

# Promoter and Rule 10b-5 Basis for Accountability

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# THE PROMOTER AND RULE 10b-5; BASIS FOR ACCOUNTABILITY

*John Frohling*†\*

Promoters' profits have traditionally posed a troublesome problem to American courts.<sup>1</sup> The passage of the Securities Act of 1933<sup>2</sup> (hereinafter referred to as the 1933 act), however, introduced a powerful weapon wholly apart from remedies which were available at common law<sup>3</sup> by requiring disclosure of material facts by companies subject to the act. In many instances the promoter must reveal the very transactions which might otherwise have formed the basis for a secret profit. Still, the 1933 act is designed to secure disclosure only, and does not provide a remedy against the promoter except perhaps when he acts in some other capacity.<sup>4</sup> Recent developments under section 10(b) of the Securities Exchange Act of 1934<sup>5</sup> (hereinafter referred to as the 1934 act) indicate, however, that a more direct remedy to redress promoters' secret profits may exist. The purpose of this paper is to show that the common law remedies protecting against promoters' excesses are inadequate; that although the problem of promoters' frauds has been largely eliminated because of the disclosure provisions of the 1933 act, where these requirements are not applicable, section 10(b) provides a remedy against the promoter; and finally that in certain cases even where full disclosure has been made, a remedy should exist under either state or federal law to correct a grossly inequitable or otherwise fraudulent arrangement.

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<sup>1</sup> One commentator has complained: "For generations judicial remedies for promoters' frauds and the recovery of secret profits have stood as a monument to judicial ineptitude." Reuschlein, "Federalization—Design for Corporate Reform in a National Economy," 91 U. Pa. L. Rev. 91, 108 (1942). For a short discussion of some of the leading British cases see Note, 28 Geo. L.J. 535 (1940).

<sup>2</sup> 48 Stat. 74 (1933) as amended, 15 U.S.C. §§ 77a.-77aa. (1958).

<sup>3</sup> The term "common law" is used to refer to all the remedies available to corporation, shareholder or creditor against promoters whether provided by statute or by judicial authority and is not used in its narrow or technical sense. But see Landis, *Statutes and the Sources of Law*, "Harvard Legal Essays" 213, 214 (1934).

<sup>4</sup> To ensure that these disclosure requirements have been complied with, the act also contains remedial provisions of both a civil and criminal nature. However under the 1933 act the promoter is not liable as such. See Douglas & Bates, "Some Effects of the Securities Act Upon Investment Banking," 1 U. Chi. L. Rev. 283, 285 n.9 (1933). For example, although § 11 of the 1933 act provides the purchaser with civil remedies against the issuer, director of the issuer, and certain other persons signing the registration statement, the promoter is not specifically included.

<sup>5</sup> 48 Stat. 881 (1934) as amended, 15 U.S.C. §§ 78a-j (1958), as amended, 15 U.S.C. §§ 78c-d (Supp. III, 1962).

## I. RELIEF AT COMMON LAW

In the past, courts have not been able to develop consistent rules governing the promoter's relationship with his company.<sup>6</sup> Considerable conflict exists as to when his duty begins and ends<sup>7</sup> and whether he is more an agent<sup>8</sup> or trustee.<sup>9</sup> It has long been recognized that the promoter performs an important function to the corporation because his efforts may be in large part responsible for the company's later success<sup>10</sup> and perhaps because his profession is a hazardous one. For all this the promoter is entitled to compensation, but by the majority rule he cannot recover the value of services performed by way of enforcing a contract of employment executed by the not-yet-created corporation<sup>11</sup> nor even by recovery on a quantum meruit basis.<sup>12</sup> Of course, as a practical matter, the promoter is not often left without compensation because the corporation, especially where it is successful, customarily ratifies the promoter's contract.

Yet the excesses of some promoters have led courts to rule that the promoter owes a fiduciary obligation of some sort to his company and cannot profit unduly at its expense. Taken as a whole, however, the rules controlling secret profits have been conflicting, leading to opposite decisions in similar factual situations, and have been largely inadequate to deal with the problem of promoters' frauds. Only a few rules are uni-

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<sup>6</sup> McGowan, "Legal Controls of Corporate Promoters' Profits," 25 Geo. L.J., 269, 271-72 (1937).

<sup>7</sup> Note, 7 U. Chi. L. Rev. 534 (1940). This factor is important because the quantum of relief depends on whether the promoter was under a fiduciary duty when he bought the property and later sold it to the corporation. If he purchased it before he started promoting the company he could resell it at fair value, while if he acquired the property after his fiduciary duty had commenced he must resell at cost. See *Bigelow v. Old Dominion Copper Mining & Smelting Co.*, 74 N.J. Eq. 457, 503, 71 Atl. 153, 172 (Ch. 1908).

<sup>8</sup> See 1 Dewing, *Financial Policy of Corporations* 419 (5th ed. 1953).

<sup>9</sup> *Yeiser v. U.S. Board & Paper Co.*, 107 Fed. 340, 348 (6th Cir. 1901). The strict rules governing trusteeship however have never been applied. In the face of this almost irreconcilable conflict Professor Isaacs was prompted to say that:

[E]very attempt to fit the promoter into a common-law scheme has not only failed but has led to embarrassment and abuses. He tries to act as agent. The courts discover that he cannot. Call him an outsider, and you have not only a bald fiction but you make him free to deal at arms' length with the corporation and make secret profits. Call a halt by declaring him a fiduciary—a fiduciary with the burdens but none of the advantages of an ordinary fiduciary. You must modify the statement and retract it at every turn, and finally you find it leading to a recovery of secret profits that were assented to by every one in interest, and that now can be recovered to enrich those who were never damaged.

Isaacs, "The Promoter: A Legislative Problem," 38 Harv. L. Rev. 887, 898-99 (1927).

<sup>10</sup> Ehrich & Bunzi, noting this importance, said: "The corporation is in the hands of the promoter like clay in the hands of the potter." Ehrich & Bunzi, "Promoters' Contracts," 38 Yale L.J. 1011 (1929). See also 1 Dewing, *supra* note 8, at 415.

<sup>11</sup> It is said that at the time such a contract was purportedly made there was no one capable of making it. See *Clifton v. Tomb*, 21 F.2d 893, 900 (4th Cir. 1927).

<sup>12</sup> This rule is said to be based on the fact that it is difficult to determine the value of the promoters' services and because the corporation had no real opportunity to accept or reject the promoters' services. See *Ballantine, Corporations* 113 (rev. ed. 1946).

form.<sup>13</sup> If innocent subscribers, purchasing directly from the corporation, are part of the original promotion, recovery has usually been permitted.<sup>14</sup> Or, if the promoter purchases all the company's shares, and later sells them to the public himself, recovery has consistently been denied.<sup>15</sup> Beyond this, there is little consistency among decisions, and one is pressed to comprehend the distinctions developed by the courts.

If the promoter purchases all the issued but not all the authorized stock of the company, and if the company later approves the promoter's transaction prior to the time when other shareholders are brought into the company, the decisions are hopelessly conflicting. Some courts deny recovery on the theory that since at the time the promoter sold his property to the company, all of the then shareholders approved of the transaction, the company should not be allowed to repudiate it.<sup>16</sup> This rule, styled the *Lewisohn* rule, gives controlling weight to the performance of corporate acts and the controlling consideration of these decisions has been, as noted, whether all the then shareholders assented to the actions of the promoters. The *Lewisohn* rule has been criticized on the grounds that "consent" where the promoter occupies both sides of the transaction is fictitious, and that the rule sacrifices substance for form, thereby making it possible for the promoter to avoid liability by the simple process of first purchasing all the company's shares.<sup>17</sup>

The majority of courts<sup>18</sup> have either refused to follow the *Lewisohn* rule, or engrafted modifications upon it even where the promoter is the only original subscriber. Thus, if at the time the promoter subscribed to his shares it was contemplated that subscribers would later be solicited, recovery has been permitted even though the promoter owned the only outstanding shares.<sup>19</sup> Also, if he later donated back to the corporation part of his shares, which shares were later sold to innocent subscribers, recovery has been allowed.<sup>20</sup> And, indeed, some courts have even gone so

<sup>13</sup> Note, 81 U. Pa. L. Rev. 746, 747 (1933).

<sup>14</sup> See, e.g., *Davis v. Las Ovas Co.*, 227 U.S. 80 (1913).

<sup>15</sup> *Miles Wide Copper Co. v. Piper*, 29 Ariz. 129, 239 Pac. 799 (1925).

<sup>16</sup> *Old Dominion Copper Mining & Smelting Co. v. Lewisohn*, 210 U.S. 206 (1908); *Ball v. Bread, Elliot & Harrison*, 294 Fed. 227 (2d Cir. 1923), cert. denied, 264 U.S. 584 (1924). See also *Hays v. The Georgian, Inc.*, 280 Mass. 10, 181 N.E. 765 (1932).

<sup>17</sup> The *Lewisohn* court recognized this as a possibility but failed to give any weight to later contributions by innocent shareholders. This is especially anomalous considering that the court looked upon an injury to the individual shareholder as the basis for the corporate action. 210 U.S. at 211.

<sup>18</sup> See generally Berle, "Compensation of Bankers and Promoters Through Stock Profits," 42 Harv. L. Rev. 748 (1929); Brockelbank, "The Compensation of Promoters," 13 Ore. L. Rev. 195 (1934); McGowan, "Legal Controls of Corporate Promoters' Profits," 25 Geo. L.J. 269 (1937); Note, 28 Geo. L.J. 535, 540 (1940).

<sup>19</sup> *Arnold v. Searing*, 78 N.J. Eq. 146, 78 Atl. 762 (Ch. 1910); 73 N.J. Eq. 262, 67 Atl. 831 (Ch. 1907) (on demurrer).

<sup>20</sup> *California-Calaveras Mining Co. v. Walls*, 170 Cal. 285, 149 Pac. 595 (1915); *Torrey v. Toledo Portland Cement Co.*, 158 Mich. 348, 122 N.W. 614 (1909).

far as to repudiate *Lewisohn* on the same facts as were presented in that case.<sup>21</sup> This result is typified by the *Bigelow* decision which, in contrast to *Lewisohn*, stands as a unique illustration of the divergence of thought between two courts on the same problem. The *Bigelow* rule, although reaching a laudable result, has itself been criticized.<sup>22</sup> Nevertheless, it represents the better rule.

But although *Bigelow* appears to constitute a repudiation of *Lewisohn*, subsequent events cast doubt upon this conclusion, especially with regard to the question of corporate assent when the promoters controlled the corporation. Twenty years after *Bigelow* came *Hays v. The Georgian, Inc.*,<sup>23</sup> in which Massachusetts refused to apply the rule of the former case in a similar factual situation.<sup>24</sup> *Bigelow* had permitted recovery where promoters had subscribed to all the issued but not all the authorized stock because, the court held, the promoters' fiduciary duty extended to subsequent sales to innocent shareholders where these sales were contemplated by the promoters. In *Hays* the promoters, or their agents, purchased all the authorized stock before they resold it to the public and recovery was denied.<sup>25</sup> In both cases the corporate approval occurred while the corporations were under the control of the promoters, and in both cases sales to the public were contemplated. But *Hays*, by refusing recovery simply because the promoters had first purchased all the authorized stock, seemed to reject *Bigelow* completely by not giving controlling weight to whether the later sales had been contemplated. In effect, *Hays*, no less than *Lewisohn*, engendered a rule based on meaningless technicalities that are easily circumvented.<sup>26</sup>

Likewise, *Lewisohn* was narrowed by *McCandless v. Furlaud*.<sup>27</sup> In this case, as in *Lewisohn*, the promoters had purchased all the issued but

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<sup>21</sup> *Old Dominion Copper Mining & Smelting Co. v. Bigelow*, 203 Mass. 159, 89 N.E. 193 (1909). See also *Beal v. Smith*, 46 Cal. App. 271, 189 Pac. 341 (1st Dist. 1920); *Hollander v. Breeze Corp.*, 131 N.J. Eq. 585, 26 A.2d 507 (Ch. 1941), *aff'd*, 131 N.J. Eq. 613, 26 A.2d 522 (Ct. Err. & App. 1942).

<sup>22</sup> See Little, "Promoters' Frauds in the Organization of Corporations: The Old Dominion Copper Mining Cases," 5 Ill. L. Rev. 87 (1910); Weston, "Promoters' Liability: Old Dominion v. Bigelow," 30 Harv. L. Rev. 39 (1916). By permitting recovery to the corporation without determining who the shareholders were at the time the fraud was committed, it is said, some shareholders who had not actually been injured were permitted to benefit from the corporation's recovery while other persons who had been shareholders at the time of the fraud were left to their own remedies, if indeed they had any. It has been held that recovery by the corporation bars recovery by an innocent co-partner. *Barrett v. Shambeau*, 187 Minn. 430, 245 N.W. 830 (1932).

<sup>23</sup> 280 Mass. 10, 181 N.E. 765 (1932).

<sup>24</sup> See Comment, 45 Yale L.J. 511, 512 (1936).

<sup>25</sup> Professor Berle criticizes the rule that shareholders who have purchased directly from the promoters should not be protected. See Berle, *supra* note 18, at 757-58. See also *Balantyne, Lattin, & Jennings, Cases on Corporations* 205 (2d ed. 1953).

<sup>26</sup> See Notes, 47 Harv. L. Rev. 1031 (1934); 19 Va. L. Rev. 274, 278 (1933).

