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## Regulation of Business - SEC Rule X-10B-5 - Recovery by Corporation Fraudulently Induced to Issue Shares

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REGULATION OF BUSINESS — SEC RULE X-10B-5 — RECOVERY BY CORPORATION FRAUDULENTLY INDUCED TO ISSUE SHARES — Defendants, Mountain States Securities Corporation and former officers of Consolidated American Industries, Inc., organized a dummy corporation, the Mid-Atlantic Development Company. The defendants drew a formal contract whereby Mid-Atlantic agreed to transfer worthless Cuban insurance company stock and equally valueless Honduran oil exploration rights to Consolidated in exchange for 700,000 shares of Consolidated stock. Consolidated's former secretary falsely certified a corporate resolution authorizing the issuance of the stock, and its former general counsel advised Consolidated's stock transfer agent that the transaction was exempt from SEC regulation. Acting on these representations, the transfer agent issued the Consolidated stock. Since at this time Mid-Atlantic had been dissolved, the Consolidated stock was issued to Mid-Atlantic's distributees who sold to individual investors throughout the world. The plaintiff, trustee in bankruptcy for Consolidated, brought the present action under section 10 (b) of the

Federal Securities Exchange Act of 1934<sup>1</sup> and its implementing regulation, rule X-10B-5,<sup>2</sup> to recover the value of the stock improperly issued. The district court dismissed, holding that the facts failed to state a cause of action under either the statute or rule X-10B-5. On appeal, *held*, reversed, one judge dissenting. Because the issuance of its own stock by Consolidated was a "sale" within the meaning of rule X-10B-5, plaintiff had a cause of action under the rule. *Hooper v. Mountain States Sec. Corp.*, 282 F.2d 195 (5th Cir.), *cert. denied*, 365 U.S. 814 (1961).

Under section 10 (b) of the Federal Securities Exchange Act of 1934, the Securities Exchange Commission in 1942 promulgated rule X-10B-5 in order to extend protection under the act to defrauded sellers, as well as purchasers, of securities.<sup>3</sup> Although the defrauded party is not given an express civil cause of action by either section 10 (b) or rule X-10B-5, such a right has been repeatedly recognized since the 1946 decision of *Kardon v. National Gypsum Co.*<sup>4</sup> The courts have, however, had difficulty defining the class protected by X-10B-5. The *Kardon* case gave protection to "investors," a term broad enough to include defrauded stockholders who were induced without disclosure of material facts by majority shareholders to sell their holdings at less than actual value. However, shareholders have been denied relief in an attempt to recover "insider profits" under rule X-10B-5, for the court felt that the rule protected only "purchasers" and "sellers" of securities and not those injured as a result of the mismanagement of corporate affairs.<sup>5</sup>

<sup>1</sup> "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 . . .

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

<sup>2</sup> "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,

(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." SEC Reg. X-10B-5, 17 C.F.R. § 240.10b-5 (1949).

<sup>3</sup> "The new rule closes a loophole in the protections against fraud administered by the Commission by prohibiting individuals or companies from buying securities if they engage in fraud in their purchase." SEC Securities Exchange Act of 1934 Release No. 3230, May 21, 1942.

<sup>4</sup> 69 F. Supp. 512 (E.D. Pa. 1946), 46 MICH. L. REV. 680 (1948); see also *Slavin v. Germantown Fire Ins. Co.*, 174 F.2d 799 (3d Cir. 1949); *Acker v. Schulte*, 74 F. Supp. 683 (S.D.N.Y. 1947); *Mills v. Sarjem Corp.*, 133 F. Supp. 753 (D.N.J. 1955).

<sup>5</sup> *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir. 1952), 100 U. PA. L. REV. 1251 (1952), criticized in Comment, 4 STAN. L. REV. 308 (1952); see also *Joseph v. Farnsworth Radio & Television Corp.*, 198 F.2d 883 (2d Cir. 1952).

