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Federal Jurisdiction - Securities and Exchange Commission - Application of Rule X - 10B-5 to Transactions Involving Non- Securities

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FEDERAL JURISDICTION — SECURITIES AND EXCHANGE COMMISSION — APPLICATION OF RULE X-10B-5 TO TRANSACTIONS INVOLVING NON-SECURITIES — Plaintiff brought an action for damages and the cancellation of certain instruments under section 10 (b) of the Securities Exchange Act of 1934¹ and rule X-10B-5 promulgated thereunder by the Securities and Exchange Commission.² She proved a series of interrelated acts which took place

¹ 48 Stat. 891, 15 U.S.C. (1952) §78j. "SEC. 10. 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 the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

² 17 C.F.R. 240, 10b-5 (1949). "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 made, in the light of the

over a period of months by which the defendants fraudulently deprived her of both securities and other property. The defendants objected to the jurisdiction of the district court on the ground that rule X-10B-5 was not applicable to transactions involving non-securities. The district court retained jurisdiction on the theory that all of the acts complained of were part of a single transaction which was within the scope of the rule. On appeal, *held*, affirmed. Rule X-10B-5 is applicable to the securities in a single transaction or scheme involving a combination of securities and non-securities. *Errion v. Connell*, (9th Cir. 1956) 236 F. (2d) 447.

*Kardon v. National Gypsum Co.*³ sparked the development of case law interpreting rule X-10B-5 by eliminating prior doubts as to the existence of a private right of action for violation of its provisions. The principal case poses the question: Is the remedy available when the violation of the rule occurs in connection with a transaction involving both securities and other property? The court held that rule X-10B-5 was applicable to the securities in a combination transaction, and that the federal court could properly award damages for the entire fraudulent scheme.⁴ The language of rule X-10B-5, "It shall be unlawful . . . to engage in any act . . . which operates . . . as a fraud . . . in connection with the purchase or sale of any security,"⁵ is susceptible of three different constructions. (1) The rule could be held to be totally inapplicable to combination transactions, even as to the securities involved therein. (2) It could be considered applicable to combination transactions, but only to the extent of the securities involved therein. (3) It could be construed as applicable to combination transactions, and as providing the basis for a civil remedy for both the securities and non-securities involved therein. The defendants argued in favor of the first interpretation; the court adopted the second one.⁶ The holding in the principal case, i.e., that the rule is applicable to the securities in a combination transaction, is easily warranted by a literal reading of its language. Furthermore, as pointed out

circumstances under which they were made, 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."

³ (E.D. Pa. 1946) 69 F. Supp. 512. *Accord*: *Fry v. Schumaker*, (E.D. Pa. 1947) 83 F. Supp. 476; *Speed v. TransAmerica Corp.*, (D.C. Del. 1947) 71 F. Supp. 457; *Osborne v. Mallory*, (S.D. N.Y. 1949) 86 F. Supp. 869. See also dictum in *Slavin v. Germantown Fire Ins.*, (3d Cir. 1949) 174 F. (2d) 799, in support of a civil remedy.

⁴ The court cited *Hurn v. Oursler*, 289 U.S. 238 (1933), to the effect that the federal court may properly entertain a single cause of action supported by two distinct grounds, only one of which presents a federal question. In the principal case there was a single fraudulent scheme, the court said, involving two types of property: "securities, over which the federal court had jurisdiction, and the other non-securities over which the federal court normally has no jurisdiction." Principal case at 454. The single fraudulent scheme encompassed both types, however, and the court felt that "the thought of requiring two lawsuits in this situation is untenable." *Ibid*.

⁵ 17 C.F.R. 240, 10b-5 (1949).

⁶ The court does not expressly adopt the second construction, but this seems to be a necessary implication of their citing the *Oursler* case. It could be argued that the court adopted the third construction and merely cited the *Oursler* case as a makeweight argument, but the language cited in note 6 *supra* does not support this view.

in the *amicus curiae* brief filed by the Securities and Exchange Commission,⁷ to adopt the interpretation advocated by the defendants would afford the fraudulent purchaser or seller an easy means to circumvent the provisions of the rule. By merely including a non-security in the transaction he could immunize himself from federal liability, both in criminal and civil cases. Such a construction would destroy much of the usefulness of the rule, could not be supported without a strained reading of its language, and is hardly consistent with its purpose.⁸

The third possible construction of the rule, although not considered by the court in its opinion, would not require a strained interpretation of the rule, nor would it alter the criminal liability imposed by it.⁹ To establish tort liability for violations of rule X-10B-5 with respect to non-securities under this interpretation, it would be necessary for the plaintiff to prove an act done with respect to such property which is prohibited by the rule, and which results in the invasion of an interest which the rule was designed to protect.¹⁰ In applying these principles to the principal case, it could be argued that defrauding the plaintiff of the non-securities was an "act . . . which operates . . . as a fraud . . . done in connection with the purchase or sale of . . . a security,"¹¹ and therefore an act squarely prohibited by the rule. The interest intended to be protected by the rule could be defined as the interest in being free from fraud "in connection with the purchase or sale of any security . . ." ¹² Basic to this analysis is the idea that the fraud with respect to the securities and non-securities is inseparable, that there is a single scheme which is fraudulent with respect to both types of property. This is not to suggest that either the Securities Exchange Act of 1934, or rule X-10B-5, was intended to establish a remedy with respect to non-securities as such, but, that where the fraud is intimately associated with the entire transaction a single action with respect to both types of property should be allowed in order

⁷ Principal case at 454.

