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CASE COMMENTS

SEC RULE X-10B-5 AS A WEAPON AGAINST THE STOCK SWINDLE

Prior to the Securities Act of 1933¹ and the Securities Exchange Act of 1934,² a person defrauded in a securities transaction had only the common law action of deceit on which to rely for relief, unless the mail fraud statute was applicable.³ The common law action of fraud and deceit became impractical in many instances because the more astute swindlers found that the elements of this tort served as guide posts which enabled them, by using only half-truths, omissions, opinions and puffings, to avoid actual commission thereof.⁴ A weapon presently being used against fraudulent half-truths and misleading omissions in securities transactions is section 10B⁵ of the Securities Exchange Act and rule X-10B-5⁶ promulgated by the Securities and

¹48 Stat. 74 (1933), 15 U.S.C. § 77a (1958).

²48 Stat. 881 (1934), 15 U.S.C. § 78a (1958).

³18 U.S.C. § 1341 (1958).

⁴In order to sustain a cause of action at common law for fraud and deceit the defrauded party had to show that a false misrepresentation of fact had been made by the defendant; that the defendant knew such statement was false; that the defendant intended the plaintiff to act in reliance upon the statement; that, in fact, the plaintiff did reasonably rely thereon; and that the plaintiff suffered damages as a result of such reliance. Prosser, *Torts* § 86 (2d ed. 1955). The leading case on this subject is *Derry v. Peek*, [1888] 14 A.C. 337. See also Shulman, *Civil Liability and the Securities Act*, 43 *Yale L.J.* 227, 233 (1933); White, *From the Frying Pan into the Fire: Swindlers and the Securities Acts*, 45 *A.B.A.J.* 129, 130 (1959).

⁵This section reads as follows: "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 . . . 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." 48 Stat. 891 (1934), 15 U.S.C. § 78j(b) (1958).

⁶This rule reads as follows: "It shall be unlawful for any person directly or indirectly, by use of any means or instrumentality of interstate commerce, or 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 statements of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person . . . in connection with the purchase or sale of any security." 17 C.F.R. § 240.10b-5 (1949). The SEC adopted the language for this rule from section 17 of the Securities Act of 1933. 48 Stat. 84-85 (1933), 15 U.S.C. § 77q (1958).

Exchange Commission in 1942 under the authority of that statutory section. The statute and the rule prohibit fraudulent practices in connection with the purchase or sale of any security.⁷

A recent expansion in the meaning of the term "sale" is found in *Hooper v. Mountain States Sec. Corp.*⁸ decided by the Court of Appeals for the Fifth Circuit. The principal question in this case was whether a corporation misled by fraud into the issuance of its stock in return for spurious assets is a seller, or, whether such a transaction could be called a sale under X-10B-5 of the Exchange Act.⁹ If this action was within the purview of the Exchange Act so that service of process could run throughout the nation, then the federal district court in Alabama could obtain jurisdiction over the non-resident defendants.¹⁰ On the other hand, if this transaction was not covered by the Exchange Act under section 10B and rule X-10B-5, the federal

⁷The purpose for the adoption of X-10B-5 was stated in *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir. 1952): "While the Rule may have been somewhat loosely drawn its meaning and scope are not difficult to ascertain when reference is had to the scheme of SEC Regulations and the purpose underlying the adoption of X-10B-5. Prior to its adoption the only prohibitions against fraud in the sale or purchase of securities were contained in Section 17(a) of the 1933 Act, 15 U.S.C.A. § 779(a) and Section 15(c) of the 1934 Act, 15 U.S.C.A. § 780(c). Section 17(a) of the 1933 Act only made it unlawful to defraud or deceive purchasers of securities, and Section 15(c) of the 1934 Act dealt only with fraudulent practices by security brokers or dealers in over-the-counter markets. No prohibition existed against fraud on a seller of securities by the purchaser if the latter was not a broker or dealer. . . . [T]he SEC adopted Rule § X10B-5 to close this . . . loophole in the protection against fraud . . . by prohibiting individuals or companies from buying securities if they engage in fraud in their purchase." 193 F.2d at 463.

In *Fratt v. Robinson*, 203 F.2d 627 (9th Cir. 1953), the court said: "We think the authors of the Act realized that the remedy of the abuses sought to be applied by the Act would be more or less completely effective in the proportion of security-trading done on or through the established businesses. To this end § 10 was enacted in order that those who desire to promote crooked deals would see little advantage in using devious methods to by-pass the security dealing business houses under regulation. And further, that prospective crooked deals would be under a powerful deterrent by reason of the fact that perpetrators of fraud in security exchanges would be in violation of federal laws." 203 F.2d at 631.

⁸282 F.2d 195 (5th Cir. 1960). Cert denied, 365 U.S. 814 (1961).

⁹Id at 200.

