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INVESTORS' CIVIL REMEDIES UNDER THE FEDERAL SECURITIES LAWS

MURRAY L. SIMPSON

Congress, through legislation between 1933 and 1940, and the courts, through liberal interpretation thereof, have given the investor a broader and more definitive approach to civil recovery. With a few exceptions, the federal securities laws have created substantial improvements, both in substance and procedure, over the common law remedies available to an investor in the fraudulent purchase or sale of a security.

The Securities Act of 19331 (hereinafter referred to as Securities Act) and the Securities Exchange Act of 19342 (hereinafter referred to as Exchange Act) provide the basic liabilities upon which an investor may formulate his cause of action. The remedies created under the other four federal securities acts3 are based in substance upon those created by the Securities Act and Exchange Act, and except by cross reference will not be discussed in this article.

The underlying difference between the federal statutory remedies and those available at common law is the general shifting of the burden of proof to the defendants. The reason is that the facts necessary to establish the proof needed by the plaintiff in his common law action, such as the action of deceit, are so often peculiarly within the knowledge of the defendant that the plaintiff has great difficulty in proving his case.


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The author intends to discuss the expressed and implied remedies available to the injured investor under the Securities Act and Exchange Act, the significant advantages, if any, over the companion common law remedies, and some of the problems he may be faced with in establishing his case. In discussing the remedies an investor may have, the author assumes that the facts necessary to prove the substantive allegations exist, and does not intend to present the problems of evidence that the plaintiff may incur.

**Civil Liabilities on Account of False Registration Statement**

Any purchaser acquiring a security which is offered under an effective registration statement has a variety of persons to sue if "any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading. . . ." As in common law, the question of truth or omission must relate to a material fact rather than an opinion, and the accuracy or completeness of the registration statement is only considered as of its effective date.

In one of the first law review articles following the passage of the Securities Act, Professor Harry Shulman effectively summarized the Act and Section 11:

> It requires a picture not simply of the show window, but of the entire store. It requires not simply truth in the statements volunteered, but disclosure. And, for false statement, it provides civil liability.\(^5\)

Liability under Section 11 is created with two great departures from the elements of the common law actions of rescission and deceit. The first is that the plaintiff can sue under this section without having to prove that the misrepresentation was addressed or intended to influence him. The cause of action runs in favor of all innocent buyers, thus eliminating the requirement of "privity" of the parties.

The other departure from the two common law actions is the absence of any requirement of proof that the plaintiff "relied" on the registration statement. However, if the plaintiff acquired the security after the issuer has made generally available to its security holders an earning statement covering a period of at least twelve months begin-

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ning after the effective date of the registration statement, recovery is conditioned on proof that the plaintiff relied upon the untrue statement in the registration statement when acquiring the security. But during this first year following the effective date of the registration statement, the investor need only establish the existence of the material untruth or omission and is relieved of the burden of proving reliance or of showing that the untruth or omission was the cause of the loss suffered.

As in common law rescission, there is no element of scienter in the plaintiff’s cause of action under Section 11. Liability is imposed because of the existence of an untrue statement or the omission of a material fact required to be stated regardless of the intentions or good faith of the defendants. To exempt from civil liability a person who in good faith makes a misstatement would be contrary to the purpose of the entire Act as well, as it is practically impossible to deny a “claim” of good faith. The House Committee Report stated:

Their essential characteristic consists of a requirement that all those responsible for statements upon the face of which the public is solicited to invest its money shall be held to standards like those imposed by law on a fiduciary.

The absence of privity between the plaintiff and the defendant places liability on a great number of persons, namely, the issuer, its directors, the underwriters, the experts having prepared certain parts of the registration statement, etc. In addition, the plaintiff can reach any person he can show to be in a control relationship with any of the persons liable under Section 11.

The liability of the issuer under Section 11 is virtually absolute, its only affirmative defense being that of proving the plaintiff knew of the untruth or omission alleged in the complaint at the time the security was acquired. The issuer may not assert as a defense that it had made a reasonable investigation or that it had acted in good faith. Section 11 does, however, provide certain affirmative defenses to all persons, other than the issuer, liable on account of the false registration statement. These defenses are specifically set out in Section 11(b), its effect

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6 *Hearings Before the Senate Committee on Banking and Currency on S. 875, 73d Cong., 1st Sess. 205 (1933).*

7 *H.R. REP. No. 85, 73d Cong., 1st Sess. 5 (1933).*

8 Section 11(a) specifically lists every person liable under that section. 48 Stat. 82 (1933), 15 U.S.C. § 77k(a) (1958).

being to impose liability on the directors, officers, experts and underwriters based upon standards of negligence rather than of fraud. The standard of reasonableness required in these defenses is "that required of a prudent man in the management of his own property."\textsuperscript{10}

The House Committee, in providing these defenses, justified the placing of the burden of proof upon the defendants:

Every lawyer knows that with all the facts in the control of the defendant, it is practically impossible for a buyer to prove a state of knowledge or a failure to exercise due care on the part of defendant. Unless responsibility is to involve merely paper liability, it is necessary to throw the burden of disproving responsibility for reprehensible acts of omission or commission on those who purport to issue statements for the public's reliance. . . .\textsuperscript{11}

This explains the Act's departure from the underlying obstacle faced by the plaintiff in a common law action, i.e., the necessity of proving facts peculiarly within the knowledge of the defendant.

