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Securities Regulation-SEC Rule 10b-5-Recovery by Corporation Induced by Fraud of Insider to Issue Shares

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SECURITIES REGULATION—SEC RULE 10b-5—RECOVERY BY CORPORATION INDUCED BY FRAUD OF INSIDER TO ISSUE SHARES—Trustees in reorganization of a corporation brought suit on its behalf to recover damages under section 10(b) of the Securities Exchange Act of 1934[1] and rule 10b-5 of the Securities and Exchange Commission,[2] alleging that the corporation

1 "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 any facility of any national securities exchange . . .

"(b) 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. § 78(j) (1958).

2 "It shall be unlawful for any person, directly or indirectly, by the use of any means

had been fraudulently induced by defendant, its comptroller, to issue stock for inadequate consideration. Also named as defendants were the American Stock Exchange and several banks and brokers, whose alleged complicity in the improper public distribution of the shares made them parties to the scheme to defraud the corporation. On a motion by all defendants but the comptroller to dismiss the complaint for failure to state a cause of action, based upon the assertion that the corporation had no rights under rule 10b-5 where corporate mismanagement was at issue, *held*, motion to dismiss denied. An issuing corporation's right to recover under rule 10b-5 against those participating in a scheme to defraud it of its stock is not precluded by the fact that the fraud was perpetrated by a corporate insider. *Pettit v. American Stock Exch.*, 217 F. Supp. 21 (S.D.N.Y. 1963).

A corporation induced by fraud to issue its stock for overvalued compensation was first held to be within the protection of section 10(b) in *Hooper v. Mountain States Sec. Corp.*,[3] where the Fifth Circuit ruled that the legislative standard of "in the public interest"[4] was broad enough to include such a corporation, and that the issuance of stock was a "sale" within the meaning of rule 10b-5. While this liberal interpretation has been criticized as inconsistent with the legislative history of the 1934 act,[5] the right of a corporation to avail itself of the benefits of the rule has been recognized in several other decisions.[6] The principal case, however, is the first to uphold a corporate right of recovery under rule 10b-5 for acts which would also constitute a breach of fiduciary duty to the corporation by an insider.[7]

or instrumentality of interstate commerce, or of 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 statement of a material fact or to omit to state a material fact necessary in order to make the statements . . . 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).

3 282 F.2d 195 (5th Cir. 1960), *cert. denied*, 365 U.S. 814 (1961). Although neither § 10(b) nor rule 10b-5 provides for civil liability, it is well established that a remedy for investors is implicit under the principle that a violation of a statute creates a claim in favor of an injured party intended to be protected by the act. *E.g.*, Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946); RESTATEMENT, TORTS § 286 (1934). For an extensive criticism of this result in light of the legislative history of § 10(b), see Ruder, *Civil Liability Under Rule 10-5: Judicial Revision of Legislative Intent?*, 57 NW. U.L. REV. 627 (1963).

4 Securities Exchange Act of 1934, § 10(b), 48 Stat. 891, 15 U.S.C. § 78(j) (1958).

5 See 59 MICH. L. REV. 1267 (1961); 13 STAN. L. REV. 378 (1961); *cf.* Ruder, *supra* note 3, at 654; Note, 61 HARV. L. REV. 869 (1948).

6 H. L. Green Co. v. Childree, 185 F. Supp. 95 (S.D.N.Y. 1960) (allowed without consideration of the problem); Taussig v. Wellington Fund, Inc., 187 F. Supp. 179 (D. Del. 1960) (employed as a basis for federal jurisdiction); McClure v. Borne Chem. Co., 292 F.2d 824 (3d Cir.) (dictum), *cert. denied*, 368 U.S. 939 (1961); Slavin v. Germantown Fire Ins. Co., 174 F.2d 799 (3d Cir. 1949) (dictum).

7 Corporations have been permitted to sue in their capacity as investors under rule 10b-5. Donovan, Inc. v. Taylor, 136 F. Supp. 552 (N.D. Cal. 1955); 13 STAN. L. REV. 378, 380-81, nn.7, 8 (1961).

