ITSFEA's Effect on Either an Implied Cause of Action for Damages by Contemporaneous Traders or an Action for Damages or Rescission by the Party in Privity with the Inside Trader

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ITSFEA's Effect on Either an Implied Cause of Action for Damages by Contemporaneous Traders or an Action for Damages or Rescission by the Party in Privity with the Inside Trader

William K.S. Wang*

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I. **INTRODUCTION**

Two years ago Congress enacted the Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA). This statute added section 20A to the Securities Exchange Act of 1934. The new provision created an express cause of action for contemporaneous traders against a defendant who engages in illegal insider

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4. The statute leaves the task of defining the term "contemporaneous" to the courts. See Report of the House Committee on Energy and Commerce on the Insider Trading and Securities Fraud Enforcement Act of 1988, H.R. REP. No. 910, 100th Cong., 2d Sess. 27 (Sept. 9, 1988) [hereinafter Report] (stating that "[t]he bill does not define the term 'contemporaneous,' which has developed through case law"). Roughly speaking, "contemporaneous" trades are trades (1) opposite in type to the insider trade, and (2) occurring during the period commencing the instant of the insider trade and ending a "short" period thereafter (e.g. one day or possibly a few days). Cf. Alfus v. Pyramid Tech. Corp., 745 F. Supp. 1511, 1522 (N.D. Cal. 1990) (noting that the contemporaneous trade "must have occurred after the wrongful insider transaction . . . [and that] the contemporaneous requirement has been deemed not met if plaintiff's trade occurred more than a few days apart from the defendants' transactions"); O'Connor & Assocs. v. Dean Witter Reynolds, Inc., 559 F. Supp. 800, 803 (S.D.N.Y. 1983).

Until the defendant trades he has not violated his obligation either to disclose or to abstain from trading, because the obligation has not yet come into existence. Therefore, a plaintiff whose trades were completed prior to those of the defendant can claim no injury from the defendant's nondisclosure, regardless of the defendant's later use of inside information in the course of his trading.

*Id.*

For a discussion of the case law defining "contemporaneous," see Wang, *The "Contemporaneous" Traders Who Can Sue an Inside Trader*, 38 HASTINGS L. J. 1175 (1987). This Article uses the phrases "contemporaneous traders" and "opposite-type contemporaneous traders" as synonyms. Included among
trading or tipping.

Section 20A provides in pertinent part:

Liability to contemporaneous traders for insider trading

(a) Private Rights of Action Based on Contemporaneous Trading

Any person who violates any provision of this title or the rules or regulations thereunder by purchasing or selling a security while in possession of material, nonpublic information shall be liable in an action in any court of competent jurisdiction to any person who, contemporaneously with the purchase or sale of securities that is the subject of such violation, has purchased (where such violation is based on a sale of securities) or sold (where such violation is based on a purchase of securities) securities of the same class.

(b) Limitations on Liability

(1) Contemporaneous trading actions limited to profit gained or loss avoided

The total amount of damages imposed under subsection (a) shall not exceed the profit gained or loss avoided in the transaction or transactions that are the subject of the violation.

(2) Offsetting disgorgements against liability

The total amount of damages imposed against any person under subsection (a) shall be diminished by the amounts, if any, that such person may be required to disgorge, pursuant to a court order obtained at the instance of the Commission, in a proceeding brought under section 21(d) of this title relating to the same transaction or transactions.

5. Section 20A is part of Title 15 of the United States Code. Nevertheless, Title 15 of the United States Code has not been enacted into "positive law" by Congress. See Preface to the United States Code. See generally 1 U.S.C. § 204(a) (1988). Title 15 is a compilation of separate statutes. When Congress amends statutes codified in Title 15, Congress treats each statute individually. Thus, the word "title" in § 20A cannot mean Title 15 of the United States Code. Instead, the word "title" must refer to Title I of the original Securities Exchange Act of 1934. The 1934 statute was divided into two titles: "Title I—Regulations of Securities Exchanges" and "Title II—Amendments to Securities Act of 1933." See note at 15 U.S.C. § 78a (1988). In effect, "Title I" constituted what is now referred to as the Securities Exchange Act of 1934. See id.


(c) **Joint and Several Liability for Communicating**

Any person who violates any provision of this title or the rules and regulations thereunder by communicating material, nonpublic information shall be jointly and severally liable under subsection (a) with, and to the same extent as, any person or persons liable under subsection (a) to whom the communication was directed.

(d) **Authority Not To Restrict Other Express or Implied Rights of Action**

Nothing in this section shall be construed to limit or condition the right of any person to bring an action to enforce a requirement of this title or the availability of any cause of action implied from a provision of against violations of either the 1934 Act or the rules or regulations adopted thereunder. The courts have interpreted § 21(d) to permit the SEC to obtain other forms of equitable relief against violators, including disgorgement of profits. See SEC v. Clark, 915 F.2d 439, 442 n.4 (9th Cir. 1990) (noting that "'[i]t is well settled that § 21(d) permits the SEC to obtain more than injunctive relief"); id. at 453 (noting further that "'[t]he SEC's power to obtain injunctive relief has been broadly read to include disgorgement of profits realized from violations of the securities laws"); SEC v. First City Fin. Corp., 890 F.2d 1215, 1230 (D.C. Cir. 1989) (stating that "[d]isgorgement, then, is available simply because the relevant provisions of the Securities Exchange Act of 1934, sections 21(d) and (e), vest jurisdiction in the federal courts"); I T. HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION § 9.5, at 401-03 (2d ed. 1990); M. STEINBERG, SECURITIES REGULATION: LIABILITIES AND REMEDIES § 12.03 (1990); M. STEINBERG & R. FERRARA, SECURITIES PRACTICE: FEDERAL AND STATE ENFORCEMENT §§ 5.08, 5.09 (1991). For a discussion of disgorgement, see D. LANGEVOORT, INSIDER TRADING: REGULATION, ENFORCEMENT & PREVENTION § 8.03[2] (1991); Cheney & Sibears, A New Measure of Disgorgement in SEC Insider Trading Cases, 69 MASS. L. REV. 180 (1984); Ellsworth, Disgorgement in Securities Fraud Actions Brought By the SEC, 1977 DUKE L.J. 641; Gonson & Quinn, The Disgorgement Dilemma: Who Gets the Money Covered by the SEC in Insider Trading Cases?, 35 FED. B. NEWS & J. 192 (1988); Wang, supra note 4, at 1192 & n.75; Note, Equitable Claims to Disgorged Insider Trading Profits, 1989 Wis. L. REV. 1433; Comment, The Measure of Disgorgement in SEC Enforcement Actions Against Inside Traders Under Rule 10b-5, 34 CATH. U.L. REV. 445 (1985). Section 20A diminishes a defendant's liability to contemporaneous traders by the defendant's disgorgement in an SEC action for court-ordered equitable relief under § 21(d), but not by the defendant's payment of a civil penalty to the U.S. Treasury pursuant to § 21A of the Securities Exchange Act of 1934. Section 21A is codified as 15 U.S.C. § 78u-1 (1988). For a discussion of § 21A, see Aldave, supra note 1, at 905-12; Friedman, supra note 1, at 476-79; Phillips, supra note 1, at 17, col. 3, 20, col. 1; Pitt & Groskaufmanis, supra note 1, at 3-4.

Recently, Congress adopted the Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429 (1990). Under certain circumstances, this statute empowers the SEC staff to seek disgorgement in SEC administrative proceedings. See Securities Exchange Act of 1934 §§ 21B(e), 21C(e). Perhaps as a result of an oversight, in 1990 Congress failed to amend § 20A to reduce a defendant's liability to contemporaneous traders by the defendant's disgorgement in an SEC administrative proceeding under §§ 21B and 21C, as opposed to a judicial proceeding under § 21(d). Cf. Litton Indus., v. Lehman Bros. Kuhn Loeb Inc., 734 F. Supp. 1071 (S.D.N.Y. 1990). The court found that the plaintiff was not a contemporaneous opposite-type trader. The plaintiff sued insider trading defendants for the disgorgement measure of damages, rather than the traditional out-of-pocket measure of damages. The court ruled "that once ill-gotten gains have been disgorged to the SEC, there remains no unjust enrichment and, therefore, no basis for further disgorgement in an implied private action." Id. at 1076.
Section 20A(a) creates an express private cause of action for contemporaneous opposite-type traders. The section limits, however, the total amount of damages recoverable to the defendants' profit. Any award is further reduced by amounts disgorged in an action brought by the Securities and Exchange Commission (SEC) under its general power to seek equitable relief.

This Article will discuss the following four issues: (1) Does ITSFEA's express action preclude a concurrent implied action for damages by the same contemporaneous traders, so as to preclude double damages liability of the defendant? (2) Does ITSFEA's express action preclude an implied action for actual damages by the party on the other side of the illegal insider trade? (3) Does ITSFEA's express action preclude the party on the other side of the insider trade from suing for rescission either as a general Rule 10b-5 remedy or under section 29(b) of the Securities Exchange Act of 1934? (4) Does section 20A itself create a statutory cause of action for rescission for the party on the other side of the insider trade?

These issues have important policy implications. Under section 20A's damages action, the defendant's profit realized from illegal trading would be split among the members of the contemporaneous trader class. Each member of the class, including the party in privity, would receive only a small portion of his or her actual damages. If contemporaneous traders are allowed an implied cause of action in addition to their express section 20A action, these plaintiffs will receive a greater portion of their actual damages. The party on the other side of the illegal insider trade has a more meritorious claim than other contemporaneous traders, especially if the party has a "special relationship" with the insider trading defendant. A separate direct suit for damages or rescission would make such a plaintiff whole. Although the Securities Exchange Act of 1934 does provide for significant criminal and civil penalties arising from prosecutions by the Justice Department. ITSFEA amended § 32(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78ff(a) (1988), increasing the criminal penalties for violations of the Act or rules adopted thereunder. The maximum fine for natural persons is now one million dollars and for entities other than natural persons the maximum fine is two and one-half
penalties, the limited damages liability imposed by section 20A provides little
deterrence to insider trading. Additional deterrence will be available if the total
liability from private causes of action is not limited to the profit realized by the
insider trader.

II. DO CONTEMPORANEOUS TRADERS HAVE BOTH AN EXPRESS AND AN IMPLIED
CAUSE OF ACTION FOR DAMAGES AGAINST AN INSIDER TRADING DEFENDANT?

Prior to ITSFEA, the Second Circuit granted contemporaneous traders an
implied cause of action for damages against insider traders and tippers who violated
Rule 10b-5 under the "special relationship" theory. In contrast, when insider

18. Civil penalties arise from prosecutions by the Securities and Exchange Commission. Section
21A, 15 U.S.C. § 78u-1 (1988), authorizes the SEC to seek a court order imposing a civil penalty on any
person who violates the Act, or any rule adopted thereunder, by buying or selling securities while in
possession of material nonpublic information, or tipping a person who subsequently buys or sells securi-
ties. The penalty is payable to the U.S. Treasury and cannot exceed three times the profit gained or loss
circumstances, § 21A also authorizes the SEC to seek a civil penalty against "any person who, at the
time of the violation, directly or indirectly controlled the person who committed such violation." Section
exceed the greater of $1,000,000 or three times the amount of the profit gained or loss avoided as a result
is a tipper, the latter amount is the "profit gained or loss avoided by the person or persons to whom the
controlled person directed such communication." Id. For discussion of these civil penalties, see sources
cited supra note 1.

relationship of "trust and confidence" between the parties to the insider trade as a basis for insider
trading. For a discussion of Chiarella's "special relationship" theory, see infra text accompanying notes
72-107; Wang, Trading on Material Nonpublic Information on Impersonal Stock Markets: Who Is

20. See Wilson v. Comtech Telecommunications Corp., 648 F.2d 88, 94-95 (2d Cir. 1981); see
also Wang, supra note 19, at 1217, 1279-81 (discussing Wilson). For an argument that dictum in the
Supreme Court opinion of Chiarella v. United States, 445 U.S. 222, 230-33 (1980), should have deterred
the Second Circuit from creating an implied private cause of action for contemporaneous traders—in
contrast to the party in contractual privity with the insider trader—see infra notes 34, 99; Wang, supra
note 19, at 1270-71, 1281. Dictum in an Eighth Circuit opinion may endorse Wilson's contemporaneous
class of plaintiffs. Laventhal v. General Dynamics Corp., 704 F.2d 407, 412 (8th Cir. 1983), cert.
denied, 464 U.S. 846 (1983). At least two district courts in the Eighth Circuit have interpreted
memorandum opinion also endorses the Wilson class of contemporaneous traders. Laventhal v. Katy
(April 13, 1990). For a discussion of district courts outside the Second and Eighth Circuits that have
endorsed the contemporaneous class of plaintiffs, see Wang, supra note 4, at 1177 & n.13. For a pre-
Chiarella Sixth Circuit opinion refusing to hold an insider trader liable to contemporaneous traders, see
Fridrich v. Bradford, 542 F.2d 307 (6th Cir. 1976) (attempting to outline what a private plaintiff suing a
stock market insider trader under Rule 10b-5 must demonstrate, but failing to explain clearly whether
the essential element is privity of contract, causation of harm by the insider's act of trading, either of the
above, or both), cert. denied, 429 U.S. 1053 (1977). For a discussion of Fridrich, see Wang, supra note
trading/tipping liability under Rule 10b-5 was based on the "misappropriation"\(^{21}\) theory, the Second Circuit refused to grant an implied cause of action for damages to "marketplace" or, by implication, to contemporaneous traders.\(^{22}\) In an implied action for damages brought under the "special relationship" theory on behalf of a broad class of opposite-type traders, the Second Circuit limited the class's recovery to the insider trading profit.\(^{23}\)

ITSFEA provides for an express cause of action for contemporaneous traders against an insider trader or tipper who violates federal securities law.\(^{24}\) The question arises whether section 20A precludes implied causes of action for damages by contemporaneous traders against the same defendant. Allowing contemporaneous traders both an implied and an express damages action would not allow double recovery of actual damages.\(^{25}\) As noted earlier, both section 20A and the Second Circuit—in its implied action—limit the damages recovery of contemporaneous traders to the insider trading profit.\(^{26}\) The aggregate losses of the contemporaneous traders would generally far exceed the insider trading profit.\(^{27}\) Allowing contemporaneous traders to recover twice the insider trading profit in the two actions would still not make the plaintiff class whole.\(^{28}\)

\(^{19}\) at 1262-67.

\(^{21}\) The misappropriation theory is based on a breach of duty to one's information source—generally an employer. For a discussion of the misappropriation theory, see SEC v. Clark, 915

\(^{22}\) F.2d 439, 443-53 (9th Cir. 1990); see infra notes 169-78 and accompanying text.


\(^{24}\) Elkind v. Liggett & Myers, Inc., 635 F.2d 156, 172-73 (2d Cir. 1980) (stating that limiting the recovery to the insider's gain offers the most equitable solution to the difficult problems created by conflicting interests). For a discussion of Elkind's ceiling on liability, see Wang, supra note 19, at 1276-79, 1283.

\(^{25}\) Section 28(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78bb(a) (1988), provides: "[N]o person permitted to maintain a suit for damages under the provisions of this title shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of." See Ososky v. Zipf, 645 F.2d 107, 111 (2d Cir. 1981) (noting that "[t]he statutory language suggests that one purpose of section 28(a) is to prevent double recovery by those who assert both state and federal claims arising out of the same conduct") (dictum); see also Upton v. Trinidad Petroleum Corp., 468 F. Supp. 330, 337 (N.D. Ala. 1979) (stating that under § 28(a), "[s]ince the court has already decided that the Securities Act of Alabama entitles plaintiff to recover his actual damages ... there can be no specific recovery under [the Securities Exchange Act of 1934]").

\(^{26}\) See supra text accompanying notes 5-7.

\(^{27}\) Cf. Elkind, 635 F.2d at 170 (stating that "[a]n equally compelling reason for rejecting the theory [of granting actual damages to each contemporaneous trader plaintiff] is its potential for imposition of Draconian, exorbitant damages, out of all proportion to the wrong committed"); Wang, supra note 19, at 1276-79 (questioning Elkind's logical consistency in allowing contemporaneous traders to recover but then limiting their aggregate recovery to the insider trading profits).

\(^{28}\) See Henning, supra note 2, at 33 (stating that § 20A "may allow only a negligible recovery compared to the loss suffered by contemporaneous traders"). Cf. D. Langevoort, supra note 6, § 9.02[2], at 9-8 (noting that "each [proper] plaintiff should recover the amount necessary to fully compensate for his injury. While this could result in extremely large damage awards—far in excess of
Is an insider trader's conduct the "but-for" cause of the losses of contemporaneous traders? The insider trade itself causes no harm to most, if not all, of the contemporaneously trading plaintiffs. On the other hand, the insider trading defendant's nondisclosure does cause the losses of the contemporaneously trading plaintiffs. Had the defendant disclosed the material nonpublic information to the plaintiffs, they would not have bought or sold.

Prior to ITSFEA, the Second Circuit in Elkind chose to limit the recovery in a class action to the profit from the insider trading. Two possible rationales exist for that decision. The court may have believed that an award of some multiple of the insider trading profit would be too novel a remedy to adopt in an implied cause of action. Alternatively, the Second Circuit may have found that an award to contemporaneous traders of more than the insider trading profit would be unnecessarily punitive. The intent of the Elkind court may have been to create at least some deterrence by providing a mechanism for disgorgement of the insider trading profit to an arbitrary class of private plaintiffs. If the second rationale were the basis of the Elkind ceiling, the Second Circuit may now choose to rely on ITSFEA and discontinue implying a private cause of action for contemporaneous traders.

any gains the defendant made from his unlawful trading, it is the only measure that makes each person who was defrauded 'whole'."

The "contemporaneous" plaintiffs in the express and the implied causes of action are not necessarily identical. Section 20A's express action is limited to contemporaneous traders of the same class of securities as those traded by the defendant. In an implied cause of action, if any, the courts might allow suit by a broader class of "contemporaneous" plaintiffs. For example, in the implied cause of action the courts might allow convertible debenture traders, or even option traders, to sue an insider trader of common stock. For discussion of these issues, see Henning, supra note 2, at 35-41, 46-52; Wang, supra note 4, at 1187-88.

