

Securities Regulation
Quinn - Fall 2004

SECURITIES ACT OF 1933

I. STATUTORY DEFINITION OF SECURITY

A. Investment Contracts - Definition

1. SEC v. Joiner – p. 18

- a. **Facts:** Joyner Co. owns a large tract of land. They sent letters to people, offering to sell surrounding land. Joyner claimed that the company was going to drill for oil on their land and that if oil was found the purchasers would earn a lot of money. Joyner claimed that the land was in the heart of the most oil producing land in Texas, and that all the purchasers had to do was buy the land and they would get the benefits (*passive investment*). The SEC alleged securities fraud, claiming the oil interest was a security and an investment contract. Joyner claimed he was just selling land.
- b. The Supreme Court held that the sale was the sale of an investment contract, not land. It is a sale of land plus drilling with an expectation that the land value will increase.
- c. **Test:** The Court looked to the following in determining whether a security existed: 1) the terms of the offer, 2) the plan of distribution, **and** 3) the economic inducements that were held out to the prospective purchaser.
- d. The Court stated that Joyner's promise to drill and the oil made the land valuable (these were his efforts). Without the oil, the land was worthless. There was a possibility that the landowner and Joiner would lose out (common enterprise), so it is an investment contract.

2. SEC v. Howey – p. 19

- a. **Howey** is still the leading case on the definition of an investment contract.
- b. **Facts:** Howey was selling orange groves to the public. They also offered to do the cultivating of the citrus groves. Possible investors were offered a land sales contract, a service contract, and a warranty. Howey pushed the service arrangement but did not require investors to purchase one from them. Mails were used and there was no registration statement filed. Purchasers were sophisticated investors that did not reside in Florida. The investors lacked the knowledge and skill necessary to care for and cultivate the citrus trees, but they expected profits. The SEC alleged that the sale of the grove strips plus the service contract plus the warranty was a sale of an investment contract that needed to be registered.
- c. The Supreme Court articulated a more detailed test for an investment contract. It said that state law interpreted the term "investment contract" and that Congress must have known this and intended state law to control the definition of the term. The court defined an investment contract as a flexible principle and said that an investment contract means a contract, transaction, or

Securities Regulation
Quinn - Fall 2004

scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or third party.

- d. Investment contract **TEST: Whether the scheme involved (1) an investment of money (2) in a common enterprise (3) with the expectation of profits (4) to come solely from the efforts of others.**
- e. **NOTE:** “The Securities Act prohibits the offer as well as the sale of unregistered, nonexempt securities. Hence it is enough that the respondents merely offer the essential ingredients of an investment contract.”

| |
|--|
| <u>Howey Investment Contract Test</u> |
|--|

- | |
|--|
| <ul style="list-style-type: none">1) investment of money2) in a common enterprise3) w/ expectation of profits4) solely from the efforts of others |
|--|

3. **“Investment of Money” element of an Investment Contract**

a. **International Board of Teamsters v. Daniel** – p. 27

- 1) **Facts:** Daniel was a truckdriver who was laid off, went back to work and then left the company and was denied his pension. To get the pension, the contract required that he work 20 continuous years, which he had not done. Daniel had been told by the teamsters that the break in his employment would not affect his pension. This was a material misstatement to Daniel. The pension plan was compulsory and noncontributory. The amount people received in pension did not correspond directly to the number of years a person worked. Someone who worked 20 years received the same amount as someone who worked 40.
- 2) The Supreme Court held that this was not an investment contract, and therefore not a security, because there was no specific consideration given in exchange for the plan. SC held this is not an investment contract because the employee makes no payment to the plan, the employer does. Therefore, a **non-contributory, compulsory pension is NOT an investment of money.**
- 3) The Court said that it would look at the economic realities of the transaction when deciding whether something was a security. Because the pension plan was an insignificant part of the entire employment contract it was not an “investment of money.” The employee chose to work at the company. He was selling his labor *to obtain a livelihood*, not to make an investment in the future.
- 4) The “through the efforts of others” prong of the test is likewise not met because the pension depended on the length of Daniel’s employments, not

Securities Regulation
Quinn - Fall 2004

on the management of the company. The majority of income generated by the plan came from the employer's contributions and so did not depend on the efforts of the fund managers.

- 5) The Supreme Court also said that ERISA provides enough protection to employees and that there is no need to include pension plans into the securities laws.

4. **“Common Enterprise” element of an Investment Contract**

a. **Brodt v. Bache** – p. 23

- 1) **Facts:** Bache solicited appellants to open commodities trading accounts. They sold their portfolios and invested in discretionary accounts (firm could trade on the accounts without getting the customer's prior approval) with Bache. Bache said they would reap profits. They lost money and the company was insolvent. Bache received a commission from trading on the individual accounts.
- 2) SC held that there is NOT an investment contract because there is no common enterprise. There is no link between the investors (horizontal commonality) and no vertical commonality because the firm always makes money regardless of how the investment performs. The broker gets a commission whether the client gets a profit or a loss, Bache's success did not depend clients.
- 3) **NOTE:** commodities futures are not securities but if a trade agreement is an investment contract the agreement will be brought under the securities laws.

5. **“From the effort of Others” element of an Investment Contract**

a. **SEC v. Glenn Turner Enterprises** – p. 36

- 1) **Facts:** Glenn Turner formed an organization called Dare to be Great, which ran seminars on how to get rich. People had to pay money to attend the seminars. People running seminar show up in expensive cars acting like they are rich. It was a pyramid scheme, in which you could recruit others and get a percentage of their membership fee. (Doomed to collapse and a big fraud because you have to keep recruiting more people in order to make a profit).
- 2) Turner argued that it is not an investment contract because the investor has to recruit to get money, therefore it is not “from the efforts of others.” Also, you are not a passive investor, they have to do something, so the investors are different from those in Howey.
- 3) The 9th Circuit held that the plans were securities. The court is not going to read “solely from the efforts of others” literally; instead it interpreted the term ”solely” broadly. The 9th circuit looked to see whether the efforts

Securities Regulation
Quinn - Fall 2004

of others are the essential managerial efforts that affect the failure/success of the enterprise. It finds that while the investor has to exert some effort, the significant decisions come from others. Thus, the last prong of the Howey test is satisfied.

b. **SEC v. Aqua-Sonic Products** – p. 41

- 1) **FACTS:** Aqua-Sonic would sell licensees the right to sell Steri Products. Ultrasonic Corp. was responsible for all sales of Steri for the benefit of the licensee. Licensee could cancel the contract. Ultrasonic performed all significant marketing functions. The licensees were told that if they entered the agreement, they would derive substantial tax benefits. 50 licensees entered the agreements and had no experience selling Steri Products. The venture collapsed.
- 2) **NOTE:** Courts have said that usually a franchise arrangement is not going to be an investment contract because the investor's profits will depend on how well the investor manages the venture, not on the efforts of others.
- 3) As in the Glen Turner case, here the defendant argues for a strict interpretation of the term "solely." The SEC, on the other hand, argued for a totality of the circumstances approach.
- 4) The court rejected the defendant's argument, stating that they believed the Supreme Court would likely look to the totality of the circumstances in interpreting the term "solely." Specifically, "the court would consider whether, under all the circumstances, the scheme was being promoted primarily as an investment or as a means whereby participants could pool their own activities, their money and the promoter's contribution in a meaningful way." P. 43
- 5) The court focused on how something was promoted. The economic substance/reality is that it is pitched to people as an investment that requires minimal to no work. **If you pitch something as an investment, then you come under the securities laws.**

c. **SEC v. SG, Ltd.** – p. 49

- 1) **FACTS:** D had a "virtual stock market" game. D set the price of the stocks and people bought it. SG said one company was great and raised the price by 215% per year. D stopped people from pulling out their money, but kept letting others in. D said not investment contract, it's just a game.
- 2) If you are spending money to consume something (like a game) then it is not a security. The court held that this was a **Ponzi Scheme** (people invest money, and get "return" from the new investors the schemer recruits). **Ponzi** schemes fall under the efforts of others because the

Securities Regulation
Quinn - Fall 2004

managerial/promotional efforts of the “managers” determining the failure or success of the enterprise.

