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Securities Legislation - Fraud of Corporation Officers as Violation of Securities and Exchange Act of 1934

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SECURITIES LEGISLATION—FRAUD OF CORPORATION OFFICERS AS VIOLATION OF SECURITIES AND EXCHANGE ACT OF 1934—The plaintiffs brought a stockholders' derivative suit in a federal district court, claiming that defendant directors had violated section 10 (b) of the Securities and Exchange Act of 1934¹ and rule X-10B-5 of the Securities and Exchange Commission.² It was alleged that defendants who controlled a majority of the capital stock of the Algoma Coal and Coke Co., had purchased for the Algoma Company stock in two other corporations which they had formed and had manipulated the affairs of the Algoma Company so that business profits were diverted to those other corporations, thereby securing profits to themselves at the expense of plaintiff stockholders. On defendants' motion to dismiss for failure to state a cause of action arising under the Securities and Exchange Act of 1934, *held*, motion granted. The Securities and Exchange Act of 1934 confers on the federal courts exclusive jurisdiction only over those actions involving a right of recovery that goes beyond the common law rights that could be fully adjudicated and enforced by an appropriate

¹ 48 Stat. L. 881 (1934), 15 U.S.C. (1952) §78j (b).

² "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 upon any person,

in connection with the purchase or sale of any security." SEC Release No. 3230, effective May 21, 1942.

action in a state court. *Beury v. Beury*, (D.C. W.Va. 1954) 127 F. Supp. 786.

However one may feel about the result in this particular case, the proposition for which it stands arises from an error in reasoning which, if relied upon, will be unduly restrictive of the scope of rule X-10B-5 of the Securities Exchange Commission. The court reasons that since the federal courts have exclusive jurisdiction over all claims arising under the Securities and Exchange Act, and since Congress did not intend that act to deprive state courts of jurisdiction over all actions for fraud wherein purchases or sales of securities might be involved, rule X-10B-5 must not have been intended to cover actions for fraud which could have been maintained in state courts at common law. However, it does not follow from the fact that Congress did not intend to withdraw from the state courts *all* fraud actions involving the purchase or sale of securities that it did not intend to withdraw *this particular kind* of fraud action from those courts. Accordingly, the question ought to be whether this particular transaction falls within the provisions of rule X-10B-5 and therefore is subject to the exclusive jurisdiction of the federal courts. In this connection, the pivotal question should be whether the fraud alleged in the principal case arose "in connection with" the purchase or sale of securities.³ Construing this language in terms of the policy underlying the formulation by the SEC of rule X-10B-5,⁴ it appears that the fraud involved in the particular case is not of the kind which that rule was intended to remedy. The corporation was not injured by the purchase of the shares, as such, there being no evidence that it did not get what it paid for. The injury to the corporation arose only from the alleged subsequent mismanagement of its affairs by the defendants. Although the purchase of those shares might be said to be a part of the general scheme to defraud, the primary basis upon which liability is asserted is the violation by the defendants of their fiduciary duties as directors. The court could have reached the result it did without restricting the scope of rule X-10B-5 by supporting the rule advanced in *Birnbaum v. Newport Steel Co.*⁵ In that case the court dismissed a complaint which alleged that the defendant, president of the board of directors, had rejected an offer for a profitable merger in order to permit the negotiation of a private sale of his own interests in the corporation at twice the market value. The court held that section 10 (b)—pursuant to which rule X-10B-5 was promulgated—"was

³ The language of rule X-10B-5 would include any scheme or device whose object is to defraud, so long as it involved use of a "means or instrumentality of interstate commerce" and was perpetrated "in connection with the purchase or sale of securities." See note 2 *supra*.

⁴ The rule was intended only to remedy the fact that under the existing Securities and Exchange Act no remedy existed for fraud in the purchase of securities by persons other than brokers and dealers. In particular, it was aimed at requiring disclosure by corporate "insiders" seeking to take advantage of knowledge they possessed by virtue of their office. LOSS, SECURITIES REGULATION 810 (1951).

⁵ (2d Cir. 1952) 193 F. (2d) 461.

directed solely at that type of misrepresentation or fraudulent practice usually associated with the sale or purchase of securities rather than at fraudulent mismanagement of corporate affairs, and that Rule X-10B-5 extended protection only to the defrauded purchaser or seller.”⁶ This represents a more sound approach to the construction problem than that taken in the principal case and accomplishes a result more in keeping with what the rule was intended to accomplish.⁷

Douglas Peck, S.Ed.

⁶ *Birnbaum v. Newport Steel Co.*, (2d Cir. 1952) 193 F. (2d) 461 at 464.

⁷ See note 4 *supra*. Under this view *Robinson v. Difford*, (D.C. Pa. 1950) 92 F. Supp. 145, cited by the court in the principal case as being improperly decided, is clearly distinguishable and represents a proper case for the application of rule X-10B-5. In that case, the fraud alleged was the director's action in inducing the minority shareholders to sell their shares to the directors at a price substantially below the market value. There was, therefore, no question but that the fraud was “in connection with the purchase or sale of securities,” the only question being whether §10(b) applied to private transactions. The court properly held that the complaint stated a cause of action under §10(b).