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## Civil Liabilities Under the Securities Act of 1933

John E. Curby

*Washington University School of Law*

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will affirm the decisions of the lower federal courts and declare securities to be subjects of interstate commerce.

What will the Supreme Court decide if it is faced with the task of determining the validity of the Securities Act of 1933? That is a question which this writer will not assume to answer. It can be said, nevertheless, that the court, if it so desires, would find no difficulty in affirming the Act as being within the power of Congress to regulate commerce among the states. *Gibbons v. Ogden*, the *Pigg Case*, and the decisions of the inferior federal courts define commerce to be *intercourse*, so as to include the sale, offer to sell, and transportation of securities. On the basis of the *Lottery Case*, the transportation of securities is traffic subject to federal control. These authorities should prevail over *Paul v. Virginia* and *Nathan v. Louisiana* since those cases have been distinguished on other grounds.

HERMAN GORALNIK, '35.

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#### CIVIL LIABILITIES UNDER THE SECURITIES ACT OF 1933

The purchaser of a misrepresented security, who suffers a loss thereby, would naturally hold certain groups of persons morally responsible for his having been injured. These groups would usually include the issuer, the underwriters, the persons or institutions assisting the underwriter in distributing the security, and the salesman from whom the security was purchased. The actions available to such an injured party at common law were limited to an action at law in fraud and deceit and a proceeding in equity to rescind the contract of purchase. The nature of these actions necessarily restricted the number of persons against whom the purchaser could recover. In England legislation has extended this group, and it is with this background of experience that Congress has enacted the Securities Act of 1933.<sup>1</sup>

In an action for fraud and deceit the burden was upon the plaintiff<sup>2</sup> to prove that the defendant made a material misrepresentation with knowledge that it was false, or made it recklessly without regard to its truth, and that the plaintiff relied<sup>3</sup> upon the

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<sup>1</sup> "The committee is fortified in these sections (secs. 11 and 12) by similar safeguards in the English Companies Act of 1929. What is deemed necessary for sound financing in conservative England ought not to be unnecessary for the more feverish pace which American finance has developed." 73d Congress, 1st Sess. House Report No. 85, p. 9.

<sup>2</sup> 2 Cooley on Torts (4th ed.) par. 349.

<sup>3</sup> But a defendant is liable when the public is to be influenced to act by the representation: *Paddock v. Fletcher* (1869) 42 Vt. 389; *Terwiliger v. Gt. Western Tel. Co.* (1873) 59 Ill. 249.

statement and suffered injury thereby. It was, therefore, comparatively easy for an astute securities salesman to defend himself in such a suit because all he had to prove was one of the following sets of facts: (1) That the plaintiff knew of the misstatement or should have known as a reasonable person;<sup>4</sup> (2) that the plaintiff did not rely upon the misstatement;<sup>5</sup> (3) that the misstatement was not a material one;<sup>6</sup> or (4) that the defendant did not know of the untruth of the statement<sup>7</sup> or act carelessly in not ascertaining the untruth.<sup>8</sup> The problem thus arose how to protect the investor not only from the actual misrepresentations of a salesman, but also from the statements made in a prospectus by promoters or directors of a corporation which was about to issue a security. Normally there were no actual misrepresentations in the prospectus, but there might not be a full disclosure of facts which would give an entirely different outlook to the security from an investor's point of view. Such facts should be made known to the investor in order for him not to be misled into making a poor investment.

In 1889 the English court, in the celebrated case of *Derry v. Peek*,<sup>9</sup> decided that a director of a company, issuing a prospectus, was not liable for false statements that were negligently made in the prospectus. The following year Parliament passed the Directors' Liability Act<sup>10</sup> by which a director was made liable for material<sup>11</sup> misrepresentations that were made, unless it could be shown that he had reasonable grounds to believe that the statements were true. This same liability has been preserved in all the subsequent English Companies Acts.<sup>12</sup> Thus the burden was placed upon the directors of corporations to be careful as to what was in the prospectus.

