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SECURITIES—Purchaser of Outstanding Shares of Same Class as Registered Issue Cannot Bring Suit Under Section 11(a) of Securities Act —*Colonial Realty Corp. v. Brunswick Corp.**

Pursuant to section 5 of the Securities Act of 1933,[1] defendant-seller filed a registration statement covering a large issue of debentures and the common stock issuable upon their conversion.[2] Through a series of purchases on the open market beginning four months after this filing, plaintiff acquired a large amount of defendant's outstanding common stock. Subsequently, the market value of the common stock dropped and plaintiff sustained a considerable loss on its investment. Although it conceded that it had not purchased any of the shares converted from the registered issue of debentures, plaintiff instituted a suit for damages[3] claiming, *inter alia*, that alleged material misstatements in the registration statement gave it a right to recover under section 11 of the Securities Act,[4] which provides in relevant part that:

> (a) In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, *any person acquiring such security* (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, . . . sue . . . ." [Emphasis added.]

On defendants' motion for summary judgment, the United States District Court for the Southern District of New York dismissed plaintiff's claim. The use of the words "such security" in section 11(a) of

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* 257 F. Supp. 875 (S.D.N.Y. 1966) [hereinafter referred to as principal case].

1. 48 Stat. 74 (1933), as amended, 15 U.S.C. §§ 77a–aa (1964). Section 5, 68 Stat. 684 (1954), 15 U.S.C. § 77e (1964), makes it unlawful to issue securities through the mails or interstate commerce unless a registration statement is in effect, except as a particular issue or transaction might be exempt from registration by § 3, 48 Stat. 75 (1933), as amended, 15 U.S.C. § 77c (1964), or § 4, 78 Stat. 580 (1964), 15 U.S.C. § 77d (1964). Section 7, 48 Stat. 78 (1933), 15 U.S.C. § 77g (1964), deals with the information required in the registration statement.

2. The registration statement covered an issue of $25,634,400 of debentures as well as any common stock which would be converted therefrom. At the time the present suit was instituted, only 209 shares of common stock had been converted from the debentures.

3. Between May 2, 1961, and August 6, 1962, the plaintiff acquired over 30,000 shares of the outstanding common stock at a purchase price of over $1,600,000. The alleged loss in value was over $1,000,000.

4. 48 Stat. 82 (1933), as amended, 15 U.S.C. § 77k (1964). The claim under § 11 was the first count of a 39-count complaint; trial on the other counts is still pending. The other claims were made under the 1933 Act §§ 12, 48 Stat. 84 (1933), as amended, 15 U.S.C. § 77*l* (1964); 17, 48 Stat. 84 (1933), as amended, 15 U.S.C. § 77g (1964); the Securities Exchange Act of 1934, §§ 9, 48 Stat. 889 (1934), 15 U.S.C. § 78i (1964); 10(b), 48 Stat. 891 (1934), 15 U.S.C. § 78j(b) (1964); 15, 49 Stat. 1377 (1936), as amended, 15 U.S.C. § 78o (1964); 18, 48 Stat. 897 (1934), as amended, 15 U.S.C. § 78r (1964); and the common law.

the Securities Act limits the applicability of that section to securities which are, in fact, issued under the registration statement: the section does not cover *unregistered securities* even if they are of the same class.

The court in the principal case conceded that, as a matter of economic reality, the prospectus (which contained the alleged misstatement) affects, because of its wide circulation, the value of the shares outstanding at the time it is distributed, as well as that of the new issue which is the subject of the registration statement. Indeed, financial institutions, market experts, brokers, and dealers digest and analyze the prospectus, and their opinions inevitably affect market values of *all* outstanding stock.[5] However, in light of the act's legislative history, its general scheme of regulation, and the language contained in its other provisions, the court was compelled to deny the plaintiff's cause of action.

