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INDIVIDUAL RECOVERY FOR PROMOTER'S FRAUD— PROCEDURAL PROBLEMS UNDER S.E.C. RULE 10b-5

Recovery by an individual investor for the fraudulent practices of corporate promoters has been difficult.¹ The typical case arises when the promoter, acting through a controlled board of directors, causes the corporation to issue stock to him in return for inadequate consideration. Stock is then sold to the public without disclosure of the earlier sale to the promoter. The investor who buys into the corporation expecting to share proportionately in the assets finds that he gets far less because the transfer to the promoter has caused dilution of the stock's value. If the fraud is discovered and the individual stockholder attempts to seek redress, he is often deterred by the financial risks involved in maintaining a private suit, especially since his potential recovery will be limited by the number of shares he holds. Prior to the Securities Act of 1933² and the Securities Exchange Act of 1934³ the defrauded investor was limited to remedies available under state⁴ or common law.⁵ While state blue sky laws regulating traffic in securities were in force in all but one state⁶ when the Securities Act was passed, no two were exactly alike, the extent of their enforcement varied greatly, and the defrauded investor was hampered by limited state court jurisdiction.⁷ The common law and equitable remedies—breach of warranty, rescission, and the tort action of deceit—were notoriously inadequate because of the proof requirements and the defenses available.⁸

¹ Kalven & Rosenfield, *The Contemporary Function of the Class Suit*, 8 U. CHI. L. REV. 684 (1941).

² 48 Stat. 74 (1933) as amended, 15 U.S.C. §§ 77a-77aa (1958) [hereinafter Securities Act].

³ 48 Stat. 881 (1934) as amended, 15 U.S.C. §§ 78a-j (1958), as amended, 15 U.S.C. §§ 78c-d (Supp. III, 1962) [hereinafter Exchange Act].

⁴ See 3 LOSS, SECURITIES REGULATION 1631-43 (2d ed. 1961) [hereinafter 3 LOSS].

⁵ *Id.* at 1430-35, 1624-31. See generally Frohling, *The Promoter and Rule 10b-5; Basis for Accountability*, 48 CORNELL L.Q. 274 (1962); Comment, *The Prospects for Rule X-10B-5: An Emerging Remedy for Defrauded Investors*, 59 YALE L.J. 1120 (1950).

⁶ LOSS & COWETT, BLUE SKY LAW 17 (1958). See 1 & 2 BLUE SKY L. REP. for a current collection of state blue sky laws.

⁷ LOSS & COWETT, BLUE SKY LAW 17-86 (1958). The extent to which individual civil remedies have been included in state blue sky laws varies widely. Loss has classified the civil remedies available into four separate categories: (1) voidability provisions of various kinds; (2) liability provisions modeled after or resembling either the Uniform Securities Act or the Securities Act of 1933; (3) private remedy provisions based on surety bonds which may be required as an incident of registration; and (4) various provisions which are more or less sui generis, 3 LOSS at 1632. In addition to the diverse civil liability provisions of the state laws, the variety of blue sky laws has caused wide comment. Professor Jennings has classified the state acts into four categories: "(1) fraud prevention; (2) licensing of broker-dealers; (3) qualification of securities, restricted to fraud prevention by compelling 'full disclosure'; and (4) qualification of securities, with imposition of varying degrees of substantive regulation of the terms and conditions under which securities may be sold or issued." Jennings, *The Role of the States in Corporate Regulation and Investor Protection*, 23 LAW & CONTEMP. PROB. 193, 208-13 (1958). The extent to which individual states enforce the statutes has led to the classification of certain states as stringent enforcers, e.g., California, Illinois and Ohio, while others are often considered lenient. See LOSS & COWETT, *op. cit. supra* at 67-79, for a discussion of state administrative habits in enforcing the statutes.

