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Corporations—Section 10(b) of Securities Exchange Act—Rule X-10B-5—Private Right of Action for Defrauded Issuing Corporation.—Hooper v. Mountain States Securities Corp.

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Corporations—Section 10(b) of Securities Exchange Act—Rule X-10B-5—Private Right of Action for Defrauded Issuing Corporation.—*Hooper v. Mountain States Securities Corp.*[1]—One BenJack Cage had controlled Consolidated American Industries, Inc. and had been an officer and director thereof. In October 1956, he resigned in favor of a new management. Shortly thereafter he conspired with the other defendants to obtain 700,000 shares of Consolidated's unissued stock in exchange for certain assets of another corporation, Mid-Atlantic Development Company, which was owned by Cage and the other defendants. The assets to be exchanged, consisting in certain purported rights to purchase stock of a Cuban insurance company and to acquire certain oil concessions in Honduras, were presumably without value. To obtain for Mid-Atlantic the right to purchase the Cuban insurance company stock, Cage, through interstate communications to the new management of Consolidated, made false representations whereby Consolidated was induced to send $10,000 to Cuba. Thereafter the defendants' scheme was consummated through the preparation and presentation to Consolidated's transfer agent of certain spurious documents purporting to show authorization for the issuance of 700,000 of Consolidated's shares in exchange for the "rights" owned by Mid-Atlantic. At the time par value of Consolidated's shares was 1¢; market value varied from $1.00 to $2.75 per share. Plaintiff, as trustee in bankruptcy of Consolidated, brought suit in the United States District Court for the Middle District of Alabama alleging that Consolidated was injured as a result of defendants' fraudulent conspiracy in violation of Section 10(b) of the Securities Exchange Act[2] and the Commission's Rule X-10B-5,[3] and seeking an accounting and damages. Defendants moved to dismiss contending that: (i) an issuer was not an investor within the meaning of Section 10(b) and Rule X-10B-5 and therefore could

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[1] 282 F.2d 195 (5th Cir. 1960), cert. denied, 29 U.S.L. Week 3240 (U.S. Feb. 21, 1961).

[2] Section 10(b), Securities Exchange Act of 1934, 48 Stat. 891 (1934), 15 U.S.C. § 78j(b) (1958): "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 . . . (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

[3] Rule X-10B-5, 17 C.F.R. 240.10b-5 (Supp. 1960):

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

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

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

not predicate a private right of action thereunder; and (ii) there was no "sale" of securities by Consolidated. The District Court, relying principally on *Howard v. Furst*,[4] accepted defendants' contentions and dismissed the complaint. The Court of Appeals for the Fifth Circuit reversed and remanded. HELD: Although not an investor,[5] the issuing corporation could predicate a private right under X-10B-5.[6] The issuance was a "sale" within the meaning of the Act.

This case presents the first important consideration[7] of a defrauded corporate issuer's right to bring an action under Rule X-10B-5.[8] Although there is no specific section of the Securities Exchange Act creating civil liability under Section 10(b) or Rule X-10B-5, the violation thereof has been held to create civil liability on the theory that where violation of a prohibitory statute causes injury to a person whose interest the statute was intended to protect, that person has a right of action.[9] Previously civil suits successfully

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[4] 238 F.2d 790 (2d Cir. 1956), cert. denied, 353 U.S. 937 (1957). In that case a civil action was brought as a stockholders' derivative suit alleging a violation of Securities Exchange Act § 14(a), 15 U.S.C. § 78n(a), and Rule X-14A-9, 17 C.F.R. 240.14a-9 (Supp. 1960), on solicitation of proxies. In affirming the dismissal of the complaint the court said:

> ". . . Here the statute authorizes the formulation of rules and regulations 'in the public interest or for the protection of investors.' There is literally nothing to support the view that any substantial rights were created for the benefit of the corporation." (793).

[5] It is notable that plaintiff argued alternatively that if the issuing corporation were not a "seller," it was a "purchaser." It would seem that if the court had accepted this latter contention, it would have had no difficulty finding the corporation an "investor." The rejection of this approach is probably explained by the existence of a difficult question as to whether defendants' spurious assets were "securities" within the meaning of the Act. On the latter point see § 3(a)(10), 48 Stat. 882 (1934), 15 U.S.C. § 78(c)(a)(10) (1958); Loss, Securities Regulation 302, 305 (1951).

[6] This contradictory interpretation of identical language in two similar sections of the Act (see supra note 4) is probably justifiable in light of the peculiar legislative history of § 14(a). A provision expressly authorizing regulations under the section for the protection of the corporate issuer as well as investors was stricken from the Act prior to its passage. H.R. 9323, Union Cal. No. 302 (Apr. 25, 1934). Section 10(b) has no such legislative history. Moreover the interpretation in Howard v. Furst must be viewed in light of the isuue therein, which was, essentially, whether a corporation had a cause of action based on its own violation.

[7] In H. L. Green Co. v. Childree, 185 F. Supp. 95 (S.D.N.Y. 1960), decided some five weeks before the present case, the District Court decided the issuance of a corporation's stock in exchange for the stock of another corporation was a "purchase or sale" within the meaning of § 10(b) and the defrauded corporation had a federal cause of action. However, the case presents no discussion of the issues pertinent here.

[8] The advantages of basing the action on violation of the Securities Exchange Act rather than on common law fraud and deceit or on the watered stock doctrine [in this case as set out in the Const. Del., Art. IX, § 3; Del. Code Ann. tit. 8, §§ 152, 163, 164 (1953)] are substantial. Section 27 of the Act, 48 Stat. 902 (1934), 15 U.S.C. § 78aa (1958), allows liberal choice of forum and nationwide service of process. In addition, the federal action removes such obstacles as the requirement of privity, proof of specific damage, inadequacy of the right of rescission or the right to recover up to par value of stock of a much greater market value. See Comment, 59 Yale L.J. 1120, 1130-33 (1950): White, Swindlers and the Securities Acts, 45 A.B.A.J. 129 (1959).

