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Tort Liability for Misstatements or Omissions in Sales of Securities

*Lawrence J. Hayes**

THIS ARTICLE DEALS with certain civil liabilities created by the Securities Act of 1933¹ and the Securities Exchange Act of 1934² in connection with the sale of securities. It is centered on liability occasioned by misstatements or omissions in sales of securities.

To place this particular subject in proper focus, it seems necessary to first review generally some of the statutory bases for liability. These statutory liabilities are in addition to whatever liabilities may exist at common law, or by virtue of state statutory enactments.³ Thus the lawyer reviewing a particular set of facts in contemplation of the rights of his client should envision that if it is determined that a complaint should be filed, that complaint will likely sound in a number of counts of both common law and statutory derivation (subject, however, to the requirement of security for costs considered subsequently).

Liability Under Section 11

Section 11 of the 1933 Act (as amended) creates a basis for civil liability where there is a registration statement filed with the S. E. C. which contains an untrue statement of a material fact, or omits the statement of a material fact required to be included, or omits a material fact necessary to make statements which are contained in the registration statement or in the prospectus not misleading.⁴

It is important to note that under Section 11 the right to sue is not limited to the original purchaser but inures to any person who innocently acquires the securities. This "innocence" does not exist if the purchaser knew of the untruth or omission.

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¹ 15 U. S. C., Sec. 77a, et seq.

² 15 U. S. C., Sec. 78a, et seq.

³ Sec. 16, Securities Act of 1933; Sec. 28(a), Securities Exchange Act of 1934. See, for a general comparison of state and federal regulation, 2 Oleck, *Modern Corporation Law*, c. 34 (1959).

⁴ A small offering filed pursuant to Sec. 3 of the 1933 Act under Regulation A (generally, in an amount not exceeding \$300,000) is an exempt offering and such a filing is not a "registration."

Section 11 does not require the plaintiff to tender his stock. That is, the remedy is not limited to rescission. By its very terms Section 11 includes an action for damages.

The parties defendant in a suit under Section 11 for defects in the registration statement include the issuer, the persons who signed the registration statement, the directors, partners (if any), experts and underwriters. The securities *dealer* is not a proper party defendant under this section whereas a controlling person under Section 15 is.⁵ The underwriter's liability is limited to the total price at which the securities written by him and distributed to the public were offered to the public, unless the underwriter received preferential treatment from the issuer.

In the instance of a cause of action based upon Section 11, any party defendant except the issuer may avoid liability by proving any one of the following defenses:

1. That he had effectively resigned before the effective date of registration and notice.⁶

2. That he did not know that the registration statement had become effective and that upon becoming aware of the fact he notified the S. E. C. in writing to that effect, took the action required by Section 11(b) (1) and gave reasonable public notice that the registration statement had in fact become effective without his knowledge.⁷

3. That generally he had reasonable ground for belief and actually did believe in the truth and accuracy of the statements contained in the registration statement.⁸

Any defendant in a Section 11 action is entitled thereunder to reduce damages by proving that the depreciation in value claimed resulted from some cause other than the claimed defect in the registration statement.⁹

⁵ Sec. 15 of the 1933 Act creates a liability in the controlling person if he controls a person otherwise liable under Sec. 11 or Sec. 12 of the Act. It is a defense to such controlling person that he had no knowledge or reasonable ground of belief as to the existence of facts by reason of which the liability of the controlled person is alleged to exist.

⁶ Sec. 11(b) (1), *supra* n. 1.

⁷ Sec. 11(b) (2), *supra* n. 1.

⁸ Sec. 11(b) (3). This subsection makes important distinctions between those portions of the registration statement which are general representations, those made on the basis of expert opinion, and those purporting to be based on public documents.

⁹ Sec. 11(e), *supra* n. 1.

There has been very little precedent as to Section 11 actions, possibly by reason of the standards maintained by the S. E. C. itself to assure full disclosure in a registration statement.

Liability Under Section 12(1)

Section 12 of the 1933 Act has much broader scope than Section 11. It is not limited to securities sold pursuant to registration with the S. E. C. On the other hand, liability under Section 12 by its terms exists only in favor of the person who actually purchases the security in the first instance, whereas, as indicated earlier, liability under Section 11 exists as to subsequent purchasers.

Section 12(1) provides generally that any person who offers or sells a security in violation of Section 5 of the Act may sue for damages or rescission. Section 5 makes it unlawful to sell securities through the instruments of commerce when a required registration statement is not in effect, or to sell securities without observance of Section 5's requirements as to contents of the prospectus and timeliness of its delivery.

