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The Measure of Recovery Under Rule 10b-5: A Restitution Alternative to Tort Damages

*Robert B. Thompson**

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I. INTRODUCTION

The law relating to private remedies available under rule 10b-5[1] is confused.[2] Commentators list up to a dozen separate measures of recovery that prospective plaintiffs may pursue if defrauded in connection with the purchase or sale of a security.[3] Courts mix and match these measures in a way that both obscures their substantive and historical backgrounds and creates difficulty for subsequent courts and scholars seeking a coherent body of law. The "catch-all" nature of the rule encourages an ad hoc approach by which a court provides the most appropriate remedy under the circumstances;[4] but this approach also fosters a misunderstanding of

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1. 17 C.F.R. § 240.10b-5 (1982). The rule provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) to employ any device, scheme, or artifice to defraud,
>
> (b) to make any untrue statement of a material act or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

The Securities and Exchange Commission (SEC) promulgated the rule in 1942 to implement § 10(b) of the Securities Exchange Act of 1934. 15 U.S.C. § 78j(b) (1976). That section provides in pertinent part:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> . . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

2. Courts in the three decades after the rule's enactment concentrated on whether the rule allowed a private cause of action to be implied, and the elements necessary for finding liability. *See infra* notes 16-19 and accompanying text. The courts seldom needed to address the measure of plaintiff's recovery until after the resolution of these threshold questions, leaving undeveloped the issue of remedy. *See, e.g.*, Abrahamson v. Fleschner, 392 F. Supp. 740, 746 (S.D.N.Y. 1975). Although a multitude of cases now have addressed the measure of recovery, courts have used such a variety of approaches that the uncertainty is greater than when no cases at all existed. See *infra* note 18 for a brief description of the historical development of the implied cause of action under the rule.

3. 5C A. JACOBS, LITIGATION AND PRACTICE UNDER RULE 10b-5 11-122-23 (2d ed. 1983). Professor Loss lists a general rule qualified by eight "voracious exceptions." *See* L. LOSS, FUNDAMENTALS OF SECURITIES REGULATION 1132-41 (1983).

4. *See, e.g.*, Hackbart v. Holmes, 675 F.2d 1114, 1121 (10th Cir. 1982); Nye v. Blyth Eastman Dillion & Co., 588 F.2d 1189, 1198 (8th Cir. 1978); Osofsky v. Zipf, 645 F.2d 107, 111 (2d Cir. 1981); *see also* Cobine, *Elements of Liability and Actual Damages in Rule 10b-*

the rule's remedies, as illustrated by the variety of sometimes inconsistent descriptions of the same case.[5]

The primary practical difference among the measures of recovery in rule 10b-5 cases is how they allocate between the parties the post-transaction change in the value of the transferred securities. Securities by nature fluctuate in value; by the time a court decides that relief is appropriate in a fraud case the securities may be worth more or less than the amount paid for them in the transaction. Only part of this change in value may be due to the misrepresentations; other factors, such as general movement in the stock market since the transaction, also contribute to a fluctuation in value. Some remedies, like those termed "out of pocket," allow a plaintiff to recover only for the harm resulting from the misrepresentation itself and exclude any additional harm caused by a change in the market or some other factor that was not the proximate consequence of the fraud.[6] In contrast, a remedy based on rescission allows the plaintiff to unwind the transaction and recover the entire purchase price, even though this may permit the plaintiff to escape a bargain that was bad independent of the fraud.[7]

Recent decisions in securities cases evidence a trend toward a result that combines elements of both out of pocket and rescission theories. Courts increasingly are awarding the victim of fraud—the plaintiff—the difference between the value of what he gave up, measured at the time of the transaction, and the value of what he received, measured at a reasonable time after discovery of the fraud.[8] This intermediate approach allows a victim to place upon a

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5 *Actions*, 1972 U. ILL. L.F. 651, 682 (1972).

5. For example, courts citing the well-known case Janigan v. Taylor, 344 F.2d 781 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965), have described its measure of recovery as based on the following theories: benefit of the bargain, Rochez Bros., Inc. v. Rhoades, 491 F.2d 402, 415 (3d Cir. 1973); out of pocket, Gordon v. Burr, 366 F. Supp. 156, 170 n.13 (S.D.N.Y. 1973), *aff'd in part and rev'd in part*, 506 F.2d 1080 (2d Cir. 1974); modified out of pocket, Myzel v. Fields, 386 F.2d 718, 747 (8th Cir. 1967); an exception to the out of pocket rule, Hackbart v. Holmes, 675 F.2d 1114, 1122 (10th Cir. 1982); "rescission measure of damages," Gottlieb v. Sandia Am. Corp., 304 F. Supp. 980, 990 (E.D. Pa. 1969); unjust enrichment, Rude v. Cambell Square, 411 F. Supp. 1040, 1050 (D.S.D. 1976); and windfall profits, Thomas v. Duralite Co., 524 F.2d 577, 589 (3d Cir. 1975).

6. *See infra* note 25 and accompanying text.

7. *See infra* note 76 and accompanying text.

8. Compare the cases discussed in the text accompanying *infra* notes 47-60, which apply the modified out of pocket approach, with the cases discussed in the text accompanying *infra* notes 61-79, which use a rescissory approach, and with SEC v. MacDonald, 699 F.2d 47 (1st Cir. 1983), discussed in the text accompanying *infra* notes 150-67. *See* Recent Development, *Damages for Insider Trading in the Open Market: A New Limitation on Recovery*

defrauding defendant the risk of any change in the market until a reasonable time after the discovery of the fraud, but not beyond. As in earlier rule 10b-5 cases, however, courts are reaching this remedial result without a clear understanding of the substantive foundation for the measure of recovery.

The thesis of the Article is that much of the confusion about rule 10b-5 remedies turns on the courts' failure to recognize adequately that the rule derives from two separate and independent sources at common law. Rule 10b-5 draws primarily on tort concepts that focus on harm to the plaintiff and limit recovery by principles of legal causation. In addition, the rule, like common-law fraud, traces its lineage to principles based on unjust enrichment. This second source focuses on the defendant's gain and requires the defendant to return all benefit received through the fraudulent transaction, even if that gain exceeds plaintiff's loss. Recovery under rule 10b-5 sometimes is supported by tort principles, sometimes supported by unjust enrichment principles, and sometimes by both.

In many transactions, the tort focus on plaintiff's loss does not produce a different result from the unjust enrichment focus on defendant's gain. In some transactions, however, the results will not be the same. In those cases when a different result does occur, a court's recognition of unjust enrichment as an independent legal basis for recovery permits the plaintiff to recover the gain, even if he has not suffered an equivalent loss. Courts that fail to distinguish the difference in the underlying rationale improperly attempt to apply tort limitations to recoveries based on unjust enrichment. The unjust enrichment remedy, which compensates victims of misrepresentations and also deters potential defendants from engaging in fraudulent activity, is particularly suited to the federal securities laws that have both compensatory and deterrent purposes.

This Article traces the unjust enrichment heritage of rule 10b-5 and discusses circumstances in which courts should apply those principles. Part II identifies the sources that courts utilize to deter-

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Under Rule 10b-5, 34 VAND. L. REV. 797, 812-13 (1981).

The American Law Institute's proposed Federal Securities Code adopts a similar approach. FEDERAL SECURITIES CODE §§ 1703, 1708 (Proposed Official Draft 1980). The Code provides for both rescission and damages, but the two remedies usually produce the same mathematical result. Under either remedy the defendant usually bears the risk of any change in the market until a reasonable time after discovery of the fraud. *See id.* § 1708 introductory comment.

mine the defendant's obligation in cases of securities fraud. Part III of this Article considers the available measures of recovery in 10b-5 actions based on tort principles. Part IV discusses remedies based on unjust enrichment/restitution. Finally, this Article in part V outlines the limitations on the availability of the unjust enrichment remedy.[9]

II. Sources of the Defendant's Obligation in Cases of Securities Fraud

Fraud in a securities transaction can create obligations stemming from three separate but overlapping areas of the law. This may be illustrated in a typical simple transaction in which a defendant's misrepresentation of the characteristics of a security induces a plaintiff to purchase the security. First, the falsity of the representations in some situations could constitute a breach of warranty and thus a breach of the contract of sale. A plaintiff could sue for contract damages based on his expectancy, seeking to be put in the position he would have been in had the defendant performed under the contract.[10] Second, the misrepresentation may be a wrong for which tort law will provide a remedy in damages. Recovery under this theory would reflect the general purposes of tort law—compensating plaintiff for any harm caused by the wrong and returning plaintiff to his pretransaction position.[11]

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9. This Article accepts unjust enrichment as an appropriate measure of recovery in fraud cases, but does not seek to compare the various measures of recovery in their effects on economic efficiency, which would be an entirely separate article. The increased application of economic analysis to legal issues that has become widespread in academic legal writing in recent years also has touched this area of the law. *See, e.g.*, Fischel, *Use of Modern Finance Theory*, 38 Bus. Law. 1, 17 (1982); Mather, *Restitution as a Remedy for Breach of Contract: The Case of the Partially Performing Seller*, 92 Yale L.J. 14, 21-28 (1982). Economic theory well may affect the particular kinds of cases in which unjust enrichment is viewed as appropriate, but it should not affect the basic point of this Article, which is that courts should understand the independence of the two bases of obligations underlying rule 10b-5.

10. *See generally* 5 A. Corbin, Contracts § 992 (1964). The limits on a contract action involving a securities purchase are discussed *infra* note 20 and accompanying text. A plaintiff in a breach of contract suit may seek alternatives to damages such as specific performance or rescission. *See* Restatement (Second) of Contracts § 377 comment a (1979). The purpose of contract damages recovery is to put the plaintiff in a position equivalent to where he would have been if the defendant had performed the contract. Hawkins v. McGee, 8 N.H. 114, 117, 146 A. 641, 643 (1929). This Article sometimes refers to the principles that support this remedy as expectancy principles to distinguish them from the unjust enrichment principles that support recoveries labelled restitution.

11. *See* W. Prosser, Law of Torts § 110 (4th ed. 1971); *see also* D. Dobbs, Handbook on the Law of Remedies § 9.2 (1973).

Last, courts recognize that defendant's misrepresentation creates an obligation based upon principles of unjust enrichment, often described under the heading of restitution.[12] Unlike tort principles that look to the harm to the plaintiff, restitution uses the benefit to the defendant as the basis of the obligation, characterizing the benefit obtained through a fraudulent transaction as unjust enrichment.[13]

Fraud cases are confusing because more than one of these three historical bases of obligations may support an award in the same factual situation and may result in the same recovery for the plaintiff. The harm measured by what the plaintiff gave up often equals both the profit the plaintiff expected to make on the contract and the defendant's gain from the transaction, as the following example illustrates: Plaintiff is induced by misrepresentations to pay $10,000 to defendant for securities that would be worth $10,000 if they had the qualities represented by defendant, but in fact lack those qualities and are worthless. In this case plaintiff's loss (the $10,000 cash) equals plaintiff's expectancy (securities worth $10,000) and also defendant's gain ($10,000 cash), so the plaintiff's recovery will be the same, regardless of which theory a court uses.

In some situations, however, the amount of recovery may depend on which theory a court chooses to apply. Plaintiff may have made a good bargain in paying $10,000 for securities that would in fact be worth $15,000 if they had the characteristics represented by defendant. Under a contract measure of damages that sought to provide plaintiff with the benefit of his bargain, plaintiff would receive $15,000. This is $5000 more than he would recover under a tort damages remedy that would give him $10,000 to return him to the position he occupied prior to the transaction. Another difference in the measure of recovery is illustrated when defendant by

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12. The ordinary meaning of restitution does not by itself accurately convey the breadth of this basis of obligation. The dictionary definition suggests restoration to a plaintiff of something plaintiff once had. The law of restitution instead focuses on the unjust enrichment of the defendant, which usually returns plaintiff to his previous position, but sometimes goes further and puts the plaintiff in a better position if necessary to prevent the unjust enrichment of the defendant. The early drafts of the *Restatement of Restitution* were titled *Restatement of Restitution and Unjust Enrichment*; the shortening of the title that occurred after American Law Institute approval did not indicate a departure from the emphasis on unjust enrichment. The tendency of courts, however, to use the dictionary meaning of restitution to limit the body of law has led to much confusion in rule 10b-5 cases. *See infra* part IV.

13. *See generally* 1 G. PALMER, THE LAW OF RESTITUTION § 1.1, at 1 (1978).

misrepresentation induces plaintiff to sell for fifty dollars stock worth sixty dollars and whichdefendant is able to resell for seventy dollars after a rise in the stock market. Plaintiff's loss in tort limited by traditional principles of proximate cause may be only ten dollars while defendant's gain is twenty dollars. The amount of recovery thus depends on which basis of obligation is present in each case.[14]

Rule 10b-5 relies on each of these bases of obligations to varying degrees. The rule is a general antifraud provision that prohibits misrepresentations, omissions, or other fraudulent activity in connection with the purchase or sale of securities. While neither the rule nor the statute from which it comes expressly provides for a private cause of action for persons injured by the prohibited conduct,[15] courts have been willing to imply a private remedy for more than thirty-five years.[16] Today the existence of this implied remedy is "simply beyond peradventure."[17]

Because the rule 10b-5 cause of action is implied, courts have had no express guidance in determining the appropriate measure of recovery for a violation of the rule. Courts have been free to choose one of the three categories of remedy and tailor the measure of recovery to comply with the principles of the selected remedy. Tort concepts have been the dominant theory shaping the measure of recovery, in large part because courts used tort theory as the primary basis for implying the private right of action.[18] Al-

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14. Each of the different bases of obligation may not apply to all misrepresentations. Misrepresentations may exist when there is no contract or defendant has received no benefit, but defendant nevertheless should be responsible for the foreseeable harm caused to plaintiff. If the misrepresentation is innocent, a court may compel a defendant to return what was exchanged in the transaction but not hold the defendant responsible for any additional harm that plaintiff may have suffered because of the misrepresentation.

15. The SEC initially intended to use the rule to seek injunctive action against an insider who purchased stock from shareholders without disclosing certain favorable information. *See* Comments of Milton V. Freeman, Conference on Codification of the Federal Securities Laws, (Nov. 18 & 19, 1966) 22 Bus. Law. 793, 922 (1967).

16. The decision of the federal district court in Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946), was the first to allow the private cause of action.

17. Herman & MacLean v. Huddleston, 103 S. Ct. 683, 687 (1983).

18. Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946), the first case to find an implied right of action under rule 10b-5, relied on the tort principle that "[t]he disregard of the command of a statute is a wrongful act and a tort." *Id.* at 513 (citing Restatement of Torts § 286 (1939)). Other approaches rely on § 29 of the 1934 Securities Exchange Act, 15 U.S.C. § 78cc(b) (1982). *See infra* note 69. The Supreme Court in J.I. Case Co. v. Borak, 377 U.S. 426 (1964), found an implied cause of action under the proxy provisions of the 1934 Act on a general theory that the court may fashion any appropriate remedy for the violation of a federal right. Fifteen years later the Court discounted the tort theory in Touche Ross & Co. v. Redington, 442 U.S. 560 (1979); "[The] argument in favor of

though unjust enrichment principles are evident in a fewer number of rule 10b-5 cases, there has been a steady flow of such cases dating from the earliest rule 10b-5 decisions.[19] The expectation principles of contract law have not provided an independent basis for rule 10b-5 recovery in part because the misrepresentation may not be contained in an express warranty and because the Uniform Commercial Code does not recognize any implied warranties of value for investment securities.[20] These expectation based principles, however, have had a strong indirect influence in shaping the measure of recovery for the tort out of pocket recovery, as discussed in part III. The remainder of this Article therefore focuses on tort principles measuring harm to the plaintiff and unjust enrichment principles measuring gain to the defendant.

III. TRADITIONAL RULE 10b-5 RECOVERY—REMEDIES BASED ON TORT

A. *Out of Pocket Damages*

Out of pocket damages are the usual form of relief available for a rule 10b-5 violation.[21] This measure awards the victim of fraud the difference between the price the victim paid (or the consideration transferred) and the actual value that the victim received in the transaction.[22] The out of pocket measure, borrowed

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implication of a private right of action based on tort principles, therefore, is entirely misplaced." *Id.* at 568. While the Court since *Borak* has followed a stricter standard for implication of a private cause of action, the rule 10b-5 implied claims have survived. The analogy to tort law also continues since many courts consider the implied cause of action to be "essentially a tort claim." *See, e.g.,* Huddleston v. Herman & MacLean, 640 F.2d 534, 555 (5th Cir. 1981), *aff'd in part and rev'd in part,* 103 S. Ct. 683 (1983) (quoting Moody v. Bache & Co., 570 F.2d 523, 527 (5th Cir. 1978)).

19. *See infra* notes 61-101 and accompanying text.