The court in the principal case was confronted with dicta in two decisions of its own court of appeals to the effect that the only rights granted to a corporate issuer or its stockholders by the Securities Exchange Act of 1934 are those which the statute expressly created. In distinguishing the Second Circuit's holding in *Howard v. Furst*[8] that a corporation has no right to enjoin improper proxy solicitations under section 14(a)[9] and rule 14a-9,[10] the court reasoned that the policy of preventing harassment of insurgents in a proxy context, which justified denial of that right, did not apply when a corporation had been defrauded of its stock.[11] The principal obstacle to the court's holding, however, appears to be the dictum in *Birnbaum v. Newport Steel Corp.*[12] that section 10(b) and rule 10b-5 were not intended to protect a corporation from a breach of fiduciary duty by a corporate insider. Conceding that questions of internal corporate affairs should not be subject to federal jurisdiction when a purchase or sale of securities is only "incidental to a major mismanagement issue," the court in the principal case nevertheless reasoned that the participation of corporate insiders should not prevent the application of the rule to an illegal securities transaction. It would seem that questions of corporate mismanagement to which the rule is inapplicable may best be differentiated from stock fraud on the basis of an issuing corporation's status as a "seller."[13] Such a distinction clearly circumvents the *Birnbaum* decision, since the final holding in that case was that the plaintiff corporation, which was not a party to the transaction, had not been alleged to be a purchaser or seller and was therefore not within the scope of the rule.[14]

The court's application of rule 10b-5 in favor of the issuing corporation, despite the involvement of an insider, has been criticized on the ground that it is inconsistent to impose a federal standard of fiduciary duty in connection with all the internal affairs of a corporation which are related to an allegedly fraudulent transfer of its securities, while leaving other aspects of corporate management to state law.[15] However, if the court was correct in upholding the right of the corporation to utilize the rule, it would seem even more inconsistent to deny that right only in those cases in which a fraudulent scheme includes corporate insiders. A refusal to apply rule 10b-5 in such cases because of the *Birnbaum* dicta that section 10b-5 was not

8 238 F.2d 790, 793 (2d Cir. 1956).

9 48 Stat. 895 (1934), 15 U.S.C. § 78(n)(a) (1958).

10 17 C.F.R. § 240.14a-9 (1949).

11 The court's distinction appears somewhat superficial, since the policy against harassment of corporate insurgents was not determinative in the *Howard* case. Moreover, the statutory standard to guide the SEC in implementing § 14(a) is identical to the language of § 10(b).

12 193 F.2d 461, 464 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952).

13 See Hooper v. Mountain States Sec. Corp., 282 F.2d 195 (5th Cir.), *cert. denied*, 365 U.S. 814 (1961).

14 See 3 LOSS, SECURITIES REGULATION 1770-71 (2d ed. 1961). *But cf.* Kremer v. Selheimer, 215 F. Supp. 549 (E.D. Pa. 1963).

15 See 63 COLUM. L. REV. 934, 943 (1963).

directed at fraudulent mismanagement would prevent the application of the rule to fraudulent securities transactions which fall within the language of the rule. While it is true that there is no basis for imputing to Congress an intent to draw into the federal courts all the facets of internal corporate affairs on the basis of the rule-making power in section 10(b), neither is there any indication that Congress intended to exclude from the purview of that section only those fraudulent transfers involving corporate insiders. Moreover, there is little possibility that a flood of suits alleging corporate mismanagement and basing federal jurisdiction on a securities transaction will arise, since it may be inferred from the principal case that an action which may be brought in a state court for a breach of the fiduciary duty of corporate insiders will not be subject to federal jurisdiction under rule 10b-5 unless a fraudulently induced issuance of securities is a major element of the alleged mismanagement. Finally, in a derivative suit by trustees in bankruptcy or stockholders when a corporation has been defrauded of its stock, the advantages of granting a corporate right of action under rule 10b-5 would appear to outweigh greatly the resulting asymmetry in the law governing corporate mismanagement. A right of corporate recovery eliminates the practical difficulties involved in a class action under the rule on behalf of a large group of defrauded purchasers.[16] If a corporation's action for fraud were brought without the procedural and jurisdictional benefits of the act, effective recovery would be less likely.[17]