The Securities Act of 1933 was enacted to regulate the marketing of specific issues of securities. It requires comprehensive registration in order to assure a complete, honest, and competent disclosure of the nature and value of securities being offered to the public. The act, however, was not intended to regulate the trading of *outstanding* securities.[6] When the House bill which was to become the 1933 Act was presented to Congress in substantially its final form, the scope of its civil liability provisions was described as entitling

5. "These arguments have the sound ring of economic reality but unfortunately they merely point up the problems involved in the present scheme of statutory regulation." Principal case at 881. There can be no dispute that the information appearing in the registration statement may have a profound economic effect on holders of all outstanding securities. For a judicial recognition of this fact, *cf.* Columbia Gen. Inv. Corp. v. SEC, 265 F.2d 559 (5th Cir. 1959), affirming the SEC's issuance of a stop order against the effectiveness of a misleading registration statement over the issuer's contention that such order could not issue if the registrant desired to withdraw the statement voluntarily since such withdrawal was of no concern to anyone other than the registrant.

6. In the words of James M. Landis, one of the draftsmen of the House bill, who later served as SEC chairman, "throughout, its patent concern was primarily with the flow of securities from the issuer through underwriters to the public rather than with the subsequent buying and selling of the securities by the public." Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 36 (1959).

Regulation of trading in *outstanding* securities was one of the basic purposes of the Securities Exchange Act of 1934. Generally, the *1934 Act* contemplates continuous registration of an entire class of outstanding stock through periodic filing of reports under § 12, 48 Stat. 892 (1934), as amended, 15 U.S.C. § 78*l* (1964), and § 13, 48 Stat. 894 (1934), as amended, 15 U.S.C. § 78m (1964). The express civil liabilities which the 1934 Act creates generally run only against the issuer and persons controlling the issuing corporation and involve very difficult matters of proof. Therefore, a buyer in the present plaintiff's shoes has a much less effective remedy under the 1934 Act than he would have under the 1933 Act if the court in the principal case had upheld his claim. For an excellent analysis and discussion of the interrelationship of the 1933 and 1934 Acts and their frequently overlapping and inconsistent disclosure requirements, see Cohen, *"Truth in Securities" Revisited*, 79 HARV. L. REV. 1340 (1966), which also contains sweeping proposals for a more coordinated system of federal securities regulation which would incorporate the more effective aspects of both Acts.

". . . the *buyer of registered securities sold upon a registration statement* including an untrue statement or omission of material fact, to sue . . . ."[7] Since its enactment, commentators have assumed that, in view of the act's restrictive purpose, its remedial provisions are to be interpreted narrowly.[8]

Moreover, the basic structure of the act[9] leaves little doubt that Congress intended to limit strictly the civil liability which flows from non-compliance with its provisions. Procedural obstacles have been placed in the paths of would-be plaintiffs so as to limit the potentially great liability which might otherwise be incurred. Indeed, the possibility that the court would require the plaintiff to undertake the cost of the suit coupled with the generally heavy litigation expense involved therein and a short statute of limitations applicable to section 11 actions tend to discourage litigation of even substantively sound claims.[10] These obstacles are evidence of the fact that the primary purpose underlying the imposition of liability

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7. H.R. REP. No. 85, 73d Cong., 1st Sess. 9 (1933).

> The bill *affects only new offerings* of securities sold through the use of the mails or of instrumentalities of interstate or foreign transportation or communication. It does not affect the ordinary redistribution of securities unless such redistribution takes on the characteristics of a new offering by reason of the control of the issuer possessed by those responsible for the offering.

Id. at 5. (Emphasis added.)

8. *E.g.*, 3 LOSS, SECURITIES REGULATION 1731 n.160 (1961) [hereinafter cited as LOSS] ("Presumably, however, the open-market buyer must be able to trace his particular securities to the registration statement when it covered additional securities of an outstanding class"); Cohen, *supra* note 6, at 1340, 1341, 1355-74; Flanagin, *The Federal Securities Act and the Locked-in Stockholder*, 63 MICH. L. REV. 1139, 1141 (1965); Painter, *Civil Liabilities and Administrative Sanctions Under the Securities Act of 1933*, 34 U. MO. KAN. CITY L. REV. 185 (1966); Schulman, *Civil Liability and the Securities Act*, 43 YALE L.J. 227 (1933); Comment, *Civil Liability for Misstatements in Documents Filed Under Securities Act and Securities Exchange Act*, 44 YALE L.J. 456 (1935).

