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CORPORATIONS -LIABILITY OF BROKER ON MISLEADING CIRCULARS

CORPORATIONS — LIABILITY OF BROKER ON MISLEADING CIRCULARS — The possibilities of civil and criminal liability under the recent Securities Act of 1933 [1] and the Securities Exchange Act of 1934 [2] have caused considerable fear to those business groups which take part in the business of issuing and transferring corporate securities. The federal acts do subject the vendor of securities who induces sales by means of false or misleading prospectuses and circulars to a possibility of civil liability which was not present under the common law. In a recent Michigan case,[3] the court reached substantially the objectives sought by

[1] 48 Stat. 74, U. S. C. tit. 15, sec. 77a ff. (1933). For discussion see James, "The Securities Act of 1933," 32 MICH. L. REV. 624 (1934). The Act was amended by Securities Exchange Act of 1934, 48 Stat. 881, U. S. C. tit. 15, sec. 78a. For discussion see James, "Amendments to the Securities Act of 1933," 32 MICH. L. REV. 1130 (1934).

[2] 48 Stat. 881, U. S. C. tit. 15, sec. 78a ff. For discussion see Tracy and MacChesney, "Securities Exchange Act of 1934," 32 MICH. L. REV. 1025 (1934).

[3] Wolfe v. Kusterer & Co., 269 Mich. 424, 257 N. W. 729 (1934).

these acts by applying the existing rules of common law in the state. This comment will attempt to show the various possibilities of liability, under the common law, of brokers who issue misleading circulars describing the securities which they sell.

In *Wolfe v. Kusterer and Co.*, the defendant was a firm of brokers. The plaintiff, acting through her son as agent, informed the defendant that she desired to invest in safe securities, suggesting bonds secured by first mortgages on real estate. The defendant suggested various securities, including bonds of the Central Security Company, and gave to the son a circular which the defendant had prepared describing these bonds. The bonds of the Central Security Company were described as collateral trust gold bonds secured by 100 per cent deposit with a trustee of the direct obligations of certain mortgage companies, which obligations were in turn secured by deposits of guaranteed first mortgages on real estate, "And in lieu of the above United States government bonds, United States Treasury certificates of indebtedness and/or cash may be deposited." [3a] The original trust indenture provided that any amount of either type of security mentioned could be deposited and provided further, "Certificates of Deposit issued by the Trustee . . . shall be deemed to be and considered as cash." [3b] The trustee bank, contrary to a collateral indenture which the defendant had secured from the trustee whereby the latter should furnish bond for repayment should the cash collateral exceed ten per cent, sold all the securities held, deposited the money with itself, and held certificates of deposit against itself as security. Neither the fact that certificates of deposit issued by the trustee bank should be considered as "cash" nor the fact that the defendant was so apprehensive of the danger in this provision as to require the supplementary indenture, was communicated to the plaintiff or her son. The trustee bank became insolvent and the bonds proved almost worthless. Upon discovery of the loss, the plaintiff rescinded the contract of purchase, tendered back the bonds, and asked a return by the defendant of the purchase price. Upon the defendant's refusal to repay, the plaintiff sued at law and recovered a judgment for the purchase money.

Theoretically there are three possible common law actions which a purchaser may employ against a broker who has induced a purchase by means of misleading circulars. The purchaser may rescind the contract of purchase and recover the price paid, as was done in the instant case. Or the purchaser may affirm the contract and bring an action for damages either in tort for fraud and deceit or in contract for breach of warranty. There are some elements which are common requirements

[3a] 269 Mich. 424 at 426.