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<sup>4</sup> 12 R. C. L., par. 10, *Farrar v. Churchill* (1890) 135 U. S. 609; *Morris v. McMahan* (1898) 75 Mo. App. 494; *McFarland v. Carlsbad Hot Springs Sanitarium Co. et al.* (1913) 68 Ore. 530, 137 Pac. 209, Ann. Cas. (1915) C. 555.

<sup>5</sup> None has a right to rely upon representations but those to whose influence whose actions they were made. See: *Hindman v. First Nat'l Bank* (1902) 112 Fed. 931, and *Henry v. Dennis* (1901) 95 Me. 24; 49 A. 58.

<sup>6</sup> 2 Cooley on Torts (4th ed.) par. 362, and cases cited.

<sup>7</sup> *Ibid.*, par. 348. Plaintiff must show material misrepresentation.

<sup>8</sup> Cf. *Taylor v. Ashton* (1843) 11 M. and W. 401, 152 Eng. Rep. 860, and *Beebe v. Knapp* (1873) 28 Mich. 53.

<sup>9</sup> (L. R.) 14 A. C. 337.

<sup>10</sup> Directors' Liability Act 1890 (52 and 54 Vict., ch. 64).

<sup>11</sup> The English courts have held that where "material" contracts are required to be stated in the prospectus, any contract that would be likely to influence the judgment of an intending applicant as to whether or not he should take up the shares would be deemed material. *Sullivan v. Metcalf* (1880) 5 C. P. Div. 455; *Twycross v. Grant* (1877), L. R. 2 C. P. Div. 409; *Cackett v. Keswick* (1902) 2 Ch. 456.

<sup>12</sup> Companies Act 1929 (19 and 20 Geo. 5 c. 23) s. 37.

Parliament, however, soon discovered that this liability alone was not sufficient to deter the issuing of securities which were really unsafe for the public to purchase as an investment. There were, therefore, further stringent regulations imposed upon those issuing a prospectus,<sup>13</sup> or in case a prospectus was not to be used, upon those filing statements with the registrar.<sup>14</sup> These regulations consisted of requiring facts as to the promoting and organization of the company, the shares of stock authorized, commissions paid to promoters, interest of directors in property purchased by the company, amount of paid in shares, to what use and extent the sums received from the issue will be utilized, and many other facts which were formerly known only to the men organizing the company.<sup>15</sup> A misstatement or failure to state a material fact<sup>16</sup> required to be stated in the prospectus or statement filed with the registrar, would make the director or promoter, or any other person authorizing the issuance of the prospectus, liable for the damages<sup>17</sup> sustained by any person subscribing to the issue who had relied<sup>18</sup> upon the prospectus or statement. These same persons were also made liable to a fine for not only having made fraudulent<sup>19</sup> misstatements of material facts, but also for failure to state material facts that were required by the act to be stated in the prospectus.<sup>20</sup>

Under the English Companies Act the subscriber to shares under the prospectus was the only person who could hold the director or the promoter liable.<sup>21</sup> Furthermore, it was neces-

<sup>13</sup> *Ibid.*, Sched. IV, parts 1, 2 and 3.

<sup>14</sup> *Ibid.*, Sched. III.

<sup>15</sup> See notes 13 and 14.

<sup>16</sup> In an action to hold a subscriber the court held: That the mere reference to an important contract was not true notice of the contract. One should look at the entire prospectus together to see if it is fraudulent. *Aarons Reef v. Twiss* (1896) A. C. 273. In the case of *Greenwood v. Leather Shod Wheel Co.* (1900) 1 Ch. 421 (C. A.) the court held that disclosure under the Companies Act cannot be evaded by a general waiver clause in the prospectus or the contract to take shares.

<sup>17</sup> Companies Act 1929. (19 and 20 Geo. 5, c. 23) s. 37 (1) (a), (b), (c), (d).

<sup>18</sup> *Ibid.*, s. 37. (1)—“Shall be liable to all persons who subscribe for any shares or debentures on the faith of . . .”

