

1956

SECURITIES REGULATION-CIVIL LIABILITY UNDER RULE X-10B-5 FOR FRAUD IN THE PURCHASE OR SALE OF SECURITIES

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Recommended Citation

J. D. Voss S.Ed., *SECURITIES REGULATION-CIVIL LIABILITY UNDER RULE X-10B-5 FOR FRAUD IN THE PURCHASE OR SALE OF SECURITIES*, 52 MICH. L. REV. 893 ().

Available at: <https://repository.law.umich.edu/mlr/vol52/iss6/7>

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SECURITIES REGULATION—CIVIL LIABILITY UNDER RULE X-10B-5 FOR FRAUD IN THE PURCHASE OR SALE OF SECURITIES—On May 21, 1942 the Securities and Exchange Commission, pursuant to section 10(b) of the Securities Exchange Act of 1934,¹ promulgated rule X-10B-5.² The purpose of the new rule was apparently to close a loophole in the then existing pattern of regulation of the purchase

⁵⁴ Rogers, "Modern Warfare and Its Effect on Policy Construction," 1952 *INS. L.J.* 360.

⁵⁵ *N.Y. TIMES*, Aug. 9, 1953, §3, p. 1.

⁵⁶ Follmann, "Commercial Accident Insurance," 1952 *INS. L.J.* 737 at 744.

⁵⁷ *Ibid.*

and sale of securities.³ The loophole resulted from a gap between section 17(a) of the Securities Act of 1933,⁴ which prohibits the use of fraud in the *sale* of securities by any person, and section 15(c)(1) of the Securities Exchange Act of 1934,⁵ which prohibits the use of fraud in the sale or purchase of securities by brokers and dealers.⁶ The two sections, while overlapping in part, do not cover the *purchase* of securities by "any person." Rule X-10B-5 merely repeats the language of section 17(a), but extends the prohibition to the purchase as well as the sale of securities.

The broad language of X-10B-5, coupled with the development by the courts of the concept of implied liability under the various sections of both the Securities Act of 1933 and the Securities Exchange Act of 1934, offered to defrauded sellers of securities a bright and promising hook upon which to hang their claims for legal relief. It is the purpose here to discuss briefly the present condition of this somewhat nebulous legal peg.

I. *Implied Liability Under the Securities Acts*

The Securities Act of 1933 and the Securities Exchange Act of 1934 contain several sections which expressly give a civil cause of action against a violator of the particular section creating the cause of action.⁷ The liabilities so created are restricted by special statutes

³ See SEC Release No. 3230, May 21, 1942, in which X-10B-5 is described as closing "a loophole in the protections against fraud . . . by prohibiting individuals or companies from buying securities if they engage in fraud in their purchase."

⁴ 48 Stat. L. 84, §17(a) (1933), 15 U.S.C. (1946) §77q(a).

⁵ 48 Stat. L. 895, §15(c) (1934), as amended by 52 Stat. L. 1075, §2 (1938), 15 U.S.C. (1946) §78o(c).

⁶ The Securities Exchange Act of 1934 defines brokers and dealers as follows: "The term 'broker' means any person engaged in the business of effecting transactions in securities for the account of others, but does not include a bank." 48 Stat. L. 882, §3(a)(4) (1934), 15 U.S.C. (1946) §78c(a)(4). "The term 'dealer' means any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise, but does not include a bank, or any person insofar as he buys or sells securities for his own account, either individually or in some fiduciary capacity, but not as a part of a regular business." 48 Stat. L. 882, §3(a)(5) (1934), 15 U.S.C. (1946) §78c(a)(5).