20. *See* U.C.C. §§ 2-105(1), 8-306(2) (1977).

21. *See* L. Loss, *supra* note 3, at 1133-34.

22. Madigan, Inc. v. Goodman, 498 F.2d 233 (7th Cir. 1974); Estate Counseling Service, Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 303 F.2d 527, 533 (10th Cir. 1962); *see also* D. DOBBS, *supra* note 11, § 9.2; W. PROSSER, *supra* note 11, § 110. Courts sometimes use a different phrasing: the difference between the fair value that the victim received and the fair value of what the victim would have received had there been no fraudulent conduct. Affiliated Ute Citizens v. United States, 406 U.S. 128, 155 (1972); Glick v. Campagna, 613 F.2d 31 (3d Cir. 1979); Dupuy v. Dupuy, 551 F.2d 1005, 1024-25 (5th Cir.), *cert. denied,* 434 U.S. 911 (1977). The alternatives theoretically could produce different recoveries but courts have not placed any significance on the difference in wording. The alternative phrasing probably reflects the court's intention to limit plaintiffs' damages to the harm that is proximately related to the fraud. The difference can be illustrated with an example from Dobbs. Plaintiff paid $25,000 for a house that defendant represented to be termite free. The plaintiff made a bad bargain because even termite free the house was worth only $22,000. Because the house had termites, its actual value was only $19,000. If the measure of damages is

from the common-law tort action of deceit, reflects the tort goals of compensating the injured party for harm and returning plaintiff to the position he occupied prior to the fraud.[23] Consistent with causation limits on a tort recovery, the out of pocket recovery measures the actual value on the day of the transaction and excludes any loss that is due to a subsequent decline in the market unrelated to the misrepresentation.[24] This tort approach reflects what courts perceive to be the reality of the securities marketplace—that any investor must assume a risk of fluctuation in stock value.[25] The out of pocket rule prevents a plaintiff from shifting to

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the difference between what the plaintiff received ($19,000) and what he paid ($25,000), plaintiff can collect $6000. If the measure is the difference between what he received ($19,000) and what he would have obtained had the representation been true ($22,000), plaintiff is made "whole" for the fraud but is still stuck with the bad bargain. D. DOBBS, *supra* note 11, § 9.2, at 596.

23. RESTATEMENT (SECOND) OF TORTS § 549(1)(a) and comment 2 (1977). Commentators have called the out of pocket measure a restitutionary remedy because the remedy seeks to restore plaintiff to the position plaintiff occupied before the fraud. *See, e.g.*, D. DOBBS, *supra* note 11, § 9.2. While this terminology is correct in describing the result, *see id.* § 4.1, restitution is a misnomer if used to suggest that the theoretical basis for a remedy is the law of restitution or unjust enrichment. *See supra* note 12. The restitutionary action of returning plaintiff to the *status quo ante* is found in both the law of tort and unjust enrichment but is based on different, sometimes conflicting purposes. Restoring the plaintiff to his prefraud position often quantifies the compensation for the injury as determined under tort principles. *See* RESTATEMENT (SECOND) OF TORTS § 547(1)(a) and comment 3 (1977). The law of unjust enrichment also tends to restore plaintiff to his former position, requiring a defendant to return any benefit obtained by fraud. This restoration to the plaintiff, however, does not exhaust the basis for defendant's obligation under unjust enrichment. A court applying unjust enrichment principles may require the defendant to turn over additional benefit that he acquired by reason of infringement of another's interest, even if the plaintiff's recovery thereby exceeds his injury flowing from the violation. *See infra* part IV. Thus, although an out of pocket recovery shares the restitutionary result of restoring the *status quo ante,* courts should recognize that the remedy is based on tort principles; such recovery may parallel, but does not necessarily exhaust any recovery based on unjust enrichment/ restitution.

24. *See* Sharp v. Coopers & Lybrand, 649 F.2d 175, 190 (3d Cir. 1981) ("Our goal in formulating a damage instruction must be to compensate appellees precisely for the damage directly resulting from appellant's wrongful acts."), *cert. denied,* 455 U.S. 938 (1982); Huddleston v. Herman & MacLean, 640 F.2d 534, 549 (5th Cir. 1981) ("If the investment decision is induced by misstatements or omissions that are material and that were relied on by the claimant, but are not the proximate reason for his pecuniary loss, recovery under the Rule is not permitted."), *aff'd in part and rev'd in part,* 103 S. Ct. 683 (1983).

25. *See* Huddleston v. Herman & MacLean, 640 F.2d at 555 (rescissional measure unfair if it compensates an investor for nonspecific risks that he assumes by entering the market); *see generally* Note, *The Measure of Damages in Rule 10b-5 Cases Involving Actively Traded Securities,* 26 STAN. L. REV. 371, 375-76 (1974) (Stocks that have a fluctuating value are influenced as much by general economic market factors as by factors specific to individual issues. Any rescissionary measure necessarily is speculative and unjust if it compensates an investor for the nonspecific risk that he must assume any time he enters the market.).

Conversely, a post-fraud market change in plaintiff's favor that reduces his cash loss

the defendant this usual market risk.

The usual rule 10b-5 out of pocket award does not include any recovery for what the plaintiff may have gained if the defendant had performed as promised, an objective usually associated with the law of contract. A majority of states, however, have adopted such a "benefit of the bargain" test as the measure of damages for a tort remedy based on deceit.[26] This merging of tort and contract theory results from the nature of a cause of action based on misrepresentation and deceit.

Deceit is an economic tort, resembling contract principles more than tort principles in the interests it seeks to protect.[27] Also, deceit and the traditional common-law warranty action share a common historical ancestry with the common-law writ of trespass on the case.[28] Many courts, because of this factual and historical similarity, believe that recovery under the two claims should be similar. In particular, courts have expressed concern that a defendant who has committed fraud should not be treated better than a defendant who has only breached a contract.[29] A defendant who breaches a contract, even in good faith, must make good the promises in the contract and give the plaintiff the benefit of the plaintiff's expectancy. If defendants who engage in fraudulent conduct must do no more than simply return to the plaintiff the original consideration, there will be less deterrence of fraudulent activity than of innocent contract breaches.[30]

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does not affect a plaintiff's ability to recovery under an out of pocket approach for the full decline due to the fraud. *See* Cant v. A. G. Becker & Co., 379 F. Supp. 972 (N.D. Ill. 1974); Voege v. Ackerman, 364 F. Supp. 72 (S.D.N.Y. 1973).

26. *See* Southern Ice Co. v. Morris, 219 F. 551 (5th Cir. 1915) (construing Georgia law); Tillis v. Smith Sons Lumber Co., 188 Ala. 122, 65 So. 1015 (1914); Waddell v. White, 56 Ariz. 420, 109 P.2d 843 (1940); Otis & Co. v. Grimes, 97 Colo. 219, 48 P.2d 788 (1935); Ford v. Dubiskie & Co., 105 Conn. 572, 136 A. 560 (1927); Nye Odorless Incinerator Corp. v. Fleton, 35 Del. 236, 162 A. 504 (1931); Strickland v. Muir, 198 So. 2d 49 (Fla. Dist. Ct. App. 1967); Chesrown v. Black, 155 Ill. App. 422 (Ill. Ct. App. 1910); Sriver v. Maley, 128 Ind. App. 619, 151 N.E.2d 518 (Ind. Ct. App. 1958); Chellis v. Cole, 116 Me. 283, 101 A. 444 (1917); Roche v. Gryzmish, 277 Mass. 575, 179 N.E. 215 (1931); Whiting v. Price, 172 Mass. 240, 51 N.E. 1084 (1898); Chapman v. Bible, 171 Mich. 663, 137 N.W. 533 (1912); Jeck v. O'Meara, 343 Mo. 559, 122 S.W.2d 897 (1938); Gunderson v. Havana-Clyde Mining Co., 22 N.D. 329, 133 N.W. 554 (1911); Beare v. Wright, 14 N.D. 26, 103 N.W. 632 (1905).

27. *See* D. DOBBS, *supra* note 11, § 9.1; *see also* W. PROSSER, *supra* note 11, § 105.

28. *See* D. DOBBS, *supra* note 11, § 9.1. W. PROSSER, *supra* note 11, § 105.

29. *See, e.g.,* United States v. Ben Grunstein & Sons Co., 137 F. Supp. 197 (D.N.J. 1955); Stout v. Martin, 87 W. Va. 1, 6, 104 S.E. 157, 159 (1920); C. MCCORMICK, DAMAGES § 121 (1935) (a willful fraud should cost as much as a broken promise).

30. *See, e.g.,* United States v. Ben Grunstein & Sons Co., 137 F. Supp. 197 (D.N.J. 1955); Morse v. Hutchins, 102 Mass. 439 (1869); Stout v. Martin, 87 W. Va. 1, 104 S.E. 157 (1920).

Federal courts in rule 10b-5 cases do no follow these common-law precedents except in unusual circumstances.[31] The rejection of the expectation measure is based on a mixture of statutory interpretation, policy considerations, and history. First, courts have interpreted section 28 of the Securities Exchange Act of 1934 (1934 Act)[32] as limiting the available measures of recovery under section 10(b) and rule 10b-5.[33] After stating that the rights and remedies under the 1934 Act are in addition to all rights and remedies then existing at law or in equity, section 28 adds that no person can "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."[34] Many courts read this "actual damages" phrasing to exclude the expected fruits of unrealized expectation,[35] even though respectable contrary authority holds that Congress intended the section only to prevent double recovery on the same facts in two separate actions in federal and state court or to exclude punitive damages.[36]

Second, the federal courts' rejection of the benefit of the bargain measure may also reflect the lingering effects of the pre-*Erie*[37] federal common-law rule of damages, which used the out of pocket measure. Several modern federal securities decisions[38] have cited the Supreme Court's 1889 decision in *Smith v. Bolles* to exclude the use of the benefit of the bargain measure of recovery in rule 10b-5 cases.[39] In *Smith* the Court refused to allow a defrauded

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31. *See, e.g.*, Osofsky v. Zipf, 645 F.2d 107 (2d Cir. 1981); Madigan, Inc. v. Goodman, 498 F.2d 233 (7th Cir. 1974); Levine v. Seilon, Inc., 439 F.2d 328 (2d Cir. 1971); Estate Counseling Service, Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 303 F.2d 527 (10th Cir. 1962).

32. 15 U.S.C. § 78bb (1976).

33. *See, e.g.*, Madigan, Inc. v. Goodman, 498 F.2d 233 (7th Cir. 1974); Levine v. Seilon, Inc., 439 F.2d 328 (2d Cir. 1971); Estate Planning Service, Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 303 F.2d 527 (10th Cir. 1962).

34. 15 U.S.C. § 78bb(a) (1976).

35. *See, e.g.*, Madigan, Inc. v. Goodman, 498 F.2d 233 (7th Cir. 1974); Levine v. Seilon, Inc., 439 F.2d 328 (2d Cir. 1971); Estate Counseling Service, Inc. v. Merrill Lyncb, Pierce, Fenner & Smith, Inc., 303 F.2d 527 (10th Cir. 1962).

36. *See* Osofsky v. Zipf, 645 F.2d 107 (2d Cir. 1981); Jolın R. Lewis, Inc. v. Newman, 446 F.2d 800 (5th Cir. 1971); *see also* 3 L. Loss, Securities Regulation 1624 (2d ed. 1961 & 1969 Supp.).

37. Erie R.R. Co. v. Tompkins, 304 U.S. 64 (1938).

38. *See* Estate Counseling Service, Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 303 F.2d 527 (10th Cir. 1962) (quoting Smith v. Bolles, 132 U.S. 125 (1889)); *see also* Janigan v. Taylor, 344 F.2d 781, 786 (1st Cir.) (quoting Sigafus v. Porter, 179 U.S. 116, 125 (1900)), *cert. denied*, 382 U.S. 879 (1965).

39. 132 U.S. 125 (1889).

purchaser of stock to recover the "expected fruits of an unrealized expectation."[40]

Last, even if not bowing to the precedent of *Smith,* modern courts may continue to share the *Smith* Court's policy concerns. Securities by nature have a fluctuating and more uncertain value than other kinds of property subject to fraudulent transactions. Thus, measuring the value of the securities' expected worth at completion of the unfulfilled contract may be more difficult than determining the value of tangible property and therefore too speculative to be the basis for damages. The Second Circuit recently recognized these policy concerns but *allowed* the use of a benefit of the bargain measure in the limited situation of a tender offer. The court felt that it could establish with reasonable certainty the expectancy damages in the transaction, thus distinguishing the case from the *Smith v. Bolles* preoccupation with speculative damages.[41] The dispute between the contract and tort measures, however, may not be particularly important because consequential damages are available for both measures[42], these damages, when added to the out of pocket or benefit of the bargain amounts, narrow, if not eliminate, any difference between the total recovery under either measure.

B. Consequential Damages

The out of pocket measure does not exhaust the possible damages that measure plaintiff's harm caused by a misrepresentation. The plaintiff may have incurred expenses, such as the cost of investigating the contemplated deal, or subsequent expenditures that the fraudulent transaction forced the plaintiff to make. The plaintiff may recover consequential damages for these costs when they are the proximate result of the misrepresentation.[43] A plaintiff seeking consequential damages for fraud either at common law or

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40. *Id.* at 130.

41. Osofsky v. Zipf, 645 F.2d 107, 114 (2d Cir. 1981) (speculative nature of benefit of bargain in Smith v. Bolles underlay rejection of that measure of damage in contrast to instant case where the amount that actually was to be received could be determined with certainty). Courts have applied the benefit of the bargain rule in a variety of situations. *See, e.g.,* John R. Lewis, Inc. v. Newman, 446 F.2d 800 (5th Cir. 1971); *see also* 5C A. JACOBS, *supra* note 3, at 1155.

42. *See* D. DOBBS, *supra* note 11, at § 9.3.

43. *See* Madigan, Inc. v. Goodman, 498 F.2d 233 (7th Cir. 1974) (consequential damage incurred by plaintiff while trying to avoid insolvency of company purchased from defendant); Bowman & Bourdon, Inc. v. Rohr, 296 F. Supp. 847, 852 (D. Mass.), *aff'd,* 417 F.2d 780 (1969).

under federal securities legislation must establish the causal nexus with substantial certainty.[44]

Courts in some situations include within consequential damages a loss resulting from a general decline in the market following the fraudulent transaction if the plaintiffs can demonstrate that their decision to enter the securities market at all was the "natural, proximate, and foreseeable consequence of defendants' fraud."[45]

C. *The Modified Out of Pocket Measure—A Tort/Restitution Hybrid*

The out of pocket measure requires a court to fix the value of securities at the time of the transaction. Determining the value that a fluctuating intangible had at a prior point in time can be

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44. Foster v. Financial Technology, Inc., 517 F.2d 1068 (9th Cir. 1975); Zeller v. Bogue Elec. Mfg. Corp., 476 F.2d 795 (2d Cir.), *cert. denied,* 414 U.S. 908 (1973); Maryville Academy v. Loeb Rboades & Co., 530 F. Supp. 1061 (N.D. Ill. 1981) (no requisite causal connection); *see also* RESTATEMENT (SECOND) OF TORTS § 549(2) (1977).

45. Garnatz v. Stifel, Nicolaus & Co., 559 F.2d 1357, 1361 (8tb Cir. 1977), *cert. denied,* 435 U.S. 951 (1978); *see also* Chasins v. Smith, Barney & Co., 438 F.2d 1167 (2d Cir. 1970). The court in *Garnatz* held that plaintiff's "express disdain" for speculation would have precluded his participation in a bond margin account program in the absence of the defendant's misrepresentations about the safety of the program. *Garnatz,* 559 F.2d at 1360. The court recognized in a footnote that consequential damages provided one theoretical base for its result, but mentioned rescissionary damages and out of pocket damages with value determined at a post-transaction date as other possible theories and declined to "adopt any one perspective." *Id.* at 1361 n.1. Similarly, the court in *Chasins* rejected the defendant's attempt to limit damages to the out of pocket measure, ruling instead that plaintiff's recovery of the entire difference between the purchase price and subsequent resale price was "justified where . . . the evil is not the price at which [plaintiff] bought but the fact of being induced to buy and invest for some future growth in these stocks without disclosure of [defendant's] interest . . . ." *Chasins,* 438 F.2d at 1173.