- 3) It is not a game because (1) there is no term, and (2) there is no chance/risk on which companies go up or down.

d. **SEC v. Edwards** – p. 1 in supplement

- 1) **Facts:** Edwards sold payphones which the buyers would lease back to him. Edwards promised a return of 14% and convinces more than 10,000 people to invest over \$300,000. The company goes bankrupt shortly thereafter.
- 2) Edwards argued that because the profit was guaranteed the purchase agreement was not an investment contract. It is instead a fixed return.
- 3) The Supreme Court rejects Edward’s argument saying that there is no bright line rule. An investment contract is defined broadly and flexibly and Edward’s interpretation would create a loophole in the definition. The court says that the risk being shared by the investors is the risk that the endeavor will collapse. Thus, this is a case of an investment contract.

6. **Real Estate Interests**

a. **Hocking v. Dubois** – p. 34

- 1) **FACTS:** A guy sells a condo and the developer manages a rental pool for the condo. The Buyer sues saying that the sale of the condo with the rental pool agreement constitutes an investment contract.
- 2) The 9th Circuit in a 6-5 decision held that this is potentially an offer of an investment contract because the court must look at the deal from the buyer’s perspective.

B. **Stocks and Notes**

1. **United Housing Foundation v. Forman** – p. 66

- a. **Facts:** Co-Op. People buying apartment receive shares of stock in a corporation which gives them a right to live there. If they want to move, they can only sell the shares for what they paid – they cannot make a profit.
- b. SC held that it was not a security. They rejected the literal approach that anything called stock was automatically a security. Supreme Court said it would not interpret “stock” literally - just because it is in the form of a stock certificate, does not mean that it’s a security. You have to focus on the economic reality.
- c. This stock did not conform to the characteristics of stock.
 - 1) They were not investing for a profit, but to acquire a place to live.

Securities Regulation
Quinn - Fall 2004

- 2) The stock did not confer the rights that normally accompany stock. It was not transferable, could not be pledged, no voting rights, and had to be offered back to the co-op at their initial selling price
 - d. The people buying the stock are buying it so they can live in the building, not to make an investment. There was no expectation of profit. So, the people are really just buying a place to live.
2. **Landreth Timber Co v. Landreth** – p. 67
- a. **Facts:** Landreth owned 100% of stock in a sawmill, which was sold through a broker Dennis. Shortly before the sale the mill was damaged by fire, but Landreth made representations about rebuilding it and about other financial results. Dennis bought the stock and assigned it to Landreth Timber. Landreth was brought on to manage the business. Rebuilding cost more than anticipated and the operation did not live up to expectations; it was sold at a loss. P sued under Rule 10b-5 and various section of the 1933 Act. Landreth moved for summary judgment based on the allegation that under the business doctrine federal securities laws did not apply, since no security was involved. The district court granted the motion. P appealed.
 - b. The Supreme Court rejected the business doctrine argument. The court held that this stock, unlike United Housing Foundation, possessed all the characteristics identified in United Housing Foundation as traditionally associated with common stock.
 - c. The Court further held that the economic reality of the transaction will only be looked at when the instruments involved are “unusual...not easily characterized as investments.” The Howey economic reality test is thus only for investment contracts and is not appropriate for other securities.
 - d. The following are **characteristics of common stock**:
 - 1) The right to receive dividends contingent upon an apportionment of profits;
 - 2) Negotiability;
 - 3) The ability to be pledged or hypothecated (i.e., to be used as collateral);
 - 4) The conferring of voting rights in proportion to the number of shares owned; and
 - 5) The capacity to appreciate in value.
 - e. The dissent said that the stocks were not securities because they were not traded on a public market. Also the investor was in a position to negotiate

Securities Regulation
Quinn - Fall 2004

appropriate contractual warranties and to insist on access to inside information before consummating the transaction.

3. **Reves v. Ernst & Young** – p. 79
 - a. **Facts:** Farmer's coop was an agricultural co-op with 23,000 members; it sold promissory demand notes at higher than bank rates of interest in order to capitalize its operations to both members and non-members through newsletter ads. Arthur Young audited the co-op. The notes were neither insured nor guaranteed, but were advertised as safe. The co-op declared bankruptcy with investors holding 10 million in notes. Reves files a suit against Arthur Young- accounting firm on the theory that they aided and abetted securities fraud (note: a recent supreme court case held that there is no private right of action for aiding and abetting).
 - b. The Supreme Court adopted the second circuit's **family resemblance test** for determining when something is a security.
 - c. The **general rule is that a note is presumed to be a security**. This presumption, however, is rebuttable. The Court considered the following **four factors**:
 - 1) The motivations that would prompt a reasonable seller and buyer to enter into the transaction.
 - a) If the seller's purpose is to raise money for the general use of a business enterprise or to finance substantial investments and if the buyer is interested primarily in the profit the note is expected to generate, then it is a security.
 - b) If a note is exchanged to facilitate the purchase and sale of an asset or consumer good, to correct the seller's cash flow difficulties, or to advance some other commercial or consumer purpose, then the note is not a security.
 - 2) The plan of distribution of the instrument is examined to determine whether it is an instrument in which there is common trading for speculation or investment.
 - 3) The reasonable expectations of the investing public.
 - a) If the seller promotes something as an investment then it's a big factor as to whether it will be treated as an investment.
 - 4) Whether some factor exists such as the existence of another regulatory scheme significantly reduces the risk of the instrument, thereby rendering application of the Securities Act unnecessary.

Securities Regulation
Quinn - Fall 2004

- d. Applying these factors, the court held that the notes were in fact notes and therefore securities subject to the securities laws.
- e. The court also stated that the following types of notes **would not** be considered securities:
 - 1) Notes delivered for consumer financing;
 - 2) The note secured by a mortgage on a home;
 - 3) The short term note secured by a lien on a small business;
 - 4) Note evidencing the character of a loan;
 - 5) Notes evidencing loans by commercial banks; and
 - 6) Notes that formalize an open-account debt incurred in the ordinary course of business.

II. MATERIALITY

A. Qualitative Information

1. In the matter of Franchard Corp. – p. 204

- a. **Facts:** Glickman formed a real estate limited partnership as the general partner, selling limited partnership interests to the public. Franchard Corporation was formed to hold all of Glickman's general partnership interests with Glickman as president and the controlling shareholder. D registered offerings with the SEC to raise more capital. In the course of the offerings, Glickman borrowed funds from D without authorization or disclosure; he also pledged his controlling stock in D for additional personal loans. It also became apparent that Glickman was in personal financial trouble. The registration statements did not include any of this information. The SEC brought an action for a stop order to suspend the effectiveness of three of D's registration statements under which securities of D were still being offered.
- b. This case was brought before the SEC's administrative body. They held that these things reflected the business ability, integrity, and motivation of the management. The information was highly material to the evaluation of the competence and reliability of the registrant's management. They also revealed where the control of the corporation might end up. Furthermore, the information was particularly relevant where the securities are being sold to the public largely on the reputation of the president.
- c. Basically, an insider of a corporation that is asking the public for funds must, in return, relinquish various areas of privacy with respect to his financial affairs, which impinge significantly upon the affairs of the company.

B. SEC v. JOS. Schlitz Brewing Co. – p. 209

- 1. **Facts:** Schlitz Company was bribing US and Spanish corporations to carry their product. The SEC sued saying that this information was material and should have been included in the company's registration statement.