Section 11(b)(3)(C) provides an affirmative defense to a person other than the expert himself, regarding any part of the registration statement purporting to have been made on the authority of an expert, where the burden of proof is sustained that "he had no reasonable ground to believe and did not believe . . . that the statements therein were untrue . . . or that such part of the registration statement did not fairly represent the statement of the expert." This defense clearly mitigates the burden of due care when reliance is placed upon experts in the use of material in the registration statement prepared by experts. The Securities and Exchange Commission will not permit central data in the registration statement such as description of business, underwriting arrangements, description of property, promotional history, etc. to be stated on the authority of an expert. Information may only be "expertized" insofar as it is of a type requiring the expert skill, knowledge or opinion with respect to which the expert is qualified to testify, and any portion of the registration statement prepared or certified by an expert must be plainly identified. In a proceeding to determine the suspension of a security from registration, the Commission held that management cannot avoid responsibility by relying blindly on the expert's work, even if properly employed.\textsuperscript{12} The facts necessary for the issuance of an order in this case are not the same, however, as those necessary to prove civil liability.

\textsuperscript{11} H.R. REP. No. 85, 73d Cong., 1st Sess. 9 (1933).
\textsuperscript{12} See Interstate Hosiery Mills, Inc., 4 S.E.C. 706 (1939).
The only remedy available under Section 11 is to sue for damages. An action for rescission against anyone but the immediate seller would not restore the parties to the status existing before the sale, and would place a disproportionate and unnecessary burden upon such persons as the directors, officers and experts. Damages are purely compensatory and not penal, notwithstanding the action created by the Act is based on fraud.13

The amount of recovery is measured by the difference between the amount paid for the security and either (1) the value of the security as of the time suit was brought, or (2) the price at which the security was disposed of in the market before suit, or (3) the price at which the security was disposed of after suit but before judgment, if such damages shall be less than the difference between the amount paid and the value as of the time the suit was brought. Therefore, if the market goes up before judgment, the defendant gets the benefit if the stock is sold, but if the market falls, the plaintiff still cannot get more than the difference between the purchase price and the value at the time the suit was filed. And in any case, the amount recoverable may not exceed the price at which the security was offered to the public, adversely affecting the purchaser who acquired the security in the open market at a price higher than its original offering.

In an action under Section 11, the defendant, including the issuer, may reduce the damages recoverable to the extent he proves the depreciation in value of the security involved did not result from the untrue statement or omission to state a material fact in the registration statement. This is a form of causation as a partial defense rather than an element of the cause of action.

The liability of the underwriter is also limited to the total price at which the securities directly or indirectly underwritten by him and distributed were offered to the public. But if an underwriter receives some benefit from the issuer which the other underwriters do not share in proportion to their respective interests, he may be liable for the entire issue.

Section 11 provides that the court may, in its discretion, require an undertaking for the payment of costs, including reasonable attorney’s fees. This has the effect of deterring the filing of many complaints (or defenses).

It should be noted at this point that since the gist of the cause of

action under Section 11 is a false effective registration statement, deficiencies in a preliminary prospectus ("red herring") or an expanded "tombstone ad" do not create Section 11 liability. A preliminary prospectus is not part of an effective registration statement, and the "tombstone ad" is not part of a registration statement at all.

One of the few places where the statutory remedy under Section 11 severely limits its advantage over the common law actions is the restrictive, double-barreled statute of limitations.14 No action may be brought to enforce any liability created by Section 11 unless it is brought within one year after the discovery of the untrue statement or omission, or after such discovery should have been made by the exercise of reasonable diligence, and in no event may it be brought more than three years after the security was bona fide offered to the public. The federal courts consistently follow under the Securities Act the general rule that, when the same statute which creates a cause of action also contains a limitation period, the statute of limitations not only bars the remedy but also destroys the liability. The plaintiff must therefore plead and prove facts showing that he is within the statute of limitations.15

CIVIL LIABILITIES ARISING IN CONNECTION WITH PROSPECTUSES AND COMMUNICATIONS

Section 12 of the Securities Act creates two distinct liabilities and will be discussed separately, while the similarities and common problems will be discussed together. Section 12(1) creates a liability upon any person who "offers or sells a security in violation of Section 5" (Registration of Securities), and Section 12(2) makes a person liable for offering or selling a security "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."17

SECTION 12(1)

This section gives the purchaser of any security the right to sue the seller for damages or rescission by proving that the security was sold

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15 Pennsylvania Co. for Insurances v. Deckert, 123 F. 2d 979 (3rd Cir. 1941).
in violation of Section 5 of the Securities Act.18 The only affirmative defense then available is that the particular security or transaction was exempt from the provisions of Section 5, and the burden of proving this exemption is on the defendant.19 The defendant’s intent or knowledge of the violation is again irrelevant, and the fact that the purchaser knew the security was not registered or that the prospectus failed to meet the requirements of Section 10 of the Securities Act does not affect his cause of action. There is no defense, as will be seen exists in Section 12(2), based on the purchaser’s knowledge, and the courts are generally reluctant to bar the plaintiff by his conduct except in very clear cases.20

Assuming the use of the mails or instruments of transportation or communication in interstate commerce, Section 5 declares it unlawful for any person, directly or indirectly, to sell, or deliver after sale, a security unless a registration statement for such security is in effect; to transmit a prospectus for a security with respect to which a registration statement has been filed where the prospectus fails to meet the requirements of Section 10, or to transmit such security for sale or delivery after sale without being accompanied or preceded by a Section 10 prospectus; or to offer to sell or offer to buy any security where a registration statement has not been filed as to such security, or while the registration statement is the subject of a refusal order or stop order.