⁸ The preamble to the Securities Exchange Act states, "For the reasons hereinafter enumerated, transactions in securities . . . are affected with a national public interest which makes it necessary to provide for regulation and control of such transactions and of practices and matters related thereto. . . ." 48 Stat. 881 (1934), 15 U.S.C. (1952) §78 (b). It has been stated that the primary purposes of Congress in enacting the Securities Exchange Act were to "protect the general investing public," and to "make the . . . control of securities transactions reasonably complete and effective." Dissenting opinion in *Baird v. Franklin*, (2d Cir. 1944) 141 F. (2d) 238 at 244; and *Fratt v. Robinson*, (9th Cir. 1953) 203 F. (2d) 627 at 631. The purpose of rule X-10B-5 was to close "a loophole," by "prohibiting individuals or companies from buying securities if they engage in fraud. . . ." Exch. Act Release 3230, May 21, 1942.

⁹ Under this construction the rule is still applicable only where there is fraud with respect to the sale or purchase of a security.

¹⁰ 2 TORTS RESTATEMENT §286 (1934). "The violation of a legislative enactment by doing a prohibited act, or by failing to do a required act, makes the actor liable for an invasion of an interest of another if: (a) the intent of the enactment is exclusively or in part to protect an interest of the other as an individual; and (b) the interest invaded is one which the enactment is intended to protect. . . ."

¹¹ 17 C.F.R. 240, 10b-5 (1949).

¹² 48 Stat. 891 (1934), 15 U.S.C. (1952) §78j.

to preserve the efficacy of the rule. In many such cases it may be impossible to ascertain whether or not fraud in fact exists, or to estimate damages, unless the transaction as a whole is considered.¹³ It is not unreasonable to attribute to Congress an intent to establish jurisdiction over the non-securities in a combination transaction where such treatment is necessary to the successful implementation of section 10 (b).¹⁴ Adoption of the third construction is also more consistent with judicial economy, as it would permit a person defrauded in a single transaction, involving both securities and non-securities, to be able to recover for losses sustained with respect to both types of property in one action in all jurisdictions. Such a remedy is now available in state actions for common law fraud, and in federal actions in jurisdictions following the Ninth Circuit's approach to both *Hurn v. Oursler* and rule X-10B-5. There is, however, disagreement among the courts as to the requirements and scope of *Oursler* joinder.¹⁵ Where the *Oursler* doctrine is more limited, as in the Second Circuit,¹⁶ it would not have been possible to maintain an action in the federal courts for recovery with respect to the non-securities under the interpretation given rule X-10B-5 in the principal case. In such a jurisdiction, the practical effect of construing the rule as applicable only to the securities in a combination transaction would be to force a plaintiff to choose between a federal action, in which recovery would be allowed only for the securities, or a state action, in which he could recover for fraud with respect to both types of property. This result may tend to induce courts following a narrower view of the *Oursler* case to adopt the third possible construction of rule X-10B-5, although this tendency will probably be counterbalanced by the reluctance of such courts to allow federal encroachment upon the traditional sphere of state judicial activity.¹⁷

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¹³ For example, as in the principal case, if *A* were to obtain from *B* \$10,000 worth of real property and \$10,000 worth of securities, for real property valued at \$10,000 but fraudulently misrepresented to be of greater value, it would be impossible for *B* to prove his damages with respect to the securities without also proving his loss with respect to the real property.

¹⁴ See CCH, Federal Securities Law Reports, No. 574, 6-7 (1957), reporting on proposed changes in the anti-fraud provisions of §10 of the Securities Exchange Act. "Another change in Sec. 10 (b) would make it clear that the jurisdictional provisions are intended to be as broad as the Constitutional powers of the federal government with respect to the mails and interstate commerce."

¹⁵ See 2 MOORE, FEDERAL PRACTICE, 2d ed., §2:06 (5) (1948); Shulman and Jaegerman, "Some Jurisdictional Limitations on Federal Procedure," 45 YALE L.J. 393 (1936); Clark, "The Cause of Action," 82 UNIV. PA. L. REV. 354 (1934).

¹⁶ See *Musher Foundation v. Alba Trading Co.*, (2d Cir. 1942) 127 F. (2d) 9; *Lewis v. Vendome Bags*, (2d Cir. 1939) 108 F. (2d) 16; *Zalkind v. Scheinman*, (2d Cir. 1943) 139 F. (2d) 895.

¹⁷ Interpreting rule X-10B-5 involves essentially the same policy issues as were present in the *Oursler* decision. The interests of the litigants in judicial efficiency must be balanced against the interests of the state in maintaining its jurisdictional integrity. See Shulman and Jaegerman, "Some Jurisdictional Limitations on Federal Procedure," 45 YALE L.J. 393 (1936).