⁷ Securities Act of 1933: Sec. 11 provides for liability for making untrue statements in a registration statement, §12(1) provides for liability for violation of §5, which has to do with transactions on unregistered exchanges, and §12(2) provides for liability for the sale of securities by means of untrue or misleading statements in a prospectus. 48 Stat. L. 82, §11 (1933), 15 U.S.C. (1946) §77k; 48 Stat. L. 84, §12 (1933), 15 U.S.C. (1946) §77l. Securities Exchange Act of 1934: Sec. 9(e) provides for liability for manipulation of securities on a registered exchange, §16(b) gives a cause of action to corporations to recapture profits made by an insider through speculation in the corporation's securities, and §18 provides for liability for misleading statements in a registration statement. 48 Stat. L. 889, §9(e) (1934), 15 U.S.C. (1946) §78i(e); 48 Stat. L. 896, §16(b) (1934), 15 U.S.C. (1946) §77p(b); 48 Stat. L. 897, §18 (1934) as amended by 49 Stat. L. 1379, §5 (1936), 15 U.S.C. (1946) §78r.

of limitation.⁸ In addition, the act of 1934 contains a section rendering void any contract made in violation of any of the sections of the act.⁹ Those sections which do not expressly create a cause of action merely make unlawful the conduct prohibited by the section or by the rules and regulations prescribed by the Securities and Exchange Commission pursuant to the section.

In spite of this absence of express civil liability for violation of most of the sections in each act, the courts have developed an implied civil liability. The first move in this direction was made in the case of *Geismar v. Bond & Goodwin, Inc.*¹⁰ The court held that section 29(b) of the Securities Exchange Act of 1934, as amended in 1938,¹¹ "clearly contemplates that a civil suit" may be brought for a violation of section 15(c)(1) of the act.¹² A different basis of liability was applied in *Baird v. Franklin*.¹³ In this case, involving an action under section 6(b) of the Securities Exchange Act of 1934,¹⁴ the court made use of the common law doctrine of recognizing a private action based on a violation of a statute designed to protect a certain class of persons.¹⁵ Since the act was for the protection of investors, the court reasoned that to construe section 6(b) as not creating a civil liability would be to render the purpose of the act a "snare and a delusion." These two theories were merged in *Goldstein v. Groesbeck*,¹⁶ an action under the Public Utility Holding Company Act of 1935,¹⁷ which contains a section almost identical with section 29(b) of the Securities Exchange Act of 1934.¹⁸

⁸ The limitation is usually one year from the date of discovery of the violation, but not more than three years from the date of the violation.

⁹ Sec. 29(b) of the Securities Exchange Act of 1934, 48 Stat. L. 903, §29(b) (1934), as amended by 52 Stat. L. 1076, §3 (1938), 15 U.S.C. (1946) §78cc.

¹⁰ (D.C. N.Y. 1941) 40 F. Supp. 876 at 878.

¹¹ 48 Stat. L. 903, §29(b) (1934), as amended by 52 Stat. L. 1076, §3 (1938), 15 U.S.C. (1946) §78cc. The amendment added a proviso to §29(b) to the effect that the section would not apply to render contracts made in violation of the act void in an action brought in reliance on §29(b) for a violation of §15 unless the action is brought within one year after discovery of the violation, and within three years of the date of the violation. The amendment is significant in that §15 does not expressly create a civil cause of action.

¹² *Geismar v. Bond & Goodwin, Inc.*, (D.C. N.Y. 1941) 40 F. Supp. 876 at 878.

¹³ (2d Cir. 1944) 141 F. (2d) 238, cert. den. 323 U.S. 737, 65 S.Ct. 36 (1944).

¹⁴ 48 Stat. L. 885, §6(b) (1934), 15 U.S.C. (1946) §78f(b).

¹⁵ This theory was expounded by Judge Clark in what is termed a dissenting opinion, but which actually is a discussion of whether §6(b) could be the basis for the cause of action, a question which the majority assumed without discussion. Judge Clark disagreed with the court only on the question of whether the plaintiffs had shown damages.

¹⁶ (2d Cir. 1944) 142 F. (2d) 422, cert. den. 323 U.S. 737, 65 S.Ct. 36 (1944).

¹⁷ 49 Stat. L. 803 (1935), 15 U.S.C. (1946) §79 et seq.

¹⁸ The court applied both the common law theory of private action based on a statute and the rationale of *Geismar v. Bond & Goodwin*, (D.C. N.Y. 1941) 40 F. Supp. 876.