Sections 3 and 4 of the Securities Act define the securities and the transactions, respectively, which are exempt from the provisions of Section 5. Space does not permit an analysis of these sections, but their importance in determining whether a cause of action exists under Section 12(1) cannot be stressed enough. Due caution must be given to the easy proof available under some of these exemptions, at least in establishing a prima facie defense for the defendant.

One of the most serious problems faced by an issuer arises when an exemption from the provisions of Section 5 is relied upon in good faith during an intrastate offering (offer and sale only to residents of the state where the issuer is incorporated and does business) or a private placement (transactions by an issuer not involving any public offering), while the purchaser took the security with a view to distr-

20 See Dale v. Rosenfeld, 229 F. 2d 855 (2nd Cir. 1956).
bution, thus defeating the issuer's exemption. This problem has become more acute since the Crowell-Collier opinion\(^2\) dealt a severe blow to the issuer's reliance on the "investment letter." In deciding what is meant by "holding for investment," the Commission, in the Crowell-Collier case, made clear the fact that time is not the controlling factor. In determining the purchaser's intent as to whether he took "with a view to distribution," a long lapse of time is still, however, the strongest evidence.

Even though Section 12(1) does not apply to the ordinary brokers' transactions,\(^2\)\(^2\) a broker-dealer may become liable for violating Section 5 if he effects a distribution of securities from a person in a control relationship with the issuer, thus becoming a statutory underwriter and losing the exemption available under Section 4(1). Many similar corollary problems exist in this area which cannot be made the subject of this article.

An interesting situation was created by the 1954 amendment to Section 12\(^2\)\(^3\) wherein the words "offer or" were inserted. A seller can now make an illegal offer (assuming jurisdictional means used) followed by a legal sale, i.e., he makes an offer in violation of Section 5(b)(1) or 5(c), but the sale is made after the effective date of the registration statement and a statutory prospectus accompanies the security. Since Section 12(1) (as well as 12(2)) refers to any person who "offers or sells," the seller may be liable to the purchaser even though the actual sale was not in violation of Section 5. Furthermore, since Section 12(1) makes no reference to delivery but refers to any person who violates Section 5, there may be a legal offer and sale but a delivery after sale in violation of Section 5(b)(2).\(^2\)\(^4\)

**SECTION 12 (2)**

This section creates liability for the use of untrue statements or omissions to state a material fact in connection with the offer or sale of any security, whether or not registered. The only securities exempt

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\(^{23}\) The amendment is contained in § 9, 68 Stat. 686 (1954).

\(^{24}\) On transactions made within 40 days after the effective date of the registration statement a dealer must deliver a statutory prospectus, and failure to do so will place him in violation of Section 5, unless he is relying on the ordinary brokers' transaction exemption under Section 4(2).
from Section 12(2) are government, municipal and certain bank securities set forth in Section 3(a)(2).

Unlike Section 12(1), the liability of the seller under this section is not absolute. The seller has a defense if he can 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." This shifting of the burden of proof again eliminates the element of *scienter* from the plaintiff's cause of action since he does not have to prove, nor even allege, that the person making the false statement knew it was false. This defense limits an action under Section 12(2) to intentional or negligent misstatements or omissions, but the defendant often has a difficult time sustaining the burden of proof that in the exercise of reasonable care he could not have known of the falsity. 25

The plaintiff has another distinct advantage over the common law actions in that he does not have to prove reliance, 26 but only that he did *not* know of the untruth or omission. In *Murphy v. Cady*, 27 the court held that in addition to this allegation that the plaintiff did not know the representations were false, the plaintiff must allege and prove that he could not have ascertained their falsity by the exercise of reasonable care.

In *Dale v. Rosenfeld*, 28 the plaintiff in a Section 12(2) action claimed that he believed the statement under the heading "Underwriting" meant that the underwriting was a firm commitment, though he later learned at a stockholders' meeting that it was a "best efforts" deal. The prospectus contained a statement that "A copy of the Underwriting Agreement may be examined at the offices of the Underwriter." In reversing the lower court, Judge Swan stated that the court need not find that the prospectus contained untrue statements, but that it is sufficient if the statements are misleading. In denying the defendant's claim that the plaintiff could have ascertained the true facts had he examined the underwriting agreement, the court held that the "availability elsewhere of truthful information cannot excuse untruths or misleading omissions in the prospectus." 29


26 *Newberg v. American Dryer Corp.* 195 F. Supp. 345 (E.D. Pa., 1961). The court held that the plaintiff need not allege reliance on any misstatement, or any causal connection between the alleged violation and damages claimed.

27 30 F. Supp. 466 (S.D. Me. 1939).

28 229 F. 2d 855 (2nd Cir. 1956).

29 Id. at 858.
The element of reliance is related to the concept of materiality. As in the common law actions, the plaintiff must prove the misstatement or omission was of a material fact, and what differentiates an opinion from a material fact varies in each case. The Court of Appeals for the Ninth Circuit recently handed down an opinion which held that the defendant-salesman had failed to disclose material information which he had a duty to do because of "his position of trust and confidence" and his "superior knowledge." The court acknowledged the fact that an action for deceit cannot be founded upon the mere expression of an opinion, but held that since an expression of an opinion, if honestly made, is an expression of what the speaker believes to be a fact, the expression of a dishonest opinion to one entitled to rely upon it constitutes deceit for which an action will lie.