29. For discussion of the harm of the insider trade itself, see Wang, supra note 19, at 1234-40.
30. For discussion of the harm of the nondisclosure, see Wang, supra note 19, at 1255, 1258-62 (discussing Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974)); id. at 1278-79 (discussing Elkind v. Liggett & Myers, Inc., 635 F.2d 156 (2d Cir. 1980)).
31. Elkind, 635 F.2d at 172-73.
32. The Elkind court considered three alternative measures of damages: (1) plaintiffs' actual out-of-pocket losses caused by the nondisclosure; (2) the harm caused plaintiffs by the trade (as opposed to the nondisclosure); and (3) plaintiffs' losses caused by the nondisclosure, but limited to the amount of the insider trading profit and distributed pro rata among the plaintiffs. Elkind, 635 F.2d at 170-73. In the forced choice among these three alternatives, the court opted for the third: "as between the [three] various alternatives we are persuaded, after weighing the pros and cons, that the disgorgement measure, despite some disadvantages, offers the most equitable resolution of the difficult problems created by conflicting interests." Id. at 173.
33. Cf. id. at 172 (stating that "[t]o the extent that [the disgorgement measure] makes the tipper and tippees liable up to the amount gained by their misconduct, it should deter tipping of inside information and tippee-trading. . . . In most cases the damages recoverable under the disgorgement measure would be roughly commensurate to the actual harm caused by the tippee's wrongful conduct").
34. Cf. Litton Indus. v. Lehman Bros. Kuhn Loeb Inc., 734 F. Supp. 1071, 1073-77 (S.D.N.Y. 1990) (explaining that the plaintiff was not a contemporaneous opposite-type trader; plaintiff sued insider trading defendants for the disgorgement measure of damages, rather than the traditional out-of-pocket measure of damages; the court ruled "that once ill-gotten gains have been disgorged to the SEC, there remains no unjust enrichment and, therefore, no basis for further disgorgement in a[n] [implied] private action"; id. at 1076).
a voluntary decision would avoid the issue of whether ITSFEA's section 20A preempts the earlier-created implied cause of action.

Suppose, however, that the Second Circuit reaches the issue of whether section 20A precludes recovery by contemporaneous traders of double the insider trading profit. Congress had the power to adopt a double-profit remedy in section 20A and chose not to do so. Indeed, recovery under section 20A is further reduced by any disgorgement ordered by a court in an equitable action brought by the SEC. Whether this congressional policy decision limiting recovery under section 20A precludes a finding of additional liability under an implied cause of action is not clear. Such double liability might frustrate congressional intent. On the other hand, section 20A plainly states that it precludes no implied action. The House Committee Report accompanying ITSFEA does not specifically address the issue of whether contemporaneous traders should be allowed both an express and an implied cause of action for damages. Nevertheless, the Report emphasizes the Committee’s desire to allow the courts leeway to develop implied private causes of action for non-contemporaneous traders, such as takeover bidders. The discussion then notes:

[In such suits] the potential harm to the plaintiff from the defendant’s

Arguably, dictum in the Supreme Court opinion of Chiarella v. United States, 445 U.S. 222, 230-33 (1980), should have deterred the Second Circuit from creating an implied private cause of action for contemporaneous traders in the first place. I have contended that Chiarella suggested an implied cause of action under the “special relationship” theory exists, but the only private party who can sue an insider trader on this ground is the party on the other side of the trade. See Wang, supra note 19, at 1270-71, 1281 (suggesting a contractual privity requirement in private suits against insider trading defendants liable under the “special relationship” theory). For further discussion, see infra note 99.

See supra note 6 and accompanying text. When the SEC obtains disgorgement of profits of an insider trader in an equitable suit, the disgorgement generally goes to contemporaneous traders. See Wang, supra note 4, at 1192 & n.75.

See supra text accompanying note 7.


Id. at 28.

Originally, because of a concern about the effects of insider trading on takeover bidders, the draft of ITSFEA contained the following proposed § 20A(a)(2) of the Securities Exchange Act of 1934:

Any person (other than a person entitled to recovery solely under paragraph (1) of this subsection [i.e., recovery by contemporaneous traders]) injured by a violation described in such paragraphs in connection with such person's purchase or sale of securities may bring an action in any court of competent jurisdiction to seek recovery of any damages caused by such violation, or for appropriate equitable relief, or both.


When the full House Energy and Commerce Committee marked up ITSFEA, the Committee members disagreed on the meaning of the above provision. Rather than jeopardize enactment of the bill, the Committee deleted the provision, but inserted in the House Report language supporting the assertion that a takeover bidder has standing to sue an insider trading defendant. See Report, supra note 4, at 28; Kaswell, supra note 1, at 168-69.
insider trading or tipping may be far greater than the profit gained or loss avoided by the defendant. The Committee recognizes that where the plaintiff demonstrates that he was defrauded by the defendant’s insider trading and suffered actual damages proximately caused by the defendant’s behavior, a cap of profit gained or loss avoided by the defendant, which is applicable for actions by contemporaneous traders, is not appropriate.\textsuperscript{40}

This language suggests that the Committee intended to preclude an implied cause of action for contemporaneous traders. On the other hand, the Report’s discussion of section 20A concludes:

The section on private rights of action explicitly states that nothing in this section may be construed \textit{in any fashion} to limit . . . the availability of any cause of action implied under the Exchange Act. The Committee in fact expressly recognizes the implied right of action under the securities laws for cases including \textit{but not limited to} the situations such as that noted above in the Anheuser-Busch case [a suit by a takeover bidder].\textsuperscript{41}

On balance, section 20A’s legislative history may suggest that Congress intended to limit the total damages recovery of contemporaneous traders in all actions to the insider trading profit. The text of section 20A(b)(1) reinforces this suggestion.\textsuperscript{42} Section 20A(d), however, expressly states that it should not be construed to limit implied actions.\textsuperscript{43} In short, ITSFEA is ambiguous as to whether it precludes contemporaneous traders from bringing both an express and an implied


[A] provision in the private rights section [of ITSFEA], stating that nothing in the section shall be construed to limit or condition the availability of any cause of action implied under the Exchange Act, will assure that plaintiffs other than contemporaneous traders will continue to have standing to bring implied rights of action under section 10(b).

\textsuperscript{41} Report, supra note 4, at 28 (emphasis added). See id. at 27:

At the full Committee markup, the Committee also accepted an amendment to delete the paragraph containing an express private right of action for parties other than contemporaneous traders. The Committee’s intention in this amendment was to avoid creating an express cause of action which might have the unintended effect of freezing the law or in any way restricting the potential rights of action which have been implied by the courts in this area. Rather, the Committee wanted to give the courts leeway to develop such private rights of action in an expansive fashion in the future.

Cf. 134 CONG. REC. S17,218 (daily ed. Oct. 21, 1988) (statement of Sen. Proxmire). “This provision [§ 20A of ITSFEA] is not intended to restrict the evolving law on private rights of action.” \textit{Id.} “To the contrary, the courts are given leeway to develop such private rights of action in an expansive fashion as they see fit.” \textit{Id.} See generally Gabaldon, supra note 2, at 1088 (discussing the legislative history of § 20A(d) and the intent to give the courts wide discretion to develop implied actions); Pitt & Shapiro, supra note 1, at 237 (stating that “[§ 20A(d) is] an express invitation to the judiciary to imply additional causes of action as appropriate”).


cause of action for damages and recovering double the defendants' insider trading profit through the two actions.\(^4\)

44. Section 20A(a) creates an express cause of action for contemporaneous traders of "securities of the same class" bought or sold by the insider trader. For the text of § 20A(a), see supra text accompanying note 5. Suppose the defendant violates Rule 10b-5 by purchasing IBM common stock based on material nonpublic information. ITSFEA would create an express cause of action for contemporaneous sellers of IBM stock (the same class of security). Would this express cause of action preclude an implied cause of action against the defendant (stock buyer) by contemporaneous sellers of call options on IBM stock?

Even before ITSFEA, it was not clear whether option traders had an implied cause of action against an insider trader of stock. Laventhal v. General Dynamics Corp., 704 F.2d 407 (8th Cir.), cert. denied, 464 U.S. 846 (1983), held that option sellers cannot sue a defendant who bought common stock based on material nonpublic information. For discussion of Laventhal, see Henning, supra note 2, at 38-41, 46-48. Earlier, a district court in the Eighth Circuit had taken a different approach but then reversed its position after the Eighth Circuit opinion in Laventhal. Compare In re McDonnell Douglas Corp. Sec. Litig., 1982 Transfer Binder Fed. Sec. L. Rep. (CCH) ¶ 98,838, at 94,318 (E.D. Mo. 1982) (allowing two classes of plaintiffs—purchasers of common stock and purchasers of options—to sue defendants who allegedly sold stock based on insider information and noting that "[t]he action for improper insider trading protects securityholders under the 1934 Act, and both option and stock purchasers have here alleged the same core of operative facts to pose liability") with In re McDonnell Douglas Corp. Sec. Litig., 567 F. Supp. 126, 127 (E.D. Mo. 1983) (concluding that "the option purchaser has no standing to sue with respect to insider transactions in shares").

A court in the Southern District of New York "agree[d] with the Laventhal court's reasoning and result." Starkman v. Warner Communications, Inc., 671 F. Supp. 297, 304 (S.D.N.Y. 1987). The Starkman court refused to allow option purchasers to sue defendants who allegedly sold the stock based on material nonpublic information. Id. at 301-07. The court also refused to allow option purchasers to sue for alleged affirmative misrepresentations by the issuer of the underlying stock. Id. at 302-08.

In contrast, another district court gave an option trader standing to sue an insider trader of stock. One of the plaintiffs in that case purchased call options on Polaroid stock, and two of the defendants sold Polaroid stock. The court refused to dismiss the option buyer's complaint against the alleged insider traders of stock:

> Call options are 'securities' within the meaning of section 10(b) and Rule 10b-5. . . . Although . . . [the plaintiff option buyer] may have difficulty in establishing that he was damaged by the [insider stock] trading . . . he does state a claim upon which relief can be granted and the motion to dismiss . . . must be denied. . . .


Dictum in still another district court opinion was even more supportive of an option trader's right to sue an insider trader of common stock, stating that "[c]ertainly, a purchaser of stock is injured by insider trading in that stock. An option trader is likewise injured by insider trading in the underlying shares since the price of the option is directly related to the price of the stock." Moskowitz v. Lopp, 128 F.R.D. 624, 635 (E.D. Pa. 1989).

If pre-ITSFEA option traders did have an implied cause of action against insider traders of stock, then ITSFEA's effect on this implied action is not clear. Congress deliberately chose to create an express action only for contemporaneous traders of "securities of the same class" purchased or sold by the defendant. Thus, an option trader would not have an express action against an insider trader of stock. Section 20A(d), however, states that the provision does not limit any implied cause of action. For an implausible suggestion that the phrase "same class" in § 20A(a) may be broadly interpreted to allow an option trader to bring an express cause of action against an insider trader of stock, see Note, Private Right, supra note 2, at 667-68. For a pre-ITSFEA discussion of option trader standing to sue insider traders of stock, see Wang, supra note 4, at 1187-88. For a pre-ITSFEA discussion of option trader standing to sue both insider trading and misrepresentation defendants, see Note, Securities Regulation

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A recent district court opinion directly addressed this ambiguity and decided that a plaintiff class of contemporaneous traders cannot bring both an express and an implied cause of action against insider trading defendants. The plaintiffs contended they could recover cumulative remedies by citing the language of section 20A(d), which states that the provision shall not be construed to limit any implied actions. The court, however, held that section 20A(d) was intended to preserve implied actions only for plaintiffs other than contemporaneous traders. Furthermore, permitting both causes of action might subject defendants to "damage awards far exceeding the extent of their wrongful profit." Such a recovery "would undermine the damage limitations of § 20A."  

Although not addressing the issue of double liability, dictum in another district court opinion indicates that section 20A does not completely preempt implied actions by contemporaneous traders against insider traders. The plaintiff class consisted of purchasers of Pyramid Technology Corp. stock between October 31, 1988, and March 23, 1989. The plaintiff class representative bought on January 9, 1989, and February 7, 1989. ITSFEA applies to actions that arose on or after November 19, 1988. The plaintiff specifically disclaimed any intent to proceed under section 20A. If section 20A's express action preempts implied actions by contemporaneous traders, the plaintiffs who traded after November 19, 1988—including the class representative—would have lacked standing to sue. The court did not rely on this rationale and stated: "§ 20A does not preempt preexisting remedies. § 78t-1(d) [§ 20A(d)]." Instead, the court dismissed the plaintiffs' claim for failure to prove that the trades were made contemporaneously with any defendants' stock sale.

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46. Id. at 709. For the text of § 20A(d), see supra text accompanying note 7.
47. Preletz, 749 F. Supp. at 709.
48. Id. at 710.
49. Id.
51. Id. at 1514.
52. Id.
53. Id. at 1522. Section 9 of ITSFEA provides: "The amendments made by this Act, except for section 6, shall not apply to any actions occurring before the date of enactment of this Act." Pub. L. No. 100-704 § 9 (discussed in note at 15 U.S.C. § 78(o) (1988)).
54. Alfus, 745 F. Supp. at 1522.
55. Id. By "preexisting remedies," the court must have meant preexisting types of remedies, not causes of action accruing prior to the effective date of the statute. If, after ITSFEA's effective date, § 20A completely precluded an implied cause of action by contemporaneous traders, then the class representative would have lacked standing; and the court would have dismissed the class action.
56. After discussing the definition of "contemporaneous," the court held that the named plaintiff class representative "has failed to allege that she traded contemporaneously with any defendants' stock sale."
In summary, the courts are just beginning to confront this issue. While several district courts have expressed opinions as to whether contemporaneous traders can obtain double the insider trading profit through both an express action for damages under section 20A and an implied action for damages under Rule 10b-5, no definitive approach has emerged. The issue remains unresolved.

III. DOES SECTION 20A PRECLUDE THE PARTY ON THE OTHER SIDE OF THE INSIDER TRADE FROM BRINGING AN ACTION FOR EITHER DAMAGES OR RESCISSION?

Another issue is whether ITSFEA precludes the party in contractual privity with the insider trader from bringing an action for damages or for rescission as a general Rule 10b-5 remedy or under section 29(b) of the 1934 Act. A threshold problem is identifying who is in contractual privity with an insider trader. The increased automation of securities trades may partially address this difficulty by facilitating the re-creation of transactions. The task should be easier if the insider sale and therefore lacks standing to bring a private insider trading claim.” Id. at 1523.

57. One leading commentator has inferred from ITSFEA's legislative history that other market-place traders (e.g. those who can demonstrate privity or causation in fact) cannot bring suit apart from § 20A to avoid § 20A's cap on damages.

Although the matter is hardly clear, the strong inference from the legislative history is that persons whose claims are based solely on the abstain or disclose principle (i.e., marketplace traders alleging a breach of duty of disclosure based on a pre-existing fiduciary relationship) are limited to the section 20A remedy.

D. Langevoort, supra note 6, § 9.02[3], at 9-14.


The stock exchanges have no system which details trades and trading times by customer. Stock systems include only the broker-dealers involved and whether the broker-dealer acted as principal or agent. Customer information for all market segments is critical to assessing threats to the intermarket system, and all major exchanges should be required to maintain such an information system.

trade is large, relative to the volume of the security traded. In the landmark state law case of *Goodwin v. Agassiz*, the plaintiff purchased 700 shares of a company on the Boston Stock Exchange through a broker. After the transaction, the plaintiff was able to discover that he was in privity with the president and a director of the issuer. When institutions buy or sell large blocks of stock, the transactions are often handled by so-called block-positioning brokerage firms. With such transac-

match both sides of a trade. Previously, trading records were kept on paper which had to be pieced together to identify the firms that participated in a particular transaction." The SEC's Spy System: Monitoring Computers—and Fielding Tips, Bus. Wk., April 23, 1984, at 29, 30 (stating that "[t]he NASD . . . can now recreate [over-the-counter] stock trades by identifying the serial numbers of terminals where they originated"). Cf. SEC v. Golconda Mining Co., 327 F. Supp. 257, 258-59 (S.D.N.Y. 1971) (addressing the factual setting where, pursuant to a consent decree, insider trading defendants deposited profits with a trustee, who used his best efforts to locate the persons with whom the defendants traded; the trustee was able to locate some, but not all, of those who transacted with the defendants).

61. See Note, Damages to Uninformed Traders for Insider Trading on Impersonal Exchanges, 74 COLUM. L. REV. 299, 312 n.120 (1974) (noting that "[t]he problem of tracing transactions through the exchange so as to determine with whom the insider traded has probably been overstated [b]rokers do have records of their transactions. . . . [although] as the volume on the exchange increases, the problem of tracing becomes more difficult").


63. *Id.* at 363, 186 N.E. at 660. For discussion of a more recent example of a purchaser refusing to pay for or accept delivery of Equity Funding stock because the purchaser suspected insider trading, see Jefferies & Co., Inc. v. Arkus-Duntov, 357 F. Supp. 1206, 1210-13 (S.D.N.Y. 1973).

In Feldman v. Simkins Indus., Inc., 679 F.2d 1299, 1305-06 (9th Cir. 1982), *cert. denied*, 484 U.S. 954 (1987), one of the plaintiff's claims was brought under § 12 of the Securities Act of 1933. The plaintiff purchased 500 shares of Fibreboard common stock and attempted to demonstrate contractual privity with the defendant. *Id.* at 1302, 1303. During the relevant period, the defendant's massive sales constituted nearly one half of the shares traded. *Id.* at 1306. Nevertheless, the defendant used only one brokerage firm and was able to offer evidence that matched the purchase by the plaintiff's broker against a sale of an equal number of shares at the same time and price from a brokerage firm different than the defendant's. The court held that the plaintiff had failed to demonstrate contractual privity with the defendant. *Id.* at 1305-06. Suppose the sale of an equal number of shares at the same time and price had been from the defendant's brokerage firm. An interesting question would be whether the court would have ruled that the plaintiff had made a sufficient showing of contractual privity.

tions, tracing the party in privity should be even easier. Large block trades constituted 51.1 percent of all New York Stock Exchange reported volume in 1989.