The plaintiff seeking recovery under Section 12(1) need only allege and prove:

1. That the defendant was a seller, or under Section 15 of the 1933 Act, a person in control of a seller. It appears that a broker for the seller is a "seller."¹⁰

2. That the mails or some means of transportation or communication in interstate commerce was involved in the offer or sale to the particular plaintiff (rather than merely generally used).¹¹

3. That the defendant failed to comply with either the registration or prospectus requirement under Section 5 of the 1933 Act.

4. In the event plaintiff seeks rescission, that adequate tender was made.

5. That the action is not barred by the statute of limitations under Section 13.

The defense to succeed would have to rebuff plaintiff in one of those aspects. For example, the defense would try to show that

¹⁰ Cady v. Murphy, 113 F. 2d 988 (1 Cir., 1940) cert. den. 311 U. S. 705.

¹¹ Farrell v. Reynolds, 11 N. Y. Supp. 2d 117 (1939) affd. 258 App. Div. 864, 16 N. Y. S. 2d 530 (1939).

the transaction did not require registration since it was purely intrastate or constituted a private offering. Intent or knowledge of the seller would not seem to be a factor in determining liability where the complaint rests on Section 12(1).¹²

Liability Under Section 12(2)

The reach of Section 12(2) is far beyond that of 12(1). Section 12(2) provides:

Any person who offers or sells a security (whether or not exempted by the provisions of section 3, other than paragraph (2) of subsection (a) thereof), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

The plaintiff seeking recovery under Section 12(2) is required to allege and prove:

1. That the defendant (s) offered or sold a security, including a security otherwise exempt by the provisions of Section 3 of the Act pertaining to exempted securities. *All security sales* are within its ambit except governmental securities under Section 3(a) (2).

2. That the sale was in fact made to this plaintiff.

3. That the mails or some means of transportation or communication in interstate commerce was involved in the offer or

¹² See Peterson Engine Co., Inc., 2 S. E. C. 893, 903 (1937), and Wonneman v. Stratford Securities Co., U. S. Dist. Ct. (S. D. N. Y.) (1961) No. 140-388.

sale to the particular plaintiff (rather than merely generally used). An oral communication can be enough.¹³

4. That the offer was made by means of a prospectus or oral communication.

5. That such prospectus or oral communication included an untrue statement of a material fact or omitted to state a material fact necessary in order to make the statements not misleading in the light of the circumstances under which they are made.

6. That the purchaser had no knowledge of any such untruth or omission.

The statutory liability under Section 12(2) is not limited to rescission. If the purchaser no longer owns the security he may recover damages.

As heretofore indicated, in an action under Section 11 the ordinary buyer will not be entitled to sue the dealer from whom he purchased since the dealer is not a proper party defendant under that Section. Therefore, in order to reach the dealer, a count under Section 12(2) would seem indispensable.¹⁴

Where the plaintiff sues under Section 12(2) the defendant may meet the plaintiff on the elements of plaintiff's case, may defend on limitations where applicable and may defend by showing that the *seller* did not know of such untruth or omission and in the exercise of reasonable care could not have known.

Section 12(2) smacks of common law rescission. While the similarities and differences are beyond the scope of this paper, they should be kept in mind.¹⁵

¹³ The use of the mails problem takes on an added dimension under Sec. 12(2) in the case where the misrepresentation is oral and not in commerce or is made by supplemental advertising literature rather than the prospectus. As to oral misrepresentations, a liberal construction was followed in *Schillner v. H. Vaughan Clarke & Co.*, 134 F. 2d 875, 878 (2 Cir., 1943); *Blackwell v. Bentsen*, 203 F. 2d 690 (5 Cir., 1954), cert. dismissed, 347 U. S. 925 (1954), and *MacClain v. Bules*, 275 F. 2d 431 (8 Cir., 1960). The Seventh Circuit has taken the lead in requiring strict proof as to use of the channels of interstate commerce. *Kemper v. Lohnes*, 173 F. 2d 44, 46 (1949). There apparently are no decisions as yet touching precisely the question of misrepresentation by collateral written instruments. If the term "prospectus" is properly broadly defined to include all of the offering literature, the plaintiff has no problem.

¹⁴ *Cady v. Murphy*, *supra* n. 10.

¹⁵ For an excellent comparison of the two see 3 Loss, *Securities Regulation*, 1702 et seq. (2d ed. 1961).