While some commentators explain both *Garnatz* and *Chasins* in terms of consequential damages principles, *see* D. DOBBS, *supra* note 11, at § 9.3, others use "rescissory measure of damages" or "gross economic harm" to define the recovery, illustrating the overlap of theories that often characterizes descriptions of damages in rule 10b-5 cases. *Compare* Cobine, *supra* note 4, at 673 (a special form of rescissory damages) *with* A. JACOBS, *supra* note 3, at 1150 n.15 (*Chasins* as a mirror image to cover). *See* Recent Development, *supra* note 8, at 805 n.55 (in practice the distinction between *Chasins* and rescission is "more theoretical than real"). Some commentators have criticized the *Chasins* decision for disregarding causation principles. *See* Mullaney, *Theories of Measuring Damages in Security Cases and the Effect of Damage on Liability,* 46 FORDHAM L. REV. 277, 288 (1977); Note, *Rule 10b-5 Damages: The Runaway Development of a Common Law Remedy,* 28 U. FLA. L. REV. 76, 85 n.83 (1975); Comment, *supra* note 25, at 374 (criticizes unworkability of exploring the subjective determination of the plaintiff investors, particularly in a class action setting). This criticism has some merit if the *Chasins* recovery is based on tort principles, but does not apply necessarily to recovery based on unjust enrichment where recovery can exceed the plaintiff's loss if necessary to prevent a defendant from benefiting as a result of fraudulent conduct. The legal causation limits on unjust enrichment, which differ from such limits on tort recovery, are discussed *infra* text accompanying notes 140-49.

more difficult than ascertaining the value of a house or a hoat.[46] The problem is particularly acute when the transaction concerns a closely held corporation whose shares have no ready market or when the fraud is so widespread that the market price of a widely traded stock does not reflect its actual value at the time of the transaction. In these situations, courts have modified the out of pocket recovery by measuring the value of the intangible securities at a more easily ascertainable date after the fraudulent transaction. Courts have used either the date of public discovery of the fraud[47] or the date that the plaintiff discovered or should have discovered the fraud.[48]

The difference between the transaction price and the fair value at some later time does not necessarily equal the amount of the harm caused by the misrepresentation. The price on the subsequent date may be influenced by many things separate from the discovery of the fraud, such as a general decline in the market. Recovery based on the subsequent dates thus may allow plaintiffs to recovery for harm not related to the fraud.[49] One federal district court criticized the use of the modified out of pocket measure because

> it completely disregards the many other factors which influence price fluctuation over time of stocks in general or of a particular stock. It therefore has the potential of creating a windfall recovery to a plaintiff in the nature of indemnification against the risks of the vicissitudes of the market, and at the same time saddling defendants with payments far out of proportion to the damage caused by their fraud.[50]

The cases that allow the use of the subsequent date provide a variety of reasons—and sometimes no reason—for transferring the risk of the subsequent market change to the defendant. The court in some cases simply may accept the subsequent date as good evidence of what the stock was worth at the earlier time. For exam-

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46. *See* Shulman, *Civil Liability and the Securities Act,* 43 YALE L.J. 227, 229-30 (1933).

47. *See* Harris v. American Inv. Co., 523 F.2d 220, 226 (8th Cir. 1975), *cert. denied,* 423 U.S. 1054 (1976).

48. *See* Richardson v. MacArthur, 451 F.2d 35, 43-44 (10th Cir. 1971); Esplin v. Hirschi, 402 F.2d 94, 104-05 (10th Cir. 1968), *cert. denied,* 394 U.S. 928 (1969).

49. *See, e.g.,* Crane, *An Analysis of Causation Under Rule 10b-5,* 9 SEC. REG. L.J. 99, 132 (1981); Note, *Federal Regulation of Securities: Some Problems of Civil Liability,* 48 HARV. L. REV. 107, 116 (1934) (urges causation approach to § 12 of 1933 Act to eliminate plaintiff's opportunity for speculation).

50. Bonime v. Doyle, 416 F. Supp. 1372, 1384 (S.D.N.Y. 1976), *aff'd,* 556 F.2d 554 (2d Cir. 1977), *cert. denied,* 431 U.S. 924 (1977); *see also* Sharp v. Coopers & Lybrand, 649 F.2d 175, 190 (3d Cir. 1981).

ple, one court seeking to determine the value of the stock of a closely held corporation used a sale two weeks after the fraudulent transaction as the best evidence of the value of the stock given the absence of a ready market.[51]

Apart from the "best evidence" cases, courts deal with the causal connection between the misrepresentation and the subsequent change in price in three different ways. First, some decisions provide specific causation findings to support the use of a date subsequent to the transaction. In these cases the jury decided that the plaintiff/seller would have held the stock and could have obtained the subsequent rise in price in the absence of the misrepresentation. Thus, even though plaintiff recovered for subsequent changes in the market, that recovery measured the harm that was causally related to defendant's rule 10b-5 violation.[52] Second, some courts use causation principles to explain why the plaintiff cannot use a date beyond a reasonable time after the discovery of the fraud.[53] In these cases the plaintiff's opportunity to reinvest or "cover" after the discovery of the fraud triggers a second investment decision by the injured party that breaks the causal connection to further damages from any subsequent change in the market. When this situation occurs, the causal basis for excluding any loss after the second investment decision is obvious—plaintiff's decision is said to have been a sufficient intervening cause. Less obvious is the basis for the court's assumption that the entire price decline between the dates of the fraud and the intervening cause is attributable to the fraud.[54] While courts may be assuming what the

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51. *See* Ross v. Licht, 263 F. Supp. 395, 410 (S.D.N.Y. 1967). The plaintiff complained that the defendant induced him to sell the shares for too low a price. The court believed that the subsequent price could not be significantly in excess of the true value because the corporation sold to friends and relatives of the insiders. The court, however, did not recognize that the price might have been too low because the corporation went public eight months later at a much higher price. *See also* Elkind v. Liggett & Meyers, 472 F. Supp. 123 (S.D.N.Y. 1978), *aff'd in part and rev'd in part,* 653 F.2d 156 (2nd Cir. 1980); Sarlie v. E.L. Bruce Co., 265 F. Supp. 371, 376 (S.D.N.Y. 1967) (the court could support the use of a later date because the defendant's noncompliance with discovery prevented the plaintiff from accurately determining the results of the fraud).

52. Dupuy v. Dupuy, 551 F.2d 1005, 1024-25 (5th Cir. 1977), *cert. denied,* 434 U.S. 911 (1977); Myzel v. Field 386 F.2d 718, 744-45 n.23 (8th Cir.), *cert. denied,* 390 U.S. 951 (1968).

53. *See* Arrington v. Merrill Lynch, Pierce, Fenner & Smith Inc., 651 F.2d 615 (9th Cir. 1981); Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90, 105 (10th Cir. 1971) (recovery was "the amount it would have taken [plaintiff] to invest in the *TGS* market within a reasonable period of time after he became informed of the [corrective press] release"), *cert. denied,* 404 U.S. 1004 (1971), *reh'g denied,* 405 U.S. 918 (1972).

54. The court in *Arrington* approved a measure of damages to compensate the plaintiffs for the difference between their actual financial position on the day they discovered the

jury found in the previous cases—that a defrauded seller would have kept the stock but for the fraud and would have sold at the highest price after the discovery of the fraud[55]—neither the commentary nor the cases articulate a basis for this proposition.

Last, some courts use a subsequent date and make no reference to a causal link between the violation and the value on the subsequent date used to measure damages.[56] The courts state only that the disclosure date is the first date that the market value reflects the true value unaffected by the fraud.[57] These courts do not attempt to justify their implicit holding that the entire decline in price until the day of discovery is caused by the fraud. One of these cases, however, suggests an alternative rationale with overtones of restitution that does not require the same causal connection. In *Esplin v. Hirschi* the court reasoned that the discovery date was the first date that a plaintiff was in a position to seek redress either through rescission of the contract or an action for

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fraud and had to sell their stock at a loss, and the position they would have been in on that day if no fraud had occurred. The court noted that the loss arose because the defendant broker did not disclose the multiplier effect of margin accounts in a declining market and implied that the subsequent declines that occurred before the day of discovery were tbe consequential result of violation. *Arrington,* 651 F.2d at 621; *see also* Nye v. Blyth, Eastman, Dillon & Co., 588 F.2d 1189 (8th Cir. 1978); Richardson v. MacArthur, 451 F.2d 35 (10th Cir. 1971). In *Mitchell,* only four days elapsed between the misleading press release and the corrective announcement that triggered the "cover" obligation. *See Mitchell,* 446 F.2d at 96. The court may have assumed that the new mineral discovery and not changes in the market caused the entire change in price during that short period. Some writers have described the result in *Mitchell* as an essentially rescissory remedy with a reinvestment obligation. *See* Comment, *supra* note 25, at 379; *see also* SEC v. MacDonald, 699 F.2d 47 (1st Cir. 1983); Elkind v. Liggett & Meyers, Inc., 653 F.2d 156, 168 n.25 (2d Cir. 1980) (describing *Mitchell* as modified rescissory). In *Mitchell,* however, no contract on which the parties could base rescission existed and defendant received no benefit that would justify a recovery based on unjust enrichment. "Rescissory" may describe the *Mitchell* result, but the term does not explain adequately the rationale, which has no substantive connection to rescission. *See supra* notes 111-19 and accompanying text. The result, which the court described as one patterned for the particular case, appears to be based on tort. *See Mitchell,* 446 F.2d at 105.

Section 927 of the *Restatement (Second) of Torts* suggests another possible rationale in its use of damages measured by the highest intermediate value after the fraud. The comment accompanying § 927 states that the highest intermediate value rule is needed to prevent the defendant from realizing speculative possibilities on a rise in the market without compensation to the plaintiff who is deprived of those possibilities. RESTATEMENT (SECOND) OF TORTS § 927 comment e (1977). The deterrent purpose may replace a specific focus on actual gain realized or on a causal connection hetween the violation and plaintiff's loss.

55. *See* Recent Development, *supra* note 8, at 803-04.

56. *See* Harris v. American Inv. Co., 523 F.2d 220, 226 (8th Cir. 1975), *cert. denied,* 423 U.S. 1054 (1976); Esplin v. Hirschi, 402 F.2d 94, 104 (10th Cir. 1968), *cert. denied,* 394 U.S. 928 (1969).

57. *See* Esplin v. Hirschi, 402 F.2d 94 (10th Cir. 1968).

damages; until the date he discovers the fraud, plaintiff has the right to rely on defendant's misrepresentations, placing on the defendant the risk of downward fluctuation during that period.[58] A similar logic finds that the seller's obligation to accept the burden of any loss of value between the date of sale and the disclosure date is rooted in the contract of sale,[59] obligating the seller to take back the risks he would have borne but for the wrongful sale.[60] The latter argument, however, is based on the existence of a contract that gives an innocent party the right to disaffirm the transaction and require defendant to return any benefit received. The cases using the modified out of pocket remedy do not always concern a direct transaction between plaintiff and defendant that would establish the contract normally required for the rescission. Courts in these cases tend to combine the independent theoretical justifications of tort and unjust enrichment without developing the necessary ties to either.

IV. Remedies Based on Unjust Enrichment

A. Rescission as an Alternative to Out of Pocket Damages

While the out of pocket measure is the usual standard for recovery in a rule 10b-5 action, most courts recognize that a plaintiff instead may choose rescission or a money judgment that is the financial equivalent of rescission.[61] The alternative reflects the

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58. *See id.* at 104. The court thus partially equates recovery under tort damages with recovery under rescission even though the plaintiff did not seek rescission. The Federal Securities Code reflects the *Esplin* approach. *See supra* note 8.

Esplin, however, also has elements that suggest a traditional tort causation basis for its rationale. The court stated that the rule is applicable in situations where the purchaser acquires the securities for investment purposes and intends to retain them for a reasonable time. This emphasis appears to be based on the famous New York case of Hotaling v. A. B. Leach & Co., 247 N.Y. 84, 159 N.E. 870 (1928), in which the New York Court of Appeals moved away from the strict out of pocket rule of Reno v. Bull, 226 N.Y. 546, 124 N.E. 144 (1919), and held that when the defendant knew that the plaintiff purchased the bonds for investment and when the misrepresentations went to the financial security of the bonds, the misrepresentations proximately caused the plaintiff's losses from a decline in the market.

59. *See* Green v. Occidental Petroleum Corp., 541 F.2d 1335, 1343 (9th Cir. 1976) (Sneed, J., concurring).

60. *See id.*; *see also* Citizens Nat'l Bank v. Pigford, 166 So. 749 (Miss. 1936) (Until plaintiff discovered the fraud he had a right to rely on defendant's misrepresentation that certain surety companies had secured the bonds. The court imposed on defendant all the risks of downside fluctuation in the market value until that time.), *cert. denied,* 299 U.S. 564 (1936).

61. *See, e.g.,* Abrahamson v. Fleschner, 392 F. Supp. 740 (S.D.N.Y. 1975), *aff'd in part and rev'd in part,* 568 F.2d 862 (2d Cir. 1977), *cert. denied,* 436 U.S. 913 (1978). Some courts state that rescission and restitution is the usual remedy in a rule 10b-5 case. *See*

traditional choice of a nonbreaching party to a contract: either disaffirm a breached contract and require the defendant to return any benefit obtained through the contract or affirm the contract and sue for damages.[62] Courts provided a similar rescission remedy to the victim of a tortious misrepresentation. A party injured by common-law fraud sought the restitutionary relief by filing a "bill for rescission and restitution,"[63] a term that remains in use today. Rescission and restitution in this context means simply that the defendant's tort or contract breach entitles the plaintiff to cease performance under the contract if a contract exists and seek restitutionary relief as an alternative to contract or tort damages. The restitution remedy then requires the defendant to restore the property that he obtained by fraud. Rescission and restitution thus implements the predominate goal of the law of restitution: to prevent unjust enrichment of a person who receives a benefit by the infringement of another person's interest or by another's loss.[64]

John R. Lewis, Inc. v. Newman, 446 F.2d 800, 805 (5th Cir. 1971); *see also* Nelson v. Serwold, 576 F.2d 1332, 1338 (9th Cir. 1978), *cert. denied,* 439 U.S. 970, *appealed,* 687 F.2d 278 (9th Cir. 1982) (the recent trend is to look to defendant's profits rather than to plaintiff's loss in measuring damage); Ohio Drill & Tool Co. v. Johnson, 498 F.2d 186 (6th Cir. 1974), *appealed,* 625 F.2d 738 (6th Cir. 1980). A more accurate statement is that, although rescission and restitution is a remedy, other remedies are available. At the other extreme, some courts have suggested that the plaintiff cannot obtain rescission if he can receive damages; this clearly is not an accurate statement of the law. *See* Gilbert v. Meyer, 362 F. Supp. 168 (S.D.N.Y. 1973); 1 G. PALMER, *supra* note 13, at § 3.12.

62. *See* 1 G. PALMER, *supra* note 13, at §§ 3.1, 3.3. One judge has suggested that the defendant is under an obligation imposed by contract "to accept the return of the risk he wrongfully sbifted. . . ." Green v. Occidental Petroleum Corp., 541 F.2d 1335, 1343 (9th Cir. 1976) (Sneed, J., concurring). *See* Marr v. Tumulty, 256 N.Y. 15, 175 N.E. 356 (1931) (Once fraud is shown, plaintiff can force defendant to take back what he transferred; the right is not dependent on plaintiff returning securities whose market value equaled the market value at the time of the transaction). While the obligation that justifies transferring the market risk may spring from the contract, it does not reflect the expectancy goal of contract remedies. Instead, plaintiff's historical right to choose the rescission and restitution remedy reflects the principles of unjust enrichment. *See* J. POMEROY, EQUITY JURISPRUDENCE § 873 (5th ed. 1941). *But see* Shulman, *supra* note 46, at 244 (the difference at common law between buyer's action for rescission and damages is historical, not based on logic or principle).

63. *See* 5 A. CORBIN, *supra* note 10, at § 1102. Both Corbin and Palmer criticize as unhelpful the use of the term rescission. Courts of equity usually granted the rescission and restitution remedy since law courts were slower to recognize fraud in the inducement. *See* 1 G. PALMER, *supra* note 13, at §§ 3.1-3.7. Law courts sometimes gave similar restitution-based recovery in quasi-contract. *Id.*

64. *See* RESTATEMENT (SECOND) OF RESTITUTION § 1 (Tent. Draft No. 1, 1983); *see also* J. POMEROY, *supra* note 62, at § 873. "[T]he jurisdiction of chancery . . . embraced all those cases where a party, although still keeping within the limits of the strict law . . . had committed some unconscientious act or breach of good faith, and had thereby obtained an undue advantage over another, which advantage, . . . equity would not suffer him retain. *Id.*;

The result is the same as that sought in tort law—returning plaintiff as nearly as possible to his position prior to the tort—but the similarity between the ultimate objectives of tort and unjust enrichment should not obscure the fundamental difference in approach between the two sources of obligations. Unjust enrichment looks to the defendant's gain as the basis of the obligation and the measure of recovery, while tort law looks to plaintiff's injury and awards damages based on the harm to the plaintiff. The difference is illustrated by those cases in which the court permitted rescission and restitution even absent a showing that defendant's misrepresentation caused the plaintiff's pecuniary harm—a showing required for tort damages.[65] Similarly, defendant's intent to defraud is not a prerequisite to recovery based on rescission, even though it is required for a recovery in deceit. Courts can require a defendant who made an innocent misrepresentation to return the consideration received in the transaction.[66]

When 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 pursuing an action for damages.[67] This result is consistent with the common-law fraud precedent and also with the Supreme Court's general approach to securities law remedies that "federal courts may use any available

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see generally D. DOBBS, *supra* note 11, § 9.3 (rescission is contrasted to damages; emphasis is on the inequity of allowing a party to keep benefits caused by his own misstatement); G. PALMER, *supra* note 13, § 3.1 230 (rescission of a contract for fraud in inducement is part of the law of restitution, which generally is concerned with giving relief for unjust enrichment). Rescission was granted primarily by courts of equity, but occasionally by courts of law. With the merger of law and equity, this distinction today primarily concerns a defendant's right to a jury trial. Courts have struggled with whether juries can award rescissory damages. *See* Myzel v. Fields, 386 F.2d 718, 742 n.17 (8th Cir. 1967), *cert. denied,* 390 U.S. 951 (1968); Johns Hopkins Univ. v. Hutton, 343 F. Supp. 245, 251 (D. Md. 1972), *rev'd,* 488 F.2d 912 (4th Cir. 1973), *cert. denied,* 416 U.S. 916 (1974).