Assume that an institution engaging in a block trade is able to ascertain that the party on the other side was an insider trader. After this discovery, the institu-

65. For examples of cases where the plaintiff apparently had no trouble identifying the party on the other side of the block trade, see Ceres Partners v. GEL Assocs., 918 F.2d 349 (2d Cir. 1990); T. Rowe Price New Horizons Fund, Inc. v. Preletz, 749 F. Supp. 705, 707 (D. Md. 1990); State Teachers Retirement Bd. v. Fluor Corp., 500 F. Supp. 278, 284 (S.D.N.Y. 1980); In re Equity Funding Corp. of Am. Sec. Litig., 416 F. Supp. 161, 174-75, 185 (C.D. Cal. 1976).


66. Block trades are defined as transactions of 10,000 or more shares.

67. NEW YORK STOCK EXCHANGE, FACT BOOK 1990, at 17. For a table listing New York Stock Exchange block trades as a percentage of reported volume from 1965 to 1989, see id. at 81. For a table listing New York Stock Exchange block trades as a percentage of reported volume from 1965 to 1986, see TASK FORCE, supra note 64, at VI-9. A 1988 article stated: "Wall Street's block trading desks upstairs handle about 51 percent of the NYSE's share volume and closer to 70 percent of the dollar volume." Whither the Specialists?, INST. INV. 58-59, (Sept. 1988). Another 1988 article gave an almost identical figure for 1987 block trading: "[B]y 1987 they [block trades] had increased to 51.2% of [New York Stock Exchange] volume." Sieffert & Turnbull, supra note 64, at 13. See W. KLEIN & J. COFFEE, supra note 64, at 359 (stating that "[t]oday . . . block trades account for roughly half the NYSE volume"). A 1984 article stated:

The best estimate is that institutional trading accounts for at least 70 percent, and probably close to 80 percent of the daily trading volume of companies listed on the New York Stock Exchange. Block trades, all but a minor fraction of which can be presumed to represent institutional trading, now account for over 50 percent of volume.


A study by the Securities Industry Association concluded that trading by institutions was 54.6% of New York Stock Exchange volume in 1988. Trading by securities firms trading for their own accounts was 26.2% of the volume. The balance of the trading was by small investors (18.2%). Power, Small Investors Are Punier Than Many Think, Wall St. J., Mar. 28, 1989, at C1, col. 2. Another source reported: "[I]nstitutions own about 45% of the $3 trillion of public-issue corporation stock outstanding. . . . Furthermore, institutions account for between 70% and 80% of market trading." Carter, The New Shareholder Power, 16 PEPPERDINE L. REV. 1045, 1047 (1989) (citing D. Ruder, speaking at the 27th Annual Corporate Counsel Institute (Oct. 11, 1988)). In 1986, TIME reported: "Even though they control only about 33% of the equity on U.S. exchanges, institutional investors currently make about eight out of every ten stock trades each day." Manic Market, TIME, Nov. 10, 1986, at 64, 65. See V. BRUDNEY & M. CHIRELSTEIN, CASES AND MATERIALS ON CORPORATE FINANCE 116 (3d ed. 1987) (observing that "[i]nstitutional participation in the volume of trading on the [New York Stock] Exchange . . . was more than 80% by 1986").

tional investor might opt out of any contemporaneous trader class action and sue the insider trader directly for damages or rescission. Does section 20A preclude such a plaintiff from pursuing these direct causes of action? The basis for the insider trader’s liability could be either the “special relationship” or the misappropriation theory. Part II of this Article analyzes the effect of section 20A on implied actions by the class of all contemporaneous traders—a class including both the party on the other side of the insider trade and some other opposite-type traders.

68. For examples of direct suits by institutional investors alleging insider trading, see cases cited supra note 65. For discussion of an actual example of a purchaser refusing to pay for or accept delivery of Equity Funding stock because the purchaser suspected insider trading, see Jefferies & Co., Inc. v. Arkus-Duntov, 357 F. Supp. 1206, 1210-13 (S.D.N.Y. 1973).

69. See supra note 20 and accompanying text; infra text accompanying notes 72-168.

70. See supra note 21 and accompanying text; infra notes 169-99 and accompanying text.

71. See supra notes 19-56 and accompanying text. For discussion of the case law interpreting “contemporaneous,” see Wang, supra note 4. Apparently, only one judge, Celebrezze, has suggested that the “contemporaneous” trader plaintiffs would be those who might have been on the other side of the insider trade. Fridrich v. Bradford, 542 F.2d 307, 326 & n.11 (6th Cir. 1976) (Celebrezze, J., concurring), cert. denied, 429 U.S. 1053 (1977). Earlier in his opinion, Judge Celebrezze explained that he would allow contemporaneous traders to sue because of the difficulty of identifying the party on the other side of the insider trade. Id. at 324. He noted that “[s]ince the mechanics of the marketplace make it virtually impossible to identify the actual investors with whom an insider is trading, the duty of disclosure is owed to investors as a class who trade on the market during the period of insider trading. . . . Since there is no practical method for matching purchases and sales in the open market, requiring privity in the common law sense as an element of rule 10b-5 would create an insurmountable obstacle for plaintiffs.” Id. at 324-25. The contemporaneous traders are surrogate plaintiffs for those actually in contractual privity with the insiders. Id. at 326 n.11. Judge Celebrezze wrote:

As noted above, the mechanics of the market necessitate designation of the class of contemporaneous investors as surrogate plaintiffs for those who actually traded with the insiders. This class must include investors who were in no way involved in the insider transactions, and except for the time of their trading, are indiscernible from subsequent traders. However, to accomplish the deterrent and compensatory purposes of 10b-5, it is better to be overinclusive in the definition of the plaintiff class than underinclusive.

Id.

For discussion of Judge Celebrezze’s concurrence, see Friedman, supra note 1, at 485; Wang, supra note 4, at 1176-77, 1179-82; Wang, supra note 19, at 1267-69.

At least one commentator has praised Judge Celebrezze’s rationale as the “best theoretical justification for a rule permitting standing for contemporaneous traders who were not in privity with the insider or his tippee . . . .” Friedman, supra note 1, at 485. Nevertheless, Judge Celebrezze’s concurrence is not the law of the Sixth Circuit. Judge Engel, joined by Judge Peck, wrote the majority opinion for the Fridrich panel and did not endorse Judge Celebrezze’s contemporaneous class of plaintiffs approach. See 542 F.2d 307, 318-23 (6th Cir. 1976); Wang, supra note 4, at 1176-77 & n.10. For additional discussion of the majority opinion in Fridrich, see Wang, supra note 19, at 1262-67, 1284; supra note 20.

Although the Second Circuit has endorsed the contemporaneous trader class of plaintiffs approach, that circuit has not embraced Judge Celebrezze’s rationale. See Friedman, supra note 1, at 485 (stating that “[t]he best theoretical justification [for the contemporaneous trader class] . . . was articulated not in the Second Circuit, but rather by Judge Celebrezze of the Sixth Circuit”). Nevertheless, when discussing the proper class of civil plaintiffs against stock market insider traders, some other opinions have emphasized the supposed difficulty of identifying the party in contractual privity with the insider trader. See Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 236 (2d Cir. 1974); Backman v. Polaroid Corp., 540 F. Supp. 667, 669 (D. Mass. 1982); supra note 59 (discussing the problem of ascer-
Discussed below, in Part III, is the effect of section 20A on a plaintiff in privity with the insider trader who opts out of any contemporaneous trader class action and directly sues a defendant. Section A considers whether such a plaintiff can bring a cause of action when the defendant is liable under the special relationship rationale. Section B analyzes this issue when the defendant is liable under the misappropriation theory.

A. Suit by the Party in Privity Against a Defendant Liable Under the Special Relationship Theory

1. Explanation of the Special Relationship “Triangle”

The party in privity with the insider trader certainly should have a cause of action against a defendant who is liable under the “special relationship” theory. As a matter of policy and logic, section 20A should not affect this cause of action. A general explanation of the special relationship theory will demonstrate this point.

In *Chiarella v. United States*, for the first time the Supreme Court addressed the application of Rule 10b-5 to stock market insider trading. Chiarella worked for a financial printer. Among the documents he handled were five announcements of takeover bids. Although the identities of the targets were concealed, Chiarella was able to deduce the names from other information in the documents. Without disclosing his knowledge, Chiarella bought stock in the targets and sold the shares at a profit immediately after the tender offers were announced. The trial court convicted Chiarella of violating section 10(b) and Rule 10b-5, and the Second Circuit affirmed. In an opinion by Justice Powell, the Supreme Court reversed the conviction on the grounds that trade based on material nonpublic information does not per se trigger a duty of prior disclosure. There must have been “an affirmative duty to disclose [the information] . . . before trading,” based on a “relationship of trust and confidence between parties to a transaction.”

Chiarella worked for a printing firm hired by the takeover bidders. He did not...
work directly or indirectly for the target corporations whose shares he traded. Unlike employees of the target corporations, Chiarella lacked a special relationship with the target company shareholders from whom he bought. Therefore, Chiarella did not violate section 10(b) or Rule 10b-5.80

In 1983, the Supreme Court decided its second stock market insider trading case, Dirks v. SEC.81 In 1973, Raymond L. Dirks, a securities analyst, learned of widespread fraud at Equity Funding Corporation of America.82 His sources were former and current employees of the company.83 Dirks relayed his information to Equity Funding’s auditors and to the Wall Street Journal.84 The Journal contacted the SEC, whose staff met with Dirks on the same day that the New York Stock Exchange halted trading in Equity Funding shares. The following day, the SEC suspended trading in the stock for ten days. The fraudulent scheme collapsed within the next week. During the course of these events, Dirks conveyed the results of his investigation to certain institutional investors, many of which sold their holdings of Equity Funding stock prior to the trading halt.85 The Commission brought a disciplinary proceeding against Dirks and, after finding that he had violated section 10(b) and Rule 10b-5, imposed the mild sanction of censure.86 The D.C. Circuit affirmed the censure,87 but the Supreme Court reversed.88 Writing for a six-justice majority, Justice Powell rejected the SEC’s theory that, by knowingly receiving confidential information from an insider, a tippee inherits the insider’s fiduciary relationship to the issuer’s shareholders.89

Justice Powell’s reasoning included the following steps. Normally, a tippee has no fiduciary relationship with the issuer’s shareholders.90 A tippee can violate Rule 10b-5 if he or she participates, after the fact, in the insider/tipper’s breach of fiduciary duty by tipping.91 The tippee participates after the fact in the insider/tipper’s breach if “the tippee knows or should know that there has been a breach [by the insider/tipper].”92 An insider/tipper breaches a fiduciary duty by tipping only if the

80. Justice Powell did not reach another possible basis for Chiarella’s conviction. Powell concluded that the misappropriation theory had not been included in the jury instructions. Id. at 235-37. For discussion of the misappropriation theory, see infra notes 169-81 and accompanying text.
82. Id. at 649.
83. Id.
84. See id. at 649, 652 n.8.
85. Id. at 648-50; Dirks v. SEC, 681 F.2d 824, 829-32 (D.C. Cir. 1982).
87. Dirks v. SEC, 681 F.2d 824 (D.C. Cir. 1982).
89. Id. at 655-59.
90. Id. at 655.
91. Id. at 659-61.
92. Id. at 660.
insider/tipper receives a personal benefit from the disclosure. The benefit can be indirect and includes an enhancement of reputation that will translate into future earnings, an expectation of reciprocal tips, or even a good feeling when giving confidential information to a friend or relative. In the Court's words, "[t]he tip and trade [by a relative or friend] resemble trading by the insider himself followed by a gift of the profits to the recipient." The Court found that, because Dirks' tippers were whistle-blowers who obtained no personal benefit, they breached no fiduciary duty and did not violate Rule 10b-5. Consequently, Dirks did not participate after the fact in any Rule 10b-5 violation.

Although Chiarella's conviction and Dirks' censure were both reversed, the Court stated for the first time in Chiarella, and restated in Dirks, that Rule 10b-5 prohibits insider trading on an impersonal stock market if a special relationship exists between the contracting parties. Chiarella extrapolated from face-to-face transactions to impersonal stock market trading. If the president of a closely held corporation cannot purchase stock from a shareholder based on material nonpublic information, the president of a publicly traded corporation cannot do so for the same reason. In both cases, the gravamen of the offense is the nondisclosure, and the president has a fiduciary duty to disclose to the shareholder. Justice Powell's Chiarella decision indicates that, in stock market insider trades as well as face-to-face transactions, the duty to disclose—based upon a "special relationship"—is owed to the party in privity with the insider trader. In exonerating Chiarella, Justice Powell repeatedly emphasized that Chiarella had no special relationship with those who sold to him.

93. Dirks 463 U.S. at 661-64.
94. Id. at 663-64.
95. Id. at 664.
96. Id. at 665-67.
97. Id. at 667. Dirks did not violate Rule 10b-5 himself because he "was a stranger to Equity Funding, with no pre-existing fiduciary duty to its shareholders." Dirks 463 U.S. at 665.
99. Chiarella, 445 U.S. at 229 (stating that "[a] purchaser of stock who has no duty to a prospective seller because he is neither an insider nor a fiduciary has been held to have no obligation to reveal material facts") (emphasis added, citations omitted); id. at 230 (noting that "administrative and judicial interpretations have established that silence . . . may operate as a fraud actionable under § 10(b). . . . But such liability is premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction") (emphasis added); id. at 231 n.14 (noting that "[t]hese considerations are insufficient to support a duty to disclose. A duty arises from the relationship between parties [to a transaction] . . . and not merely from one's ability to acquire information because of his position in the market") (emphasis added); id. at 231-32 (stating that "[t]he Court of Appeals, like the trial court, failed to identify a relationship between the petitioner and the sellers.") (emphasis added); id. at 232-33 (noting that "[n]o duty could arise from petitioner's relationship with the sellers of the target company's securities, . . . [H]e was not a person in whom the sellers had placed their trust and confidence. He was, in fact, a complete stranger who dealt with the sellers only through impersonal market transactions") (emphasis added); cf. Chiarella 445 U.S. at 228 (noting that under the common law, "the duty to disclose arises when one party has information 'that the other [party] is entitled to know because of a fiduciary or other similar relation of trust and confidence between them'") (bracketed material in original, emphasis added) (footnote to this quotation is cited in the Court's later § 10(b) discussion at 445
Like Chiarella, Dirks was not a private civil action. Nevertheless, Dirks reinforces Chiarella's implicit suggestion that the duty to disclose—based on the "special relationship" theory—is owed the party in privity with the insider trader. In Dirks, Justice Powell stated:

We were explicit in Chiarella in saying there can be no duty to disclose where the person who has traded on inside information "... was not a person in whom the sellers [of the securities] had placed their trust and confidence." 445 U.S., at 232. Not to require such a fiduciary relationship, we recognized, would "depar[t] radically from the established doctrine that duty arises from a specific relationship between two

U.S. 231 n.14). See also United States v. Chestman, 947 F.2d 551, 565 (2d Cir. 1991) (en banc) (citing and quoting Chiarella): "Rather, a duty to disclose or abstain arises only from ""a fiduciary or other similar relation of trust and confidence between [the parties to the transaction]."" Chiarella, 445 U.S. at 228 ... (quoting RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1976))."

Arguably this dictum in Chiarella suggests that an implied cause of action under the "special relationship" theory exists, but that the only private party who can sue an insider trader on this ground is the party on the other side of the trade. Privity in this context means that the buyer's order is matched with the seller's, whether or not the buyer receives any share certificate, the seller's share certificate, or someone else's share certificate. Transfer agents, however, often match certificates by chance. 5C A. Jacobs, supra note 59, § 260.03[c][vii][C], at 11-112. See id. for a discussion of two types of "privity," matched order privity and matched certificate privity.

Harvey L. Pitt, Esq. independently arrived at the same conclusion that Chiarella suggested a privity requirement for an implied private civil action. H. Pitt, After the Fall: The Ins and Outs of Rule 10b-5, in TWELFTH ANNUAL INSTITUTE ON SECURITIES REGULATION 643, 662-63 (A. Fleischer, M. Lipton, & R. Mundheim eds. 1980); cf. Note, Securities Regulation for a Changing Market: Option Trader Standing Under Rule 10b-5, 97 YALE L.J. 623, 640 n.106 (1988). Although rejecting a privity requirement, the Note recognizes that "[t]he requirement of a duty in tort law serves to limit both the defendant and the plaintiff classes. ... [Chiarella's] emphasis on the common law tort origins of the cause of action indicates that it intends the fiduciary principle to serve this dual purpose under Rule 10b-5." Id. Contra Fishman, Duty to Disclose Under Rule 10b-5 in Face-to-Face Transactions, 12 J. CORP. L. 251, 291 n.285 (1987) (stating that "nothing in the [Chiarella] Court's opinion indicates that it intended to limit civil liability for insider trading insofar as it applied to insiders purchasing shares without disclosing material inside information known to them by reason of their position"); Note, Laventhal v. Gen. Dynamics Corporation: No Recovery for the Plaintiff-Option Holder in a Case of Insider Trading Under Rule 10b-5, 79 NW. U.L. REV. 780, 792 n.72 (1984) (observing that "[t]he court sought to limit only the defendant class ... and did not consider, even in passing, what group of investors might comprise the plaintiff class ... "). But cf. Ruder & Cross, Limitations on Civil Liability Under Rule 10b-5, 1972 DUKE L.J. 1125, 1132 (making a pre-Chiarella statement: "If liability is limited to those who can trace their transactions to the insider, the plaintiffs who recover will be receiving a windfall due to the accident that their transactions could be traced to insiders").

The Second Circuit rejected this privity requirement in Wilson. See supra note 20 and accompanying text; cf. In re McDonnell Douglas Corp. Sec. Litig., 587 F. Supp. 625, 630 (E.D. Mo. 1983) (stating that although Dirks reaffirmed the special relationship requirement, "[t]he Supreme Court did not discuss or limit the application of the 'contemporaneous trading' rule").

