1-1-1973

Securities

John A. Humbach
Elisabeth Haub School of Law at Pace University, jhumbach@law.pace.edu

XI. Securities

Introduction

*John A. Humbach**

During the past year, the Second Circuit again had occasion to decide several cases in which significant issues under the federal securities laws were raised. Although none of last year's lot seems destined to become a landmark, these cases do contain some important refinements and clarifications of earlier, broad policy thrusts. The flurry of new regulatory promulgations[1] by the Securities and Exchange Commission may have commanded the focus of the securities bar in recent months, but the decisions of the Second Circuit in the securities area, last year as usual, also deserve the securities lawyer's careful attention.

As an example of clarification and refinement, the court in *SEC v. Manor Nursing Centers, Inc.*[2] seems to have somewhat circumscribed the "disgorging of profits" remedy for anti-fraud violations, earlier approved in *SEC v. Texas Gulf Sulphur*.[3] The Second Circuit upheld the district court's order that proceeds of an unlawfully made public offering be refunded to the public investors (through a trustee appointed for such purpose); however, the Second Circuit refused to require that the *profits and income* earned on such proceeds be returned.[4] Disgorgement of the proceeds of the offering, the court agreed, was an important deterrent to violations of the securities laws, but to require disgorgement of profits and income earned on such proceeds was characterized as a penalty, and not remedial,[5] and thus was not justifiable. The court did not discuss the fact that, by allowing the violators to retain their gains from the use of the investors' proceeds, the investors were left entirely uncompensated for their risk of loss as a result of possible dissipation of the proceeds. This risk of loss is not unreal. One of the violators in *Manor*, for example, has already filed a voluntary petition in bankruptcy.[6] Are the other violators to keep their gains while the bankrupt violator's loss may have to be borne by the public investors?

---

* Associate Professor of Law, Fordham University School of Law; B.A., Miami University, 1963; J.D. summa cum laude, Ohio State University, 1966.

[1] New rules and proposed rules include: Rule 144, re restricted securities, Sec. Act Rel. No. 5223 (Jan. 11, 1972); Rule 145, re business combinations, Sec. Act Rel. No. 5316 (Oct. 6, 1972); Proposed Rule 146, re private offering exemption, Sec. Act Rel. No. 5336 (Nov. 28, 1972); and Proposed Rule 147, re intrastate exemption, Sec. Act Rel. No. 5349 (Jan. 8, 1973).

[2] 458 F.2d 1082 (2d Cir. 1972).

[3] 446 F.2d 1301 (2d Cir. 1971).

[4] SEC v. Manor Nursing Centers, Inc., 458 F.2d at 1103-05.

[5] *Id.* at 1104.

[6] *Id.* at 1105, n.28.

In the same case,[7] the Second Circuit approved an extension of the coverage of the prospectus delivery requirement[8] contained in section 5(b)(2) of the Securities Act of 1933[9] [hereinafter referred to as the 1933 Act]. In short, the court held that the prospectus delivery requirement is violated, even when a prospectus in the correct form is duly delivered, if that prospectus contains material inaccuracies in the information included.[10] This extension is certainly of some theoretical interest, and may prove to have unexpected practical and analytical consequences as well.

The main force of the prospectus delivery requirement, as traditionally understood, is to require every security delivered for sale (through use of the jurisdictional means) to be accompanied or preceded by a prospectus, as prescribed elsewhere in the 1933 Act. While the term "prospectus" broadly includes virtually any form of written selling material,[11] the prescribed form of prospectus, for purposes of the prospectus delivery requirement, is one which includes (with specified exceptions) "the information contained in the registration statement."[12] The manifest purpose of the prospectus delivery requirement is to serve the anti-fraud, full disclosure objectives of the 1933 Act by implementing one of the Act's two main approaches to these objectives: To get into the investor's hands useful informative material that has passed the scrutiny of a protective governmental agency and that has (outwardly at least) met the agency's standards of disclosure.

The other main approach of the 1933 Act is more direct, consisting of provisions which simply declare various "frauds" in connection with the sales of securities to be unlawful, or provide remedies for such "frauds."[13] Whereas the prospectus delivery requirement is, then, a part of a *mechanism* to make fraudulent conduct more difficult and its occurrence less likely, it

---

[7] *Id.* at 1098-1100.

[8] 15 U.S.C. § 77e(b)(2)(1970), which provides in part:

(b) It shall be unlawful for any person, directly or indirectly—

. . .