9. For summaries of the scope of the 1933 Act, see, *e.g.*, Douglas & Bates, *The Federal Securities Act of 1933*, 43 YALE L.J. 171 (1933); Halleran & Calderwood, *Effect of Federal Regulation on Distribution of and Trading in Securities*, 28 GEO. WASH. L. REV. 86 (1959); Reinoehl, *Basic Pattern and Coverage of the 1933 Act*, 34 U. MO. KAN. CITY L. REV. 172 (1966); and authorities cited note 8 *supra*.

10. Section 11(e) gives the court the authority to require, at its discretion, an undertaking for the costs of the suit, including attorney's fees. A summary or direced judgment may be the ground for a similar assessment of costs, should the court believe the suit to have been without merit. Generally, the costs incurred in obtaining the necessary matters of proof are extremely heavy, and there is a general tendency to avoid throwing good money after bad when an investment loss has been incurred. *Cf.* Fox v. Glickman Corp., CCH FED. SEC. L. REP. (Transfer Binder 1964-1966) ¶ 91682 (S.D.N.Y. May. 3, 1966); Dabny v. Allegheny Corp., 164 F. Supp. 28 (S.D.N.Y. 1958); Montague v. Electronic Corp. of America, 76 F. Supp. 933 (S.D.N.Y. 1948).

Section 13, 48 Stat. 84 (1933), as amended, 15 U.S.C. § 77m (1964), provides that no action may be maintained under either §§ 11 or 12 unless it is brought within one year after the discovery of the untrue statement or omission, and in no case more than three years after the security was bona fide offered to the public. See, *e.g.*, Shonts v. Hirliman, 28 F. Supp. 478 (S.D. Cal. 1939); Fischman v. Raytheon Mfg. Co., 9 F.R.D. 707 (S.D.N.Y. 1949); M. J. Hall & Co. v. Johnson, 92 N.Y.S.2d 202 (Sup. Ct. 1940). *But see* Escott v. Barchriss Constr. Corp., 340 F.2d 731 (2d Cir. 1965).

under the 1933 Act is to produce an *in terrorem* or deterrent effect.[11] Since the act is not primarily concerned with recovery, there is no apparent reason for reading section 11 so as to provide compensation to anyone who may have suffered a loss which is traceable to the seller's misrepresentation. The court in the principal case admitted that to give a right of recovery to only those purchasers who fortuitously acquired shares from a particular registered issue while denying that same right to those who happened to buy completely fungible but unregistered shares on the open market is indeed an arbitrary distinction when viewed from the standpoint of compensation for market losses due to false registration; a distortion of the financial condition of the defendant-seller inflates the market value of its stock and the later, inevitable drop in price results in a loss to *anyone* holding that stock, regardless of whether it is stock which happened to be the subject of the registration statement alleged to have precipitated the market decline. Nevertheless, and in spite of the appeal to one's sense of equity of a right to compensation for anyone holding adversely affected shares, the arbitrary limits on the remedy provided in section 11 may be justified if the paramount purpose of the provisions is penal rather than compensatory.[12] And, the penal nature of the provision is demonstrated by the fact, dis-

11. See, *e.g.*, Note, 72 YALE L.J. 406, 410 (1962), which asserts that insurance agreements indemnifying underwriters run counter to the 1933 Act's basic policy of holding great personal liability over the heads of those responsible for the truthfulness and competence of the registration statement. Shulman, *supra* note 8, states that:

> It is not the object of the Act simply to provide a legal remedy for the investor who has bought securities upon a false representation, to compensate him for a loss incurred. Even the provisions for civil liability are calculated to be largely preventive rather than redressive.

Id. at 227; *cf.* Wogahn v. Stevens, 236 Wis. 122, 294 N.W. 503 (1940), characterizing § 11 as penal rather than remedial in nature, and therefore holding that the cause of action which it creates is unassignable.