Ironically, although in Wilson the Second Circuit refused to apply Chiarella to limit the class of civil plaintiffs who can sue an insider trader liable under the "special relationship" theory (endorsed in Chiarella), the Second Circuit did apply Chiarella to limit the class of plaintiffs who can sue "misappropriators." Moss v. Morgan Stanley Inc., 719 F.2d 5, 10-13, 15-16 (2d Cir. 1983), cert. denied sub nom. Moss v. Newman, 465 U.S. 1025 (1984). For additional discussion of Moss, see supra note 22 and accompanying text; infra notes 182-87, 194-95 and accompanying text.
Later in Dirks, the majority commented: "We reaffirm today that '[a] duty [to disclose] arises from the relationship between parties. . . ." Still later, the Dirks Court stated that a "general duty to forego market transactions 'based on material nonpublic information.' . . . would 'depar[t] radically from the established doctrine that duty arises from a specific relationship between two parties.'" By re-emphasizing the fiduciary relationship between the insider trader and the party on the other side of the transaction, the Court reinforced its earlier indication that a duty to disclose is owed to the party in privity.

The Chiarella and Dirks "special relationship" can be analogized to a triangle:

ISSUER

INSIDER TRADER/TIPPER

[OUTSIDER/TIPpee AS PARTICIPANT
AFTER THE FACT]

PARTY ON OTHER SIDE OF INSIDER TRADE

At the apex of the triangle is the issuer of the stock traded. At the left base of the triangle is the insider trader/tipper. At the right base of the triangle is the party on the other side of the insider trade. The insider/tipper is in the triangle because of his or her direct or indirect employment by the issuer. The party on the other side of the insider trade is in the triangle because of his or her ownership of the issuer's stock. Because of their mutual relationship to the issuer, the insider/tipper and the party on the other side of the trade have a special relationship. The special relationship creates a duty to disclose.

The outsider/tippee enters the triangle if the insider/tipper breaches a duty by

100. Dirks, 463 U.S. at 654-55 (bracketed material in original) (emphasis added).
101. Id. at 657-58 (quoting Chiarella, 445 U.S. at 231-32 n.14) (emphasis added).
102. Id. at 666 n.27 (citing and quoting from Chiarella, 445 U.S. 222, 233 (1980)) (emphasis added).
103. Suppose the insider trader sells to a buyer who previously held no stock in the issuer. That buyer has the requisite special relationship with the insider trader because the buyer enters the special relationship triangle at the moment the transaction takes place. See Chiarella, 445 U.S. 222, 227 n.8 (1980) (mentioning that in Cady, Roberts & Co., 40 S.E.C. 907 (1961), "'[t]he Commission embraced the reasoning of Judge Learned Hand that 'the director or officer assumed a fiduciary relation to the buyer by the very sale; . . . .Id. [Cady, Roberts], at 914 n. 23, quoting Gratz v. Claughton, 187 F. 2d 46, 49 (CA2), cert. denied, 341 U.S. 920 (1951).""); United States v. Chestman, 947 F.2d 551, 565 n.2 (2d Cir. 1991) (en banc) (quoting Chiarella). For discussion of problems with this approach, see Wang, supra note 19, at 1287-88.
105. See id.
tipping and if the tippee knows or should know of that breach. In that instance, the tippee participates after the fact in the insider/tipper’s breach of a duty to disclose to the party on the other side of the tippee’s insider trade.

2. The Implied Rule 10b-5 Action for Actual Damages by the Party on the Other Side of the Insider Trade (Against a Defendant Who Breaches a “Special Relationship”)

Suppose the insider/tipper trades or tips in breach of a duty to disclose to the party on the other side of the insider trade. This nondisclosure harms the innocent party in contractual privity. Had the defendant disclosed, the party on the other side would not have traded. This victim should have an implied Rule 10b-5 action against the defendant for actual damages.

Section 20A should not preclude this implied cause of action. First, section 20A(d) expressly states that the provision should not be construed to limit any implied cause of action. Second, the House Committee Report accompanying ITSFEA states “where the plaintiff demonstrates that he was defrauded by the defendant’s insider trading and suffered actual damages proximately caused by the defendant’s behavior, a cap of profit gained or loss avoided by the defendant, which is applicable for actions by contemporaneous traders, is not appropriate.” This quotation appears in a discussion of victims other than contemporaneous opposite-type traders. Nevertheless, the language suggests that Congress did not wish its express cause of action to preclude an implied action for damages by anyone who can demonstrate proximate harm. Such recovery does not create the Draconian liability that would result if each contemporaneous trader could claim actual damages.

As mentioned earlier, section 20A does not define “contemporaneous.” One issue is whether “contemporaneous” traders must transact in the same geographic

106. Dirks, 463 U.S. at 660.
107. Id. at 659-61. For additional discussion of tippee liability, see supra notes 89-92 and accompanying text; Wang, supra note 19, at 1287-90.
108. See Friedman, supra note 1, at 484.

A second class includes those investors who purchase from or sell to an insider during a period in which that insider has not disclosed material information. These investors have the strongest claim for relief since a violation of rule 10b-5 has occurred and their purchase or sale was caused by the insider’s illegal trading.

Id.

109. See supra text accompanying note 7. For additional discussion of § 20A(d), see supra note 41 and accompanying text. But see T. Rowe Price New Horizons Fund, Inc. v. Preletz, 749 F. Supp. 705, 709 (D. Md. 1990) (holding that § 20A(d) was intended to preserve implied actions only for plaintiffs other than contemporaneous traders and that contemporaneous traders could not bring both an implied and an express action for damages). For discussion of Preletz, see supra notes 45-49 and accompanying text.
110. Report, supra note 4, at 28. See supra note 40 and accompanying text.
111. See Report, supra note 4, at 28.
112. See supra note 4.
“place” as the insider trade. For example, an insider trade in IBM might take place at a particular specialist’s booth on the Midwest Stock Exchange at the same time that IBM common is trading on other regional exchanges, the over-the-counter market, and the New York Stock Exchange.

If “contemporaneous” traders must transact in the same narrowly defined “place,” a face-to-face insider trade might have no “contemporaneous” traders. On the other hand, if “contemporaneous” traders need not transact in the same place as the insider trade, section 20A would create an express cause of action for contemporaneous buyers against the seller in the hypothetical face-to-face transaction. This less meritorious suit by contemporaneous buyers should not preclude the more appropriate action by the purchaser who actually dealt directly with the defendant.

The market in which institutions occasionally trade directly with one another is often called the Fourth Market. Although these transactions may be made anony-

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113. For discussion of this question, see Wang, supra note 4, at 1184-86.
114. For the pertinent text of § 20A, see supra text accompanying note 5.
115. For discussion of the Fourth Market, see L. Loss & J. Seligman, supra note 64, at 2577-78 (discussing Instinet, a computerized institutional trading service); W. Sharpe & G. Alexander, supra note 64, at 44; Russo & Wang, The Structure of Securities Market—Past and Future, 41 Fordham L. Rev. 1, 36 n.142 (1972). Cf. Torres, Big Board Facing Serious Erosion As Market for Stocks, Chief Warns, Wall St. J., Mar. 13, 1991, at C1, col. 1 (reporting that NYSE Chairman, William Donaldson, stated that current trends indicate that brokerage firms are willing to conduct more trades privately with large investment funds away from the NYSE and other stock exchanges); Torres & Power, Sliding Market: Big Board Is Losing Some of Its Influence Over Stock Trading, Wall St. J., April 17, 1990, at A6, col. 3 (reporting that “[e]xperts on institutions’ other electronic-trading efforts see the day not far off when about 20 of the giant investment funds will bypass exchanges altogether and trade with each other”). For a discussion of Instinet, a computerized communications system that enables institutions to trade directly with one another through anonymous bids and offers, see Seligman, supra note 64, at 115-16. For further discussion of Instinet and other similar private networks, see Anders & Torres, The New Market: Computers Bypass Wall Street Middlemen and Stir Controversy, Wall St. J., Aug. 28, 1991, at 1, col. 6.

The New York Stock Exchange has approved an “off-hours crossing session” from 4:15 p.m. to 5 p.m., during which large traders will be able to enter orders in Exchange-listed stocks using the 4 p.m. closing price. At 5 p.m., Exchange computers will match buy and sell orders and execute transactions. See Power, New York Stock Exchange Sets Its First Limited Off-Hours Trades, Wall St. J., Sept. 1, 1990, at C1, col. 3. The SEC has approved a similar after-hours trading program proposed by the American Stock Exchange. See SEC Approves Amex Proposal to Begin Its Own After-Hours Trading Program, 23 Sec. Reg. & L. Rep. (BNA) 1235 (Aug. 16, 1991).

The National Association of Securities Dealers has created a centralized, automated closed trading system for securities based on the new Rule 144A exemption. The American Stock Exchange and the New York Stock Exchange plan to launch similar systems. See Torres & Power, Turf War: Markets Fight for Private Placements, Wall St. J., July 11, 1990, at C1, col. 2. If some institutional investors are able to use these trading systems directly, the Fourth Market may expand. See Karol, The Effects of Rule 144A, 23 Rev. Sec. & Commodities Reg. 125, 130 (1990) (noting that the NASD electronic marketplace for Rule 144A securities is called PORTAL; “PORTAL participants are restricted to QIB’s [qualified institutional buyers] and must be approved by the NASD”). According to Reilly & Bagley, New SEC Rules Govern Unregistered Securities for Private Placement, Nat’l L.J., Feb. 5, 1990, at 26, col. 1, “[t]he NASD has established the PORTAL Market to create a market for transactions under Rule 144A. . . . Investors meeting the ‘qualified institutional buyer’ requirements of Rule 144A may apply to be designated as ‘Portal qualified’ so that they may buy and sell securities on the PORTAL Market.” Id. at 28, col. 4. Rule 144A provides a safe-harbor exemption from the registration require-
mously through a computer system, they still have some features of face-to-face trading. At present, however, most institutional block trading is done not in the Fourth Market, but in the market maintained by so-called “block positioners” or “block traders.” These are well-capitalized firms that act as market makers.  

Even a transaction between an institution and a block positioner has aspects of a face-to-face trade. The two parties communicate with each other by telephone or electronic system prior to a transaction. When buying or selling a block, a market maker may act either as agent or principal. If the firm acts as a principal, the initial block trade resembles a face-to-face deal, although the positioner will unload all or most of the block immediately after the initial transaction. Even when the positioner decides to act as an agent, it frequently ends up taking part of a block into its own account because of insufficient matching orders on the other side.

116. For discussion of block-positioning firms, see sources cited supra, note 64.

117. See R. Hamilton, supra note 64, at 426 (stating that “[w]hen a department receives an order to buy or sell a large block of stock, it contacts other institutions to see whether they want to participate on the other side of the trade”); W. Klein & J. Coffee, supra note 64, at 359 (noting that “[a]n elaborate electronic network connects the trading desks of the major institutional investors so that it is possible to solicit hundreds of institutions very quickly to ascertain if they wish to take a piece of the block”); L. Loss & J. Seligman, supra note 64, at 2576; Task Force, supra note 64, at VI-9. “Typically the institutional trading departments of these [positioner] firms maintain direct phone lines to the trading desks of hundreds of these institutions.” Id. “Once the firm has been given an order to buy or sell a large block of stock by an institution, it will contact other institutions to see whether they want to participate on the other side of the trade.” Id. See also Fischel, supra note 64, at 126 (observing that “[a] broker dealing in a large block of stock will call other dealers and institutions to find one interested in the other end of the deal”); Frankhauser & Frye, Front Running, 21 Rev. of Sec. & Comm. Reg. 179, 180 (1988) (stating that “the price of the block is . . . negotiated directly between the parties . . . .”); Large Order, supra note 64, at 1336; Seligman, supra note 64, at 115 (stating that “[b]ecause the block trading market is not centralized, institutions and block houses rely on telephone or electronic systems to communicate trading interest”); Siefert & Turnbull, supra note 64, at 13 (observing that “[t]o shop a block, a [block-trading] firm contacts other institutions in an effort to line up interest for the opposite side of the block at a specified price”).

118. Task Force, supra note 64, at VI-10; L. Loss & J. Seligman, supra note 64, at 2573 (stating that “[t]he block trader may act as an agent and operate on a straight commission basis. Alternatively, the block trader may act as a dealer . . . .”); Seligman, supra note 64, at 115.

119. See W. Sharpe & G. Alexander, supra note 64, at 40 (stating that “[a]ssuming PF [a pension fund seeking to sell a block] accepts the deal, the block house now becomes the owner of the shares but first must cross them on the NYSE, since the block house is a member of the exchange”).

120. To facilitate a block trade, a market-maker may buy shares for its own inventory or sell from its inventory. See R. Jennings & H. Marsh, Securities Regulation: Cases and Materials 565 (6th ed. 1987); R. Hamilton, supra note 64, at 426 (noting that “[s]ome firms . . . use their own capital to take parts of a block trade that cannot be entirely placed with institutional investors”); W. Klein & J. Coffee, supra note 64, at 359; W. Sharpe & G. Alexander, supra note 64, at 40; Task Force, supra note 64, at VI-10 (observing that “[o]nce the firm has put together as many of the buyers and sellers as it can find, it may choose to commit its own capital to complete the transaction . . . .”); Large Order, supra note 64, at 1336 (noting that “[t]he block-trading firm may determine to take all or part of the other side for its own account”); Siefert & Turnbull, supra note 64, at 13.
After assembling both sides of a transaction, the positioning firm generally will cross the block on the floor of either the New York Stock Exchange or a regional stock exchange.\textsuperscript{121} A small part of the block may be absorbed by the stock exchange specialist, by investors who have left limit orders with the specialist, or by customers of floor brokers present at the specialist's post. With block trades, the line between a face-to-face transaction and an anonymous stock market transaction has become blurred.\textsuperscript{122} The more the block trade resembles a face-to-face transaction, the worthier the suit of the party in privity appears in comparison with that of contemporaneous traders.\textsuperscript{123}

3. An Action for Rescission as a General Rule 10b-5 Remedy or Under Section 29(b) (Against a Defendant Who Breaches a "Special Relationship")

Even assuming \textit{arguendo} that section 20A precludes the party in privity with the insider trader from suing for actual damages, that plaintiff might still obtain rescission of the trade as a general Rule 10b-5 remedy or under section 29(b) of the Securities Exchange Act of 1934, if rescission is possible.\textsuperscript{124} In \textit{Randall v. Loftsgaarden}, the Supreme Court noted: "The issue whether and under what circumstances rescission or a rescissory measure of damages is available under § 10(b) is an unsettled one."\textsuperscript{125} This statement was a digression. The section 10(b)

\textsuperscript{121} R. Hamilton, \textit{supra} note 64, § 18.7 at 426 (noting that "[w]hen the transaction is put together . . . , it is usually passed through the NYSE floor"); W. Klein and J. Coffee, \textit{supra} note 64, at 359; L. Loss & J. Seligman, \textit{supra} note 64, at 2576; S. Mittra & C. Gassen, \textit{supra} note 64, at 60; W. Sharpe & G. Alexander, \textit{supra} note 64, at 40; Task Force, \textit{supra} note 64, at VI-10 to VI-11; id. at VI-10 (stating that "[d]espite the ability of these firms not to take these orders [for stock listed on the New York Stock Exchange after April 26, 1979] down to the floor, the great majority of orders are brought there to be executed since most institutions feel more comfortable about having their transactions executed on an exchange floor where they are subjected to the auction market"); Large Order, \textit{supra} note 64, at 1336-37 (noting that generally a block is brought to the NYSE floor, although "[i]n some instances, a member firm may direct a block trade to a regional exchange, where the crowds are often smaller than on the NYSE and blocks can be crossed with less likelihood of interruption"; id. at 1337); Seligman, \textit{supra} note 64, at 115. "After a block trade is assembled in a listed non-rule 19c-3 security the trade usually will be brought to an exchange for execution." Id. "Usually block trades are executed on the NYSE." Id. Accord, Siefert & Turnbull, \textit{supra} note 64, at 13 (stating that "[o]nce a block has been negotiated, securities exchange rules generally require that their members cross block trades on the exchange floor").

\textsuperscript{122} Cf. Fishman, \textit{supra} note 99, at 256. "Face-to-face transactions do not lend themselves to generalization because they can take many forms . . . . [T]hey may include transactions similar to typical insider trading transactions on the open market, except that the transactions are negotiated directly between dealers or brokers representing the parties." \textit{Id.} For a related discussion of the difficulty of drawing the line between "fortuitous" and "non-fortuitous" stock transactions, see Wang, \textit{supra} note 19, at 1309-10.

\textsuperscript{123} Cf. D. Langevoort, \textit{supra} note 6, § 9.02[1], at 9-3 n.2. "Where a transaction is face to face, the lawsuit is substantially easier, since privity is clear and the measure of damages obvious." \textit{Id.} "In a face to face transaction, the duty of disclosure is owed to the person with whom the insider is dealing." \textit{Id.}


\textsuperscript{125} 478 U.S. 647, 661 (1986). Nevertheless, the Court did note: "But there is authority for allowing the § 10(b) plaintiff, at least in some circumstances, to choose between 'undoing the bargain
issue was whether a rescissory measure of damages should be reduced by tax benefits received by the plaintiff from a tax shelter investment.\textsuperscript{126} Despite the uncertainty created by this surprising dictum, some generalizations about rescission are still possible.