[3b] Quoted from the Record of Appeal of Wolfe v. Kusterer from the Circuit Court, Kent County, p. 114.

for maintaining each of these actions. Thus, in any of the three actions, the plaintiff must prove that the defendant made a material representation of fact, which was false, which the defendant intended the plaintiff to rely upon, and which the plaintiff did rely upon to his injury.[4] The greatest divergence among the requirements for maintaining these actions is the type of act and state of mind of the defendant which the plaintiff must establish. Apparently most jurisdictions today permit a plaintiff to rescind a contract upon a showing of an innocent misrepresentation by the other party, if the other necessary elements are present.[5] A study of the cases involving damage actions either in contract for breach of warranty or in tort for deceit leaves one in doubt as to the type of act and state of mind of the defendant which the plaintiff must prove. The courts do not clearly distinguish between the two types of damage actions, but it seems fairly clear that, at least up to the present time, the courts have been very hesitant in finding implied warranties from the representations made in the sale of securities.[6] With respect to tort actions in deceit, Michigan has long followed a rule which is apparently peculiar to itself. In Michigan it is the well-established rule that actual fraud for the purpose of all legal or equitable actions may be found from innocent misrepresentations, made with no intent to deceive, if the misrepresentations actually deceive another party and the loss of the deceived party inures directly to the benefit of the misrepresenting party.[7] Originally, it seems, it was necessary in maintaining an action in deceit to prove that the defendant had an actual intent to deceive. Apparently most states still follow this rule, as does Michigan if the misrepresenting party does not stand in a posi-

[4] There may well be a difference between deceit and rescission in the requirement of proof of damage. In deceit actions "pecuniary" damage must be shown, but the courts are very liberal in granting rescission for misrepresentations which have "induced" the rescinding party to enter into the contract. See 32 MICH. L. REV. 968 (1934) and 48 HARV. L. REV. 480 (1935).

[5] Bankers' Mortgage Bond Co. v. Rosenthal, 226 Ala. 135, 145 So. 456 (1932); Pritchett v. Fife, 8 Ala. App. 462, 62 So. 1001 (1913); Pohl v. Mills, 218 Cal. 641, 24 Pac. (2d) 476 (1933); Henry v. Kopf, 104 Conn. 73, 131 Atl. 412 (1925); American Educational Co. v. Taggert, 124 Ill. App. 567 (1906); Montgomery Door and Sash Co. v. Atlantic Lumber Co., 206 Mass. 144, 92 N. E. 71 (1910); Seneca Wire & Mfg. Co. v. Leach & Co., 247 N. Y. 1, 159 N. E. 700 (1928). Cases collected in DAWSON, CASES ON RESCISSION OF CONTRACTS, 2nd ed., 209 (1934).

[6] Goodwyn v. Folds, 30 Ga. App. 204, 117 S. E. 335 (1923); Burwash v. Ballou, 230 Ill. 34, 82 N. E. 355 (1907). See Shulman, "Civil Liability and the Securities Act," 43 YALE L. J. 227 at 230 (1933).

[7] Holcomb v. Noble, 69 Mich. 396, 37 N. W. 497 (1888); Rosenberg v. Cyrowski, 227 Mich. 508, 198 N. W. 905 (1924). For an application of the rule in a deceit action, see Aldrich v. Scribner, 154 Mich. 23, 117 N. W. 581 (1908), and for a case dealing with rescission, see Bucannan v. Raymond, 224 Mich. 462, 194 N. W. 980 (1923).

tion to profit directly from the losses of the relying party.[8] There are cases which seem to show a more liberal attitude toward the type of proof needed for maintaining the deceit action.[9] One line of cases holds that proof of a negligent misrepresentation by the defendant is sufficient for maintaining the deceit action,[10] but the view has been severely criticized.[11]

This discussion might lead one to think that the common law affords adequate relief to those purchasers who suffer loss by relying on misrepresentations in the circulars of security brokers. However, one is surprised to find the scarcity of cases in which there has been actual recovery. This scarcity can be explained by the fact that an ordinary rescission action encounters a number of obstacles [12] which, due to rather extraordinary facts, are not present in the instant case. A common obstacle to rescission in the case of a sale of securities is that the action can be maintained only against the immediate vendor,[13] but in the instant case the immediate vendor had prepared the misleading circular. Also, rescission requires a substantial restoration of the *status quo*