Securities Regulation
Quinn - Fall 2004

2. The court finds this information material because the company action/information reflects the integrity of the business and the threat of losing their liquor license.
3. While Schlitz argued that the bribes were just a small percentage of sales. The court, however, focused more on the impact rather than the size of the payments. The court discussed the difference between quantitative and qualitative information. It stated that both types of information could be material.

C. Virginia Bankshares v. Sandberg – p. 220

1. This case discusses materiality in the context of proxy solicitations.
2. **Facts:** First American Bank of VA (“FABI”) and VBI (a wholly owned subsidiary of FABI) merged. VBI then owned 85% of Bank’s shares. Minority shareholders owned the other 15%. FABI decided to send out a proxy solicitation for the minority shares describing a share price of \$42 per share as a high and fair price. The proxy solicitations were subject to the proxy rules. Sandberg voted against the proposal and felt that she was cheated and the statements describing the price were misleading. Sandberg sued the FABI under § 14(a) (specifically Rule 14a-9) for making materially misleading statements in a proxy solicitation.
3. **Blue Chip Stocks** stands for the proposition that a Plaintiff cannot bring a private cause of action under the securities laws unless she is a buyer or a seller of securities.
4. The plaintiff’s argument is that the company’s directors said that the stock price was fair but they did not really believe that the statement was true.
5. The court held that an opinion could be material. To avoid liability, you need to back up your opinion with facts. “Mere disbelief” is not enough for liability under 14(a) (misleading proxy statement) without a factual demonstration that the proxy statement was false or misleading.
6. If a director is trying to mislead you but the price is actually fair, then that **is not** a material fact.
7. If a director is trying to mislead you and the price is not fair then that **is** a material fact; it is materially misleading.

D. Basic v. Levinson – p. 225

1. **Facts:** Combustion Engineering wants to acquire Basic and included the plan in their strategic plan. They had meetings with Basic to discuss the possibility of merger. Basic made three public statements denying that it was engaged in merger talks. Eventually, Basic took the offer. Basic shareholder sues, claiming that three public statements were misleading and a violation of 10(b) and that the denials depressed the stock price.

Securities Regulation
Quinn - Fall 2004

2. The Supreme Court stated that “Whether merger discussions are material depends on the facts.
 - a. To assess the probability that the event will occur, a factfinder will need to look to indicia of interest in the transaction at the highest corporate levels, such as board resolutions, instructions to investment bankers, and actual negotiations between principals or their intermediaries;
 - b. To assess the magnitude of the transaction to the issuer of the securities allegedly manipulated, a factfinder will need to consider such facts as the size of the two corporate entities and of the potential premiums over market value.
 3. The 6th circuit says you don’t have to say anything, but if you deny something is happening the denial is material.
 4. This materiality test applies to any future event.
- E. **Wieglos v. Commonwealth Edison** – p. 242
1. **Facts:** Edison wants to build a nuclear reactor. It offers stocks. The regulator initially denies the license, but then reverses the decision and approves the license. The plaintiff claims the company’s predictions as to the reactor’s cost were incorrect and misleading, and that the company should have disclosed the license application. The company, however, argued that its actions fell under the safe harbor of rule 175.
 2. **Rule 175** says that if you make a prediction in a filing you cannot be liable for the prediction if you have a reasonable basis.
 3. The court held that this information is not material because a reasonable investor does not need to know everything that could go wrong. The court also seemed to suggest that a company should not need to disclose information a reasonable investor should already know it.
 4. If the information is firm specific it must be disclosed. But, if the information is out in the market place then you do not need to disclose the information. Materiality depends not only on the magnitude of an effect but also on its probability.
- F. **Kaufman v. Trumps Castle** – p. 255
1. **Facts:** A Trump casino issues bonds to raise funds that pay 14% interest at a time when other bonds paid 9% interest. Trump issued a statement that said they believed that they could pay the bonds back from income generated from the casino. Trump defaults on the bonds and the plaintiffs sue.
 2. Trump argued that it gave predictions and provided plenty of detailed cautionary language. The court sided with Trump because Trump provided meaningful cautionary language. The court stated that a vague or blanket (boilerplate)

Securities Regulation
Quinn - Fall 2004

disclaimer which merely warns the reader that the investment has risks will ordinarily be inadequate to provide misinformation. To suffice, they must be substantive and tailored to the specific future projections, estimates, or opinions in the prospectus that the plaintiffs challenge.

G. Eisenstadt Case

1. **Facts:** Intel made a public announcement that they were hiring investment bankers to sell the company. The stock goes up. The company enters into private negotiations for the sale. Several companies say they want to buy Intel for much less. Intel said that the auction was going smoothly. Several investors purchased stock on this statement. Intel sold for much less. The people who bought the stock sued.
2. The court holds that the statement was not material because it is common knowledge that people puff when they are trying to sell something. A statement said as sales puffing is not a material statement.
3. The court also stated that the truth would have been misleading because people would have overreacted.

III. SECURITIES ACT OF 1933

A. Public Offerings of Securities- Registration

1. Dissemination of Information During Registration

a. Pre-Filing Period

1) Carl M. Loeb, Rhoades & Co. – p. 127

- a) **Facts:** Arvida published a news release with the plans of holding a public offering to fund a new development. Response to the press release was positive. Two days later the company and underwriters received specific offers to buy. After the press release, the SEC initiated an action and claimed a violation of § 5(c). The company then filed a registration statement that included information about \$30 million in mortgages and the company had been operating at a loss.
- b) Held: publicity prior to the filing of the registration statement via public media, is presumed to set in motion or be a part of the distribution process and therefore involves an offer to sell.
- c) **Statements by means of publicity efforts which condition the public mind or arouse public interest in the particular securities during the pre-filing period even if not couched in terms of an express offer will constitute an offer for the purposes of § 5.**
- d) Here, the company furnished price data, named the underwriter, etc., so it is a selling effort and a violation of **5(c)**. This is a prime example of gun jumping. If the press asks you a question you can answer but you can only provide factual data.

Securities Regulation
Quinn - Fall 2004

B. Exemptions From Registration

1. Private Offering Exemption

a. SEC v. Ralston Purina Co. – p. 436

- 1) **Facts:** Between 1947 and 1951, Ralston Purina sold nearly 2 million of its stock to employees from all levels of the company without registration and, in doing so, made use of the mails. In each of these years, a corporate resolution authorized the sale of common stock to employees who, without solicitation by the corporation, inquired as to the manner in which common stock could be purchased from D. Sales in each year were to approximately 400 employees. The company claimed that only key employees bought the stock and that the employees initiates the sale, so the transaction should fall under § 4(2).
- 2) The court said that to determine whether an offering was public or private “it is essential to examine the circumstances under which the distinction is sought to be established and to consider the purposes sought to be achieved by such distinction.”
- 3) Application of § 4(2) should turn on whether the class of persons affected are sophisticated investors and thus don’t need protection of the Act or not. Basically, **an offering to those who are shown to be able to fend for themselves is a transaction “not involving any public offering.”**
- 4) **TEST:** Do the **offerees** need the protection of the securities laws?
- 5) Court basically looks at (in interpreting § 4(2)):
 - a) **The availability of information,**
 - b) **Sophistication of the investors, and**
 - c) **Number of offerees**
- 6) The court said that the focus should be on the need of the **offerees** for the protections afforded by registration. The employees here were not shown to have access to the kind of information which registration would disclose. The obvious opportunities for pressure and imposition make it advisable that they be entitled to compliance with § 5.

b. SEC v. Murphy – p. 446

- 1) Murphy formed Intertie and was Chairman of the Board. Intertie promoted 30 limited partnerships. Murphy would buy a cable TV company, finance it, and then sell it to one of the partnerships. Intertie engaged a securities brokerage firm to find investors who wanted to buy interests in the cable companies. These securities were not registered, and Murphy claimed they were exempt under 4(2). Murphy did not assure that

Securities Regulation
Quinn - Fall 2004

the securities were offered to only a small number of sophisticated investors. He was heavily involved in the offerings.

