

BUTTERMORE AND FOLTZ

ATTORNEYS AT LAW
445 EAST BROAD STREET
PO Box 2189
WESTFIELD, NJ 07091-2189

TEL (908) 232-0292
FAX (908) 232-3277
dfoltz@baf-law.com

GRANT M. BUTTERMORE (1924-2011)
DAVID B. FOLTZ †
† ALSO ADMITTED IN NEW YORK AND PENNSYLVANIA

July 25, 2016

Memorandum to: FILE
From: David B. Foltz

RE: Can Rescission of a Share or Asset Purchase Agreement be Contractually Excluded in the United States

Rescission, in the US, is an equitable remedy which requires a finding of fraud, and it cannot be contractually excluded.

Rule 10b-5 of the regulations issued under the Securities Exchange Act of 1934 (17 CFR § 240.10b-5) states, with regard to employment of manipulative and deceptive devices, that: It shall be unlawful for any person, directly or indirectly, by 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 an device, scheme, or artifice to defraud,
 - (b) To make an untrue statement or a material fact or to omit to state a material fact necessary in order to make statements made, in 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 definition of a security is quite broad, but clearly includes the common and preferred shares of a publicly traded corporation.

In Gannet v. Register Publishing Co., 428 F. Supp 818 (1977) the Court stated that New York law, like the law of most states, gives an injured party the option to rescind a contract induced by fraud. But the right does not persist indefinitely. New York Law is very clear that the right to rescind for fraud must be exercised within a reasonable time after the injured party learns of the wrong. If the injured party neglects to notify the other party promptly of his intention to rescind, or if he accepts benefits under the contract and thereby affirms it, he loses his right to rescind. New York Tel. Co. v. Jamestown Tel. Corp., 282 N.Y. 365, 26 N.E. 2d 295 (1940); Richard v. Credit Suisse, 242 N.Y. 346, 152 N.E. 110 (1926); Gravenhorst v. Zimmerman, 236 N.Y. 22, 139 N.E. 766 (1923); Soviero Bros. Contracting Corp. v. City of New York, 286 App. Div. 435, 142 N.Y.S.2d 508 (1st Dept. 1955); McNaught v. Equitable Life Assurance Soc'y, 136 App. Div. 774, 121 N.Y.S. 447 (2d Dept. 1910); Big Top Stores, Inc. v. Ardsley Toy Shoppe, Ltd., 64 Misc.2d 894, 315 N.Y.S.2d 897 (S.Ct. N.Y. Co. 1962); Flamm v. Noble, 43 N.Y.S.2d 922 (S.Ct. N.Y. Co. 1943), *aff'd*, 266 App. Div. 1001, 45; N.Y.S. 2d 413 (1st Dept. 1943). Restatement, Contracts, §§ 349, 480, 482, 483, 484.

NEW YORK OFFICE
111 BROADWAY, SUITE 1805
NEW YORK, NY 10006
TEL (212) 227-3139

ASSOCIATE MEMBER OF THE PARLEX GROUP
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WWW.PARLEX.ORG

PENNSYLVANIA OFFICE
620 PORTER STREET, SUITE 200
EASTON, PA 18042
TEL (610) 252-2925

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July 25, 2015
Memorandum to: FILE
Page 2

The Court went on to state that, a party has a right to rescind a contract, where he was induced to enter into by fraud; but he must do so promptly upon discovery of the fraud, and cannot speculate as to whether it would be more profitable to affirm the contract or rescind it. Sarantides v. Williams, Belmont & Co., Inc., 180 N.Y.S. 741, 743 (S.Ct. App. Term 1920) In determining whether the injured party has lost the power to avoid the contract by delaying unreasonably in manifesting to the other party his intention to avoid the transaction, the speculative character of the contract is an influential factor. Restatement, Contracts, § 483. Comment (a) to this section of the Restatement states:

But the injured party delays giving information of his intention at his peril. He cannot lie by and delay choosing whether avoidance or affirmance will be more profitable, especially if the contract relates to a speculative transaction.

Furthermore, the Court stated that, several federal cases have held subsequent conduct evidencing affirmance of the conduct after full knowledge of the fraud extinguishes the substantive right to disaffirm notwithstanding the anti-waiver provisions of the statute. Eyman v. Marsha Development Corp., 301 F.Supp. 931 (E.D.Mo. 1969); Junker v. Midterra Associates, Inc., 49 F.R.D. 310 (S.D.N.Y. 1970), and cases cited therein.

Because the current US Supreme Court does not recognize a federal common law, claims of fraud must be pled under a federal statute or regulation, such as Rule 10b-5, or under the common law of an individual state. No attempt to exclude rescission by contract should be respected by any US court, because the court can not countenance fraud in a contract. Under the common law of New Jersey and New York, as well as the Restatement (Second) of Contracts § 205 and the Uniform Commercial Code of many states, every contract contains an implied covenant of good faith and fair dealing, which covenant can not be reconciled to fraud.

