Rule 10B-5 and Texas Gulf Sulphur: An Evolution of Questions and Answers

Ronald A. Shapo

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I. THE SAGA OF A MINING DISCOVERY

Our story opened on a cold, blustery night in November, 1963, as the "desolate, musky-covered land around the mining town of Timmins, Ontario . . ."2 was going through the first snow of winter. There followed from that time (during which the original drilling took place in which deposits of various valuable minerals, including copper, zinc, silver, and lead were sought), until April 16, 1964, a period of clandestine operations8 conducted by Texas Gulf Sulphur Company.4 There operations culminated in the verified discovery of one of the biggest and richest bodies of ore ever uncovered.5

There was a sharp increase in market price of Texas Gulf shares during this time (from seventeen to thirty-four dollars) and, after the discovery was made public, a continued steep rise (as high as one hundred and twenty-two dollars earlier this year). But the fact is that definite knowledge of the mining explorations was limited to relatively few individuals until April 12, 1964. Prior to that time, there was only a continually growing number of rumors and suggestions to alert the investor in, or holder of, Texas Gulf stock. It was in large part to answer those

† Formerly Executive Editor, University of Miami Law Review; Student Instructor in Research and Writing for Freshmen.
1. Emphasis is the author's, except as otherwise indicated.
2. For a continuation of this rather dramatized account of the early facts concerning the Texas Gulf "find," see Welles, Bonanza Trouble, Life, Aug. 6, 1965, p. 29.
3. As we shall see, Texas Gulf Sulphur Co. maintains it had sound reason for keeping its work secret.
4. "We were faced with possible leaks of information—our drilling program was under surveillance by people in low flying aircraft; . . ." A Report by [the] President, at the Annual Meeting of Stockholders, Texas Gulf Sulphur Co., Houston, Texas, Apr. 22, 1965. See text accompanying notes 22 and 23 infra.
5. Hereinafter referred to variously as "Texas Gulf," "Company" and "defendant-company."
6. The facts recited above, and those which follow, have been gleaned from a number of sources. See, e.g., Welles, Bonanza Trouble, supra, note 2; Report, supra note 3; Business Week, May 8, 1965, p. 141; Wall Street Journal, Apr. 21, 1965, p. 4, col. 3.
who "rumored," and to inform (perhaps "assuage" would be a more proper term) those who heard "something's up," that the Company, on April 12, issued a press release which stated, in part:

These reports [the "rumors"] exaggerate the scale of operations, and mention plans and statistics of size and grade of ore that are without factual basis and have evidently originated by speculation of people not connected with TGS. The drilling done to date has not been conclusive, but the statements made by outside quarters are unreliable and include information and figures not available to TGS.

Following this announcement, and for the next four days, the price of the shares dipped an average of two to three points. But on April 16, 1964, following its preparation the night before, the Company released another statement: "Texas Gulf Sulphur Company has made a major discovery of zinc, copper and silver in the Timmins area of Ontario, Canada . . . . Preliminary data indicate a reserve of more than 25 million tons of ore . . . ." That day the price of Texas Gulf stock rose approximately three points on the incredible volume of 444,200 shares. Two weeks following this second release, the market value had gone from thirty-four to fifty-eight dollars per share.

It was only natural that the Securities and Exchange Commission, always mindful of activities concerning unusually active stocks, would commence a preliminary investigation. What they found led the Commission to believe that there had been numerous and flagrant violations of section 10-B of the Securities Exchange Act of 1934 and of Rule 10B-5, adopted thereunder. After a prolonged period of inquiry, the

6. Carried in newspapers the following day.
7. Ibid.
8. For the Company's explanation of the necessity of these two closely-timed, yet somewhat divergent statements, see text accompanying note 23, infra.
9. Supra note 7.
10. Hereinafter referred to as the "Commission" or the SEC.
Commission filed suit against the Company and several individual defendants (officers, directors, and employees) on April 19, 1965.18 The complaint included a recitation of many of the undisputed facts discussed above, and made further crucial allegations concerning the behavior of the defendants. The SEC "charged" that the individual defendants had "Knowledge and information of material facts concerning the result of defendant Texas Gulf’s drilling . . . not generally known by the investing public" and had thereafter purchased Texas Gulf stock "without disclosing to the seller the . . . material facts." The defendants were also charged with having passed this "inside information" on to family and friends who were able to purchase stock from sellers who had no access to the "bullish" information about the mining explorations. Furthermore, and more expectedly, the SEC alleged that the Company’s press release of April 12, 1964, was known by certain of the defendants to be "materially false and misleading."

Clearly, if the allegations were correct, violations of Rule 10B-514 were committed. Most obviously, the alleged acts are rendered "unlawful" by clause 2 of the Rule;15 it might also be argued that the complaint stated a cause of action under clause 1.16 The Commission sought broad relief. It asked that several of the defendants be directed to offer rescission to the persons from whom they bought.17 This relief does not seem extraordinary, but in an unprecedented18 move, the SEC sought to have the court order certain of the defendants who "tipped" the inside information to outsiders,19 who in turn purchased the stock for their own benefit, to make restitution to those who sold to the outsiders.20 In the language coined by Professor Loss, the "tippor" must pay back the profits which inured to their "tippers."21

The defendants, in their answers, disputed few of the tangible facts

14. Hereinafter, sometimes called the "Rule."
15. Supra note 13.
16. Ibid. In addition, although no specific "act, practice or course of business [by the defendants] which operates . . . as a fraud . . . " is designated as such by the Commission, it is also reasonable to presume that it will argue that all of the facts alleged constitute such actions and, as such, violate clause 3 of the Rule. This is most probable in that the Commission’s first prayer for relief asked that the individual defendants be enjoined, inter alia, from such conduct.
17. Each of the defendant-officers and directors who had purchased stock during the "suspect" period offered to turn over their profits to the Company, but these offers were "summarily rejected by the SEC." Wall Street Journal, Apr. 23, 1965, p. 3.
18. Ramifications of this and other "new" aspects present in Texas Gulf will be discussed later. See Part IV, infra.
19. As we shall see later, there is room to argue that once outsiders gain "inside information," they become, for all practical purposes, insiders themselves, and can possibly be held civilly liable as such. See text accompanying note 112 et. seq., infra.
20. One other order sought was that the defendants nullify all unexercised stock options granted during the period involved.
21. This latter penalty seems harsh indeed. Further consideration of this is found in Part IV, infra.
alleged. For the most part, they argued that they bought the stock because: The Company's over-all business prospects were excellent at the time (and they were); that sound business practice dictated a tight-lip policy; and, most importantly, that they did not know the magnitude of the ore discovery before the news was made public on April 16, 1964.