<sup>19</sup> *Ibid.*, s. 35.

<sup>20</sup> In the famous case of *Rex. v. Kysant* (1931) 1 K. B. 442, the court held a director liable under the Larceny Act 1861 (24 and 25 Vict. c. 96) s. 84, for wilful failure to state material facts. This extended the liability that was under the Companies Act (*supra*) n. 18.

<sup>21</sup> Companies Act 1929 (19 and 20 Geo. 5 c. 23) s. 37 d. See also *Peek v. Gurney* (1873) L. R. 6 H. L. 377, wherein the court held that prospectus was not addressed to persons who may read it and buy shares in the open market on the faith of it. But this does not apply where the prospectus was used to induce a person to take shares in the open market. *Andrews v. Mockford* (1896) 1 Q. B. 372.

sary that the plaintiff have relied upon the misstatement or omission of fact in the prospectus.<sup>22</sup>

These legislative enactments shifted the burden of proof upon the defendant in such cases. The defendant was liable unless he could prove: (1) That the plaintiff did not rely upon the misstatement; (2) that there was no misstatement; or (3) that the defendant believed that the statements were true and had reasonable<sup>23</sup> grounds for such belief. There were also other defenses such as that the defendant had removed his name from the prospectus as soon as he had learned of the misstatement and gave due notice of the removal; that his name was used without his consent; that he had withdrawn his name before the issuance of the prospectus; and that the statements were those of experts which he had reasonable ground to believe and did believe to be true.<sup>24</sup>

Under the English Companies Act of 1929 there is a provision that there may be contribution among all those who are responsible for the issuing of the prospectus,<sup>25</sup> thus changing the former rule that contribution among joint tort-feasors is not permissible.<sup>26</sup>

From this brief sketch it can be seen that there has been an active effort on the part of Parliament to restrict the issuance of fraudulent securities. The grounds upon which an action against a person misleading others as to the purchase of securities might be maintained were broadened over a period of years.

In the United States there have been many attempts to regulate the issuance of securities. These attempts have consisted mainly of the passage of State "Blue Sky" laws.<sup>27</sup> Despite these ef-

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<sup>22</sup> See note 21 above as to Companies Act.

<sup>23</sup> The English courts have refrained from giving an exact definition of reasonable, but they have held, for instance, that the mere reliance upon a statement of a manager or co-director by another director signing the prospectus was not reasonable grounds for belief. *Adams v. Thrift* (1915) 2 Ch. 21. (This might have an effect upon the American courts when they are called upon to decide whether or not a director had reasonable grounds for belief—see section 11, Securities Act of 1933.)

<sup>24</sup> Companies Act 1929 (19 and 20 Geo. 5 c. 23) s. 37 (d i-iv).

<sup>25</sup> *Ibid.*, s. 37 (3).

<sup>26</sup> Cf. *Gerson v. Simpson* (1903) 2 K. B. 197.

<sup>27</sup> Delaware and Nevada are the only two states that have not passed "Blue Sky" laws. There have been several attempts to pass federal laws regulating the sale of securities, but the only regulation by the federal government prior to the enactment of the Security Act of 1933 was by means of the Postal Fraud Act. U. S. C. A. Title 18, par. 338. Cf. Ashby, "Federal Regulation of Securities Sales," (1928) 22 Ill. Law Rev. 635; and Thompson, "Regulation of Security Sales in Interstate Commerce," 1923, 9 A. B. A. J., 157.

Sed vide 12 R. C. L. 347, par. 102: "It is sometimes declared that in actions for damages for false representation it is not necessary to allege or prove

forts, as President Roosevelt said in his message to the Seventy-Third Congress, ". . . the public has sustained severe losses through practices neither ethical nor honest on the part of many persons and corporations selling securities." In actions for fraud and deceit many states have followed the decision of *Derry v. Peek*.<sup>28</sup> Recovery would be denied unless a person could prove fraud on the part of the defendant.<sup>29</sup> *Scienter* was one of the necessary elements of the action.<sup>30</sup> The burden was still upon the plaintiff to prove all the allegations necessary to support a common-law action of fraud and deceit.<sup>31</sup> The Securities Act of 1933 was passed to remedy this situation.