12. SEC v. Texas Gulf Sulphur Co., 258 F. Supp. 262 (S.D.N.Y. 1965). This case demonstrates that the arbitrary nature of a remedy is irrelevant where the underlying rationale for the providing of the remedy is, in the first instance, to effect a penal sanction. The SEC complaint demanded relief in the form of an order compelling the insider defendants to offer recission and/or restitution to the person or persons from whom each of these defendants purchased stock and options or calls to purchase the company's stock during the period in which the defendants had information as to the value of the stock, which information had not yet been made public. From the standpoint of granting relief for investment injuries, the SEC proposal is clearly arbitrary; the very limited class of sellers who would be permitted to recover in such a situation had wholly personal reasons for deciding to sell their *Texas Gulf* holdings when they did. The mere fortuity that their stock was purchased by one of the defendant-insiders would not seem to give them a more equitable claim than that of any of the other *Texas Gulf* shareholders who happened to sell during the period of insider manipulation. This is clearly a case of using private compensation for a penal purpose and is a more extreme example of arbitrariness than that which is the result of the narrow interpretation of § 11 in the principal case. Indeed, in the principal case, the plaintiff is denied recovery although it has suffered a loss attributable to the alleged misrepresentations of the defendant whereas recovery in *Texas Gulf* would result in a windfall for the compensated parties.

cussed above, that Congress intended the provisions to serve as a deterrent.

The fact that liability may exist under section 11 without regard to whether the issuer acted in bad faith is an additional argument for limiting the scope of that section. In the principal case, for example, to hold that the issuing corporation is liable, for unintentional misrepresentations, to each of the holders of the more than 16,000,000 outstanding shares of the defendant's common stock is to extract a rather large price for mere negligence. But, this would, in fact, be the logical result of expanding section 11 to admit the plaintiff's claim. The 1933 Act should not be interpreted to allow such a devastating result since its purpose was not simply to protect the purchaser of securities, but to do so "with the *least possible interference to honest business.*"[13] There has been only a handful of suits brought under section 11,[14] and yet it has been established that the act has produced a considerably high quality of disclosure;[15] arguably this indicates that unlimited liability is not necessary for section 11 to be an effective sanction.

Furthermore, the language of other portions of the 1933 Act supports a restrictive reading of section 11. For example, section 6(a), which stipulates which signatures are to appear on the registration statement (and upon which signatures section 11 liability may be predicated), provides that the registration statement shall be effective only as to the specific issue of securities which it purports to cover.[16] Although this requirement is primarily designed to assure that new and separate statements will be filed for later issues, and

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13. S. REP. No. 47, 73d Cong., 1st Sess. 6-7 (1933).

14. See generally 3 Loss 1683-92, for an extensive compilation of suits brought under the 1933 Act and an analysis of factors which account for the scarcity of adjudicated claims and recoveries. It should be noted, however, that one reason for the scarcity of § 11 litigation would seem to be the likelihood of out-of-court settlement where a § 11 claim appears to be substantively well-founded, since the virtually strict liability of the offending issuer tends to discourage the contesting of such an accusation.

15. See, *e.g.*, Cohen, *supra* note 6, at 1355:

> In actual experience however, instances of liability have been remarkably few; instead, the liability provisions have had the *in terrorem* effect of creating an extraordinarily high sense of care and responsibility in the preparation of registration statements.

16. 48 Stat. 78 (1933), 15 U.S.C. § 77f(a) (1964), provides, subsequent to setting forth the procedure for filing a registration statement, that "a registration statement shall be deemed effective only as to the securities specified therein as proposed to be offered."

Section 4(3)(A), 78 Stat. 580 (1964), 15 U.S.C. § 77d(3)(A) (1964), is only consistent with the restricting of § 11(a) to registered shares. It forces a dealer to differentiate between shares newly issued and shares outstanding by requiring him to deliver a prospectus as part of any open market transaction in new shares during a 40-day period subsequent to their initial public offering.

