Michigan Law Review

Volume 46 | Issue 5

1948

CORPORATIONS--SECTION 10b OF THE SECURITIES EXCHANGE ACT--RULE X-10B-5--DUTY OF DISCLOSURE IN PURCHASING SHARES

John E. Grosboll S.Ed.
University of Michigan Law School

CORPORATIONS—SECTION 10b OF THE SECURITIES EXCHANGE ACT—RULE X-10B-5—DUTY OF DISCLOSURE IN PURCHASING SHARES—Plaintiffs (father and son) and defendants (two brothers) had owned all the capital stock of two corporations. The four constituted the entire board of directors. De-

fendants secretly entered into a contract with the National Gypsum Company agreeing to sell the latter the plant and equipment of one of the corporations and one third of the output of the other corporation over a three year period. Later the defendants purchased all of plaintiffs' stock in the two corporations. At that time plaintiffs knew nothing about the negotiations between defendants and National Gypsum, nor did defendants make any disclosures relative thereto. At the meeting during which the stock was sold to defendants, plaintiffs' attorney asked one of the defendants whether he had made any agreement for the resale of the stock and received a negative answer. The defendants then proceeded to consummate their transaction with National Gypsum. Plaintiffs brought an action in the federal district court against defendants for an accounting of profits claiming violation of Rule X-10B-5 [1] under section 10b [2] of the Securities Exchange Act of 1934. *Held*, for plaintiffs. *Kardon v. National Gypsum Co.*, (D.C. Pa. 1947) 73 F. Supp. 798.

This case came before the same court on a previous occasion on motions to dismiss on grounds of lack of jurisdiction over defendants and failure to state a cause of action.[3] In denying these motions the court found jurisdiction under section 274 of the act which authorizes extraterritorial service in suits to enforce "any liability or duty created by this title or rules and regulations thereunder." [4] The alleged acts of defendants were found to give rise to such liability on either of two grounds: first, the common law doctrine that violation of a statute is a tort if the injured party is a member of the class for whose special benefit the statute was enacted; and, second, the implication of a correlative remedy from section 29b,[5] which provides that contracts in violation of any provision of the act shall be void. The construction that Congress did not intend civil liability under the act to be restricted to violation of those sections expressly so providing has had other support.[6] Conceding jurisdiction under the act for

[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 of any facility of any national securities exchange,

(1) to employ any device, scheme, or artifice to defraud,

(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 on any person,

in connection with the purchase or sale of any security." S.E.C. Release No. 3230 (May 21, 1942).

[2] 48 Stat. L. 891 (1934), 15 U.S.C. (1940) § 78j.

[3] Kardon v. National Gypsum Co., (D.C. Pa. 1946) 69 F. Supp. 512.

[4] 48 Stat. L. 902 (1934), 15 U.S.C. (1940) § 78aa.

[5] 48 Stat. L. 903 (1934), amended 52 Stat. L. 1076 (1938), 15 U.S.C. (1940) § 78cc.

[6] Baird v. Franklin, (C.C.A. 2d, 1944) 141 F. (2d) 238 (based on breach of statutory duty). The 1938 amendment to § 29b strengthens the view that Congress intended to provide a cause of action for any section of the act which involves a contract. Goldstein v. Groesbeck, (C.C.A. 2d, 1944) 142 F. (2d) 422 accepts this interpretation. Cases which have recognized a private cause of action for violation of Rule X-10B-5 are: Fifth-Third Union Trust Co. v. Block, (S.D. Ohio 1946) Civil

violation of Rule X-10B-5, there are further questions, however, as yet undecided. This rule was promulgated in May, 1942, for the purpose of closing some of the gaps involving fraudulent sales and purchases of securities.[7] It will be noted that the rule literally reaches "any person" in connection with the "purchase or sale of any security," and sub-paragraph (2) of the rule leaves the way open for federal courts to impose a higher fiduciary duty on officers and directors in purchasing their corporation's stock than was done under the various common law views. Probably the majority common law view is that directors do not occupy a fiduciary relationship to the shareholders individually and thus are under no duty to disclose facts in their knowledge, beyond the scope of active fraud. Some states have taken the minority view, holding that in purchasing stock from shareholders the directors are under a fiduciary duty of disclosure. Still other jurisdictions, although purporting to follow the majority view, recognize that there can be special circumstances which, although short of active fraud, will give rise to a duty of disclosure.[8] Clearly, Rule X-10B-5 goes at least as far as the minority view noted above in imposing a duty of disclosure on directors and officers. It is interesting to note the above court's construction of the rule: "Under any reasonably liberal construction, these provisions apply to directors and officers, who in purchasing the stock of the corporation from others, fail to disclose a fact coming to their knowledge by reason of their position, which would materially affect the judgment of the other party to the transaction."[9] Such an interpretation, if strictly followed, undoubtedly places an extremely high fiduciary duty on officers and directors. To what extent this rule affects other persons is not yet clear. It is possible that the rule will be construed as reaching only insiders or those in collusion with insiders.[10] If not so confined, surely the duty of disclosure will vary in degree with the status of the purchaser; for it would seem that one who is not an insider nor in collusion therewith should be able to deal at arm's length with a shareholder without revealing all he knows about the stock, assuming no active fraud is present. To hold otherwise would be to put a premium on the seller's stupidity in not seeking to learn the facts. Thus far the only controversies that have arisen under the rule have involved non-disclosures of such a character as would have been recognized as a breach of duty at least under the minority common law view.[11] Thus the precise scope of the rule is as yet a matter of speculation. But at least in those states which impose no duty of disclosure on insiders purchasing shares, Rule X-10B-5 provides a needed and welcome civil remedy to shareholders.

John E. Grosboll, S.Ed.

No. 1507; Slavin v. Germantown Fire Insurance Co., (E.D. Pa. 1946) Civil No. 6564; Fry v. Schumacher, C.C.H. SECURITIES ACT SERV., ¶ 90366 (1947).

[7] Purcell, Foster, and Hill, "Enforcing the Accountability of Corporate Management and Related Activities of the S.E.C.," 32 VA. L. REV. 497 at 551 et seq. (1946).

[8] For a discussion of these common law views, see BALLANTINE, CORPORATIONS, rev. ed., 211 et seq. (1946), and cases cited.

[9] Principal case at 800.

[10] For an argument to this effect, see 59 HARV. L. REV. 769 at 774 (1946).

[11] Matter of Purchase and Retirement of Ward La France Truck Corporation Class "A" and Class "B" Stocks, S.E.C. Release No. 3445 (June 11, 1943); for further citations, see 59 HARV. L. REV. 769 (1946).