(2) to carry or cause to be carried through the mails or in interstate commerce any such security for the purpose of sale or for delivery after sale, unless accompanied or preceded by a prospectus that meets the requirements of subsection (a) of section 10.

[9] 15 U.S.C. §§ 77a *et seq.* (1970).

[10] SEC v. Manor Nursing Centers, Inc., 458 F.2d at 1103-05.

[11] Securities Act of 1933 § 2(10), 15 U.S.C. § 77b(10)(1970).

[12] Securities Act of 1933 § 10(a), 15 U.S.C. § 77j(a)(1970). The minimum statutorily required contents of the registration statement are detailed in the itemization constituting Schedule A to the Securities Act of 1933.

[13] Securities Act of 1933 §§ 11, 12, and 17, 15 U.S.C. §§ 77k, 77*l*, and 77q (1970). The 1933 Act's anti-fraud prohibitions are more or less geared to frauds in connection with distributions of securities. Paralleling these 1933 Act provisions are the prohibitions of Rule 10b-5, 17 C.F.R. § 240.10b-5, promulgated under section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(1970), which is directed at purchases and sales of securities generally.

has from the outset been supplemented by other provisions aimed directly at the substantive abuse.[14]

Of course, the mechanistic approach of the prospectus delivery requirement was never considered to be divorced in its operation from the provisions of the 1933 Act which are aimed directly at fraudulent conduct per se. In fact, section 12 of the 1933 Act[15] makes it explicit that the prospectus referred to is expected to meet certain high standards of candor and disclosure. Nonetheless, it has been convenient and customary in analysis to separate the mechanical, *mala prohibita*-type proscriptions of the 1933 Act from its more purely substantive *mala in se* standards. This is particularly so inasmuch as the answers to important subsidiary questions arising under the two distinctive approaches of the 1933 Act might well depend upon which of the two happens to be under consideration. One such subsidiary question, where a difference of outcomes might be very desirable, is the question of the requisite mental element necessary to characterize an act as a violation of law.[16]

In *Manor Nursing Centers*, one of the court's tasks was to determine which provisions of the securities laws were violated by the use of a prospectus containing material misrepresentations as to details of the underwriting arrangements. On the facts of the case, the court was readily able to find

---

[14] One might wonder, at this late occasion, why the federal securities laws do not rely entirely on direct prohibitions of the substantive abuses and remedies for violations. Obviously there is administrative convenience and efficiency in establishing a mechanism for filtering out and deterring undesired conduct. Simple standards of conduct which are easily defined, and within which the possibilities for effecting undesirable results are minimized, are presumably the appeal of most *mala prohibita*. Moreover, such simple standards permit justification of the strict criminal and other liability which usually attaches to such regulatory measures. But the same strict liability would seem also to be reason for special caution in extending the coverage of such regulation to particular types of conduct which may not have been originally within its contemplation.

[15] 15 U.S.C. § 77*l* (1970).

[16] Even a cursory reading of section 12 of the Securities Act of 1933, 15 U.S.C. § 77*l* (1970), indicates that the draftsmen of the Act conceived the mechanistic section 5 requirements (which include the prospectus delivery requirement) as being something quite distinct from the direct substantive prohibitions of the Act. In pertinent part, section 12 declares the following to be liable to purchasers of securities:

> Any person who—
> (1) offers or sells a security in violation of [section 5] . . . or
> (2) offers or sells a security . . . by means of a prospectus or oral communication, which includes an untrue statement of a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading . . ., *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.* . . .

15 U.S.C. § 77*l* (1970) (emphasis added). Significantly, a requisite mental element was specified for violation of the substantive standard prescribed in subdivision (2) of section 12, but no statutory mental element was made necessary for violation of the mechanistic section 5 requirements.

violations of the traditionally relied upon anti-fraud provisions in the 1933 Act and the Securities Exchange Act of 1934 [hereinafter referred to as the 1934 Act].[17] Furthermore, these violations seemed to provide a sufficient basis for granting the relief requested by the Securities and Exchange Commission, and approved by the court. It is difficult to see why it was necessary to extend the mechanistic prospectus delivery requirement to cover exactly the same sort of conduct already covered by these other, traditionally applicable substantive provisions. Yet, this is what the district court judge did,[18] and the Second Circuit affirmed her decision on this point.

