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CORPORATIONS — STOCK MARKET MANIPULATION — RESCISSION FOR FRAUD — To obtain a more favorable market ratio for the contemplated exchange, defendants maintained an artificial market in Harriman Bank stock, then offered to exchange that stock for Liberty Bank stock. In a suit brought by former Liberty Bank stockholders to obtain a rescission of the executed exchange upon the ground of fraud, *held*, that a good cause of action was stated. *Wilcox v. Harriman Securities Corporation et al.*, (D. C. N. Y. 1933) 10 F. Supp. 532.

Relief in the instant case was granted upon the ground that, "If persons boost the quoted price of a stock above its real value by fictitious sales in order to induce the public to take over their stock at the artificial levels, one who acquires stock for value from the manipulators may treat the transaction as one infected by fraud and may rescind."[1] The decision is perhaps correct, but it represents an extension of the orthodox conceptions of fraud.

[1] 10 F. Supp. 532 at 535.

To support a claim of fraud at common law, it is necessary to show that one party has represented to another, falsely, a material matter of fact, with knowledge of the falsity of the representation and with the intent that the other party should rely thereon, and that that other party had relied thereon, sustaining consequent damage. In a court of equity, however, the legal requirement of scienter is relaxed in rescission cases, upon the ground that the mere benefit through misrepresentation, however innocently made, is inequitable, and that a court of equity will restore the parties to the positions they occupied before the transaction. But since the purpose of rescission is a restoration of the status quo, equity substitutes for the requirement of scienter the requirement of privity of contract.[2] As applied to security exchange frauds, the important requirements are that the representation be addressed to the plaintiff or others of his class, that it concern a matter of fact, and that the parties be in privity of contract, or else that the defendant have knowledge of the falsity of his statement.

The cases commonly cited in support of the proposition that price manipulation upon security exchanges may be considered to infect with fraud the sales and purchases made in reliance thereon can in general be classified into three groups. The most commonly cited case in the first group is *Bedford v. Bagshaw*,[3] in which the defendant, to show a compliance with the listing requirements of the London Stock Exchange, made false statements to the listing committee as to the allotment of shares in the corporation which he promoted; when the listing was approved, the plaintiff bought shares relying upon the supposed compliance with the rules of the Exchange; the court allowed a recovery for deceit. If, however, the case be interpreted to mean that a representation to the exchange officials was ipso facto a representation to any and all persons who might at any time become interested in the stock, it would seem to be wrongly decided. Upon this basis, the case was overruled by the House of Lords in the later case of *Peek v. Gurney*.[4] On the other hand, in *Tindle v. Birkett*,[5] the defendant, insolvent at the time, made a favorable financial statement to R. G. Dun & Co., intending to induce reliance upon that statement by those considering the extension of credit to his firm; the plaintiff did extend credit in reliance upon the Dun statement, and sued for damages when the defendant was declared a bankrupt. The court held it immaterial that the representations were not made to the plaintiff directly if it was

[2] Shulman, "Civil Liability and the Securities Act," 43 YALE L. J. 227 (1933); 2 WILLISTON, SALES, §§ 636a, 636b (1924).

[3] 4 H. & N. 538, 157 Eng. Rep. 951 (1859).

[4] L. R. 6 Eng. & Ir. App. 377 at 397 (1873).

[5] 171 N. Y. 520, 64 N. E. 210 (1902).

intended that the plaintiff, or another in his position, be the one to rely upon them. The true question, then, in this class of cases, would seem to be a question of fact, rather than one of law; the criterion must be one of the intended scope of the representation and of the class of persons intended to be influenced thereby.[6]

The second class of cases involves a suit by one member of a stock market pool against another for breach of their contract of joint adventure.[7] In such cases, recovery has been denied upon the ground that the contracts were illegal, and judges have commonly used very strong language in condemning such a contract as a fraud upon the public. The cases cannot, however, be admitted to be in point in such a case as the present; it is one thing to deny the aid of the courts to the pool operator who wishes to enforce his contract against another member of the pool, and it is another thing to waive the requirements of actionable fraud already mentioned.