- 2) The person or party claiming the exemption has the burden of proof. If the issuer cannot keep track of who the offerees were, then the issuer will pretty much loose because the test turns on the identities of the offerees.
- 3) An issuer means every person who issues or proposes to issue a security. Thus, when a person organizes or sponsors the organization of limited partnerships and is primarily responsible for the success and failure of the venture for which the partnership is formed, he will be considered an issuer for purposes of determining the availability of the private offering exemption.
- 4) In construing the securities laws, the courts will look to the substance over the form of the transaction, to its economic realities.

2. **Secondary Transactions**

a. **SEC v. Chinese Consolidated Benevolent Assoc.** – p. 484

- 1) **Facts:** Chinese government issues bonds to sell in US. D is a nonprofit organization that advertised the offering of the bond, collected money from people, and transmitted the money to China. D receives no compensation for the service.
- 2) Court held that D was an underwriter. Court says: they were an **essential cog in the public offering (underwriters are like conduits)**. D participated in the distribution and there is no intent requirement to be underwriter

3. **US v. Sherwood** – p. 485

- a. **Facts:** Sherwood (D) purchased shares from the issuer and from another shareholder of the issuer. He owned 8% of the outstanding stock, but was not an officer or director; furthermore, he had had a falling out with Doyle, the president. D has the stock for more than two years. He had also consented to an SEC decree that he would not sell the stock without registration, if a registration statement were needed. D sold 12,000 shares over various exchanges in daily transactions. US brings a criminal contempt action, alleging that D is a control person who has made an unlawful public distribution and/or that he is an underwriter since he bought the securities from the issuer with a view to a public distribution.
- b. Court held that the determination of who is a control person is a factual based inquiry. That a person purchases stock from a control person does not automatically make the buyer a control person.

Securities Regulation
Quinn - Fall 2004

- c. Here, D bought the stock from a control person, but he is not a control person. He could not get a place on the Board and he had a falling out with Doyle, who controlled the management decisions. He **also** held onto the stock for two years, so there is no intent to distribute. Thus, there is no proof that D had a view to distribute the stock at the time of the purchase. Thus, D need not register the shares he sold on this basis.
 - d. **Note:** the court created a safe harbor. If a buyer holds stock for two years and then sells it, the buyer will not be found to have had a view to distribute the stock at the time of the purchase and therefore will not be an underwriter.
4. **Ira Haupt & Co.** – p. 488
- a. **Facts:** Schulte owned 22% of Park & Tilford stock; a trust run by his son owned 67%; a corporation he controlled owned 2%; and the public owned 9%. The stock was selling at about \$57 per share. The Price Administration controlled the retail price of liquor, but the demand for it was so high (during the war) that it could be resold at a higher price. Schulte called in Haupt, a broker-dealer, and indicated that Park & Tilford was going to declare a dividend of its liquor inventory to its shareholders and that in connection therewith it wanted to sell some of its stock moved up in price. D was authorized to sell 73,000 shares for the trust at \$80 or better and 200 shares on each quarter point the stock moved up for Schulte personally. None of the sales were registered.
 - b. D claims that he is exempt under § 4(3) and § 4(4).
 - c. The key **issue** is whether the sale was a distribution.
 - d. The court defined a distribution as “the entire process by which in the course of a public offering the block of securities is dispersed and ultimately comes to rest in the hand of the investing public.” p. 492
 - e. D is an underwriter because Schulte was a control person and D effected a distribution in a control person’s stock. A distribution is the entire process by which a block of securities is dispersed to the public. It makes no difference that when the distribution began D might not have known the exact number of shares that were to be distributed, nor that there were certain conditions (such as price) attached to the sale. On the facts, D knew that a large number of shares were to be sold. D knew of the dividend plan and that the stock would go up. Thus, D has the necessary intent to make a distribution for a control person (for the purposes of the liability section being applies here-1934 act) and thus he is not exempt under § 4(3).
 - f. The court then finds that § 4(4) exemption is not available to the broker because the securities laws differentiate between trading and distribution. The

Securities Regulation
Quinn - Fall 2004

idea of the § 4(4) exemption is to facilitate trading. This exemption allows the broker to help/participate/facilitate the trading activity.

5. **US v. Wolfson** – p. 501
 - a. **Facts:** Wolfson controlled Continental Enterprises, and with his family and close associated owned 40% of its stock. Over a period of 18 months, D's sold 55% of their own holdings (25% of the corporation's outstanding shares) without registering the sales. The US brought criminal charges of conspiracy to sell unregistered stock and an action for selling unregistered stock. Ds were convicted and appeal their conviction.
 - b. **Issue:** Are transactions between control persons and brokers exempt from registration when the brokers are considered underwriters under section 2(11) of the 33 Act (which makes control persons issuers)?
 - c. The court held no. § 4(4) is unavailable because it is designed only to exempt the broker's part in securities transactions, not a control person's exemption. The seller has to have its own exemption and cannot rely on the broker's exemption. Also, the volume of sales by Ds indicated a distribution rather than an ordinary brokerage transaction, so the broker here may not have an exemption.

C. Civil Liabilities

1. **Escott v. Barchris Construction Corp.** – p. 327
 - a. **Facts:** Plaintiff brings suit against Barchris under § 11 for material misrepresentations in the registration statement. Barchris was building bowling alleys for a small down payment and an installment contract from the purchaser, which contract was either discounted or the alley was sold to a finance company and leased back. Barchris was in a cash bind and the industry was overbuilt. At the time of registration it overstated sales and earnings by significant margins. Barchris was inadequately financed and defaulted on the payment of the interest on the debentures. Plaintiff claims inadequacies and omissions in the prospectus.
 - b. **Russo** was the acting CEO. The court held him liable under § 11 because he knew all of the relevant facts and could not have believed that there were no untrue statements or material omissions in the registration statement.
 - c. **Vitolo & Pugliese** are liable for some reasons as Russo even though they had a limited education. They did not fulfill their duty to investigate and were present when things were discussed. They could not have believed that the registration statement was wholly true and that no material facts had been omitted.

Securities Regulation
Quinn - Fall 2004

- d. **Kircher** was the CFO and accountant. He helped prepare the registration statement. The court found that he withheld information from the lawyers & knew that the figures in the statement were incorrect. Thus, he's liable.
 - e. **Birenbaum** was the young lawyer who became a director. The court said that he knew of some relevant facts through daily activities and he should have made a reasonable investigation to make sure that the statements were true. As a lawyer, he should have known that he needed to investigate the facts.
 - f. **Auslander** was an outside director. He did a limited investigation before joining the company, but signed the registration statement without reading it. The court said that he did not act as a prudent man would have acted in relying on "comparative strangers." He should have investigated further.
 - g. **Grant** was the lawyer who prepared the registration statement. The court said that he did not reasonably investigate the underlying facts. He did not check what he should have/could have checked, thus the due diligence defense was not applicable to him. He failed to look at the written record. **If something is verifiable you must check it.**
 - h. **Underwriters & Coleman.** None of the underwriters except for one investigated the statement. But, when Coleman, the only underwriter to investigate, became a director his investigation stopped. Coleman delegated the investigation to someone else who failed to check the documentation, insist on committee minutes, etc. Thus, Coleman and the underwriter were liable because they should know that people "puff" and exaggerate when conveying information to underwriters in order to induce them to underwrite. Investors often rely on the reputation of underwriters. They are thus required to investigate the accuracy of the underlying data in the registration statement.
 - i. **Peat, Marwick** were the accounting experts responsible for the financial part of the registration statement. The auditor in charge of the audit did not follow the prescribed company guidelines or follow procedures required under GAAP (Generally Accepted Accounting Principles).
2. **Feit v. Leasco Data Processing Equipment Corp.** – p. 346 (§ 11)
- a. **Facts:** A surplus surplus statement was omitted from the registration statement because the directors assumed that the company manager would not give them the information to calculate the surplus surplus. The directors never asked the manager for the information.
 - b. **Held:** What constitutes "reasonable investigation" and a "reasonable ground to believe" will vary with the degree of involvement of the individual, his expertise, and his access to the pertinent information and data.