In *Kardon v. National Gypsum Co.*,¹⁹ the first attempt to base a private cause of action on a violation of X-10B-5 was successful. The action arose out of a purchase of stock by two directors of the issuing corporation from two other directors of the same corporation. Prior to the purchase, the defendants had negotiated for a sale of all the corporation's assets without the knowledge of the plaintiffs. Subsequent to the transfer of the stock, the defendants consummated the sale of the assets and realized a handsome profit. On motions to dismiss for lack of jurisdiction and failure to state a cause of action, the court held that there was an implied liability for violation of X-10B-5 on the common law theory of a private action based on a statute. As an afterthought, the court also approved the rationale of Judge Coxe in the *Geismar* case, that section 29(b) of the act implies that Congress intended to create a civil liability for violation of the various sections of the act.

Since the *Kardon* case, the various district and circuit courts have been in substantial agreement on the proposition that section 10(b) and X-10B-5 create an implied civil liability.²⁰ However, it is still unclear what the scope of the liability is, and there remains much room for speculation when attempting to sketch its outer boundaries.

II. General Scope of the Liability Under X-10B-5

A. *The Securities Covered.* Section 10(b) and X-10B-5 both refer to "any security registered on a national securities exchange or any security not so registered."²¹ The question has been raised in

¹⁹ (D.C. Pa. 1946) 69 F. Supp. 512 (motion to dismiss); (D.C. Pa. 1947) 73 F. Supp. 798 (on the merits); (D.C. Pa. 1947) 83 F. Supp. 613 (request for additional findings of fact and law).

²⁰ *Acker v. Schulte*, (D.C. N.Y. 1947) 74 F. Supp. 683; *Montague v. Electronic Corp. of America*, (D.C. N.Y. 1948) 76 F. Supp. 933; *Seward v. Hammond*, (D.C. Mass. 1948) 8 F.R.D. 457; *Slavin v. Germantown Fire Ins. Co.*, (3d Cir. 1949) 174 F. (2d) 799; *Hawkins v. Merrill, Lynch, Pierce, F  nner & Beane*, (D.C. Ark. 1949) 85 F. Supp. 104; *Robinson v. Difford*, (D.C. Pa. 1950) 92 F. Supp. 145; *Fischman v. Raytheon Mfg. Co.*, (2d Cir. 1951) 188 F. (2d) 783; *Rosenberg v. Globe Aircraft Corp.*, (D.C. Pa. 1948) 80 F. Supp. 123; *Birnbaum v. Newport Steel Corp.*, (2d Cir. 1952) 193 F. (2d) 461; *Joseph v. Farnsworth Radio & Television Corp.*, (D.C. N.Y. 1951) 99 F. Supp. 701; *Fry v. Schumaker*, (D.C. Pa. 1947) 83 F. Supp. 476; *Stella v. Kaiser*, (D.C. N.Y. 1948) 82 F. Supp. 301; *Osborne v. Mallory*, (D.C. N.Y. 1949) 86 F. Supp. 869; *Speed v. Transamerica*, (D.C. Del. 1951) 99 F. Supp. 808; *Northern Trust Co. v. Essaness Theatres Corp.*, (D.C. Ill. 1952) 103 F. Supp. 954; *Fratt v. Robinson*, (9th Cir. 1953) 203 F. (2d) 627; 59 *YALE L.J.* 1120 (1950); 61 *HARV. L. REV.* 858 (1948). For a complete treatment of all the problems surrounding X-10B-5, see Loss, *SECURITIES REGULATION*, c. XIII (1951).