⁸ Hooper v. Mountain States Sec. Corp., 282 F.2d 195, 201 (5th Cir. 1960), cert. denied, 365 U.S. 814 (1961). See White, *From the Frying Pan into the Fire: Swindlers and the Securities Acts*, 45 A.B.A.J. 129 (1959); Comment, *The Prospects for Rule X-10B-5: An Emerging Remedy for Defrauded Investors*, 59 YALE L.J. 1120 (1950). For a discussion of the applicability of the common law in the securities context, see Shulman, *Civil Liability and the Securities Act*, 43 YALE L.J. 227 (1933).

In 1933 and 1934 Congress added to these pre-existing remedies by including several express liability sections in the Securities and Exchange Acts.⁹ Although these federally created remedies offered procedural advantages in their broad venue and service of process provisions,¹⁰ they were circumscribed by limitations that often proved too stringent to overcome.¹¹ As a result much activity has centered around section 10(b) of the Exchange Act¹² which is not limited by internal restrictions. Rule 10b-5, promulgated in 1942 by the Securities and Exchange Commission under section 10(b), makes it unlawful for:

any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national security exchange,

(1) to employ any device, scheme, or artifice to defraud,

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statement made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.¹³

The prerequisites for liability under rule 10b-5 are minimal. By its terms all that need be shown is that some fraud, material misstatement or omission occurred in connection with the purchase or sale of a security coupled with the use of any instrumentality of interstate commerce, any national security exchange, or the mails.¹⁴ This broad liability for fraudulent stock manipulation in addition to the liberal joinder and class action provisions of the Federal Rules of Civil Procedure,

⁹ The Securities Act included three express liability sections: § 11, 15 U.S.C. § 77k (1958), created liability for misleading statements in the registration of securities; § 12(1), 15 U.S.C. § 77l(1) (1958), created liability for anyone who offers to sell a security in violation of the registration or prospectus provisions of the act; § 12(a), 15 U.S.C. § 77l(2) (1958), created liability for misstatements or omissions generally in the offer for sale of a security, registered or not. The Exchange Act also included three express liability provisions: § 9e, 15 U.S.C. § 78l (1958), imposed liability for manipulation of securities registered on an exchange; § 16b, 15 U.S.C. § 78p(b) (1958), imposed liability on corporate insiders for short-term trading profits; § 18, 15 U.S.C. § 78r (1958), imposed liability for misleading statements in documents filed with the Commissioner.

¹⁰ Section 22(a) of the Securities Act, 15 U.S.C. § 77v(a) (1958), and § 27 of the Exchange Act, 15 U.S.C. § 78aa (1958), allow for a wide choice of venue. Both sections also provide for nationwide service of process. This would be an important advantage over state remedies in situations where the only contact which a promoter had with a particular state was through mail delivered into the state or telephone calls terminating there.

¹¹ See 3 Loss at 1691-1746; Frohling, *supra* note 5, at 291. These limitations include a relatively short statute of limitations: Securities Act § 13, 15 U.S.C. § 77m (1958), requires that suits brought under § 12(2) of that act be commenced within one year after discovery of the fraud and within three years after the original sale; Exchange Act §§ 9(e) and 18 also have a one and three year requirement while § 16(b) has a straight two year limit. Another limiting feature is the requirement of privity imposed on suits brought under 12(1) of the Securities Act. Both §§ 11 and 12(2) of the Securities Act allow a defense of reasonable care to the defendant so that he can show ignorance of the misstatement. Sections 9(e) and 18 of the Exchange Act require proof that the fraud or misstatement affected the prices of the securities which the plaintiff purchased or sold. Section 9(e) also requires that the fraud be willful, and § 18 requires proof that the plaintiff relied on the misstatement.

¹² 3 Loss at 1747.

¹³ 17 C.F.R. § 240.10b-5 (1949).

¹⁴ For a discussion of the relative ease of showing a rule 10b-5 violation see 3 Loss at 1764-65.

has, in general, substantially advanced the position of the defrauded investor. This Comment will seek to examine the extent to which this advancement has aided the investor in the promoter's fraud situation, and will examine the procedural difficulties he may encounter on his path to recovery.