Liability Under Section 10 of the 1934 Act and Rule X-10B-5

Section 10(b) of the Exchange Act of 1934 makes it unlawful for any person by use of the instruments of interstate commerce or any facility of any national securities exchange to use any manipulative or deceptive device in the *purchase* or sale of securities in contravention of the rules of the Commission.

Section 10 was intended as an "anti-fraud" remedy with no direct intent in the first instance to create a new basis for civil liability. The Commission promulgated Rule X-10B-5¹⁶ and the courts soon implied a civil liability for damages¹⁷ from Section 10(b) and the Rule.

Thus, whereas Sections 11 and 12 of the 1933 Act appear to create causes of action for the *buyer* of securities, Section 10(b) opened the door for persons wrongfully induced to sell their securities by the misrepresentations of the *buyer*.

What is most significant is that most of the courts which have faced the implied liability doctrine have extended the remedy to the *buyer* as well as the seller, so that the buyer is not limited by the inhibitions¹⁸ surrounding remedies under Sections 11 and 12.

The Ninth Circuit in *Ellis v. Carter* has given most recent expression to a broad interpretation of Section 10(b) and Rule X-10B-5(2).¹⁹ It has been followed by a Delaware District Court decision which described *Ellis* as "particularly persuasive."²⁰

¹⁶ Rule X-10B-5. Employment of manipulative and deceptive devices.— 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 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. (Exch. Act Release 3230, eff. 5/21/42).

¹⁷ *Kardon v. National Gypsum Co.*, 73 F. Supp. 798 (E. D. Pa. 1947), 83 F. Supp. 613 (E. D. Pa. 1947); *Fischman v. Raytheon Mfg. Co.*, 188 F. 2d 783 (2 Cir., 1951); *Fratt v. Robinson*, 203 F. 2d 627 (9 Cir., 1953); *Speed v. Transamerica Corp.*, 235 F. 2d 369 (3 Cir., 1956).

The liability created under subparagraphs (1) and (3) of the Rule is in addition to that for untrue statements or omissions under Rule X-10B-5(2); that liability is beyond the scope of this commentary.

¹⁸ Such as the statute of limitations and security for costs under the 1933 Act, afterwards discussed.

¹⁹ 291 F. 2d 270 (9 Cir. 1961).

²⁰ *Dauphin Corp. v. Redwald Corp.*, 201 F. Supp. 406 (D. Del., 1962).

Since this implied liability doctrine is in large measure a creature of judicial decision and with the development of the law still incomplete, there is no final certainty at this time in important areas such as whether the misstatement or omission must be fraudulent, whether reliance and scienter are essential elements, whether privity of contract is important, whether the tests of "commerce" are the same as under the 1933 Act, and what should be the measure of damages.²¹

What Constitutes Misstatements and Omissions

For the lawyer pursuing a civil remedy under either the 1933 or 1934 Act it will soon become evident that usually the easiest part of his journey is proof of the objectionable misstatement or omission itself. The statutory language is broad and interpretations have been liberal. A sampling of the outlook of the S. E. C. and of court decisions is enough to illustrate the point.

Rule 405 as promulgated by the S. E. C. defines "material" in this fashion:

The term "material" when used to qualify a requirement for the furnishing of information as to any subject, limits the information required to those matters as to which an average prudent investor ought reasonably to be informed before purchasing the security registered.

The Commission in *In re C. A. Howard* had before it a stop order proceeding, wherein it defined a "material fact" as "a fact which, if it had been correctly stated, would have deterred or tended to deter the average prudent investor from purchasing the securities in question."²²

In an early case interpreting the mail fraud statute, the Supreme Court indicated that "to promise what one does not mean to perform or to declare an opinion as to future events which one does not hold, is a fraud."²³

Unless statements as to prospects for the future are based

²¹ Cf. Loss, *Securities Regulations*, *op. cit. supra*, n. 15, at 1764, et seq. The same work considers whether under the cases there is not also an implied right of action under Section 17 of the 1933 Act. As to Section 10(b), see also 37 A. L. R. 2d 1649.

²² 1 S. E. C. 6 (1934).