¹⁰None of the defendants were residents of Alabama; however, if the court found this transaction to come within the purview of section 10B and rule X-10B-5, service of process would run throughout the entire United States under section 27 of the Securities Exchange Act. Also, if the court found the alleged fraudulent transaction to come within the provisions of X-10B-5, the plaintiff could get into the federal court without diversity by showing that such fraud was perpetrated through the use of any means or facility of interstate commerce, either directly or indirectly. If this is shown, the plaintiff receives the additional benefits of federal procedure and discovery methods, as well as pendent jurisdiction by the federal court over non-securities transaction. *Errion v. Connell*, 236 F.2d 447 (9th Cir. 1956).

court could not get jurisdiction over these defendants, and the complaint would have to be dismissed, leaving the plaintiff to his other remedies.¹¹ The federal district court dismissed the complaint on the ground that the fraudulent scheme was not in connection with the purchase or sale of any security.¹² On appeal, this decision was reversed. Whether or not there was a "purchase" of securities was immaterial, for the Court of Appeals held that there was a "sale" within the meaning of the Exchange Act.¹³

The swindle as originally planned involved a rather complicated scheme aimed at obtaining control of the then unissued stock of Consolidated American Industries. Briefly, the scheme was: (1) to form a corporate vehicle through which certain worthless contract rights could be exchanged for Consolidated's unissued stock; (2) the dissolution of the vehicle corporation; (3) the distribution of Consolidated's stock to the owners of the vehicle corporation as a liquidating dividend; and (4) the later disposition of such stock over-the-counter, allegedly exempt from SEC registration.¹⁴

The actual accomplishment of this scheme was not carried out in the above manner but by presenting certain forged documents to Consolidated's transfer agent.¹⁵ In so doing, however, the swindlers did secure control of 700,000 shares of previously unissued Consolidated stock, over 400,000 shares of which were then sold to individual investors throughout the world.¹⁶ The par value of such stock was only one cent per share, but its market trading value was \$1.00 per share. Thus this swindle apparently netted, before expenses, over \$400,000.¹⁷

The method of accomplishing this swindle, contrary to the original plan, presented the court with certain difficulties in fitting the complaint into rule X-10B-5 under the Exchange Act, an Act apparently designed to deal with the more sophisticated swindle, such as the one originally planned in this case. However, the court virtually treated the original plan of the swindle as though it had been accomplished, with the result that the opinion contains loose factual as well as legal ends, not entirely concealed by its somewhat flippant tenor.

¹¹Recission of the issue of the stock by the trustee in bankruptcy, Hooper, may have been an available remedy; or perhaps an action for common law deceit could have been utilized by the plaintiff.

¹²The case is apparently unreported.

¹³282 F.2d at 202, 203.

¹⁴Id. at 199.

¹⁵Id. at 200.

¹⁶Ibid.

¹⁷282 F.2d at 199.

The principal arguments which the defendants made were that the transaction and suit were not within the purview of rule X-10B-5 because: (1) The Act was designed to protect investors, and a corporation issuing its own stock is not an investor;¹⁸ (2) The issue of corporate stock is not a sale of such stock so as to qualify under this rule;¹⁹ (3) The Exchange Act does not authorize a private right of action where the sale of securities is made directly by a seller to a buyer, and not through a securities exchange or an organized over-the-counter market.²⁰

In discussing the first argument the Court of Appeals for the Fifth Circuit stated that the SEC had two bases under section 10B for the promulgation of X-10B-5—"in the public interest" or "for the protection of investors." Since the SEC could promulgate this rule "in the public interest," a corporation defrauded into the issuance of its own stock for worthless assets may rely upon this rule for a right of action, even though the corporation is not an investor.²¹ Taking this position, the court reasoned that since the broad purpose of the legislation is to keep the channels of interstate commerce, the securities exchanges, and the mail free from fraud the expression "in the public interest" does not require those intended for protection to be part of the general public.²²

In discussing the second issue, whether the issuance of corporate stock may be a sale of stock under X-10B-5, the court did not analyze the fraudulent scheme in terms of accepted legal or accounting doctrines in regard to the issuance of unissued stock.²³ As this court viewed the matter, before the transaction the corporation had 700,000 shares of unissued stock which it could issue to the public in exchange for property, while after the transaction the corporation had only worthless property. Thus, the court said that the transaction had "many earmarks of a sale."²⁴

¹⁸Id. at 201.

¹⁹Ibid.

²⁰Ibid.

²¹A corporation qualifies for protection under this rule. *Slavin v. Germantown Fire Ins. Co.*, 174 F.2d 799, 805 (3d Cir. 1949) (dictum). 15 U.S.C. § 78c(a)(9) (1958).

²²282 F.2d at 202. See also note 7 *supra*.

²³The general rule is as follows: Certificates of stock are not property of the issuing corporation. They are only evidences of the respective units of interest owned by the several stockholders in a corporation. 13 Am. Jur. Corporations § 173 (1938).

²⁴"Certainly the transactions between Consolidated and the apparent transferee, Mid-Atlantic, had many earmarks of a sale. Mid-Atlantic had properties which it ostensibly valued highly. It was willing to trade these properties as consideration for Consolidated stock." 282 F.2d at 202.