In another part[19] of its opinion in *Manor Nursing Centers*, the Second Circuit confirmed the trend towards removing the insulation from vulnerability which was once (perhaps optimistically) believed to be enjoyed by the more peripheral figures in a public distribution of securities. The court held three relatively minor selling shareholders to be in violation of the anti-fraud provisions (sections 17(a) of the 1933 Act and 10(b) of the 1934 Act)[20] because they failed to make inquiries following indications that the offering might not have been going as well as hoped. The information available to the three shareholders did not suggest wrongdoing, but consisted merely of facts which, if pursued and linked together with other presumably discoverable information, might lead one to uncover actual wrongoing. The disturbing feature of this holding is that it seems to require all participants in a public offering to police the offering *rather actively* at the risk of being implicated in any violation of the securities laws which might be perpetrated by other participants.

In *Radiation Dynamics, Inc. v. Goldmuntz*,[21] the court made a predictable (though perhaps not obvious) point concerning the time at which a Rule 10b-5 "purchase" or "sale" occurs for purposes of delineating the duties imposed by that rule. The court held that the time of purchase and sale is the time when the parties *commit* themselves to each other contractually rather than when the actual exchange of money and securities occurs.[22] This result recognizes the risk-shifting function which contracts properly should perform as much as it implies that information can never be "*material*" to a decision when it is available only after the decision is legally irrevocable. Still the result seems slightly uncomfortable to one adjusted to the full-candor philosophy of Rule 10b-5; for example, if A contracts to sell XYZ common stock to B, the closing to be held five days hence, this holding

---

[17] Specifically, the court found violations of section 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q(a)(1970), section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b)(1970), and Rule 10b-5, 17 C.F.R. § 240.10b-5 (1971), promulgated under the latter section. 458 F.2d at 1094-97.

[18] SEC v. Manor Nursing Centers, Inc., 340 F. Supp. 913 (S.D.N.Y. 1971).

[19] 458 F.2d at 1097.

[20] *Supra* note 17.

[21] 464 F.2d 876 (2d Cir. 1972).

[22] *Id.* at 890-91.

would impose no obligation on A to pass along to B any information concerning XYZ which A acquired between the contract date and the closing. Thus, A could silently take B's money and deliver to B shares which A knows to be worthless. Apparently, the possibility that B might have preferred to breach his contract and pay the legal measure of damages, as he would be entitled to do, is of no consequence for these purposes.

When dealing with remedial legislation, such as the securities laws, the courts have often demonstrated flexibility in applying the rules of remedies, both with regard to the fashioning of remedies and also as to the question of their availability.[23] This is reasonable, for in the absence of an appropriate remedy, the rights conferred by remedial legislation may be wholly illusory. In *Dopp v. Franklin National Bank*,[24] the Second Circuit found itself again at the interface between the substantive remedial provisions and the historical rules circumscribing equitable intervention; the result was not entirely satisfactory. Even though the facts alleged a definite course of misleading conduct, allegedly relied upon by the plaintiff to his potentially irreparable injury, the majority of the panel denied the requested injunctive relief.[25] Although the action had been brought under Rule 10b-5, the soundness of the plaintiff's theory, applying that Rule to the alleged violations, was not beyond doubt. But the majority did not even decide the Rule 10b-5 issues. Rather it rested its decision upon "established principles of equitable remedies and standards of appellate review."[26] After a "weighing of equities,"[27] the court denied preliminary equitable relief which, in effect, left plaintiff only with a right to pursue an uncertain measure of damages.

Finally, reference should be made to *United States v. Projansky*,[28] which is significant not so much for the legal issues ably decided, but for its rich and entertaining description, in detail, of a good old-fashioned stock manipulation scheme. For those who believe that nearly forty years of careful regulation have driven out all but super-sophisticated swindles and minor, isolated hanky-panky, here is proof *contra*. Judge Moore recounted vividly the bumbling, the back-stabbing and the pure ineptitude of a plan to push up the price of an issue of common stock. The case seems to demonstrate two points in particular: The days of large-scale, outright manipulation are not entirely past; and, for the manipulator, if the government does not get you, your fellow manipulators probably will.

---

[23] J.I. Case Co. v. Borak, 377 U.S. 426 (1964), is the landmark decision supporting this proposition in regard to securities legislation. There the Court stated that "[i]t is for the federal courts 'to adjust their remedies so as to grant the necessary relief' where federally secured rights are invaded." 377 U.S. at 433.

[24] 461 F.2d 873 (2d Cir. 1972).

[25] In so holding, the majority disagreed with the district court and with Associate Justice Clark, sitting by designation, who dissented from the majority's opinion.

[26] Dopp v. Franklin National Bank, 461 F.2d at 875.

[27] *Id.* at 876.

[28] 465 F.2d 123 (2d Cir. 1972).