Congress relied upon the precedents set by Parliament in the English Companies Act of 1929,<sup>32</sup> both as to the requirements that should be stated in the prospectus or registration statement and as to the civil liabilities imposed. There are two main divisions of civil liability arising under the Act. The first<sup>33</sup> is the liability arising from making a false registration statement, the second<sup>34</sup> is the liability imposed upon persons who have violated section 5 of the Securities Act,<sup>35</sup> or who have used false prospectuses or made false oral representations through the mails or in interstate commerce in order to sell securities.

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scienter, or that the the representations were recklessly made in conscious ignorance of whether they were true or not, but that it is sufficient if the representations were false in fact, and that the defendant may be liable for damages because of them even though he did not know they were untrue." See also: *Carter v. Glass* (1880) 44 Mich. 154, 6 N. W. 200; *Genner v. Mosher* (1899) 58 Neb. 135, 78 N. W. 384, 46 L. R. A. 244; *Foster v. Kennedy* (1862) 38 Ala. 359; *Aldrich v. Scribner* (1912) 154 Mich. 23, 117 N. W. 581, 18 L. R. A. (N. S.) 379; *Westerman v. Corder* 1912, 86 Kan. 239, 119 Pac. 868, 39 L. R. A. (N. S.) 160.

<sup>28</sup> See above note 9.

<sup>29</sup> "Mere ignorance, or negligence, or stupidity on the part of the persons making the representations does not constitute fraud if he intends honestly to tell the truth, although his statements understood according to their seeming meaning may be ever so misleading." *Kountze v. Kennedy* (1895) 147 N. Y. 124, 41 N. E. 414, 29 L. R. A. 360.

<sup>30</sup> *Peters v. Lohman* (1913) 171 Mo. App. 465, 156 S. W. 783; *Reno v. Bull* (1916) 226 N. Y. 546, 124 N. E. 144. Knowledge presumed, see 12 R. C. L. 335 and cases cited. Cf. *Jeremiah Smith*, "Liability for Negligent Language," (1900) 14 Harv. Law Rev. 184. English equity courts find fraud without mens rea, see *Nocton v. Ashburton* (1914) H. L. A. C. 932. See also 12 R. C. L. 347, par. 102.

<sup>31</sup> Fraud is never presumed and the party alleging and relying upon it must prove it. *Hoeller v. Haffner* (1900) 155 Mo. 56, 56 S. W. 312; *Bowden v. Bowden* (1874) 75 Ill. 143.

<sup>32</sup> Cf. 73d Cong., 1st Sess. Senate, Report No. 47, p. 5; 73d Cong., 1st Sess. H. R., Report No. 85, p. 9.

<sup>33</sup> May 27, 1933, c. 38. Title 1, par. 11.

<sup>34</sup> *Ibid.*, par. 12.

<sup>35</sup> May 27, 1933, c. 38. Title 1, par. 5. This section makes it unlawful: 1. To use any means of communication or transportation in interstate com-

The Securities Act requires that where securities are to be sold in interstate commerce, a registration statement must be filed with the Federal Trade Commission.<sup>34</sup> This statement must contain some thirty-two different facts regarding the organization of the issuing company:<sup>37</sup> the directors, salaries of over \$25,000 commissions to be paid for underwriting, etc. There are certain securities that are exempt from this provision, such as state and governmental securities, short-term banking transactions, securities of building and loan associations, common-carrier securities, and others;<sup>38</sup> and, therefore the liabilities arising from the making of a false registration statement do not apply. But all kinds of securities are covered under the second division of liability mentioned above.<sup>39</sup>

Section 11 of the Securities Act allows any person acquiring a security which should have been registered to bring an action provided that he does so in good faith if he establishes one of the following groups of facts:

1. That there has been a misstatement of a material fact in the registration statement.
2. That there has been an omission<sup>40</sup> to state a material fact required to be stated in the registration statement.
3. That there has been a failure to state a material fact which would be necessary to prevent other statements from being misleading.