²¹ See notes 1 and 2 *supra*. The term "security" is defined in both acts very broadly, and includes "any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share,

several cases whether X-10B-5 covers transactions in all securities, or only transactions in securities either listed on a national stock exchange or dealt in by dealers and brokers. The basis for the argument that only listed securities or securities dealt in on "over-the-counter" markets are covered is that the preamble to the act of 1934 seems to indicate that only securities on national exchanges and on over-the-counter markets are to come within the purview of the act.²² The cases agree, however, that X-10B-5 covers transactions in all securities, including transactions between two individual investors, regardless of whether the securities are listed or dealt in on an over-the-counter market. This conclusion is reached by some of the courts by defining "over-the-counter market" to mean transaction in any security not listed on a national stock exchange, and therefore even the preamble to the act covers all securities.²³ The other rationale is that while "over-the-counter market" means transaction through a broker or dealer, the language of section 10(b) and X-10B-5 is so unambiguous that the preamble to the act cannot be referred to in determining their meaning, and the words "or any security not so registered" clearly covers all securities.²⁴

B. *Use of Instrumentalities of Interstate Commerce.* It has been held that X-10B-5 covers transactions in securities even though no element of fraud takes place in the use of the instrumentality of interstate commerce. It is necessary only that such an instrumentality be used "in connection with" a transaction effected by fraudulent means.²⁵ Thus, if a meeting between the parties to the transaction is arranged by means of the telephone or the mails, and the fraud takes place at the meeting, the transaction will come under the operation of X-10B-5. Furthermore, it is not necessary that the transaction itself

investment contract, voting-trust certificate, certificate of deposit, for a security, or in general, any instrument commonly known as a 'security'; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing. . . ." Securities Exchange Act of 1934, 48 Stat. L. 882, §3(a)(10) (1934), 15 U.S.C. (1946) §78c(a)(10).

²² The preamble reads in part: "For the reasons hereinafter enumerated, transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets are affected with a national public interest which makes it necessary to provide for regulation and control of such transactions. . . ." 48 Stat. L. 881, §2 (1934), 15 U.S.C. (1946) §78(b).

²³ *Robinson v. Difford*, (D.C. Pa. 1950) 92 F. Supp. 145 at 147; *Northern Trust Co. v. Essaness Theatres Corp.*, (D.C. Ill. 1952) 103 F. Supp. 954 at 961.

²⁴ *Speed v. Transamerica Corp.*, (D.C. Del. 1951) 99 F. Supp. 808; *Fratt v. Robinson*, (9th Cir. 1953) 203 F. (2d) 627.

²⁵ *Northern Trust Co. v. Essaness Theatres Corp.*, (D.C. Ill. 1952) 103 F. Supp. 954 at 964; *Fratt v. Robinson*, (9th Cir. 1953) 203 F. (2d) 627 at 634.

be one which transverses state boundaries. As long as an instrumentality of interstate commerce, such as the telephone or the mails, is used in some connection with the transaction, the Securities Acts apply. And this is true even though the transaction involves securities of a local nature.²⁶

C. *Persons Liable*. For the most part, X-10B-5 has been used in situations involving the purchase of securities by "insiders." Early enforcement by the Commission set this pattern, and apparently has influenced the development of the civil liability.²⁷ The most striking example of the use of X-10B-5 as the basis for an action against corporate insiders is the *Transamerica* case.²⁸ In that case, which involved the purchase of securities of a subsidiary corporation by the parent without disclosure of an increase in the actual value of the subsidiary's assets, the court allowed recovery for fraud in favor of plaintiffs who had sold their shares in response to offers to buy mailed out by the defendant corporation, and in favor of plaintiffs who had turned in their stock for redemption or held it in spite of the declared redemption.²⁹ The result in the *Transamerica* case is not too surprising, since the situation involved a large number of investors and presented an instance in which regulation of the transaction was in the public interest.

In *Robinson v. Difford*³⁰ and *Northern Trust Co. v. Essaness Theatres Corp.*,³¹ however, the corporations involved were relatively closed corporations, and the parties interested were few in number. In each case, an action was allowed against a corporation for fraud under X-10B-5 in the purchase of its own stock. In neither case was there a strong element of public interest, but on the contrary both cases arose out of dealings between stockholders in privately held corporations.

A more recent case, *Fratt v. Robinson*,³² arose out of the same dispute that gave rise to the *Difford* case. The plaintiff was one of the

²⁶ *Northern Trust Co. v. Essaness Theatres Corp.*, (D.C. Ill. 1952) 103 F. Supp. 954 at 964.