Securities Regulation
Quinn - Fall 2004

- c. **Director-defendants** failed to fulfill their duty of reasonable investigation and that they had no reasonable ground to believe that an omission of an estimate of surplus surplus was not materially misleading. The directors should have asked the manager for the information, especially because they later made piece with the manager.
 - d. **Underwriters-defendants.** The court seems to imply that the underwriters should be held to a higher standard. Tacit reliance on management is unacceptable but you can reasonably rely on them. Here they escape because they independently examined the audit report and the report of an actuary on the company, made searching inquires of D's bank, and made study of corporate minutes and major agreements.
3. **Pinter v. Dahl** – p. 366 (§ 12(a)(1))
- a. **Facts:** Pinter sells unregistered securities (oil and gas interests) to Dahl. Other people invested when Dahl did. Dahl helped them, but got no commission from Pinter. The venture proved to be worthless. Dahl and the other buyers sought rescission under § 12(1), for the sale of unregistered securities. Pinter sues Dahl for contribution.
 - b. The Supreme Court says that liability under § 12 extends only to the person who successfully solicits the purchase, motivated at least in part by a desire to serve his own financial interests or those of the securities owner.
 - c. The Supreme Court says that because § 2(3) includes solicitation in the definition of the terms “sale or sell” solicitation is included in § 12. The “purchase from” requirement of § 12 focuses on the defendant’s relationship with the plaintiff-purchaser.
 - d. **TEST:** Liability extends only to the person who actually sells and who **successfully** solicits the purchase, motivated, at least in part, by a desire to service his own financial interests or those of a securities owner. If person has such a motivation, it is fair to say the buyer purchased the security from him to align him with the owner in a rescission action.
 - e. **Rule** → liability extends to only those who successfully solicit the purchase, motivated at least in part by a desire to serve his own financial interests or those of a security owner.
4. **Gustafson v. Alloyd Company** - p. 374 (§ 12(a)(2))
- a. **Facts:** P purchased all of corporate stock from D sellers. He brings suit under § 12(a)(2) of the 1933 Act, claiming that sale agreement was “prospectus” under the Act and that it contained material misstatements sufficient to support an action for rescission under § 12(a)(2).

Securities Regulation
Quinn - Fall 2004

- b. The court held that whatever else “prospectus” may mean, under § 12(a)(2), the term is confined to a document that, absent an overriding exemption, must include the “information contained in the registration statement.” In sum, the word “prospectus” is a term of art referring to a document that describes a public offering of securities by an issuer or its controlling shareholder.
- c. The court says that it is not plausible that Congress created § 12(b)(2) liability for “every casual communication between a buyer and seller in the secondary market.”

IV. SECURITIES EXCHANGE ACT OF 1934

A. Securities Fraud Litigation Under Rule 10b-5

1. Ernst & Ernst v. Hochfelder – p. 528 (scienter)

- a. **Facts:** Ernst & Ernst was retained by First Securities. E&E prepared statements to the SEC and Midwest stock exchange. Respondents gave money to First Securities’ president who was supposed to invest them in escrow accounts. There were no escrow accounts and he used them for his own personal investment. There was no record of them on the firm financials. The President committed suicide and left a note saying the escrows were fake. The President had a “mail rule” that he could only open the mail addressed to him, to cover the fraud.
- b. Plaintiff sued the accounting firm, claiming that if they had not been negligent in their audit, they would have found the irregularity in the firm’s financial documents. The mail rule was an irregular procedure that should have been reported to the SEC, thus the firm was negligent.
- c. **RULE:** An intent to deceive, manipulate, or defraud is required for civil liability under § 10(b) and Rule 10b-5.
- d. Dissent: says that if negligence is a factor when the SEC sues under Rule 10b-5, then it must be a violation factor when a private party sues.
 - 1) **Note:** A future Supreme Court case imposed the same scienter standard on the SEC. Thus negligence is not enough under either scenario.

2. Texas Gulf Sulphur – p. 541 note 4 (“in connection with”)

- a. **Facts:** Company discovers minerals but they want to buy land at a cheap price so that they issue a statement saying discovery is not a big deal. When it comes out that the discovery was huge the stock price increases. The SEC sues.
- b. D argued that they just wanted cheap land; they had no intention to defraud investors. The court says that public statements that are reasonably likely to influence investors are “in connection with” the purchase or sale of securities.

Securities Regulation
Quinn - Fall 2004

3. **Superintendent of Insurance v. Bankers Life & Casualty – p. 539 (“in connection with”)**
 - a. **Facts:** Banker’s Life agreed to sell all of Manhattan’s stock to Begole for 5 million. Begole conspired with others to pay for the stock with Manhattan’s assets. They arranged to obtain a check from Irving Trust for 5 million, but they had no funds there. They purchased stock from Manhattan. Then Manhattan sold treasury bonds for \$5 million and the president uses this money to cover the check from Irving Trust. Begole had effectively bought all of Manhattan’s stock using its own assets.
 - b. There is no misrepresentation about what the security is worth. Nevertheless, there was a fraud and a sale of a security. The company was tricked with regards to proceeds of the sale so that satisfies the “in connection with” standard.
 - c. **Fraud is “in connection with” if an injury as a result of deceptive practices touches the sale of a security as an investor.**
4. **SEC v Zanford (“in connection with”)**
 - a. **Facts:** Zanford convinces investors to invest in an account and says that he will invest the money conservatively. He raises about \$500,000. Zanford buys and sells the securities as he said he would, but keeps the money for himself.
 - b. The Supreme Court said that a misrepresentation is not limited to the value of securities. The **fraud is “in connection with” a purchase or sale of securities if the fraud and the securities trading coincide.**
5. **Dodds v. Cigna – p. 569 (“statute of limitations”)**
 - a. **Facts:** Dodds’ husband dies and she wanted to invest that money. She met with Palumbos. He left her securities materials. She never read the prospectus [claimed she didn’t understand it], but decided to go with his investment strategy. Her accountant later said that her investments were too risky. She filed suit against Cigna within one year from the date her accountant told her that the investments were bad, more than one year after the date on which she made the investment in which she suffered losses.
 - b. **Rule:** a plaintiff in a federal securities case will be deemed to have discovered fraud for the purposes of triggering the statute of limitations when reasonable investor of ordinary intelligence would have discovered the existence of the fraud.
 - c. The court rejected the widow’s argument that the time should have started when she had actual notice of the fraud. Instead, **the court held** that because the widow had **constructive notice** of the fraud (the information contained in

Securities Regulation
Quinn - Fall 2004

the different prospectuses she was given) the time began to toll when she purchased the investments. Her action was thus time barred.