The Commission's complaint, as was to be expected, triggered a number of private actions brought under the Rule by former shareholders of the Company who had sold their stock to either the insiders, their tippees or others during the period in question.

The problems—some real, some mythical—presented in the Texas Gulf litigation (including both the SEC and the private actions) are manifold and significant. In order to properly understand them, and perhaps some of the likely or desired results, it is first necessary to understand the Rule.

II. 10B-5: THE RULE AND ITS PURPOSES

A. The Implied Right in General

It is only fair to say that when the Commission adopted the Rule on May 21, 1942, the objective most immediately in mind was to extend protection to sellers against the unlawful acts of persons offering to buy securities from them. The courts have not, however, been willing to allow a cut-and-dried view of the Rule's meaning to prevail. As a result, many basic questions have been raised since its adoption concerning what duties it imposes and what rights it creates. With respect to the duties, at very least, the Rule charges insiders with an affirmative duty to disclose material facts which are unknown to others with whom they deal, which if known, would affect the investment judgment of those others. Concerning any rights created, the Rule does not so easily yield even "at very least" conclusions. No express right of action of any sort

22. The SEC has no quarrel with such a policy, but maintains that insiders must not purchase while it is in force. See discussion of the Cady, Roberts & Co. proceeding, in text accompanying notes 80-84, infra.

23. As previously pointed out, an enormous number of important and often intriguing questions are raised by these charges, denials and "justifications" (defenses). They will be considered at length in Part IV, infra.


26. The problem of whether, and to whom, a private right of action is accorded under the Rule is dealt with in Part II-A, infra.

27. Prior to the adoption of 10B-5, there was nothing in either the Securities Act, or the Exchange Act which covered fraud in the purchase by persons other than brokers or dealers.

28. The following expression of Commission intent was released on the same day that the Rule was announced: "The new rule closes a loophole in protections against fraud, administered by the Commission by prohibiting individuals or corporations from buying securities if they engage in fraud in their purchase . . . ." SEC Release No. 3230, at 183-184 (May 21, 1942).

29. See Part III, infra.
is provided by the section or the Rule. Thus, suits instituted by private persons have been founded upon an implied right of action. The basis for the implication is found in the opening phrase of the Rule: "It shall be unlawful . . . ." Some have maintained that this language only gives a right of enforcement to the Commission, and does not create a private civil remedy, but this argument has not met favor. Indeed, since the landmark decision in Kardon v. National Gypsum Co., seven circuit courts and ten district courts have recognized an implied right of action under the Rule.

An inherently stronger and still viable argument exists against the implication of a remedy for the buyer of securities under 10B-5. The argument is that since the buyer is given express remedies under sections 11 and 12 of the Securities Act of 1933, he has no need for further relief, and thus none should be implied from the Exchange Act of 1934. The same arguments have been used in favor of denying a right to the buyer under section 17(a) of the Securities Act, the provisions of which are practically identical to Rule 10B-5, and in the light of which the latter was framed. The argument is that a buyer who could sue pursuant to such express remedy should be allowed to find no place for himself in the language of section 17(a) or Rule 10B-5. A most literary and philosophical expression of this view is found in Professor Loss' treaties:

30. Professor Loss has stated: "It does not seem too much to say that the implied liabilities have turned out to be far more significant than the express liabilities which Congress created." 3 Loss, Securities Regulation 1759 (2d ed. 1961).

31. 69 F. Supp. 512 (E.D. Pa. 1946). This case, and the other significant ones under 10B-5, are discussed at length in Part III, infra.

32. See, e.g., First Circuit: Janigan v. Taylor, 344 F.2d 781 (1st Cir. 1965); Second Circuit: List v. Fashion Park, Inc., 340 F.2d 457 (2d Cir. 1965); Ruckel v. Roto Am. Corp., 339 F.2d 24 (2d Cir. 1964); Fischman v. Raytheon Mfg. Co., 188 F.2d 783 (2d Cir. 1951); Third Circuit: Speed v. Transamerica Corp., 235 F.2d 369 (3d Cir. 1956); Slavin v. Germantown Fire Ins. Co., 174 F.2d 799 (3d Cir. 1949) (dictum); Fifth Circuit: Hooper v. Mountain States Sec. Corp., 282 F.2d 195 (5th Cir. 1960); Reed v. Riddle Airlines, 266 F.2d 314 (5th Cir. 1959); Eighth Circuit: Boone v. Baugh, 308 F.2d 711 (8th Cir. 1962); Ninth Circuit: Royal Air Properties, Inc. v. Smith, 312 F.2d 210 (9th Cir. 1962); Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961); Errion v. Connell, 236 F.2d 447 (9th Cir 1956); Tenth Circuit: Crist v. United Underwriters, Ltd., 343 F.2d 902 (10th Cir. 1965); Stevens v. Vowell, 343 F.2d 374 (10th Cir. 1965).

33. 15 U.S.C. § 77k (1958). Briefly stated, this section provides in detailed fashion that the purchaser of a registered security may sue the issuer for untrue statements of material facts in the registration statement.

34. 15 U.S.C. § 771 (1958). Here again, actions are only for buyers, and though it applies to sales of unregistered securities (if in violation of § 5) as well as those registered, when there has been an untrue statement or an omission, it has a great limitation in that the seller is only "liable to the person purchasing such security from him . . . ." Thus, privity is required for an action to lie.


