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OVERVIEW

During the past term,[1] the Tenth Circuit reviewed only three decisions[2] dealing with the Securities Act of 1933 (1933 Act)[3] and the Securities Exchange Act of 1934 (1934 Act).[4] The court considered section 12(2),[5] section 13,[6] and section 17(a)[7] of the 1933 Act; section 10(b)[8] of the 1934 Act and rule 10b-5[9] were also discussed. These Tenth Circuit decisions followed well-established precedents. An examination of these decisions will, nevertheless, serve to further clarify the position of the Tenth Circuit on these securities issues.

I. SCIENTER AND THE STATUTE OF LIMITATIONS

In *Wertheim & Co. v. Codding Embryological Sciences, Inc.*,[10] the Tenth Circuit reviewed a securities offering of a corporation organized to engage in a special beef stock promotion. The plaintiff charged violations of section 12(2) and 17(a) of the 1933 Act and noncompliance with section 10(b) of the 1934 Act and rule 10b-5.[11] The trial court found that the defendants had indeed made material misstatements[12] and a material omission;[13] nevertheless, the trial court found for the defendant. In a decision delivered by Judge McWilliams, the Tenth Circuit affirmed.

A. *The Section 10(b) Claim*

The trial court concluded that the misrepresentations and the omission were the result of mere negligence and that the defendant acted in good faith. Under *Hochfelder*, the absence of scienter is fatal to a private damages action predicated on section 10(b).[14] Judge McWilliams, noting that one's

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1. This survey covers opinions filed from June 1, 1979 to May 31, 1980.
2. Wertheim & Co. v. Codding Embryological Sciences, Inc., 620 F.2d 764 (10th Cir. 1980); Cronin v. Midwestern Okla. Dev. Auth., 619 F.2d 856 (10th Cir. 1980); and United States v. Jensen, 608 F.2d 1349 (10th Cir. 1979).
3. 15 U.S.C. §§ 77a-77aa (1976).
4. *Id.* §§ 78a-78kk.
5. *Id.* § 77*l*(2).
6. *Id.* § 77m.
7. *Id.* § 77q(a).
8. *Id.* § 78j(b).
9. 17 C.F.R. § 240.10b-5 (1980).
10. 620 F.2d 764 (10th Cir. 1980).
11. *Id.*
12. The defendants had misrepresented the magnitude of the cost overruns in connection with the construction of a building. *Id.* at 766.
13. The defendants also failed to disclose that they had previously engaged in a similar venture with another company. That enterprise had ended as a financial failure. Moreover, the defendants were involved in a protracted lawsuit in connection with the prior venture. C.H. Codding & Sons v. Armour & Co., 404 F.2d 1 (10th Cir. 1968). The plaintiffs were not informed of this litigation. 620 F.2d at 766.
14. Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976). Even assuming that the statements were made with the requisite scienter, the trial court held, in the alternative, that the plaintiffs

"state of mind almost invariably presents an issue of fact," ruled that the trial court's negligence finding was not clearly erroneous and hence would not be disturbed on appeal.[15]

The plaintiff urged that reckless misconduct should be deemed the equivalent of scienter.[16] Judge McWilliams recognized that other circuits have decided that the reach of scienter includes recklessness,[17] but the judge concluded that the trial court's determination that the defendant's conduct was merely negligent precluded such an inquiry in the instant case.[18]

B. *The Section 12(2) and 17(a) Claims*

Acknowledging that a section 12(2) claim survives the lack of scienter, the Tenth Circuit turned to section 13 of the 1933 Act, which imposes a one-year statute of limitations commencing "after the discovery of the untrue statement or omission." The defendant first discovered the misrepresentations in December 1973; the action was not filed until January 1975—one month too late. Because there was insufficient evidence to toll section 13, Judge McWilliams dismissed the section 12(2) claim.[19]

On appeal, the plaintiffs did not pursue the section 17(a) claim. At the trial level, counsel indicated that this claim was included under the umbrella of rule 10b-5.[20] This presents a vivid illustration of how *Aaron v. SEC*[21] may well move the battleground for securities fraud from section 10(b) to section 17(a). That rule 10b-5 has overshadowed section 17(a) in the past is without question. The implications of *Aaron* on private damage actions based on section 17(a), however, may well breathe new life into this anti-fraud provision.

Hochfelder and *Aaron* both stand for the proposition that the scienter requirement under the anti-fraud sections does not turn upon the identity of the plaintiff or upon the nature of the relief sought; rather, what is determinative is the language and legislative history of the statutory provision. It seems, therefore, that this logic allows a private plaintiff seeking money damages to prevail under section 17(a)(2) and (3) without a showing of scienter. The catch, of course, is that the Supreme Court has not yet decided whether it will imply a private action under section 17(a) of the 1933 Act.[22] Until the Court resolves this question, private plaintiffs undoubtedly will pursue section 17(a) claims with much more vigor than they have in the past.

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could not show that they had in fact relied on the representations or that they had acted with due diligence in the transaction. 620 F.2d at 766.

15. *Id.*

16. The *Hochfelder* Court refrained from deciding whether reckless behavior was a form of scienter. 425 U.S. at 193 & 194 n.12.