6. **Blue Chips Stamps v. Manor Drug Stores** – p. 573 (**standing to sue**)
 - a. **Facts:** Under a consent decree in an antitrust case, Blue Chip was required to offer a substantial number of shares to retailers that used its stamp service. They were registered and sold. Two years later, 1 purchaser sued under 10b-5, alleging that the prospectus was overly negative, so P did not purchase the shares. Defendant offered the shares to the public at a higher price.
 - b. **Issue:** Can P sue, even though he did not purchase or sell the security?
 - c. The Court concludes that Congress did not intend a private cause of action for money damages to the non-purchasing offeree of a stock offering registered under the 33 Act or loss of the opportunity to purchase due to an overly pessimistic prospectus.
 - d. **Rule:** A plaintiff must actually purchase or sell stock in order to bring a private cause of action for money damages under § 10(b) and Rule 10b-5.
 - e. Allowing a suit to be brought by a non-purchaser would lead to an unlimited number of potential plaintiffs, because they can claim that they read a company statement in prospectus or newspaper that caused them not to purchase the stock when they would have.
7. **Wharf Holdings Limited v. United International Holdings** – p. 580 (**standing to sue**)
 - a. **Facts:** US firm helps Hong King co. get cable TV license, and has an oral agreement to buy 10% of stock in Hong Kong firm if it gets the license.
 - b. The court differentiates between the speculative question of how many shares you would have bought if there wasn't a misstatement (Blue Chips) and an oral agreement.
 - c. Supreme Court says that *Blue Chip* only applies w/ potential buyers, but here they were actual buyers, *even though* it was an oral K to buy securities
 - d. Supreme Court holds that an **oral agreement can be enforced**. It doesn't raise the speculative concerns that were found in Blue Chip.
8. **Central Bank v. First Interstate Bank** – p. 583 (**aider and abettor liability**)
 - a. **Facts:** Central Bank is a trustee for two municipal bond offerings. Requirement that bonds have an appraised value of at least 160% of bond's obligations. There is an initial offering. Before the second offering, the real estate market declined and the bank knew that the appraisal was wrong. They did not do a new appraisal until after the second offering. II argues that if the

Securities Regulation
Quinn - Fall 2004

bank had done another appraisal before the second offering, then the second offering would not have occurred. They argue that the bank allowed the issuer to sell when they knew it should not have, therefore they aided and abetted the violation of 10(b).

- b. **Rule: no liability for aiding and abetting in a private cause of action.**
 - 1) The plain language of the statute does not include liability for aiding and abetting and so it will not be included.
 - 2) The statutory language “directly or indirectly” does not include aiding and abetting.
 - 3) Congress enacted criminal aiding and abetting liability, but not civil aiding and abetting liability. Specifically, Congress has not enacted civil aiding and abetting liability in the securities laws.
 - c. The court says that policy concerns, that aider and abettor liability deters secondary actors from contributing to fraud and ensures that defrauded plaintiffs are made whole, cannot override the language and structure of the Act.
 - d. The court again argues that expansive litigation may lead to the failure of new and smaller business due to the large cost of defending aider and abettor cases.
 - e. The dissent says that the majority decision goes against a well of established lower court precedent. It also identifies a workable 3 part test for aider and abettor liability, thereby negating the majority’s allegations of confusion and high litigation costs.
9. **Basic v. Levinson – p. 735 (reliance)**
- a. **Facts:** Combustion Engineering wants to acquire Basic and included the plan in their strategic plan. They had meetings with Basic to discuss the possibility of merger. Basic made three public statements denying that it was engaged in merger talks. Eventually, Basic took the offer.
 - b. **Issue:** Whether a person, who traded a company’s shares on an exchange, after material misstatements were made, may invoke a rebuttable presumption that in trading, he relied on the integrity of the price set by the market?
 - c. The Supreme Court held that there is a rebuttable presumption that misleading statements to the market artificially depress the market price of the shares. It accepts the **fraud on the market theory**.
 - 1) “Where materially misleading statements have been disseminated into an impersonal, well developed market for securities, the reliance of the individual plaintiffs on the integrity of the market price may be presumed.”

**Securities Regulation
Quinn - Fall 2004**

- d. This presumed reliance, however, is rebuttable. The **defendant has the burden of proof**.
 - 1) Any showing that **severs the link between the alleged misrepresentations and either the price received** by the plaintiff **or his decision to trade** will be sufficient to rebut the presumption of reliance
 - e. The dissent says that the fraud on the market theory is too new to be made into law. Also, people who buy stocks do not necessarily believe that the market price is the true value of the stock. People disagree over the value of a security; otherwise there would be no trading.
10. **In Re Apple Computer** – p. 743 (**reliance**)
- a. **Facts:** Plaintiff alleges that Apple Computers misled the market about the capabilities and prospects of a novel office computer and disk drive. They claim they purchased the stock in reliance on the artificially high stock price and then suffered damages.
 - b. The Supreme Court held that “the defendant’s failure to disclose material information may be excused where that information has been made credibly available to the market by other sources.”
 - c. There were press releases in the public that the computer was risky, so the defendant is not liable. **When deficiencies are corrected with lots of *media coverage*, reliance using fraud on the market will be rebutted.**
11. **Santa Fe Industries v. Green** – p. 782 (**fraud or deception/scienter**)
- a. **Facts:** Company bought 60% of the shares of another company. They then purchased up to 95% of the shares. Company does a short-form merger in accordance with Delaware law and buys out the remaining 5% of minority stock. The appraisal set the share price at \$25 per share so the company offered the minority shareholder \$150 per share. The company informs the minority shareholders that they can challenge the share price in a DE chancery court. The minority shareholders sue the company in federal court seeking to set aside the merger saying that the share price was really \$772 per share.
 - b. The Supreme Court held that negligence is not enough to show scienter under Rule 10b-5.
 - c. The Court also held that breach of fiduciary duty is something ordinarily left to the states and that federal law should not impose a stricter standard of fiduciary duty than that require by the laws of a state. State law will generally govern the internal affairs of a corporation and states should remain free to regulate corporate conduct except where federal law **expressly** requires certain responsibilities of directors with respect to shareholders.

Securities Regulation
Quinn - Fall 2004

12. **Zoelsch v. Arthur Andersen** – p. 603 (**extraterritorial 10b-5 reach**)

- a. **Facts:** Plaintiffs are West German citizens; the defendant is the US branch of Arthur Andersen. P invested on a tax shelter plan via a German limited partnership that invested in property in the US. German Arthur Andersen audited the partnership. P claims that the US Arthur Andersen branch provided misleading information to the German Arthur Andersen branch knowing that the information would be included in an audit report. The Audit report is prepared in Germany and all of the transactions take place in Germany.
- b. The Court dismisses the case for lack of subject matter jurisdiction.
- c. **Test:** Jurisdiction is appropriate when the fraudulent statements or misrepresentations originate in the US, are made with scienter and in connection with the purchase or sale of securities, and “directly cause” the harm to those who claim to be defrauded even if the reliance and damages occur elsewhere.

13. **Insider Trading Cases**

a. **Cady, Roberts Co.** – p. 632 (SEC Opinion)

- 1) **Facts:** Broker got information that the Board was going to cut a dividend, so he placed an order to sell Curtis-Wright stock for his customers before the news of the dividend was disseminated to the public.
- 2) The SEC says that if you have special access to material non-public information you must either disclose the information to the public or abstain from trading.
- 3) A broker who receives inside information from the corporation and uses it to assist his customers in making sales before public disclosure of a material fact is liable.
- 4) The obligation rests on the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing.

b. **SEC v. Texas Gulf Sulphur** – p. 657 (5th Circuit)

- 1) **Facts:** Plaintiff claimed officers of TGS bought stock or calls using material nonpublic information about a drilling site in Canada. Two of the officers had given information to others for use and recommended purchase while the information was undisclosed to others.
- 2) Court holds that **ANYONE in possession of material inside information must either DISCLOSE** it to the investing public, **or** if he is disabled

Securities Regulation
Quinn - Fall 2004

from disclosing it in order to protect corporate confidence, must **ABSTAIN from trading in or RECOMMENDING** the securities concerned while such information remains undisclosed.