36. With respect to § 17(a), see Sowards, Federal Securities Act § 10.01(1) (1965), and see generally, 3 Loss, Securities Regulation 1787-8 (2d ed. 1961).

37. The other major anti-fraud provision is § 15(c)(1) of the Exchange Act, and particularly Rule 15(1)-(2) thereunder. This section applies to the use of a "manipulative, deceptive or other fraudulent device or contrivance "by a broker or dealer, and thus is not really germane to this discussion.
[I]s not this potpourri [i.e., the “mixing” of express and implied remedies by buyers] the reductio ad absurdum of the view which opens Rule 10B-5 and 17(a) to buyers who for some reason find their express remedies under the 1933 Act to be inadequate? The development is more than a little reminiscent of what a German scholar has called “the flight into the general clauses” . . . based on “good faith” and similar formulas.

At this juncture, a logical question would seem to be: In view of the extensive express liability provisions in favor of the purchaser, why is he attracted to Rule 10B-5? The answers verily bound out of those very express liability provisions once they are contrasted with the Rule. Other than the obvious limitations on the opportunities to apply section 11 (e.g., registered securities only) and section 12 (e.g., requires privity), both sections have a shorter statute of limitations and section 11 provides that a plaintiff may be required to furnish costs of the suit, including reasonable attorney’s fees. Since none of these factors, which can preclude or inhibit buyers’ suits under the express actions, pertains to 10B-5, the advantages incident to its use are obvious.

Most courts, once faced with the problem, have allowed the buyer to sue. Two cases which have dismissed a buyer’s 10B-5 complaint have done so on somewhat different grounds. One decision was written by the author of the Kardon opinion and enunciated a requirement that the two acts, being in pari materia, must be construed together. Believing that Congress could not have meant the buyer to have an easier time after 1934 than under the Securities Act, he ruled that an action could not be maintained under 10B-5.

Of course, one other alternative remedy which the buyer must overcome in his quest to both “have his cake and eat it” is section 17(a) of the Securities Act. As noted previously, 10B-5 was modeled after, and is almost a carbon copy of, section 17(a)—merely slightly broadening clause 2 and extending protection (if not an action) to the seller. It

38. 3 Loss, Securities Regulation 1789-90 (2d ed. 1961).
39. Supra note 30.
40. Both §§ 11 and 12 are governed by § 13, which limits the time for bringing an action to one year following discovery of the wrong, with a maximum of three years after the alleged violation. 15 U.S.C. § 77m (1958). For a discussion of which statute of limitations to apply, see text accompanying notes 53 and 56, infra.
42. See, e.g., Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961) (a well-reasoned opinion); Fischman v. Raytheon Mfg. Co., 188 F.2d 783 (2d Cir. 1951).
44. That is, free of the restrictions accompanying his express rights. See text accompanying notes 39-41, supra.
is, therefore, quite difficult from an intellectually precise viewpoint to reconcile affording the buyer civil relief under both. It is submitted, however, that this is no reason to conclude that there should not, in fact, be a buyer's right implied under 10B-5.

B. The Buyer is "In"

Whereas the prior provisions discussed limited the right to suit under them to the buyer, section 10(B) and Rule 10B-5 specifically applies "in connection with the purchase or sale . . . ." Had Congress actually wanted solely to "close a loophole in protections against fraud . . . in the purchase . . .," it seems unlikely that it would have included so clear a reference to the "sale." All of the other provisions indicate an ability, even a tendency, for Congress to limit application of securities legislation when it so desires.

Perhaps a greater semblance of consistency could be found if no private action was implied for the buyer under 17(a), since what express relief there is, is found in the same Act. Then 10B-5, offering the only comprehensive relief to the buyer and the sole relief to the seller, would make more sense.

Regardless of the section 17(a) solution, it would appear that while Congress may not have primarily intended to create a right for the buyer under section 10(B) and the Rule, certainly the overriding goal of both Acts was to afford the greatest possible relief to the investor. It does not seem logical to argue that because the primary effect of the Rule was to extend a "new" right to the seller, that the buyer should be precluded from reaping its collateral results. Is it not, then, most reasonable (and most effective of the broad purpose of the Act) to believe that the rights given the buyer by sections 11 and 12 of the 1933 Act have been made corollary to, and been expanded by, Rule 10B-5?

46. Professor Sowards seems to have carried this realization to its logical conclusion when he stated that if, as indeed appears to be the case, the buyer has a civil right under 10B-5, it is not even necessary to determine if the same is true under § 17(a). SOWARDS, FEDERAL SECURITIES ACT, § 10.01 (1)(1965).
47. See text accompanying notes 39-41, supra.
48. From the Commission's release of May 21, 1942, supra note 28.
49. Alas, however, this does not appear to be the case. See, e.g., SOWARDS, THE FEDERAL SECURITIES ACT (1965). But see, 3 LOSS, SECURITIES REGULATION, 1428 n.20, 1785 n.338 and accompanying text (2d ed. 1961).
50. 78 CONG. REC. 7861 (1934).
51. A negative answer brings into play the step-child-seller, favorite son-buyer dilemma raised by Loss: Should they [the courts] permit buyers to sue under 10b-5 and thus ignore the safeguards which Congress chose to throw around buyers' actions in §§ 11 and 12? Or should they restrict the Kardon doctrine to suits by sellers [e.g., Texas Gulf] and thus treat the seller step-child far better than the buyer favorite son—not to mention the fact that any discrimination between seller and buyer would fly in the face of § 10(b) and the rule?
C. The Right Assumed: Issues in the Pleadings

What, then, of the seller (or buyer who is allowed to escape the limits of section 13) who sues under the Rule. How long does he have to commence his action? Neither the section nor the Rule provide for, or allude to, a period of limitations. Thus, with a federal statute in question, a good attorney's fancy naturally turns to thoughts of the *Erie* doctrine. Certainly, the forum's statute should control when the action is at law. And since 10B-5 is at base an anti-fraud provision, the action would properly be legal. This is probably so even if the plaintiff seeks equitable rescission as an alternative, or in addition, to damages. But as of this time there appears to be no definite holding on the characterization of the 10B-5 remedy.