The third class of cases commonly cited are criminal or quasi-criminal actions. In *People v. Rice*,[8] the Attorney General of New York brought an action under the Martin Act[9] to enjoin the defendants' stock market activities, including both "wash sales" and the touting of stocks by the use of a "tipster sheet." The court held both types of activity to be fraudulent within the terms of the act. And in *United States v. Brown*,[10] the members of a bull pool were prosecuted for the use of the mails to defraud in connection with their market activities and their touting of stocks through a "tipster sheet"; a demurrer to the indictment was overruled. In both these cases, it must be noted, the prosecution depended upon the terms of a statute. But for another reason, these cases must be a dubious authority upon which to predicate civil liability. For criminal liability, it is true there must be a fraudulent representation addressed to someone; but from the very nature of the case and the parties, the issue of whether the representation was addressed to a particular individual or class cannot become so acute as it

[6] Ottinger v. Bennett, 203 N. Y. 554, 96 N. E. 1123 (1911), memorandum adopting dissenting opinion of Miller, J., 144 App. Div. 525 at 532, 129 N. Y. S. 819 (1911); Hindman v. Bank, (C. C. A. 6th, 1902) 112 F. 931 at 941, 57 L. R. A. 108; Hunnewell v. Duxbury, 154 Mass. 286, 28 N. E. 267, 13 L. R. A. 733 (1891); Peek v. Gurney, L. R. 6 Eng. & Ir. App. 377 (1873); Andrews v. Mockford, [1896] 1 Q. B. 372; but see Walsham v. Stainton, 1 DeG. J. & S. 678, 46 Eng. Rep. 268 (1863); Miller v. Barber, 66 N. Y. 558 (1876).

[7] Ridgely v. Keene, 134 App. Div. 647, 119 N. Y. S. 451 (1909); Scott v. Brown, [1892] 2 Q. B. 724.

[8] 221 App. Div. 443, 223 N. Y. S. 566 (1927).

[9] 12 N. Y. Consol. Laws (Cummings & Gilbert, Cum. Supp. 1921-1923, v. 1), pp. 878-880, §§ 352, 353.

[10] 5 F. Supp. 81 (1933).

becomes in civil cases. Further, in neither of these cases was there any consideration of the vital issue of whether the purchase or sale of stock upon the exchange can be considered to be a representation of a matter of fact.

The decided cases, then, afford small ground upon which to predicate civil liability for the maintenance of an artificial market in securities upon the validity of which a member of the public relies in the purchase of stocks or bonds. It does not necessarily follow, however, that such relief should be denied. As we have seen, the requirement that the representation be addressed to the plaintiff is primarily a question of fact rather than of law. And for the purposes of the motion to dismiss, this requirement would seem to be met in the *Wilcox* case, for it is alleged that the very end and aim of the artificial market was to induce the stockholders of the Liberty National Bank, i.e., the plaintiffs, to exchange their stock for the manipulated stock.

But the requirement that the representation concern a matter of fact is not so easily satisfied. Assuming that a purchase of stock upon the exchange is a representation,[11] it would seem at first sight to be a representation of the opinion of the purchaser as to the value of the stock and hence not actionable. The question has only once been before a court for decision in this country, and in that case it was held that "wash sales" of stock did not constitute actionable fraud.[12] But there is another possible interpretation. The higher market price set through the maintenance of an artificial market would create an exchange ratio unfavorable to the plaintiffs; if, therefore, the plaintiffs relied upon the market in making their exchange, it must be that they relied, not upon any representation of value, but upon the supposed existence of buyers for the stock at that price level. The representation, then, is not one of value, but of the existence of a bona fide demand for the stock at that price; such a representation is a false representation of a material matter of fact, and hence actionable.

It must be noted that the effect of this case, if sustained, must of necessity be most limited. Rescission is here sought, not for a sale or purchase of stock made on the exchange itself, but for a transaction effected through other channels following stock market manipulation. The distinction becomes important in regard to the requirement of privity of contract; because of that requirement, the remedy of rescission is available only where the vendor has himself made the representation. But identity of vendor and representor is rarely found in the ordinary stock market transaction, and even where it is found, the

[11] See Berle, "Liability for Stock Market Manipulation," 31 COL. L. REV. 264 at 270, 271 (1931).

[12] McGlynn v. Seymour, 14 Daly (N. Y.) 420 (1888).

anonymity of the transaction is likely to prove an effective cloak by which the representor may avoid liability.