I

INDIVIDUAL AND CORPORATE CAUSES OF ACTION

Neither section 10(b) nor rule 10b-5 expressly provides for a private remedy. Nevertheless, commencing with the first case to consider the question, *Kardon v. National Gypsum Co.*,¹⁵ the courts have uniformly found an individual cause of action.¹⁶ Two recent cases¹⁷ have taken a further step, and have found that a corporation which was defrauded into issuing its stock in return for spurious assets also has a cause of action under rule 10b-5.¹⁸

*Hooper v. Mountain States Sec. Corp.*¹⁹ was an action by a trustee in bankruptcy seeking recovery for the defrauded corporation, Consolidated American Industries, Inc. The corporation issued 700,000 shares of its stock in return for stock purchase options in a Cuban insurance company and certain oil exploration rights in Honduras. Consolidated's transfer agent was deceived into issuing the stock for these worthless assets by a document forged by former corporate officials. The stock was issued to Mid-Atlantic Development Co., a corporation created by Mountain States Sec. Corp. and other individual defendants to perpetrate the fraud. Mid-Atlantic was dissolved and the stock reissued to its distributees. It was then sold to the public, the profits going to the perpetrators of the fraud. The Court of Appeals for the Fifth Circuit, asserting that a significant purpose of rule 10b-5 was to extend protection to sellers, found that the issuance of stock by Consolidated was a sale and that, as a corporation, it had standing to sue under section 10(b) and rule 10b-5. All who participated in the fraud were held liable.

¹⁵ 73 F. Supp. 798 (E.D. Pa. 1947).

¹⁶ *E.g.*, *Fratt v. Robinson*, 203 F.2d 627, 631-32 (9th Cir. 1953); *Fischman v. Raytheon Mfg. Co.*, 188 F.2d 783, 786-87 (2d Cir. 1951). Recognition of a cause of action under 10b-5 creates several anomalous situations. Rule 10b-5, by its terms, extends to both buyers and sellers. By allowing a buyer to bring suit under 10b-5, the courts have overridden the restrictions imposed upon the litigating buyer by the liability sections of the Securities Act which specifically apply to him. See *Ellis v. Carter*, 291 F.2d 270 (9th Cir. 1961), for an excellent development of this problem. There the court recognized that to permit buyers to sue under 10b-5, free of the restrictions imposed by the Securities Act, was to say "in effect that the procedural restrictions which Congress carefully provided in the 1933 act with regard to a buyer's civil remedy were completely nullified or ignored by Congress a year later in giving buyers an unrestricted civil remedy." *Id.* at 273. Nevertheless, the court felt this approach was better than several other possible constructions of section 10(b) and rule 10b-5 which it proposed because, "it requires no variance in procedure under the 1934 act as between buyers and sellers" and "as between two acts which deal with the problem, it permits the most recent enactment to govern." *Id.* at 274.

¹⁷ *Hooper v. Mountain States Sec. Corp.*, 282 F.2d 195 (5th Cir. 1960), *cert. denied*, 365 U.S. 814 (1961); *Pettit v. American Stock Exch.*, 217 F. Supp. 21 (S.D.N.Y. 1963). *Cf.* *Taussig v. Wellington Fund, Inc.*, 187 F. Supp. 179 (D. Del. 1960).

¹⁸ Other recent cases have also recognized a corporate cause of action by implication. *Dauphin Corp. v. Sentinel Alarm Corp.*, 206 F. Supp. 432 (D. Del. 1962); *Dauphin Corp. v. Davis*, 201 F. Supp. 470 (D. Del. 1962); *Dauphin Corp. v. Redwall Corp.*, 201 F. Supp. 466 (D. Del. 1962); *H. L. Green Co. v. Childree*, 185 F. Supp. 95 (S.D.N.Y. 1960).

¹⁹ 282 F.2d 195 (5th Cir. 1960).