<sup>27</sup> 296 U.S. 140 (1935).

not all the authorized shares. Yet, contrary to the holding in *Lewisohn*, the Supreme Court held, at least where the rights of creditors are involved, that where a promoter occupied both sides of the transaction, the corporation was entitled to an accounting against the promoters.<sup>28</sup> The Court said, "Consent in such conditions, so far as it gives approval to conduct in fraud of the rights of others, is a word and nothing more. It is not in accordance with realities."<sup>29</sup> Thus, a significant departure seems to have been created, and, indeed, to some, *McCandless* represented an overruling of *Lewisohn*.<sup>30</sup> This contention is not, however, fully justified.<sup>31</sup> In any event the case can hardly be looked upon as a solution to the problem of promoters' secret profits since it failed to reject squarely the *Lewisohn* doctrine.<sup>32</sup>

*Jeffer v. Utah Power & Light Co.*<sup>33</sup> is a reminder that the incredible array of judicially created obstacles insulating promoters still exist. Plaintiffs, preferred shareholders, brought a shareholders' bill to recover secret profits and to cancel common stock issued to promoters for inadequate consideration or alternatively to require the promoters to pay full value for their shares.

Because of the promoters' profits the company, from its inception, had obligations far exceeding its assets. Yet the court denied recovery on a number of technical grounds. Plaintiffs were not stockholders at the time the fraud was committed;<sup>34</sup> plaintiffs had not presented a "definite allegation" of the value of the property sold by the promoters (even though the promoter's costs were alleged);<sup>35</sup> plaintiffs had not shown that the prior owners of their shares had not previously assented to the promoters dealings;<sup>36</sup> since there were sufficient assets to cover plaintiffs'

<sup>28</sup> Note, 24 Calif. L. Rev. 465, 467 (1936). See also Comment, 45 Yale L.J. 511 (1936); Note, 31 Ill. L. Rev. 392 (1936).

<sup>29</sup> *McCandless v. Furlaud*, supra note 27, at 160.

<sup>30</sup> 1 Hornstein, Corporation Law & Practice, § 94, n.50 (1959). For a contrary view see Notes, 36 Colum. L. Rev. 488, 489 (1936); 49 Harv. L. Rev. 785 (1936); 20 Minn. L. Rev. 552, 554 (1936); 84 U. Pa. L. Rev. 409, 415-18 (1936).

<sup>31</sup> The *McCandless* court specifically distinguished and left open the question of whether ". . . the corporation itself at the instance of new shareholders would be permitted to disaffirm the fraud and maintain a suit in equity for appropriate relief." 296 U.S. at 160. In a subsequent case which relied upon *Lewisohn* and distinguished *McCandless*, certiorari was denied. *Arn v. Dunnet*, 93 F.2d 634 (10th Cir. 1937), cert. denied, 304 U.S. 577 (1938).

<sup>32</sup> *McCandless* has been criticized because it applied the liberal Bigelow rule to creditors without a clear declaration of whether that rule would also be applied to shareholders for whose protection the rule was first developed. See Ballantine, Lattin, & Jennings, supra note 25, at 205.

<sup>33</sup> 136 Me. 454, 12 A.2d 592 (1940), 54 Harv. L. Rev. 139.

<sup>34</sup> 136 Me. at 465, 12 A.2d at 597.

<sup>35</sup> Once the plaintiffs had shown that the promoters had transferred property for excessive consideration, the burden should have shifted to the promoters to establish that they acted fairly in dealing with the company. Compare *Erlanger v. New Sombrero Phosphate Co.*, 3 App. Cas. 1218, 1229 (H.L. 1878).

<sup>36</sup> 136 Me. at 466, 12 A.2d at 599.

class of stock plaintiffs had no right to complain that a more junior class was under water;<sup>37</sup> and finally, plaintiffs had no right to assume that the more junior securities represented genuine assets received by the corporation since there was no proof that plaintiffs' stock was not worth what they had paid for it.<sup>38</sup>

The *Jefferies* holding, of course, must be considered in the factual context from which it arose, since it involved a suit at the instance of a preferred shareholder to recover for injuries which might be said to have more directly injured another class but, nevertheless, the court's language is indeed broad.

### *Recent Developments*

Two of the most important recent cases are *San Juan Uranium Corp. v. Wolfe*,<sup>39</sup> and *Northridge Coop. Section No. 1 v. 32d Ave. Constr. Corp.*<sup>40</sup> In the first case the Court of Appeals for the Tenth Circuit adopted the Massachusetts or *Bigelow* rule by distinguishing a prior decision of the same circuit which had followed *Lewisohn*. In the second case the New York Court of Appeals, although exhibiting a slight preference for the Massachusetts rule, nonetheless denied recovery on a technical ground and in effect preserved some of the distinctions developed in earlier decisions.

In *San Juan* it was alleged that promoters organized a corporation and thereafter sold stock on the representation that the corporation had paid \$25,000 cash for its sole asset, certain mining claims. It was further alleged<sup>41</sup> that in fact the promoters had acquired said leases for no consideration at all and that following the sale to the public, a check for \$25,000 was delivered to the promoters who put the money to their own use. The court, in permitting recovery against the promoters, recognized that the Massachusetts rule was the prevailing one. It noted that the promoter has a fiduciary duty, distinguished an earlier Tenth Circuit case<sup>42</sup> on the grounds that the public had supplied the \$25,000 which was paid to the promoters, and held "that the technical assent of the corporation through its promoters to the deceptive transaction is no defense to an action by the corporation when freed of its bonds."<sup>43</sup>

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<sup>37</sup> An important inducement to the purchase of a senior security is the extent to which this class is cushioned by more junior securities. This is said to be reflected in the purchase price of the security. See Note, 54 Harv. L. Rev. 139, 140 (1940) (citing *Dodd, Stock Watering* 19-20 (1930)).

<sup>38</sup> 136 Me. at 466, 12 A.2d at 601.

<sup>39</sup> 241 F.2d 121 (10th Cir. 1957).

<sup>40</sup> 2 N.Y.2d 514, 141 N.E.2d 802, 161 N.Y.S.2d 404 (1957).

<sup>41</sup> Since this was an appeal from the dismissal of plaintiff's action for failure to state a claim upon which relief can be granted these allegations were accepted as true.

<sup>42</sup> *Arn v. Dunnett*, 93 F.2d 634 (10th Cir.), cert. denied, 304 U.S. 577 (1927).

<sup>43</sup> 241 F.2d at 123.

The *Northridge* case presented the question of whether a corporation which owned a cooperative apartment building could attack contracts dealing with rent under a ground lease and construction costs, executed between it and corporations controlled by its promoters. The Appellate Division of the New York Supreme Court had ruled that allegations pertaining to contracts executed before members of the public had subscribed should be stricken as sham, basing its holding on the view that the promoter owed no fiduciary obligation to the corporation prior to the subscription by the tenants<sup>44</sup> and hence was free, in effect, to engage in self dealing. The court suggested that the promoter only owed the duty of making full disclosure to tenants once they had subscribed for stock and found that, since the promoters included a clause in the subscription contracts which revealed the existence of these contracts and stated that the subscribers had read them, the promoters' duty of disclosure had been fulfilled. The Court of Appeals upheld the Appellate Division, striking as sham those allegations which rested upon the promoters' acts prior to any subscription by the tenants. In so doing the court modified the lower court's holding by stating that it approved of it only insofar as it was not inconsistent with the principle that if the promoter had made sales to innocent persons as part of the promotional scheme he would be liable.<sup>45</sup> The Court of Appeals conceded that the sales to these subscribers were contemplated, but went on to hold that sufficient disclosure had been made to them since they were made aware of the existence of the contracts previously executed by the promoters.<sup>46</sup> But, while the Court of Appeals clearly introduced the concept of the Massachusetts rule as to contemplated purchasers, it nonetheless denied recovery by deciding as a matter of law that disclosure had been made. In view of the conflicting evidence whether the shareholders had actual notice of these contracts, especially their terms, it is submitted that the court may have been unwise in deciding this question as a matter of law, since it permitted the promoters to escape liability because of constructive notice of the contracts without considering whether the subscribers had knowledge of the details of the contracts including the unreasonableness of their terms.

*Pipeline Corp. v. Bedford*<sup>47</sup> is another interesting recent case. There promoters received stock having a par value of \$367,000 in return for

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<sup>44</sup> See especially *Northridge Co-op Section No. 1, Inc. v. 32nd Avenue Construction Corp.*, 286 App. Div. 422, 427, 142 N.Y.S.2d 534, 539-40.

<sup>45</sup> See *Old Dominion Copper Mining & Smelting Co. v. Bigelow*, supra note 21.

<sup>46</sup> There was some dispute as to whether the subscribers ever saw these contracts or, more importantly, whether they knew of their terms, especially the interests of the promoters in the other companies. See 2 N.Y.2d at 527, 141 N.E.2d at 810, 161 N.Y.S.2d at 412.

<sup>47</sup> 145 A.2d 206 (Del. Ch. 1958).



a nonexclusive license for which they had paid no consideration. In holding the promoters liable to the extent of their secret profit, which apparently was the par value of the shares issued to them, the Delaware Court of Chancery ruled, *inter alia*, that the promoters had not sustained the burden of showing that the license was worth the value they had assigned to it and that they had contemplated sales to the public at the time they transferred the license to the corporation. What was significant about Chancellor Seitz's opinion, however, was that he permitted recovery despite the fact that the Texas Securities Commission had approved three of the company's four stock offerings,<sup>48</sup> and despite the fact that the company had filed a notification and a copy of its offering circular with the SEC for two of its offerings in which disclosure of the promoters' transactions had been made.<sup>49</sup> In rejecting these filings as conclusive evidence of the absence of fraud, the court interestingly enough first passed upon the adequacy of the disclosure made, implying that it was deficient since the company did not state that the license was not worth the value of the stock transferred to the promoters for it, even though the promoters had disclosed that they had paid nothing for it. The court also noted that the company had failed to disclose that the value of the license lay in the company's ability to exploit the license which the court concluded the company was unable to do. Finally, suggested Chancellor Seitz, even assuming that adequate disclosure had been made, this would not be binding for state law purposes. He said:

I have found that the stock was in fact issued for an inadequate consideration (in a non-arms length transaction). Consequently, the court questions how far disclosure can be a substitute for compliance with the Delaware Constitutional and statutory requirements that where stock is to be issued for property, such property must have a value at least equalling the full value of the stock. The extent of the disclosure might be persuasive in a close value case. This is not such a case where the defendants have the burden.<sup>50</sup>

The case represents an unusual contrast of federal versus state control of promoter's profits and appears to be the only case in which a state court has suggested that disclosure made by promoters is insufficient to bind the corporation.<sup>51</sup>

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<sup>48</sup> The other offering was apparently not registered with the Texas Commission. The defendants' contention, that this approval was conclusive as to value in the absence of fraud, was denied by the Delaware court. 145 A.2d at 214-15.

<sup>49</sup> These offerings were made pursuant to the exemption provided for by § 3(b) of the 1933 act, Reg. A. Rules 255 and 256 promulgated as part of Reg. A require an issuer to file with the Commission a notification on Form 1-A, and a copy of its offering circular. The company disclosed that the promoters had given no cash consideration for the license but had received \$367,000 in par value of securities when they transferred it to the company.

<sup>50</sup> 145 A.2d at 214.

<sup>51</sup> See also *Bergeson v. Life Ins. Corp.*, 170 F. Supp. 150 (D. Utah 1958), *aff'd in part*,

Despite a tendency in some of the more recent cases to hold the promoter liable and to apply the more liberal Massachusetts rule, since this rule like the *Lewisohn* rule is characterized and burdened by unnecessary technical distinctions, it cannot be said that either rule satisfactorily deals with the problem. It is therefore advisable to examine other remedies to determine whether they might be utilized to permit recovery against promoters.

## II. FEDERAL SECURITIES LAW PROTECTION—DISCLOSURE

The disclosure requirements of the Securities Act of 1933 have eliminated to a great extent the problem of promoters' frauds. Under some circumstances, however, these provisions have no application and it is in these cases that section 10(b) of the 1934 act could be utilized to protect persons purchasing stock in new companies. In addition even where the disclosure requirements do apply there is the possibility that some further protection would be desirable and that section 10(b) could be the source of that protection.

Prior to the 1933 act an investor was required to rely on the almost unrestrained<sup>52</sup> representations of promoters, but after passage of the act the promoter was at least under some obligation to disclose material facts where the registration provisions of the act applied.<sup>53</sup> Generally, the 1933 act protects against promoters' frauds in two ways: there are the prophylactic effects of disclosure and the redressive provisions which come into play once material misrepresentations or omissions of facts have been made.<sup>54</sup>

Disclosure has without question greatly reduced the incidents of fraud.<sup>55</sup> Many specific items of information are required to be disclosed

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reversed in part, 265 F.2d 227 (10th Cir. 1959) (issue of promoters' profit held inapplicable by appellate court); *Gladstone v. Bennett*, 153 A.2d 577 (Sup. Ct. Del. 1959) (distinguishing *Pipeline* in denying recovery against promoters on finding that no fiduciary obligation existed because full disclosure had been made); *Johndahl v. Columbus Trotting Ass'n*, 104 Ohio App. 118, 147 N.E.2d 101 (1956) (reversing lower court which permitted recovery of a secret profit on finding that there was inadequate evidence to show that the property transferred to the company by the promoters was not worth the value assigned to it).

<sup>52</sup> Although Blue Sky Laws existed when the Securities Act of 1933 was enacted, they were not in force in all states and even in those states where they did exist they often were not enforced effectively. Since such statutes only regulated intrastate transactions it was an easy thing for the promoter to sell his stock in a state where there was no law at all or to register it in a state where the law was not enforced. See Hearings on S. 875, 73d Cong., 1st Sess. 322-24 (1933). See also Berger, "Real Estate Syndication: Property, Promotion, and the Need for Protection," 69 *Yale L.J.* 725, 785 (1960).

<sup>53</sup> The legislative history of the 1933 act gives strong indication that Congress was aware of the failure in the past of promoters to make disclosure and indeed cited this failure as one of the reasons for which the Act was passed. H.R. Rep. No. 85 to accompany H.R. 5480, 73d Cong., 1st Sess. 99 (1933).

<sup>54</sup> For extensive treatment of these latter provisions, see generally Douglas & Bates, *supra* note 4; Shulman, "Civil Liability and the Securities Act," 43 *Yale L.J.* 227 (1933).