A further aspect of this case must be noticed: Professor Berle is of the opinion that a corporation whose stock is traded is placed under a duty to stockholders, either actual or prospective, to see that, so far as it is itself concerned, the market is "free."[13] If such an obligation exists, it opens up a possible additional ground for liability in the instant case. Whether or not the Harriman Bank itself is alleged to have participated in the market operations does not clearly appear from the report, but it does appear that directors of the Bank are charged with participation, and it is also charged that the principal pool operator was the Bank's affiliate, the Harriman Securities Corporation. This would seem, then, to be an appropriate occasion for the court to disregard the corporate fiction upon the ground that it is here only a cloak for fraud. It must, however, be admitted that the existence of such an obligation to stockholders seems a little doubtful; an examination of the cases indicates that the basis of the rule prohibiting a corporation from dealing in its own stocks (save, perhaps, with funds from surplus, etc.) is to prevent the waste of corporate assets and to protect creditors.[14]

We come, then, to the conclusion that in certain limited circumstances the ordinarily accepted doctrines of fraud and deceit will permit an action for damages or for rescission in cases of the manipulation of security prices. The Securities Exchange Act of 1934[15] has created in addition a statutory remedy in favor of those "who shall purchase or sell any security at a price which was affected by" the proscribed manipulation.[16] The problems raised by the *Wilcox* case and the Securities Exchange Act offer interesting possibilities from the point of view of bankers who support the market during the primary marketing of securities as well as those who operate secondary marketing pools. It seems desirable, therefore, to attempt some survey of the desirability and economic function of manipulation, yet recognizing the difficulty of adequate generalization.

It is possible to take the stand, since the function of a security mar-

[13] Berle, "Liability for Stock Market Manipulation," 31 COL. L. REV. 264 at 274 (1931).

[14] The cases are reviewed in In re Fechheimer Fishel Co., (C. C. A. 2d, 1914) 212 F. 357.

[15] Public, No. 291, 73rd Cong., 2d Sess., 48 Stat. 881.

[16] Sec. 9(e), 48 Stat. 890. Just what manipulation is proscribed is not so clear; it may be that the broad prohibitions of §§ 9(a) 1 and 9(a) 2 will be so construed as to include such pegging operations as those involved in the Wilcox case. It seems more likely, however, that the grant of power to the Commission in § 9(a) 6 to prescribe reasonable rules and regulations regarding pegging operations will be held to except such operations from the prohibition of the earlier subsections.

ket is to bring together the stream of buyers and sellers, to furnish a measure of value of the wealth invested in securities, and to furnish a means for the transfer of that wealth from one form into another,[17] that all price manipulation is illegitimate.[18] Such a stand, however, seems to oversimplify the problem. The common practice of supporting new issues has been attacked upon the ground that it encourages the flotation of issues at prices unwarranted by the condition of the market, but the practice may be defended as an effort to minimize losses to investors from market reactions which seem to be inevitable in this country.[19] Similarly, little generalization is possible in regard to manipulative practices for the secondary distribution of securities. If the market is to perform its functions at all in times of great stress, the efforts of individuals or groups to provide an orderly market become essential, as in the case of the "bankers' pool" of 1929, or the ordinary efforts of specialists to assure an orderly market in their particular stocks. Again, manipulative activity is required when it becomes necessary for an individual or group to dispose of holdings too large to be absorbed by the market without the aid of such activity. In general, such types of activity aid, rather than hinder, the performance of the functions of the security markets, although abuses are sometimes present. There are other types which are concededly undesirable. Thus, the Securities Exchange Act specifically prohibits the formerly common practice of marketing unsold or treasury stock of a corporation through the manipulations of "option pools."[20] And it is difficult to conceive of an economic function performed by that type of market pool whose sole purpose is the conscious marking up of prices in order to unload a given issue on the public at a profit to the syndicate.[21]

In view of the difficulty of generalizing as to the desirability of price pegging in the markets, Congress itself refused to prohibit the practice altogether, preferring to leave that regulation to the Commission.[22] Yet the investigation made by Congress was one of the most exhaustive made in recent times. In view of the doubt surrounding the entire subject, it is to be expected that the courts will exercise a similar caution in extending the rule of the *Wilcox* case.

W. J. S.

[17] BERLE AND MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 299 (1932).

[18] "As a matter of fact, any pool which seeks to bring about a change in the price of a security through manipulation is 'illegitimate' according to our definition, inasmuch as it thereby lessens the efficiency of an exchange in the performance of those functions which, as we indicated, are the only justification for its existence." TWENTIETH CENTURY FUND, STOCK-MARKET CONTROL, 193 (1934).

[19] TWENTIETH CENTURY FUND, THE SECURITY MARKETS 445 ff. (1935).

[20] Sec. 9(b).

[21] TWENTIETH CENTURY FUND, THE SECURITY MARKETS 499 ff. (1935).

[22] See H. Rep. 1383; S. Rep. 792; H. Rep. 1838, 73rd Cong., 2d Sess.