In *Pettit v. American Stock Exch.*²⁰ a corporate insider in control of Swan-Finch caused stock to be issued to himself in return for inadequate consideration. Through a series of transactions involving the American Stock Exchange, stock brokers and dealers, various banks, and others, the stock was sold to the public, the profit going to the insider. The district court recognized that the corporate issuance of stock fell squarely within the prohibitions of 10b-5 as interpreted by *Hooper*. Since the insider had fled the country, the only defendants before the court were those whose facilities or services were used by the insider for the purpose of distribution of the stock. The court held that both transactions, the initial issue of stock and the later distribution, were essential to the overall scheme and allowed the trustees in reorganization to bring a corporate cause of action under 10b-5 against all the defendants even though their participation may have been tangential to the specific fraud.

While neither *Hooper* nor *Pettit* is a promoter's fraud case, the facts in both are similar to the typical case where the promoter, in control of the corporation and before a public sale of the stock, has stock issued to himself for inadequate consideration. If the reasoning and results of those cases can be extended to the promoter's fraud case, then the defrauded investor may find his road to recovery easier than in the past. Once the corporate cause of action is recognized, the individual investor may be able to overcome some of the financial and motivational difficulties inherent in an individual suit through the device of a shareholder's derivative suit.²¹

Such a corporate cause of action was found by the Massachusetts Supreme Court in *Old Dominion Copper Mining & Smelting Co. v. Bigelow*.²² That case, decided in 1909, involved a suit by the corporation against its promoters, Bigelow and Lewisohn. At the time of the fraud the promoters owned all the issued stock and controlled the board of directors. They caused the corporation to issue them additional stock in return for property worth less than the par value of the stock. At the time of this transaction the promoters intended to have the corporation sell other stock to the public in order to raise working capital. This sale was carried out as planned without disclosure of the earlier stock transfer to the promoters.²³

The court in *Bigelow* recognized that the individual investors who put cash into the fledgling corporation had been harmed but based its decision on the harm that had been done to the corporation as an entity. "The theory upon which corporations are founded is that they are artificial persons, distinct and separate from officers and stockholders."²⁴ In addition, the court recognized that the promoters violated the fiduciary position which all promoters occupy and that they were just as liable when uninformed stockholders were expected to join the corporation as when disclosure was not made to existing stockholders.²⁵

²⁰ 217 F. Supp. 21 (S.D.N.Y. 1963).

²¹ See discussion of the use of a shareholder's derivative suit at note 55 *infra* and accompanying text.

²² 203 Mass. 159, 89 N.E. 193 (1909).

²³ Since the promoter's liability was joint and several, Bigelow, the only promoter over whom the court had jurisdiction, was liable for the entire profit realized. Lewisohn had moved to New York before the fraud was discovered and died there leaving his entire estate in that state. An earlier suit in the federal court against Lewisohn on the basis of diversity of citizenship resulted in the case discussed in text accompanying note 26 *infra*.

²⁴ 203 Mass. 159, 192, 89 N.E. 193, 208 (1909).

²⁵ *Id.* at 187, 89 N.E. at 206.

The court created the doctrine that corporate assent to this type of fraud is a fiction when, as part of the original scheme, sales to the public are contemplated. The promoter's defense of corporate consent, which would have prohibited the corporation from later claiming injury, was thereby overcome. In finding this corporate cause of action, the Massachusetts court eased the burden on the individual shareholder by making it possible for the corporation to seek redress directly.

The United States Supreme Court, on identical facts arising out of the same scheme, reached the opposite conclusion in *Old Dominion Copper Mining & Smelting Co. v. Lewisohn*.²⁶ The Court took the position that the promoters owed no fiduciary duty to the corporation, when at the time of the fraudulent transaction they owned or controlled the only outstanding shares and the directors consented to the stock transfer.²⁷

Although the *Bigelow* doctrine was accepted by a majority of courts outside the federal system,²⁸ the promoter was still able to avoid liability if he followed any one of four possible exculpatory routes outlined by the Massachusetts court: (1) providing an independent board of directors and making full disclosure to them; (2) making full disclosure to each original subscriber of stock; (3) procuring ratification of the act by a vote of the stockholders; or (4) purchasing all the stock authorized.²⁹ Recovery remained difficult for the individual investor because of the technical distinctions which grew to limit *Bigelow*.³⁰ Finding an adequate

²⁶ 210 U.S. 206 (1908).