Unlike Section 11, the dependence in Section 12(2) on the use of the mails or facilities of interstate commerce in the offer or sale of the security gives rise to one of the exceptions to the advantages the statutory remedy under the federal acts has over the common law remedies. Under Section 11 the basis for federal regulation is the filing and effectiveness of the offending registration statement with the Commission, while Section 12(2) has a jurisdictional requirement which often leaves the plaintiff with only the common law or state statutory remedies.

The jurisdictional language under Section 12(2) is less comprehensive than that of Section 17(a), the general anti-fraud provision of the Securities Act upon which governmental civil enforcement and criminal proceedings are based. The problem which has arisen under Section 12(2) is whether the misrepresentation itself must be transmitted through the mails or the facilities of interstate commerce.

The Court of Appeals for the Seventh Circuit in Kemper v. Lohnes, a Section 12(2) action, held that the untrue statement is the "gravamen of the offense" and must be made by the use of the mails or by any means or instruments of transportation or communication in interstate commerce. The court affirmed the granting of the defendant's motion to dismiss the complaint for lack of jurisdiction on the basis that the alleged misrepresentations were not transmitted by use of the mails,

Anderson v. Knox, 297 F. 2d 702 (9th Cir. 1961). This decision is interesting for the purpose of seeing the extent the court went to in considering the salesman's statements as a material fact rather than an opinion.

173 F. 2d 44 (7th Cir. 1949).
and that the mails were used solely to advertise the security and arrange a meeting between the parties.

The logic behind the Kemper opinion was seriously questioned by the Eighth Circuit in 1960, when the court stated that this opinion "seems to us an artificial interpretation and unwarranted curbing of the operation of [Section 12], which manifestly is a remedial statute...." The court agreed with two prior cases in the Second Circuit and the Fifth Circuit that the word "sells" involves as an inherent element the delivery of the security, and that the use of the mails to effect the delivery of a security brings the situation within the remedial provisions of Section 12(2) as much as does a use which represents an incident of any other element of its sale.

While the Seventh Circuit has never reversed its holding in the Kemper case, its limited interpretation of Section 12(2) appears to be outweighed by the other circuits. The court in Blackwell v. Bentsen adequately summarizes what appears to be the better and dominant view today:

This is a remedial statute. It should be liberally construed to accomplish the dominant legislative purpose in adopting it, which is to prevent the use of the mails, and other instrumentalities of interstate commerce, in the perpetration of investment frauds.... Here the sales were apparently by oral communication, but the transactions were consummated by the use of the mails, which in our opinion brings the transaction within the statute. Delivery of the deeds and contracts is an integral part of the sale.

QUESTIONS COMMON TO SECTIONS 12(1) AND 12(2)

Section 12 provides that any prospective defendant "shall be liable to the person purchasing such security from him," indicating that there must be privity between the plaintiff and the defendant. The purchaser can recover only from his immediate seller, while in a common law

33 Id. at 434.
34 Schillner v. H. Vaughan Clarke & Co., 134 F. 2d 875 (2d Cir. 1943).
35 Blackwell v. Bentsen, 203 F. 2d 690 (5th Cir. 1953).
36 In 1951 the Seventh Circuit took a different view in a criminal mail fraud case by stating that "the question is whether what was sent through the mail was part and parcel of a scheme to defraud." United States v. Sylvanus, 192 F. 2d 96, 106 (7th Cir. 1951).
37 203 F. 2d 690 (5th Cir. 1953).
38 Id. at 693. In Creswell-Keith, Inc. v. Willingham, 264 F. 2d 76, 80 (8th Cir. 1959), the court stated that it seemed unlikely that Congress intended that acts subject to criminal liability under Section 17(a) would not create civil liability under Section 12(2).
deceit action there is no absolute requirement of privity. The purchaser under Section 12 may, however, seek recovery from any person who controls his immediate seller, subject to the specific defense available to a controlling person.

Section 1540 (as amended), creating the liability of controlling persons, states that such person “shall also be liable jointly and severally with and to the same extent as such controlled person . . . is liable, unless the controlling person had no knowledge of or reasonable grounds to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.” By placing liability on controlling persons, the possibility of avoiding the intended consequences of the Act through delegation to subsidiary companies, agents or managers is reduced. What constitutes “control” is often a difficult question of fact, especially where the person liable under Section 11 or 12 is not acting within the scope of his duty to his principal.

Because of the privity requirement, a purchaser in a firm-commitment underwriting can recover only from the dealer who sold to him (excluding the possible control situation), while in a best-efforts distribution where the broker may act as the issuer’s agent and title passes from the issuer directly to the ultimate purchaser, the latter can reach the issuer under Section 12. In the firm-commitment situation where the investor has to sue the dealer from whom he purchased, the dealer can bring in the underwriter, and the underwriter can then bring in the issuer under third party practice42 and settle the ultimate liability in one action.

Since a broker for the issuer in a best-efforts distribution is a “person who sells” within the meaning of Section 12, liability is imposed not only on the issuer, but also on the brokers when selling securities owned by other persons.43 This then raises the interesting question of the issuer’s liability when he has nothing to do with the broker’s misstatement. It may depend entirely on the defense the issuer has available under 12(2) if he can prove he did not know, and in the exercise of reasonable care could not have known, of the untruth or omission.

In seeking rescission under Section 12 the plaintiff is entitled to re-

40 Section 15 creates a liability on persons who control any person proven liable under Section 11 or 12. 48 Stat. 84 (1933), 15 U.S.C. § 77o (1958).

