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Securities Regulation - Controlling Stockholders as "Issuers" Under the Securities Act of 1933

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SECURITIES REGULATION—CONTROLLING STOCKHOLDERS AS “ISSUERS” UNDER THE SECURITIES ACT OF 1933—The Securities and Exchange Commission sought an injunction to restrain the corporate defendant, a brokerage company, and the individual defendant, its president and controlling stockholder, from selling stock in an oil company. At the time the stock was issued and sold, the individual defendant was also president and controlling stockholder of the oil company. No registration statement was in effect with reference to the stock, which was sold through the mails in interstate commerce in violation of section 5 of the Securities Act of 1933.¹ Section 5 of the act applies only to transac-

¹ 48 Stat. L. 77, §5 (1933), 15 U.S.C. (1952) §77e: “(a). Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly—(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell or offer to buy such security through the use or medium of any prospectus or otherwise; or (2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.”

tions by an "issuer, underwriter, or dealer."² *Held*, for the plaintiff. The corporate defendant and the individual defendant, as persons directly or indirectly in control of the oil company, were "issuers" of the stock of that company; therefore, their transactions were not exempt from the registration provisions of section 5. *Securities & Exchange Commission v. Kaye, Real & Co.*, (D.C. N.Y. 1954) 122 F. Supp. 639.

The problem of determining who is the "issuer" of a security under the Securities Act of 1933 may assume serious proportions for investors in view of the civil and criminal liabilities created by the act.³ Section 12 of the act provides that any person who purchases a security sold in violation of section 5 may sue the seller either for the purchase price or for damages.⁴ Section 24 makes any willful violation of the provisions of the act a crime punishable by fine and imprisonment.⁵ Thus, so far as section 5 violations are concerned, both civil and criminal liability depend upon whether the defendant, as a controlling stockholder, is an "issuer" of securities illegally sold. In the present case the court turned to section 2(11) to find that both defendants were "issuers" of the stock of the oil company.⁶ This paragraph defines the term "underwriter" as used in the act, and its use in defining the term "issuer" does not seem to be warranted.⁷ Section 2(4) purports to define the term "issuer" as "every person who issues or proposes to issue any security."⁸ The second part of this paragraph exempts from individual liability as an "issuer," members of a "trust, committee, or other legal entity."⁹ As interpreted by the courts, the phrase "other legal entity" does not embrace a corporation.¹⁰ For this reason, stockholder liability for section 5 violations involving corporate securities is not defined by any of the above sections of the act. The language of these sections certainly does not support the conclusion that a controlling stockholder is per se an "issuer" of corporate securities. This view is strengthened by the fact that section 15 of

² 48 Stat. L. 77, §4 (1933), 15 U.S.C. (1952) §77d: "The provisions of section 5 shall not apply to any of the following transactions: (1) Transactions by any person other than an issuer, underwriter, or dealer. . . ."

³ When, as in the present case, suit is brought by the SEC to enjoin violation of the act, the problem becomes less serious since the threat of financial loss to the stockholder is removed.

⁴ 48 Stat. L. 84, §12 (1933), 15 U.S.C. (1952) §77l.

⁵ 48 Stat. L. 87, §24 (1933), 15 U.S.C. (1952) §77x.

⁶ 48 Stat. L. 74, §2(11) (1933), 15 U.S.C. (1952) §77b(11).

⁷ *Ibid.* After defining an underwriter as one who purchases a security from an issuer for certain purposes, §2(11) continues: "As used in this paragraph the term 'issuer' shall include, in addition to an issuer, any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer." This definition of "issuer" is thus expressly limited to the purposes of the paragraph, i.e., of defining "underwriter." See *Shaw v. United States*, (9th Cir. 1942) 131 F. (2d) 476.

⁸ 48 Stat. L. 74, §2(4) (1933), amended by 48 Stat. L. 905, §210 (1934), 15 U.S.C. (1952) §77b(4): "The term 'issuer' means every person who issues or proposes to issue any security . . . except that in the case of an unincorporated association . . . or in the case of a trust, committee, or other legal entity, the trustees or members thereof shall not be individually liable as issuers of any security. . . ."

⁹ *Ibid.*

¹⁰ *Landay v. United States*, (6th Cir. 1939) 108 F. (2d) 698.

the act covers specifically the liability of "controlling persons." Under this section every person who controls, through stock ownership, any person liable under section 12 is also liable jointly and severally to the same extent as the controlled person.¹¹ This is true "unless the controlling person had no knowledge of or reasonable grounds to believe in the existence of the facts" by reason of which the controlled person is liable.¹² This section preserves a logical distinction between the issuer's liability and that of controlling persons. The importance of this distinction lies in the escape clause of section 15 just quoted. Assuming a violation of section 5, the "issuer" of the illegal security cannot escape liability under section 12. The theory of the present decision means that *controlling stockholders* with no knowledge of the illegal transactions face the same absolute liability, i.e., that of an "issuer."¹³ The more realistic view, under section 15, relieves from liability those stockholders who, while controlling the issuing corporation, had no knowledge of or reasonable grounds for believing in the existence of the facts which constituted a violation of the act. Thus, the corporation is the only "issuer" of its own stock, and only corporate assets are subject to the absolute liability of section 12. This analysis preserves the legal entity of the corporation without lessening the protection afforded to purchasers of securities by the act.

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¹¹ 48 Stat. L. 84, §15 (1933), amended by 48 Stat. L. 908, §208 (1934), 15 U.S.C. (1952) §770.

¹² *Ibid.*

¹³ Note 7 *supra*. It should be noted that this theory was extended under §2(11) by the court in the present case to hold that the corporate defendant was also an "issuer." By this analysis, "issuer" now includes "any person under direct or indirect common control with the issuer."