[9] Fratt v. Robinson, 203 F.2d 627 (9th Cir. 1953); Fischman v. Raytheon Mfg. Co.,

maintained under the Rule had been brought by persons within the "investor" class and thus clearly within the class afforded protection by the statute.

Defendants' argument against allowing recovery under Rule X-10B-5 to a corporation issuing its own stock in exchange for consideration ran somewhat this way. Issuance, interpretation, and application of a regulation may not extend beyond the limits of its legislative source. The enabling act, Section 10(b), gives the SEC the power to prescribe only those rules "necessary or appropriate in the public interest or for the protection of investors." To the extent that the statute is designed to protect the interests of the state or the public as a whole, violation results in no civil liability [witness Restatement, Torts Sections 286-88 (1934)]. Thus Rule X-10B-5 can give rise to a private right of action only in the event the "seller" or "purchaser" is an "investor." The conclusion is that, whatever it may be, such corporate issuer as is here involved is not an "investor." The court agreed with defendants that Consolidated was not an investor.[10] This seems quite correct. Although the term "investor" is not defined in the Act, in its normal use it refers to one who lays out money or capital with a view to obtaining income or profit. The mere issuance of stock, qua issuance, for the purpose of increasing assets, is not in any sense an investment. This is not to say a corporation could not be an invester in appropriate circumstances, for example, (i) where it sells stock of other corporations from its portfolio, (ii) where it buys securities of another corporation,[11] or, perhaps, (iii) where a corporation either purchases its own stock to hold as treasury stock or sells from its treasury stock. Having granted that Consolidated was not an investor, the court held that nonetheless the words "in the public interest" gave rise to a private right of action. This is the crucial holding of the case; it is by no means an inevitable one on the facts. Defendants' contention that "in the public interest" shows only an intent to protect the public generally, therefore giving rise to no private rights, is a strong one particularly in light of the alternative language "or for the protection of investors" —the classic maxim of statutory interpretation: *expressio unius exclusio alterius*. The court certainly could not have been criticized from a technically legal point of view if it had accepted this contention. By the same token it can hardly be criticized for interpreting the language "in the public interest" as seeking to protect those very persons who would be engaged in securities transactions and giving them a standing apart from that of the public generally. The courts position is aided by the stated purpose of the Act as set forth in Section 2,[12] *inter alia*, "to insure the maintenance of fair and honest markets [in securities transactions]," and make the control of

188 F.2d 783 (2d Cir. 1951); Slavin v. Germantown Fire Ins. Co., 174 F.2d 799 (3d Cir. 1949); Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946). See Restatement, Torts §§ 286-88 (1934); Prosser, Torts § 39 (2d ed. 1955); Thayer, Public Wrongs and Private Actions, 27 Harv. L. Rev. (1913).

[10] Supra note 1, at 201-02.

[11] In this case the court chose to view Consolidated as a "seller" and not as a "purchaser." See supra note 6.

[12] 48 Stat. 881 (1934), 15 U.S.C. § 78b (1958).

securities "reasonably complete and effective." It is certainly in the interest of "fair and honest markets" to prevent corporate issuers of securities from being defrauded; nothing will tend more to deter fraudulent practices in this area and thus make the Act more "reasonably complete and effective" than to give the defrauded issuer a right to seek redress in damages in the federal courts. Ultimately the problem seems to be a jurisprudential one. Either interpretation would seem equally defensible. In this situation the court could quite properly consider the ultimate effect which would be produced if either interpretation were applied to similar cases, and choose that interpretation which, when applied, would produce the greatest advantage to the general community. Beyond a doubt the courts position is that calculated to produce the best effect in the community.

Defendants further denied that the transaction by which the corporation was allegedly defrauded into issuing its stock constituted a "sale." Defendants' major objection to holding the transaction a sale appears to have been the contention that the corporation gave up nothing of value. This is founded on the accounting theory that issuance of stock is not a reduction of assets and thus issuance without compensation does not cause any loss to the corporation but only results in a reduction of the value of the shares of the other stockholders. The court held that if the transaction were not a sale in the common law traditional sense, it certainly was an arrangement coming within the definition of "sale" in the Act,[13] i.e., "any contract to buy, purchase, or otherwise dispose of." This conclusion also seems proper. Defendants' contention disregards too far the corporate entity. It fails also to take into account the substantial effect of the transaction. The corporation has suffered a loss in the sense that it has given up something which it could have sold or traded elsewhere, thereby acquiring assets. Further, the corporation has acquired a liability, not in the technical sense, but in the sense that it has obliged itself to pay a percentage of its assets to the holders of the issued stock upon liquidation (assuming a liquidation with assets). It appears that the court has correctly found that the controlling factor is the substantial effect of the transaction in light of the Congressional purpose to curb fraudulent stock transactions, rather than a semantic interpretation of "sale."

The case indicates the unwillingness of the court to accept a confining view of Section 10(b) and Rule X-10B-5. This is in accord with the background and history of the Securities Exchange Act generally, wherein fraud is sought to be prohibited. Here the fraud was monumental. Any remedy but that afforded by a private action under Rule X-10B-5 was demonstrably inadequate. The court quite properly rendered its decision in the light of these considerations.

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[13] Securities Exchange Act § 3(a)(14), 48 Stat. 882 (1934), 15 U.S.C. § 78c(a)(14) (1958).