41 Without the 1934 amendment inserting this defense (§ 208, 48 Stat. 908) the controlling person was liable to the same extent as the person controlled with no defense available.


43 Cady v. Murphy, 113 F. 2d 988 (1st Cir. 1940).
cover the consideration paid for the security with interest, less the amount of any income received thereon, upon tender of the security. Since the Act does not specify how or when tender should be made, it appears appropriate to condition tender upon full payment of judgment recovered.\textsuperscript{44} When the plaintiff no longer owns the security he may recover damages which are to be measured as to result in the substantial equivalent of rescission.

The statute of limitations for actions under Section 12 is similar to the double-barreled limitations placed upon Section 11 actions. For liability under 12(1), an action must be brought within one year after the violation of Section 5, and no more than three years after the security was bona fide offered to the public. Under 12(2), the action must be brought within one year after the discovery of the untrue statement or omission, or after such discovery should have been made by the exercise of reasonable diligence (same as in Section 11), and no more than three years after the sale. As in Section 11, one of the greatest difficulties in applying the limitations period arises in the determination of when an untrue statement or omission could have been discovered "by the exercise of reasonable diligence." This undoubtedly is a question of fact to be decided in each case.

**SUPPLEMENT TO SECURITIES ACT REMEDIES**

Sellers may try to avoid the liability provisions of Sections 11 and 12 by obtaining stipulations from buyers to waive compliance by the sellers with the requirements of the law. Section 14 of the Securities Act therefore provides that:

Any condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this title or of the rules and regulations of the Commission shall be void.\textsuperscript{45}

In addition, the courts have repeatedly held that a hedge clause or legend disclaiming liability has little, if any, legal effect as protection against civil liability where a person makes a representation which he knows, or in the exercise of reasonable care could have discovered, is false or misleading.\textsuperscript{46}

\textsuperscript{44} Stadia Oil & Uranium Co. v. Wheelis, 251 F. 2d 269 (10th Cir. 1957).
\textsuperscript{45} 48 Stat. 84 (1933), 15 U.S.C. § 77n (1958). Note that the word "compliance" is in the language of the statute, while Section 12 has no penal provision.
There is no express provision in Section 12 as there is in Section 11 for the undertaking of costs. The Federal Rules of Civil Procedure do provide that costs shall be allowed to the prevailing party unless the court otherwise directs, but these costs do not normally include attorneys' fees as Section 11 specifically provides.

Another area not specifically provided for in the Securities Act is the question of whether an action under Sections 11 or 12 is assignable or survives the death of the plaintiff. There are relatively few cases on this point but the trend is in favor of the assignability and survival of these actions by applying a remedial rather than a penal approach to the Act.

It is important to note that the remedies created by Sections 11 and 12 are "in addition to any and all other rights and remedies that may exist at law or in equity." Furthermore, the jurisdiction of the United States District Courts over Section 11 and 12 actions is concurrent with the state courts, meaning that the plaintiff may choose either forum to bring his action. Another advantage of these federal remedies is the wide choice of venue available to the plaintiff and extraterritorial service of process.

REMEDIES CREATED BY EXCHANGE ACT

The Securities Exchange Act of 1934 contains three specific provisions on civil liability, Sections 9(e), 16(b), and 18. The liability created under Section 16(b) for "short-swing" profits by insiders requires an exhaustive analysis in itself and will not be discussed herein. Also, the recovery under that section inures to the corporation and not to an investor.

SECTION 9(e)

Section 9 of the Exchange Act contains specific prohibitions against the manipulation of prices of securities registered on a national securities exchange. Subsection (e) provides that any person who willfully participates in any act or transaction which is in violation of that

51 Ibid.
section shall be "liable to any person who shall purchase or sell any security at a price which was affected by such act or transaction. . .".53

The remedy to the investor under 9(e) ignores the common law element of privity, but the causation requirement is even more severe than the burden faced by the plaintiff in a common law deceit action. Under the statutory remedy, the plaintiff must prove that he bought or sold at a price that was "affected by" the manipulation, and taking into consideration the factors affecting the rise and fall of stock prices, it is often difficult for the plaintiff to sustain this burden.

Moreover, the plaintiff has to prove that the defendant "willfully" participated in the manipulation, a requirement not found in any of the other remedies created by the six federal securities acts. The courts have applied various meanings to the term "willfully," with the most liberal interpretations given by the Commission in broker-dealer revocation cases.54

Section 9(e) does provide a definite advantage over the Securities Act’s remedies in that there is no express reference to the plaintiff’s knowledge of the manipulation, while another requirement, of less difficulty, is that the plaintiff must affirmatively allege and prove that the security involved is registered on a national securities exchange.55

In general, the maintenance of an action under this section is very difficult, especially since the prohibitions of Section 9 are multiple and the facts necessary to prove manipulation are not easily accessible to the plaintiff. Many transactions, however, prohibited by Section 9(e) regarding registered securities are also prohibited by the general anti-fraud provisions and come within the language of these sections the same as with an unregistered security.56

The statute of limitations under 9(e) appears very definite by providing that the action must be brought within one year after the discovery of the facts constituting the violation and within three years after the violation as the maximum. "Reasonable diligence" has been read into the interpretation of "discovery of the facts" by the Fifth

56 See Barrett & Co., 9 S.E.C. 319 (1941).
Circuit, which held that discovery is to be determined by an objective standard, and actual knowledge or notice of facts which, in the exercise of due diligence, would have led to actual knowledge constitutes discovery.\footnote{Goldenberg v. Bache & Co., 270 F. 2d 675, 681 (5th Cir. 1959).}

\textbf{SECTION 18}

Section 18 of the Exchange Act\footnote{48 Stat. 897 (1934), 15 U.S.C. § 78r (1958).} creates a liability for making, or causing to be made, any false or misleading statement of a material fact in any application, report or document filed pursuant to any of the provisions of the Act.