17. Rolf v. Blyth, Eastman, Dillion & Co., 570 F.2d 38 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978); Sunstrand v. Sun Chem. Corp., 553 F.2d 1033 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977).

18. 620 F.2d at 766-67.

19. *Id.* at 767.

20. *Id.*

21. 100 S. Ct. 1945 (1980).

22. *Id.* at 1951. For a detailed discussion of the *Aaron* decision and its possible ramifications, see Aaron v. SEC: *The Scienter Requirement in SEC Injunctive Actions*, which immediately follows this overview, *infra* at 493.

II. BOND COUNSEL AND TRUSTEE'S LIABILITY

Cronin v. Midwestern Oklahoma Development Authority,[23] involved a securities fraud action by purchasers of two issues of industrial development revenue bonds. The bonds went into default, and numerous defendants were named in the litigation.[24] The purchasers' complaint alleged, in part, that the bond counsel and trustee had violated or aided and abetted violations of rule 10b-5 by failing to disclose certain allegedly material facts. The district court granted summary judgment to the bond counsel and to the trustee, and the plaintiffs appealed. Judge Doyle, speaking for the Tenth Circuit panel, directed the trial court to vacate all of the summary judgment orders. In essence, Judge Doyle overruled the trial court's decision because the "orders are replete with conclusory statements" and the facts surrounding the bonds' issuance needed further development.[25] The Tenth Circuit did look, however, to one legal conclusion of the lower court. The trial court assumed that since the express fraud was committed by a broker-dealer's sales representative, the purchasers were required to prove that the bond counsel and the indenture trustee were privy to the misrepresentation. Judge Doyle disagreed. He noted that the defendants would be liable if "shown to have had participat[ed] in the issuance of the bonds and thus [to have] owed a duty to all of the buyers to reveal the facts . . . and [liability would also result] if the defendant-lawyers and banks knowingly aided the underwriter in the issuance of value-depleted bonds."[26]

III. BROKER'S FRAUD UNDER SECTION 17(A)

The Tenth Circuit confronted a criminal prosecution based on alleged violations of section 17(a) of the 1933 Act in *United States v. Jensen*.[27] The defendant was the principal operator of a stock brokerage firm called Associated Underwriters (Associated). Associated operated by having an investor enter into a "conversion investment contract." Under this agreement, Associated would select certain securities, using the investor's funds for the purchase price. Next, both a "call" option and a "put" option[28] would be acquired on these securities. As additional protection, the put options were to be guaranteed by a financially secure institution. Thus, the investors were promised a fixed return on their investment, not subject to the vagaries of the stock market.

Associated fell into financial difficulties. One of Associated's customers defrauded the brokerage house out of $300,000. Many of these stocks were sold to the investor's accounts at prices far in excess of their fair market

23. 619 F.2d 856 (10th Cir. 1980).

24. The defendants included: the bond issuer and its officials, the private corporation which received the bond proceeds, the underwriters, the bond counsel, the indenture trustees, and the broker-dealers involved in selling the bonds to the plaintiff.

25. 619 F.2d at 862.

26. *Id.*

27. 608 F.2d 1349 (10th Cir. 1979).

28. The purchaser of a call option has the right to buy stock at a given price. In contrast, the put option gives one the right to sell a given number of shares of stock, at a specific price, within a specified time frame.

value. Moreover, the defendant began to function as the writer of both the put and call options, as well as becoming the guarantor of the put option, thus, guaranteeing its own legal obligations. Associated subsequently went bankrupt and left its customers with virtually worthless stock.[29]

On appeal, the defendant, Jensen, argued that there was no *sale* of the common stock. Instead, he argued that the investors merely purchased an investment contract.[30] Judge Logan, speaking for the court, focused on the legal obligations between the defendant and the investors. Specifically, the court considered whether Jensen was acting in the capacity of a broker or of a debtor. The court examined Jensen's representation that the investor's money would be used to purchase stocks, "which were then placed in the individual accounts, with each investor being notified." Concluding that this was essentially a brokerage account, the court held that purchases of stock by brokers are the equivalent of sales to the customers.[31]

The defendant urged that there was no fraud committed within the meaning of subsections (2) and (3) of section 17(a). Judge Logan rejected this argument, finding misrepresentations,[32] omissions,[33] and a fraudulent course of business.[34]

Finally, Jensen contended that the fraudulent practices did not have the necessary nexus to the sale of securities. The Tenth Circuit also rejected this argument, reasoning that "fraud does not have to relate directly to the value or nature of stock to be a section 17(a) violation."[35] After viewing the transaction as a whole, Judge Logan concluded that if stock was sold, then section 17(a) applies, and if a section 17(a)(2) or (3) fraud was committed at some point in the transaction, then there was the requisite fraud in the sale of the securities.[36]

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29. 608 F.2d at 1353.
30. *Id.*
31. *Id.*
32. The court noted that, contrary to Jensen's original statements, Associated acted as the guarantor, with Jensen writing the put and call options on worthless stock. *Id.* at 1354.
33. The defendant failed to notify the investors of the changed nature of the investment agreement. *Id.*
34. Jensen used stock that he knew was essentially worthless, selling it to the investors at highly inflated prices. Furthermore, he devised a "sham put and call option transaction" and then guaranteed the put options himself. *Id.*
35. *Id.*
36. *Id.* at 1354-55.