²⁷ 59 HARV. L. REV. 769 (1946); 44 ILL. L. REV. 841 (1950).

²⁸ *Speed v. Transamerica Corp.*, (D.C. Del. 1951) 99 F. Supp. 808.

²⁹ The litigation was long and involved. See *Geller v. Transamerica Corp.*, (D.C. Del. 1943) 53 F. Supp. 625, *affd. per curiam* (3d Cir. 1945) 151 F. (2d) 534; *Zahn v. Transamerica Corp.*, (3d Cir. 1947) 162 F. (2d) 36, noted 46 MICH. L. REV. 1061 (1948) and 61 HARV. L. REV. 359 (1948); *Friedman v. Transamerica Corp.*, (D.C. Del. 1945) 63 F. Supp. 247. The Zahn and Friedman cases were decided on the merits with *Speed v. Transamerica Corp.*, (D.C. Del. 1951) 99 F. Supp. 808.

³⁰ (D.C. Pa. 1950) 92 F. Supp. 145.

³¹ (D.C. Ill. 1952) 103 F. Supp. 954.

³² (9th Cir. 1953) 203 F. (2d) 627.

defrauded stockholders who had not joined in the *Difford* litigation. The district court, in an unreported oral opinion,³³ dismissed the action on the ground that the scope of the Securities Exchange Act of 1934 did not cover the transaction, a holding contra to the *Difford* case. The Court of Appeals for the Ninth Circuit reversed, holding that the transaction did fall within the scope of the act and X-10B-5. While this case involved corporate insiders, the private nature of the transaction would seem to indicate a tendency of the courts to extend the operation of X-10B-5 beyond the normal operation of the Securities Acts.³⁴

III. *A Speculative Conclusion*

There are many more problems raised by X-10B-5 than those discussed here. Such questions as the necessity for privity between the seller and the purchaser,³⁵ the elements of the fraud that must be alleged,³⁶ the nature of the duty of disclosure imposed,³⁷ and other related questions have been the subject of much comment.³⁸ Underlying all of these questions is the much more important problem of how far X-10B-5 should be allowed to encroach upon local regulation of private security transactions. The cumulative effect of the courts' holding that X-10B-5 covers all securities, with apparently no limitation except the definition of "security" in the acts, and that even intrastate transactions may give rise to liability, is that almost any transaction involving a sale of securities will fall under the strictures of X-10B-5 and the regulation of the Securities and Exchange Commission. Even more important to the investor is the threat of civil liability completely independent of local statutory or common law liability for fraud. It seems quite possible that the next logical step will be an attempt to use X-10B-5 to fix liability on a private investor for any act which contravenes any provision of X-10B-5 in either the sale or the purchase of securities in a private transaction.

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³³ *Fratt v. Robinson*, D.C. Wash., July 31, 1951, No. 2765. The general content of the oral opinion is discussed in *Northern Trust Co. v. Essaness Theatres Corp.*, (D.C. Ill. 1952) 103 F. (2d) 954 at 965.

³⁴ Almost all of the sections of both acts are aimed at regulation of securities registered on a national exchange or of brokers and dealers in securities.

³⁵ See *Birnbaum v. Newport Steel Corp.*, (2d Cir. 1952) 193 F. (2d) 461, noted 100 *UNIV. PA. L. REV.* 1251 (1952); *Joseph v. Farnsworth Radio & Television Corp.*, (D.C. N.Y. 1951) 99 F. Supp. 701, noted 4 *STAN. L. REV.* 308 (1952).

³⁶ See *Seward v. Hammond*, (D.C. Mass. 1948) 8 *F.R.D.* 457; *Speed v. Transamerica Corp.*, (D.C. Del. 1951) 99 F. Supp. 808.

³⁷ See 59 *YALE L.J.* 1120 (1950).

³⁸ 36 *CALIF. L. REV.* 325 (1948); 44 *ILL. L. REV.* 841 (1950); 14 *UNIV. CHI. L. REV.* 471 (1947); 59 *HARV. L. REV.* 769 (1946).