As in Section 9(e), the plaintiff is faced with the burden of proving that the price of the security he purchased or sold "was affected" by the false statement. In addition, the plaintiff must prove that he purchased or sold the security "in reliance" upon such statement, and that he did not know the statement was false or misleading. Assuming the plaintiff manages to prove all this, the defendant may maintain that he acted in good faith with no knowledge that such statement was false or misleading.

The only advantage to the plaintiff over a common law remedy is the absence of any requirement of privity. The statute of limitations is identical with that under Section 9(e), which further restricts the plaintiff in comparison to his possible common law action. But the plaintiff is not limited to this statutory remedy and, as under 9(e), can usually seek relief under the more liberal remedies implied from the anti-fraud provisions in Rule 10b-5.

\textbf{IMPLIED REMEDIES UNDER THE EXCHANGE ACT}

The dominant purpose of the securities acts has been the regulation of the issuance of securities and transactions upon national securities exchanges as well as in other phases of the organized securities market. These acts have expressly provided for civil remedies in specific situations for the injured investor, and in addition, the courts have inferred and created civil remedies in his favor based upon violation of the substantive provisions of the Acts, whether or not within an organized securities market. The most comprehensive, and presumably the most liberal, of these remedies is the one impliedly granted to a person de-
frauded in the purchase or sale of a security by one who is in violation of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.\footnote{\textit{Hughes} at 437.}

Section 10(b) declares it unlawful to use or employ any manipulative or deceptive device or contrivance in connection with the purchase or sale of any security in contravention of the rules prescribed by the Commission. In 1942, the Commission promulgated thereunder Rule 10b-5, derived from the substantive language of the anti-fraud provision of the Securities Act (Section 17(a)), providing that:

\begin{quote}
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.
\end{quote}

The liability created by this Rule presents a less strict criterion of fraud than that imposed at common law. The Rule appears to require proof of some fraud or material misstatement, which may be half-truths or even silence if a duty to speak exists. And unlike its counterpart under the Securities Act, the unlawful activity applies in connection with the purchase as well as the sale of any security.


This case involved a review of a broker-dealer revocation order for violation of Rule 15c1-2 under the Exchange Act. Since the definition in that rule of what constitutes a manipulative or deceptive device or contrivance by a broker or dealer is identical with the language in Rule 10b-5, the decision can be considered in connection with the extent of Rule 10-5's prohibition. The court stated in the \textit{Hughes} case that:

\begin{quote}
We need not stop to decide, however, how far common-law fraud was shown. . . . The essential objective of securities legislation is to protect those who do not know market conditions from the overreachings of those who do.\footnote{139 F. 2d 434 (2d Cir. 1943).}
\end{quote}
Since neither the Act (10(b)) nor Rule 10b-5 thereunder expressly created a civil remedy for violation thereof, a cause of action was implied based on the theory that when a statute is violated and one of the class for whose benefit the statute was enacted is injured, a civil remedy is imputed from the violation. The landmark case implying a civil remedy for the violation of Rule 10b-5 is *Kardon v. National Gypsum Co.* decided in 1946 by Judge William H. Kirkpatrick. The *Kardon* doctrine has been followed by four different Courts of Appeals and several district courts including the Northern District of Illinois in a 1952 decision in *Northern Trust Co. v. Essaness Theatres Corp.* In the *Northern Trust* case, Judge La Buy held that the Exchange Act created a civil right of action in persons injured by the violation of its provision against the use of manipulative or deceptive devices. In the *Kardon* decision, where the defendants argued that there can be no implied remedy where Congress created express remedies in certain sections and not in 10(b), the court stated:

Where, as here, the whole statute discloses a broad purpose to regulate securities transactions of all kinds and, as a part of such regulation, the specific section in question provides for the elimination of all manipulative or deceptive methods in such transactions, the construction contended for by the defendants may not be adopted. 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.

Another basis for implied liability, which was also considered in the *Kardon* case, is the statutory enactment that a contract in violation of the Act is void. This necessarily implies a civil remedy to relieve the plaintiff of his obligations thereunder.

The advantages of the implied cause of action under Rule 10b-5 over the common law and other statutory remedies are numerous. There is no requirement of proof of causation between the alleged act and the damages suffered. *Scienter* is not an element of the plaintiff's case, particularly when his cause of action is based on the making of an untrue statement or omission to state a material fact, rather than

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64 *Hooper v. Mountain States Sec. Corp.*, 282 F. 2d 195 (5th Cir. 1960); *Beury v. Beury*, 222 F. 2d 464 (4th Cir. 1955) (dictum); *Fratt v. Robinson*, 203 F. 2d 627 (9th Cir. 1953); *Fischman v. Raytheon Mfg. Co.*, 188 F. 2d 783 (2d Cir. 1951); *Slavin v. Germantown Fire Ins. Co.*, 174 F. 2d 799 (3rd Cir. 1949).
proof that the defendant employed a device, scheme or artifice to defraud or his acts operated as a fraud or deceit upon the plaintiff. Furthermore, the plaintiff is not faced with any express defenses or substitute elements as exist in Sections 11 and 12(2) of the Securities Act.