<sup>55</sup> Demmler, "Registration under the Securities Act of 1933," 10 *Bus. Law.* 42 (1954);

by Schedule A<sup>56</sup> and the forms for registration promulgated thereunder. The Commission moved quickly to utilize its powers regarding disclosure to establish high standards.<sup>57</sup> In *Matter of Brandywine Brewing Co.*,<sup>58</sup> it was established that a determination of value made by the board of directors of property acquired by the company, although perhaps binding for state law purposes, was not binding on the Commission. In *Continental Distillers*, the Commission ruled that it was deceptive not to disclose that the purchase price paid by a corporation was not the result of an arms' length transaction. The Commission said:

The very least that was necessary to avoid a misleading effect in this respect was to state, in connection with the property item on the balance sheet, that cost was determined in a sale in which the vendor, Reynolds, was in control of the vendee, the corporation.<sup>59</sup>

Another basic proposition was developed in *Matter of Unity Gold Corp.*,<sup>60</sup> which held that neither the value of shares paid to the promoter for property transferred to the company nor paid to him for services rendered can be treated as part of the cost of the property where these shares were later donated back to the company. And, although the Commission rejects the view that the value of property is fixed exclusively by the promoters' cost or contemporaneous sales, the burden of proving a higher value is upon the person claiming it. These early cases, discussed in detail elsewhere,<sup>61</sup> have set the standards which apply even today, with subsequent cases adding little new in the way of philosophy or substantial change,<sup>62</sup> except that the Commission, in the case of speculative offerings, presently requires that the speculative nature of an offering be disclosed as well as the percentage of capital contribution to be made by the public if the issue is sold and the percentage of ownership it will receive for this contribution.<sup>63</sup>

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Heller, "Disclosure Requirements under Federal Securities Regulation," 16 Bus. Law. 300 (1961); MacChesney, "The Securities Act and the Promoter," 25 Calif. L. Rev. 66, 78-80 (1936).

<sup>56</sup> 48 Stat. 74, 88-91 (1933), 15 U.S.C. 77aa (1958).

<sup>57</sup> See, e.g., *Matter of Snow Point Mining Co.*, 1 S.E.C. 311 (1936); *Matter of Continental Distillers & Importers Corp.*, 1 S.E.C. 54 (1935); *Matter of Haddam Distillers Corp.*, 1 S.E.C. 37 (1934), 1 S.E.C. 48 (1934).

<sup>58</sup> 1 S.E.C. 123 (1935).

<sup>59</sup> *Matter of Continental Distillers & Importers Corp.*, supra note 57, at 78.

<sup>60</sup> 1 S.E.C. 25 (1934).

<sup>61</sup> See MacChesney, supra note 55, at 66; MacChesney & O'Brien, "Full Disclosure Under the Securities Act," 4 Law & Contemp. Prob. 133, 135-40 (1937).

<sup>62</sup> For a recent application of these rules see *Hart Oil Corp.*, Securities Act Rel. 4147 (1959); *Fort Pierce Port & Terminal Co.*, Securities Act Rel. 3951 (1958).

<sup>63</sup> See General Instruction D(b) for Form S-2 (cited in *Isreals & Duff*, When Corporations Go Public 190 (1962)). A typical statement is:

The Promoters' out-of-pocket expenses were approximately \$8,000.00 for which the said Promoters received 787,500 shares of the Company's stock of which 708,750 shares were escrowed. After giving effect to the sale of the shares hereby offered to the public,

The prophylactic effects of the 1933 act have received much praiseworthy comment,<sup>64</sup> with some authors even suggesting that the problem of promoters' frauds has all but disappeared because the promoters' chief weapon, secrecy, has been eliminated.<sup>65</sup> Insofar as the question of promoters' profits has not recently been brought before the courts with frequency<sup>66</sup> this suggestion may be to a great extent true. Yet it is the contention of the present author that the danger of promoters' fraud still exists, and that Rule 10b-5 can be utilized with benefit in various situations to combat them.<sup>67</sup>

The disclosure provisions cannot guarantee that frauds will not be attempted<sup>68</sup> because these provisions do not apply to all offerings of securities. To mention only a few exceptions, intrastate offerings are exempt;<sup>69</sup> issues under \$300,000,<sup>70</sup> which comprise a substantial portion of the financing done in this country,<sup>71</sup> are excluded from the registra-

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the purchasers thereof will have invested \$486,000.00, or approximately 98.38% of the capital of the Company and will own approximately 33.10% of the voting control. The Promoters will have contributed mining property and out-of-pocket expenses of approximately \$8,000.00 to the capital of the Company and will own approximately 66.90 percent of the voting control. Should the property prove not to be a successful operation and the Company be liquidated, the Promoters will receive 66.90 percent of each dollar paid to the stockholders in liquidation.

Registration Statement, Olympia Mines, Inc., File No. 2-18838, p. 4 (1962).

<sup>64</sup> 1 Hornstein, Corporation § 94 (1959); McGowan, *supra* note 18, at 292; Note, 28 Geo. L.J. 535 at 544-47 (1940).

<sup>65</sup> Baker & Cary, Cases on Corporations 768 (1958).

<sup>66</sup> See De Capriles, Business Organization, 33 N.Y.U.L. Rev. 527, 544 (1958).

<sup>67</sup> Recent experience in real estate syndication shows that the American investing public still invests large sums of money in projects about which full disclosure has not been made. See Berger, *supra* note 52, at 756-58. The conduct of a promoter in this area has at times been somewhat less than satisfactory. See Bradford, "What the Investor Should Know in Buying Real Estate Issues Today," Magazine of Wall Street 12, 56 (April 7, 1962).

<sup>68</sup> In *State v. Whiteaker*, 118 Ore. 656, 661, 247 Pac. 1077, 1079 (1926) the court said:

We do not deem it advisable to lay down any hard and fast rule to determine whether similar offerings to the public may be sold without a license. Were we to do so, a certain class of gentlemen of the "J. Rufus Wallingford" type—"they toil not neither do they spin"—would lie awake nights endeavoring to conceive some devious and shadowy way of evading the law. It is more advisable to deal with each case as it arises.

<sup>69</sup> Section 3(a)(11) of the 1933 act. The Commission takes the position that this exemption obtains even where there were prior purchases by promoters out of state, provided such purchases were pursuant to § 4(1) exemption. McCauley, "Intrastate Securities Transactions Under the Federal Securities Act," 107 U. Pa. L. Rev. 937, 945 (1959).

<sup>70</sup> There have been recent attempts to amend this section to allow the permissible limit to be increased to \$500,000. See Hearings on S. 810 and S. 843, 85th Cong., 1st Sess. (1957); S. Hearings on S. 1178, 1179, 1180, 1181 and 1182, 86th Cong. 1st Sess. (1959). In computing the aggregate offering price under § 3(b), Rule 253(c) excludes the value of shares issued to promoters provided these shares will not be offered to the public for a year and suitable escrow arrangements are made. The purpose of this provision is said to be to preserve the private offering exemption for the promoters' shares. See 1 Loss, Securities Regulations 618-19 (2d ed. 1961).

<sup>71</sup> In 1945 there were 572 Reg. A offerings which had a total offering price of \$39 million; in 1955 there were 1628 such offerings with a total offering price of \$296 million. 1 Loss, *supra* note 70, at 643. In fiscal 1960 the aggregate offering price of 1049 such offerings was \$224.9 million, SEC 26 Ann. Rep. 47 (1960). Since there are no filing requirements for offers made pursuant to § 3(a)(11), it is difficult to determine the aggregate value of said offerings. However, the Commission in estimating the amount of "other" offering, which

tion requirements by virtue of section 3(b) of the 1933 act (as implemented by Regulation A promulgated thereunder). Although Regulation A, which sets out the appropriate standards for offerings made pursuant to this exemption, provides some protection to investors in that an offering circular is required to be delivered if a written offer is made, the same disclosure requirements, especially with respect to financial data, which obtain in the case of a full registration, do not apply.<sup>72</sup> Under this exemption the issuer files a notice<sup>73</sup> in the regional office rather than with the Commission's Division of Corporation Finance.

Likewise, the private placement exemption contained in section 4(1) of the act, for which no filing requirements whatever are prescribed, withdraws from the Commission's control a substantial amount of the annual security financing done in this country.<sup>74</sup> The aggregate effect of these exemptions and others<sup>75</sup> is that a relatively large percentage of the securities sold each year are not protected by the benefit of full disclosure.

Even where the registration requirements do apply they do not preclude the possibility of fraud. The Commission cannot guarantee that full and accurate disclosure will always be made, and indeed specifically disclaims doing so.<sup>76</sup> For one thing, the Commission is unable to physically verify whether that which is listed as value is honest and reasonable.<sup>77</sup> This would require a much larger staff than the Commission presently has, especially considering the substantial increase in the number of registrations recently filed.<sup>78</sup> There is also the real but unfortunate possibility that the staff will simply not detect a misleading or complete

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is composed chiefly of intrastate offering, states that in fiscal 1959 \$254,368,000 was offered; in fiscal 1960, \$219,314,000; and in fiscal 1961, \$295,535,000. SEC Statistical Bull. 17 (April 1962).

<sup>72</sup> See Berger, *supra* note 52, at 764.

<sup>73</sup> See Reg. A, Rule 255, Form 1-A Notification under Reg. A. Under Reg. A some protection is afforded by the fact that promoters are required to escrow their stock for one year. See Reg. A, Rule 253.

<sup>74</sup> The aggregate value of the private placement during fiscal 1959 was \$3,754,915,000; in fiscal 1960 \$3,496,888,000; and in fiscal 1961 \$4,998,624,000. SEC Statistical Bull. 17 (April 1962). See also Berle, *Power Without Property* 44 (1957). The contention could be made that in many respects such persons do not need the protection of disclosure since they are often as sophisticated as the issuer.

<sup>75</sup> For a discussion of other exemptions see Sargent, "Pledges & Foreclosure Rights Under the Securities Act of 1933," 45 Va. L. Rev. 885, 887 (1959).

<sup>76</sup> See Rule 425.

<sup>77</sup> See Demmler, *supra* note 55, at 48; Heller, *supra* note 55, at 301, 320. See Securities Act of 1933 § 24.

<sup>78</sup> From July 1, 1935, until June 30, 1936, 781 registration statements were filed while the SEC had a staff of 1077, SEC 2d Ann. Rep. 31, 61 (1936), whereas in fiscal 1960, 1628 registration statements were filed while the Commission had a staff of 980 persons, SEC 26 Ann. Rep. 35, 225 (1960). This situation had become even worse in fiscal 1961. Although the year end totals for fiscal 1961 are not available as yet, the eight months ending February 28, 1962, showed a total of 1550 registrations filed or 60% higher than any previous like period. Even the market decline in May 1962 could not have prevented fiscal 1961 from being the busiest year to date. See SEC News Digest (March 23, 1962).

failure to disclose before a particular offering of securities has been made.

The real possibility exists therefore that disclosure will not entirely eliminate the existence of fraud. It would appear that an additional remedy is necessary if the public is to be fully protected against the overreaching of promoters.

### III. THE PROMOTER AND SECTION 10(b)

It was demonstrated in the previous section that even though the disclosure requirements have partly eliminated frauds associated with the issuance of securities since these provisions do not everywhere apply, and since the possibility of human error and the fraudulent bent of some promoters still exist, an additional remedy is called for. Can Rule 10b-5 provide such a remedy?<sup>79</sup> Can a corporation recover for alleged violations of section 10(b); what is the substantive scope of the section; are there procedural advantages to suing under 10(b) rather than some provisions of the 1933 act; is the chance of recovery greater under 10(b); is there a similarity between the facts of *Hooper v. Mountain States Securities Corp.*<sup>81</sup> and the classic promoter's fraud and does this similarity suggest that section 10(b) might apply; and finally, does disclosure eliminate the section as a possible source of relief? In *Hooper*, decided under section 10(b), the court permitted the corporation to recover against former officers who fraudulently induced the corporation to issue stock for inadequate consideration which, although not a promoter's fraud of the classic type, does raise the question of whether section 10(b) can be utilized to redress promoters' frauds and indicates that affirmative answers to these questions might be called for.

#### *An Implied Right of Action Based Upon Violation of Rule 10b-5 Is Available to the Corporation*

Section 10(b) was a relatively unimportant part of the protective scheme until the Commission adopted Rule 10b-5 in 1942. That rule provides:

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,

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<sup>79</sup> See Baker & Cary, *supra* note 65, at 768 (citing *Matter of Breeze Corp.*, 131 N.J. Eq. 585, 26 A.2d 507 (Ch. 1941), *aff'd*, 131 N.J. Eq. 613, 26 A.2d 522 (Ct. Err. & App. 1942)). See also Heller, *supra* note 55, at 301.

<sup>80</sup> In pleading for regulation in the area of real estate syndication Professor Berger did not consider Rule 10b-5. *Supra* note 52 at 725. While the present author agrees that more comprehensive regulation is called for, Rule 10b-5 could prove helpful in providing protection before such regulation is enacted. This author does not intend to treat the application of Rule 10b-5 to purchases or sales by insiders. See Conant, "Duties of Disclosure of Corporate Insiders Who Purchase Shares," 46 Cornell L.Q. 53 (1960).

<sup>81</sup> 282 F.2d 195 (5th Cir. 1960), *cert. denied*, 365 U.S. 814 (1961).

- (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.<sup>82</sup>

Even now much of its usefulness stems from its utilization by private persons,<sup>83</sup> as opposed to the Commission itself.

Section 10(b) does not expressly provide that a private person has a right to bring suit based on this section. Yet no case, including the very first one to discuss this point,<sup>84</sup> has ever denied that this right exists.<sup>85</sup> This rule is in accord with the principle of American jurisprudence that private rights of action can be implied if a plaintiff is injured by a defendant's violation of a statute, if the statute was designed for the protection of a class of which the plaintiff is a member.<sup>86</sup> While there may be some difference of opinion as to the basis of this action, relief has usually been justified either on a theory that a breach of the statutory duty constitutes negligence,<sup>87</sup> or that private rights can be inferred as a matter of statutory construction.<sup>88</sup> Although implied rights of action had their major development in cases where the defendant's conduct could be characterized as negligent, perhaps the frequency with which private actions have been recognized in situations where the defendant's activity lacked such "flavor," and the present general acceptance that implied rights of action, can best be justified on the theory that Congress, by

<sup>82</sup> Section 10(b) is not self-executing. See Note, 42 Va. L. Rev. 537, 539 (1956).