- 3) Tippers inside the corporation who pass along information to relatives, friends, and business associates outside the corporation are insiders. These tippers were held liable for the profits made by the tippees.
 - 4) **All were in violation**. The drill results were material. The insiders were not trading on an equal footing with the outside investors. They had access to the information about the probability of the finding ore on the land, while the public was unaware of the favorable probabilities or unproductive exploration.
- c. **Chiarella v. US** – p. 672 (Supreme Court Case)
- 1) **Facts:** An employee of a financial printing firm, who was working on documents related to a contemplated tender offer, ascertained the identities of the companies which were the targets of those offers, purchased stock in those companies, and sold stock at a profit after the tender offers were announced. Employee returned the money as part of a settlement with the SEC in a civil case. The US then instituted a criminal proceeding against him.
 - 2) **Rule:** One who fails to disclose material information prior to the consummation of a transaction commits fraud only when he is under a duty to do so.
 - a) “The duty to disclose arises when one party has information that the other party is entitled to know because of a fiduciary or other similar relationship of trust and confidence between them.”
 - 3) “A purchaser of stock who has no duty **to a prospective seller** because he is neither an insider nor a fiduciary has been held to have no obligation to reveal material facts.”
 - 4) Burger Dissent: said that liability should be established when an informational advantage is obtained not by superior experience, foresight, or industry, but by unlawful mens. He introduces the misappropriation theory.
- d. **US v. Newman** – p. 678
- 1) **Facts:** Bankers hired by bidder in a takeover. The bankers use inside information to trade stocks.
 - 2) The second circuit held that the bankers had criminally violated Rule 10b-5, based on the misappropriation theory because they breached a duty to the **source of the information**.

Securities Regulation
Quinn - Fall 2004

- e. **US v. Carpenter** – p. 678
- 1) **Facts:** Wall Street Journal (“WSJ”) writer traded on inside information that he later published in his column. The column affected the company’s stock price. The writer breached a duty to the WSJ. Writer had told D the info and D also traded on the stock prior to the publication of the column.
 - 2) **Issue:** Is D liable for insider trading?
 - 3) 2d Cir: upholds conviction under the misappropriation theory. The Supreme Court has a 4-4 split which means that the 2nd Circuit opinion is still good law.
- f. **United States v. O’Hagan** – p. 679
- 1) **Facts:** O’Hagan was a crooked lawyer before engaging in insider trading. He was a securities partner who was embezzling funds. O’Hagan had previously embezzled money, and decided to use inside information regarding the hostile take-over as a means of recouping the client funds that he had embezzled
 - 2) The Supreme Court accepts the misappropriation theory. The **misappropriation theory** holds that a person commits fraud in connection with a securities transaction and thereby violates § 10 and Rule 10b5 when he misappropriates confidential information for securities trading purposes, in breach of a duty owed not to trading party but to the source of the information.
 - 3) **RULE:** A person who trades in securities for personal profit, using confidential **information misappropriated in breach of a fiduciary duty to the source of the information**, is guilty of violating Rule 10b-5.
 - a) “Misappropriators...deal in deception. A fiduciary who pretends loyalty to the principal while secretly converting the principal’s information for personal gain, dupes or defrauds the principal.”
 - 4) The court finds the “in connection with: requirement satisfied because the Defendant’s fraud is consummated when, without disclosure to the source, the defendant uses the information to purchase or sell securities.
- g. **Chestman Case** – p. 690
- 1) **Facts:** This is a criminal case. Ira was chairman of Waldbaum’s stores – A&P is going buy Walbaums.’ Ira tells his sister that this is going to happen and says that she has to keep the information confidential. Ira’s sister tells her daughter and says that this is confidential information. The daughter tells her husband, the guy named Lowe, and tells him to keep the information confidential. Lowe buys Walbums stock and tips his stockbroker, Chestman. Chestman then buys the stock.

Securities Regulation
Quinn - Fall 2004

- 2) The key in this whole chain of transactions is that you have to show that Lowe owed a duty to his wife. Because if there was no duty, then there was no breach of duty. This case turns on relationships between husbands and wives.
 - 3) The court said, a fiduciary duty does not automatically exist between spouses or family members. The duty is determined on case by case basis.
 - 4) There are several ways you can show this fiduciary duty:
 - a) You can show that someone expressly agrees to accept a duty, **or**
 - b) You can imply a fiduciary duty based on prior dealings or a past practice of keeping confidential information.
 - 5) The court says that there was no duty here. Lowe never expressly agreed to keep the information confidential and there was not enough evidence to imply a duty based on a prior sharing of confidential information.
 - 6) Critics of this case says that this is stupid because you have securities fraud that is turning on the relationship between family members
- h. **Dirks v. SEC** – p. 683 (**tippee liability**)
- 1) **Facts:** Dirks gets information from a former officer of a corporation, stating that the company was full of crooks and the stock would plummet when fraud was uncovered. The officer wanted Dirks to verify the fraud and disclose it. Dirks tried to inform SEC and the WSJ of the fraud but no one listened. Dirks traded the company's stock based on the information he discovered. Dirks was not an insider and had no duty to shareholders.
 - 2) **Test** for whether a tippee is liable: A tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach.
 - a) **Test** for whether the insider breached a duty: The test is whether the insider personally will benefit, directly or indirectly, such as a pecuniary gain or a reputational benefit that will translate into future earnings (basically was there a gift or a quid pro quo arrangement?).
 - 3) Tippee responsibility must be related back to insider responsibility by a necessary finding that the tippee knew the information was given to him in breach of a duty by a person having a special relationship to the issuer not to disclose the information.
 - 4) **RULE:**
 - a) There is no tippee liability, unless the tipper breaches a duty.

**Securities Regulation
Quinn - Fall 2004**

- b) The tipper breaches a duty only if the information is improperly disclosed. Tipper must have a fiduciary duty, then seek to breach that duty under circumstances where:
 - i. The **tippee knew or should have known that the tipper was breaching a duty**; and
 - ii. The **tipper received a personal benefit** from disclosing the information to the tippee (The benefit does not necessarily have to be financial in nature).

- 5) In Dirks, the tippers received no monetary or personal benefit for revealing secrets. They were motivated to uncover the fraud. Therefore, he was not held liable.

- 6) Dissent- have this policy response to majority's construction. Common law framework- unless

- i. **US v. Kim** – p. 693
 - 1) **Facts:** Company CEO disclosed confidential information to the members of a group called Young Presidents Organization (“YPO”). YPO members sign a confidentiality commitment by which they agree to keep all things disclosed by other members strictly confidential. Kim traded on the info the CEO disclosed. Kim also passed the information along to other close friends and family members.
 - 2) **Issue:** Is Kim liable for insider trading?
 - 3) The court says that there could be a fiduciary duty in a non-fiduciary situation, if a similar relationship of trust and confidence exists. You have a similar relationship if you have dominance, superiority, and control.
 - 4) **Held:** Liability depends on whether you are under a duty to keep the information confidential. An express agreement to keep the information confidential can provide the basis for misappropriation liability only if the express agreement sets forth a relationship with the hallmarks of a fiduciary relationship.
 - 5) **NOTE:** In view of the US government the Kim case was wrong. The SEC now has a rule where the duty is presumed in certain situations. The conduct in Kim predated this rule, the rule does cover the conduct here and Kim would be held liable.

- j. **Switzer Case**
 - 1) **Facts:** Switzer, football coach, overhears a CEO tell his wife that he is going to be traveling for a major deal.

Securities Regulation
Quinn - Fall 2004

- 2) The CEO did not tip Switzer because he did not know that Switzer was there and listening. Thus, the CEO (Tipper) did not breach a duty so Switzer was free and clear.
- 3) The tippee inherits the tipper's duty. If the tipper did not breach a duty then there is no liability to the tippee.