Regardless of any express reference to reliance, the courts have assumed that no recovery can be granted without some proof of reliance. In Reed v. Riddle Airlines67 the court denied a seller's action for rescission of a contract to sell 112,500 shares of stock because the buyer had allegedly stated that there was no market for the stock. Judge Rives held that the evidence supported the lower court's finding that the plaintiff "did not rely" on the buyer's alleged statements.68

What about privity between the parties? Professor Louis Loss feels that the plaintiff under a 10b-5 action should have at least the same leeway regarding suit against participating agents, directors and officers as under Section 12(2) of the Securities Act, which is considerably more restrictive on its face.69 Several cases have indicated some favoritism towards his view, but no definite decision against the privity requirement exists.70

One of the advantages in a 10b-5 action over the express remedies is the absence of the restrictive, double-barreled statute of limitations. Since there is none provided in the Act and there is no general federal statute of limitations for civil actions, the general fraud statute of limitations of the forum state must be applied.71 Thus, even though a plaintiff's cause of action under an express remedy (Section 12 of Securities Act) is barred by the short statute of limitations in Section 13 of the Securities Act, he may still be able to bring his action under Rule 10b-5 in a state that has a longer limitations period.72 This also creates the problem of "forum shopping" since the Act provides na-

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67 266 F. 2d 314 (5th Cir. 1959).
69 3 Loss, Securities Regulation 1769 (1961).
71 Fischman v. Raytheon Mfg. Co., 188 F. 2d 783 (2d Cir. 1951). Here the court allowed the 10b-5 action where the longer state statute of limitations kept the action alive.
tionwide service of process with the right to bring the action in any
district wherein any act or transaction constituting the violation oc-
curred, or in any district wherein the defendant is found, lives or
transacts business. 73 Another problem, just worth mentioning, is the
conflict that may arise between the state and federal laws regarding
the tolling of statutes of limitations, and reference should be made to
the applicable statutes if the facts warrant it. The United States Dis-
trict Courts have exclusive jurisdiction over all actions based on vi-
olation of the Exchange Act or rules thereunder, contrary to the
Securities Act where the action may be brought in a state court or
the district court. 74

Another important facet of the 10b-5 remedy, and probably one of
its most significant advantages, is the right of a buyer to sue there-
under and avoid the restrictions imposed by the Securities Act.
Whether the buyer has a right to sue under this remedy has often been
argued on the basis that he is given specific remedies under the Securi-
ties Act, but the seller, aside from Sections 9(e) and 18 of the Ex-
change Act can only recover because the Commission promulgated
Rule 10b-5 and the courts implied a remedy under it. The theory
behind this view is that to allow buyers to sue under 10b-5 would be
to ignore the safeguards cast around their remedies by express Con-
gressional action.

The opposing position is that it is unfair to allow the seller such a
broad remedy while limiting the buyer to the restrictions under the
express remedies. The most recent decision in this area follows the
overwhelming opinion of the courts in favor of the buyer having a
private remedy, in addition to and free of restrictions imposed under
the Securities Act. 75 In view of the Kardon doctrine and its continued
support no other decision would appear possible. However, the United
States Supreme Court has yet to render its opinion on a 10b-5 action,
and the ultimate applicability to such an action of the rule expressio
unius est exclusio alterius remains to be decided upon by the Court.

See text at note 51 supra for similar, but less liberal, venue provisions under the
Securities Act of 1933.

74 Ibid.

75 Dauphin Corp. v. Redwall Corp., 201 F. Supp. 466 (D. Del. 1962), recognizing pre-
vious decisions on the same issue in Ellis v. Carter, 291 F. 2d 270 (9th Cir. 1961);
Matheson v. Armbrust, 284 F. 2d 670 (9th Cir. 1960); Fischman v. Raytheon Mfg. Co.,
188 F. 2d 783 (2d Cir. 1951); Rosenberg v. Globe Aircraft Corp., 80 F. Supp. 123 (E.D.
Pa. 1948).
INVESTORS’ CIVIL REMEDIES UNDER FEDERAL LAWS

The plaintiff has the burden, as in Section 12(2) of the Securities Act, of showing that the mails or facilities of interstate commerce were used by the defendant in the employment of the alleged manipulative and deceptive device. However, one advantage not available under the Securities Act is that the use of any facility of any national securities exchange may be used to establish jurisdiction in lieu of the use of the mails or facilities of interstate commerce.

The anomaly created by implied remedies is that no express measure of damages exists. Therefore, the plaintiff who proves a violation of Rule 10b-5 appears to have a wide choice of relief. He may seek a rescission of the purchase or sale, or may ask for damages based upon the out-of-pocket or even the loss-of-bargain rule. In addition, an accounting for profits may be obtained, since the injured party is entitled to require the defendant to disgorge all gains made at his expense.

The Exchange Act also provides for the liability of controlling persons, but the defense available to such persons is more tenacious than that provided by the Securities Act. Under the Exchange Act, the controlling person is liable to the same extent as the person he controls unless he acted in good faith and did not directly or indirectly induce the act or acts constituting the violation. This is obviously easier than proving lack of knowledge or exercise of due care in belief of the facts constituting the violation.

Other sections of the Exchange Act have given rise to implied remedies, but none have been as complete and far-reaching as the decisions under Rule 10b-5. The other four securities acts contain more limited civil liability provisions based on false filing, insiders’

76 See the second Kardon decision, 73 F. Supp. 798 (E.D. Penn. 1947).

77 Speed v. Transamerica Corp., 135 F. Supp. 176 (D. Del. 1955). In this opinion Judge Leahy presents an interesting determination of the damages available to the injured investor.