²⁷ The *Lewisohn* doctrine, that there is no corporate cause of action if there is corporate consent, has been narrowed. In *McCandless v. Furlaud*, 296 U.S. 140 (1935), the promoters undertook to purchase debt securities and bonds from a corporation for resale to the public. After obtaining subscriptions, the promoters transferred property, through a complex transaction, to the corporation in exchange for cash, debt securities and stock, the cash and bonds being far in excess of the value of the properties transferred. The stock and securities were sold to the public at enormous profit. In an action by a receiver on behalf of the creditors of the defrauded corporation, the Court held that the promoters breached their fiduciary duty since the transaction was in the nature of a depletion of assets by way of a fraudulent conveyance which placed the corporation on the brink of insolvency. The Court required that the defendants disgorge the stock as well as the cash and securities. Although the Court based its decision on the wrongful depletion of the corporate assets, the case has been viewed by some as overruling or restricting *Lewisohn*. See the dissenting opinion, *Id.* at 168. A court of appeals case, *Arn v. Dunnett*, 93 F.2d 634 (10th Cir. 1937), *cert. denied*, 304 U.S. 577 (1938), chose to follow the *Lewisohn* rule and distinguished *McCandless*. Recently, however, the Court of Appeals for the Tenth Circuit distinguished its prior decision in *Arn*, and adopted the *Bigelow* doctrine. *San Juan Uranium Corp. v. Wolfe*, 241 F.2d 121 (10th Cir. 1957) (applying Oklahoma law). It stated that "the technical assent of the corporation through its promoters to the deceptive transaction is no defense to an action by the corporation when freed of its bonds." *Id.* at 123.

²⁸ See Berle, *Compensation of Bankers and Promoters Through Stock Profits*, 42 HARV. L. REV. 748, 757 n.20 (1929); Brockelbank, *The Compensation of Promoters*, 13 ORE. L. REV. 195, 210 (1937); Note, 28 GEO. L.J. 535, 540 (1940).

²⁹ *Old Dominion Copper Mining & Smelting Co. v. Bigelow*, 203 Mass. 159, 178, 89 N.E. 193, 202 (1909).

³⁰ Recognition of a corporate cause of action in *Bigelow* was premised on the fact that the defense of corporate consent is a fiction if sales to the public are contemplated as part of the entire scheme of promotion. This premise was apparently limited to the situation where the incoming stockholders purchase from the corporation. In 1932 the Massachusetts court in *Hays v. The Georgian, Inc.*, 280 Mass. 10, 181 N.E. 765 (1932), refused to apply the *Bigelow* doctrine where the promoters or their agents first purchased all the authorized stock and then resold it to the public. See also *Jeffs v. Utah Power & Light Co.*, 136 Me. 454, 12 A.2d 592 (1940) (various technical grounds); *Northridge Coop. Sec. No. 1 v. 32nd Ave. Constr. Corp.*, 161 N.Y.S.2d. 404, 141 N.E. 2d 802 (1957) (disclosure).

means by which an individual could recover was the need that had prodded the court in *Bigelow*, against well recognized difficulties, to find a corporate cause of action. It was this same recognized need³¹ that caused the courts in *Hooper* and *Pettit* to find a corporate remedy under rule 10b-5.

Since the Federal Rules of Civil Procedure providing liberal joinder and class action provisions were promulgated prior to the decisions in *Hooper* and *Pettit*, whether this need was as pressing as it was when *Bigelow* was decided is questionable. Attention must also be focused on whether the need still exists to the extent that it might be an element in recognizing a corporate remedy under rule 10b-5 for a typical promoter's fraud situation. Finally, investigation must be made of the feasibility of proceeding on a corporate cause of action under rule 10b-5.