Rule 413, 17 C.F.R. § 230.413 (1964), provides that:

> the registration of additional securities of the same class as other securities for which a registration statement is already in effect shall be effected through a separate registration statement relating to the additional securities.

To the same effect, see Rule 416, 17 C.F.R. § 230.416 (1964).

although it does not expressly purport to limit liability for a single misleading statement, it is difficult to reconcile this provision with the theory that the registration of a single issue may be the basis of liability for losses incurred on an entire class of outstanding securities.

Finally, judicial precedent offers an additional, although somewhat weaker, source of authority for the court's holding in the principal case. *Fischman v. Raytheon Mfg. Co.*[17] is the only prior case which makes specific mention of the class of plaintiffs entitled to recover under section 11.[18] In that case, holders of common stock (stock not converted from preferred) brought an action alleging a section 11 violation. The basis of their suit was a misleading registration statement which covered an issue of preferred stock and the common stock to which it was convertible. The section 11 claim was abandoned before adjudication; nonetheless, on appeal, the Second Circuit said:

> A suit under § 11 of the 1933 Act requires no proof of fraud or deceit, and such a suit may be maintained only by one who comes within a narrow class of persons, *i.e. those who purchase securities that are the direct subject of the prospectus and registration statement* (here the purchasers of preferred stock).[19]

The validity of this statement has gone unchallenged, but it must be recognized that it is mere dicta.

Although there is little doubt that the court reached the proper result in the principal case, its restrictive construction of section 11 does raise some tangential questions with respect to the effectiveness and integrated application of the scheme of civil remedies created by the 1933 and 1934 Acts. Recently, concern has been engendered by the general judicial liberality in implying remedies to supplement

17. 188 F.2d 783 (2d Cir. 1951), *reversing on other grounds* 9 F.R.D. 707 (S.D.N.Y. 1949).

18. See also Barnes v. Osofsky, 254 F. Supp. 721 (S.D.N.Y. 1966); Rudnick v. Franchard Corp., 237 F. Supp. 871 (S.D.N.Y. 1965).

19. Fischman v. Raytheon Mfg. Co., 188 F.2d 783, 786 (2d Cir. 1951) (Emphasis added.) However, the issue of the scope of the class of plaintiffs to be compensated under § 11 was in no way before the *Fischman* court. Its holding, in fact, did no more than imply a remedy for the plaintiffs under § 10(b) of the 1934 Act; and the language concerning § 11's scope should be read as an effort to strengthen, by showing a lack of alternative remedies, their ultimate conclusion that a § 10(b) recovery was necessary and proper.

Two cases have purported to base holdings on the *Fischman* case, but neither are on point factually. The *Rudnick* case, *supra* note 18, was a summary dismissal of a § 11 suit against an underwriter of a first issue of stock only, where plaintiff had purchased stock which was the subject of a second issue. The holding was seemingly based on a failure to show reliance where intervening financial information is available. The *Barnes* case, *supra* note 18, was a judicial approval of a stipulation of consent and agreement settlement of a § 11 suit. An objection by an outstanding shareholder to the terms of the settlement which limited recovery to those who had acquired shares identifiable to the registered issue was dismissed solely on the basis of the *Fischman* dicta.

those which are expressly provided.[20] Consequently, the question arises as to the propriety of *implying* a remedy under other sections of the Securities Acts for a plaintiff who is properly denied relief under section 11.[21] It can be forcefully argued that, since section 11 expressly deals with registration misstatement situations and is the broadest provision for recovery in this area,[22] a plaintiff who fails to come under its protection was not intended to have another remedy and none should be *implied* in his behalf. The breadth of the provision is evidenced by the fact that section 11 does not require elements of proof or relationships between the litigants which are necessary under other provisions relied upon by the plaintiff. For example, under the 1933 Act, section 12(1) imposes civil liability only upon those who have sold *unregistered* securities in violation of section 5,[23] and section 12(2), which imposes liability on those selling securities (regardless of whether they are required to be registered) by means of a prospectus or oral communication containing an untruth or omission of material fact, contains a privity requirement.[24] Moreover, under the 1934 Act,[25] section 9(e) recovery