The liabilities under this section extend to the issuers, directors, or persons named as about to become directors, partners, or per-

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merce, or the mails, for selling securities for which a registration statement has not been duly filed. 2. To send such a security through interstate commerce or the mails after sale. 3. To use mails or instruments of interstate commerce to carry a prospectus of a security unless the same complies with the regulations set forth in sec. 10 of this Act. 4. To send a security for sale or for delivery after sale through interstate commerce or the mails which has not been preceded by a prospectus in accordance with sec. 10 of this Act. Par. 5 is not to be interpreted as to include sales of securities which sale takes place entirely through intra-state transactions.

<sup>36</sup> *Ibid.*, par. 6.

<sup>37</sup> *Ibid.*, schedules A and B.

<sup>38</sup> *Ibid.*, par. 3. This paragraph sets forth all the exempted securities.

<sup>39</sup> *Ibid.*, par. 12.

<sup>40</sup> At common law mere non-disclosure was not actionable, that is a complete failure to give any facts as to the matter in question; *Keats v. Earl of Cadogen* (1851) 10 C. B. 591; but see *New Brunswick v. Muggeridge* (1860) 1 Dr. and Sm. 383, 62 Eng. Rep. 418, where the court held, in an action to enforce a contract, that a person contracting to take shares on the statements in a prospectus has a right not only not to be misled by any statements actually false, but also to be informed of all the facts the knowledge of which might reasonably have deterred him from so contracting. (This is known as the "Golden Rule" for prospectuses.)

sons named as about to become partners, underwriters, and experts<sup>41</sup> whose signed statements are in the registration statement. The following are the defenses available to the above:<sup>42</sup>

1. To the issuer: That the plaintiff knew of the misstatement or omission at the time of acquiring the security. (This practically makes the issuer an insurer of the statements in the registration statement.)

2. To those other than the issuer excluding experts: (a) That the plaintiff knew of the misstatement or omission, before acquiring the security. (b) That he had resigned from his position as director, etc., prior to the effective date of registration, and that due notice was given the public. (c) Lack of notice or knowledge of the fact that he was named in the registration statement. (d) Reasonable ground to believe and that he did believe in the truth and accuracy of the registration statement.

3. To experts: (a) Same as 2 (a). (b) Defendant actually believed in the statement made, that there were reasonable grounds for that belief, and that there was reasonable investigation as basis for that belief. (c) The defective part of the registration statement was not fairly representative of his statement. (d) Defective statement was not a fair copy or extract of the report or valuation.

Under section 11 there is a right of contribution<sup>43</sup> among those liable under that section, and the duty of reasonableness imposed upon those making the registration statement is that of a person in a fiduciary capacity.<sup>44</sup>

A plaintiff endeavoring to recover under section 12 need only prove either that there has been a violation of section 5,<sup>45</sup> and that the defendant had sold him the security in violation thereof, or in cases where the seller has used a prospectus or an oral communi-

<sup>41</sup> *Glanzer v. Shepard* (1912) 233 N. Y. 236, 135 N. E. 275, 23 A. L. R. 1425, held that a weigher was liable for his negligence when he knew that a third person would rely upon his statements. This extended the rule that had been layed down in *MacPherson v. Buick Motor Car Co.* (1916) 217 N. Y. 393, 111 N. E. 1050. But in the case of *Ultramares v. Touche* (1931) 255 N. Y. 170, 174 N. E. 441, 74 A. L. R. 1139, it was held that liability should not be extended to accountants even though they were grossly negligent and knew that some third person would rely upon their statements because such a great liability would be against public policy. Thus we can readily see that this act has gone far in extending liability for negligence.

<sup>42</sup> May 27, 1933, c. 38. Title 1, par. 11 (b).

<sup>43</sup> May 27, 1933, c. 38. Title 1, par. 11 (f).