65. *See* Stillwell v. Rankin, 55 Mont. 130, 134, 174 P. 186, 187 (1918); *accord* Barrons v. Myers, 109 N.W. 862 (Mich. 1906); *see also* Shulman, *supra* note 46, at 250.

66. *See* Seneca Wire & Mfg. Co. v. A. B. Leach & Co., 247 N.Y. 1, 159 N.E. 700 (1928). Recovery for innocent misrepresentation is comparable to recovery for mutual mistake in the formation of a contract. "If rescission . . ., followed by restitution of each party, is justified in simple cases of mutual mistake, it is equally justified in cases where there is a mutual mistake and one of the parties innocently verbalizes that mistake." D. DOBBS, *supra* note 11, § 9.2, at 609; *see also* 1 G. PALMER, *supra* note 13, at § 3.1.

67. *See, e.g.,* Blackie v. Barrack, 524 F.2d 891, 909 (9th Cir. 1975), *cert. denied,* 429 U.S. 816 (1976); Crist v. United Underwriters, Ltd., 343 F.2d 902 (10th Cir. 1965); Errion v. Connell, 236 F.2d 447 (9th Cir. 1956); Johns Hopkins Univ. v. Hutton, 326 F. Supp. 250, 262 (D. Md. 1971), *aff'd in part and rev'd in part,* 488 F.2d 912 (4th Cir. 1973), *cert. denied,* 416 U.S. 916 (1974).

remedy to make good the wrong done."[68] In addition, section 29 of the 1934 Act[69] provides specific statutory authorization for rescission of any contract made in violation of the Act.[70] Alternatively, some courts interpreted the "actual damages" provision of section 28 of the 1934 Act to allow defrauded parties a choice of rescission or profits on resale instead of out of pocket damages.[71]

When 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.[72] One of the earliest rule 10b-5 cases, *Speed v. Transamerica Corp.*,[73] reflects such a rescissory measure of damages based on unjust enrichment principles. In *Speed*, defendant insiders induced plaintiffs to sell their stock at a price that did not reflect unrealized appreciation of the company's main asset, which the insiders intended to liquidate. The court refused to use the defendant's proposed out of pocket measure and instead chose a rescissory remedy to prevent defendants from keeping the benefits obtained by fraud.[74] Rescissory recovery in these circumstances relieves the plaintiff of the obligation to prove damages with the particularity mandated in a tort action seeking damages. For example, in *Holdsworth v. Strong*[75] the court permitted a rescissory measure of recovery upon the plaintiff's showing merely that the defendant received a benefit by inducing plaintiff to relinquish participation

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68. J.I. Case Co. v. Borak, 377 U.S. 426, 433 (1964) (quoting Bell v. Hood, 327 U.S. 678, 684 (1946)).

69. 15 U.S.C. § 78cc(b) (1982). Section 29 provides that

> [e]very contract made in violation of any provision of this chapter or of any rule (including any contract for listing a security on an exchange) heretofore or hereafter made, the performance of which involves the violation of, or the continuance of any relationship or practice in violation of, any provision of this chapter or any rule or regulation thereunder, shall be void . . . .

70. Courts have interpreted § 29 to mean that these contracts are voidable at the option of the innocent party. *See, e.g.*, Eastside Church of Christ v. National Plan, Inc., 391 F.2d 357 (5th Cir.), *cert. denied*, 393 U.S. 913 (1968).

71. Abrahamson v. Fleschner, 392 F. Supp. 740, 746 (S.D.N.Y. 1975), *aff'd in part and rev'd in part*, 568 F.2d 862 (2d Cir. 1977), *cert. denied*, 436 U.S. 913 (1978).

72. *See, e.g.*, Poole v. Camden, 79 W. Va. 310, 314, 92 S.E. 454, 455 (1916) (defendant ordered to pay plaintiff the value of any shares that defendant could not restore).

73. 135 F. Supp. 176 (D. Del. 1955), *aff'd*, 235 F.2d 369 (3d Cir. 1956).

74. *Id.* at 186. The district court refused to adopt defendant's out of pocket measure of damages stating that the perpetrator of fraud must disgorge the gains made at the expense of injured shareholders. *See also* A. JACOBS, *supra* note 3, at 11-72 (the basis for rescissory damages is the unjust enrichment that plaintiff bestowed on defendant).

75. 545 F.2d 687, 697 (10th Cir. 1976), *cert. denied*, 430 U.S. 955 (1977).

in a profitable enterprise.

When a plaintiff chooses the rescission and restitution remedy, he tenders to the defendant that which he received and the defendant returns the consideration received from the plaintiff. Rescission thus has an obvious advantage over out of pocket recovery because it permits a plaintiff to shift the risk of a declining market to the defendant. Consider the following hypothetical: Defendant misrepresents that certain stock possesses qualities that make it worth $10 more per share than it would be worth without those qualities and plaintiff purchases the stock, relying on the misrepresentation. After discovering the fraud, plaintiff will want to recover for the amount attributable to the fraud and can do so under an out of pocket measure. If, however, plaintiff discovers the fraud after world events have driven down the price of all stocks, the plaintiff can choose to unwind the sale, return the depreciated stock, and receive back undepreciated cash, recovering not only the loss caused by the misrepresentation, but also the loss caused by the decline in the market.[76] Judges and writers recognize that litigants will choose between rescission or damages based on whether the market has risen or fallen since the transaction.[77]

The concern that rescission will redistribute market risks that have nothing to do with the fraud has influenced courts in securities cases to adopt the restrictions on rescission developed by equity courts, particularly the requirement that plaintiffs file suits for rescission promptly after notice of the fraud.[78] Courts show particular concern that plaintiffs not be permitted to delay a choice of the rescission remedy while speculating on the fluctuating

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76. *See, e.g.*, Doyle v. Union Bank & Trust Co., 59 P.2d 1171 (Mont. 1936); Beare v. Wright, 14 N.D. 26, 33, 103 N.W. 632, 634 (1905) ("he could have escaped all the consequences of a bad speculation [not only those due to fraud] by withdrawing from it by rescission"); Poole v. Camden, 79 W. Va. 310, 92 S.E. 454 (1916); *see generally* 1 G. PALMER, *supra* note 13, at § 3.8 ("[o]ne of the most striking differences between restitution and the damage action"). *But see* Note, *supra* note 25, at 375-76 (1974) (any rescissory measure of damages necessarily is speculative and unjust if it compensates an investor for the nonspecific risk that he must assume any time that he enters the market).

77. *See, e.g.*, Estate Counseling Service, Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 303 F.2d 527, 532 (10th Cir. 1962) (advantageous for plaintiff to claim rescission if loss was imminent or to disclaim rescission if profit was apparent; prompt election required); L. Loss, *supra* note 3, at 1133; *see also* A. JACOBS, *supra* note 3, at 11-69; 1 G. PALMER, *supra* note 13, at § 3.8.

78. *See, e.g.*, Baumel v. Rosen, 412 F.2d 571, 574 (4th Cir. 1969) (rescission barred because plaintiff waited 18 months), *cert. denied*, 396 U.S. 1037 (1970); Hickman v. Groesbeck, 389 F. Supp. 769 (D. Utah 1974); Maginess v. Western Sec. Corp., 38 Cal. App. 56, 175 P. 277 (1918); *see also* 12A C.J.S. *Cancellation of Instruments: Rescission* § 68 (1980).

value of the property in question.[79]

B. *The Windfall Profits Cases—Measuring the Defendant's Gain*

The "windfall profits" cases, in which a defrauded seller of stock recovers profits made by defendants on a subsequent resale of the fraudulently acquired property, provide another example of recovery based on unjust enrichment principles. The First Circuit Court of Appeals in 1965 decided the best-known windfall profits case, *Janigan v. Taylor*.[80] The *Janigan* plaintiffs were a class of individuals who sold their stock to the corporation's president for approximately $40,000; less than two years later, the defendant sold the stock for $700,000. The court approved a recovery of defendant's net profit from the resale.[81]

Janigan clearly reflects the court's reliance on an unjust enrichment rationale, rather than on liability measured by plaintiff's harm. The court acknowledged that out of pocket and consequent-

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79. *See, e.g.*, Johns Hopkins Univ. v. Hutton, 326 F. Supp. 250, 262-63 (D. Md. 1971) (plaintiff must not delay filing, particularly if by delaying, he desires to engage in, or actually does engage in, speculation), *aff'd in part and rev'd in part*, 488 F.2d 912 (4th Cir. 1973), *cert. denied*, 416 U.S. 916 (1974).

Courts have applied the Supreme Court's concern over oil wells expressed in Twin-Lick Oil Co. v. Marbury, 91 U.S. 587 (1875), to securities:

> Property worth thousands today is worth nothing to-morrow . . . . The injustice, therefore, is obvious, of permitting one holding the right to assert an ownership in such property to voluntarily await the event, and then decide, when the danger which is over has been at the risk of another, to come in and share the profit.

Id. at 592-93, *quoted in* Baumel v. Rosen, 412 F.2d 571, 574-75 (4th Cir. 1969). Courts interpret the securities law as intended to protect innocent investors, not those who seek to speculate at a defendant's expense. *See* Myzel v. Fields, 386 F.2d 718, 741 n.15 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968); Royal Air Properties, Inc. v. Smitb, 312 F.2d 210, 213-14 (9th Cir. 1962).

80. 344 F.2d 781 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965).

81. *Id.* at 783, 787. The appellate court required the trial court to modify the award to permit defendant an allowance for a 10% bonus of the company's net pre-tax profits under a procedure that predated the fraud unless plaintiff could show that there would have been a change in this compensation. *Id.* at 787.

The Supreme Court approved *Janigan* in Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972). The Court referred to the unjust enrichment recovery as "damages." *Id.* at 155. Restitution often leads to a money award, but it is distinct from damages. *See* 1 G. PALMER, *supra* noto 13, at § 3.1. Courts frequently blur this distinction. *See, e.g.*, Burgess v. Premier Corp., 727 F.2d 826, 837 (9th Cir. 1984). Lower courts have extended *Janigan* to include defrauded purchasers as well. *See, e.g.*, Zeller v. Bogue Elec. Mfg. Corp., 476 F.2d 795, 801-02 (2d Cir.) (The thrust of the rationale in *Janigan* and *Ute* does not preclude windfall profits to purchasers. The difficulty of showing that the fraudulent seller received the gain may prevent courts from applying the rationale.), *cert. denied*, 414 U.S. 908 (1973); *see also* Hackbart v. Hohnes, 675 F.2d 1114, 1122 (10th Cir. 1982).

ial damages rules, which courts usually apply in defrauded buyer cases, did not cover the expected fruit of unrealized expectations.[82] The court, however, recognized that defrauded seller cases are different because "future accretions not foreseeable at the time of the transfer even on the true facts, and hence speculative, are subject to another factor, viz., that they accrued to the fraudulent party."[83] The other factor to which the court referred is the unjust enrichment of the defendant, which equity requires the wrongdoer to disgorge.[84]

Recovery in restitution is based on unjust enrichment, measured by the benefit received "by reason of an infringement of another person's interest, or of loss suffered by the other."[85] Unjust enrichment does not require that plaintiff prove *losses* that were causally related to the violation,[86] but rather looks to defendant's gain derived from the fraud.[87] Unjust enrichment also does not require that defendant's gain equal plaintiff's loss in the transaction; if the gain is more, the plaintiff may recover that amount.[88] *Janigan* supports the windfall for plaintiffs because "[i]t is more appropriate to give the defrauded party the benefit even of windfalls than to let the fraudulent party keep them."[89] This preference reflects a deterrent element that often accompanies a compensatory

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82. Janigan v. Taylor, 344 F.2d 781, 786 (1st Cir. 1965).

83. *Id.*

84. *Id.*; *see also* Nelson v. Serwold, 576 F.2d 1332, 1339 (9th Cir.), *cert. denied*, 439 U.S. 970 (1978).

85. RESTATEMENT (SECOND) OF RESTITUTION § 1 (Tent. Draft No. 1, 1983); *see* 1 G. PALMER, *supra* note 13, at § 3.8 (necessary that there be some injury but it need not be measured in money).

86. *See* 3 & 6 L. LOSS, SECURITIES REGULATION 1627, 3883 (1961 & Supp. 1969); 1 G. PALMER, *supra* note 13, at § 3.8.

87. *See infra* text accompanying notes 94-101.

88. *See, e.g.*, Federal Sugar Ref. Co. v. United States Equalization Bd., 268 F. 575 (S.D.N.Y. 1920) (defendant wrongfully interfered with plaintiff's contract and took plaintiff's place as a supplier to a third party; plaintiff permitted to sue for defendant's profits awarded even though plaintiff would bave lost money had it.been able to carry out the contract); Raven Red Ash Coal Co. v. Ball, 185 Va. 534, 39 S.E.2d 231 (1946) (no economic loss to plaintiff but court allowed him to recover defendant's benefit); *see also* 1 G. PALMER, *supra* note 13, at §§ 2.6, 2.10; RESTATEMENT (SECOND) OF RESTITUTION § 1 (Tent. Draft No. 1, 1983).

89. *Janigan* 344 F.2d at 786; *see also* Rude v. Cambell Square, Inc., 411 F. Supp. 1040, 1050 (D.S.D. 1976). *Janigan*, is very similar to a famous equity case decided 40 years earlier. Judge Cardozo wrote an opinion for the New York Court of Appeals allowing a defrauded seller of corporate stock to recover not merely the difference between value and the amount paid by the defendant, but the price on resale if that was greater than the value. Falk v. Hoffman, 233 N.Y. 199, 135 N.E. 243 (1922).

result in recoveries based on unjust enrichment.[90] The two-pronged purpose is consistent with the federal securities laws, which courts long have recognized as designed to both compensate and deter.[91] While some courts and defendants have termed punitive any recovery based on unjust enrichment,[92] other courts have recognized appropriately that there is no "harshness in a remedy which takes from a fraudulent actor what was generated by his conduct."[93]

Limits to recovery based on unjust enrichment do exist, of course, but courts determine these limits primarily by the relationship of the defendant's gain to the fraud, not the relationship of plaintiff's loss to the violation. The *Janigan* court recognized that a court would not require a defendant to return any extraordinary gains attributable to his personal efforts that were unconnected to the fraud.[94] The court provided a now-famous illustration of this exception to the recovery of windfall profits: "If an artist acquired paints by fraud and used them in producing a valuable portrait we would not suggest that the defrauded party would be entitled to the portrait, or to the proceeds of its sale."[95] On the particular facts of *Janigan* the court found that defendant's efforts did not fall within this exception. Defendant testified that following the acquisition of the stock, he acted no differently and worked no harder than he had before the acquisition. He also stated that the company's financial recovery resulted from price rises, increased efficiency, and an improvement in the business cycle primarily affecting the company's customers.[96] The *Janigan* court appeared to require some extraordinary effort or talent on the part of the defendant to preclude unjust enrichment recovery.

Subsequent cases confirm the difficulty of coming within the

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90. Although both compensatory and deterrent purposes are evident, unjust enrichment recovery does not promote either fully. Full compensation may require more than the return of the benefit the defendant received by virtue of the harm. *See supra* note 81. Maximum deterrence may require that defendant give back more than the amount taken. *See infra* note 205 and accompanying text.

91. *See, e.g.,* Nelson v. Serwold, 576 F.2d 1332, 1339 (9th Cir. 1978) ("To allow violators of the Act to profit by their misconduct would undermine the deterrence that the Act was intended to effect."), *cert. denied,* 439 U.S. 970 (1978).

92. *See, e.g.,* Glick v. Campagna, 613 F.2d 31, 37 (3d Cir. 1979).

