforcement proceeding.101 In Kohler and Ross, the courts did seem to be concerned with approximating the seller's real loss, but the out-of-pocket measure can only achieve that goal when the plaintiff would have sold his stock at the end of whatever period is used for the hindsight estimation of "fair value." The District Court applied a somewhat more sophisticated measure in Myzel, but its instructions were confusing and the decision was tainted with the List test of causation.

2. Framing an Appropriate Measure of Damages

In developing an appropriate standard for measuring damages in active-market cases, it should be kept in mind that even after the plaintiff has established that his sale was caused by the insider's market activity, the insider's liability is still subject to two conditions. First, the plaintiff has to establish that he actually suffered a loss. Second, he has to demonstrate that his loss is compensable under the Rule. An examination of the first problem suggests a measure of damages which an examination of the second tends to confirm.

The fact that an insider's presence in the market caused an investor to sell when he did is immaterial unless the investor would otherwise have held on to his stock until after disclosure and eventually have sold it for more.102 But proof of the seller's probable con-

98. Id. at 411.
99. See pp. 867-69 supra.
102. Thus if a Texas Gulf shareholder ordered his broker to sell at thirty on April 1st, the order being good for that day only, and the stock reached thirty that day solely because insiders were buying, the insiders clearly caused the sale. But if he would have renewed that order on April 8th and the stock would then have reached thirty without any help from the insiders, it seems unfair to charge the insiders with responsibility for his failure to profit from the boom following the disclosure of the copper strike on April 16th. Similarly, if he would have retained his stock until the following December, when its price was back down to thirty again, his "loss," if it can be spoken of as such, was wholly unrelated to the insider's offense. In other words, if he would never have cashed in on his paper profits, or if he would have sold but reinvested unwisely, so that by the time of the suit he would have been no richer than he in fact was, it seems inaccurate to say that the insiders caused him to "lose" something of value.

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duct is hard to come by. In most cases, not even the seller has any idea of what he would have done with the stock had he not sold when he did. If investors as a class were characterized by scrupulous honesty, a requirement that they prove causation of loss, as well as causation of sale, would probably bar recoveries altogether. Human nature being what it is, the more likely result is a chorus of assurances that a sale at any but the most propitious moment would have been unthinkable.103

If the issue of damages is not to turn on the trier of fact’s appraisal of the seller’s veracity, some sort of presumption of fact concerning his probable conduct seems essential. But the difficulty of generalizing in this area makes it hard to suggest a satisfactory one. On the one hand, the law operates arbitrarily and inappropriately if it compels even an admitted tortfeasor to pay for a “loss” that the plaintiff would have suffered anyway. On the other, as the courts have pointed out, it seems unduly harsh on the seller to deny recovery because of problems of proof that the insider himself created.104

Similar problems have arisen in other areas of the law, but no adequate solution has yet been advanced. In some of the cases discussed above, the courts purported to rely on the Restatement of Restitution, but the Restatement’s “solution” simply rephrases the same problem in different terms. Section 151 of the Restatement provides that where the defendant gained possession of the plaintiff’s property by consciously tortious conduct, the plaintiff may recover the value of the property at the time of the tort “or a higher value if this is required to avoid injustice where the property has fluctuated in value . . . .” In Comment c, the Reporter elaborates on the latter measure:

Where the subject matter is of fluctuating value, and where the person deprived of it might have secured a higher amount for it had he not been so deprived, justice to him may require that the measure of recovery be more than the value at the time of deprivation. . . . In such cases the person deprived is entitled to be put in substantially the position in which he would have been had there not been the deprivation, and this may result in granting to him an amount equal to the highest value reached by the subject matter within a reasonable time after the tortious conduct. This

103. For example, see p. 882 supra. Theoretically, the plaintiff would have to show, not only that he would have sold at the most propitious moment, but also that he would have reinvested the proceeds profitably (or at least avoided a loss).

is done if he can prove that he probably would have made a sale while the subject matter was at its highest point in value.\textsuperscript{105} 

In active-market cases, the Restatement rule is of little if any assistance. Ordinarily the seller will be unable to "prove" that he would have sold at any specific time. This limits him to the "value" of the stock at the time of the tort, and "value" is an ambiguous term. It might stand for "market value," but that interpretation would result in denying recovery altogether when the plaintiff sold at market, as would usually be the case with listed stocks. Alternatively, it might mean "value" in the light of events subsequent to the sale—disclosure, for instance. But that seems inconsistent with the Restatement's treatment of the "reasonable time after" measure as a distinct remedy. In any case, the Restatement gives no help in determining which subsequent events might be relevant. 