<sup>83</sup> Cf. Loss, *supra* note 70, at 1959.

<sup>84</sup> *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946).

<sup>85</sup> The Supreme Court has yet to pass upon this question but has denied certiorari on three courts of appeals cases which have recognized the existence of such a right. See *Hooper v. Mountain States Sec. Corp.*, 282 F.2d 195 (5th Cir. 1960), cert. denied, 365 U.S. 814 (1961); *Matheson v. Armbrust*, 284 F.2d 670 (9th Cir. 1960), cert. denied, 365 U.S. 870 (1961); *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir. 1952), cert. denied, 343 U.S. 956 (1952) (dictum).

<sup>86</sup> See *Texas & Pac. Ry. v. Rigsby*, 241 U.S. 33, 39-40 (1916); *Narramore v. Cleveland C., C. & St. L. Ry.*, 96 Fed. 298 (6th Cir. 1899). Judge Taft (later Chief Justice) said in *Narramore* that the intention to create civil liability should be presumed "unless it is to be inferred from the whole purview of the Act" that it was the legislative intent to do otherwise. 96 Fed. at 300. Compare *Kardon v. National Gypsum Co.*, *supra* note 84 at 514. In *Abounader v. Strohmeyer & Arpe Co.*, 243 N.Y. 458, 465, 154 N.E. 309, 311 (1926), the New York Court of Appeals said that the doctrine was so well known as to not be open to question.

<sup>87</sup> Some argue that such conduct constitutes negligence per se, Thayer, "Public Wrong & Private Action," 27 Harv. L. Rev. 317 (1914), while others contend that it constitutes merely evidence of negligence, Lowndes, "Civil Liability Created by Criminal Legislation," 16 Minn. L. Rev. 361 (1932).

<sup>88</sup> This view was criticized by both Professors Thayer and Lowndes but for different reasons. Thayer called the search for unexpressed intent a dangerous business permissible only within narrow limits. 27 Harv. L. Rev. *supra* note 87, at 320. Professor Lowndes intimates that it cannot validly be done. 16 Minn. L. Rev. *supra* note 87, at 365 n.8.

omitting any reference to them recognized their existence and intended that they should exist.<sup>89</sup>

Under the federal securities laws, private rights of action have been recognized under many provisions of the various acts<sup>90</sup> principally upon the statutory construction theory as it is embodied in the Restatement of Torts.<sup>91</sup>

In the first case<sup>92</sup> which held that Rule 10b-5 supported a private right of action, the district court, after citing the Torts Restatement, rested its decision on the ground that:

This rule [Section 286] is more than merely a canon of statutory interpretation. The disregard of the command of a statute is a wrongful act and a tort . . . Of course, the legislature may withhold from parties injured the right to recover damages arising by reason of violation of a statute but the right is so fundamental and so deeply ingrained in the law that where it is not expressly denied the intention to withhold it should appear very clearly and plainly . . . In other words, in view of the general purpose of the Act, the mere omission of an express provision for civil liability is not sufficient to negative what the general law implies.

Throughout the entire line of Rule 10b-5 cases which have raised the question of private rights of action, the position of the courts has been consistent and clear in recognizing such a right.<sup>93</sup>

<sup>89</sup> Loss, "The SEC Proxy Rules in the Courts," 73 Harv. L. Rev. 1041, 1048 (1960). See *Reitmeister v. Reitmeister*, 162 F.2d 691 (2d Cir. 1947) (holding that Communications Act of 1934 created an implied right of action); *City & County of San Francisco v. Western Air Lines, Inc.*, 22 Cal. Rptr. 216 (Dist. Ct. App. 1962) (holding that Federal Airport Act did not create an implied right of action); *Fitzgerald v. Pan American World Airways*, 229 F.2d 499 (2d Cir. 1956) (holding that Civil Aeronautics Act of 1938 created an implied right of action).

<sup>90</sup> Private rights of action have been implied from various provisions of the federal securities laws. See *Dann v. Studebaker Packard*, 238 F.2d 201 (6th Cir. 1961) (§ 14 of the 1934 act and rules promulgated thereunder); *Goldstein v. Groesbeck*, 142 F.2d 422 (2d Cir.), cert. denied, 323 U.S. 737 (1944) (§ 4(a)(2) of the Holding Company Act of 1935); *Baird v. Franklin*, 141 F.2d 238 (2d Cir.), cert. denied, 323 U.S. 737 (1944) (§ 6(b) of the 1934 act); *Osborne v. Mallory*, 86 F. Supp. 869 (S.D.N.Y. 1949) (§ 17(a) of the 1933 act, § 15(c)(1) of the 1934 act and Rule 15c1-2 promulgated thereunder); *Hawkins v. Merrill, Lynch, Pierce, Fenner & Beane*, 85 F. Supp. 104 (W.D. Ark. 1949) (§§ 11(d) and 17(a) of the 1934 act and Rule 17a-5 promulgated thereunder); *Remar v. Clayton Securities Corp.*, 81 F. Supp. 1014 (D. Mass. 1949) (§ 7 of the 1934 act, Regs. T and U promulgated thereunder).

<sup>91</sup> Restatement, Torts § 286 (1934). Note, 1962 Duke L.J. 423, 433. Judge Clark, in one of the early cases recognizing a private right of action based on a violation of a provision of the 1934 act (*Baird v. Franklin*) said:

One of the primary purposes of Congress in enacting the Securities Exchange Act of 1934 was to protect the general investing public. . . . Section 2 also states that another goal of the statute is to make the control of securities transactions "reasonably complete and effective." If these aims are to be followed by the Act, then, if the investing public is to be completely and effectively protected, § 6(b) must be construed as granting to injured investors individual causes of action to enforce the statutory duties imposed upon the exchanges.

141 F.2d at 244-45. Although this statement appears in Judge Clark's dissenting opinion the majority agreed with him as to the existence of a private right of action.

<sup>92</sup> *Kardon v. National Gypsum Co.*, supra note 84, at 513-14. See Note, 46 Mich. L. Rev. 680 (1948).

<sup>93</sup> See also *Fischman v. Raytheon Mfg. Co.*, 188 F.2d 783, 786-87 (2d Cir. 1951); *Fratt*



With respect to the precise question of whether a corporation can bring a private action based on violations of Rule 10b-5, several recent cases, including the *Hooper* case, have either expressly stated that a corporation has such a right or have recognized its existence by implication.<sup>94</sup>

*Rule 10b-5 Offers More Protection Than the Common Law*

There is little question<sup>95</sup> that Rule 10b-5 extends to circumstances not covered by the common law,<sup>96</sup> and that actions under this rule are not shackled by the restrictions which attended those actions.<sup>97</sup> It applies to securities traded anywhere,<sup>98</sup> with arguments that face-to-face transactions were not intended to be covered being consistently rejected.<sup>99</sup> By the Rule's express terms it applies to both buyers and sellers, an improvement over section 17(a) of the 1933 act upon which it was modeled.<sup>100</sup> In addition, Rule 10b-5 is not limited to frauds committed

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v. *Robinson*, 203 F.2d 627 (9th Cir. 1953). In addition, when Congress amended § 29(b) of the 1934 act in 1938 it imposed a statute of limitations with respect to any action based on violations of § 15(c)(1) which, like § 10(b), does not expressly provide for a private right of action. Thus, it is said, by imposing a statute of limitations on such actions Congress impliedly recognized them. By parallel reasoning private rights under § 10(b) may be similarly inferred. See *Goldstein v. Grosbeck*, supra note 90; *Geismar v. Bond & Goodwin, Inc.*, 40 F. Supp. 876 (S.D.N.Y. 1941). Also because the express liability provisions of the 1934 act deal with special types of conduct whereas Congress intended that the act's coverage should be reasonably complete and effective (see § 2) and because the act was intended to provide broader relief than the common law (see § 28(a)), § 10(b) should not be construed as prohibiting actions which the common law recognized.

<sup>94</sup> *Hooper v. Mountain States Sec. Corp.*, 282 F.2d 195 (5th Cir. 1960), cert. denied, 365 U.S. 814 (1961); *Dauphin Corp. v. Sentinel Alarm Corp.*, 206 F. Supp. 432 (D. Del. 1962); *Dauphin Corp. v. Davis*, 201 F. Supp. 470 (D. Del. 1962); *Dauphin Corp. v. Redwall Corp.*, 201 F. Supp. 466 (D. Del. 1962).

<sup>95</sup> A recent student note seems to imply that despite express statements to the contrary, Rule 10b-5 has not afforded relief except in situations when relief would have been available at common law. See Note, 62 Colum. L. Rev. 735, 737 n.17, 738 n.25 (1962). Insofar as that note is meant to convey this impression, the present author takes sharp issue. The number of cases which have permitted recovery since the adoption of Rule 10b-5 gives sufficient evidence that the lot of the common law has been improved and perhaps has caused modification of the common law itself. See Conant, supra note 80 at 75; Note, 40 Minn. L. Rev. 62 at 64 n.20, 75 (1955).

<sup>96</sup> *Ellis v. Carter*, 291 F.2d 270 (9th Cir. 1961); *Speed v. Transamerica*, 99 F. Supp. 808, 829, 831 (D. Del. 1951); *Kardon v. National Gypsum Co.*, 73 F. Supp. 798, 802 (E.D. Pa. 1947). Cf. *SEC v. Chenery Corp.*, 318 U.S. 80, 89 (1943). Compare, however, *Connelly v. Balkwill*, 174 F. Supp. 49, 59 (N.D. Ohio 1959). Common law made certain exceptions to the general rule that disclosure was not required, where there was a confidential relationship or the defendant had special knowledge unavailable to plaintiff. See *Prosser, Torts* 534-35 (2d ed. 1955). Curiously enough one court has held that Rule 10b-5 applies only to frauds not cognizable at common law. *Beury v. Beury*, 127 F. Supp. 786 (S.D.W. Va. 1954); but see 222 F.2d 464, 465 (4th Cir. 1955) (expressing disagreement with the district court in dismissing the appeal); 54 Mich. L. Rev. 149. The lower court's holding has not been followed and there seems to be no justification whatever for doing so. See § 28 of the 1934 act.

<sup>97</sup> See *White*, "From the Frying Pan into the Fire: Swindlers and the Securities Acts," 45 A.B.A.J. 129 (1959); Note, 4 Stan. L. Rev. 308 (1952), for a general discussion of the various rules of the duties of disclosure imposed upon different persons under Rule 10b-5. See Conant, supra note 80, at 53; Note, 40 Minn. L. Rev. 62 (1955).

<sup>98</sup> *Fratt v. Robinson*, 203 F.2d 627, 630 (9th Cir. 1953).

<sup>99</sup> E.g., *Slavin v. Germantown Fire Ins. Co.*, 174 F.2d 799 (3d Cir. 1949).

<sup>100</sup> It is said that one of the main purposes of promulgating the Rule was to extend

by a broker or dealer.<sup>101</sup> Nor is a plaintiff's recovery limited to the difference between the sale price and fair value but includes defendant's profit.<sup>102</sup> Regarding the standards of disclosure created by Rule 10b-5, although extensive treatment is beyond the purview of this paper, there is little question that the rule has created an advantageous climate for the suitor. It has been suggested that Rule 10b-5 has only provided relief in situations where the common law would also have provided relief. With the benefit of hindsight perhaps it could be said that the facts of these cases seem to fall within the common law rules. This does not tell the whole story, however, because there seems to be a clear difference between Rule 10b-5 and the common law.<sup>103</sup> A review of the leading Rule 10b-5 cases reveals that, not only is the federal rule as liberal as the most liberal common law rule, but more important, the Rule 10b-5 cases have avoided relying on common law authority basing their holdings instead on new and different grounds, thus giving Rule 10b-5 the flexibility to cover new situations as they arise.<sup>104</sup> But even assuming Rule 10b-5 has not enlarged upon the common law from the standpoint of announcing a broader *rule* of recovery, the great number of cases which have permitted recovery demonstrate that Rule 10b-5, has certainly done so in fact perhaps by influencing the attitude of courts with respect to this entire area of conduct. Thus, the courts applying Rule 10b-5 have, almost without exception, concentrated on the essence of the defendant's evil, and avoided adherence to useless technicalities in order to provide protection to investors never heretofore, as a practical matter, possible.

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protection to the defrauded seller which § 17(a) of the 1933 act did not do. Securities Exch. Act Release 3230 (1942).

<sup>101</sup> Section 15(c)(1) of the 1934 act and Rules 15c1-1 to 15c1-9 promulgated thereunder.

<sup>102</sup> *Kardon v. National Gypsum Co.*, supra note 96; Leech, "Transactions in Corporate Control," 104 U. Pa. L. Rev. 725, 737 n.32 (1956).

<sup>103</sup> Note, 40 Minn. L. Rev. supra note 97. Cf. Reuschlein, "Federalization—Design for Corporate Reform in a National Economy," 91 U. Pa. L. Rev. 91, 108-09.

<sup>104</sup> Perhaps the only significant substantive limitation imposed upon the rule to date relates to the problems of intracorporate affairs. *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir.), cert. denied, 343 U.S. 956 (1952), approved in 100 U. Pa. L. Rev. 1251 (1952); 54 Mich. L. Rev. 149 (1955); criticized in 4 Stan. L. Rev. 308 (1952). In *Birnbaum*, Judge Hand speaking for the Second Circuit said:

That section [10(b)] was 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. . . .