93. Nelson v. Serwold, 576 F.2d 1332, 1339 (9th Cir. 1978), *cert. denied,* 439 U.S. 970 (1978); *see also* Jones, *The Recovery of Benefits Gained from a Breach of Contract,* 99 L. Q. Rev. 443, 456 (1983) ("Moreover, to be deprived of what you have gained can never be a penal liability . . . .").

94. *Janigan,* 344 F.2d at 787.

95. *Id.*

96. *Id.*

Janigan exception. *Rochez Brothers, Inc. v. Rhoades*[97] concerned a corporation with two equal owners who disagreed about how to run the corporation. The trial court characterized the defendant purchaser (Rhoades) an an aggressive entrepreneur and the plaintiff seller (Rochez) as a more cautious investor who was not inclined to take risks. Rhoades purchased Rochez' stock and nine months later sold the entire company at a substantial profit.[98] The court found that much of the increased resale value neither existed nor could have existed while Rochez was half-owner, in part because plaintiff's caution would have prevented the company from taking advantage of certain financial opportunities.[99] Nevertheless, the Third Circuit Court of Appeals refused to allow any reduction under the *Janigan* exception.[100] It would not permit defendant to retain any value arising from the consolidation of control because defendant obtained that control by fraud.[101]

C. *The Tort/Restitution Confusion*

For a variety of reasons, courts have been slow to recognize unjust enrichment as an independent basis of recovery in rule 10b-5 cases and instead have dealt with securities fraud primarily under tort concepts. The neglect of the unjust enrichment remedy is due in part to the historical development of the different substantive areas of the law—tort principles coalesced well before those underlying the law of restitution.[102] If the principles based on plaintiff's harm (tort) and defendant's gain (unjust enrichment) led to the same result in a case, courts not surprisingly would think

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97. 491 F.2d 402 (3d Cir. 1973).

98. *Id.* at 412.

99. Rochez Bros. v. Rhoades, 353 F. Supp. 795, 804 (W.D. Pa. 1973), *vacated*, 491 F.2d 402 (3d Cir. 1973).

100. *Rochez Bros.*, 491 F.2d at 412.

101. *Id.* The court's failure to invoke the *Janigan* exception in these circumstances led one writer to conclude that *Rochez* had "destroyed whatever vitality the *Janigan* limitation possessed." *See* Note, *supra* note 45, at 94. The district court in *Rude v. Campell Square, Inc.* similarly focused its interpretation of the *Janigan* rule and its exception on the fruits of defendant's fraud. 411 F. Supp. 1040 (D.S.D. 1976). In *Rude* the value of a corporation had increased dramatically after the corporation's president fraudulently purchased the 51% interest held by the original cofounder's widow. The corporation's increased wealth reflected the effect of natural commercial growth on the real estate that was the corporation's major asset and a "windfall" in commercial development around that property. The court refused to apply the *Janigan* exception and gave plaintiff the benefits of the windfall rather than let the fraudulent party keep them. *Id.* at 1050.

102. "The common elements of the claims we now call restitutionary were not widely perceived until well into this century." RESTATEMENT (SECOND) OF RESTITUTION, Introduction at 1 (Tent. Draft No. 1, 1983).

(and write) of recovery in tort law terms. Courts in rule 10b-5 cases have exacerbated this tendency to apply tort concepts because tort theory was so important in the creation of the implied private cause of action itself.[103] Courts also have used tort law analogies in numerous rule 10b-5 cases to define the elements of the implied cause of action.[104] Not surprisingly, courts faced for the first time with the question of remedy in rule 10b-5 cases found that tort law provided an attractive route through familiar territory.[105] Unfortunately, this tort law slant has had several limiting effects on the development of remedies for rule 10b-5 violations. Some early cases and commentary excluded unjust enrichment as a basis of obligation by construing section 28 of the 1934 Act[106] to prevent any recovery based on gains that accrue to the defrauding party.[107] While later courts abandoned this explicit exclusion of gain, the exclusion of unjust enrichment recovery remains implicit in recent cases and commentary which simply fail to mention unjust enrichment as an alternative to recovery based on tort principles. Courts and commentators view rule 10b-5 as essentially a tort claim re-

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103. *See supra* note 18.

104. *See, e.g.*, List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir.) (common-law requirement that the misstatement be material is present for rule 10b-5 actions), *cert. denied*, 382 U.S. 811 (1965); Trussell v. United Underwriters, Ltd., 228 F. Supp. 757, 771 (D. Colo. 1964) (rule 10b-5 plaintiffs must show the tort concept of proximate causation); Kohler v. Kohler Co., 208 F. Supp. 808, 823 (E.D. Wis. 1962) (reliance is an indispensable element of 10b-5 actions), *aff'd on other grounds*, 319 F.2d 634 (7th Cir. 1963).

105. *See* Moody v. Bache & Co., 570 F.2d 523 (5th Cir. 1978); Trussell v. United Underwriters, Ltd., 228 F. Supp. 757 (D. Colo. 1964). *But see* Green v. Wolf Corp., 406 F. 2d 291, 303 (2d Cir. 1968) (rejecting punitive damages: "We have gone far beyond the limits of the common law in imposing liability under 10b-5 and thus may not import all other aspects of common-law fraud without scrutiny."), *cert. denied*, 395 U.S. 977 (1969). The use of tort theory to imply a cause of action need not have limited the remedy to tort damages. Traditionally, courts recognized that a victim of a tort could seek a remedy in restitution instead of damages, a remedy misleadingly termed "to waive the tort and sue in assumpsit." *See* 1 G. Palmer, *supra* note 13, at § 2.1. Rule 10b-5 cases bave not employed such terms but instead focus on the usual tort remedy of damages.

106. 15 U.S.C. § 78bb(a) (1982).

107. *See* Ohio Drill & Tool Co. v. Johnson, 361 F. Supp. 255, 261 (S.D. Ohio 1973) (damage includes only actual losses and not the gains that accrue to the defrauding party), *vacated*, 498 F.2d 186 (6th Cir. 1974); Kohler v. Kohler Co., 208 F. Supp. 808, 825 (E.D. Wis. 1962) (plaintiff may not recover any actual or potential gain that defendant received), *aff'd on other grounds*, 319 F.2d 634 (7th Cir. 1963); *see also* Note, *Remedies for Private Parties Under Rule 10b-5*, 10 B.C. Indus. & Com. L. Rev. 337, 343 (1969) ("This disgorgement of profit theory is inappropriate to measure damages in 10b-5 actions."). *But see* Nelson v. Serwold, 576 F.2d 1332, 1338 (9th Cir. 1978), *cert. denied*, 439 U.S. 970 (1978). This construction cannot be attributed only to a tort bias. It is a plausible interpretation of the "actual damages" wording of the statute, even though reasonable contrary interpretations exist. *See supra* notes 35-36 and accompanying text.

quiring a plaintiff to show cause in fact and proximate cause.[108] Although a rule 10b-5 action *is* essentially a tort claim when the fraudulent transaction has provided no benefit to defendant, courts have phrased their holdings so broadly to suggest that tort principles are a requirement for recovery in any case, which would include cases in which unjust enrichment is present.[109] 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, and in particular any profits that plaintiffs could not have acquired for themselves. 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.

1. Application of Tort Principles to Recoveries Termed Rescissory

In the normal rescission case, the parties unwind the transaction, with each party returning to the other that which he received in the transaction. When the defendant returns that which he obtained by fraud he also puts the plaintiff back in the position he was in before the fraudulent transaction. The result is the same as that achieved by the out of pocket and consequential damage measures, so that courts sometimes assume that the same tort principles support all the remedies. Courts thus appear to use the mea-

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108. *See, e.g.,* Moody v. Bache & Co., 570 F.2d 523, 527 (5th Cir. 1978); Trussell v. United Underwriters, Ltd., 228 F. Supp. 757, 771 (D. Colo. 1964); *see also* Cobine, *supra* note 4, at 654 (because rule 10b-5 is based on statutory tort theory, a 10b-5 plaintiff, like any tort plaintiff, must show that defendant's conduct was not only the cause in fact of injuries but also was the proximate cause); Note, *Insiders' Liability Under Rule 10b-5 for the Illegal Purchase of Actively Traded Securities,* 78 YALE L.J. 864, 868 (1969) [hereinafter cited as Note, *Insiders Liability*] (if liability is based on tort doctrine, the doctrine itself restricts liability to those losses that defendant actually caused); Note, *Civil Liability Under Section 10b and Rule 10b-5: A Suggestion for Replacing the Doctrine of Privity,* 75 YALE L.J. 658, 677 (1965) (abandonment of causation requirement would do violence to logical underpinnings of implied civil liability).

109. *See* Huddleston v. Herman & MacLean, 640 F.2d 534, 549 (5th Cir. 1981) (recovery not permitted under rule 10b-5 if the misrepresentation is not the proximate reason for plaintiff's loss), *aff'd in part and rev'd in part,* 103 S. Ct. 683 (1983); Beissinger v. Rockwood Computer Corp., 529 F. Supp. 770, 787 (E.D. Pa. 1981).

sures interchangeably.[110]

The rescissory label is attractive to courts because it communicates easily the result that the court believes is appropriate—measuring value at a day subsequent to the transaction in the traditional manner of rescission. This label, however, often inaccurately describes the courts' reasoning for applying the rescissory measure. Courts rely not on the fact that defendant must return a benefit received by fraud,[111] but rather on the perception that the subsequent change in the market is part of plaintiff's harm causally related to defendant's violation.

Applying this tort view of rescission, several courts limit plaintiff's rescissory award to compensation for injuries proximately related to defendant's fraud and therefore refuse any recovery that would put the plaintiff in a better position than he enjoyed before the fraud.[112] The court in *American General Insurance Co. v. Equitable General Corp.*[113] applied this type of limitation when a corporation's misrepresentations induced the plaintiff to sell its stock back to the corporation for $32.50 per share and therefore miss out on a subsequent acquisition of the entire company for fifty-one dollars per share. The court awarded the plaintiff what it termed a rescissory measure of recovery, but limited the award to an amount based on a forty-four dollars per share value. The court concluded that, absent the misrepresentation, the plaintiff would have continued as a shareholder and would have participated in the subsequent bidding war, which would have resulted in the corporation's being sold for only forty-four dollars per share.[114] The award of any additional money would give plaintiff a recovery that it would not have been in a position to acquire absent the fraud and there-

110. *See, e.g.,* Meyers v. Moody, 693 F.2d 1196, 1215 n.15 (5th Cir. 1982) (court of appeals used a consequential damages theory to affirm an award that the district court had termed rescissory), *aff'g* 475 F. Supp. 232 (N.D. Tex. 1979), *cert. denied,* 104 S. Ct. 287 (1983); *see also* Garnatz v. Stifel, Nicolaus & Co., 559 F.2d 1357, 1361 (8th Cir. 1977), *cert. denied,* 435 U.S. 951 (1978); note 45 and accompanying text.

111. *See supra* notes 85-87 and accompanying text.

112. *See, e.g.,* Glick v. Campagna, 613 F.2d 31, 37 (3d Cir. 1979); *see also* Huddleston v. Herman & MacLean, 640 F.2d 534, 554 (5th Cir. 1981) ("[rescission's] purpose is to return the defrauded purchaser to the status quo ante") (citing Green v. Occidental Petroleum Corp., 541 F.2d 1335, 1342 (1976) (Sneed, J., concurring)), *aff'd in part and rev'd in part,* 103 S. Ct. 683 (1983); Garnatz v. Stifel, Nicolaus & Co., 559 F.2d 1357, 1361 (8th Cir. 1977), *cert. denied,* 435 U.S. 951 (1978); Cant v. A.G. Becker & Co., 384 F. Supp. 814, 816 (N.D. Ill. 1974).

113. American Gen. Ins. Co. v. Equitable Gen. Corp., 493 F. Supp. 721 (E.D. Va. 1980).

114. *Id.* at 758-59, 766.

fore compensate it for harm not causally related to the violation.[115]

Similar tort principles also may explain the broker churning cases that label their recovery as rescissory. Like true rescission cases, some broker churning cases measure the value of securities at a time after the fraudulent transaction. These decisions, however, reduce the plaintiff's loss by an index that reflects the average decline in the market during the time of the violations.[116] Under tort principles, if the evidence indicated that plaintiff's portfolio would have declined in value even if the broker had not fraudulently mismanaged it, then the fraud was not the legal cause of the loss and plaintiff could not recover.

In contrast, if traditional grounds for rescission were present in either of the fact situations described in the last two paragraphs—if the defendant derived a benefit through a fraudulent transaction with the plaintiff—true rescission would require the defendant to return the entire consideration even if plaintiff thereby would recovery an amount beyond that causally related to the loss.[117] Thus the plaintiff in *American General* could recover based on the fifty-one dollar price and the plaintiff in the broker churning case could recover the entire decline in price.[118] Recovery based on unjust enrichment may not be appropriate in the cases just discussed; the defendant may not have received an identifiable gain or, in churning cases, the plaintiff's loss causally related to the violation may exceed the benefit (the broker's commission) that the defendant received in the transaction. In such cases to label the remedy rescissory, however, only disguises a tort based recovery[119] and confuses courts that attempt to apply a true rescissory measure of relief when grounds for recovery based on unjust en-

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115. *Id.* at 759; *see supra* notes 24-25.

116. *See* Rolf v. Blyth, Eastman, Dillon & Co., 570 F.2d 38, 49 n.22 (2d Cir.) ("The rescission theory of damages which we essentially utilize here cannot restore a plaintiff to a *better* position than he would have been in had the fraud not occurred.") (emphasis in original), *cert. denied,* 439 U.S. 1039 (1978). Churning occurs when a dealer induces excessive transactions in a customer's account that sometimes results in losses to the customer hut commissions to the broker. *See* Note, *Churning by Securities Dealers,* 80 HARV. L. REV. 869 (1967).

117. *See supra* note 76; *infra* part IV; *see also* G. DOUTHWAITE, ATTORNEY'S GUIDE TO RESTITUTION 323 (1977).

118. *See* Chasins v. Smith, Barney & Co., 438 F.2d 1167 (2d Cir. 1970) (award includes decline in price); Janigan v. Taylor, 344 F.2d 781 (1st Cir.) (award includes subsequent profits), *cert. denied,* 382 U.S. 879 (1965).

119. Some commentators see any distinction between out of pocket recovery and rescission as involving only "semantics." *E.g.,* Note, *supra* noto 45, at 87. As illustrated in the text, however, the two measures can produce different results.

richment do exist.

2. Tort Limitations on Windfall Profits Recovery

Courts frequently misunderstand the *Janigan* measure of recovery because they insist on viewing the recovery from the plaintiff's standpoint, as normally would be appropriate in a tort case. While courts readily acknowledge that the purpose of restitution is to prevent unjust enrichment, they often include a second "purpose," that of putting the plaintiff back where he was before the fraud.[120] This second purpose is the goal of tort law and also the usual result of recovery on the basis of unjust enrichment. Courts, however, often raise the second purpose to an absolute limitation that denies the plaintiff any recovery that he could not have obtained absent the fraud.[121]

For example, a panel of the Second Circuit has limited *Janigan* to situations "where there are present both elements . . . namely (1) that a wrongdoer might be profiting by his own wrong, and (2) that, even if there were fraud, the defrauded party might have been in the position of earning the profits it seeks from the wrongdoer."[122] To make the *Janigan* decision consistent with this view, courts and commentators read into *Janigan* an assumption that, but for the fraud, the seller would have retained the stock and obtained the subsequent price increase.[123]

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120. Thomas v. Duralite Co., 524 F.2d 577, 589 (3d Cir. 1975); Gerstle v. Gamble-Skogmo, 478 F.2d 1281, 1306 (2d Cir. 1973); Zeller v. Boque Elec. Mfg. Co., 476 F.2d 795, 802 (2d Cir.), *cert. denied*, 414 U.S. 908 (1973).

121. *See, e.g.*, Glick v. Campagna, 613 F.2d 31, 37 (3d Cir. 1979); Simon v. New Haven Board & Carton Co., 516 F.2d 303, 306 (2d Cir. 1975).

122. Simon v. New Haven Board & Carton Co., 516 F.2d 303, 306 (2d Cir. 1975).

123. *See, e.g.*, Capital Investments, Inc. v. Bank of Sturgeon Bay, 430 F. Supp. 534, 537 (E.D. Wis. 1977) (all rescissory damage decisions reflect the common assumption that but for the fraud, defrauded seller would have retained securities and obtained the purchaser's profits on resale; courts will not award profits if defendant can show that plaintiff would not have retained securities), *aff'd*, 577 F.2d 745 (7th Cir. 1978); Gould v. American Hawaiian S.S. Co., 362 F. Supp. 771 (D. Del 1973), *vacated*, 535 F.2d 761 (3d Cir. 1976); Jacobs, *The Measure of Damages in Rule 10b-5 Cases*, 65 GEO. L.J. 1093, 1096 n.16 (1977); Weiskopf, *Remedies Under Rule 10b-5*, 45 ST. JOHN'S L. REV. 733, 737 (1971); Note, *supra* note 107, at 344; Comment, *SEC v. MacDonald*, 52 U. CIN. L. REV. 277, 282 n.34 (1983).