The protected class has generally been broadened by the decisions which have applied X-10B-5 to a variety of fact situations. Despite the language of the statute,<sup>6</sup> the courts have extended rule X-10B-5 to govern transactions in which neither a national stock exchange nor a professional stock broker was involved.<sup>7</sup> For example, in *Errion v. Connell*<sup>8</sup> the plaintiff, who exchanged two parcels of land and securities worth \$124,000 for 125 acres of oyster beds purportedly of equal value, but actually worth only \$12,500, gained relief under rule X-10B-5. The principal case specifically rejects "investors" as defining the protected class and recognizes that rule X-10B-5 may be applied not only "for the protection of investors," but also "in the public interest."<sup>9</sup> In calling Consolidated a "seller," and thus within the protected class, the court needed to counter the dictum in *Howard v. Furst*<sup>10</sup> that "there is literally nothing to support the view that any substantive rights were created for the benefit of the corporation."<sup>11</sup> This case may be superficially distinguished because it arose under section 14 (a)<sup>12</sup> rather than section 10 (b). Nevertheless, it raises a valid question whether a corporation was intended to be protected under section 10 (b) because "in the public interest or for the protection of investors" is the statutory standard to guide the SEC in adopting rules to implement both sections 10 (b) and 14 (a). However, even if this standard does give the SEC the power to protect corporations, rule X-10B-5 would appear to protect only sellers and purchasers, and it is not at all clear that the SEC intended that a corporation *issuing* its own shares outside the market should be classified a "seller." Nevertheless, the court in the principal case<sup>13</sup> did reason that the issuance of \$700,000 worth of stock constituted a "sale."

While the courts still speak of "sellers" and "purchasers," the decisions of *Errion v. Connell* and the principal case demonstrate that courts are moving toward considering any transfer of property a "sale" or "purchase" and toward permitting the defrauded party a remedy under federal law. While doubts have been raised whether this broad definition of the protected class was intended by Congress<sup>14</sup> or the SEC, the alternative is to relegate plaintiffs to fraud remedies under state law. State remedies tend to be inadequate because interstate transactions often present difficult problems in securing jurisdiction over nonresident defendants. In con-

<sup>6</sup> Securities Exchange Act of 1934, § 2, 48 Stat. 881 (1934), 15 U.S.C. § 78 (b) (1958).

<sup>7</sup> *Fratt v. Robinson*, 203 F.2d 627 (9th Cir. 1953); *Robinson v. Difford*, 92 F. Supp. 145 (E.D. Pa. 1950), 64 HARV. L. REV. 1018 (1951); *Northern Trust v. Essaness Theatres Corp.*, 103 F. Supp. 954 (N.D. Ill. 1952).

<sup>8</sup> 236 F.2d 447 (9th Cir. 1956), 55 MICH. L. REV. 1017 (1957), 70 HARV. L. REV. 1309 (1957), 9 STAN. L. REV. 589 (1957).

<sup>9</sup> Securities Exchange Act of 1934, § 10 (b), quoted in note 1 *supra*.

<sup>10</sup> 238 F.2d 790 (2d Cir. 1956).

<sup>11</sup> *Id.* at 793.

<sup>12</sup> Securities Exchange Act of 1934, § 14 (a), 48 Stat. 895 (1934), 15 U.S.C. § 78n (a) (1958); SEC Reg. X-14A-9, 17 C.F.R. § 240.14a9 (Supp. 1960).

<sup>13</sup> Principal case at 203.

<sup>14</sup> See generally Comments, 61 HARV. L. REV. 858 (1948), 59 YALE L.J. 1120 (1950), 52 MICH. L. REV. 893 (1954), 42 VA. L. REV. 537 (1956).

trast, rule X-10B-5 affords plaintiffs the use of special provisions relating to venue and service of process and thus enables them to overcome many procedural obstacles.<sup>15</sup> This fact alone may well justify the broad definition of the protected class under the rule.

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<sup>15</sup> Securities Exchange Act of 1934, § 27, 48 Stat. 902 (1934), as amended, 15 U.S.C. § 78aa (1958).