<sup>44</sup> *Ibid.*, par. 11 (c). As to the nature of fiduciary duty see American Restatement of the Law of Trusts, sec. 169. Also see *Harvard College v. Amory* (1830) 9 Pick (Mass.) 446, and *King v. Talbot* (1869) 40 N. Y. 76.

<sup>45</sup> See above note 35.



cation in the mails or interstate commerce, the plaintiff need only show that that was a misstatement of a material fact or an omission to state a material fact which under the circumstances was necessary to prevent the prospectus from being misleading.<sup>46</sup>

Under both sections 11 and 12 of the Securities Act the plaintiff can recover the damages sustained in case he no longer has the security, or upon returning the security he may recover the purchase price with interest, less the amount of income that had been paid on the security,<sup>47</sup> provided, however, that under no circumstances, in so far as section 11 is concerned,<sup>48</sup> should the plaintiff be allowed to recover more than the amount at which the security was offered to the public.

There are some differences between sections 11 and 12. Under the former any person acquiring the security in good faith, may recover from the persons specified as being liable, while under the latter only the purchaser may recover and then only from any seller of the security. Again in section 11 there are certain securities that are exempted, while under section 12 the liability applies to all securities.

Under section 15 of the Securities Act, liability under sections 11 and 12 is extended to persons, who through control of other persons, or through control of the majority of stock of a corporation, cause the agents of the corporation to violate those sections. This is an extension of liability of stockholders beyond that of the common law.<sup>49</sup> The corporate entity is disregarded, and those behind it are made liable.

Although Congress has followed the general plan of liabilities that is found in the English Companies Act of 1929, it is of interest to notice the changes that have been made.

The English law does not allow recovery to anyone but the subscriber to the stock, while in section 11 the plaintiff need only be an acquirer in good faith of the security. Again in the Eng-

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<sup>46</sup> May 27, 1933, c. 38. Title 1, par. 11 (e), par. 12 (2).

<sup>47</sup> *Ibid.*, par. 11 (g).

<sup>48</sup> *Ibid.*, par. 12 (2).

<sup>49</sup> Stockholders have been made liable in deceit for making untrue statements to a creditor, *Ver Wys v. Vander Mey* (1919) 206 Mich. 499, 173 N. W. 504; *Barnard Mfg. Co. v. Ralston Milling Co.* (1913) 71 Wash. 659, 129 Pac. 389; but usually the stockholder was not liable for the torts of the corporation, the corporation being considered an entity in and of itself, unless statute provides otherwise. 14 C. J., pp. 949-950, 990-991. Generally speaking, a stockholder, not an officer, and in no way connected with the management of the corporate business, cannot be held personally responsible for the torts of the corporation. 7 Thompson, *Corporations* (3rd ed.), par. 5438. But the Circuit Court of U. S. has held that the entity can be disregarded when it is used merely for the purpose of committing fraud on the law, *United States v. Milwaukee Refrigerator Co.* (1905) 142 Fed. 247.

lish law it is necessary that the plaintiff have relied upon the prospectus or the statement filed with the registrar, while under the Securities Act the mere fact that a person bought a security, coupled with the fact that there was a falsity in the registration statement or prospectus, gives rise to an action. Whereas the English courts have interpreted omissions of material facts to be a basis for liability under the companies act, Congress has included omissions to state material facts in both sections 11 and 12 as a basis for liability.

Under both the Securities Act and the English Companies Act the burden<sup>50</sup> has been placed upon the defendant to prove his innocence, but the defenses under the Security Act are more limited than under the English Act. Especially is this true of the issuer, who is made practically an insurer. JOHN E. CURBY, '34.

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<sup>50</sup> Cf., 73d Congress, 1st Sess. H. R., Report No. 85, p. 24. "The committee has deemed this shift (from the plaintiff to the defendant) just and necessary inasmuch as the knowledge of the seller as to any flaw in his selling statements or the failure of the seller to exercise reasonable care are matters in regard to which the seller may readily testify, but in regard to which the buyer is seldom in a position to give a convincing proof."