In one commentator's opinion, it was reasonably certain that the plaintiff in *Janigan* would have refused the initial sale and held on to the stock until the subsequent resale. *See* Painter, *Inside Information: Growing Pains for the Development of Federal Corporation Law Under Rule 10b-5*, 65 COLUM. L. REV. 1361, 1377 (1965). Use of this theory as the basis for the plaintiff's recovery is open to a serious factual causation question in many windfall profits cases. *See* Note, *Insiders Liability*, *supra* note 108, at 883 (court termed dubious the assumption that plaintiff in *Baumel* would have retained stock); Comment, *Private Remedies Available Under Rule 10b-5*, 20 Sw. L.J. 620, 626 (1966) (basic rescission premise that

The resulting limitations, however, simply are not consistent with the law of unjust enrichment or with *Janigan* itself. Recovery based on principles of restitution and unjust enrichment provides a remedy " 'by which defendant is made to disgorge ill-gotten gains or to restore the status quo, or . . . both . . . .' "[124] Restitution goes beyond returning the plaintiff to an earlier position if necessary to prevent defendant's unjust enrichment.[125] The *Janigan* court recognized that recovery did not turn on what the plaintiff would have been in a position to obtain: "It may, as in the case at bar, be *entirely speculative* whether, had plaintiffs not sold, the series of fortunate occurrences would have happened in the same way, and to their same profit."[126] Instead the court gave recovery because "it is simple equity that a wrongdoer should disgorge his fraudulent enrichment."[127]

Several of the federal courts of appeal in the last decade have recognized the possibility that recovery based on unjust enrichment principles can put the plaintiff in a better position than he was in before the fraud. In *Thomas v. Duralite*,[128] the Third Circuit acknowledged that the

> theory of damages which allows windfall profits does not depend solely on the premise that, but for the fraud, the injured party would have realized these gains. Additionally, there is the philosophy that if the defendant made profits through the use of assets which he had fraudulently acquired, he should not be permitted to keep them.[129]

Similarly, the Second Circuit in *Zeller v. Bogue Electric Manufacturing Corp.*[130] noted that a fraudulent seller should be required "to disgorge any profits he would not otherwise have been in a position to realize if [the profits] can be traced with sufficient certainty."[131] The court found that the unjust enrichment remedy

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plaintiff would have retained stock does not always seem to be warranted).

One commentator has argued that the mere fact that a plaintiff sold should indicate his willingness to sell at an equitable price, so courts should require plaintiffs to disprove, or at least allow defendants to try to prove, that the plaintiff would have sold at some higher price—the fair market perhaps—but short of the resale price. Note, *supra* note 107, at 344.

124. SEC v. Commonwealth Chem. Sec. Inc., 574 F.2d 90, 95 (2d Cir. 1978) (quoting 5 J. MOORE, FEDERAL PRACTICE ¶ 38.24[2], at 190.6 (1977)).

125. *See* G. DOUTHWAITE, *supra* note 117, at 323.

126. *Janigan*, 344 F.2d at 786 (emphasis supplied).

127. *Id.*

128. 524 F.2d 577 (3d Cir. 1975).

129. *Id.* at 589.

130. 476 F.2d 795 (2d Cir.), *cert. denied*, 414 U.S. 908 (1973).

131. *Id.* at 802 n.10. The benefit in question concerned a parent corporation's obtaining loans from its subsidiary (on whose behalf plaintiff brought the derivative suit) at below-market interest rates. Plaintiff also alleged that the loans enabled the defendant to

did not depend upon the defrauded purchaser's showing that the defendant received a benefit that the plaintiff otherwise would have been in a position to obtain.[132] In *Gerstle v. Gamble-Skogmo, Inc.* the Second Circuit acknowledged that it could base recovery on either recapturing defendant's unjust enrichment or returning plaintiff to his prefraud position, but found neither appropriate on the facts in that case.[133]

Two recent cases illustrate how recovery in a single transaction can vary depending upon whether the court bases the award on unjust enrichment or on tort concepts of restoring plaintiff to his position prior to the fraud.[134] In these two cases the courts al-

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avoid having to sell certain assets in a depressed market, thus producing additional benefit when the assets were sold eventually at more favorable terms. The court suggested that the interest rate spread should not be considered a benefit obtained from an invasion of subsidiary's interest unless plaintiff could sbow that a new company witb characteristics similar to tbe subsidiary could find borrowers at the market rate and had money to lend to them. Even after plaintiff made this sbowing the court still conditioned recovery upon a showing that the parent could have preserved the profit in question only by the below-market loan from the subsidiary.

132. *Id.*

133. 478 F.2d 1281 (2d Cir. 1973). Gamble-Skogmo owned 52% of General Outdoor Advertising (GOA) and sought shareholder approval for a merger of the two companies. The proxy solicitation failed to disclose the parent company's plan to sell GOA's nine local advertising plants for well in excess of the "book" value. *Id.* at 1284-89. The court affirmed the parent's obligation to return to the subsidiary's minority shareholders a proportional share of the appreciation on the plants sold within nine months after the merger because this was a benefit that the parent had acquired by misrepresentation. *Id.* at 1290, 1310. The court, however, did not accept the plaintiffs' argument that the defendants also were obligated to return the subsequent appreciation in the value of the other unrelated businesses, which the defendant's misrepresentations did not concern and which the defendant did not sell until nine years after the merger. *Id.* at 1305-06. The court found that adequate disclosure would not have assured that plaintiff minority shareholders would have obtained the appreciated profit of the businesses sold after nine years. *Id.* The court concluded that the merger would have occurred even absent the fraud but only after a change in terms. Plaintiffs would have received a share of the appreciation of the local advertising plant, but the share would not include the other assets. The court viewed plaintiffs' request for the remaining assets' highest intermediate value between the merger and the day of judgment as based similarly and likewise rejected that claim as " 'too untenable and speculative to support an award of damages.' " *Id.* at 1305 (quoting the trial court, 332 F. Supp. at 647). The court recognized that *Janigan* contained an independent rationale based on unjust enrichment. 478 F.2d at 1306. Nonetheless, the court negated the rationale with the conclusory statement that "the nexus between the misrepresentation and the damage award would be too thin if . . . stretched to include appreciation [of the value of the shares of the remaining assets]." *Id.* In a footnote, the court referred to a "general recognition of the unfairness to defendants of undue prolongation of the period for calculating damages." *Id.* at 1306 n.27. According to the court both the requirement for prompt filing of suit and the limitation of highest value to a reasonable time after the tortious conduct reflect this general concern. *Id.* The First Circuit's recent decision in SEC v. MacDonald, 699 F.2d 47 (1st Cir. 1983), made a similar point, which is criticized in the text accompanying *supra* notes 154-63.

134. Nelson v. Serwold, 687 F.2d 278 (9th Cir. 1982), *cert. denied*, 439 U.S. 970 (1978);

lowed the plaintiffs to recover windfall profits from one defendant under the unjust enrichment rationale in *Janigan*. When grounds for unjust enrichment did not exist against other defendants, however, the courts found that the plaintiffs could recover only the amount they would have been in a position to obtain if the fraud had not occurred. These cases confirm the independent foundation of recovery based on unjust enrichment and, as shown in the next part, seek to develop appropriate limits on that recovery by focusing on the defendant's gain and its relation to the fraud.

V. THE SEARCH FOR LIMITS ON UNJUST ENRICHMENT RECOVERY

A. *General Principles*

Recognizing unjust enrichment as a basis for recovery under rule 10b-5 neither will provide a panacea for all rule 10b-5 plaintiffs nor negate the importance of tort based liability. The ele-

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American Gen. Ins. Co. v. Equitable Gen. Corp., 493 F. Supp. 721 (E.D. Va. 1980). In *Nelson* an insider, acting on behalf of a group, purchased stock from the estate of a deceased shareholder after misrepresenting the prospects of the company. Defendant Serwold, who made the misrepresentations, held title to the stock of the entire group of purchasers. In the more recent *Nelson* decision, the Ninth Circuit limited the windfall profit recovery to the 30% of the plaintiff's stock that defendant Serwold personally received. The court refused to hold Serwold liable for windfall profits on the 70% of the stock that he did not beneficially own. The court recognized that the plaintiff could recover from Serwold for misrepresentations relating to the stock, but only on a tort-based theory, which limits recovery to that which restores plaintiff to the position plaintiff would have been in absent the fraud. In limiting recovery under this tort theory, the court seemed to ignore the finding of the earlier panel, which said that its result could be supported by the *Janigan* portion of *Affiliated Ute* and also from the out of pocket portion of that rule. The earlier panel had found that absent the misrepresentation, plaintiff's shares probably would have remained in the administration's safe deposit box as "historical curiosities" and would have been there when the favorable sale of the company occurred six years later. *Nelson*, 576 F.2d at 1339 n.5. One commentator, discussing a similar case, argued that a broader award to include the profits of others could be justified not on unjust enrichment principles, but as an "administrative sanction for the enforcement of rules of fiduciary conduct set by law." Jones, *Unjust Enrichment and the Fiduciary's Duty of Loyalty*, 84 L.Q. REV. 472, 498 (quoting *In re* Philadelphia & West. R.R., 64 F. Supp. 738, 741 (E.D. Pa. 1946)).

In *American General* defendant's officers' misrepresentations concerning the company's merger status induced the plaintiff to sell to the defendant corporation a 10% block of its own stock. The corporation subsequently retired those shares so that when the corporation subsequently merged into another corporation at a higher per share price, the benefit of the fraud accrued to all of defendant's shareholders. The individual shareholders/defendants received a portion of this gain, but the court assumed that the stockholders who were innocent of wrongdoing would not be required to disgorge and that equity would not require the culpable shareholders to disgorge the gain of the innocent shareholders. *American General*, 493 F. Supp. at 760 n.68. As so limited, the *Janigan* gain provided less than the recovery based on restoring plaintiff to his prefraud position. *See supra* notes 113-15 and accompanying text. Although the court called this measure rescissional, the theory appears to be a disguised out of pocket/consequential recovery.

ments of unjust enrichment recovery will not be present in many cases and the court must base liability, if it exists at all, on tort principles. Even when the defendant does benefit by the fraud, tort principles may provide the preferred method of recovery if plaintiff's loss exceeds the defendant's gain traceable to the violation. Courts therefore must consider unjust enrichment as one of two alternative, independent bases of obligation that provide recovery for a rule 10b-5 violation.

Fundamental to recovery based on unjust enrichment is the requirement that a defendant acquire a benefit by reason of infringing another's interest or causing a plaintiff to suffer loss.[135] Cases may fail to provide grounds for unjust enrichment recovery because (1) defendant received no benefit; (2) no link exists between any benefit the defendant received and the invasion of plaintiff's interest (a fact causation analysis); or (3) even when the defendant could not have obtained the benefit but for the violation, other intervening factors so dilute the connection that the court as a matter of policy should not permit recovery (a legal causation analysis).

Recovery based on unjust enrichment is impossible when the defendant receives no benefit,[136] so the court need not consider the difficult question of whether the benefit is linked to the fraud. For example, in *Mitchell v. Texas Gulf Sulphur Co.*,[137] the defendant received no tangible benefit from its misleading press release because it did not engage in any stock trading. Nevertheless, the court held that the action caused harm to the plaintiffs; and allowed them to recover under tort law principles, which operate independently of any gain by the wrongdoer.

When benefit to the defendant clearly exists, a court next must determine whether the fraud was a factor in permitting defendant to obtain the benefit. Courts in some cases deny unjust enrichment recovery because the alleged violation has no factual

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135. RESTATEMENT (SECOND) OF RESTITUTION § 1 (Tent. Draft No. 1, 1983).

136. Benefit in securities cases usually is easy to identify in the form of money paid for securities or services, such as brokerage commissions. In restitution, however, benefit can have a meaning much broader than the consideration directly transferred in a transaction. *See* 1 G. PALMER, *supra* note 13, at § 1.8. Thus, future securities cases may raise more questions about the definition of benefit than have been addressed until now. Reprosystem B.V. v. SCM Corp., 727 F.2d 257 (2d Cir. 1984) (no unjust enrichment recovery because no benefit).

137. 446 F.2d 90 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971). *See* supra notes 54 & 111-19.

connection to the gain. In *SEC v. Wills*[138] the Commission sought return of compensation received from a corporation by certain of its officers who had violated the proxy regulations. The court found that the compensation was unrelated to the securities violation because the SEC failed to demonstrate the requisite causal link. The SEC did not show that with full disclosure the corporation would have fired the officers or that their compensation was attributable to securities violations rather than some legitimate source.[139]

Once a court establishes the existence of both a benefit and its cause in fact relationship to the violation, the court next must consider the most difficult question—whether, for policy reasons it should impose any other limit in the nature of a legal causation requirement. Courts in restitution cases impose policy limits similar to tort "proximate cause" limitations.[140] Courts, however, must resist the temptation to transfer to restitution the substance of proximate cause developed in tort because the policies that underlie the limitations in each area are entirely different.[141]

The most developed of the legal cause limitations in restitution is the *Janigan* "artist" exception, when the intervening force of defendant's individual efforts breaks the connection between the gain and the fraud.[142] As the pattern of the courts' interpretation of that exception illustrates, defendant's efforts must be extraordinary to qualify as an intervening cause.[143] Cases subsequent to *Janigan* also offer some specific suggestions about when intervening causes will be sufficient to invoke the exception. Courts have held that market changes, natural commercial growth, and windfalls from external sources do not break the connection of the gain

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138. 472 F. Supp. 1250 (D.D.C. 1978).

139. *Id.* at 1276; *see also* SEC v. Galaxy Foods, Inc., 417 F. Supp. 1225 (E.D.N.Y. 1976) (requiring one defendant to return gain that came from sponsoring others to buy unregistered securities; the court allowed a second defendant whose gain came from working in the retail, rather than the promotional, side of the operation to keep his salary), *aff'd*, 556 F.2d 559 (2d Cir.), *cert. denied*, 434 U.S. 855 (1977). *But see* Ohio Drill & Tool Co. v. Johnson, 498 F.2d 186, 193 (6th Cir. 1974) (court refused to make defendants disgorge profits for issuing misleading proxy statements and held that misleading proxies which may have resulted in defendant's election to receive compensation in the form of stock in lieu of cash were not a sufficient connection).

140. *See* W. PROSSER, *supra* note 11, § 42. Professor Prosser termed the word "proximate" unfortunate because it places the wrong emphasis on the concept, but he despaired of any prospect that the term would be changed. *Id.*

141. *See infra* notes 147-49 and accompanying text

142. *See supra* note 94 and accompanying text.

143. *See supra* notes 97-101 and accompanying text.

with the fraud.[144] On the other hand, some cases suggest that the passage of time should be a limiting factor,[145] while others suggest that plaintiff's "consumption" of either a speculative opportunity or a tax benefit should break the connection.[146]

The generalizations and confusion that accompany the search for legal cause in tort law, will plague the struggle to establish these limits. As in tort law, courts best can work out legal cause in restitution on a case-by-case basis. Nevertheless, the wholesale importation of precedents or rationales from tort law will lead only to improper limits on restitution recovery. Many of the policies that shape the legal causation limits in tort do not have the same effect when unjust enrichment is the basis for recovery. Courts impose proximate cause limits in tort law in part to prevent draconian liability for violations.[147] The liability problem is not nearly so severe in restitution because the defendant's gain places a natural ceiling on the amount of recovery. In addition, limits in tort sometimes rest on a fear of imposing too great a liability for mere negli-

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144. *Id.*

145. *See* Thomas v. Duralite, 524 F.2d 577 (3d Cir. 1975); Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281 (2d Cir. 1973). In *Thomas* the court expressed an unwillingness to assess damages for an indefinite period of time in the future, but actually based its reversal of the lower court's decision on the grounds that the trial judge did not consider adequately the defendants' special efforts and talents contributed after the fraudulent transaction, a reason that illustrates the more traditional view of the *Janigan* exception. *Id.* at 587, 589. Defendants purchased plaintiff's 47½% interest in two companies, subsequently resold at a profit, and then received additional compensation through a later renegotiation of the resale agreement. The district court awarded the plaintiff his proportional interest of the defendant's cumulative proceeds under the agreement as modified. *Id.* at 583. The circuit court suggested that the reason for the additional compensation contained in the modified agreement was the individual talents of the two defendants, who had become very important employees to the acquiring company. *Id.* at 587-88. Under these facts, the additional compensation is not something that the defendants gained by fraud, but something they likely would have obtained anyway. The defendants did not receive the additional compensation at the plaintiff's expense and therefore the plaintiff should not recover this in restitution.