\textbf{(a) Rescission as a General Rule 10b-5 Remedy}

Two leading commentators have noted:

The cases are uniform in stating that one remedy which may be available to a defrauded plaintiff under Rule 10b-5 is to seek rescission of the transaction and recover his securities, if he is a seller, or recover the amount paid for the securities, if he is a buyer, upon tendering the return of what he himself received in the transaction.\textsuperscript{127}

\begin{quote}
\textit{The cases are uniform in stating that one remedy which may be available to a defrauded plaintiff under Rule 10b-5 is to seek rescission of the transaction and recover his securities, if he is a seller, or recover the amount paid for the securities, if he is a buyer, upon tendering the return of what he himself received in the transaction.}
\end{quote}

\textsuperscript{127} R. JENNINGS & H. MARSH, supra note 120, at 1384-85. See Huddleston v. Herman & MacLean, 640 F.2d 534, 554 (5th Cir. Mar. 1981) (dictum), \textit{aff'd in part and rev'd in part on other grounds}, 459 U.S. 375 (1983); Glick v. Campagna, 613 F.2d 31, 36 (3d Cir. 1979) (stating that “a defrauded seller may sue for damages or for rescission in a 10b-5 case’’); Wheat v. Hall, 535 F.2d 874 (5th Cir. 1976) (affirming rescission in a § 10(b) case); Woolf v. S.D. Cohn & Co., 515 F.2d 591, 605 (5th Cir. 1975) (stating in dictum that “plaintiffs were seeking a relatively simple form of relief, closely analogous to rescission, a recognized remedy under 10b-5’’), \textit{vacated on other grounds}, 426 U.S. 944 (1976); Metro-Goldwyn-Mayer, Inc. v. Ross, 509 F.2d 930, 933 (2d Cir. 1975) (allowing rescission of a stock-for-stock exchange agreement induced by fraud); Flaks v. Koegel, 504 F.2d 702, 707 (2d Cir. 1974) (stating that “the plaintiffs [buyers] are really not requesting compensatory damages but rather rescission and are simply seeking the recovery of the amounts paid for their stock. This is an appropriate remedy under sections 10(b)’’); Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341, 391 (2d Cir.) (noting that “a defrauded shareholder also can bring suit for rescission and restitution under § 10b of the 1934 Act . . . or under § 29(b) of the 1934 Act . . . ’’), \textit{cert. denied}, 414 U.S. 910 (1973) (for a subsequent Supreme Court decision in this case dealing with other issues, see 430 U.S. 1 (1977)); John R. Lewis Inc. v. Newman, 446 F.2d 800, 805 (5th Cir. 1971) (declaring that “[t]hough the usual remedy in a Rule 10b-5 case involving a defrauded buyer is rescission and restitution.”) (dictum); Sackett v. Beaman, 399 F.2d 884, 891 (9th Cir. 1968) (explaining that a defrauded buyer can sue under Rule 10b-5 for either rescission or damages); Quintel Corp. v. Citibank, 596 F. Supp. 797, 803 (S.D.N.Y. 1984) (stating that “[a] defrauded plaintiff has the option of rescinding a transaction and being restored to his prior position, or of affirming the transaction and suing for damages suffered’’); Malik v. Universal Resources Corp., 425 F. Supp. 350, 364 n.60 (S.D. Cal. 1976) (noting that “[r]escission is an acknowledged discretionary remedy for violations of § 17(a) of the Securities Act of 1933 and Rule 10b-5’’); Bowman & Bourdon, Inc. v. Rohr, 296 F. Supp. 847 (D. Mass. 1969) (granting rescission in a case where plaintiff's primary claim was under § 10(b) and Rule 10b-5), \textit{aff'd per curiam on opinion below}, 417 F.2d 780 (1st Cir. 1969). Cf. Pelletier v. Stuart-James Co., Inc., 863 F.2d 1550, 1558 (11th Cir. 1989) (stating in dictum that “a rescissional remedy may be available to a defrauded plaintiff under Rule 10b-5’’); D. DOBBS, \textsc{Handbook on the Law of Remedies} § 9.3, at 615 (1973) (noting that “[r]escission is a perfectly appropriate remedy in accord with what has just been said [about Rule 10b-5], and it is awarded to a buyer, along with restitution of his money, without difficulty’’); Thompson, \textsc{The Measure of Recovery Under Rule 10b-5: A Restitution Alternative to Tort Damages}, 37 \textsc{Vand. L. Rev.} 349, 367 (1984) (stating that “[w]hen courts recognized the existence of private causes of action under rule 10b-5, most courts also acknowledged that a rule 10b-5 plaintiff could seek rescission instead of
Another authoritative treatise summarizes: "Courts acknowledge that rescission is available for 10b-5 breaches."\(^{128}\)

The right to rescission may be lost by unreasonable delay,\(^{129}\) by waiver or pursuing an action for damages"); Weiskopf, Remedies Under Rule 10b-5, 45 St. John's L. Rev. 733, 752-53 (1973). While granting "rescission" to a plaintiff not in privity with the defendant, another court noted that rescission is an appropriate remedy in Rule 10b-5 cases under certain circumstances. Bruschi v. Brown, 876 F.2d 1526, 1531-32 (11th Cir. 1989).

Interestingly, one district court in Illinois has refused to enforce payment on the outstanding purchase price of a security sold in violation of the federal securities laws, including § 10(b) and Rule 10b-5. Johnston v. Bumba, 764 F. Supp. 1263, 1283 (N.D. Ill. 1991). The opinion accepted an analogy to "a contract involving illegal gambling where, absent an authorizing statute, the courts will not enforce the affirmative claims of either party, but leave the parties where they are." Id. at 1283 n.24.

This Article's discussion of rescission is restricted to defendants in contractual privity with the plaintiff. See generally Ross v. Bank South, 885 F.2d 723, 742 (11th Cir. 1989) (en banc) (Tjoflat, J., concurring) (stating that "[r]escission is available, however, only against parties to a contract—a court may not order rescission in a buyer's [Rule 10b-5] action against a defrauding party who is not a party to the contract of sale"), cert. denied, 110 S.Ct 1924 (1990); In re Washington Pub. Power Supply Sys., 650 F. Supp. 1346, 1355 (W.D. Wash. 1986) (noting that "[t]here is authority that indicates that privity is a prerequisite to the availability of rescission [under Rule 10b-5]"); In re Longhorn Sec. Litig., 573 F. Supp. 255, 273 (W.D. Okla. 1983) (stating that "strict privity... is still required in an action for rescission [under Rule 10b-5]"); 4 A. Bromberg & L. Lowenfels, Securities Fraud & Commodities Fraud § 8.5(131), at 208.3 (1989) (noting that "the absence of privity will usually preclude relief in the form of rescission, because of the difficulty of restoring the status quo").

128. 5 C. Jacobs, supra note 59, § 260.03[c][vi], at 11-65 (numerous citations omitted). Jacobs distinguishes between the remedy of "rescission" of a completed contract and the supplemental remedy of putting the parties back in their original positions. Id. at 11-73 to 11-74. This Article will instead use the term "rescission" to refer to the combined remedy of rescission of a single fraudulent trade plus restoration of the parties to the status occupied before that trade. Cf. Pelletier v. Stuart-James Co., 863 F.2d 1550, 1558 n.19 (11th Cir. 1989) (noting that "[r]escission is the avoidance or undoing of the transaction [and] its purpose is to return the defrauded purchaser to the status quo ante"); Myzel v. Fields, 386 F.2d 718, 742 (8th Cir. 1967) (stating that "[r]ecision calls for cancellation of the bargain, and the return of the parties to the status quo ante"), cert. denied, 390 U.S. 951 (1968); 5 C. A. Jacobs, supra note 59, at 11-64 (stating that the general rule is that a defrauded plaintiff has two choices: (1) affirming the transaction and suing for damages, or (2) rescinding the transaction and returning to the status before the fraudulent trade).

129. Occidental Life Ins. Co. v. Pat Ryan & Assoc., 496 F.2d 1255, 1268 (4th Cir.) (stating that "a party must also act with 'reasonable dispatch' if he seeks rescission under Section 10(b)"); cert. denied, 419 U.S. 1023 (1974); Johns Hopkins Univ. v. Hutton, 488 F.2d 912, 917 (4th Cir. 1973) (holding that a plaintiff seeking rescission is "required to act with reasonable dispatch after it has either actual knowledge of the fraud or notice of facts which, in the exercise of due diligence, would have led to knowledge thereof"), cert. denied, 416 U.S. 916 (1974); Baumel v. Rosen, 412 F.2d 571, 574-75 (4th Cir. 1969) (holding that a party seeking rescission must act with reasonable dispatch after discovery of the ground for rescission; otherwise the right to rescind is lost), cert. denied, 396 U.S. 1037 (1970); Gannett Co. v. Register Publishing Co., 428 F. Supp. 818, 827 (D. Conn. 1977) (stating "[i]n Rule 10b-5 cases the law is well established that rescission must be demanded promptly after discovery of the fraud, or the right to rescission will be lost"). See Randall v. Loftsgaarden, 478 U.S. 647, 666 (1986) (stating "[i]n cases under § 10(b), some courts have barred plaintiffs from electing rescission... where they delayed tender or suit in order to increase their expected recovery should the market decline"); Feldman v. Pioneer Petroleum, Inc., 813 F.2d 296, 301 n.10 (10th Cir.) (stating that the district court was justified in denying rescission "upon a finding that plaintiffs waited nearly two years to assert this equitable relief after they had 'information sufficiently suggestive of the alleged fraud' by the defendants"), cert. denied, 484 U.S. 954 (1987); Bosse v. Crowell Collier and MacMillan, 565 F.2d 602, 611
estoppel, or possibly on other equitable grounds. The Eleventh Circuit has

n.15 (9th Cir. 1977) (affirming the district court's dismissal of a Rule 10b-5 rescission claim because of laches by plaintiff); Wheat v. Hall, 535 F.2d 874, 876 (5th Cir. 1976) (finding that the plaintiff was not guilty of laches, but apparently accepting defendant's contention that laches bars a Rule 10b-5 rescission claim); Myzel v. Fields, 386 F.2d 718, 740 n.15 (8th Cir. 1967) (holding that "a party upon notice of the grounds of rescission must immediately elect to affirm or deny the contract"), cert. denied, 390 U.S. 951 (1968); Estate Counseling Serv., Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 303 F.2d 527, 532 (10th Cir. 1962) (stating "[i]n view of the speculative nature of the transaction and with a fluctuating market, the law required the [plaintiff] . . . to act promptly or waive its right to rescind")]; Ladenberger v. Blunt, Ellis & Lowe, Inc., No. 85-C7248, 1987 U.S. Dist. LEXIS 7699, at *12 (N.D. Ill. Aug. 19, 1987) (stating "[t]he law requires that where a party desires to rescind a contract entered into, that party must act promptly or bear the consequences") (dictum); American Gen. Ins. Co. v. Equitable Gen. Corp., 493 F. Supp. 721, 756 (E.D. Va. 1980) (stating "[a] party seeking rescission under § 10(b) is 'required to act with reasonable dispatch . . .' ") (quoting Johns Hopkins Univ. v. Hutton, 488 F.2d 912, 917 (4th Cir. 1973)); Goodman v. Poland, 395 F. Supp. 660, 676-78 (D. Md. 1975) (finding that the plaintiff was not guilty of unreasonable delay or laches, but apparently accepting defendant's contention that unreasonable delay or laches bars a Rule 10b-5 rescission claim); Hickman v. Groesbeck, 389 F. Supp. 769, 780 (D. Utah 1974) (stating "there is a promptness rule which requires the plaintiff to seek rescission as soon as fraud or misrepresentation is discovered"); Marth v. Industrial Incomes Inc., 290 F. Supp. 755, 759 (S.D.N.Y. 1968) (stating "whether the defense is labelled laches or mitigation, a good defense to a claim for rescission has been made out"); R. Jennings & H. Marsh, supra note 120, at 1385 (stating "the right to rescission may be lost by laches on the part of the plaintiff"); Jacobs, Affirmative Defenses to Securities Exchange Act Rule 10b-5 Actions, 61 CORNELL L. REV. 857, 882-83 (1976) (stating that "[i]nstances of laches may therefore preclude a plaintiff from obtaining an equitable remedy such as rescission"); Thompson, supra note 127, at 369-70. Cf. Jordan v. Duff and Phelps, Inc., 815 F.2d 429, 440 (7th Cir. 1987) (holding that "[a] prompt demand for rescission is important in allocating risks among parties"), cert. denied, 485 U.S. 901 (1988); 5C A. Jacobs, supra note 59, § 260.03[c][vi], at 11-70 ("[C]ertain affirmative defenses preclude a plaintiff from obtaining rescission").

130. Occidental Life Ins. Co. v. Pat Ryan & Assocs., 496 F.2d 1255, 1267 n.9 (4th Cir.) (stating that "[p]rinciples of equity, like estoppel and waiver, apply equally to actions brought under Section 29(b), as well as those brought under Section 10(b)"); cert. denied, 419 U.S. 1023 (1974); Royal Air Properties, Inc. v. Smith, 312 F.2d 210, 213 (9th Cir. 1962) (stating that "[e]stoppel and waiver are defenses to a civil action brought under sections 10(b) and 29(b) of the Securities Exchange Act of 1934"). See R. Jennings & H. Marsh, supra note 120, at 1385; Weiskopf, supra note 127, at 756. Cf. Adelman v. CGS Scientific Corp., 332 F. Supp. 137, 146 (E.D. Pa. 1971) (stating that "it is highly probable that plaintiff's demand for rescission was made as soon as practicable and was timely and that plaintiff will not be barred from seeking to rescind the contract under the doctrine of waiver"); Marth v. Industrial Incomes Inc., 290 F. Supp. 755, 759 (S.D.N.Y. 1968) (refusing to strike affirmative defense of estoppel at preliminary stage of Rule 10b-5 rescission claim). But cf. TMF Tool Co. v. Siebengartner, 899 F.2d 584, 590 (7th Cir. 1990) (discussing waiver of state law breach of fiduciary duty and stating: "[A] prerequisite ingredient of the waiver of a right or privilege consists of an intention to relinquish it." (quoting 28 AM. JUR. 2d Estoppel & Waiver § 158 (1966)); Salstone v. Gen. Felt, No. 84-C9976, 1989 U.S. Dist. LEXIS 7685, at *18 (N.D. Ill. 1989) (noting that "[w]aiver, the relinquishment of a known right . . . must be limited to instances where the plaintiff intends that effect, especially in securities fraud cases").

131. See 5C A. Jacobs, supra note 59, § 260.03[c][vi], at 11-70 to 11-72. Cf. Taylor v. Door to Door Transp. Servs., Inc., 691 F. Supp. 27, 35 (S.D. Ohio 1988) (stating that "[r]escission of a sale is appropriate to unravel transactions affected through violations of Rule 10b-5 to the extent that it may be done fairly and without injuring the rights of innocent parties") (dictum); Steinberg, The Propriety and Scope of Cumulative Remedies Under the Federal Securities Laws, 67 CORNELL L. REV. 557, 606 (1982) (declaring that "[o]nce the parties have consummated a transaction, courts are extremely reluctant to grant the aggrieved litigant the remedy of rescission [as a general Rule 10b-5 remedy] except in
stated that the potential availability of rescission as a remedy "does not alter the essential elements of the cause of action. [T]he plaintiff must establish the following: '(1) a misstatement or an omission . . . (5) that proximately caused his injury.'"132

Suppose an insider trading defendant violates Rule 10b-5 by breaching a "special relationship" to the party in privity. The fiduciary relationship creates a duty to disclose. The nondisclosure harms the innocent party on the opposite side. As noted earlier, this victim should have an implied cause of action for actual damages against the insider trader; and section 20A should not preempt such a suit. Unclear is whether rescission is available under Rule 10b-5 when the plaintiff has an adequate Rule 10b-5 remedy at law for damages.133 Assuming arguendo that the most egregious situations"); In re Fortune Sys. Sec. Litig., 680 F. Supp. 1360, 1369 (N.D. Cal. 1987) (stating in dictum that "[t]he choice [whether to grant rescission] is within the discretion of the trial judge"); In re Washington Public Power Supply Sys., 650 F. Supp. 1346, 1355 (W.D. Wash. 1986) (refusing to allow rescission "because it would over-compensate the plaintiff for his injuries" and indicating that § 28(a) of the Securities Exchange Act would preclude such overcompensation); Malik v. Universal Resources Corp., 425 F. Supp. 350, 364 n.60 (S.D. Cal. 1976) (stating that "[r]escission is an acknowledged discretionary remedy for violations of § 17(a) of the Securities Act of 1933 and Rule 10b-5") (emphasis added)).


Under the "remedy" argument, plaintiffs assert that they are entitled to the remedy of rescission, regardless of whether the causation element ... is satisfied. Plaintiffs ignore the fact that "loss causation" is an element that must be proven before plaintiffs are entitled to recover anything in this action, regardless of the remedy. Even if rescission was chosen as the appropriate remedy in this action, plaintiffs would still have to prove that their damages were a direct result of the alleged omissions.

Id.

For criticism of such holdings, see Thompson, supra note 127, at 373-81 (arguing that the proper focus for restitutionary remedies is the defendant's gain, not the plaintiff's loss); Thompson argues:

This tort orientation to rule 10b-5 leads some courts unnecessarily to impose tort law legal causation limitations on recoveries that are based on rescission or windfall profits. Courts limit these two remedies to prevent plaintiffs from recovering losses that are not proximately caused by the fraud . . . . While such concerns are appropriate for tort based recovery, they do not apply equally to recovery based on unjust enrichment. This erroneous view is present in both rescission and windfall profits cases; yet, both kinds of cases can be understood best by looking to the unjust enrichment of the defendant.

Id. at 375.