[8] Rosenberg v. Cyrowski, 227 Mich. 508 at 512, (see n. 7, supra) states: "But when the person making the representations is not a party to the transaction and in no way profits by the act of the party defrauded in reliance on the representations made by him, he is liable for damage only in case he knows the representations made by him to be false, and makes them for the purpose of deception and with the intent that they shall be relied on and acted on by the person to whom they are made and loss or damage results therefrom." For similar cases, see Preston Motors Corp. v. Wood, 208 Ala. 172, 94 So. 70 (1922); First Nat. Bank v. Person, 101 Minn. 30, 111 N. W. 730 (1907); Nash v. Minnesota Title Ins. Co., 163 Mass. 574, 40 N. E. 1039 (1895); Tilghman v. West, 43 N. C. 183 (1851); Spead v. Tomlinson, 73 N. H. 46, 59 Atl. 376 (1904).

[9] Some cases say the intent to deceive is shown when a defendant makes a statement which he knows to be false or which he does not know to be true, for the purpose of inducing reliance. Connell v. El Paso Gold Mining Co., 33 Colo. 30, 78 Pac. 677 (1904); Pellette v. Mann Auto Co., 116 Kan. 16, 225 Pac. 1067 (1924); Hanson v. Kline, 136 Iowa 101, 113 N. W. 504 (1907); Huntress v. Blodgett, 206 Mass. 318, 92 N. E. 427 (1910); Palmer v. Goldberg, 128 Wis. 103, 107 N. W. 478 (1906).

[10] Prestwood v. Carlton, 162 Ala. 327, 50 So. 254 (1909); Trimble v. Reid, 97 Ky. 713, 31 S. W. 861 (1895); Paretti v. Rebenack, 81 Mo. App. 494 (1899); Whitehurst v. Life Ins. Co. of Virginia, 149 N. C. 273, 62 S. E. 1067 (1908).

[11] Bohlen, "Misrepresentation as Deceit, Negligence, or Warranty," 42 HARV. L. REV. 733 (1929); Carpenter, "Responsibility for Intentional, Negligent and Innocent Misrepresentation," 9 ORE. L. REV. 413 (1930); Bohlen, "Should Negligent Misrepresentations Be Treated as Negligence or Fraud?," 18 VA. L. REV. 703 (1932).

[12] For a rather full discussion of this point, see Shulman, "Civil Liability and the Securities Act," 43 YALE L. J. 227 at 231 (1933).

[13] The concept of rescission at common law was based on the idea of a sale or contract between the parties to the action. See 3 WILLISTON, CONTRACTS, sec. 1531 (1931). This difficulty is removed under the recent federal acts, for the rescinding party is allowed an action against others than the immediate vendor.

by the plaintiff,[14] and it happened here that the purchaser still had the identical bonds purchased, so this was possible. Also, if the plaintiff delays in bringing his action or accepts dividends or other benefits growing out of the contract, after discovery of the misrepresentations, he may be held to have waived his right to rescind.[15] Slight reflection shows that these hazards are peculiarly effective in sales of securities. Having successfully passed these hazards, there are two general requirements which the plaintiff must prove to maintain an action for rescission or on either of the affirmance theories. There must be proof of misrepresentation of a material fact, and proof that the plaintiff relied on that misrepresentation. These were the principal points at issue in the instant case.

There was no actual fraud in the instant case, for the defendant had no intent to deceive the plaintiff; nor did the defendant make a false statement either orally or in the circular.[16] The fault of the defendant was that it failed to disclose that certificates of deposit issued by the trustee bank should be considered as "cash" as that term was used in the trust indenture and as copied in the defendant's circular. Also the defendant failed to disclose the fact that the defendant was so apprehensive of the danger in this provision as to require the supplementary indenture. The cases hold that a person can make a misrepresentation by stating facts which are true as far as they go but are misleading because of failure to disclose other pertinent facts.[17] Here the plaintiff asked to purchase bonds secured by first real estate mortgages, and the defendant by the circular and the oral representations [18] led the

[14] Edenborn v. Sim, (C. C. A. 2d, 1913) 206 Fed. 275; Gifford v. Carvill, 29 Cal. 589 (1866); Franey v. Warner, 96 Wis. 222, 71 N. W. 81 (1897); Mayo v. Knowlton, 134 N. Y. 250, 31 N. E. 985 (1892); Jordan & Davis v. Annex Corp., 109 Va. 625, 64 S. E. 1050 (1909).