20. A discussion of the remedies implied from § 17(a), 48 Stat. 84 (1933), as amended, 15 U.S.C. § 77q(a) (1964), under the 1933 Act and § 10(b), 48 Stat. 891 (1934), 15 U.S.C. § 78j(b) (1964), as implemented by Rule 10b-5, 17 C.F.R. § 240.10b-5 (1964), is not intended to extend beyond the noting of their existence and the fact that the principal case discusses rule 10b-5 as the basis of a possible remedy for the present plaintiff. See notes 28 & 32 *infra* and accompanying text.

21. *Cf.* note 4 *supra*, citing other sections of the Securities Acts which have been pleaded in the present case.

22. One of the purposes of the civil liability provisions of the 1933 Act was to broaden the action of common law deceit. Rosenberg v. Hano, 121 F.2d 818, 819 (3d Cir. 1941). For an early analysis of the specific ways in which § 11 is an improvement over common law recovery, see Note, 38 MICH. L. REV. 1103 (1940). See generally 3 Loss 1682-92, 1721-42. Liability under § 11 is imposed jointly and severally upon different classes of defendants responsible in various ways for the truth of the registration statement. As to the issuer of the securities, liability is virtually absolute if the statement is shown to contain a material misstatement or omission; neither privity, reliance, nor scienter is a requisite element of the plaintiff's case. Section 11(a) provides that suit may be brought against:

> (1) every person who signed the registration statement; (2) every person who was a director of (or person performing similar functions) or partner in, the issuer at the time of the filing of the part of the registration statement with respect to which his liability is asserted; (3) every person who, with his consent, is named in the registration statement as being or about to become a director, person performing similar functions, or partner; (4) every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registation statement, with respect to the statement in such registration statement, report or valuation, which purports to have been prepared or certified by him; (5) every underwriter with respect to such security.

23. 48 Stat. 84 (1933), as amended, 15 U.S.C. § 77*l*(1) (1964).

24. 48 Stat. 84 (1933), as amended, 15 U.S.C. § 77*l*(2) (1964). This section contemplates only a suit by a buyer against the immediate seller, typically the dealer who made the sale. But "controlling persons" under § 15 may possibly also be held liable. However, such suit would, practically speaking, also require proof of scienter. See generally 3 Loss 1699-1721.

25. *Cf.* note 6 *supra*.

is predicated upon proof of a *willful* misstatement and proof that such misstatement actually caused the securities to drop in value,[26] while section 18(a) requires, in addition, proof that the plaintiff relied upon the misstatement.[27] Since these requirements of willfulness, causation, and reliance impose an almost impossible burden of proof on any plaintiff, it is not surprising to find a dearth of litigation under these latter two sections. This is not to suggest that, because neither the 1933 nor the 1934 Act provides a substitute remedy in cases where section 11 is not applicable, the court in the principal case should have construed that section so as to permit plaintiff to recover. Nor should it move the court to *imply* a substitute remedy.

However, the fact is that other courts have already significantly expanded civil remedies for investment injuries beyond the restricted rights of action expressly provided by Congress, by implying a right of action for both injured purchasers and sellers of securities under section 10(b) and rule 10b-5 of the 1934 Act.[28] The rule simply declares "unlawful" any fraudulent scheme or misrepresentation effectuated through interstate commerce.[29] The implied right of action under the rule has been held to be concurrent with the express provisions of the 1933 and 1934 Acts,[30] but is not subject to their proce-

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26. 48 Stat. 890 (1934), 15 U.S.C. § 78i(e) (1964). This section deals with specific prohibitions against manipulation of prices of securities registered on a national securities exchange, and the liability runs in favor of anyone who has purchased or sold a security at a price affected by the prohibited acts or transactions. See generally 3 Loss 1747-51.