In addition to the question of when the plaintiff must file his complaint, there is some issue with respect to its necessary ingredients, particularly concerning reliance, scienter and privity. Although the language of the Rule does not expressly indicate that reliance is necessary, most courts have simply assumed that it is a prerequisite to recovery. However, it does seem that, particularly with regard to clauses (1) and (3), scienter can be dispensed with due to the broad scope of the Rule,

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52. See note 40, supra.
54. Should, however, the court consider the 10B-5 right as a "federally created" one to be prosecuted solely in equity, then of course the allowable period should be governed by laches.
55. See *Holmberg v. Armbrecht*, 327 U.S. 392 (1946) which held that where liability is statutorily predicated, a prayer for equitable relief affects merely the remedy, not the legal right.
56. Dictum in a recent decision does stress the fraudulent nature of the 10B-5 action and thus lends support to the belief that it would properly be considered "legal" when determining whether to look to a state statute or laches. *Janigan v. Taylor*, 344 F.2d 781, 784 (1st Cir. 1965). This case also concerns the interesting, and not "just academic" question of whether the statutory time is tolled until the discovery of the violation, even if such a tolling practice is not the rule in forum state? The court answered in the affirmative since the right is tied to the federal statute. "*F*ederal law must determine the date of accrual [of the cause] here even though the period of limitation is determined by state law." But see, *Azalea Meats, Inc. v. Muscat*, 246 F. Supp. 780 (S.D. Fla. 1965) (Dicta: the action was brought more than the maximum period after the "discovery" of the Fraud.).
57. In view of the fraud-preventive source of the Rule, it is important to keep in mind Rule 9(b) of the federal rules of civil procedure as a general guide in forming pleadings. "[C]ircumstances constituting fraud . . . shall be pleaded with particularity."
58. See, e.g., *Janigan v. Taylor*, 344 F.2d 781 (1st Cir. 1965); *Reed v. Riddle Airlines*, 266 F.2d 314, 319 (5th Cir. 1959); *Kohler v. Kohler*, 208 F. Supp. 808, 823 (E.D. Wis. 1962), aff'd, 319 F.2d 634 (7th Cir. 1965).

But one court did recently articulate a basic rationale which probably formed the basis of the assumption by the others:

Assuredly, to abandon the requirement of reliance would be to facilitate outsiders' proof of insiders' fraud, and to that extent the interpretation for which plaintiff contends might advance the purposes of Rule 10b-5. But this strikes us as an inadequate reason for reading out of the rule so basic an element of tort law as the principle of causation in fact. *List v. Fashion Park, Inc.*, 340 F.2d 457, 463 (2d Cir. 1965).
when contrasted to common law deceit.\textsuperscript{59} Finally, contrary to the more restrictive section 12(2), it can be said that privity is not essential under the Rule, especially where there has been at least some showing of reliance.\textsuperscript{60}

As seen above (with appropriate qualifications noted) the 10B-5 remedy exists primarily for the purpose of discouraging fraudulent conduct. But, just as fraud is the basis of the Rule, so disclosure is its foremost objective. At common law, the courts were not in accord as to the duty of disclosure to be imposed on an insider. The preferable view seemed to be the one laid down in the landmark case of \textit{Strong v. Repide}.\textsuperscript{61} There the controlling stockholder and manager of a corporation purchased stock from outsiders without disclosure of the then current status of negotiations for the sale of the property. The court enunciated the so-called "special facts" doctrine and held the defendants guilty of a breach of their duty of disclosure. At the common law, however, this represented the minority position; the prevalent view required no such disclosure by corporate fiduciaries.\textsuperscript{62}

It is clear, therefore, that the Rule grew out of the minority attitude. This fact is readily and emphatically borne out by the cases.\textsuperscript{63} A statement in the \textit{Kardon}\textsuperscript{64} decision serves as a good indication of the minimum duty required by the Rule:

\begin{quote}
\textit{[T]he act is violated when directors with inside information purchase stock without full disclosure. Such conduct includes engaging in any "act, practice or course of business which . . . would operate as a fraud."} \textsuperscript{65}
\end{quote}

At first glance, however, such a basic statement is as broad in its ramifications as it is vague on its face. There are several possible theories of disclosure to be gleaned from the Rule. Some flow from its face. For example, incomplete or complete failure of disclosure can be held under clause (1) to be a "device . . . to defraud," or under clause (3), a fraudulent "act . . . or course of business." Or, if information is withheld or stated untruthfully, it can be said that a duty of disclosure under clause


\textsuperscript{60} 3 \textit{Loss, op. cit. supra} note 59, at 1767. \textit{Contra}, e.g., Joseph v. Farnsworth Radio & Television Corp., 99 F. Supp. 701 (S.D.N.Y. 1951), aff'd, 198 F.2d 883 (2d Cir. 1952) (\textit{But see}, dissenting opinion by Judge Frank). For a most thorough discussion of this problem, see Klein, \textit{op. cit. supra} note 45.

\textsuperscript{61} 213 U.S. 419 (1909).

\textsuperscript{62} For a list of authorities supporting this view see Goodwin v. Agassiz, 283 Mass. 358, 362, 186 N.E. 659, 660 (1933).

\textsuperscript{63} An analysis and discussion of many of the most important decisions on this point follows in Part III of this paper.