The Restatement of Torts takes a somewhat different position. Section 927 provides that the victim of a fraudulent conversion of chattels is entitled to "the exchange value of the subject matter or the plaintiff's interest therein at the time and place of the conversion... or a different value where that is necessary to give just compensation..." The Comments note that 

[i]f the subject matter of the conversion is a commodity which has fluctuated in value, the owner is entitled to the highest value which it reached in the market within a reasonable time after he discovered or had reason to know of the conversion. This is an equitable adjustment based on what it would have cost the deprived owner to purchase an equivalent amount of the commodity and thereby avoid loss or retain a profit... The fluctuations in value before such time are ordinarily disregarded... except where the converter disposed of the subject matter during such time.\textsuperscript{106} 

In effect, the conversion measure presumes that absent any wrongdoing by the defendant, the plaintiff would have retained the converted property until he learned of the fraud. Although the presumption obviously becomes less realistic as the liquidity of the property in question increases, it seems reasonable that in cases where certainty is unattainable, the plaintiff should be given the benefit of the doubt (assuming that the presumption is rebuttable). 

The distinctive feature of the conversion measure is that it imposes  

\textsuperscript{105} RESTATEMENT OF RESTITUTION § 151, Comment e (1936).  
\textsuperscript{106} RESTATEMENT OF TORTS § 927, Comment e (1939).
an upper limit on damages. Losses that the plaintiff suffered more than a reasonable time after learning of the fraud are noncompensable. It introduces a mitigation of damages element, and perhaps even a notion of proximate cause, by taking account of the defrauded party's ability to restore himself to something approximating his former position once he discovers the fraud. This limitation is particularly appropriate for insider trading cases, since Rule 10b-5 gives no warrant for damages in excess of the "value" of the information withheld. In tort law generally, a plaintiff must prove not only that the defendant's conduct was in fact the cause of his loss, but also that it was the proximate cause. The issue is generally framed in terms of foreseeability. Theoretically, at least, the critical question is whether or not the risk of injury and/or the identity of the plaintiff were reasonably foreseeable at the time of the offense.

But a slightly different rule applies in cases of implied tort.

The violation of a legislative enactment by doing a prohibited act, or by failing to do a required act, makes the actor liable for an invasion of an interest of another if:

(a) the intent of the enactment is exclusively or in part to protect an interest of the other as an individual; and

(b) the interest invaded is one which the enactment is intended to protect; and

(c) where the enactment is intended to protect an interest from a particular hazard, the invasion of the interest results from that hazard; and

(d) the violation is a legal cause of the invasion, and the other has not so conducted himself as to disable himself from maintaining an action.\(^{107}\)

The problem is to define the "interest" that Rule 10b-5 protects and the "hazard" that the Rule was intended to protect it from. In part the Rule protects investors from the threat to their investment posed by a potential conflict of interest for corporate managers. But its main justification, and the one most frequently cited by the courts in private actions, is that it ensures a "fair" stock market by giving all investors equal access to relevant information and subjecting all traders to "identical market risks."\(^{108}\)

But if the Rule was intended primarily to prevent unfairness, the seller's recovery should be limited to the gains that he was "unfairly"

\(^{107}\) Restatement of Torts § 286 (1939); see note 22 supra. Subsection (a) poses no problem since courts have unanimously agreed that the "intent" of Rule 10b-5 was to protect individual investors from being defrauded. E.g., Kardon v. National Gypsum Co., 89 F. Supp. 512, 514 (E.D. Pa. 1946).

deprived of. That means that he should be allowed to recover no more than the "value" of the information withheld. To the extent that the insider's profits are traceable to factors other than the effects of that information, he earned them fairly by taking the risks of the market just like any other investor. The seller did not. At worst, damages in excess of the value of the inside information would nullify the effects of the insider's superior foresight and market analysis. At best, such damages would only shift windfall profits from the person who took the risk to one who bore no risk at all. Yet return without risk, albeit in a more vicious form, is exactly what the Rule was supposed to prevent.