The Fourth Circuit adopted a similar approach in Occidental Life Ins. Co. v. Pat Ryan & Assoc., Inc., 496 F.2d 1255 (4th Cir.), *cert. denied,* 419 U.S. 1023 (1974). The purchaser of 100% of the stock of an insurance company complained of fraud by the seller and sought rescission based on *Janigan.* The court focused on the defendant's gain in the transaction and found that the plaintiffs failed to show that the defendant gained a benefit in the transaction that the defendant would not have been in a position to secure had no fraud occurred. *Id.* at 1265. The court viewed the plaintiff as having paid too high a price and implicitly concluded that the plaintiff would have overpaid by the same amount for a defect-free company. *Id.*

146. *See infra* notes 168-70 and accompanying text. One commentator suggests that recovery "will be limited to benefits that can fairly be regarded as the product of the legally protected interest." 1 G. PALMER, *supra* note 13, at § 3.3.

147. *See* W. PROSSER, *supra* note 11, § 41.

gence.[148] This concern lessens when rule 10b-5 is the basis for recovery because scienter is necessary for liability under the rule.[149] The different policies governing unjust enrichment recovery suggest, therefore, that the connection between the gain and the violation need not be as close as the connection between the plaintiff's loss and the fraud required for recovery in tort.

Application of these general principles to two more specific areas, the recent decision in *SEC v. MacDonald*[150] and open market insider trading cases, illustrates current uses of unjust enrichment concepts.

B. SEC v. MacDonald

Courts seeking to develop limits on unjust enrichment should focus on the defendant's gain and its relation to the misrepresentation. In contrast, the most recent limit to *Janigan*, the First Circuit's 1983 decision in *SEC v. MacDonald*, focuses instead on the causal link between the plaintiff's injuries and the defendant's misrepresentation, which leads to consideration of factors more appropriate to tort recovery. The defendant in *MacDonald*, the chairman of an ailing real estate investment trust, purchased stock in the trust based on his inside knowledge that the trust was about to enter into a favorable lease with a new tenant.[151] The SEC brought suit under rule 10b-5 and the trial court required defendant to disgorge the $53,012 profit realized on the subsequent sale of the stock.[152] The First Circuit, however, reversed the trial court's decision on the question of the amount of restitution. The court of appeals phrased the issue as whether a corporate officer in possession of material inside information who fraudulently purchased company stock must "disgorge the entire profits he realized from his subsequent sale of those securities. . . [or] an amount representing the increased value of the shares at a reasonable time after public dissemination of the information;"[153] the court chose the second alternative.

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148. *Id.* at 237.

149. *See* Ernst & Ernst v. Hocbfelder, 425 U.S. 185, 212-14 (1976) (10b-5 requires more than negligence). The court did not decide whether recklessness would suffice.

150. 699 F.2d 47 (1st Cir. 1983).

151. *Id.* at 48.

152. *Id.*

153. *Id.* at 52. The court also noted that the defendant undertook no actions that increased the value of the stock and that "there were no special circumstances affecting what should be the normal result in this situation." *Id.*

The *MacDonald* court quoted the rule it had established in *Janigan*, but recognized a limitation on this rule: "where the fraudulently obtained securities are publicly traded, and hence readily available, the defrauded sellers can recover only those accretions occurring up to a reasonable time after they discovered the truth."[154] Thus, *MacDonald*, using restitution as the basis for recovery, produces a *result* that is the equivalent of a modified out of pocket tort measure.[155] The American Law Institute's proposed Federal Securities Code, which it claims is a codification of *Janigan*, goes beyond the *MacDonald* result and applies a similar limitation on transactions involving all securities, whether publicly traded or not.[156]

The *MacDonald* result achieves a separation that has appealed to courts in other contexts.[157] Risks of change in the market that occur within a reasonable time following the discovery of the fraud shift to the defendants, while risks of market changes after that time fall on the plaintiff. The *MacDonald* rule in effect incorporates into restitution various plaintiff-based recovery principles from contract and tort law, such as the avoidance of loss and mitigation of damages, which prevent the plaintiff from recovering for any harm he reasonably could have prevented. Yet these plaintiff-based principles simply are not as adaptable to restitution with its focus on the defendant as they are to contract and tort law, which look to the plaintiff's harm.

Restitution seeks to prevent unjust enrichment by requiring defendant to give back any benefit obtained by fraud. Once the plaintiff shows loss or interference with his interest, the court

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154. *Id.* at 53. The court found support for this limitation in the proposed Federal Securities Code. *Id.* Judge Aldrich, who authored *Janigan*, also wrote the First Circuit's opinion in *MacDonald*.

155. The modified out of pocket cases and some cases applying a rescissory measure of damages come to the same result. *See supra* note 8 and accompanying text.

156. FEDERAL SECURITIES CODE § 1708(a) introductory comment (Proposed Official Draft 1980) states: "This codifies Janigan recognizing these cases didn't have to deal with a cut-off date for defendant's resale." The Code provides a defrauded plaintiff with a choice of damages or rescission, but it defines the alternatives to produce normally a mathematical equivalence. *Id.* § 1708 introductory comment 5(c). It achieves this equivalence by having both measures use the reasonable time after discovery of the fraud. The Code spares the plaintiff the difficulty of proving that the change in value after the transaction date is causally related to the fraud, but the plaintiff cannot shift to defendant the risk of any change in the market after a reasonable time following discovery, even though this would occur under what the comments refer to as "unadulterated rescission." *Id.* When securities are not actively traded, discovery of the fraud may offer the plaintiff little opportunity to take protective action.

157. *See supra* note 8.

should emphasize the connection between the defendant's subsequent profit and the fraud. The defendant should have the opportunity to prove that he would have obtained the benefit even without the fraud—for example, that he would have purchased the stock at the higher price once full disclosure had been made.[158] Absent such proof, however, the court should make no deduction in the recovery.

The primary impetus for the limitation in *MacDonald* appears to be the court's concern that absent the limit a plaintiff will speculate at defendant's expense.[159] Plaintiffs' choices between rescission and an out of pocket measure of recovery already provide some opportunity for speculation, but the *MacDonald* court seems to be concerned about speculation that continues after discovery of the fraud.[160] In earlier common-law cases, courts dealt with such concerns through the doctrine of laches and, to some extent, election of remedies. If a plaintiff attempted to engage in speculation by delaying unreasonably a demand for rescission, courts considered plaintiff to have affirmed the contract and allowed him to sue only for damages.[161] In unjust enrichment terms any gain to the

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158. This argument will precipitate the same speculative criticisms leveled previously at decisions which assumed that a defrauded seller would have held the securities until the subsequent resale by the fraudulent purchaser but for the fraud. *See supra* note 123. These assertions inherently are after the fact justifications and difficult to prove. Defendant would have the best chance of disproving the existence of a connection in a case like Speed v. Transamerica Corp., 135 F. Supp. 176 (D. Del. 1955), *aff'd*, 235 F.2d 369 (3d Cir. 1956), in which the court could find some objective evidence of what a nonfraudulent party would have done. Defendants in *Speed* acquired plaintiff's steck without disclosing the liquidation value of the company's principal asset, which the insiders-defendants knew the corporation planned to liquidate. The court, however, did not award plaintiffs all that defendants gained at liquidation. The court found that even if there had been full disclosure, plaintiffs would have sold their steck. Nevertheless, a disinterested Board would have called the plaintiff's Class A shares, as permitted by the company's by-laws. The plaintiffs would have then converted their Class A shares to Class B shares, also as permitted by the by-laws, and could recover the liquidation rights of Class B shareholders. All other gain was benefit that the majority shareholder would have had even if there had been full disclosure.

A defendant in a case like *MacDonald*, however, will have difficulty demonstrating benefit in the absence of fraud because independent evidence seldom will exist to show that he would have purchased at the higher, nonfraudulently induced price. Nevertheless, as a party who has acted fraudulently, defendant should not expect the benefit of presumptions. *See* Comment, *supra* note 123, at 282 n.34.

159. 699 F.2d at 53. A three judge panel originally decided *MacDonald*, but the full five judge court then vacated that judgment and set an en banc hearing. The court's order specifically asked the parties to address this issue.

160. *Id.*

161. *See supra* notes 78-79 and accompanying text. *See* Lynch v. Vickers Energy Corp., 429 A.2d 497, 505 (Del. 1981) (rejects a mitigation limitation on rescissory measure of damages for a controlling shareholder's breach of a fiduciary duty).

defendant from a change in the market following affirmance is not unjust because plaintiff no longer is innocent and deserving of equity's protection. Only in this limited way are the conduct of the plaintiff and related doctrines like the avoidance of loss and mitigation of damages relevant in determining whether the benefit received from the fraud is unjust enrichment.

The *MacDonald* court's reliance on *Baumel v. Rosen*[162] as support for its rule, therefore, is misplaced. The plaintiff in *Baumel* engaged in conscious speculation by waiting eighteen months after notice of the fraud before filing suit.[163] In a *Baumel* situation, a plaintiff should not be able to claim defendant's subsequent gain as unjust enrichment; but if a plaintiff promptly makes a request for rescission the risk of any additional adverse change in the market until the time of judgment should remain on the defendant, as it always has in rescission cases.

The *MacDonald* court unnecessarily extended the *Baumel* rule to facts where no indication of speculation existed.[164] Failure to "cover" by itself should not lead a court to consider plaintiff as no longer innocent and the defendant's benefit as no longer unjust; the traditional rule in rescission mandating a prompt demand for return of any profit should be enough. A requirement for cover puts obligations on a plaintiff not consistent with his position as the defrauded party. A defrauded seller forced to cover probably will have to obtain more funds than he received in the fraudulent transaction because the fraud's usual effect in these cases is to cause the price to be too low while the fraud remains undiscovered.[165] In addition, the cover requirement may impose on a de-

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162. 412 F.2d 571, 576 (4th Cir. 1969), *cert. denied*, 396 U.S. 1037 (1970).

163. *Id.* at 574.

164. SEC v. MacDonald, 699 F.2d at 53. *MacDonald* cites Baumel v. Rosen, 412 F.2d 571 (4th Cir. 1969), *cert. denied*, 396 U.S. 1037 (1970), and two other cases for its rule, but none of these is clear precedent for the *MacDonald* decision. Another case that the *MacDonald* court cited, Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90 (10th Cir.), *cert. denied* 404 U.S. 1004 (1971), also is not on point because it concerned no gain to the defendant—only loss to the plaintiffs resulting from the defendant's violation. The last of the three cases relied on in *MacDonald*, Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281 (2d Cir. 1973), applies a limit similar to *MacDonald*, but was decided under § 14 of the 1934 Act and its negligence standard of scienter. 478 F.2d at 1298. Courts have not treated so well defendants found liable under the more severe scienter standard of rule 10b-5.

165. *See* Note, *Damages for SEC Rule 10b-5 Violations*, 49 TEX. L. REV. 1141, 1148-49 81971) (similar cover problem raised by Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971)). The same disadvantage does not affect defrauded purchasers, and, therefore, may be a stronger argument to require them to take action; on the other hand, there may be tax consequences or other factors that courts should not force innocent plaintiffs to bear. In an open-market situation like *MacDonald*, deter-

frauded seller an affirmative obligation to track a company after defendant has fraudulently purchased the plaintiff's ownership position in the company, thus removing the primary incentive for the defrauded seller to follow the company's progress.[166] The result of a cover requirement focuses too much on the plaintiff, creating a presumption against him when doubts should be resolved against the fraudulent party. The defendant should have the responsibility of taking the necessary action by returning the profits or buying an additional number of shares in the same company. Alternatively, defendant could seek to require plaintiff to make an election of remedies; having elected rescission, the plaintiff could not later seek a better return in out of pocket damages if the subsequent profits later fade away.[167]

Other courts in rule 10b-5 cases express concern similar to that in *MacDonald* and reduce awards by any perceived benefit to the plaintiff, such as the opportunity to speculate at the defendant's expense. For example, courts have allowed a reduction in the amount awarded in rescission to reflect the tax benefits received by the plaintiffs from a real estate tax shelter[168] or the overall market decline during the period between the transaction and the discovery of the fraud.[169]

Another court denied rescission because the plaintiff retained the potential to reap huge speculative profits during the time that the fraud was undiscovered.[170] By the time the plaintiff did discover the fraud, a weakening economy had foreclosed any possibility of speculative profit. The court termed rescission "grossly ineq-

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mining whether the plaintiff class is speculating will be more difficult than in a case like *Baumel.* This distinction may support a different rule for open-market plaintiffs, but in any event the burden should be on the defendant and the courts should not simply assume that the plaintiffs are speculating.

166. *See* Comment, *supra* note 123, at 289. A "cover" obligation also forces a plaintiff to continue dealing with a company that has defrauded him when a reasonable investor might decide that the prudent course is to avoid such companies as untrustworthy.

167. Courts historically have misused the election of remedies to limit claims based on unjust enrichment and currently do not favor restrictive application of the doctrine. *See* 1 G. PALMER, *supra* note 13, § 2.4. Nevertheless, election of remedies still seems proper in these situations. *Id.* § 3.10. *See also* Jones, *supra* note 93, at 459.

168. Austin v. Loftsgaarden, 675 F.2d 168 (8th Cir. 1982).

169. Rolf v. Blyth, Eastman, Dillon & Co., 570 F.2d 38, 49 (2d Cir.), *cert. denied,* 439 U.S. 1039 (1978). *See also supra* notes 94-99 and accompanying text.

170. Bridgen v. Scott, 456 F. Supp. 1048, 1057 (S.D. Tex. 1978). *See also* Hickman v. Groesbeck, 389 F. Supp. 769, 780 (D. Utah 1974) (rejecting rescission for lack of promptness: "To [allow recovery here] would allow plaintiffs to reap significant tax benefits while speculating on the future of their venture and then return to them the value of their initial investment when the venture failed.")

uitable" because it would

> treat them as if they had placed their money in a risk-free federally insured savings and loan. . . . Plaintiff's position is like that of a player at a roulette wheel who pays for the speculative chance of making a large gain and then wants his money back when the wheel has spun and he has not made the speculative gain.[171]

This argument goes too far. A similar argument can be made to deny any plaintiff a choice for rescission. By the time the fraud is discovered, if any time has passed, the plaintiff has had the opportunity to see which way the market is going.

Case law traditionally has recognized that depreciation in the value of the stock neither makes a tender insufficient nor causes unjust enrichment to the plaintiff.[172] While stock that is returned no longer represents the same bundle of risks as when it was transferred originally, the plaintiff did not cause the shift of risk. Similarly, the decisions reducing recovery by the tax benefit are not consistent with the principles of unjust enrichment. The plaintiff who receives a tax benefit obtains his advantage from the government, not from the defendant. Between the plaintiff and defendant, defendant surely cannot make greater claim to this benefit acquired from a third party.[173] In addition, the government can take care of itself, requiring the plaintiff upon rescission to recapture some of the tax deductions as income.[174]

These decisions focus too much on the plaintiff and impose on the innocent party the risk of any uncertainty in meeting the judicial standards. Focusing on the defendant and resolving doubts against the party committing the fraud is consistent with the law of restitution and with the dual deterrent/compensatory purposes of the federal securities laws. Restitution does not ignore advantages to the plaintiff; it requires him to return or otherwise account for what he received in the transaction to prevent the *plaintiff's*

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171. *Bridgen*, 456 F. Supp. at 1058.

172. *See* 1 G. Palmer, *supra* note 13, § 3.12.

173. *See, e.g.*, Spatz v. Borenstein, 513 F. Supp. 571, 584 (N.D. Ill. 1981) (section 12 rescission not limited by plaintiff's tax benefit); Western Fed. Corp. v. Davis, Fed. Sec. L. Rep. (CCH) ¶ 99,117 (D. Ariz. Dec. 23, 1982).

174. *See* Burgess v. Premier Corp., 727 F.2d 826, 838 (9th Cir. 1984) (court "declines to make the government the banker for fraudulent tax shelter activity," presuming that the "IRS will do its duty if the [plaintiffs] should actually recover on their judgments and thereafter fail to file amended returns as required by law"); *see generally* Note, *Real Estate Limited Partnerships and Allocational Efficiency: The Incentive to Sue for Securities Fraud*, 63 Va. L. Rev. 669 (1977) (compares tax consequences of suing for damages and rescission).

unjust enrichment.[175] The standard for determining unjust enrichment, however, varies according to whether a court focuses on the innocent party or the "fraudfeasor." The degree of restoration required takes into account the fault of the parties, assuring that the fraudfeasor rather than the innocent party will carry the risk of any uncertainty in linking the gain/loss to the violation.

C. *Open-Market Insider Trading*

Open-market insider trading cases illustrate the difference between restitution and tort in connecting the benefit or loss to the breach. These cases present analytical difficulties from both a tort and an unjust enrichment perspective, but make more sense if viewed from an unjust enrichment perspective.