\textsuperscript{65} \textit{Id.} at 514.
(2) has been breached. All is not so simple, however. Many complex problems are raised with respect to drawing lines between those who can be held to such a duty, and those who, having received disclosures from insiders, may safely act upon the disclosed information without fear of breaching a concomitant responsibility to further disclose. Many of the issues are present, expressly or impliedly, in the Texas Gulf litigation, and they will all be considered under the discussion of that situation.66

III. CASES TO DATE: A CRYSTAL BALL UNPOLISHED

The first instance which showed the Commission's attitude toward the enforcement of 10B-5 was Ward La France Corp.67 In a published report of the investigation, the Commission held that when two officers knew of, but failed to disclose to a selling stockholder, optimistic news about negotiations for a merger, they had violated the Rule. It was not too long before this construction of insiders' responsibilities met with judicial approval and expansion.

A. Kardon: Herald of Implied Liability

Loss has termed "implied liability" under the SEC statutes "[T]he most surprising development in the whole area of [the statutes'] civil liabilities."68 Judicial recognition of this area was first accorded in the now famous case of Kardon v. National Gypsum Co.69 Suit was instituted by two of the company's four stockholders (each of whom held an equal portion of the company's stock) against the other two to recover profits made by the latter following their purchase of the plaintiffs' stock. The gravamen of the complaint was that prior to the stock transaction between the parties the defendants knew of, but failed to disclose, a prior sale of the bulk of the corporate assets to another company. Therefore, the plaintiffs asserted that they were entitled to relief under section 10(B) and Rule 10B-5. The defendants moved to dismiss contending that the Rule provided no civil remedy. They argued that since such remedies are express, in other sections of the securities acts, Congress must have intended that no civil action would lie under the Rule. The court denied this motion, and thereby held that a right of action was established by the Rule, on two grounds.

The first of these grounds was the statutory tort doctrine; viz., an action for violation of a statute accrues to members of a class for whose benefit the statute was passed.70 Thus, the court, in effect, reasoned that there was a presumption in favor of the plaintiffs' alleged rights and held:

66. See Part IV, infra.
67. 13 SEC 343 (1943).
68. 3 Loss, op. cit. supra note 59, at 1757.
70. There was nothing "new" about this doctrine at the time Kardon was decided. It had been recognized by the supreme court and the writers since the early 1900's. See Bell v. Hood, 327 U.S. 678 (1946); Texas & Pac. Ry. v. Rigsby, 241 U.S. 33 (1916); 2 Cooley, TORTS 1408 (3d ed. 1906).
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Where, as here, the whole statute discloses a broad purpose to regulate securities transactions of all kinds and, as a part of such regulation, the specific section in question provides for the elimination of all manipulative or deceptive methods in such transactions, the construction contended for by the defendants may not be adopted. In other words, in view of the general purpose of the Act, the mere omission of an express provision is not sufficient to negative what the general law provides.\(^7\)

Judge Kirkpatrick also found an alternative theory on which the complaint would be sufficient: the contractual voidability theory under section 29(B) of the Exchange Act.\(^7\) The Judge wrote: "It seems to me that a statutory enactment that a contract of a certain kind shall be void almost necessarily implies a remedy in respect of it."\(^7\) Thus was this "most surprising development" launched on its ever-growing way.\(^4\) At trial, the court found for the plaintiffs, and the initial implied-basis recovery was complete.\(^7\)

B. The Transamerica Chronology, et seq.

Two suits were instituted against Transamerica Corporation upon the same facts, before the same judge, and for primarily identical relief—the second suit was successful; the first was not. The reason for the different results is of great importance.

The common facts were these. The defendant-corporation was the major stockholder of a tobacco company. As a result of this position, it knew that the market value of the large tobacco inventory was much higher than that which was reflected on the company's financial statements. In each instance, the plaintiff was a minority stockholder who, while ignorant of this information, sold his stock to Transamerica. The crucial distinction between the suits was the different theories upon which each plaintiff sought recovery.

The first suit\(^6\) sought relief on the theory of common law deceit. Since the governing law in the forum followed the so-called "majority

\(^7\) Kardon v. National Gypsum Co., \textit{supra} note 69, at 514.
\(^7\) Kardon v. National Gypsum Co., \textit{supra} note 69, at 514.
\(^7\) 3 Loss, \textit{op. cit. supra} note 59, at 1790.
\(^7\) These provisions [§ 10(b) and Rule 10b-5] apply to directors and officers who, in purchasing the stock of the corporation from others, fail to disclose a fact coming to their knowledge by reason of their position which would materially affect the judgement of the other party to the transaction. Kardon v. National Gypsum Co., 73 F. Supp. 798, 800 (E.D. Pa. 1947).
The district court, in 1943, granted the defendant a summary judgment on the basis of findings that the defendant had not actively concealed information and was under no common law duty to disclose.

The second suit predicated its claim on Rule 10B-5. This time the court denied the motion to dismiss, holding that a cause of action was stated under the Rule. Most probably, since the complaint was tested in 1947, the second plaintiff had learned from *Kardon*. The real importance of the Transamerica chronology is that it offered an early and graphic view, one of significant import and great impact, relating to the effects of 10B-5. This single Congressionally authorized and administratively promulgated provision ended, once and for all, the necessity for active deceit by a defendant-corporate insider as a condition precedent to liability for a breach of duty to disclose.

Since these early important decisions, implied liability has been given wide recognition. Many cases have enlarged upon this theme, considering a variety of problems and rendering some thoughtful and interesting decisions. Certainly the most important of these to the purview of this paper is *Cady, Roberts & Co.* Initially, the case is noteworthy because it marked the first time that the Commission imposed an affirmative obligation of disclosure on a corporate insider who was selling. This was the result of an action brought by the SEC against both Cady, Roberts and its broker-partner. The latter had received information from an insider-director of Curtiss-Wright Corporation, in advance of a public release, that the company was cutting its dividend. He thereupon executed a solicited order to sell, and sold for certain of his discretionary accounts.

The Commission gave a substantial hint of things to come (specifically a Texas Gulf-type situation) when it articulated its view of a very broad duty under the Rule.