27. 48 Stat. 897 (1934), as amended, 15 U.S.C. § 78r (1964). This section imposes liability for filing any false or misleading statement, report, or document pursuant to the provisions of the Act. See generally 3 Loss 1751-54.

28. See note 20 *supra*. Among the many excellent discussions and analyses of Rule 10b-5's impact on securities regulation and civil liability are: Klein, *The Extension of a Private Remedy to Defrauded Securities Investors Under SEC Rule 10b-5*, 20 U. MIAMI L. REV. 81 (1965); Ruder, *Civil Liability Under Rule 10b-5: Judicial Revision of Legislative Intent?*, 57 NW. U.L. REV. 627 (1963); Simpson, *Investors' Civil Remedies Under the Federal Securities Laws*, 12 DE PAUL L. REV. 71 (1962).

The classic analysis of the many anomalies presented by the judicial implication of remedies which would not otherwise exist under the scheme of federal securities regulation is by Professor Loss, 3 Loss 1778-97.

29. 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,
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> (1) to employ any device, scheme, or artifice to defraud,
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> (2) to make any untrue statement 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
>
> (3) 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.

30. Fischman v. Raytheon Mfg. Co., 188 F.2d 783 (2d Cir. 1951), was the landmark decision giving the buyer a remedy under rule 10b-5. That case held that it was necessary to allege fraud in addition to the material misstatement which is the basis of a § 11 action. However, later cases have considerably undermined the concept of fraud, bringing it closer to the language of clause (2) of the rule, note 29 *supra*. It

dural and substantive restrictions.[31] Consistent with the recent judicial trend, the court in the principal case indicated that the misstatements and omissions in the registration statement filed by defendants might well constitute the quasi-fraud required for recovery under rule 10b-5.[32] Whether plaintiff may ultimately recover on the basis of this implied right of action is not known at the present time, and no attempt to predict the matters of proof that might be required of it or the extent of its possible recovery thereunder will be under-

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should be noted that his language bears a striking resemblance to that which describes actionable conduct under § 11(a). See, *e.g.*, Texas Continental Life Ins. Co. v. Bankers Bond Co., 187 F. Supp. 14, 23 (W.D. Ky. 1960), which states:

> A plaintiff purchaser need only prove that a statement in a prospectus or oral communication is in fact false or is a misleading omission and that he did not know of such untruth or omission.

Note, 63 MICH. L. REV. 1070 (1965), examines the holding of Trussell v. United Underwriters, Ltd., 228 F. Supp. 757 (D. Colo. 1964), as representative of a growing number of decisions permitting a buyer's suit under rule 10b-5, including suit for alleged misstatements and omissions under clause (2) of the rule, note 29 *supra*.

31. See note 10 *supra*, setting forth the strict requirements of the statute of limitations and the undertaking for costs under § 11. See Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961), for an excellent discussion of the unavoidable clash between the various restrictions which are placed on the remedies expressly created by Congress and the negation of these restrictions by a remedy implied under rule 10b-5.

Section 11 has previously been circumvented by the 10b-5 route to the extent that the statute of limitations requirement has been negated by a proceeding under rule 10b-5 which is controlled by the typically longer state statute of limitations. Fischman v. Raytheon Mfg. Co., 188 F.2d 783 (2d Cir. 1951). Indeed this is the anomaly of the implied right of recovery for the injured buyer under the rule, *i.e.*, when conduct which is actionable under § 11 of the 1933 Act becomes actionable under rule 10b-5, there is a circumvention of the restrictive conditions under which the buyer's suit was intended to be conducted. Similarly, the rule undermines the same restrictions which are also incident to § 12(2) of the 1933 Act. Trussel v. United Underwriters, Ltd., *supra* note 30, is a good recent example of the trend toward accepting the inherent anomalies involved in applying rule 10b-5 to conduct otherwise actionable under the more restrictive provisions of the 1933 Act.