133. See supra notes 108-23 and accompanying text.

134. SC A. JACOBS, supra note 59, § 260.03[c][vi], at 11-66. Some decisions have indicated that rescission will be granted only when damages are difficult to measure. Baumel v. Rosen, 283 F. Supp. 128, 146 (D. Md. 1968) (stating that "equity will act when the fixing of damages presents unusual difficulties in their measurement, or where the uncertainty of correct measurement will potentially result in great injustice to either of the parties"), aff'd in part and rev'd in part on other grounds, 412 F.2d 571 (4th Cir. 1969), cert. denied, 396 U.S. 1037 (1970). See McIntyre v. KDI Corp., 406 F. Supp. 592, 596 (S.D. Ohio 1975) (stating that "generally speaking, there is no dispute but that a suit to rescind a merger agreement or other securities transaction induced by fraud and to recover the consideration given
section 20A precludes an implied action by the party in privity for actual damages, however, this plaintiff would lack an adequate remedy at law for money damages. This party should be able to rescind if it is feasible. The reasons for permitting

up may be maintained in equity where there are circumstances making the legal remedy inadequate") (dictum). Cf. Deckert v. Independence Shares Corp., 311 U.S. 282, 289 (1940) (discussing rescission claim under Securities Act of 1933, the Court stated: "That a suit to rescind a contract induced by fraud and to recover the consideration paid may be maintained in equity, at least where there are circumstances making the legal remedy inadequate, is well established"); Pelletier v. Stuart-James Co., 863 F.2d 1550, 1558 (11th Cir. 1989) (stating in dictum that out-of-pocket damages are the normal remedy, but the court has discretion to grant rescission when it is the best remedy); In re Washington Public Power Supply Sys., 650 F. Supp. 1346, 1355 (W.D. Wash. 1986) (refusing to allow rescission "because it would over-compensate the plaintiff for his injuries"); Gilbert v. Meyer, 362 F. Supp. 168, 176 (S.D.N.Y. 1973) (stating in dictum that "since damages are available to plaintiff under § 10(b) and Rule 10b-5 his request for a declaratory judgment, rescission and restitution [under § 29(b)] are unnecessary"); Johns Hopkins Univ. v. Hutton, 326 F. Supp. 250, 261-62 (D. Md. 1971) (suggesting that if a Rule 10b-5 plaintiff acts with reasonable dispatch, he or she can elect either rescission or damages), aff'd in part and rev'd in part, 488 F.2d 912 (4th Cir. 1973), cert. denied, 416 U.S. 916 (1974); Steinberg, supra note 131, at 606 (stating "[o]nce the parties have consummated a transaction, courts are extremely reluctant to grant the aggrieved litigant the remedy of rescission [as a general Rule 10b-5 remedy] except in the most egregious situations"). See generally D. Schoenbrod, A. MacBeth, D. Levine & D. Jung, REMEDIES: PUBLIC AND PRIVATE 549 (1990) (discussing state common law: "At bottom, the best one can say is that sometimes an adequate legal remedy bars equitable rescission, sometimes it does not, largely without rhyme or reason"). But see Thompson, supra note 127, at 365 n.61 (stating that "[a]t the other extreme some courts have suggested that the plaintiff cannot obtain [Rule 10b-5] rescission if he can receive damages; this clearly is not an accurate statement of the law"). But cf. D. Dobbs, supra note 127, § 9.4, at 624. In discussing state common law, Dobbs notes:

[T]he defendant who is forced to accept a rescission for fraud will absorb losses from sources extraneous to the fraud, even though he would not, ordinarily, be liable for the same losses in a damage suit . . . . However, such a result may be justifiable or even desirable where an intentional deceit is shown. The alternative would be to deny rescission, seemingly a poor choice in the case of a fraudulent defendant.

Id. 135. When the defendant is a buyer, he or she may no longer own the securities by the time of judgment. When the plaintiff is a buyer, he or she also may no longer own the securities at the time of judgment. Technically, pure rescission is not possible in these two situations. Cf. American Gen. Ins. Co. v. Equitable Gen. Corp., 493 F. Supp. 721, 756 (E.D. Va. 1980) (stating that "[r]escission . . . is a remedy which presupposes that the parties can be restored to the status quo ante"); McIntyre v. KDI Corp., 406 F. Supp. 592, 597 (S.D. Ohio 1975) (noting "[t]hat the plaintiff in an action under the federal securities acts for rescission of a sale of securities pursuant to a merger agreement must be in a position to return the defendant to the status quo ante by tender back of the consideration is well established"); Polakoff v. Delaware Steeplechase and Race Ass'n, 254 F. Supp. 574, 581 n.25 (D. Del. 1966) (declaring that "[i]n a Rule 10b-5 case the plaintiff can undo the bargain only 'when events since the transaction have not made rescission impossible.' " (quoting 3 Loss, SECURITIES REGULATION 1793 (2d ed. 1961))).

Even though a defrauded buyer/plaintiff no longer holds the securities, the court might permit a defrauded buyer/plaintiff to tender equivalent securities repurchased in the open market. See Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341, 391 (2d Cir.) (noting that "it is reasonable to assume . . . that a shareholder seeking rescission, even if he has disposed of his shares, should be permitted to tender substitute shares"), cert. denied, 414 U.S. 910 (1973); SC A. JacobS, supra note 59, § 260.03[c][vi][B], at 11-92 (stating that "[t]he plaintiff buyer can recover rescissional damages if he resold the stock he bought in the fraudulent transaction and cannot obtain other shares to tender to the
such a remedy are the same as those given earlier to support an implied action for

*defendant for specific restitution*) (emphasis added); L. LOSS, FUNDAMENTALS OF SECURITIES REGULATION 874 n.9 (2d ed. 1988) [hereinafter FUNDAMENTALS] (declaring that "[i]f the better rule is that, in the case of fungibles like securities, the [plaintiff] buyer need not restore the identical pieces of paper but may substitute a like amount of other pieces"); Barnett, *Neither a Tipper Nor a Tippee Be*, 8 HOUS. L. REV. 276, 298 (1970) (stating that "[i]f identical securities are available to the plaintiff, presumably he may tender such securities in place of the ones he purchased"). Cf. D. DOBBS, supra note 127, § 9.4, at 622-23. Dobbs notes that under state common law "the plaintiff is not required to make specific restitution where what he has received is fungible." *Id.* at 622. "One share of stock in a corporation, if of the same issue, is like another, and restoration of the same number of shares, though represented in different stock certificates, is usually sufficient." *Id.* at 622-23. Cf. 1 G. PALMER, THE LAW OF RESTITUTION § 3.12, at 305 (1978) (discussing state common law: "Thus, if shares of stock purchased by the plaintiff were resold before discovery of the ground for restitution, a tender of the same number of shares of the same issue usually has been allowed"); Weiskopf, supra note 127, at 757. "Often, the primary consideration behind a court's refusal to grant rescission is the fact that restoration of the status quo ante will be extremely difficult or impossible to effectuate." *Id.* "A court of equity does, however, enjoy extreme flexibility in fashioning a rescission." *Id.* Cf. Comment, *Private Remedies Available Under Rule 10b-5*, 20 Sw. L.J. 620, 626 (1966) (stating that "[i]f the security in question is readily available on the open market, there would seem to be nothing to prevent the plaintiff from restoring to the defendant sufficient cash to purchase these securities on the date of judgment rather than restoring the stock itself").

Suppose the defrauding buyer/defendant no longer holds the securities. The court might order the defendant to repurchase equivalent securities on the open market and give these to the plaintiff. See 5C A. JACOBS, supra note 59, § 260.03[c][vi][A], at 11-78 to 11-79 (declaring that "[t]he court can force the defendant to buy any available shares and to tender them to the plaintiff as specific restitution"); Merritt, A Consistent Model of Loss Causation in Securities Fraud Litigation: Suing the Remedy to the Wrong, 66 TEX. L. REV. 469, 475 n.17 (1988). Cf. RESTATEMENT OF THE LAW OF RESTITUTION § 66(4), at 264-65 (1937) (discussing state common law: "A person who has received money or fungible things and who is required to make restoration as a condition to restitution is entitled to substitute a like amount of such money or things in place of those which he has received"); *Id.* at § 66, comment (e), at 271 (discussing state common law: "[A] person having a duty of restoration can rightfully substitute other similar grain, certificates of shares or bonds"); Comment, Affiliated Ute Citizens v. United States—The Supreme Court Speaks on Rule 10b-5, 1973 UTAH L. REV. 119, 136 (stating that "since the party committing the fraud . . . does not usually retain his purchased stock, the existence of bona fide purchasers creates problems for a court applying this remedy [(rescission/restitution) and that (rescission)] these problems are somewhat obviated, however, when the stock can be easily repurchased because it is widely traded on a national exchange").

Even if a court were not willing to allow the tender (or order the return) of equivalent securities, the court might grant rescissory damages. See Glick v. Campagna, 613 F.2d 31, 37 (3d Cir. 1979) (stating that "[i]f the defendant no longer owns the stock or it is otherwise unavailable because of a merger or other intervening event, then the court may award rescissory damages to place the plaintiff in the same financial position he would have been were it possible to return the stock") (dictum); Myzel v. Fields, 386 F.2d 718, 742 (8th Cir. 1967) (explaining that "where this [rescission] is impossible because of the disposal or retirement of the stock, then equivalent value of the stock at the time of resale . . . or at the time of judgment . . . should be the proper measure of damage"); cert. denied, 390 U.S. 951 (1968); 1 R. MAGNUSON, SHAREHOLDER LITIGATION § 2.23, at 139 (1985) (stating that "[w]hen rescission is unavailable because the securities have been resold, plaintiff can still under certain circumstances use a rescissional measure"). Cf. Gottlieb v. Sandia Am. Corp., 304 F. Supp. 980, 990 (E.D. Pa. 1969) (explaining in dictum that "if the actual stock or assets which were originally traded are no longer available, damages will be awarded in the amount of the difference between the present market value of the consideration originally given and the consideration received"), aff'd in part, rev'd in part, 452 F.2d 510 (3d Cir.), cert. denied, 404 U.S. 938 (1971).

Conceivably, a court might treat such rescissory "damages" as a variant of the remedy of rescission,
rather than a variant of the remedy at law for money damages. If so, when pure rescission is impossible, that court might grant an implied action for rescissory "damages" despite the following: (1) the defendant's total money liability exceeds the ceiling on § 20A(a) damages imposed by § 20A(b); and/or (2) the court holds that § 20A(a) precludes an implied action for the remedy at law of money damages. Cf. Myzel v. Fields, 386 F.2d 718, 741 n.16 (8th Cir. 1967), cert. denied, 390 U.S. 951 (1968). "Sylvania Indus. Corp. v. Lilienfeld's Estate, 132 F.2d 887 (4 Cir. 1943) . . . [held] that an action for 'recision' and one for 'money damages' were inconsistent. However, treating 'money damages' in the case before us as rescisional damages (since the stock was nonexistent), . . . the two prayers [for rescission and for rescissional damages] are not inconsistent." Id. Cf. American Gen. Ins. Co. v. Equitable Gen. Corp., 493 F. Supp. 721, 758-67 (E.D. Va. 1980) (deciding that rescission was appropriate under § 29(b), but because actual rescission was impossible, awarding "the monetary equivalent of rescission as rescisional damages"; id. at 759); 3 L. LOSS, SECURITIES REGULATION 1793 (2d ed. 1961) (stating that "[i]f the securities are still in existence and the plaintiff [seller] elects rescission . . . since securities of the same class are fungible, the defendant should be permitted to pay the plaintiff the cash equivalent, at least when the securities are readily obtainable in the market"); id. at 1793 n.372 (discussing how a court could use a rescission judgment to facilitate rescissory damages); D. DOBBS, supra note 127, § 9.4, at 623. Dobbs notes that under state common law "[t]he plaintiff is likewise excused from restoration in specie if, before discovery of the fraud, he has disposed of the property acquired in the transaction, and he is permitted in such a case to substitute the money value of the property." Id. "If the plaintiff has transferred specific property . . . to the fraudulent defendant, he is, upon rescission, entitled to a recovery of the . . . property or its value . . . ." Id. § 9.4, at 632. Cf. 1 G. PALMER, supra, § 3.12, at 304 (stating that under state common law: "If, however, the asset cannot be returned because it was disposed of before discovery of the ground of avoidance, restoration in value will be permitted by most modern authority"); Thompson, supra note 127, at 368 (stating "[w]hen restitution of specific property is not possible, such as when the defendant has disposed of or changed the form of what he received from the plaintiff, courts, applying common-law principles, allow a money judgment that is the financial equivalent of rescission") (emphasis added). See generally Bowen v. Massachusetts, 487 U.S. 879, 893 (1988):

[E]ven the monetary aspects of the relief that the State sought are not "money damages" as that term is used in the law [Administrative Procedure Act, 5 U.S.C. § 702].

Our cases have long recognized the distinction between an action at law for damages—which are intended to provide a victim with monetary compensation for an injury to his person, property, or reputation—and an equitable action for specific relief—which may include an order providing for . . . "the recovery of specific property or monies . . . ." Larson v. Domestic & Foreign Commerce Corp., 337 U.S. 682, 688 (1949) (emphasis added). The fact that a judicial remedy may require one party to pay money to another is not a sufficient reason to characterize the relief as "money damages."

Id.

If pure rescission is impossible, still other alternative remedies may be available. For example, if the defendant bought on inside information and then resold the securities, the court conceivably might apply principles of restitution to impose a constructive trust on the profit for the benefit of the party in privity. Cf. D. DOBBS, supra note 127, § 9.3, at 617 (discussing state common law: "When the plaintiff is a seller of stock, he may wish to assert, instead of damages, either a constructive trust on the stock itself or an accounting for profits the buyer derives from the stock"). See generally Barnes v. Eastern and Western Lumber Co., 205 Or. 553, 287 P.2d 929 (1955). (stating that: (1) the officers of corporation purchased stock from plaintiffs and profited on liquidation; (2) rescission was impossible because shares no longer existed; and (3) the defendants' profits should be disgorged based on a restitutionary theory); RESTATEMENT OF THE LAW OF RESTITUTION § 160 (1937) (discussing state common law of constructive trusts). For a discussion of Rule 10b-5 cases in which a defrauded seller of stock recovered profits made by defendants on a subsequent resale, see Thompson, supra note 127, at 370-73. In Affiliated Ute Citizens v. United States, 406 U.S. 128, 155 (1972), the Court commented:
damages.\textsuperscript{136}

Section 20A should not preclude this implied rescission remedy. First, section 20A(d) expressly states that the provision should not be construed to limit any implied cause of action.\textsuperscript{137} Second, section 20A's thrust is to create actions for damages, not rescission. (Almost all the contemporaneous traders would not be in privity with the insider trading defendant and could not rescind.) Third, section 20A(b)(1)'s limit on section 20A(a) liability refers only to “damages.”\textsuperscript{138}

(b) Rescission Under Section 29(b)

Section 29(b) of the Securities Exchange Act of 1934 provides, in pertinent part:

Every contract made in violation of any provision of this chapter or of 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 . . . \textsuperscript{139}

In our view, the correct measure of damages under § 28 of the [Securities Exchange] Act . . . is the difference between the fair value of all that the mixed-blood seller received and the fair value of what he would have received had there been no fraudulent conduct . . . except for the situation where the defendant received more than the seller's actual loss. In the latter case damages are the amount of the defendant's profit. See Janigan v. Taylor, 344 F.2d 781, 786 (CA1 1965), cert. denied, 382 U.S. 879 (1965).

Id.

Professor Thompson notes that although “[t]he Court [in Ute] referred to the unjust enrichment recovery as ‘damages.’ . . . Restitution often leads to a money award, but is distinct from damages.” Thompson, supra note 127, at 370 n.81. Cf. Myzel v. Fields, 386 F.2d 718, 747 (8th Cir. 1967), cert. denied, 390 U.S. 951 (1968). The Myzel court accepted, at least for the sake of discussion, defendants’ argument “that the Janigan theory [recovery of defendant’s profit upon resale] is solely an equitable remedy for accounting similar to the theory of constructive trusts.” Id. “The objection raised is that ‘conscious wrongdoing’ must be involved and that none exists here.” Id. The court proceeded to refute the contention that there was no “conscious wrongdoing.” Id. at 747-48. Cf. D. Dobbs, supra note 127, § 9.3, at 617 (noting that “the recovery in Janigan . . . amounts to a constructive trust approach”).

\textsuperscript{136} See supra notes 108-23 and accompanying text.

\textsuperscript{137} See supra text accompanying note 7. For additional discussion of § 20A(d), see supra note 41 and accompanying text. But see T. Rowe Price New Horizons Fund, Inc. v. Preletz, 749 F. Supp. 705, 709 (D. Md. 1990) (holding that § 20A(d) was intended to preserve implied actions only for plaintiffs other than contemporaneous traders and that contemporaneous traders could not bring both an implied and an express action for damages). For discussion of Preletz, see supra notes 45-49 and accompanying text.

\textsuperscript{138} See supra text accompanying note 6.

In 1938, Congress added a statute of limitations to section 29(b) for section 15(c)(1) breaches. This amendment eliminated any doubt that section 29(b) was intended to create a private cause of action.

Language in several Supreme Court opinions indicates that section 29(b) gives the victim of federal securities fraud a right to rescind a transaction with the defrauding party. In Transamerica Mortgage Advisors, Inc. v. Lewis, the Supreme Court held that section 215 of the Investment Advisers Act gives private parties the right to sue for rescission. Section 215 contains language similar to that of Exchange Act section 29(b). In support of its holding, the Court stated:

And this Court has previously recognized that a comparable provision, § 29(b) of the Securities Exchange Act of 1934 . . . confers a "right to rescind" a contract void under the criteria of the statute [citing Mills v. Electric Auto-Lite Co., 396 U.S. 375, 388 (1970)]. . . . Moreover, the federal courts in general have viewed such language as implying an equitable cause of action for rescission or similar relief.

Transamerica cited the Court's earlier opinion of Mills v. Electric Auto-Lite Co., which contains dictum suggesting that section 29(b) allows the innocent party to rescind a transaction violating the Exchange Act or a rule promulgated thereunder:

The lower federal courts have read § 29(b), which has counterparts in the Holding Company Act, the Investment Company Act, and the Investment Advisers Act, as rendering the contract merely voidable at the option of the innocent party. . . . [citations omitted] This interpretation is eminently sensible. The interests of the victim are sufficiently protected by giving him the right to rescind . . . .

Additional support for this interpretation appears in a passing reference to section 29(b) in the Supreme Court opinion of Blue Chip Stamps v. Manor Drug Stores: "§ 29(b) of the 1934 Act . . . , providing that a contract made in violation of any provision of the 1934 Act is voidable at the option of the deceived party."

140. 52 Stat. 1076 (1938).
141. SC A. Jacobs, supra note 59, § 260.03[c][vi], at 11-66 to 11-67.
145. Id. at 387-88. See Note, supra note 139, at 870 (stating that "under Mills and Transamerica, § 29(b) provides . . . to an 'unwilling innocent' party to a contract that violates securities laws . . . a right to rescind the contract and seek restitution").
146. 421 U.S. 723, 735 (1975) (dictum) (emphasis added). See generally A.C. Frost & Co. v. Coeur D'Alene Mines Corp., 312 U.S. 38 (1941). In Coeur D'Alene, the issuer refused to honor an
More recently, however, the Supreme Court observed in *Randall v. Loftsgaarden*,\(^ {147}\) that "[t]he issue whether and under what circumstances rescission or a rescissory measure of damages is available under § 10(b) is an unsettled one."\(^ {148}\) The opinion did not mention section 29(b). Nevertheless, this surprising dictum may undercut the Court's earlier pronouncements on that provision.