The federal courts interpret rule 10b-5 to require an insider in possession of material information to either disclose the information or refrain from trading.[176] When a defendant's breach involves trading on the open market, finding plaintiffs who have sustained losses that can be linked to the insider's conduct within traditional tort doctrines is difficult. Those traders on the other side of the transaction from the insider may have sustained losses, but given the anonymous nature of the market few, if any, can show that their trading was induced by defendant's fraudulent conduct. In almost all cases plaintiffs made decisions to trade that were independent of the defendant;[177] these plaintiffs would have suffered the same losses had the defendant simply not traded and not disclosed—action that would not have been a breach of defendant's rule 10b-5 duty.[178] Some courts therefore find no causal connection

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175. *See* 1 G. PALMER, *supra* note 13, § 3.12.

176. SEC v. Texas Gulf Sulphur, 401 F.2d 833 (2d Cir. 1968)(en banc), *cert. denied*, 394 U.S. 976 (1969). *See generally* 3B H. BLOOMENTHAL, SECURITIES AND FEDERAL CORPORATE LAW § 9.08 (rev. perm. ed. 1983); W. PAINTER, FEDERAL REGULATION OF INSIDER TRADING (1968).

177. The extent to which a plaintiff can claim that defendant's silence induced the conduct is discussed *infra* notes 180-84 and accompanying text. Apart from such an argument some plaintiffs possibly may prove that defendant's trade induced the loss. This could occur, for example, if defendant's buying increased demand for the stock leading to a rise in price, which caused plaintiff to sell. Alternatively, the insiders may have preempted buyers who otherwise would have bought. *See* Wang, *Trading on Material Nonpublic Information on Impersonal Stock Markets: Who is Harmed, and Who Can Sue Whom Under SEC Rule 10b-5?*, 54 S. CAL. L. REV. 1217, 1230-45 (1981). Even if these harms do exist, identifying traders who fit into either class to establish a class of plaintiffs is practically impossible. *Id.* at 1236-40.

178. In most insider trading situations the duty is clearly in the alternative; it is no violation to remain silent so long as there is no trading. SEC v. Texas Gulf Sulphur, 401 F.2d 833, 848 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969). In that situation,

between plaintiff's loss and defendant's breach and deny any private recovery.[179]

Other courts focus not on the trade but on the nondisclosure and sometimes hold that defendant's silence caused the plaintiff's subsequent trade. Under this view, if defendant has a duty to speak, the plaintiff can connect his trading loss to defendant's breach by alleging that the plaintiff would not have traded at the price if he had possessed all essential information.[180] The effect is to make insiders responsible for the failure of the price to reflect the undisclosed information and therefore the ensuing loss.[181] At common law defendant's duty to speak (and responsibility for subsequent trading losses) arose from the fiduciary duty of a director when a shareholder relied on the director's trustworthiness in entering into a transaction with the director[182] or would have relied on the director's trustworthiness had he known of the director's involvement (which the director went to great lengths to disguise).[183]

When public, impersonal markets permitted directors to trade on nonpublic information with their shareholders or prospective shareholders without the need for a disguise, the Second Circuit in *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith* was unwilling to let insiders take advantage of the informational imbalance and extended the duty to speak to forge the necessary causal connection between defendant's silence and plaintiff's trade.[184] But the

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courts generally defer to the corporation's business judgment in not releasing information immediately. *See* State Teachers Retirement Bd. v. Fluor Corp., 654 F.2d 843 (2d Cir. 1981).

179. Fridrich v. Bradford, 542 F.2d 307 (6th Cir. 1976), *cert. denied,* 429 U.S. 1053 (1977).

180. Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972); Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974).

181. One commentator has termed such a responsihility a "quasi-Samaritan duty," leading to a causation anomaly. *See* Wang, *supra* note 177, at 1240-45. *See also* Dooley, *Enforcement of Insider Trading Restrictions,* 66 VA. L. REV. 1, 21 (1980).

182. Hotchkiss v. Fischer, 136 Kan. 530, 16 P.2d 531 (1932).

183. Strong v. Repide, 213 U.S. 419 (1909). In *Strong* an insider purchased stock from a shareholder through her agent whose office was next door to defendant's. Instead of dealing directly, defendant used two intermediaries. The court said the agent would not have sold had he known the defendant was buying. The court imposed a duty when "special facts" existed that included the concealment of identity plus defendants specific involvement in negotiations that led to favorable developments for the company.

184. Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974). *See* BALLANTINE ON CORPORATIONS 216 (1946) ("Dishonest directors should not find absolution from retributive justice by concealing their identity from their victims under the mask of the stock exchange. The basis of such liability is abuse of official position for personal profit to the detriment of those whom he was under a duty to protect.")

Shapiro court felt that to extend the insiders' duty *only* to the trader who was fortuitously matched with the insider (and often could not be identified) would "make a mockery of the 'disclose or abstain' rule" and would "frustrate a major purpose of the antifraud provisions of the [federal] securities laws: to insure the integrity and efficiency of the securities markets."[185] Therefore the court held that the duty runs to all those trading in the market during the same period opposite from the insiders.[186]

The theory developed by the *Shapiro* court creates the possibility of draconian liabilities for the insider because almost any trader will be able to say that he would not have traded if he had known the information. The breadth of potential liability caused even the *Shapiro* court to pause before awarding the damages that would flow from it.[187] Viewed from a tort damages perspective, the remedial choice in insider trading cases is either that no one will recover or that the imposition of a very broad duty with its presumption of causation will enable a very large group to recover. The latter, however, will require reasoning that may substantially distort tort damages principles.

Unjust enrichment principles offer a different approach that avoids some of these problems. The goal is not to show that plaintiff's losses are proximately related to defendant's violation or that plaintiff is recovering what plaintiff would have been in a position to gain if there had been no fraud. Rather, the guiding principle is to make the defendant give back that which he obtained by invasion of the plaintiff's interest whether or not that gain equals the plaintiff's loss. In such an approach the defendant's gain serves as a natural built-in limit which prevents draconian liability for the defendant. The most difficult question is one of standing: Which plaintiffs have rights that the defendant has infringed to entitle them to recover the gain made by the defendants? At least three groups are possible: (1) the person in privity with the insider; (2) all shareholders disadvantaged by lack of information; and (3) the corporation.

Courts that use a tort damages perspective are likely to limit standing to persons in privity with the insider. This approach also

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185. *Id.* at 236-37.

186. *Shapiro,* 495 F.2d at 241.

187. The Second Circuit left it to the district court to determine the proper measure of damage and suggested that "the nature and character of the Rule 10h-5 violations committed may require limiting the extent of liability imposed on either class of defendants." *Id.* at 242.

draws some support from the traditional common law governing rescission.[188] In an open-market setting, however, with the practical difficulty in matching buyers and sellers in a stock exchange transaction this limitation probably will prevent any plaintiffs from being able to recover.[189] This result is consistent with the view of those who believe that the prohibitory scope of rule 10b-5 is broader than the private rights it creates.[190]

Several courts and commentators justify a larger class of plaintiffs that would include all shareholders disadvantaged by the lack of information produced by the fraud. The Second Circuit in *Shapiro* concluded that an insider's duty to disclose or abstain extends to all those trading in the market during the same period.[191] In restitution terms, this is a finding that the defendant's breach infringes not just the interests of the trader who happened to be opposite the insider, but also all the interests of those in the market during the same period. The recognition that those other traders have interests that the defendant can infringe comes from the court's conclusion that the duty to disclose is necessary to preserve the integrity of the securities markets.

The proposed Federal Securities Code permits recovery by a similar class of plaintiffs, providing that the court shall divide the award pro rata among applicable plaintiffs.[192] The commentary explicitly recognizes the restitution basis for the obligation: "The theory, again, is compensation if practicable but in any event deterrence and avoidance of unjust enrichment."[193] More recently, other courts and commentators have supported both the unjust enrichment rationale of the recovery and disadvantaged shareholders as an appropriate class of plaintiffs.[194]

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188. *See supra* notes 61-66 and accompanying text.

189. *See* Wang, *supra* note 177, at 1236-37.

190. Fridrich v. Bradford, 542 F.2d 307, 320 (6th Cir. 1976) (rejecting view that "civil remedy must invariably be coextensive in its reach with the reach of the SEC, which under the Act, was designated by the Congress as the primary vehicle of its enforcement"), *cert. denied*, 429 U.S. 1053 (1977); Dooley, *supra* note 181, at 71 (Chiarella v. United States, 445 U.S. 222 (1980), "[s]uggests that the prohihitery scope of [10h-5] is broader than the private rights it creates, but this is neither novel nor unexpected in a regulatory system that has been fashioned piecemeal.").

191. *See supra* notes 184-86 and accompanying text.

192. ALI FEDERAL SECURITIES CODE §§ 1703b, 1708(b), 1711 (1980) (defendant liable for damages to persons who buy or sell from the day defendant first unlawfully buys until the day when all material facts become generally available; liability limited to amount defendant sold or bought with recovery prorated among plaintiffs if necessary).

193. *Id.* § 1711(j) introductory comment 7(a).

194. *See* Elkind v. Liggett & Myers, Inc., 635 F.2d 156 (2d Cir. 1980). Langevoort, *Insider Trading and the Fiduciary Principle: A Post-*Chiarella *Restatement*, 70 CALIF. L.

Expanding the class of plaintiffs to that suggested by *Shapiro* will create the procedural complications attendant to class actions. Individual plaintiffs may receive pro rata recoveries that are not equal to the expense of the suit or the allocation procedure.[195] Several writers, seeking a readily available plaintiff without these problems, have suggested that the corporation itself may be the most appropriate plaintiff.[196] The New York Court of Appeals adopted a similar position in *Diamond v. Oreamuno*.[197] The court in *Diamond*, using an unjust enrichment theory, permitted the corporation to recover an insider's trading gains. The court recognized as the "primary concern" the question "as between the corporation and the defendants, who has a higher claim to the proceeds. . . ."[198] Other courts have refused to accept the New York court's common-law basis for a corporation's right to sue,[199] but even apart from the resolution of that debate the corporate plaintiff has another problem establishing standing when suing under rule 10b-5. Rule 10b-5 plaintiffs must be actual purchasers or sellers of securities.[200] Since in many insider trading cases the corporation itself was not in the market at the same time as the insider, the corporation may not be able to satisfy this threshold for standing. The proposal of the corporation as plaintiff, therefore, usually comes in the context of suggestions for changes in the securities statute.[201]

Proponents of both the disadvantaged shareholders and the corporation as rule 10b-5 plaintiffs agree that in an open market context the insider trading prohibition is not designed to compen-

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REV. 1, 19-38 (1982) (preventing unjust enrichment is objective underlying the open-market duty to disclose).

195. *See* Karjala, *Statutory Regulation of Insider Trading in Impersonal Markets*, 1982 DUKE L.J. 627, 639-40. The ALI provides for alternative recovery to the corporation or the Securities Investor Protection Corp. when the trial court determines that the expense of making the proration, in relation to the amount to be awarded individual plaintiffs, does not warrant making the proration. ALI FEDERAL SECURITIES CODE § 1711(j).

196. *See, e.g.*, Karjala, *supra* note 195, at 641-44; Knauss, *Disclosure Requirements—Changing Concepts of Liability*, 24 BUS. LAW. 43, 58-59 (1968); Ratner, *Federal and State Roles in the Regulation of Insider Trading*, 31 BUS. LAW. 947, 957-60 (1976); Note, *A Re-Evaluation of Federal and State Regulation of Insider Trading on the Open Securities Market*, 58 WASH. U.L.Q. 915, 941-43 (1980).

197. Diamond v. Oreamuno, 24 N.Y.2d 494, 301 N.Y.S.2d 78, 248 N.E.2d 910 (1969).

198. *Id.* at 498, 301 N.Y.S.2d at 81, 248 N.E.2d at 912.

199. *See* Freeman v. Decio, 584 F.2d 186 (7th Cir. 1978); Schein v. Chasen, 313 So. 2d 739 (Fla. 1975).

200. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).

201. *See* Karjala, *supra* note 195, at 641-44; Ratner, *supra* note 196, at 960; Note, *supra* note 196, at 943.

sate injured victims as tort damages do. Instead, the prohibition is aimed at preventing insiders' unjust enrichment.[202] Allowing either group as plaintiffs could achieve this purpose. The claim of either group as the appropriate recipient of the enrichment does not rest explicitly on a contractual or other traditional common-law connection to defendant,[203] but on a finding by the courts such as in *Shapiro* that the protection of the securities market requires that plaintiffs have a right to expect that insiders will not take advantage of their position to trade.[204] A plaintiff class that includes those traders in the market at the same time as the insider satisfies the standing rule requiring an actual purchaser or seller and is consistent with the purposes of the securities laws as expressed in *Shapiro*.

Decisions such as *Elkind v. Liggett & Myers*[205] reflect the use by federal courts of traditional unjust enrichment principles to implement the broad remedial purposes of the securities laws, but the *Elkind* court's conclusion that gain is a requirement of rule 10b-5 liability is an overstatement. Some rule 10b-5 cases are supported by both tort and unjust enrichment rationales and some are supported by one but not the other. *Elkind* can be supported on unjust enrichment grounds even if tort grounds are not present. *Elkind* illustrates that the connection between the plaintiff and the defendant need not be as strong when a court imposes liability based on the defendant's unjust enrichment as when liability is based on compensating loss to the plaintiff. Open market insider trading cases stretch tort causation principles beyond limits most courts are willing to go, while on the alternative restitution grounds recovery does not raise the same concerns.

The unjust enrichment solution is not without defects because it provides little deterrence to an insider.[206] The defendant knows that if he is caught, he simply must hand back what he gained, and that if he is not caught, he will make a handsome profit.[207] Resolu-

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202. *See* Karjala, *supra* note 195, at 639; Langevoort, *supra* note 194, at 19-38.

203. *See* Fridrich v. Bradford, 542 F.2d 307, 326 n.11 (6th Cir. 1976) (Celebrezze, J., concurring) ("mechanics of the market necessitate designation of the class of contemporaneous investors as surrogate plaintiffs for those who actually traded"), *cert. denied*, 429 U.S. 1053 (1977). *But see* Dooley, *supra* note 181, at 21 (public investors function as a practical, if illogical surrogate).

204. *See supra* note 186 and accompanying text; *see also* Fridrich v. Bradford, 542 F.2d at 326 (Celebrezze, J., concurring).

205. 635 F.2d 156, 172 (2d Cir. 1980).

206. *See, e.g.*, Comment, *supra* note 123, at 291.

207. Both the ALI and SEC have suggested legislative changes to meet this fault. *See*

tion will have to await legislative enactment because neither tort nor unjust enrichment theories seem capable of providing a better solution.

VI. Conclusion

Since 1974 the Supreme Court has restricted the reach of the private cause of action implied under rule 10b-5.[208] In that context, lower courts seeking to determine the appropriate measure of damages have found the familiar tort concept of proximate cause to be a useful tool in preventing a plaintiff from shifting to the defendant the risk of market change subsequent to the fraudulent transaction. Some courts have suggested that there can be no liability under rule 10b-5 unless the misrepresentation is the proximate cause of the loss. These statements give too narrow a view to the purposes of the rule and fail to recognize adequately its unjust enrichment ancestry. The statements must be limited to cases in which grounds for unjust enrichment recovery do not exist and in which recovery, if the court is to find it at all, can be based only on tort theory. Unfortunately, this narrow vision has spilled over to cases in which a basis for unjust enrichment recovery does exist. The courts' inability to deal consistently with recovery that they consider to be based on rescission or a rescissory measure of damages evidences this "spill over." Courts often view these measures of recovery in tort terms, overlooking the principles of unjust enrichment that distinguish rescission and monetary awards that are the financial equivalents of rescission from the tort based out of pocket or consequential damages recoveries. As a result of this tort-influenced view, courts often mangle theories when plaintiffs seek to recover windfall profits based on unjust enrichment principles.

When courts recognize unjust enrichment as a principle justifying recovery under rule 10b-5 separate and apart from tort principles, they clarify their decisions that deal with rescission and the *Janigan* measure of recovery. Unjust enrichment as a separate theory of recovery also provides a better foundation to consider the more difficult problems raised in open-market insider trading

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Federal Securities Code § 1708 introductory comment 5(d) (Proposed Official Draft 1980); Inside Trading Sanction Act of 1983 (currently before Congress).

208. Since 1974 the Supreme Court has limited the reach of 10b-5 in a variety of ways, most recently in Dirks v. United States, 103 S. Ct. 3255 (1983). *See generally* Whitaker & Rotch, *The Supreme Court and the Counter-Revolution in Securities Regulation*, 30 Ala. L. Rev. 335 (1979).

cases. Courts therefore should recognize and apply the distinction between the tort and unjust enrichment theories to carry out the purposes of the rule 10b-5 action.