193 F.2d 461 at 464.

Professor Loss maintains, however, that 10b-5 should cover the situation where the corporation sells shares to insiders at wrongfully low price and that the dictum in *Birnbaum* about fraudulent management would be irrelevant in such circumstances. III Loss, supra note 76, at 1770-71. The absolute liability provisions of § 16 of the 1934 act, with respect to insiders' profits, is some evidence that Congress envisioned regulation over intracorporate abuses. See also *Cochran v. Channing Corp.*, Civ. No. 62-2597 (S.D.N.Y. Nov. 15, 1962).

*There Are Procedural Advantages to Suing Under Rule 10b-5*

Procedurally, Rule 10b-5 offers enough advantages over other remedies to justify its existence. The usually longer state statute of limitations is applied except perhaps where the action is purely equitable,<sup>105</sup> and a use of the mails or other instrumentality of interstate commerce will suffice to support federal jurisdiction, with no requirement of a showing that the fraud occurred during the use of the interstate instrumentality.<sup>106</sup> The applicable federal service of process and venue provisions offer advantages which may often prove decisive.<sup>107</sup> It has also been suggested that once a litigant enters the federal court he is often benefited by that court's better acquaintance with securities problems,<sup>108</sup> by a broader concept of what is a security,<sup>109</sup> who is an investor,<sup>110</sup> and what is material.

*It Is More Advantageous to Sue Under Rule 10b-5 Than to Sue Under the Express Liability Provisions of the 1933 Act*

Compared with the provisions of the 1933 act which expressly create individual rights of action, Rule 10b-5<sup>111</sup> offers definite advantages.<sup>112</sup> It applies to all securities whether or not registered and whether or not exempt.<sup>113</sup> On the other hand both sections 11 and 12 impose specific limitations or conditions upon a plaintiff's right to recover: sections 12(1) and 12(2) require privity; section 12(2) and section 11 do not provide relief if it is shown that the plaintiff knew that the defendant's statement was untrue;<sup>114</sup> under these same sections if a defendant (other

<sup>105</sup> Compare § 13 of the 1933 act. Actions under §§ 11 and 12(2) must be brought within one year after the untrue statement is discovered; under § 12(1) within one year after the violation; and in no event may any action under either section be brought under these sections after three years. See, e.g., *Errion v. Connell*, 236 F.2d 447 (9th cir. 1956); *Northern Trust Co. v. Essaness Theatres Corp.*, 103 F. Supp. 954 (N.D. Ill. 1952).

<sup>106</sup> See, however, *Boone v. Baugh*, Court of Appeals, 308 F.2d 711 (8th Cir. 1962).

<sup>107</sup> Note, 40 Minn. L. Rev. supra note 95, at 76. See also Note, 1962 Duke L.J. 151, 159.

<sup>108</sup> See White, supra note 97, at 131.

<sup>109</sup> See *Blackwell v. Bentsen*, 203 F.2d 690 (5th Cir. 1953), cert. denied, 347 U.S. 925 (1954). Compare Berger, "Real Estate Syndication: Property, Promotion, and the Need for Protection," 69 Yale L.J. 725, 775.

<sup>110</sup> *Kardon v. National Gypsum Co.*, 69 F. Supp. 512, 514 (E.D. Pa. 1946).

<sup>111</sup> Although there are occasional statements to the contrary, *Osborne v. Mallory*, 86 F. Supp. 869 (S.D.N.Y. 1949), § 17(a) probably does support an implied right of action and the Commission has urged this view. Brief for SEC, as amicus curiae, *Fratt v. Robinson*, 203 F.2d 627 (9th Cir. 1953).

<sup>112</sup> In only a few respects is § 10(b) perhaps less desirable than the express liability provisions of the 1933 act. Under § 10b-5 it is necessary to prove fraud, whereas under § 12(2) it is not. See *Thiele v. Shields*, 131 F. Supp. 416 (S.D.N.Y. 1955). Whereas under § 12(2) it is not necessary to prove causation, apparently it is under 10b-5. See II Restatement, Torts, § 286 (1934); *Remar v. Clayton Sec. Corp.*, 81 F. Supp. 1014, 1017 (D. Mass. 1949); *Baird v. Franklin*, 141 F.2d 238, 239, 245 (2d Cir.), cert. denied, 323 U.S. 737 (1944); cf. *Downing v. Howard*, 162 F.2d 654, 658 (3d Cir. 1947), cert. denied, 332 U.S. 818 (1947).

<sup>113</sup> See Note, 59 Yale L.J. 1120 (1950). The provisions of the Securities Exchange Act of 1934 provide protection comparable to the express liability provisions of the 1933 act (§§ 11, 12), or to Rule 10b-5. Compare however § 15(c) of the 1934 act.

<sup>114</sup> *Robinson v. Difford*, 92 F. Supp. 145 (E.D. Pa. 1950); see 78 Cong. Rec. 7861, 8296 (1934) (remarks of Sen. Steiwer).

than an issuer) can show that he did not know, and could not (in the exercise of reasonable care) have known, that his statement was untrue, he will not be liable. Additionally, under section 11 the plaintiff can be required to post security of costs, including reasonable attorney's fees.<sup>115</sup>

Despite the seemingly broad potential of sections 11 and 12, there is some indication that the limitations just referred to constitute substantial barriers to the buyer-plaintiff. Only infrequently have plaintiffs succeeded in recovering in actions based on these sections. In 1940 it was reported that until then only twenty-seven cases had been brought under these sections of which plaintiffs were successful in only four.<sup>116</sup> In 1961 Professor Loss reported a similar scarcity of plaintiff victories.<sup>117</sup>

In contrast to the restrictions attendant upon sections 11 and 12, suits under Rule 10b-5 are generally thought to be free of many of these limitations. This question, of course, is not settled, and difficult questions are raised and inconsistencies produced regardless of which of the differing views is taken. Essentially, the question is whether persons who assert an implied right under Rule 10b-5 should be afforded the same or better treatment than persons suing under sections 11 or 12 which expressly confer private rights of action.<sup>118</sup> Professor Loss, in commenting on one phase of this problem, has said:<sup>119</sup>

The courts were thus faced with a choice of dilemmas: Should they permit buyers to sue under 10b-5 and thus ignore the safeguards which Congress chose to throw around buyers' actions in §§ 11 and 12? Or should they restrict the Kardon doctrine to suits by sellers (or at any rate, non-buyers) and thus treat the seller's stepchild far better than the buyer's favorite son—not to mention the fact that any discrimination between seller and buyer would fly in the face of § 10b and the rule?<sup>120</sup>

Obviously, if the limitations of sections 11 and 12 apply to all actions

<sup>115</sup> This provision, it is thought, might also apply to actions under § 12. See Note, 59 Yale L.J. 1120, 1127 n.44 (1950). In *McClure v. Borne Chemical Co.*, 292 F.2d 824 (3d Cir.), cert. denied, 368 U.S. 939 (1961), it was held that neither the New Jersey nor Pennsylvania security of expenses provisions applied to federally created implied rights of action.

<sup>116</sup> Note, 59 Yale L.J. 1120, 1126 n.40 (1950).

<sup>117</sup> Loss, *supra* note 70, at 1684-92. It is reported that as of then, 77 cases had been brought under §§ 11 and 12 of which only 12 ended in verdicts for the plaintiff.

<sup>118</sup> Some say that these limitations should apply when a buyer sues under Rule 10b-5, others say that they should apply to sellers' actions with buyers having no rights at all under 10b-5, and still others urge that these limitations should apply when both the seller and the buyer sue under the rule.

<sup>119</sup> Loss, *supra* note 70, at 1780. See *Ellis v. Carter*, 291 F.2d 270, 273 (9th Cir. 1961), followed in *Dauphin Corp. v. Redwall Corp.*, 201 F. Supp. 466 (D. Del. 1962).

<sup>120</sup> The Commission has argued that where the scheme alleged was only a technical violation of Rule 10b-5 but was "most essentially" within the scope of other statutory provisions which, in expressly dealing with the specific type of security transaction involved, provide specific private remedies, the procedural limitations and substantive defenses should be read into the rule 10b-5 action. SEC Supplemental Reply Memorandum. *Speed v. Transamerica Corp.*, 99 F. Supp. 808 (D. Del. 1951) 37. Thus, the Commission urged in its brief that *Montague v. Electric Corp.*, 76 F. Supp. 933 (S.D.N.Y. 1948), and *Rosenberg v. Globe Aircraft Corp.*, 80 F. Supp. 123 (E.D. Pa. 1948), had been correctly decided. *Id.* at 39-40.

under Rule 10b-5, the rule's chief utility would be limited principally to providing the seller a right of action. Yet, without respect to the merits of the contrary views, the weight of authority is inclined toward the position that the restrictions of sections 11 and 12 are not applicable to Rule 10b-5 actions.<sup>121</sup> Since the question has not been finally decided it still poses a possible threat to the broad interpretation otherwise given to Rule 10b-5, especially since no matter which view is adopted anomalies are necessarily created.<sup>122</sup>

*The Hooper v. Mountain States Doctrine—Relief from  
Promoters' Fraud Where Disclosure Is not Made*

Until *Hooper v. Mountain States Sec. Corp.*,<sup>123</sup> no court, in a Rule 10b-5 action, had permitted recovery to a corporation which, induced by fraud, had issued stock in exchange for overvalued property.<sup>124</sup> In *Hooper*, however, the Fifth Circuit Court of Appeals did just that. In addition, it did so in an opinion broad enough to encompass the typical promoter's fraud situation.

Ben Jack Cage, the controlling stockholder and organizer of Consolidated American Industries, Inc., as a condition of new management taking control, severed his connection with Consolidated on October 18, 1956. Shortly thereafter he carried out a scheme, with the aid of others, whereby he was to fraudulently obtain 700,000 shares of stock from Consolidated. To carry out his plan he obtained the right to purchase stock in a certain Cuban insurance company and also acquired certain exploration rights in the Honduras.<sup>125</sup> Before he was able to acquire these rights, however, it was necessary to forward \$10,000 to Cuba. To ac-

<sup>121</sup> Compare *Joseph v. Farnsworth Radio & Television Corp.*, 198 F.2d 883 (2d Cir. 1952), and *Montague v. Electronic Corp.*, supra note 120, with *Fischman v. Raytheon Mfg. Co.*, 188 F.2d 783 (2d Cir. 1951); *Texas Continental Life Ins. Co. v. Banker's Bond Co.*, 187 F. Supp. 14 (W.D. Ky. 1960), aff'd in part, rev'd in part on other grounds sub nom. *Texas Continental Life Ins. Co. v. Dunne*, U.S. Ct. of Appeals, 4th Cir., Aug. 7, 1961; *Dauphin Corp. v. Redwall Corp.*, 201 F. Supp. 466 (D. Del. 1962). See generally Comment, 4 *Stan. L. Rev.* 308 (1952); Cary, *Book Review*, 75 *Harv. L. Rev.* 857, 861 (1962).

<sup>122</sup> See also *Donovan, Inc. v. Taylor*, 136 F. Supp. 552 (N.D. Cal. 1955); Latty, "The Aggrieved Buyer or Seller or Holder of Shares in a Close Corporation Under the S.E.C. Statutes," 18 *Law & Contemp. Prob.* 505, 512-15 (1953).

<sup>123</sup> 282 F.2d 195 (5th Cir. 1960), cert. denied, 365 U.S. 814 (1961).

<sup>124</sup> Previous to this corporations in their capacity as investors have been permitted to recover under Rule 10b-5. See Note, 13 *Stan. L. Rev.* 378 (1961). Compare *Slavin v. Germantown Fire Ins. Co.*, 174 F.2d 799, 805-06 (3d Cir. 1949). In a somewhat similar situation the Second Circuit Court of Appeals held, in *Howard v. Furst*, 238 F.2d 790 (1956), cert. denied, 353 U.S. 937 (1957), that Congress had not intended to protect the corporation against violations of the Commission's proxy rules. It is not contended here that Howard should control cases under Rule 10b-5 and indeed there are good reasons why it should not. See Brief for SEC as amicus curiae, 1 pp. 13-14, *Hooper v. Mountain States Sec. Corp.* 282 F.2d 195 (5th Cir. 1960), cert. denied, 365 U.S. 814 (1961). See also *Brown v. Bullock*, 294 F.2d 415 (2d Cir. 1961) (dissenting opinion). Yet the lower court in the instant case denied relief solely on the authority of Howard.

<sup>125</sup> It can be assumed that these properties had little or no value.

comply with this he represented to Consolidated's new management that Consolidated already owned this stock in the Cuban company and that \$10,000 was desperately needed in order to protect Consolidated's interests. Consolidated forwarded the money. Then, through a corporate intermediary, Mid-Atlantic,<sup>126</sup> Cage transferred these newly acquired properties to Consolidated for 700,000 shares of the company's stock having a market value of \$700,000. In order to effect this transfer, still suspicious that Consolidated's new management would not transfer the stock to him, Cage and Consolidated's former general counsel and its former secretary falsified certain documents purporting to approve the transaction just as Cage had represented it to be to Consolidated's new management.<sup>127</sup> On the strength of these documents Consolidated's transfer agent delivered the shares to Mid-Atlantic, most of which were then sold to the public by Cage and his associates.

The district court dismissed plaintiff's complaint holding that section 10(b) and Rule 10b-5 did not create a right of recovery for the corporation.<sup>128</sup> The court of appeals reversed, holding that even though the

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<sup>126</sup> Mid-Atlantic Development Co. was organized solely for this purpose.

<sup>127</sup> The secretary falsely certified corporate resolutions which purported to approve of this transaction as of October 18 although these resolutions were not written until December.