A number of lower court opinions have suggested that, under certain circumstances, an innocent victim of federal securities fraud has a statutory right under section 29(b) to rescind a transaction with the defrauding party.\(^ {149}\) The Fifth Circuit has gone further and held that an innocent party can rescind a transaction under section 29(b) without demonstrating harm from the violation.\(^ {150}\) The case option to sell securities. *Id.* at 39. Neither the option nor the underlying securities were registered under the 1933 Act, and the purchaser sued for breach of contract. *Id.* The Court held that even if 1933 Act registration were required, the issuer had to perform the contract because "the clear legislative purpose was protection of innocent purchasers of securities. ... [To allow the seller to refuse to perform] would probably seriously hinder rather than aid the real purpose of the statute." *Id.* at 43.

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147. 478 U.S. 647 (1986); see *supra* notes 125-26 and accompanying text.
149. See *Western Fed. Corp. v. Erickson*, 739 F.2d 1439, 1443 n.5 (9th Cir. 1984) (stating that "[a]n innocent party may sue under § 29(b) to rescind a contract, subject to such equitable defenses as waiver and estoppel") (dictum) (citation omitted); *Reserve Life Ins. Co. v. Provident Life Ins. Co.*, 499 F.2d 715, 726 (8th Cir. 1974) (stating that "[t]his section [29(b)] has been construed to create a rule of voidability at the option of an innocent party"); *Greater Iowa Corp. v. McLendon*, 378 F.2d 783, 792 (8th Cir. 1967) (dictum) (noting that "the only private party capable of attacking the validity of these transactions [under § 29(b)] ... are the shareholders who were allegedly defrauded"); *Royal Air Properties, Inc. v. Smith*, 312 F.2d 210, 213 (9th Cir. 1962) (stating that under § 29(b), "[t]he defrauded party ... can keep the stock or sue to rescind the sale"); *Rhoades v. Powell*, 644 F. Supp. 645, 661-65 (E.D. Cal. 1986); *Warshow v. H. Huntz & Co.*, 199 F. Supp. 581, 582 (S.D.N.Y. 1961) (stating that "[p]laintiff's rescission claim ... is specifically authorized by the Act [§ 29(b)]"); *Kardon v. National Gypsum Co.*, 69 F. Supp. 512, 514 (E.D. Pa. 1946) (declaring that "a statutory enactment [§ 29(b)] that a contract of a certain kind shall be void almost necessarily implies a remedy in respect of it"); *Thompson*, *supra* note 127, at 368 n.70 (noting that "[c]ourts have interpreted § 29 to mean that these contracts are voidable at the option of the innocent party"). *Cf. Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1051 (7th Cir.) (invoking § 29(b) to prevent a Rule 10b-5 violator from enforcing a securities contract induced by fraud), *cert. denied*, 434 U.S. 875 (1977); *Chris-Craft Indus. v. Piper Aircraft Corp.*, 480 F.2d 341, 391 (2d Cir.) (stating that "a defrauded shareholder also can bring suit for rescission and restitution under § 10b of the 1934 Act ... or under § 29(b) of the 1934 Act"); *cert. denied*, 414 U.S. 910 (1973) (for a subsequent Supreme Court decision in this case dealing with other issues, see 430 U.S. 1 (1977)); *Beres v. Thomson McKinnon Sec., Inc.* [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,395, at 97,070 (S.D.N.Y. 1987) (declaring that "[s]ection 29(b) ... has been consistently interpreted by the courts as declaring that a contract entered into between an innocent party and a defrauding wrongdoer is voidable (but not void, as some earlier commentators thought) ... The innocent party is then free to accept and enforce the contract, or avoid the contract and demand rescission"). *See generally* *Forkin v. Rooney Pace*, Inc., 804 F.2d 1047, 1051 (8th Cir. 1986) (discussing Illinois securities law, but relying on federal securities law by analogy, mentioning the strong argument in favor of allowing an *innocent* party to enforce a contract for sale of securities not registered as required by Illinois law, but noting the argument against allowing an innocent party to enforce such a contract).

involved real estate developers who dealt with a securities broker that they subsequently discovered had never registered as a broker-dealer with the Securities and Exchange Commission. The court held that, in order to rescind under section 29(b), a plaintiff was required to show that "(1) the contract involved a 'prohibited transaction,' (2) he is in contractual privity with the defendant, and (3) he is 'in the class of persons the Act was designed to protect.'" The court rejected the "argument that a section 29(b) plaintiff must prove a causal connection between the harm and the defendants' violation of the Act." An earlier Fifth Circuit opinion involving a similar fact situation also held that a plaintiff seeking section 29(b) rescission need not establish harm from the defendant's violation: "Under the voiding provision of section 29(b), it is sufficient to show merely that the prohibited transactions occurred and that appellants were in the protected class."

At the opposite extreme, a few courts have said that section 29(b) merely applies common law principles of illegal bargain. In other words, the provision voids only contracts that are illegal by their own terms (e.g., an agreement among conspirators to share profits from illegal insider trading) and not contracts that are illegal because of collateral securities fraud. Some of these same opinions also

151. Id. at 559.
152. Id. at 558-59. For discussion of whether a § 29(b) plaintiff must demonstrate proximate causation, see Gruenbaum & Steinberg, supra note 139, at 28-31.
153. Eastside Church of Christ v. National Plan, Inc., 391 F.2d 357, 362 (5th Cir.), cert. denied, 393 U.S. 913 (1968). For discussion of Eastside Church, see Gruenbaum & Steinberg, supra note 139, at 10-12. Cf. Myzel v. Fields, 386 F.2d 718, 742 (8th Cir. 1967) (while deciding another issue, briefly stating in dictum that a securities contract induced by fraud is void as a matter of law: "Section 29(b) of the statute itself declares the gale void, once there is found a violation of Rule 10b-5"), cert. denied, 390 U.S. 951 (1968).
154. For a general discussion of illegal bargains, see 6A A. CORBIN, CORBIN ON CONTRACTS §§ 1373-1378 (1962); Note, supra note 139, at 890-91 & n.116.
155. Pearlstein v. Scudder & German, 429 F.2d 1136, 1149 (2d Cir. 1970) (Friendly, J., dissenting), cert. denied, 401 U.S. 1013 (1971); Slomiak v. Bear Stearns & Co., 597 F. Supp. 676, 682 (S.D.N.Y. 1984) (stating "I think the distinction is a reasonable one if § 29(b) is viewed as a remedy for contracts which in their inception or as performed are, or become, inherently violative of the Act or regulations thereunder"); Blanes v. Paine Webber Jackson & Curtis, Inc., 593 F. Supp. 458, 464 (D.P.R. 1983) (stating that "[a]n unlawful agreement under Section 29(b) is one which by its terms violates the statute or the rules and regulations thereunder"); Drasner v. Thomson McKinnon Securities, Inc., 433 F. Supp. 485, 501-02 (S.D.N.Y. 1977) (noting that § 29(b) "only renders void those contracts which by their terms violate the Act or the rules and regulations thereunder . . . for it is only such contracts which are 'made in violation of,' or 'the performance of which involves the violation of' the statute and the rules and regulations thereunder") (emphasis added) (citations omitted). Cf. Occidental Life Ins. Co. v. Pat Ryan & Assocs., 496 F.2d 1255, 1266-67 & n.7 (refusing to grant § 29(b) rescission when the plaintiff had other remedies under the federal securities laws and when the contract was not illegal per se but involved fraud collateral to the agreement to sell the stock; the court claimed that it need not reach the issue whether § 29(b) applies only to contracts which by their own terms violate the securities laws), cert. denied, 419 U.S. 1023 (1974). See generally Gannett Co. v. Register Publishing Co., 428 F. Supp. 818, 831 (D. Conn. 1977) (stating that "conduct that affirms a fraudulently induced contract under general contract law principles, such as acceptance of benefits under the contract . . . , will terminate the injured party's power to avoid the contract on illegality grounds, where the only illegality is violation of the antifraud provisions of the securities laws"). For criticism of some of these decisions, see Gruenbaum & Steinberg, supra note 139, at 13-24.
express a reluctance to nullify a contract that has already been executed.\textsuperscript{166}

The courts seem to agree that the section 29(b) plaintiff must be in contractual privity with the defendant.\textsuperscript{167} Some courts have applied general principles of equity to limit section 29(b) rescission.\textsuperscript{168} At least one court has ruled that section 29(b)

\begin{footnotesize}
\begin{enumerate}
\item Occidental, 496 F.2d at 1267; Pearlstein, 429 F.2d at 1149 (Friendly, J., dissenting).
\item See, e.g., Thomas v. Duralite Co., 524 F.2d 577, 590 (3d Cir. 1975) (stating that “[s]ection 29(b) permits an innocent party to void a contract which was secured by the other party in violation of a rule”) (emphasis added); Eastside Church of Christ v. National Plan, Inc., 391 F.2d 357, 363 (5th Cir.), cert. denied, 393 U.S. 913 (1968); Greater Iowa Corp. v. McLendon, 378 F.2d 783, 792 (8th Cir. 1967); Natkin v. Exchange Nat'l Bank of Chicago, 342 F.2d 675, 676-77 (7th Cir. 1965) (stating that “there is nothing in the section [29(b)] which operates to create any right or cause of action against the party in violation in favor of a stranger to the contract”). Accord, Gabaldon, supra note 2, at 1065; Gruenbaum & Steinberg, supra note 139, at 32-33. For both a discussion of possible expansion of standing to sue under § 29(b), see Gabaldon, supra note 2, at 1065 n.203. For both a discussion of possible expansion of standing and an argument for such expansion, see Gruenbaum & Steinberg, supra note 139, at 32-36.
\item Freeman v. Marine Midland Bank-New York, 419 F. Supp. 440, 453 (E.D.N.Y. 1976) (recognizing that § 29(b) has been interpreted to make contracts voidable at the option of the innocent party, but holding that “a court should apply principles of equity when considering a rescission action under section 29(b”), rev'd on other grounds, 494 F.2d 1334, 1338-39 (2d Cir. 1974). See Western Fed. Corp. v. Erickson, 739 F.2d 1439, 1443 n.5 (9th Cir. 1984) (dictum) (stating that “[a]n innocent party may sue under § 29(b) to rescind a contract, subject to such equitable defenses as waiver and estoppel”); Occidental, 496 F.2d at 1267 n.9 (stating that “[p]rinciples of equity, like estoppel and waiver, apply equally to actions brought under Section 29(b), as well as those brought under Section 10(b)”; Royal Air Properties, Inc. v. Smith, 312 F.2d 210, 213 (9th Cir. 1962) (stating that “[e]stoppel and waiver are defenses to a civil action brought under sections 10(b) and 29(b) of the Securities Exchange Act of 1934”). Compare Regional Properties, Inc. v. Financial & Real Estate Consulting Co., 752 F.2d 178, 182-83 (5th Cir. 1985) (noting that under Texas law, the plaintiff’s right to rescind a contract is subject to various equitable defenses—which cannot be asserted if the defendant comes to court with unclean hands—and that, because the defendant in the case knowingly violated federal securities law, the defendant had unclean hands and could not assert equitable defenses to § 29(b) rescission) with Texas Int’l Airlines v. Nat’l Airlines, Inc., 714 F.2d 533, 537 (5th Cir. 1983) (stating in dictum that “this court in Regional Properties [678 F.2d 552 (5th Cir. 1982)] opted to allow all the traditional equitable defenses in section 29(b) actions because ‘virtually all other courts that have decided this issue’ have held that equitable defenses are available”), cert. denied, 465 U.S. 1052 (1984) and Regional Properties, Inc. v. Financial and Real Estate Consulting Co., 678 F.2d 552, 562 (5th Cir. 1982) (noting that “we have no hesitation in holding that there are such defenses [to a § 29(b) action] and that they, in fact, encompass all the traditional equitable defenses. . . . W[e] join with virtually all other courts that have decided this issue and hold that all equitable defenses are available in a section 29(b) cause of action”).

In Mills v. Electric Auto-Lite Co., 396 U.S. 375 (1970), the plaintiff minority shareholders brought an action to set aside a merger allegedly approved by the shareholders as a result of a materially misleading proxy solicitation. The Court noted:

\[P]etitioners are not parties to the merger agreement and thus do not enjoy a statutory right under § 29(b) to set it aside. Furthermore, while they do have a derivative right to invoke Auto-Lite’s status as a party to the agreement, a determination of what relief should be granted in Auto-Lite’s name must hinge on whether setting aside the merger would be in the best interests of the shareholders as a whole. In short, in the context of a suit such as this one, § 29(b) leaves the matter of relief where it would be under Borak without specific statutory language—the merger should be set aside only if a court of equity concludes, from all the circumstances, that it would be equitable to do so.

\textit{Id.} at 388 (emphasis added).
\end{enumerate}
\end{footnotesize}
rescission is subject to a reasonableness test.\textsuperscript{159}

Assume arguendo that section 20A precludes the party in privity's implied action for actual damages. That plaintiff would lack an adequate remedy at law for money damages and would have an additional argument for section 29(b) rescission. Alternatively, assume, as this Article argues, that section 20A does not preclude the party in privity's implied action for actual damages. As mentioned earlier, the cases do not make clear whether an adequate Rule 10b-5 remedy at law for damages precludes the right to rescind as a \textit{general rule} 10b-5 remedy.\textsuperscript{160} Some commentators have suggested that section 29(b) may strengthen a Rule 10b-5 plaintiff's claim for rescission in the face of an adequate damages remedy.\textsuperscript{161} Unfortunately, section 29(b) has been invoked relatively infrequently,\textsuperscript{162} and the cases interpreting it are few.\textsuperscript{163} If interpreted broadly, section 29(b) would allow any victim to rescind when the transaction was induced by the party on the other side through a violation of Rule 10b-5. Section 29(b) rescission would seem especially appropriate in those insider trading cases in which the basis of the defendant's Rule 10b-5 liability is a breach of a special relationship to the party on the other side of the transaction, the very party seeking rescission.\textsuperscript{164} Under the same rationale, an innocent party could

\textsuperscript{159} See American Gen. Ins. Co. v. Equitable Gen. Corp., 493 F. Supp. 721 (E.D. Va. 1980). The court recognized that under § 29(b) a contract was voidable at the option of the injured plaintiff, but evaluated the reasonableness of rescission using several factors. \textit{Id.} at 755-67. The court decided rescission was appropriate, but because actual rescission was impossible, the court awarded “the monetary equivalent of rescission as rescissional damages.” \textit{Id.} at 759. Cf. Weiskopf, \textit{supra} note 127, at 751 (discussing § 29(b) and then noting: “The award of rescission in an Exchange Act case, as at common law, is purely within the discretion of the trial court”).

\textsuperscript{160} See \textit{supra} note 134 and accompanying text.

\textsuperscript{161} 5C A. Jacobs, \textit{supra} note 59, § 260.03[c][vi], at 11-68 (stating that “[s]ection 29(b) . . . possibly . . . permit[s] rescission even when damages are adequate recompense”). See Steinberg, \textit{supra} note 131, at 606 (noting that “[o]nce the parties have consummated a transaction . . . , courts are extremely reluctant to grant the aggrieved litigant the remedy of rescission [as a general Rule 10b-5 remedy] except in the most egregious situations. In this respect, section 29(b) may serve as a potent weapon for such parties”). But cf. Gilbert v. Meyer, 362 F. Supp. 168, 176 (S.D.N.Y. 1973) (dictum) (noting that “since damages are available to plaintiff under § 10(b) and Rule 10b-5, rescission and restitution [under § 29(b)] are unnecessary”).

\textsuperscript{162} Regional Properties Inc. v. Financial and Real Estate Consulting Co., 678 F.2d 552, 557 (5th Cir. 1982); Gruenbaum & Steinberg, \textit{supra} note 139, at 1, 3 & n.5.

\textsuperscript{163} Cf. Note, \textit{supra} note 139, at 867 (stating that “[d]espite the obvious importance of § 29(b), it has received little attention from commentators or from the Supreme Court”).

\textsuperscript{164} See Note, \textit{supra} note 139, at 878. “[T]he strongest case for voiding a contract . . . [occurs] where the person invoking § 29(b) is both a party to the contract and a member of the beneficiary group.” \textit{Id.} “Clearly the strongest case for invoking § 29(b) is the situation where the party seeking to void the contract is both the person for whose benefit the relevant rule was passed and is in privity of contract with the violating party.” \textit{Id.} at 879. “Voiding such contracts benefits the statutory beneficiary at the expense of the law-breaking party with minimal risk of harming third parties.” \textit{Id. But see} 5C A. Jacobs, \textit{supra} note 59, § 260.03[c][vi], at 11-69 (arguing that “[t]he availability of rescission is thus questionable for insider or tippee trading on an exchange or in the over-the-counter market”) (citing Huddleston v. Herman & MacLean, 640 F.2d 534, 554-55 (5th Cir. Mar. 1981), \textit{modified}, 459 U.S. 375 (1983)).

For a pre-Chiarella argument that the party on the other side of an insider trade should be able to rescind under § 29(b), see Note, \textit{Insider's Liability under Rule 10b-5 for the Illegal Purchase of
ITSFEA

refuse to complete an executory transaction with an insider trader who violated Rule 10b-5 through the special relationship doctrine.\textsuperscript{168}

The availability of section 29(b) rescission is not affected by section 20A. The thrust of section 20A is to give contemporaneous traders the right to sue for damages. In addition, section 20A(b)(1)’s limit on section 20A(a) liability refers only to “damages.”\textsuperscript{168} If a defendant insider trader breaches a “special relationship,” nothing in the text of ITSFEA or its legislative history suggests that Congress meant to deprive the party in privity of the right, if any, to rescind under section 29(b).\textsuperscript{167}

4. Summary

To create the Chiarrella “special relationship” theory, the Supreme Court extrapolated from face-to-face trades to stock market transactions.\textsuperscript{168} If an insider trading defendant violates Rule 10b-5 by breaching a duty to the party on the other side of the insider trade, that victim clearly should have an implied cause of action for actual damages against the defendant. The suit should not be precluded by section 20A. This conclusion is reinforced if the insider and the plaintiff engaged in a block trade that had aspects of a face-to-face transaction. Even if section 20A were to preclude an implied action for damages, the party in privity should be able to rescind as a general Rule 10b-5 remedy, or possibly under section 29(b), depending on how broadly the court interprets that provision.