The most significant aspect of the decision would appear to be the promise it holds for avoiding the conflicting and overly technical rules governing corporate actions for promoter's illegal profits by the use of rule 10b-5.[18] Promoters have succeeded in escaping liability to the corporation for a sale of overvalued property to the corporation in exchange for its stock where the promoter, at the time of the transaction, owned all of the authorized stock.[19] The theory applied is that the company should not be allowed to

16 See Cherner v. Transatron Electronic Corp., 201 F. Supp. 934 (D. Mass. 1962) in which the court refused, on the basis of the policy against a fomenting of litigation, to authorize the giving of notice by plaintiff's attorney to other investors who were allegedly defrauded by violations of the Securities Act of 1933.

17 See McClure v. Borne Chem. Co., 292 F.2d 824 (3d Cir.), *cert. denied*, 368 U.S. 939 (1961), in which stockholders in a derivative action for a violation of the Securities Exchange Act of 1934 were not required to post security for costs. Section 27 of the Securities Exchange Act of 1934 provides for venue and service of process in any district in which the defendant is found or is an inhabitant or transacts business. See also Hooper v. Mountain State Sec. Corp., 282 F.2d 195, 201 (5th Cir. 1960), *cert. denied*, 365 U.S. 814 (1961).

18 See generally Frohling, *The Promoter and Rule 10b-5; Basis for Accountability*, 48 CORNELL L.Q. 274 (1962). Although the disclosure requirements of the Securities Act of 1933 have greatly diminished the possibility of promoter's fraud, the danger of injury to a corporation still exists, since a substantial portion of financing is exempt from registration. Securities Act of 1933, § 3, 48 Stat. 75, as amended, 15 U.S.C. § 77(c) (1958).

19 Hays v. The Georgian, 280 Mass. 10, 181 N.E. 765 (1932); *cf.* Jeffs v. Utah Power & Light Co., 136 Me. 454, 12 A.2d 592 (1940). In a minority of courts, the promoter need only have purchased all the issued stock to employ this defense. *E.g.*, Old Dominion Copper Mining & Smelting Co. v. Lewisohn, 210 U.S. 206 (1908); Ball v. Breed, Elliot & Harrison, 294 Fed. 227 (2d Cir.), *cert. denied*, 264 U.S. 584 (1924).

repudiate a sale to which it has consented. The elements of promoter's fraud and those of the principal case are substantially identical, *i.e.*, the use of fraud to induce the issuance of stock for inadequate compensation. Although the corporate insider in the principal case apparently did not control the corporation, the technical defense of consent, which is merely a fiction where the promoter occupies both sides of the transaction, should be ineffective in a rule 10b-5 action in view of the expanding concept of liability-creating conduct under the rule.[20]

Since no clear answer concerning the existence of a corporate right of action under rule 10b-5 is provided by the cases, or by speculation as to legislative intent,[21] it would appear that the issue will be resolved, at least tacitly, by a consideration of the practical advantages and disadvantages of alternative results. Viewed in this light, the availability of federal jurisdiction to an issuing corporation to facilitate effective redress of an injury brought about by an insider's rule 10b-5 violation is clearly consistent with the broad congressional objective of protecting the integrity of the securities trading process.

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20 See Cady, Roberts & Co., CCH FED. SEC. L. REP. ¶ 76803 (SEC Nov. 8, 1961); Comment, 59 YALE L.J. 1120, 1123-26 (1950). Promoters have sometimes escaped liability by taking an entire issue of no-par shares. *E.g.*, Piggly Wiggly Del., Inc. v. Bartlett, 97 N.J. Eq. 469, 129 Atl. 413 (1925). It is doubtful whether such a maneuver would preclude liability in an action under rule 10b-5, since the fraudulent conduct and the injury to a corporation are substantially the same when par value stock is issued. See BALLANTINE, CORPORATIONS 841-42 (1946). *But cf.* Kremer v. Selheimer, 215 F. Supp. 549 (E.D. Pa. 1963); 13 STAN. L. REV. 378 (1961).

21 See authorities cited note 5 *supra*.