[15] Stockmen's Guaranty Loan Co. v. Sanchez, 26 N. M. 499, 194 Pac. 603 (1921); Brennan v. Nat. Equitable Inv. Co., 247 N. Y. 486, 160 N. E. 924 (1928); Buker v. Leighton Lea Ass'n, 63 App. Div. 507, 71 N. Y. S. 610 (1901); Corp. Funding & Finance Co. v. Stoffregen, 264 Pa. 215, 107 Atl. 727 (1919); Biel v. Union Fuel & Ice Co., 105 Wash. 41, 177 Pac. 813 (1919).

[16] The trial court, in its opinion, stated, "While neither the defendant nor its agent was guilty of any conscious effort to defraud, it is too well established to admit of controversy that fraud may be consummated by the concealment or non-revelation of facts as well as by intentionally false assertions." Record of Appeal from Circuit Court, Kent County, p. 115.

[17] Wiser v. Lawler, 189 U. S. 260, 23 Sup. Ct. 624, 47 L. ed. 802 (1902); Buckley v. Buckley, 230 Mich. 504, 202 N. W. 955 (1925); Thomas v. Murphy, 87 Minn. 358, 91 N. W. 1097 (1902); Hotaling v. Leach & Co., 247 N. Y. 84, 159 N. E. 870 (1928); Downey v. Finucane, 205 N. Y. 251, 98 N. E. 391 (1912); Morgan v. Hodge, 145 Wis. 143, 129 N. W. 1083 (1911).

[18] The parol evidence rule does not prevent the proof of oral statements which induce the contract, if rescission is the purpose of the action. See, Chandler Motor Sales Co. v. Dertien, 229 Mich. 630, 201 N. W. 954 (1925); Cooney v. Mossbach,

plaintiff to believe the bonds were such an investment. Under the circumstances, the defendant must have known that the plaintiff was purchasing the bonds under a false impression as to their nature. The usual difficulties in finding a misrepresentation of fact upon which the plaintiff is entitled to rely are not present in this case, for it cannot reasonably be argued that the misrepresentation is one of law,[19] or mere opinion,[20] or puffing,[21] or one dealing with future events.[22]

It is more difficult to find the element of reliance by the plaintiff. The trial court in holding for the plaintiff made no finding of reliance.[23] Counsel argued the issue of reliance and the supreme court felt that there was reliance by the plaintiff. The son of the plaintiff, being a practicing member of the Michigan bar, testified that he understood fully that collateral trust bonds were not bonds secured by real estate mortgages. Also that cash could be security for the bonds and that cash would probably be represented by certificates of deposit. It could well be argued that the son bought the bonds with utter indifference to the representations which later proved false.[24] On the other hand, the son possibly did feel, and justifiably so, that the bonds, although collateral trust bonds, were substantially the same type of investment as first mortgages on realty. The circulars stated that the bonds were secured by direct obligations of mortgage companies which were in turn secured by guaranteed real estate mortgages, "And in lieu of the above United States Government Bonds, United States Treasury certificates of indebtedness and/or cash may be deposited."[25] Also, the son could reasonably think the representations as to "cash" referred to money in small amounts temporarily awaiting investment in realty mortgages.

128 Wash. 427, 222 Pac. 893 (1924); Logan v. Collinson, 114 Kan. 620, 220 Pac. 291 (1923).

[19] Rogan v. Ill. Trust & Sav. Bank, 93 Ill. App. 39 (1901).

[20] Ferrell v. Hunt, 189 Ind. 45, 124 N. E. 745 (1919); Howard v. Merrick, 145 Ore. 573, 27 Pac. (2d) 891 (1934).