The court found a stronger basis for this part of the decision, however, in the definition of sale contained in section 3(a)(14) of the Exchange Act. According to that definition, "[T]he terms 'sale' and 'sell' each include any contract to sell or otherwise dispose of" securities.²⁵ Relying upon this definition, the court said, "If this is not a sale in the strict common law traditional sense, it certainly amounted to an arrangement in which Consolidated 'otherwise dispose[d]' of its stock."²⁶

The court, in reaching a decision upon the third point, expressly applied for the first time the doctrine formulated in *Kardon v. National Gypsum Co.* which allowed a private civil right of action for a violation of X-10B-5 where facilities of mail or interstate commerce are utilized in connection with a sale or purchase of securities.²⁷ The principle in *Kardon* had been recently recognized in the Fifth Circuit, although not applied.²⁸ Moreover, the court stated that a private right of action is available in the Fifth Circuit even though the fraudulent transaction is conducted directly between the buyer and seller and not through a securities exchange or an organized over-the-counter market.²⁹ The court found much authority for its decision in cases from other circuits dealing with this problem. By virtue of the *Hooper* decision a private right of action for violation of X-10B-5 is now accepted law in the Second,³⁰ Third,³¹ Fifth and Ninth Circuits,³² and this in itself appears to be a powerful deterrent against the stock swindle.

The *Hooper* case illustrates another expansion of X-10B-5 in holding that the term "to otherwise dispose of" securities is not meaningless. It will be invoked to encompass those securities transactions where fraud is involved even though there is no purchase or sale in the traditional sense. Further, rule X-10B-5 will be treated by the Fifth Circuit as if it had been promulgated by the SEC expressly "in the

²⁵"When used in this chapter, unless the context otherwise requires—The terms 'sale' and 'sell' each include any contract to sell or otherwise dispose of." 48 Stat. 72 (1933), 15 U.S.C. § 78c(a)(14) (1958).

²⁶282 F.2d at 203.

²⁷69 F. Supp. 512 (E.D. Pa. 1946). It may be noted that a private right of action for violation of the Securities Act of 1933 is now also available. *Osborne v. Mallory*, 86 F. Supp. 869, 878 (S.D.N.Y. 1949).

²⁸*Reed v. Riddle Airlines*, 266 F.2d 314, 315 (5th Cir. 1959).

²⁹282 F.2d at 201.

³⁰*Fischman v. Raytheon Mfg. Co.*, 188 F.2d 783 (2d Cir. 1951).

³¹*Slavin v. Germantown Fire Ins. Co.*, 174 F.2d 799 (3d Cir. 1949).

³²*Errion v. Connell*, 236 F.2d 447 (9th Cir. 1956); *Fratt v. Robinson*, 203 F.2d 627 (9th Cir. 1953).

public interest" as well as for the protection of the investor. What additional legal effect will arise from this holding is presently unknown. It is, however, clear that neither an individual nor a corporation needs the status of an investor to obtain relief from fraud under this rule.

This case is consistent with other recent decisions broadly construing X-10B-5 as a weapon to be used against the stock swindle. For example, it has been held unnecessary under X-10B-5 to allege that actual fraud occurred through the use of the mails or interstate commerce, but it is only necessary to show that fraud did take place in connection with a sale or purchase of securities.³³ Also, one court held recently that this rule is applicable to civil actions where a plaintiff seeking damages has been defrauded in transactions involving both securities and non-securities, so long as the fraud occurs in a single overall scheme involving the purchase or sale of securities.³⁴ To qualify for relief under X-10B-5 the misrepresentations or fraud do not need to relate to the securities themselves but only to the consideration paid for the securities.³⁵

Notwithstanding the fact that courts are presently construing the Rule broadly, it does have important limitations. Proof of fraud is a prerequisite to establish a cause of action under X-10B-5, whereas under section 11(b)³⁶ of the Securities Act, proof of misstatements and omissions in the registration statement or prospectus is all that is necessary. However, even an action under 11(b) may be supplemented by X-10B-5 in certain instances where some element of fraud is cognizable.³⁷

Whether this decision in *Hooper* is one of policy, peculiar to the facts of this case, or whether it carries out actual legislative intent under 10B, it is submitted that the court reached a correct result. To hold otherwise, by not allowing relief under X-10B-5, would perhaps have made it necessary for the trustee in bankruptcy, *Hooper*, to institute suits against numerous bona fide purchasers to rescind the stock transfer. Since over 400,000 shares were distributed throughout the world, such a procedure would have been impracticable, to say the least.³⁸ Perhaps *Hooper* could have relied upon the common

³³*Fratt v. Robinson*, 203 F.2d 627, 633-34 (9th Cir. 1953).

³⁴*Errion v. Connell*, 236 F.2d 447, 456 (9th Cir. 1956).

³⁵See note 33 supra.

³⁶48 Stat. 82 (1933), 15 U.S.C. § 77k (1958).

³⁷*Fischman v. Raytheon Mfg. Co.*, 188 F.2d 783, 786-87 (2d Cir. 1951).

³⁸In an action for rescission, *Hooper* would not have to show any damage suffered. 59 Yale L.J. 1120, 1131 (1950). However, without the benefit of X-10-5, the cost of such a procedure would be prohibitive.