B. Suit by the Party in Privity Against a Defendant Liable Under the Misappropriation Theory

1. Explanation of the Misappropriation Theory

In its Supreme Court brief in Chiarrella, the United States advanced an alternative theory to justify the defendant’s conviction for violating section 10(b) and Rule 10b-5. The brief argued that, by trading, Chiarrella breached his duty to the takeover bidders (his indirect employers).\textsuperscript{169} The Court did not rule on the validity

\textsuperscript{165} For pre-Chiarrella discussion supporting this conclusion, see Note, supra note 61, at 314 n.130. For discussion of an actual example of a purchaser invoking section 29(b) when refusing to pay for or accept delivery of Equity Funding stock because of a suspicion of insider trading, see Jefferies & Co., Inc. v. Arkus-Duntov, 357 F. Supp. 1206, 1210-13 (S.D.N.Y. 1973). See generally Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1051 (7th Cir.) (invoking § 29(b) to prevent a rule 10b-5 violator from enforcing a securities contract induced by fraud), cert. denied, 434 U.S. 875 (1977).

\textsuperscript{166} See supra text accompanying note 6.

\textsuperscript{167} See supra note 41 and accompanying text. But cf. T. Rowe Price New Horizons Fund, Inc. v. Preletz, 749 F. Supp. 705, 709 (D. Md. 1990) (holding that § 20A(d) was intended to preserve implied actions only for plaintiffs other than contemporaneous traders and that contemporaneous traders could not bring both an implied and an express action for damages). For discussion of Preletz, see supra notes 45-49 and accompanying text.

\textsuperscript{168} For discussion of the “special relationship” theory, see supra notes 72-107 and accompanying text.

\textsuperscript{169} See Chiarrella, 445 U.S. at 235. Chiarrella’s direct employer was a financial printing firm
of this "misappropriation" theory because it had not been submitted to the jury. In United States v. Carpenter the Second Circuit affirmed criminal convictions under section 10(b) and Rule 10b-5 based on the "misappropriation" theory. An evenly divided Supreme Court upheld these securities law convictions, but the opinion dealt only with the defendants' concurrent mail and wire fraud convictions (which the Court upheld unanimously). The four justices who voted to reverse the convictions under section 10(b) and Rule 10b-5 gave neither their reasons nor their names. Although the Supreme Court has not endorsed the Rule 10b-5 misappropriation theory, the Second Circuit, Ninth Circuit, Seventh Circuit, and apparently the Third Circuit have done so. The House Energy and Commerce Committee Report on ITSFEA supported the theory: "In the view of the Committee . . ., this type of security fraud [misappropriation] should be encompassed within Section 10(b) and Rule 10b-5."

2. No Implied Rule 10b-5 Damages Action by the Party on the Other Side of the Misappropriator's Insider Trade

Misappropriation involves a trade or tip in breach of one's duty to one's infor-
mation source, generally one's direct or indirect employer. Unlike the "special relationship" theory, the victim of misappropriation is not the party on the other side of the trade. The victim is the information source. Usually, the information source would not be a buyer or seller of securities and would lack standing to bring a Rule 10b-5 suit.

In the 1983 decision M OSS v. Morgan Stanley, the Second Circuit refused to hold misappropriators liable to "marketplace" or, impliedly, "contemporaneous" opposite-type traders. The court relied heavily on the Supreme Court's Chiarella decision. The defendants breached a duty to their employers, but neither their direct nor their indirect employers were the issuers of the stock traded. In other words, the defendant misappropriators were outside the Chiarella "special relationship triangle." Therefore, they owed no duty to disclose to the party on the other side of the trade. Consequently, the defendants owed no duty to "marketplace" or, impliedly, "contemporaneous" traders. Under the rationale of Moss, the party in privity would have no implied cause of action for damages against a misappropriator under Rule 10b-5. This moots the issue of the preemptive effect of section

179. See United States v. Chestman, 947 F.2d 551, 566-67 (2d Cir. 1991) (en banc) (emphasis added):

Under this [misappropriation] theory, a person violates Rule 10b-5 when he misappropriates material nonpublic information in breach of a fiduciary duty or similar relationship of trust and confidence and uses that information in a securities transaction.

[A] fraud-on-the-source theory of liability extends the focus of Rule 10b-5 beyond the confined sphere of fiduciary/shareholder relations . . . .

Id.

180. See id. at 566-71 (stating "[t]o date we have applied the [misappropriation] theory only in the context of employment relationships," but indicating in dictum that breaches of other fiduciary or similar relationships might suffice).


183. Id. at 13.

184. See id. at 10-14, 15-16. For discussion of Chiarella and the "special relationship triangle," see supra notes 72-107 and accompanying text.

185. Id. at 13, 16.

186. Id. But cf. United States v. Carpenter, 791 F.2d 1024, 1034 (2d Cir. 1986) (including the following puzzling dictum: "[T]he misappropriator/defendants had a . . . duty, which they breached, under section 10(b) and Rule 10b-5, to abstain from trading in securities on the basis of the misappropriated information or to do so only upon making adequate disclosure to those with whom they traded"), aff'd by an equally divided Court, 484 U.S. 19 (1987). For additional discussion of Moss, see supra note 22 and accompanying text, supra note 99, and infra notes 194-95 and accompanying text. The legislative history of ITSFEA states that § 20A's creation of an express statutory action is specifically intended to overturn the result of Moss's denial of an implied cause of action. See Report, supra note 4, at 26-27; SEC v. Clark, 915 F.2d 439, 452-53 (9th Cir. 1990); Ceres Partners v. GEL Assoc., 714 F. Supp. 679, 685 (S.D.N.Y. 1989). Cf. 134 CONG. REC. S17,220 (daily ed. Oct. 21, 1988) (statement of Sen. Garn) (explaining that "[ITSFEA] also specifically reverses the result in the Moss case. The result in Moss is inconsistent with the remedial purposes of the Exchange Act"). In addition, the House Report endorses suits against misappropriators by non-contemporaneous traders, especially takeover bidders. See supra notes 38-39 and accompanying text.
3. An Action Against a Misappropriator for Rescission as a General Rule
10b-5 Remedy or Under Section 29(b)?

An unresolved issue is whether the party in privity with a misappropriator has
the right to rescind either as a general Rule 10b-5 remedy or under section 29(b).\(^8\)
The misappropriator's transaction violates Rule 10b-5, but the party on the other
side is not the victim of the misappropriation.\(^8\) In Mills, the Court referred to the
right to rescind of the "victim."\(^8\) Similarly, Blue Chip Stamps mentioned "the
deceived party."\(^8\) The misappropriator has no duty to disclose to the party in
privity. Therefore, that party is not a victim of securities fraud and possibly not
intended to be protected by either the Exchange Act or section 10(b).\(^8\)

As noted earlier,\(^8\) the Fifth Circuit has adopted the broadest interpretation of
section 29(b). That circuit has held that an innocent party can rescind under section
29(b) without demonstrating harm from the violation. The party in privity need
only demonstrate that the transaction is forbidden and that he or she is a member of
the class the Act was designed to protect. Arguably, the Securities Exchange Act of
1934 was intended to protect not solely the victims of securities fraud, but all
members of the investing public. If so, under the Fifth Circuit interpretation of
section 29(b), a party in privity with a misappropriator might be able to rescind
under section 29(b).

Recision by a party in privity with a misappropriator would be a windfall.
Concern about such a windfall was one rationale for the Second Circuit opinion in
Moss v. Morgan Stanley Inc.:\(^8\)

[Holding a misappropriator liable for damages to open market investors
engaging in transactions opposite in type to the insider trade] would
grant . . . a windfall recovery simply to discourage tortious conduct by
securities purchasers. Yet the Supreme Court has made clear that
section 10(b) and rule 10b-5 protect investors against fraud; they do not
remedy every instance of undesirable conduct involving securities . . .
[Chiarella v. United States, 445 U.S. 222, 232 (1980)]; Santa Fe Indus-
tries, Inc. v. Green, 430 U.S. 462, 474-77 . . . As defendants owed no
duty of disclosure to plaintiff Moss [an open-market trader], they

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187. Dictum in a recent Ninth Circuit opinion approves of the Second Circuit decision in Moss. See SEC v. Clark, 915 F.2d 439, 445 & nn.8, 10 (9th Cir. 1990).
188. For the pertinent excerpt from the text of § 29(b), see supra text accompanying note 139. As
discussed earlier—supra notes 139-65 and accompanying text—§ 29(b) sometimes voids a contract
made in violation of Rule 10b-5.
189. See supra notes 179-181 and accompanying text.
190. See supra notes 144-45 and accompanying text.
191. See supra note 146 and accompanying text.
192. See generally Note, supra note 139, at 880-81 (discussing § 29(b) rescission sought by
someone who is not a statutory beneficiary, but is in privity with a violator of the securities laws).
193. See supra notes 150-53 and accompanying text.
committed no "fraud" in purchasing shares of ... stock.195

Because the Second Circuit was unwilling to grant an open-market trader the windfall of damages against a misappropriator, the Second Circuit would also probably be reluctant to grant the party in privity the windfall of rescission against a misappropriator.196 Rescission may be a more generous remedy than damages.

Allowing rescission would provide additional deterrence of misappropriation. The courts must balance this additional deterrent against the windfall to the party on the other side of the insider trade. The enactment of section 20A cuts two ways. On one hand, the express cause of action for the defendant's profit somewhat reduces the need for deterrence. On the other hand, by allowing a class action against misappropriators,197 the provision demonstrates Congress's willingness to deter misappropriation by creating a windfall for a class of unharmed civil plaintiffs. Unlike the Moss court, Congress seems to value deterrence more than avoidance of windfalls.198 In any event, section 20A does not answer the question whether the party in privity with a misappropriator would be able to rescind either as a general Rule 10b-5 remedy or under section 29(b).199 To resolve this issue the courts must balance the benefit of enhanced deterrence against the plaintiff's windfall.

IV. DOES SECTION 20A IN ITSELF CREATE A STATUTORY CAUSE OF ACTION FOR RESCISSION BY THE PARTY ON THE OTHER SIDE OF THE INSIDER TRADE?

The thrust of section 20A(a) is to create an express statutory private cause of action for damages. Almost all contemporaneous traders would not be in privity with the insider trader and could not rescind. One contemporaneous trader, however, is the party on the other side of the insider trade. For that plaintiff, rescission is often a feasible remedy.200

Whether the party on the other side could sue for rescission under ITSFEA itself is not clear. Section 20A(a) states merely that the defendant "shall be liable in an action in any court of competent jurisdiction to any person who, contemporaneously ... has purchased ... or sold ...."201 Section 20A(a) does not describe the

195. Id. at 16.
196. Cf. Pearlstein v. Scudder & German, 429 F.2d 1136, 1149 (2d Cir. 1976) (Friendly, J., dissenting) (stating that "[t]here has been a conspicuous lack of judicial enthusiasm for the doctrine [of rescission of an illegal bargain] thus incorporated [into § 29(b)] when there has been performance by the violator").
197. See supra text accompanying note 5; supra note 186 and accompanying text.
198. As mentioned earlier, the legislative history of ITSFEA states that § 20A was intended to overturn the result in Moss. See supra note 186.
199. But cf. T. Rowe Price New Horizons Fund, Inc. v. Preletz, 749 F. Supp. 705, 709 (D. Md. 1990) (holding that § 20A(d) was intended to preserve implied actions only for plaintiffs other than contemporaneous traders and that contemporaneous traders could not bring both an implied and express action for damages). For discussion of Preletz, see supra notes 45-49 and accompanying text.
200. For discussion of when rescission is feasible, see supra note 135.
form of the liability (i.e., damages, rescission, or both).\textsuperscript{202} Narrowly interpreted, the word "liable" could mean liability for only money damages. Broadly interpreted, however, the word "liable" can include liability for rescission. For example, in section 12 of the Securities Act of 1933, Congress used the word "liable" when clearly creating a cause of action for rescission:

[The defendant] . . . shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security . . . upon the tender of such security, or for damages if he no longer owns the security.\textsuperscript{203}

Although section 20A(a) does not contain the words "damage" or "damages," section 20A(b)(1) does state that "[t]he total amount of damages imposed under subsection (a) [§ 20A(a)] shall not exceed the profit gained or loss avoided . . . ."\textsuperscript{204} One interpretation of this language in subsection (b) is that Congress intended that subsection (a) create liability for damages only, and not rescission. A second interpretation of this language in subsection (b) is that Congress assumed that subsection (a) refers only to damages but did so without reflection and without intending to prevent the judiciary from rejecting Congress's facile assumption. A third interpretation is that Congress deliberately intended to limit the total liability of any sort under subsection (a) to the defendant's profit or loss avoided. A fourth interpretation is that Congress intended to limit money damages but not other forms of liability.\textsuperscript{205}

A powerful argument for a narrow interpretation of the word "liable" in section 20A(a) is that the legislative history does not mention either rescission or the party in privity with the insider trade.\textsuperscript{206} The House Report also states that section 20A was intended to overturn the result in \textit{Moss}, a case that dealt with the issue of damages to marketplace traders.\textsuperscript{207} A weak counterargument is that section 20A(a) could easily have stated that the defendant "shall be liable in an action for damages in any court" instead of simply that the defendant "shall be liable in an

\begin{itemize}
\item \textsuperscript{205} If the third interpretation is correct, § 20A(b) conceivably might not even limit rescissory "damages." Such monetary relief may be a variant of the remedy of rescission, rather than the remedy at law for "money damages." For discussion of this issue, see \textit{supra} note 135.
\item \textsuperscript{206} \textit{See Report}, \textit{supra} note 4, at 26-28. When ITSFEA came up for a vote in the House of Representatives, Congressman Norman Lent remarked that "[i]nsider traders will be liable under this new provision to persons on the opposite side of trades from the insider trader for the amount of the insider trader's profits or losses avoided." 134 \textit{CONG. REC.} H7470 (daily ed. Sept. 13, 1988) (statement of Rep. Lent).
\item \textsuperscript{207} \textit{See supra} note 186. For additional discussion of \textit{Moss}, see \textit{supra} note 22 and accompanying text; \textit{supra} note 99; \textit{supra} text accompanying notes 182-87; \textit{supra} notes 194-95 and accompanying text.
\end{itemize}
action in any court . . . .” Congress used the word “damages” in section 20A(b). The failure to include the word “damages” in section 20A(a) may have been deliberate.

More likely, the failure to include the word “damages” in section 20A(a) was inadvertent. Nevertheless, this omission makes possible the argument that section 20A creates a statutory cause of action for rescission for the party on the other side of the trade. The existence of such a remedy would strengthen the claim of a plaintiff seeking to undo a trade with a misappropriator.\textsuperscript{208} One reason Congress enacted section 20A was to allow contemporaneous traders to sue a misappropriator for damages.\textsuperscript{209} Were section 20A to create an action for rescission, Congress arguably intended to allow the party in privity to seek that remedy against a misappropriator. Even if section 20A does create a rescission remedy, the courts will still have to define the contours of the action. The resulting limitations might be much the same as those presently imposed on rescission as a general Rule 10b-5 remedy and under section 29(b).\textsuperscript{210} The section 20A action would still be valuable. Instead of merely failing to preclude rescission, section 20A would reinforce the availability of this remedy.

V. Conclusion

Section 20A of ITSFEA creates an express cause of action for contemporaneous traders against insider traders and tippers. In this action, the maximum amount of damages is the defendant’s profit\textsuperscript{211} less any amount disgorged in an action brought by the Securities and Exchange Commission under its general power to seek equitable relief. The provision specifically states that its express cause of action should not be construed to limit any implied right of action. Section 20A is ambiguous as to whether it precludes contemporaneous traders from obtaining double the defendant’s profit by bringing both an express and an implied action for damages.

Identifying the party on the other side of an insider trade is sometimes possible, especially with block trades. If identifiable, this innocent party may attempt to sue the insider trader. If the defendant is liable under the “special relationship” theory, he or she has breached a duty to disclose to the party in privity. Even after ITSFEA, that victim should have an implied cause of action for actual damages. If ITSFEA were to preclude such a damages action, the party in privity still should be able to rescind as a general Rule 10b-5 remedy. If the defendant violates Rule 10b-5 by breaching a duty to the party on the other side of the insider trade, that victim

\textsuperscript{208} For discussion of the viability of a suit for rescission by the party in privity against a defendant liable under the misappropriation theory, see supra notes 188-99 and accompanying text.

\textsuperscript{209} See supra note 186 and accompanying text.

\textsuperscript{210} For discussion of the limits on rescission as a general Rule 10b-5 remedy, see supra notes 129-32, 134 and accompanying text. For discussion of the limits on § 29(b), see supra notes 150-59 and accompanying text.

\textsuperscript{211} Under § 20A(c), tippers are liable jointly and severally “with, and to the same extent as, any person or persons liable under subsection (a) § 20A(a)] to whom the communication was directed.” See supra text accompanying note 7; note 8.
has a strong argument for rescission under section 29(b) of the Securities Exchange Act of 1934, especially if section 20A were to preclude an action for damages. The availability of rescission would depend on the courts' general interpretation of section 29(b). Section 20A of the Act would not preempt this remedy. On the other hand, if the defendant is liable under the misappropriation theory, the defendant owes no duty to disclose to the party on the other side of the trade. Even before ITSE, that party had no implied cause of action for damages in the Second Circuit.

An unsettled issue is whether the party in privity with a misappropriator has a right to rescind, either as a general Rule 10b-5 remedy or under section 29(b). Section 20A does not resolve this question. The courts will have to provide an answer by balancing the windfall to the plaintiff against the deterrent value of additional civil liability.

Conceivably, section 20A itself might be construed to create a statutory cause of action for rescission for the party on the other side of the insider trade. The legislative history does not mention rescission, but section 20A(a) does state that the defendant “shall be liable in an action” rather than “shall be liable for damages in an action.” Were section 20A to create an action for rescission, section 20A would reinforce the availability of that remedy, rather than merely failing to preclude it.