Section 17 and Rule 10B-5 apply to securities transactions by “any person.” *Misrepresentations will lie within their ambit no matter who the speaker may be.* An affirmative duty to disclose material information has been traditionally imposed on corporate “insiders,” particularly officers, directors, or controlling stockholders . . . . These three groups, however, do not exhaust the classes of persons upon whom there is such an obligation.

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77. Supra note 62 and accompanying text.
79. Supra note 32.
81. This was a report on an SEC investigation, not a court decision.
82. Actually the defendant-broker's advance notice was barely more than a half-hour. Yet, an enormous profit can be, and was made in the stock market in a matter of a few minutes, and thus there is no less of a violation. The Commission did undoubtedly consider this as one indicia of an absence of active deceit, and therefore, imposed a relatively light sanction.
Once it had so grandly subscribed to the position that the realm of potential application of the Rule is very large indeed, the Commission, speaking through its Chairman, Mr. Cary, stated the "two principal elements" on which the disclosure duty is founded, and also the rationale for its imposition:

[F]irst, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information . . . we are not to be circumscribed by fine distinctions and rigid classifications . . . persons who are in a special relationship with a company . . . thereby suffer correlative duties in trading in its securities. Intimacy demands restraint lest the uninformed be exploited.84

Though most of the cases under section 10(B) and the Rule have concerned insiders, neither is expressly limited to the activities of such persons.85 Furthermore, just as almost all private transactions are covered,86 10(B) refers to "any security," and hence is not limited to securities sold on an exchange or through an over-the-counter market.87

An interesting case concerning the omission to disclose a rather unusual material fact is Reed v. Riddle Airlines.88 The fact, known to the insider-buyer, was that a widely-renowned financier was interested in buying a large block of stock.89 The fifth circuit held that the insider had a duty to disclose this fact, and his failure to do so was grounds for liability. In another unusual case, the Rule was used to impose liability when the alleged fraud concerned the value of the consideration (land) given for the security, rather than the value of the security itself.90

Thus, it should be clear that all the present "hullabaloo" about the Rule should not be based solely on the Texas Gulf litigation. The Rule has been steadily growing in recognized scope. Some recent noteworthy litigation (other than Texas Gulf) has helped provide impetus to the battlecry of "Beware 10B-51"

84. Ibid.
85. Apparently contrary to this belief is Mills v. Sarjem Corp., 133 F. Supp. 753 (D.N.J. 1955). There, relief was denied pursuant to the court's finding that the defendants were not "insiders" and therefore, owed no duty under the Rule. This case has, however, been harshly criticized on occasion.
86. All three clauses of Rule 10B-5 apply when the prohibited act is performed "by the use of any means . . . of interstate commerce, or of the mails or of any facility of any national securities exchange."
88. 266 F.2d 314 (5th Cir. 1959).
89. His subsequent purchase did cause a spectacular rise in market price.
90. Errion v. Connell, 236 F.2d 447 (9th Cir. 1956).
C. Recent Decisions

List v. Fashion Park, Inc.\(^9\) is perhaps the most interesting recent case to come to reported circuit court decision on the pleadings or the merits. The chronology of events that formed the basis of the suit follows. On November 4, the defendant (through its directors) received word that there might be a buyer for the company. This information was not then disclosed to the plaintiff-minority stockholder. On November 17, plaintiff sold his interest\(^2\) for eighteen dollars and fifty cents per share. Five days later, negotiations for the possible sale began. On December 7, the defendant-corporation reached a preliminary understanding with the purchasing corporation and approximately two months thereafter a formal contract of sale was executed, which provided for a purchase of stock from its shareholders at a price of fifty dollars per share.

Plaintiff alleged, *inter alia*, that the defendants had failed to disclose material facts which would have affected his decision to sell. The court disagreed with this allegation, as a matter of law, for it held that the "possibility" (beginning on November 4 and continuing until the date plaintiff sold his stock) that Fashion Park *might* be sold was not a material fact.\(^9\) The essence of this finding seems to be that the Rule was not violated since, had the plaintiff known of the inside information, his judgment as to whether to sell would not have been reasonably affected.

The case is also noteworthy for its consideration, with respect to 10B-5, of reliance (discussed earlier),\(^9\) non-disclosure and administrative purpose. The court held that "total non-disclosure," is a probable ground for action under the Rule.\(^9\) And taking specific notice of the dichotomous bases of private and Commission suits under the Rule, the court said: "The aim of administrative proceedings under Rule 10B-5 is to deter misconduct by insiders, rather than to compensate their victims."\(^9\)

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91. 340 F.2d 457 (2d Cir. 1965).
92. At least one of the buyers of the plaintiff's shares was a director of the defendant-corporation.
93. It appears that the argument made along this line by the defendants in *Texas Gulf* is their best chance for success. In that case, however, among the hurdles which would have to be leaped are: (1) that the company's alternative to their primary failure to disclose, and to their allegedly misleading disclosure of April 12, would have been total disclosure; and (2) that on the basis of all information known to insiders (and their tippees), the plaintiffs' judgment of whether to sell would not have been affected, in that the information was not, prior to April 16, conclusively material.
94. *Supra* note 58.
95. The court noted that under the minority common law rule of disclosure, an insider could be liable even though "perfect silence was kept" (see Strong v. Repide, *supra* note 61) and stated: "Surely we suppose that Rule 10B-5 is as stringent in this respect as the federal common law which preceded it." *List v. Fashion Park, Inc.*, *supra* note 91, at 462. See also *Cochran v. Channing Corp.*, 211 F. Supp. 239 (S.D.N.Y. 1962).
96. The position taken by the SEC in their prayer for relief in *Texas Gulf* seems contrary to this statement. (See text accompanying notes 17-20, *supra*.) There, the Commission seeks, *inter alia*, to have the court order the defendants to make restitution to their sellers, and thus to compensate their victims. To reconcile the statement in the text with the prayer in the complaint, it is necessary to argue in a fashion analogous to one argument
The burden of proof was thus placed; its extent was established in *Stevens v. Vowell*. After perfunctorily recognizing that "[O]f course, . . . the burden is upon the plaintiff to . . . make out a case under the statute and rule . . .," the court later set forth a simple standard that the plaintiff must meet: "It is not necessary to allege or prove common law fraud, to make out a case under the statute and rule. It is only necessary to prove one of the prohibited actions such as the material mis-statement of fact or the omission to state a material fact."