<sup>128</sup> Prior to Hooper the contention that the corporation should have a right to recover under Rule 10b-5 where it sues other than as an investor was raised in *Slavin v. Germantown Fire Ins. Co.*, 174 F.2d 799 (3d Cir. 1949). In this case the principal salesman of a mutual insurance company, Rosenlund, acquired the right to purchase some 17,500 shares of stock in a new company which the mutual insurance company planned to create by converting to a stock company. In arranging for this conversion the mutual company adopted a policy that the new stock company should not be dominated by a few large stockholders but rather that its ownership should be spread widely with each shareholder being restricted to only a moderate-size holding. Pursuant thereto they asked the holders of large policies in the old mutual company to waive their preemptive right to purchase shares in the new stock company wherever the large policy holders were entitled to receive more than 1,000 shares. Rosenlund, as the broker for certain large clients of the mutual company, had been asked to obtain waivers from his clients, which he did. However, in so doing he discovered that many of his clients were not interested in acquiring stock in the new stock company. Therefore, he persuaded some of his clients to assign their right to acquire stock to him. In this way he amassed the right to purchase some 17,500 shares. However, not until just before the conversion of the mutual company was to take place did Rosenlund disclose to the mutual company that he had acquired the right to purchase so many shares. Nonetheless, Rosenlund's acquisition of the rights was approved by the stockholders and directors before the conversion and he purchased the stock paying the same value paid by other subscribers. By acquiring these shares Rosenlund acquired control of the new stock company and incidentally made a substantial profit. The majority of the Third Circuit found that since Rosenlund had paid full price for the stock the question of promoters' profits was "inapposite," and otherwise denied recovery. In his dissenting opinion, however, which is particularly interesting in view of Hooper, Chief Judge Biggs reasoned that, although the court could have decided the case on the question of state law on a theory of a breach of fiduciary duty (citing *Hurn v. Oursler*, 289 U.S. 238 (1933)), Rosenlund's acts violated Rule 10b-5 and the corporation should be given a right to recover. On this point he said:

It is clear that the right of the new corporation, Germantown, qua corporation as distinguished from its stockholders, to maintain a suit such as that at bar does not stand or fall on the issue of whether or not there was some breach of fiduciary duty by Rosenlund. The right of the corporation to maintain a suit such as that at bar arises under the statute and the rule of the Commission. If Rosenlund's course of conduct

corporation was not an "investor" within the meaning of section 10(b), Congress authorized the Commission to promulgate rules not only for the protection of investors but also those appropriate to the public interest. The court had little difficulty in finding that it was in the public interest to permit the corporation to recover and noted:

[T]he broad purpose of this legislation was to keep the channels of interstate commerce, the mail, and national security exchanges pure from fraudulent schemes, tricks, devices, and all forms of manipulation. Just as obviously those sought to be protected were the very persons who would be engaged in buying and selling and trading in corporate securities as broadly defined in the Act. Certainly a person who parts with stock owned by him as the result of fraudulent practices wrought on him by his purchaser sustains an adverse impact that differentiates him from the damage suffered by the public generally.<sup>129</sup>

In *Hooper* the defendants-appellees had argued that recovery should be denied because the corporation had suffered no loss by virtue of Cage's transaction. The court rejected this contention saying:

Even in our remote position, we would be blind to all we hear and read about were we to succumb to the artificial contention that the issuance of this stock made the corporation no poorer so that the only persons who suffered were the stockholders for whom the suit cannot be brought by the Trustee. . . . [T]he thing of value transferred in exchange for assets or the capital stock of the enterprise being acquired is the capital stock of the acquiring corporation. Considering the purpose of this legislation, it would be unrealistic to say that a corporation having the capacity to acquire \$700,000 worth of assets for its 700,000 shares of stock has suffered no loss if what it gave up was \$700,000 but what it got was zero.<sup>130</sup>

Finally, appellees urged that the corporation had an adequate remedy under state law which permitted the corporation to recover up to the par value of the shares issued. The court also rejected this position noting that:

[The corporation] is not confined to a mere cancellation of that stock nor subjected to the expense of multiple litigation against a large number of holders (many perhaps innocent) to assert a claim for the nominal par value (1¢) of this stock, the successful recovery of which would net \$7000 not what 700,000 shares would have purchased.<sup>131</sup>

The *Hooper* case is interesting because it raises the question of whether Rule 10b-5 can be utilized to redress promoters' frauds. The three phases

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was prohibited by the statute and the rule, the corporation could maintain the suit at bar.

174 F.2d at 813. The majority did recognize that under proper circumstances a corporation might be able to recover under Rule 10b-5 but since, in this case, the corporation had not been injured, Rule 10b-5 could not support recovery.

<sup>129</sup> 282 F.2d at 202.

<sup>130</sup> Id at 203. See also id. at 204, 207, 208.

<sup>131</sup> Id. at 208.

of the case quoted above seem to indicate that Rule 10b-5 could well serve to redress promoters' wrongs of the conventional type. And as we have seen such a remedy would of course be broader than the common law.<sup>132</sup>

By holding that Rule 10b-5 creates a right of recovery for a corporation where, by reason of a fraud, it is induced to issue securities in exchange for property, the court, in effect, announced a holding which encompassed the essential features of a promoters' fraud. True, defendants' conduct in *Hooper* was not a classic example of a promoters' fraud because in such cases the promoter usually controls the corporation and defrauds the corporation by issuing stock to himself in exchange for property at excessive consideration through the controlled board. In *Hooper* there was at most only forged approval by a board of directors. Yet this difference should not be controlling. The essential elements of both the *Hooper* case and that of the promoters' fraud are practically identical, *i.e.*, the employment of fraud, to have stock issued, for inadequate consideration. All are adequately covered by the *Hooper* opinion. Once more, the *method* whereby fraud is perpetrated should not determine whether relief is to be granted when action is nonetheless fraudulent. In keeping with this philosophy, fraud, within the meaning of the federal securities acts, has been broadly interpreted to cover the myriad of forms which it has assumed.<sup>133</sup> The *Hooper* court's statement to the effect that Rule 10b-5 greatly expands the protection "so hemmed in by the traditional concepts of common law misrepresentation and deceit" indicates that this court had no intention of departing from this philosophy.<sup>134</sup>

Once it is determined that the corporation has a right to recover under Rule 10b-5, the limitations and restrictions of earlier promoter fraud cases should be inapposite. Thus the corporate consent doctrine which had been employed to prevent recovery where the promoter had transferred property to a company within his control should no longer apply. By following the view that fraud, within the meaning of the securities acts, is not limited to cases of common law deceit nor even to traditional concepts of fiduciary relationships,<sup>135</sup> Rule 10b-5 should readily permit

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<sup>132</sup> Although relief was probably available at common law under these facts, the opinion did not restrict itself to such principles in granting relief. Hence the availability of relief at common law should not be considered conclusive on the issue of whether Rule 10b-5 is broader than the common law.

<sup>133</sup> *Charles Hughes & Co. v. SEC*, 139 F.2d 434 (2d Cir. 1943), cert. denied, 321 U.S. 786 (1944); *SEC v. Capital Gains Research Bureau, Inc.*, 191 F. Supp. 897 (S.D.N.Y. 1961), aff'd, 306 F.2d 606 (2d Cir. 1962) (en banc) (dissenting opinion); petition for cert. filed, 31 U.S.L. Week 3187 (U.S. Dec. 4, 1962); granted, Jan. 21, 1963.

<sup>134</sup> 282 F.2d at 201.

<sup>135</sup> See *Slavin v. Germantown Fire Ins. Co.*, 174 F.2d 799, 814 (3d Cir. 1949) (dissenting opinion); see also *Ward LaFrance Truck Corp.*, 13 S.E.C. 373 (1943); *Matter of Cady, Roberts & Co.*, CCH Fed. Sec. L. Rep. ¶ 76, 803 (Nov. 8, 1961).



an inquiry into whether the corporation, as newly constituted, was treated fairly even assuming some disclosure had been made to a controlled board.<sup>136</sup> The *Hooper* court did indeed seem to seize upon the defendants' fraudulent action, so that even though that case did not involve a question of consent it should be persuasive where the issue is presented. Consent where the promoter is on both sides of the transaction is nothing more than a sham; Rule 10b-5 is certainly broad enough to permit recovery if it results in a fraud upon the company.

Another interesting aspect of *Hooper* was that the court rejected appellees' argument that the watered stock remedy available to the corporation under state law was adequate.<sup>137</sup> The court realistically held that a cancellation of the shares issued to Cage and his associates or a recovery of up to the par value of the stock issued would not adequately recoup the company's loss.<sup>138</sup> Consequently, recovery of the market value of the shares issued was allowed without need to show that the corporation could have otherwise sold these shares, or even assuming it could, that they could have all been sold at the then current market price. Arguments similar to the one advanced by the *Hooper* court had not always been persuasive in the past. *Piggly Wiggly Delaware, Inc. v. Bartlett*, serves as one example.<sup>139</sup> In that case promoters transferred property to a corporation which had cost them \$1,000. In return they received all the company's no par stock and preferred stock which they thereafter sold to the public. They retained the proceeds from the sale of no par common for themselves making a substantial profit. Professor Ballantine thinks that this case was wrongly decided and that one of the bases upon which relief could have been granted was the injury to the corporation by being "deprived of the capital which it might have realized by the honest sale of the common shares."<sup>140</sup> There seems little difference in result to

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<sup>136</sup> See *Pipeline Corp. v. Bedford*, 145 A.2d 206 (Del. Ch. 1958).

<sup>137</sup> Brief for Appellee, *Mountain States S.E.C. Corp.*, p. 12, Brief for Appellee, Reid, p. 16. *Hooper v. Mountain States Sec. Corp.*, 282 F.2d 195 (1960).

<sup>138</sup> An action to recover promoter's secret profits is distinguishable from a watered stock action in that recovery is limited to par value in the latter remedy, while in the former the promoter is liable to the full extent of his profit. Yet virtually all the early cases measured the promoters' profit in terms of the aggregate par value of securities issued to the promoter. But see *McCandless v. Furlaud*, 296 U.S. 140 (1935). Of course, there is historical justification for this because when these cases were decided, par value was more nearly equal to market value. Still there is some question whether the courts today would gauge the promoters' profit by market value or by par value. Also the promoter was usually able to escape liability if he issued no par shares, see Ballantine, Lattin & Jennings, *Cases on Corporations* 217-20 (2d ed. 1953), so this problem cannot be totally divorced from par value. On the other hand the *Hooper* court squarely faced this issue and decided that the market value was the proper measure of recovery.

<sup>139</sup> 97 N.J. Eq. 469, 129 Atl. 413 (Ch. 1925) cf. *Jefferis v. Utah Power & Light Co.*, 136 Me. 454, 472 12 A.2d 592, 601 (1940).

<sup>140</sup> Ballantine, *supra* note 138, at 842. See *Baker & Cary, Cases on Corporations* 776 (1958).

corporation, shareholder, or promoter between the conduct prohibited in *Hooper* and that sanctioned in *Piggly Wiggly* except perhaps that no par stock was involved in the earlier case.<sup>141</sup>

A comparison of *Hooper* and the early promoter fraud cases offers hope that a significant advance has been made. Under both the *Lewisohn* and *Bigelow* rules the courts deny relief if the promoters conform to certain seemingly unimportant rituals concerning the issuance of stock. The *Lewisohn* rule denies recovery merely because the promoters own all the issued stock when they transfer their property to the company, despite the fact that no disclosure is later made when innocent shareholders purchase the previously unissued stock. The *Bigelow* rule, as restricted by *Hays*, permits the promoter to escape liability if he first purchases all the company's stock regardless of whether he later makes disclosure to innocent subscribers. Obviously, under both rules excessive deference is paid to technical transactions with little emphasis on the essence of the promoter's scheme.

Conversely, the broad interpretation of the *Hooper* court, the other interpretations of the rule covering a wide range of situations, and its freedom from technical distinctions at this time, support the conclusion that Rule 10b-5 could apply to the traditional promoter's fraud especially where the disclosure requirements do not apply or are not complied with.

Although there are no other Rule 10b-5 cases similar to *Hooper*, there are other recent cases which indicate a willingness to interpret Rule 10b-5 broadly to cover the various factual situations to which the rule has been applied. Thus in *Ellis v. Carter*,<sup>142</sup> the Court of Appeals for the Ninth Circuit held that a plaintiff could recover under Rule 10b-5 where he purchased stock from one of the defendants at a price exceeding the then market price, where the defendant did not disclose this fact, and where it was represented to him that the shares had voting rights when they in fact had none.

In *Matheson v. Armburst*,<sup>143</sup> the same court followed *Fischman v. Raytheon Mfg. Co.*<sup>144</sup> by holding that section 10(b) created a right of action in a buyer notwithstanding the fact that the acts alleged might also have violated other sections of the act. The defendant had sold the entire stock of a company to the plaintiff and in so doing had grossly misrepresented the company's financial condition. The court rejected an

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<sup>141</sup> Some courts of course had permitted recovery based on an injury similar to this but the overwhelming majority refused to recognize a right based on this wrong because it would seem this injury would necessarily be present in most cases.

<sup>142</sup> 291 F.2d 270 (9th Cir. 1961).

<sup>143</sup> 284 F.2d 670 (9th Cir. 1960), cert. denied, 365 U.S. 870 (1961).

<sup>144</sup> 188 F.2d 783 (2d Cir. 1951).

argument that because the acts complained of constituted a fraud at common law the plaintiff had a remedy under state law and therefore could not sue under section 10(b).<sup>145</sup> On the question of whether an instrumentality of interstate commerce had been used, the court ruled that a long distance telephone call, made before the final negotiations started simply to induce the plaintiff to return to Oregon where the fraudulent statements were made, was sufficient to confer jurisdiction on the federal courts.

In *Errion v. Connell*<sup>146</sup> the same court of appeals held that section 10(b) applied where the defendants fraudulently induced the plaintiff, by misrepresenting the value of their property, to exchange her securities and other property for their property. This case for the first time decided that Rule 10b-5 applied even though the fraud did not concern the value of the securities but rather the value of property which was given by defendants in exchange for securities.<sup>147</sup> These cases, and others which have previously applied Rule 10b-5 to abuses of the close corporation and to so called private dealings, indicate that courts would be justified in applying the rule to redress promoters' abuses. This would be in keeping with the purpose of the Exchange Act since such abuses frequently involve the public or wide distribution of securities.