This implies that increases in a stock's price either before the date of disclosure or after the market has finished digesting the news should be excluded from the plaintiff's damages. Taken a step further, however, this analysis can lead to an incorrect result. For it might be thought that if the effects of extraneous occurrences between the time of purchase and the time of "digestion" are to be wholly disregarded, the seller's damages should be measured by estimating what effect disclosure would have had at the time of the purchase. The fallacy of that position can best be illustrated by an example. Assume that in Texas Gulf, shortages of both sulphur and copper caused their prices to rise sharply between the date of an insider's purchase and the date when the company disclosed its copper discovery. Under the analysis suggested above, the insider would not be accountable for the increment in the value of Texas Gulf stock traceable to the sulphur shortage. This might seem to imply that since the copper shortage, which also occurred after his purchase, was responsible for part of his profits, his liability should be reduced to reflect that as well. However, insider trading consists not just in purchasing stock with inside information, but also in retaining that stock until the information is disclosed. The insider's guilt becomes fixed only on the date of disclosure.

Thus, by retaining his stock after the increase

109. Professor Painter notes that to permit a restitutionary measure of damages "is to assume that, but for the lack of disclosure [List test], the seller would have continued to hold his shares up to the time rescission is sought, and thus afford him a significant speculative advantage during the period within which an action might be brought. He holds, in short, a 'call' on the shares at the sale price until the statute of limitations has run against him." W. Painter, supra note 9, at 121. Restitutionary damages are criticized as granting the seller an "unwarranted windfall" in Kennedy & Wander, Texas Gulf Sulphur: A Most Unusual Case, 20 Bus. LAW. 1057, 1073-74 (1965).

110. The writer is indebted to Richard D. Diamond for pointing this out.

111. Thus if an insider bought Texas Gulf in November, simply as a short-term speculation, and sold it long before the Timmins discovery was disclosed, he might have transgressed the letter of the law, but in no meaningful sense was he guilty of insider trading.
in copper prices became known, the insider in the example might be said to have compounded his offense. It was just as unfair to appropriate the increment in value traceable to the increase in the price of copper as it was to appropriate the value which the undisclosed information had at the time of purchase.

The real question, therefore, is what value the market in fact attributed to the information withheld. This can only be determined empirically. The trier of fact will have to determine (1) how long the market took to absorb the information, and (2) what portion of the rise in price during that period was properly assignable to its disclosure. The result is a measure of damages similar, but not identical, to the *Restatement* conversion measure. The *Restatement* makes a converter liable for the value of the converted property within a reasonable time after the fraud is discovered. The rule suggested here would substitute the date of disclosure for the date when the fraud was discovered, and a "reasonable time" would be whatever time the market took to evaluate and reflect the information disclosed.

Like the *Restatement*, the rule suggested here imposes a definite ceiling on the seller's damages: the value of the information withheld. But there seems to be no good reason for making it a minimum as well. The insider should be able to show not only that the seller would have sold before disclosure anyway,112 but also that the plaintiff would have retained the stock after disclosure and ultimately have lost his paper profits.113 It seems highly unlikely that the latter argument would ever succeed in an active-market case. However, in a case like *Ross v. Licht*,114 where the stock was closely held and the issuer suffered major reverses shortly after the good news was disclosed, it seems quite conceivable that the seller would in fact have lost his paper profits. In short, then, the suggested measure would limit the seller's damages to the amount of his actual loss or the value of the undisclosed information, whichever is the lesser.

This measure has its unattractive aspects. Cases will arise where the insider's violation in fact caused an innocent investor to lose a windfall, and it seems distasteful to let the insider keep it. Besides, a more liberal measure of damages would undoubtedly enhance the Rule's effectiveness as a deterrent to insider trading. But similar circumstances have existed in other cases without altering the result.

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112. See p. 885 & note 102 supra.
113. Id. Once again, the same analysis would apply (in theory) if the seller would have sold after disclosure, but would have lost the profits by the time of the suit.
In *Gorris v. Scott*, a leading case in the development of the implied tort doctrine, the plaintiff argued that a statute requiring that sheep being transported by ship be kept in separate pens gave rise to a private right of action for losses suffered when unpenned sheep were washed overboard. The court found for the defendant, since the legislature enacted the law to protect against death by disease, not by drowning. The carrier’s violation caused an innocent party’s loss, and a judgment for the plaintiff would certainly have increased the statute’s effectiveness as a deterrent to unsanitary practices. Still, the plaintiff lost, and *Gorris* is good law today.

The law does have a strong policy against letting tortfeasors profit from their wrongs. But in active-market cases, at least, the losses that the insider caused will bear no logical relationship to the amount of his profits, and a measure of damages based on the concept of unjust enrichment would simply be unworkable. The weapons already furnished to the SEC by the 1934 Act are sufficient to deprive insiders of their gains and deter future violations. Civil liability is supposed to be remedial, not penal, and there seems to be no good reason to create an exception for insider trading cases.

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116. See W. Prosser, *supra* note 18, at 197 n.29.
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