A possible limitation on the seemingly relentless trend in favor of the broadest construction of 10B-5 appears in *O'Neill v. Maytag*. After the officers and directors of a company (National Air Lines) in which the plaintiff held a minority interest agreed to an exchange of stock with another company (Pan Am.) in a ratio apparently unfavorable to National, plaintiff brought a shareholder's derivative action under 10B-5. The court denied relief, holding that the alleged misrepresentation concerned only fraudulent mismanagement. Therefore, since the fraudulent practice complained of was not associated with ("in connection with" might have been more appropriate) the sale or purchase of securities, no remedy was found to exist under 10B-5. While for the insider this case might initially appear to be a ray of light in an otherwise dark void, it is not likely to have any significant effect on the trend. Rather, it seems only to be an isolated attempt to utilize the Rule which stretched too far.

Most of the cases under the Rule thus far have concerned either omissions to stated material facts or statements which have been termed misrepresentations in light of the circumstances. One which turned on an "untrue statement" was the first affirmance of a 10B-5 right by the first circuit. Plaintiff sold his stock to defendant for forty thousand dollars after the latter said at a directors meeting that there would be no material change and things were "about the same" in the company's prospects for the foreseeable future. This statement was false, and within two years of this acquisition of plaintiff's stock, defendant sold it at a profit of approximately $660,000.00. This court accorded another liberal interpretation to the Rule by finding that the defendant had not made fair or truthful disclosure "within the heavy requirements of the Act, by the single statement that things were 'about the same.'" These
facts are perhaps no more extreme than those in Texas Gulf. Ultimately, however, both situations turn on whether the relationship between the facts known to insiders regarding the company’s financial prospects, and the statements which they made about them were such as to warrant a finding of falsity or material misrepresentation.

One supreme court case and one pending Commission action complete our look into the crystal ball of litigation prior to Texas Gulf. In the first, J. I. Case Co. v. Borax, the high Court rendered a decision which may well lend great support to the argument favoring implied liability under the Rule. It upheld the existence of a like remedy under the proxy section (section 14) of the Exchange Act, the pertinent language of which is strikingly similar to section 10(B). The Court affirmed the plaintiff’s implied right to damages resulting from misleading proxy statements:

While this language [in section 14] makes no specific reference to a private right of action, among its chief purposes is “the protection of investors,” which certainly implies the availability of judicial relief where necessary to achieve that result. . . . [U]nder the circumstances here it is the duty of the courts to be alert to provide such remedies as are necessary to make effective the congressional purpose.

The proxy section and section 10(B) can, of course, be distinguished in many ways. But, nevertheless, the theoretical justification favoring implied liability under one section of the securities acts, as enunciated in Borax, would appear to apply to 10(B), and others as well. Therefore, while it is possible that the Court harbors a different view of 10(B), until such time as the problem is actually before it, it is reasonable to believe that its present membership will not “throw Kardon out.”

The pending case is of interest since, together with Texas Gulf, it is an indication of a major crackdown on 10B-5 violators by the Commission. While the only reported proceedings to date dealt with the question of venue, the facts presented therein are of interest. Once again, as in the Commission’s suit against Texas Gulf, the primary concern is with inside information which was not made available to the general public, rather than to particular buyers and sellers claiming injury. Also of significance, is the allegation in the complaint that the defendants profited

105. “It shall be unlawful for any person [hereafter is a delineation of prohibited acts] . . . 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.” 15 U.S.C. § 70n(a) (1934).
106. The proxy material failed to disclose alleged unlawful market manipulation in the company’s stock.
108. Re-read the quotation in note 74, supra.
from non-disclosure in the purchase and sale of stocks. (This resulted from a merger in which the ratio of exchange differed from the relative market values of the shares involved, and the defendants allegedly knew what effect the subsequent public disclosure would have on each company's stock.) Thus, if it eventually is settled that a private right follows along wherever the Commission can bring an action for enforcement, then the fact that non-disclosure in the sale is included in this suit portends no good for those who still resist a private action by an injured buyer.

IV. IMPORT OF TEXAS GULF

It will hopefully be clear from the foregoing that many of the problems raised in Texas Gulf are not unique. Therefore, while Texas Gulf has caused much consternation, it is but a logical continuation of the two parallel trends in insider-securities litigation—Commission actions and private suits under 10B-5. Thus, it seems that its greatest import is that its notoriety has finally made a legislatively and judicially declared "matter of public interest" (The Rule)—a truly "public matter" and concern. Some of the most vital aspects of this concern are considered below.

The answer to "Who is an insider?" is really anybody's guess. Perhaps some guidelines can be gleaned from a consideration of a few examples. As pointed out earlier, the Commission is seeking in Texas Gulf to hold the "traditional" insiders (officers and directors, etc.) responsible for the profits made by their "tippees." One wonders if the Commission has so quickly departed from the tests of "insidedness" it laid down in Cady, Roberts since the Commission did not include tippees in the latest suit. Why should the tippee not be liable for his own profits? If "any one particular person" has access to inside information and takes unfair advantage of it, should he be permitted to benefit from information he knew was "tipped?" It would seem to this writer that he should not. Nevertheless, it does appear that such will be the result.

One problem left open is whether the tipper could recover back from his tippee, but since the basis of the original insider's liability was fraudulent behavior, it is quite unlikely he could state a cause of action which would not be contrary to equity and good conscience; and if he could recover, then he would be "free and clear." Thus, a vicious cycle is created by an attempt to fix punishment for insider's non-dis-

110. Professor Loss anticipated a Texas Gulf-type problem when he wrote: "Suppose an insider has advance knowledge that his company has struck oil or is about to obtain an extremely profitable contract." His conclusion was that, "Clearly his buying stock without disclosing that fact violates the Rule . . . for the market is going up when the news gets out."
3 Loss, op. cit. supra note 59, at 1460-61.
111. See text accompanying note 17-20, supra.
112. See text accompanying note 84, supra.
closure or misleading disclosure. Furthermore, assuming that these tippees should be liable as insiders, another large problem remains with respect to where the line between the insider and the innocent should be drawn.