*Rule 10b-5 Could Be Applied Even Though  
Disclosure Has Been Made*

The crucial question here, assuming the arrangement fostered by the promoter is fundamentally unfair, is whether disclosure will insulate the promoter against liability if there is a remedy available against him under Rule 10b-5.

In the past the overwhelming tendency has been to permit a transaction to stand no matter how inherently unfair it might be as long as disclosure has been made. Of course the disclosure requirements have a salutary effect but if the arrangement is unfair in an economic sense or constitutes a fraud in the more traditional sense, should the promoter be protected?<sup>148</sup>

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<sup>145</sup> Compare *Beury v. Beury*, 127 F. Supp. 786 (S.D.W. Va. 1954), appeal dismissed, 222 F. 2d 464 (4th Cir. 1955).

<sup>146</sup> 236 F.2d 447 (9th Cir. 1956), 9 Stan. L. Rev. 589 (1957), 70 Harv. L. Rev. 1309 (1957).

<sup>147</sup> Somewhat similar facts were alleged in *Dauphin Corp. v. Redwall Corp.*, 201 F. Supp. 466 (D. Del. 1962), where, however, the fraud went to the value of a note and real estate, which was the only property in back of the note, which was given in exchange for a corporation's securities.

<sup>148</sup> This is the area of "semifrauds." Graham & Dodd, *Security Analysis* 657 (2d ed. 1940). After a shift from the bizarre blue sky fraud the promoter is now able to sell property to the public worth \$1 for \$5 and the "law can be obeyed and the public exploited just the

The importance of the public investment contribution to the development of new business<sup>149</sup> cannot be overemphasized,<sup>150</sup> as a quick look at the development of the electronics industry will clearly demonstrate. Historically new businesses have experienced difficulty in obtaining necessary financing especially from institutional lenders. This fact was clearly recognized with the passage of the Small Business Act of 1958.<sup>151</sup> New businesses are more dependent upon the public investor than are more established firms,<sup>152</sup> so that any conditions which would unnecessarily

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same." Professors Graham and Dodd suggest, as the means of correcting this condition, that the securities laws should be amended so as to prohibit investment by the public in "unseasoned securities." This recommendation constitutes a drastic approach and is contrary to the basic philosophy of the federal securities laws which reserves to the individual the decision of whether or not to invest in a particular security. In addition, the alternative means of financing new business, which is suggested by the authors, (acquiring capital from a small number of private persons who can protect their investment by keeping in close touch with the promotion) may prove increasingly more difficult in the future. See note 152, *infra*.

<sup>149</sup> Graham & Dodd, *supra* note 148, at 656. The material referred to in this paper which was contained in Graham & Dodd's second edition was not treated in the authors' third edition in 1951 in order to make possible treatment of other material which posed more important current problems to stockholders, since the creation of the SEC had largely eliminated these old abuses. See preface to third edition.

<sup>150</sup> Firms under three years of age normally account for 1/5 to 1/4 of the number of operating businesses in this country. Bridges, "The Financing of Investment by New Firms," Nat'l Bureau of Econ. Research, Conference on Research in Bus. Fin. 65, (1952).

<sup>151</sup> Hearing on Credit needs of Small Business before, Committee on Banking and Currency, 85th Cong., 1st Sess. 93, 168, 198, 209 (1957).

<sup>152</sup> A comparatively recent study by McHugh & Ciasco, "External Financing of Small-and-Medium-Size Business," Survey of Current Business 15 (October 1955), shows that new firms rely primarily on banks for their external funds but must rely more on friends and acquaintances than do old firms. Because of the absence of past earnings and the likelihood of low profits or even losses during the first years old firms are able to rely more on organized security markets to obtain funds from external sources than are new firms; new businesses which sought to obtain 13% of their total financing from the sale of equities were able only to obtain less than half of their needs, and, compared with more established firms, they sought 1/3 more equity financing. See also H. R. Hearings on Various Bills to Amend the Small Business Act, 85th Cong., 1st Sess. 70-71 (1957). Somewhat different results were reported in Small Business Financing, Fed. Reserve Bull. 8, 12, 17 (Jan. 1961). Other studies of recent trends in capital formation show that new corporations find it more desirable to obtain financing from internal sources and not external sources, Kuznets, Capital in the American Economy 282 (1961), but that of this external financing a greater percentage now comes from the issuance of stock (as opposed to other forms of long term financing), Creamer, Dobrovolsky & Borenstein, Capital in Manufacturing and Mining 145-46 (1960). Considering these trends in conjunction with the reduction in the individual's financial capacity wrought primarily by the present tax structure and the present saving habits of individuals brought on by changes in the nature of our economy, it is questionable whether sufficient financing can be obtained from private sources. See Kalmbach, "Free Enterprise in a Changing World," 14 Mich. Bus. Rev. 1, 5 (1962). Incomes are tending to become more equalized and fewer persons conduct their own enterprises. Thus now more individuals tend to divert savings to institutions which might otherwise have gone into new businesses. Kuznets, *supra* at 422-23. See also Berle, Power Without Property 32-34 (1958). As a result, these institutions are more important now as a source of capital than they have ever previously been and control a substantial percentage of the country's financing. Kuznets, *supra* at 421-22. However, institutions generally prefer "blue chips" to speculative securities. Berle, *supra* at 54. Goldsmith, "The Share of Financial Intermediaries in the National Wealth and National Assets, 1900-1949," Occasional Paper 42, p. 16, Nat. Bureau of Econ. Research (1954). Even if they were to change and become more willing to invest in new businesses there is still some reason to doubt that they would actively check the promoters' excesses, judging from their past activities with regard to participation in the

obstruct the flow of capital into this area, such as an unreasonably high return for promoters or the frequent occurrence of fraud, should be eliminated if possible. Typically, the relatively unsophisticated investor is called upon to contribute to new firms. For the small and new business it is essential to obtain financing in order to expand.

A dichotomy of thought has existed as to the effect a purchase of shares should have if full disclosure has been made in the offering circular. Professor Berle contends that the notice contained in the broker's circular should bind incoming shareholders to the promoter's deal.<sup>153</sup> On the other hand Professor Ballantine has criticized this view and said:

It is surprising that Mr. Berle should suggest making such constructive notice to the defrauded shareholders sufficient and binding upon them by law. It has been suggested by the Massachusetts court that "A profit is not secret or unlawful if all the parties having a direct interest know of it and assent to it, or do not repudiate it." Insofar as this is an intimation that disclosure to shareholders, after a secret profit-taking, calls for affirmative repudiation or rescission on their part to prevent an implied assent or ratification, it seems clearly unjust and unsound, a doctrine favorable to the wrongdoers.<sup>154</sup>

Clearly the question could be asked whether, even though an issuer has satisfied the requirements of the 1933 act, the corporation is bound to accept the promoter's deal or is able to repudiate the deal once the promoter and those controlled by him have disassociated themselves from the company.<sup>155</sup> The disclosure requirements have a specific purpose and in some respects represent a limited approach to the underlying purpose of the flotation of securities, notably the formation of capital. Hence it has been suggested that these provisions, even though supported by civil and criminal sanctions, fall short of providing adequate protection to the public. It is the opinion of Professors Graham and Dodd that a

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management of the companies whose securities they hold. Livingston, *The American Stockholder* ch. 12 (1958). Thus, the alternative offered by Graham & Dodd might not be a realistic one.

<sup>153</sup> The New York Stock Exchange has stated that the underwriting of small issues has made a substantial contribution to our economy. N.Y. Stock Exch. M.F. Education Circ. No. 152 (Dec. 26, 1961). It was reported in 1958 that even though 13.5% of the small businesses desired equity capital only 7/4 of these attempted to acquire it, the others making no effort because they assumed they could not obtain it. "Small Business Financing," 52 Fed. Reserve Bull. 12-13 (Jan. 1961). Berle, "Compensation of Bankers and Promoters Through Stock Profits," 42 Harv. L. Rev. 748, 760 (1929).

<sup>154</sup> Ballantine *Corporations* 833 (Rev. ed. 1946).

<sup>155</sup> It has been held with considerable soundness by a strong minority voice that a bona fide approval by the majority can bind the minority. See *S. Solomont & Sons Trust, Inc. v. New England Theatres Operating Corp.*, 326 Mass. 99, 93 N.E.2d 241 (1950); see Landstorm, "Ratification by Majority Stockholders—A Problem in Corporate Democracy," 31 B.U.L. Rev. 165 (1951). It is enough to say here that under the Solomont rule approval must be reasonable such as obtains from a proxy contest. 31 B.U.L. Rev. at 178; Lattin, *Corporations* 355 (1959).

tightening of federal and state regulations only led to the semi-fraud where one could obey the law but at the same time exploit the public (provided no false representations are made) by selling stock at an excessive price.<sup>156</sup> Professor Douglas (now Justice) early recognized that disclosure was in a broad sense inadequate and represented only a limited attempt to correct a broad wrong.<sup>157</sup>

More recently Livingston has recounted instances (in a somewhat different setting) where full disclosure was made but the public exploited nonetheless.<sup>158</sup> The problem is essentially whether disclosure should be used as a means to insulate the promoter especially where a grossly unfair financing arrangement is contemplated. True, if disclosure is made, most of the essential information about the company supposedly has been made available. But is this disclosure enough, especially considering that the average American investor is not especially sophisticated and may not understand the data disclosed anyway.<sup>159</sup> These practical considerations should not be overlooked with regard to promotional issues especially if respectable brokers, who are often thought to protect the unsuspecting public, are reluctant to participate,<sup>160</sup> and even if disclosure is made this

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<sup>156</sup> Graham & Dodd, *supra* note 148, at 657. Earlier these authors offered that "The great majority of such flotations [public sale of securities in new enterprises] were either downright swindles or closely equivalent thereto by reason of the unconscionable financing charges taken out of the price paid by the public." *Id.* at 651.

<sup>157</sup> Douglas & Bates, "The Federal Securities Act of 1933," 43 *Yale L.J.* 171, 172 (1933). The answer given by the National Association of Securities Dealers, Inc. to this question has been no, at least in several important instances. The NASD has taken the position that despite disclosure it is unfair for an issuer to withhold shares from the public during an offering. NASD Rules of Fair Practice, art. III § 1. See interpretation entitled "Free Riding and Withholding," NASD Manual pp. G23-G31 (promulgated April 1, 1960), as interpreted in Notice to Members of NASD (Oct. 13, 1961). Likewise the NASD retains the right to review compensation by underwriters in the sale of unseasoned securities irrespective of disclosure and with respect to mark-up in the price of a security disclosure itself does not justify a price which is unfair or excessive in the light of all other relevant circumstances. Interpretation of art. III, §§ 1 & 4 of Rules of Fair Practice. See "Issues of Unseasoned Companies—Underwriting Compensation—Withholding," Notice to Members of NASD (Dec. 26, 1961); Letter to Members (Jan. 11, 1962).

<sup>158</sup> Livingston, *The American Stockholder* 173 (1958).

<sup>159</sup> A survey by the Opinion Research Corp., "Overcoming Word Barriers in Stockholder Communications," *The Public Opinion of Industry* (October 1961) found that: Only 25% of stockholders say they can make a detailed analysis of a company from the balance sheet and income statement, 43% say they get little or nothing from such statements, 32% say they exact some meaning, *id.* at 2; only 50% are able to define assets; 70% cannot define earnings, *id.* at 4; less than 50% can define depreciation, *id.* at 12; only 17% operating revenues, *id.* at 14; 43% working capital, *id.* at 15; 5% cash flow, *id.* at 16; 5% funded debt, *id.* at 32; 1% paid-in surplus, *id.* at 34; 13% par value, *id.* at 35; 4% debt capital, *id.* at 36; and 3% equity capital, *id.* at 37. In addition only 64% of persons receiving said reports even bother to look at them, *id.* at 4. But see Heller, "Disclosure Requirements under Federal Securities Regulation," 16 *Bus. Law.* 302 n.6 (1961). The American investing class contains a large number of inexperienced persons, 20th Century Fund, *The Securities Market* 79-80 (1935), who are generally more speculative than investors of other countries, *id.* at 83. With the expansion of the base of ownership in recent years, it is fair to assume that these facts are even more true today. See Graham & Dodd, *supra* note 148, at 653; Douglas & Bates, *supra* note 157; Barron's, pp. 5, 15 (February 19, 1962).

<sup>160</sup> Cf. Graham & Dodd, *supra* note 148, at 651.

fact may not be controlling since under the Commission's present interpretation of the 1933 act, sales can be completed before a prospectus need be delivered,<sup>161</sup> and investors often do not even read prospectuses anyway.<sup>162</sup> In all, it does not seem realistic to hold that purchase by a disorganized and unsophisticated group of investors should insulate the promoter, especially when these sales are the very acts whereby these purchasers first become part of the company.<sup>163</sup>

The essential consideration in deciding this point should be balance. Assuming the continued need for public support of new businesses and that the relatively unsophisticated investor, for the most part, will be called upon to lend funds, it does not seem unreasonable to impose some standard of fairness upon the promoter's activities. The promoter is entitled to a just compensation which in many cases will be relatively high, but in the usual case it is the public which often assumes all or practically all of the monetary risk involved and for whose benefit the corporation is supposedly functioning and the promoters working. Moreover, the public has a legitimate interest in these promotions both from the standpoint of seeing that new industries are developed and from the standpoint of the conservation of capital. The attitude of our country in the past has been that investment decisions should be left to the individual with no government interference. Unfortunately, however, in some cases this has amounted to saying, in effect, that the public's capital is expendable. From an economic standpoint it may not suffice to say anymore that *laissez-faire* rules of *caveat emptor* and supply and

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<sup>161</sup> See Op. Gen. Counsel, Sec. Act Release 2623 (1941), where the General Counsel ruled that a prospectus can be delivered no later than with the confirmation. See also 1 Loss, Securities Regulations 182 (2d ed. 1961).