79 The first implied remedy was based on Section 6(b) of the Exchange Act regarding national securities exchanges, Baird v. Franklin, 141 F. 2d 238 (2d Cir. 1944). In Remar v. Clayton Sec. Corp., 81 F. Supp. 1014 (D. Mass. 1949), a remedy was implied for violation of the margin requirements of Section 7(c) of the Exchange Act. Cf. Howard v. Furst, 238 F. 2d 790 (2d Cir. 1956), regarding implied liability under Section 14(a) dealing with proxies.

trading and validity of contracts, but remedies have also been extended thereunder by the courts, particularly in the Investment Company Act of 1940. 81

Section 29(b) of the Exchange Act 82 declares that any contract made in violation of the Act or Rules thereunder shall be void. However, its effect is really to make such contracts voidable by stating that no contract will be void unless an action is brought within one year after its discovery or within three years after the violation. The voidability only applies when the plaintiff is in privity with the defendant or a third party beneficiary relationship can be established. And even though the Act contemplates a civil suit for rescission, the courts have also allowed damages to the plaintiff. 83

The statute of limitations and privity requirements of Section 29(b) do not apply to a Rule 10b-5 action inasmuch as the restrictive clause primarily deals with violations of Section 15(c) and Rule 15c1-2 84 thereunder regarding the employment of manipulative, deceptive or fraudulent devices or contrivances by a broker or dealer. But since an action under Rule 10b-5 contemplates recovery by any person, there is nothing to prevent an investor injured by a broker or dealer from bringing his action under Rule 10b-5. The procedure, however, has been to allege the violation of all applicable sections in the plaintiff’s complaint even if it may subsequently be reduced to the 10b-5 count alone.

The extent of the 10b-5 remedy was realized when a unique question was raised in Errion v. Connell. 85 In that case the issue was whether one defrauded out of non-securities and securities in the same transaction can maintain an action under Rule 10b-5. The court held that the Exchange Act merely created additional remedies for one defrauded, and the commingling of non-securities with securities in a single scheme did not oust the district court of its jurisdiction. The court thus exercised pendent jurisdiction in awarding damages for the


85 236 F. 2d 447 (9th Cir. 1956).
entire fraudulent scheme, following the doctrine established in federal courts for many years.\(^8\)

One final point should be brought out in view of the broad remedy given to the injured investor by a 10b-5 action. If an investor fails in a common law or state statutory action, can he then seek relief in the federal courts under Rule 10b-5? In \textit{Connelly v. Balkwill},\(^8\) the court granted the defendant's motion for summary judgment in a 10b-5 action on the grounds that the complaint was based on a cause of action which was no different than the unsuccessful action brought in the Ohio courts under state law. The court held that the final judgment in the state court constituted a bar to the maintenance of the 10b-5 action since both grew out of the same facts. There appears to be no escape from the doctrine of collateral estoppel if the basic issue of fact has been decided against the plaintiff in a prior action.

\textbf{Conclusion}

The author has not attempted by any means to present an exhaustive analysis of the statutory remedies available under the federal securities acts, but has merely set forth the basic remedies an injured investor may choose from, with some of the advantages and problems the plaintiff and his attorney are confronted with.

In summary, the Securities Act has two important substantive provisions, Section 5 dealing with the registration of securities and Section 17(a), being the general anti-fraud provision. Non-compliance with Section 5 results in civil liability under Section 12(1), while faulty compliance means liability under Section 11. The substantive anti-fraud language of Section 17 creates civil liability under Section 12(2), but is limited in scope. Because of this, many attempts have been made to create an implied civil remedy under Section 17 itself, but the very restrictions and differences make it less justifiable to allow the plaintiff to avoid Section 12(2) by resorting to 17(a).\(^8\)

Section 11 imposes liability on certain persons connected with the issuer without any regard to their participation in the offering, while Section 12(2) does not go as far in dealing with false and misleading

\(^{8}\) See \textit{Hurn v. Oursler}, 289 U.S. 238 (1933).


\(^{8}\) In \textit{Osborne v. Mallory}, 86 F. Supp. 869 (S.D. N.Y. 1949) the court did uphold civil liability under Section 17(a), but in that case recovery was also available and granted under Rule 10b-5.
statements in relation to Section 17(a), as Section 12(1) does regarding liability for violation of Section 5.

The concept of fraud under Rule 10b-5 has been broadened beyond the definition at common law, while the remedies implied from the substantive prohibitions of the acts have given investors a more comprehensive approach to civil recovery than even Congress provided.

These federal statutory remedies, expressed or implied, are not without their shortcomings. The litigation, especially under Sections 11 and 12(2) of the Securities Act, is very expensive. In addition to the higher federal court costs, expensive expert testimony is often needed, and many investors are reluctant to throw good money after bad. The inability to discover certain facts, particularly when there is no SEC record, the short statute of limitations under the express remedies and the specified defenses and burdens not found at common law (though still less restrictive) must also be taken into consideration by the investor. But whether the investor brings his action under the Securities Act, dealing with disclosure and fraud in the sale of securities, or under the Exchange Act, creating a broader liability for the protection of investors in the purchase and sale of securities, he will still find that in most cases the law has been strengthened to give him greater and more definitive civil recovery rights than exist at common law.
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