Questions have been raised concerning the possible "disclosure" vel non position of market analysts, reporters, cab-drivers, and corporations themselves. With respect to the analyst, it would seem that reports and news which he has come upon through independent research should not be considered "inside" information. There is, however, nothing to absolutely preclude application of the Rule. The situation of a reporter using information contained in a press statement before its release to the public is not so simply resolved. At first, a suggestion to impose liability in such an instance may appear laughable. But clearly he is in a perfect position to understand the "inside" nature of the news given to him. Therefore, if he purchased prior to publication on, for example, the Dow-Jones ticker, it is only reasonable that his duty to disclose should be tantamount to that of a tippee.

Another "first-glance comedy" is the proposition that a cab-driver who overhears a discussion between corporate insiders should be liable for profits gained by his use of the accidental tipping. Absurd? Seemingly yes. But what if the passengers and their positions are well-known to the driver? How then is that person distinguished from other insider-tippees? Granted, this example is certainly extreme. It does, however, serve to indicate the potential breadth of the Rule. It is possible we have only had a glimpse of an horizon that may stretch very far indeed.

The corporation may find itself in a dilemma. Undeniably it owes a general obligation of disclosure to its stockholders. Rule 10B-5 poses potentially far-reaching effects on that duty. If a corporation has information that is possibly material, then it must decide whether to speak. If it makes some disclosure, then it faces a charge of being misleading. If it keeps silent, it risks a suit for non-disclosure. And if it takes the wrong course of conduct, just what direction its liability will lie is unclear. If a stockholder sells to his corporation, will the corporation be ordered to make restitution to him? The point is moot, but the litigation to date does not render such an action inconceivable.

Of course the corporate insiders face no less of a dilemma. But for them, one guide is clear. If they have access to and knowledge of material

113. Two theoretical solutions to this "cycle" appear. First, perhaps a liability similar to that of joint tort-feasors could be evolved. A second possibility would be to allow a personal right of action (and thereby make available recovery) against the "tippee," and a stockholders' derivative action against the original insider-"tippor."
114. Of course this duty could logically be carried over ad infinitum with respect to tippees of tippees, etc.
115. The corporation is not charged with making any such purchases in the Texas Gulf complaint.
facts not known to the public, they must not transact. When will anyone with such information be able to safely buy or sell? The answer should logically be determined by whether he is under a disclosure duty. If such a duty exists—whether for the reporter, cabbie or any other—then he cannot safely trade, at least for the present.

What, then, constitutes sufficient disclosure? First, it is reasonable that the news must be actually available to the "public" before the "caution flag" will be lifted from the insider's portfolio. It would not be disclosed, as was contended by one Texas Gulf director,\(^\text{116}\) at the time a release is given to reporters. On the other hand, if you are concerned with a locally held corporation,\(^\text{117}\) of whom does the "public" consist? Once again, there can be no clear-cut answer. If a client seeks to avoid the attendant risks of non-disclosure to an outsider, a practitioner should probably advise him that the most widespread possible publication should be given any "special" information.\(^\text{118}\)

A new and final consideration under the Rule relates to stockholders' derivative actions. A typical pattern for such a suit is as follows. If insiders bought shares from the corporate treasury at a low price (while others lacked news indicating a rosy future for the corporation), then an injury to the corporation as seller could easily be alleged in a 10B-5 suit for non-disclosure. This may seem to fly in the face of section 16(b) of the 1934 Act, but the fact remains that the action could be, and has been,\(^\text{119}\) considered a violation of the Rule. Once more, then, a previous Congressional securities remedy appears on its way to being largely supplanted by the Rule.

One immediate result of Texas Gulf has been the "clamming-up" of many corporations and their insiders, all seeking to avoid suits by the allegedly misled outsider.\(^\text{120}\) Clearly, however, by so doing they take a correlative chance by embarking on a course of total non-disclosure.

Possibly some of the problems considered here are out of proportion. The Rule may yet turn out to be less than a sleeping giant. But, though its present use is not entirely revolutionary, it is certainly revelationary. This writer submits that the greatest value to securities law of Texas

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116. See answers filed by the individual defendants.
117. Needless to say, even the smallest ABC, Inc., probably uses at least the mails in effecting transfers of stock, both from the issuer to a holder, and between selling and purchasing stockholders.
118. At very least, this "news" must be transmitted to all existing stockholders.
120. A listing of a few of these companies and their reasons for so acting is found in "Analysts run into a 'Security Blackout'," Business Week, May 8, 1965, p. 142-3.

Editor's note: The federal district court in New York, CCH Fed. Sec. L. Rep. ¶ 91805 (Aug. 19, 1966), made a finding of fact most recently in the Texas Gulf litigation that the "insider" provisions of the Rule would only extend to those defendants who bought stock immediately prior to the press releases. Supra notes 7-9. Extended appellate litigation can be expected before the case is completely resolved however.
Gulf's mining discovery is that it unearthed so many vital questions—ones which had lain dormant for so long. Regardless of its adherence to the original Congressional intent, the present trend in the construction of 10B-5 surely appears to obviate the practical need for many of the insider-securities sections. The final outcome of all litigation under Rule 10B-5—past, pending, and probable—may very possibly appear in future legislation.

It is suggested that desirable legislation should spell out the remedies which may be pursued, expressly permitting private suits in the clear language of sections 11 and 12, provide a two year statute of limitation to run from the date of the discovery of the fraud and do away with the apparent surplusage with sections 17 and 12(2). Such action would clarify the inconsistencies which presently perplex the courts.