B. Market Manipulation

1. **United States v. Mulheren** – p. 897

- a. **Facts:** Boesky wanted to gain control of G&W and met with Davis. Davis was not interested. Boesky offered to sell his shares back to the company at 45\$/share. Davis said he would only buy back if it were the last sale. Boesky called Mulheren. Mulheren was chief trader at and general partner of Jamie Securities, a registered broker dealer. Mulheren asked if Boesky liked the stock. He said yes, and "it would be great if it traded at \$45." U.S. claimed that M purchased 75,000 shares of G&W common stock with the intent to drive the price to \$45/share, as a favor to Boesky.
- b. Manipulation is a violation that turns on the motivation of the people trading. **When an investor, who is neither a fiduciary nor an insider, engages in securities transactions in the open market with the sole intent to affect the price of the security, the transaction is manipulative and violates Rule 10b-5.**
- c. The Court held that there must be substantial evidence in the record to show that there was evidence beyond a reasonable doubt that D intended to manipulate the market.
- d. The government's theory is questionable, that it is illegally manipulative for an investor who is neither a fiduciary nor an insider to engage in securities transactions in the open market and with the sole intent to affect the price of a security.
- e. It was not proved beyond a reasonable doubt that D even knew that Boesky had a stock position in G&W. Boesky never testified he told D; D testified that he had not read the speculation in the press; and in the meeting of D with Davis, D said he did not think Boesky had a position. Further, the government did not prove beyond a reasonable doubt that D purchased the 75,000 shares for the purpose of manipulating the price of G&W stock

2. **Markowski v. SEC** – p. 907

- a. **Facts:** Markowski, CEO, & Riccio, Trader, manipulated the stock price of the company they underwrote called Mountaintop. When the company could no longer continue to actively trade Mountaintop's stock, the company went bankrupt. Mountaintop stock dropped about 75%.

Securities Regulation
Quinn - Fall 2004

- b. Court held Markowski & Riccio liable. It said that they manipulated the stock because the company had an interest in keeping customer interest.
- c. **Rule:** The legality of a transaction depends entirely on whether the investor's intent was "an investment purpose" or "solely to affect the price of a security."

C. Takeovers and Tender Offers

1. **SEC v. Carter Hawley Hale** – p. 824

- a. **Facts:** Limited wanted to take over Carter. When Limited made the offer, Carter's management did not think it would be in the shareholder's best interest, so they instituted a repurchase plan. They bought back stocks.
- b. Court used the **Eight Factor Wellman test** to determine that the company's repurchase was not a tender offer:
 - 1) Active or widespread solicitation of public shareholders for the shares of the issuer
 - a) Court said there was no direct solicitation of shareholders- no active and widespread solicitation occurred.
 - 2) Solicitation made for a substantial percentage of the issuer's stock
 - a) Court said the company did accumulate a large percentage of stock
 - 3) Offer to purchase made at a premium over the prevailing price
 - a) Court said the premium was determined not by reference to pretender offer price, but rather by reference to market price
 - 4) Terms of the offer are firm, rather than negotiable
 - a) Court said the company engaged in a number of transactions at many different market prices
 - 5) Offer contingent on the tender of a fixed number of shares, often subject to a fixed maximum number to be repurchased
 - a) Court said the company's purchases were not contingent on the tender of a fixed number of shares
 - 6) Offer only open for a limited period of time
 - a) Court said the company's offer not only open for a limited period of time, but open during the pendency of the tender offer of the Limited.
 - 7) Offeree subjected to pressure to sell his stock
 - a) Court said the company did not pressure any offeree to sell his/her stock.

Securities Regulation
Quinn - Fall 2004

- 8) Public announcements of a purchasing program concerning the target company precede or accompany rapid accumulation of a large amount of target company's securities.
- c. Court said that not all factors need be present, and some may outweigh others. But, the court did not specify which factors were more important.
2. **Hanson Trust v. SCM** – p. 829
- a. **Facts:** Hanson [English Company] made a cash tender offer to purchase SCM's shares (more than 5%). The tender offer was to last for 10 days; at \$60/share. SCM advised its shareholders not to do it. Then SCM made a deal with Merrill to create a new entity with the purpose of making a tender offer for \$70 to buy out SCM. Hanson then offered \$72. SCM/Merrill offered \$74. Hanson withdrew their tender offer. Hanson thought they could acquire slightly less than 1/3 of the shares (on the open market) and this would thus block the buyout. SCM sued for a preliminary injunction after Hanson acquired about 25% of SCM shares.
- b. **Issue:** What is a tender offer?
- c. The court held that privately negotiated security transactions are not tender offers for the purpose of the act.

D. Proxy Regulation

1. **Mills v. Electric Auto-Lite Co.** – p. 759
- a. **Facts:** A merger proposal required the approval of 2/3 of the shareholders. Mills alleged that Board lied in the proxy statement and that it was misleading in violation of Section 14-a.
- b. The Supreme Court held that if a Plaintiff can prove that 1) there is a material misrepresentation in the proxy solicitation **and** 2) that the solicitation is an essential link in the transaction, then causation has been established/shown.
2. **Virginia Bankshares v. Sandberg** – p. 765
- a. **Facts:** VA law only required that a merger proposal be submitted at the shareholder meeting. But, Virginia Bankshares ("Bank") solicited proxies on the merger from the shareholders. Bank did not need any of the minority votes to approve the merger. Bank already had enough votes for approval.
- b. Plaintiff alleged that minority shareholder votes were an essential link because of public relations purposes and because minority approval would satisfy a state law regarding the potential conflict of interest of one of the inside directors.

Securities Regulation
Quinn - Fall 2004

- c. Court holds that respondents have failed to demonstrate the equitable basis required to extend the 14(a) private action to such shareholders when any indication of congressional intent to do so is lacking
 - 1) Public relations are too speculative a reason and a state law remedy is still available to the shareholder.
- 3. **Wilson v. Great American** – p. 769
 - a. This case answered the question left open in VA Bankshares.
 - b. Addressed issue left open by Virginia Bankshares: even if minority votes not needed, what if misleading proxy statement and shareholder votes yes and shareholder loses possible remedy under state law.
 - c. **Rule:** A minority shareholder who has lost the right to a state appraisal because of a materially deceptive proxy may make a sufficient showing of causal relationship between the violation and the injury for which he seeks redress.

E. Responsibilities of Attorneys

- 1. **In re Keating, Muething, and Klekamp** – p. 405
 - a. **Facts:** Law Firm represented a business for filings with the SEC. One lawyer in the firm was on the board of the bank; another lawyer was on the board of the business' subsidiary. Both the business and the subsidiary lied or omitted facts about the loan transactions. 50-80% of the Firm's annual revenues came from the business.
 - b. The SEC brought an injunctive action against the Firm. The SEC alleged that because of the Firm's involvement with the business and subsidiary the firm knew or should have known of the material misstatements and omissions in the business' filings with the Commission. **NOTE:** This case involved a settlement agreement.
 - c. **Rule:** A law firm has a duty to make sure that the disclosure documents filed with the Commission include all of the material facts about a client that the firm has knowledge of as a result of its legal representation of that client.
- 2. **Ziemba v. Cascade International Inc.** – p. 425
 - a. **Facts:** Shareholder sues a firm for material misstatements and omissions in the company's filings. Specifically, the company omitted bad/negative news from the filings. The shareholder alleged that the firm did not make sure that the information that the Company disseminated to the public was correct. It also failed to verify as accurate information that the firm helped draft. The firm approved and reviewed a press release that the firm knew was not true. Basically, the shareholder argued that the firm was a primary violator because it failed to act.

Securities Regulation
Quinn - Fall 2004

- b. The Court found that a defendant's omission to state a material fact is proscribed only when the defendant has a duty to disclose.
- c. The Court basically agrees with the idea that a primary violator is a person **known** to have made the misleading statement.
- d. Furthermore, unless the Firm had a duty to the public or Plaintiffs then it does not have a duty to disclose. The Court articulated several factors used to determine if a duty to disclose exists, such as:
 - 1) The relationship between the plaintiff and defendant;
 - 2) The parties' relative access to the information to be disclosed;
 - 3) The benefit derived by the defendant from the purchase or sale;
 - 4) The defendant's awareness of the plaintiff's reliance on the defendant in making its investment decision, **and**
 - 5) The defendant's role in initiating the purchase or sale.
- e. The court held that there was no attorney-client relationship between the shareholder and the firm (they had no duty to disclose), the attorney-client relationship between the business and the firm forbid the Firm from discussing the information with the public, and the firm did not give any statements to the plaintiff (plaintiff did not rely on the firm).