Since the decision in Fischman v. Raytheon Mfg. Co., *supra*, numerous other cases have recognized the right of a "defrauded" buyer to sue under rule 10b-5 free of the restrictions imposed by the 1933 Act. See, *e.g.*, Royal Air Properties, Inc. v. Smith, 312 F.2d 210 (9th Cir. 1962); Boone v. Baugh, 308 F.2d 711 (8th Cir. 1962); Matheson v. Armbrust, 284 F.2d 670 (9th Cir. 1960); Ellis v. Carter, *supra*; Dauphin Corp. v. Redwall Corp., 201 F. Supp. 466 (D. Del. 1962); Texas Continental Life Ins. Co. v. Bankers Bond Co., 187 F. Supp. 14 (W.D. Ky. 1960); Greenwich Sav. Bank v. Shields, 131 F. Supp. 368 (S.D.N.Y. 1955).

32. But terms such as "fraud" and "deceit" appearing in the Investment Advisor's Act of 1940 have been construed by the Supreme Court in accordance with the legislative purpose which was to "substitute a philosophy of full disclosure for the philosophy of *caveat emptor* . . . ." S.E.C. v. Capital Gains Research Bureau, 375 U.S. 180, 186 (1963) . . . . The Court made it clear, in reversing an *en banc* decision of this Circuit, that the underlying legislative purpose was equally applicable to the 1933 and 1934 Securities Acts, . . . and that the term "fraud" should not be construed in the early common law technical sense. Rather the tendency of later cases . . . was to merge the "proscription against non-disclosure into the general proscription against fraud, treating the former, in effect, as one variety of the latter."

. . .

> The exhibits introduced on this motion seem to lend some support to the plaintiff's allegation of nondisclosure or suppression of information material to an evaluation.

Principal case at 882.

taken.[33] However, the court, in summarizing its analysis of matters which were not before it for adjudication, indicated its position on the plaintiff's ultimate chance of success as follows:

> Although Section 11 would be the simplest to satisfy it hardly follows that plaintiff will be denied an effective remedy by being precluded from proceeding on Count One [the Section 11 claim], only, of its complaint.[34]

The anomaly of the court's strictly adhering to congressional intent in considering and rejecting the section 11 claim while simultaneously suggesting the strong possibility of success on a judicially created and expanded remedy without regard to congressional intent may presage an expansion of rule 10b-5 which would significantly undermine the rationale on which the actual holding of the present case is based. Should plaintiff ultimately recover under rule 10b-5 to an extent approximating that which he unavailingly claimed under section 11, a precedent would be established for future judicial circumvention of section 11. Moreover, as mentioned above, the resulting broad liability would not be subject to the procedural safeguards which surround section 11 causes of action.[35]

Thus, the narrow construction which was placed upon section 11 by the court in the principal case may, ironically, provide the impetus for judicial extension of rule 10b-5 so as to impose liability as severe as that which was rejected in the first instance. Section 11 would remain the most effective source of recovery in those situations to which it clearly applies—misstatements in registered issues—but the expansion of the application of rule 10b-5 into the area distinctively defined both by the scope and the restrictions of section 11 would seem to render those restrictions meaningless and, further, to call into question the integrity of the federal securities regulatory scheme.

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33. See Klein, *supra* note 28, at 99-108, discussing the still unsettled questions as to what elements of proof are required in a buyer's action under rule 10b-5. A recovery would seem to be possible without proof of privity, reliance, or scienter. Klein states that in the light of the Supreme Court's apparent approval of the judicial expansion of rule 10b-5 in SEC v. Capital Gains Research Bureau, 375 U.S. 180 (1963), the anomalies associated with the rule seem destined to persist absent a comprehensive reappraisal by Congress, and that it is entirely possible that,

> given a liberal construction, Rule 10b-5 would be broad enough to encompass every type of violation presently cognizable under the express provisions of the two acts, while at the same time it would avoid the built-in restrictions and limitations contained in those provisions. Thus, for example, by the simple process of "characterization," a false or misleading registration statement, actionable under section 11 of the Securities Act, might be held to constitute a "scheme, or artifice to defraud" or an "untrue statement of a material fact" within Rule 10b-5.

34. Principal case at 883.

35. See note 10 *supra* and accompanying text.