<sup>162</sup> See Demmler, "Private Suits Based on Violation of the Proxy Rules," 20 U. Pitt. L. Rev. 587, 598 (1959). Witness the following admittedly extreme example. Promoter A organizes Company B, and sells to it, for \$15,000, property which cost him \$10,000 three days before. Company B makes a public offering in which it intends to sell 1,000 shares. The company discloses in its prospectus that the price paid to the promoter was not the result of arms-length transaction. The first 1,000 persons approached reject the opportunity to purchase Company B's stock because of the promoters' deal. Company B then changes its policy and begins to solicit less sophisticated investors. The next 1,000 prospects, not knowing anything about the \$15,000 deal, purchase one share each and the company sends a prospectus to them when confirming the sale. Assuming no misleading statements were made during the sales campaign, the act would not subject anyone to liability. But is there any question that the promoters have made off with \$14,000 for no apparent good reason? Is it not reasonable to assume that this happens to a more or less degree in many promotional offerings?

<sup>163</sup> It should be recalled that the prospective purchaser does not have a wide choice when buying stock in a promotional company. Indeed, he really can either buy the stock and accept the promoters' bargain or refrain completely from purchasing stock in the company, but if disclosure were to constitute notification there would be no way to purchase stock and yet refrain from approving the promoters' deal. Compare holdings that disclosure made at a shareholders' meeting is of no effect where proxies on the bulk of shares have been previously solicited. See Hornstein, Corporation Law & Practice § 329 n.81 (1959), citing *Rogers v. Guaranty Trust Co.*, 288 U.S. 123 (1933) (dissenting opinion); *Berendt v. Bethlehem Steel Corp.*, 108 N.J. Eq. 148, 154 Atl. 321 (Ch. 1931).

demand are desirable or even adequate means of ensuring capital necessary to ensure satisfactory development of new businesses especially where the need has already been proven great.<sup>164</sup> Contrary to this it would seem not to be too harsh a burden to impose a simple test of fairness upon the promoter's activities. Although some degree of freedom of contract might be lost, still it is apparent that at present there is a certain lack of equality of bargaining power in favor of the promoter in the usual case and the broad standards suggested here would certainly offer adequate protection to the promoter.

Assuming such a standard were desirable and feasible, where could the public look for protection against promoter's excesses? Theoretically at least, the 1933 act is designed to compel disclosure only. State law does provide some likelihood that even assuming compliance with the 1933 act, the public could receive protection from a grossly unfair financing arrangement, since many states empower their officials to consider the fairness or merits of an offering.<sup>165</sup> In addition, several of the states have specific provisions limiting the percentage of stock a promoter receives for his participation in the promotion.<sup>166</sup>

Under general principles of state corporation law relief might be possible since the typical promoters' fraud is bottomed on a breach of fiduciary duty owed by the promoter to the corporation (although it is frequently accomplished by means of a failure to disclose<sup>167</sup>), and fraud for corporate law purposes has traditionally encompassed situations other than the strict meaning of the word,<sup>168</sup> including inequitable treatment such as a deprivation of preemptive rights<sup>169</sup> or the sale of control

<sup>164</sup> See footnote 152, *supra*. In addition there have been recent attempts to express a concern for the public's interest with regard to the promotion of the corporation for the new communications satellite. See S. Rep. No. 1584, H. Rep. No. 1636, to accompany H.R. 11040, 87th Cong., 2d Sess. (1962).

<sup>165</sup> Loss & Cowett, *Blue Sky Law* 36-37 (1958) (expressing doubt whether in fact the states are more paternalistic than the 1933 act).

<sup>166</sup> See, e.g., Cal. Corp. Code §§ 25507, 25508, article 7.1. In Crawford, "Promoters Compensation—Domestic and Foreign," 23 *Cinn. L. Rev.* 1, 5-6 (1954), it was said that custom and usage seem to agree and acquiesce:

[T]hat anything up to ten percent of the common stock was once considered fair compensation to promoters who merely conceived the plan for the enterprise. However, if the promoter owns the principal assets of the business . . . and acts as banker he may rightfully take as much as fifty-one percent, thus ensuring his control of the corporation. See also Berger, "Real Estate Syndication: Property, Promotion, and the Need For Protection," 69 *Yale L.J.* 725, 782 nn.245, 248 (1960).

<sup>167</sup> Strictly speaking, secrecy is not the basis for the promoter's liability. Rather, disclosure would only seem to bear upon the question of whether the promoter can be excused from liability for his actions in contravention of his fiduciary duty. Compare Isaacs, "The Promoter: A Legislative Problem," 38 *Harv. L. Rev.* 887, 893-94 (1925).

<sup>168</sup> Compare *Strong v. Repide*, 213 U.S. 419, 431-33 (1909); *People v. Federated Radio Corp.*, 244 N.Y. 33, 154 N.E. 655 (1926).

<sup>169</sup> Failure to protect preemptive rights breaches a fiduciary duty because it constitutes inequitable discrimination, which situation resembles in some respects the promoters' fraud. In *Elliot v. Baker*, 194 Mass. 518, 523, 80 N.E. 450, 452 (1907), the court said:



to persons who intend to rob the assets of the corporation.<sup>170</sup>

*Pipelife Corp. v. Bedford*<sup>171</sup> seems to be the first state case specifically concerned with whether compliance with the disclosure requirements of the 1933 act forecloses relief under state provisions.<sup>172</sup> The court held that in view of the state constitutional and statutory provisions which prevented the issuance of shares without adequate consideration, it did not.<sup>173</sup> Interestingly, the *Pipelife* case involved the question of whether a corporation, once freed of the bonds of the promoters, could avail itself of the watered stock remedies provided by state law, in order to recover from the promoters; the court found it could. If one were to apply the Chancellor's logic one step further to the typical promoter's fraud case, it would mean that disclosure would not bind the corporation but would permit review of the promoters' actions by an independent board of directors.<sup>174</sup> Such a holding would be welcome.

However, to depend upon relief from state law is not always wise because some states have not been able to provide real protection to the public either because of inadequate statutory authority or enforcement capabilities. It is therefore desirable to examine the federal securities laws. Under federal law the problem becomes more difficult, because of the underlying philosophy of the 1933 act of disclosure.<sup>175</sup> Of course, it is not advocated here that the Commission be given authority to pass upon the merits of a particular offering. Yet by the same token disclosure should not be construed as eliminating recovery under other sections, as such with the antifraud provisions, because in at least one respect the 1933 act is not designed to require a revelation of *all* information respecting the promoters' dealings, which may be highly relevant to the question of a promoter's fraud.<sup>176</sup>

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The directors of a corporation act in a strictly fiduciary capacity. Their office is one of trust and they are held to the high standard of duty required of trustees. They cannot be permitted so to manage the affairs of their *cestuis que trust* that the system of business corporations by which so large a part of the world's work is now conducted, "may become a system of frauds."

<sup>170</sup> *Keystone Guard v. Beaman*, 264 Pa. 397, 402, 107 Atl. 835, 837 (1919). See generally Leech, "Transactions in Corporate Control," 104 U. Pa. L. Rev. 725 (1956).

<sup>171</sup> 145 A.2d 206 (Del. Ch. 1958). In *McClure v. Borne Chemical Co.*, 292 F.2d 824 (3d Cir. 1961), in ruling that state security of expenses statutes do not apply to actions under Rule 10b-5, the Third Circuit had before it a complaint which alleged a fraudulent deprivation of preemptive rights as a violation of Rule 10b-5. 292 F.2d at 826.

<sup>172</sup> Although the disclosure made in *Pipelife*, *supra* note 171, was in compliance with Reg. A and not a full registration, this difference was not a significant factor in the case.

<sup>173</sup> See footnote 171, *supra*.

<sup>174</sup> There would still remain certain practical considerations such as when does a board become independent? Assuming this question can be answered, there is a very strong likelihood that the promoters would continue to control the company.

<sup>175</sup> The question of legislative change, although providing a possible answer, will not be discussed herein.

<sup>176</sup> For instance, the disclosure requirements do not require that the promoters' cost to be disclosed unless he transferred it to the company within the last two years nor is it

Under such circumstances it is submitted that section 10(b) could apply because the defendant's conduct might be fraudulent irrespective of his compliance with the disclosure requirements. Here especially "fraud" refers not to the strict common law situation but is considered to encompass inequitable situations.<sup>177</sup>

Although it is beyond the scope of this paper to attempt to suggest the outer limits of "fraud" as used in Rule 10b-5, it seems clear to the present author that in situations where there is a substantial disparity of information between insiders and the public, the rule should apply. It is difficult to articulate hard and fast rules in this area because of the variety of circumstances in which problems arise, but this should not hinder a recognition that substantively "fraud" as used in Rule 10b-5 is very broad. The difficult task is drawing a consistent and meaningful distinction between profit-seeking conduct considered proper and that whereby an insider improves his own position at the expense of the public by reason of information not readily available. It is submitted that every time there is this substantial disparity of information the insider's conduct is similar to the common law conscious concealment of a material fact, the only difference being, at most, one of degree and not

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necessary even to indicate the promoters' compensation, direct or indirect, unless the company was organized within the last five years. See Form S-1, Item II; Form S-3, Item 12.

<sup>177</sup> Note, 71 Yale L.J. 736, 737 (1962). In *McClure v. Borne Chemical Co.*, 292 F.2d 824 (3d Cir. 1961) although the court did not pass on the merits of plaintiff's Rule 10b-5 allegations, it appears clear that the court felt these provisions should apply where there have been breaches of fiduciary duty, or other intracorporate abuses by management. It said, *inter alia*:

[T]he federal provisions [ §§ 10(b), 29(b) ] are part of a new statutory scheme which had as its purpose the creation of a new federal law of management-stock-holder relations. . . .

That Act [ Securities Exchange Act of 1934 ] deals with the protection of investors, primarily stockholders. It creates many managerial duties and liabilities unknown to the common law. It expressed federal interest in management stockholder relationships which theretofore had been almost exclusively the concern of the states. Section 10(b) imposes broad fiduciary duties on management vis-à-vis the corporation and its individual stockholders. As implemented by Rule 10b-5 and Section 29(b), Section 10(b) provides stockholders with a potent weapon for enforcement of many fiduciary duties. It can be said fairly that the Exchange Act, of which Sections 10(b) and 29(b) are parts, constitutes far reaching federal substantive corporation law.

*Id.* at 834.

[T]here seems no rational basis for concluding that the right of action implied from Section 10(b) bears a greater similarity to sections limited by security requirements than it does to Section 16(b) which is unencumbered by that requirement. Indeed, a persuasive argument could be made that the plaintiffs' complaint in the present case, alleging as it does fraudulent dealing by insiders to the detriment of stockholders, sounds as much in Section 16(b) as in any other liability section contained in the Acts.

*Id.* at 837.

In *Mills v. Sarjem Corp.*, 133 F. Supp. 753, 764-65 (D.N.J. 1955), defendants had not disclosed their plans for the company whose stock they were attempting to purchase, which would greatly enhance the value of the shares. Since they were not stockholders (even though they held options to purchase shares and contingent proxy voting rights), and had not received information from inside sources, it was held that they did not owe a fiduciary duty to the selling stockholders.

of kind. Rule 10b-5, however, by emphasizing that fraud is comparable to a breach of fiduciary duty, should provide the necessary force to shift the burden from the public to the insider which was not usually so at common law.

The important point to be made is that disclosure should not insulate the promoter, and the matter should be left open to examination on a case by case basis.

There would appear to be some justification for such a holding. The courts have taken the attitude that acts which constitute violations of the disclosure requirements *also* constitute violations of Rule 10b-5. This suggests that these sections operate independently of each other and that Rule 10b-5 is much broader than the specific civil liability provisions which provide remedies if there is a failure to disclose. In addition, the three leading cases which have dealt with the problem of what constitutes a fraud within the meaning of the 1934 act involved essentially a breach of fiduciary duty.<sup>178</sup> In addition the rule has been applied broadly to cover a wide range of situations.<sup>179</sup>

Concerning the more difficult aspect of whether 10b-5 could perhaps be utilized to check promoters' excesses occasioned by a grossly unfair situation, more caution must be exercised. At the present time there is no direct support for such relief under either the 1933 act or the 1934 act; indeed such an interpretation would raise fundamental and serious questions which might conflict with the philosophy of the 1933 act.<sup>180</sup> However, considering that promoter's fraud does constitute not only economically and socially undesirable conduct but also a breach of fiduciary duty, it is perhaps possible that given the proper circumstances Rule 10b-5 can be invoked to provide relief.<sup>181</sup>

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<sup>178</sup> See *Norris & Hirshberg, Inc. v. SEC*, 177 F.2d 228, 233 (D.C. Cir. 1949); *Hughes v. SEC*, 174 F.2d 969 (D.C. Cir. 1949); *Charles Hughes & Co. v. SEC*, 139 F.2d 434 (2d Cir. 1943), cert. denied, 321 U.S. 786 (1944). These antifraud provisions apply irrespective of whether the particular security or transaction is exempt. See Sargent, "Pledge and Foreclosure Rights Under the Securities Act of 1933," 45 Va. L. Rev. 885, 888 (1959).

<sup>179</sup> See *Cochran v. Channing Corp.*, Civ. No. 62-2597 (S.D.N.Y. Nov. 15, 1962).

<sup>180</sup> But cf. *Pub. Util. Holding Co. Act of 1935* § 11; *Investment Co. Act of 1940* (S. Rep. No. 1775, 76th Cong., 3d Sess., 11-12; H. Rep. No. 2639, 76th Cong., 3d Sess. 10 (1933)).

<sup>181</sup> Cf. *SEC v. Chenery Corp.*, 318 U.S. 80, 92 (1943). Even though it was conceded that corporate officers had made full disclosure and had paid a fair price for the stock they purchased, such act could be prohibited as not constituting a fair and equitable plan. The Court said that "abuse of corporate position, influence, and access to information may raise questions so subtle that the law can deal with them effectively only by prohibitions not concerned with the fairness of a particular transaction."