²³ *Durland v. United States*, 161 U. S. 306 (1896).

upon proper foundation they also involve misrepresentations of fact, even though the event has not yet occurred.²⁴

Valuations of experts, geological reports and similar expressions of expert opinion are regarded by the Commission as based on implied representations that appropriate standards have been met. Not to observe such standards would therefore constitute a misrepresentation of fact.²⁵

The preparation and use of a pro forma balance sheet which concealed a deficit incurred by the issuer and which failed to set forth an important assumption on which it was based constituted deception of a purchaser since he would not know the true condition of the issuer and this operated as a fraud in violation of Section 10 (b).²⁶

It is misleading to infer in a prospectus that the underwriter has made a firm commitment when actually it is undertaking only to act on a "best efforts" basis.²⁷

It was an untrue statement of a material fact where the seller had indicated that the stock of the issuing company being sold at \$4.50 per share was stock in a "nice little operating company," that the company was managed and practically controlled by a New York bank, that the company's earnings were around 30¢ a share and that the New York bank had refused to sell its stock because it believed the price would rise to \$12.00.²⁸

Neither the monumental credulity of the victim²⁹ nor the investor's sophistication or independent knowledge³⁰ offer a refuge to the defendant.

²⁴ Comstock Dexter Mines, Inc., 10 S. E. C. 358, 372 (1941); Alexander Reid & Co., Inc. Sec. Ex. Act Rel. 6727 (1962).

²⁵ Haddam Distillers Corp., 1 S. E. C. 37, 42 (1934); Oklahoma-Texas Trust, 2 S. E. C. 764, 782 (1937), affd. 100 F. 2d 888, 894 (10 Cir., 1939).

²⁶ In re Leedy Wheeler & Co., 16 S. E. C. 299 (1944).

²⁷ Dale v. Rosenfeld, 229 F. 2d 855 (2 Cir., 1956).

²⁸ Murphy v. Cady, 30 F. Supp. 466 (S. D. Maine, 1939) affd. (1 Cir., 1940), 113 F. 2d 988, cert. den. 311 U. S. 705 (*supra*, n. 10).

²⁹ Deaver v. U. S., 155 F. 2d 740, 744-745 (D. C. 1946), cert. den. 329 U. S. 766 (Mail Fraud Statute). Contra: S. E. C. v. Gold Hub Mines Co., 1 S. E. C. Jud. Dec. 634, 635 (1939) (indicating generally that more "puffing" is to be expected in the case of mining stock than the case of others.)

³⁰ Leonard Burton Corp., Sec. Ex. Act Rel. 5978 (1959).

Statute of Limitations

The limitations provisions of the 1933 Act are contained in Section 13.

An action under Section 11 must be commenced within one year after the discovery of the untruth or omission but not more than three years after the security involved was offered to the public in a bona fide offer. A like limitation exists with regard to actions brought pursuant to Section 12 (2); here, however, the three-year period commences from the date of the sale of the security rather than the date of the offer to the public. There may be inquiry whether plaintiff acted with due diligence in discovering the untruth or omission.³¹

An action based on Section 12 (1) must be started within one year after the violation of Section 5 but not more than three years after the sale of the security. It must be brought within one year after use of interstate facilities in violation of Section 5.³²

The three-year limitation is not alternative to the one-year period. Rather, the plaintiff must overcome both the one-year and the three-year limitation provisions. Since the same Act creating the cause of action also establishes limitations, under federal law the *plaintiff* must allege and prove compliance with Section 13.³³

A determination of the governing statute of limitations under the Securities Exchange Act of 1934 is more tortuous. Since the 1934 Act contains no express statute of limitations applicable to Section 10,³⁴ that defense is generally governed by the law of the state of the forum subject to possible tolling under a federal doctrine which applies where the plaintiff sues *only* in equity and plaintiff was in ignorance of the fraud without any fault or want of diligence on his part.³⁵

The temptation of a buyer to escape the confines of Section 13 under the 1933 Act is understandable. While there are con-

³¹ Dale v. Rosenfeld, 229 F. 2d 855 (2 Cir., 1956).

³² Osborne v. Mallory, 86 F. Supp. 869 (S. D. N. Y., 1949).

³³ Rosenberg v. Hano, 121 F. 2d 818 (3 Cir., 1941).

³⁴ Sec. 29 of the 1934 Act has no application.

³⁵ Holmberg v. Almbrecht, 327 U. S. 392 (1946). Northern Trust Co. v. Essaness Theatres Corp., 103 F. Supp. 954 (N. D. Ill. 1952). Query whether in an action under Sec. 10(b) compliance or not with limitations requirements is part of the sword or part of the shield.

trary District Court decisions, a buyer succeeded in *Fischman v. Raytheon Manufacturing Co.*³⁶

Jurisdiction and Procedure

Section 22 (a) of the 1933 Act gives the state and federal courts concurrent jurisdiction over "all suits in equity and actions at law brought to enforce any liability or duty created by" the Act.³⁷ Jurisdiction is created by the terms of the statute, so that neither diversity of citizenship nor jurisdictional amount is required.