[21] D. C. Land & Bldg. Co. v. McInerney, (App. D. C.) 64 F. (2d) 554 (1933).

[22] Re Nat. Pressed Brick Co., (C. C. A. 6th, 1914) 212 Fed. 878; Electric Hammer Corp. v. Deddens, 206 Ky. 232, 267 S. W. 207 (1924); Mumford v. Tolman, 157 Ill. 258, 41 N. E. 617 (1895).

[23] Under the Securities Act of 1933, as originally passed, no reliance need be proved by the plaintiff. Section 11(a) of the Act as amended [by 48 Stat. 907, sec. 206, U. S. C. tit. 15, sec. 77k (a)] requires the plaintiff to prove reliance if he acquires the security after the issuer "has made generally available to its security holders an earning statement covering a period of at least twelve months beginning after the effective date of the registration statement. . . ." 48 Stat. 907, c. 404, sec. 206 (a). Under the Securities Exchange Act of 1934 no reliance need be proved where the defendant has willfully violated the Act. Sec. 9 (e); 48 Stat. 890, U. S. C. tit. 15, sec. 78i (e). Otherwise, reliance apparently must be proved. Sec. 18; 48 Stat. 897, U. S. C. tit. 15, sec. 78r.

[24] In fact, it was the failure of the trustee bank which caused the subsequent loss and neither of the parties anticipated this contingency at the time of the sale of bonds.

[25] 269 Mich. 424 at 426.

The only doubtful elements in the case are those of a misrepresentation of a material fact by the defendant and reliance thereon by the plaintiff. The presence of these elements is essentially a fact question and the finding will depend largely on the attitude of the fact-finding body, whether it be the court or jury.[26] It is submitted that the finding of these elements in favor of the plaintiff was justified in the instant case by the fact that intangible securities were the objects of sale. Experience teaches us that most investors in securities are ignorant and are easily influenced by the lure of high returns. Securities are objects of sale which even the most intelligent investor is not in a position to evaluate as he can land or other tangible commodities; while the broker is in a position to act with expert legal and technical advice and can gain from the issuer of the security much more adequate information as to the probable value of the security. Due to the particular relationship existing between the broker and the security purchaser, all doubts should be resolved in favor of the purchaser. Possibly the results of the instant case seem harsh to the vendor of commodities, but, as has been pointed out, the facts of the case are peculiarly favorable to the result reached and the opinion is probably limited to cases involving the broker and security-purchaser relationship. With respect to security brokers, the case seems to set forth a strict duty of disclosure to prospective purchasers. Whereas the courts in the usual vendor-purchaser relation have taken the view that the buyer must beware, this case seems to show that in sales of securities the seller must beware.[27] The decision in the instant case requires the security broker, as a guaranty of non-liability, to place himself in the position of an ordinary purchaser, and to consider all the facts which the broker knows which would be relevant to the purchaser in deciding whether the security offered is the type of investment which he desires. All such relevant facts the broker must be careful to disclose. General statements by the broker to the effect that the representations are not guaranteed but are

[26] An interesting case for comparison with the instant case is Collins-Moore Co. v. Clement, (Ky. 1934) 77 S. W. (2d) 1, which was decided during the same week as the instant case. The action was in deceit and the court in holding for the defendant security broker stated: "The evidence, to put it negatively, does not reveal a novice. Rather it reveals one of that innumerable flock of lambs who played the market with a hope of profit and, alas, lost his fleece. He went into these ventures with his eyes open and with knowledge of the vicissitudes of the game, as did many other more experienced but equally unfortunate investors in recent years who paid the penalty for similar shimmering false hopes and sadly mistaken judgments."

[27] This is the general policy laid down in the provisions for civil liability in the recent federal Security Acts.

based upon information which he believes to be accurate and reliable are not sufficient to relieve him of the duty of making full disclosure.[28]

W. L. I.

[28] The court in the instant case states (269 Mich. at 431), "That the circular said: 'The statements contained herein are not guaranteed but are based upon information which we believe to be accurate and reliable,' does not relieve the defendant."