Any suit under the 1933 Act may be brought in the district wherein the defendant is found or is an inhabitant or transacts business, or in the district where the offer or sale took place, if the defendant participated therein. Process in such cases may be served in any other district in which defendant is an inhabitant or wherever the defendant may be found. It has just been held that extra-territorial service of process in an action under the Exchange Act does not confer jurisdiction over out-of-state defendants with regard to a common law count in the complaint.³⁸ Section 22 (a) expressly provides that a case properly brought in a state court may not be removed to a United States District Court.

Although the defendant may be hard pressed from the standpoint of jurisdiction and venue, in a proper case he may find comfort in the transfer provisions of Section 1404 (a) on the grounds of *forum non conveniens*.³⁹ By its terms Section 1404 (a) applies to "any action, suit or proceedings of a civil nature." It clearly applies, for example, to anti-trust litigation,⁴⁰ and no reason in logic is seen why it should not apply to the Securities Acts.

The plaintiff having found a likely forum, may well want company to lighten the economic load and increase the prize. He is helped by the applicability of the class action device authorized by Rule 23 of the Federal Rules of Civil Procedure.

³⁶ 188 F. 2d 783 (2 Cir., 1951), *supra*, n. 17. The implied liability doctrine as it touches Sec. 17 of the 1933 Act may carry with it a similar escape from the rigors of Sec. 13.

³⁷ Sec. 27 of the 1934 Act is similar but not identical to Sec. 22 (a). In the interest of brevity it is not treated separately.

³⁸ *I. L. G. W. U. v. Shields & Co.*, U. S. Dist. Ct., S. D. N. Y.; Dimock, J.; 31 L. W. 2181 (Sept. 21, 1962).

³⁹ 28 U. S. C. A., Sec. 1404 (a).

⁴⁰ *U. S. v. National City Lines*, 337 U. S. 78, 69 S. Ct. 955 (1949).

Assuming that the requirements of Rule 23 are met (such as common questions of law and fact) the device is available in actions under both the 1933 and 1934 Acts.⁴¹ However, the plaintiff's prospects with the class action device are not unlimited. The usual action under the Securities Acts is the "spurious" class action binding only upon the actual parties, intervenors, and those in privity with the parties plaintiff. A district court as a matter of discretion has refused the request of plaintiffs in a spurious class action that the principal defendant be required to divulge a list of all its stockholders,⁴² and that a broker defendant be compelled to list all persons to whom they sold stock of the corporation as principal. It was asserted without success there that unless other stockholders were notified forthwith, the statute of limitations would expire.

Assuming plaintiff succeeds in filing a good complaint (whether class action or not) the defendant will be waiting with a procedural hammer. Section 11(e) of the 1933 Act authorizes a court to require a plaintiff to provide security for costs including attorneys' fees. The 1934 Act has similar provisions but they are directed at situations *other than* those contemplated in Section 10(b).⁴³ Quite obviously, security for costs, if required, could break the plaintiff's back.

*McClure v. Borne Chemical Co., Inc.*⁴⁴ illustrates how a plaintiff may successfully "thread the needle" to avoid security for costs. This was a spurious class action under Rule 23 by the stockholders of *Borne*, alleging in part a sale of stock by the corporation to a third party in fraud and in derogation of their pre-emptive rights, all in violation of Rule X-10B-5 and Section 29 of the 1934 Act. Plaintiffs expressly averred that they claimed "no other cause of action in this litigation against these defendants." Defendants insisted that security for costs was required by a Pennsylvania state statute, by the general federal equity law, and by analogy from Section 11(e) of the 1933 Act. The Court of Appeals affirmed the trial court's order that no security for costs was required under the limited relief sought by plaintiff.

⁴¹ Cf. Loss, *Securities Regulations*, *supra*, n. 15 at p. 1819 et seq.

⁴² *Cherner v. Transitron Electronic Corp.*, 201 F. Supp. 934 (D. Mass. 1962).

⁴³ Sec. 9(e) of the 1934 Act has reference to manipulation of security prices. Sec. 18 establishes a liability for false and misleading statements filed with the S. E. C. in any filing.

⁴⁴ 292 F. 2d 824 (3 Cir., 1961), cert. den. 368 U. S. 939.