II

AVAILABILITY OF THE CLASS ACTION DEVICE

The class action based on a common question of law or fact was unavailable in actions of fraud or deceit when *Bigelow* was decided. Representative actions, however, were recognized at an early date³² and a type of class action not binding on those not before the court was embodied in 1842 in Equity Rule 48.³³ Nevertheless, the utilization of the class action device was thought to be inappropriate for the typical fraud situation. In commenting on the subjective nature of the tort of fraud and deceit, a federal court in 1931 declared:

Each plaintiff's action is necessarily predicated upon the facts which induced him to act. The right of each individual is not derivative. It must stand on allegations and proof peculiar to itself and disassociated from others. None has an interest in the cause of action or damage recovered by another. In such a case a class action may not be maintained.³⁴

Since no procedure was recognized for a class action and a private suit was often financially impractical, if relief was to be granted in *Bigelow* the only apparent solution was to find a corporate cause of action. This the court did by looking beyond the form of the transaction to the end result and holding that the corporation as an entity was not barred from bringing suit.³⁵

The situation was markedly altered when *Hooper* was decided. Rule 23(a) of the Federal Rules of Civil Procedure provided in part that:

If persons constituting a class are so numerous as to make it impracticable to bring them all before the court, such of them, one or more, as will fairly insure the adequate representation of all may, on behalf of all, sue or be sued, when the character of the right sought to be enforced for or against the class is . . .

³¹ See *Pettit v. American Stock Exch.*, 217 F. Supp. 21, 27 (S.D.N.Y. 1963).

³² *West v. Randall*, 29 Fed. Cas. 718, 722-23 (No. 17424) (C.C.D. R.I. 1820).

³³ See HOPKINS, *THE NEW FEDERAL EQUITY RULES* 104-05 (7th ed. 1930).

³⁴ *Cherry v. Howell*, 4 F. Supp. 597, 600 (E.D.N.Y. 1931), *aff'd on other grounds*, 66 F.2d 713 (2d Cir. 1933). The same conclusion was reached elsewhere: "Thus far, neither under existing codes nor under general rules of law, has a representative action to recover damages for similar frauds practiced on numerous persons been upheld." Annot., 114 A.L.R. 1015, 1019 (1938). See generally *Wilcox v. Harriman Sec. Corp.*, 10 F. Supp. 532 (S.D.N.Y. 1933); *Cavanagh v. Hutcheson*, 140 Misc. 178, 250 N.Y. Supp. 127 (Sup. Ct. 1931); *Brown v. Werblin*, 138 Misc. 29, 244 N.Y. Supp. 209 (Sup. Ct. 1930).

³⁵ *But see Old Dominion Copper Mining & Smelting Co. v. Lewisohn*, 210 U.S. 206 (1908).

(3) several, and there is a common question of law or fact affecting the several rights and a common relief is sought.

Rule 23(a)(3), termed a spurious class suit,³⁶ has been widely used for both statutory and nonstatutory claims when numerous holders of securities claimed they were defrauded by the dealers with whom they did business in the course of a common transaction.³⁷ The availability of the spurious class action device to redress similar frauds in the course of security dealings markedly improved the situation of the investor. Since the investor had, in addition to his private cause of action, the ability to bring suit as a representative of a class of defrauded investors, there would seem to be less need for the *Hooper* and *Pettit* courts to extend the implied remedy of rule 10b-5 to corporations, unless, of course, the inherent difficulties of the class action device prevented its effective use.

Meeting the requirement of rule 23(a)(3) that the class be so numerous as to make it impracticable to bring all members before the court should not be difficult in the promoter's fraud situation. With a large sale of securities to the public, the ownership would be sufficiently diverse to make joinder of all highly impracticable.

The requirement that the plaintiff "insure the adequate representation of all" might present some difficulties, especially if the class is diverse.³⁸ Since, however, the spurious class suit has been called a mere permissive joinder device, and may bind only those actually before the court,³⁹ the requirement of adequacy of representation should probably be relaxed when applied to rule 23(a)(3). This is apparently the conclusion reached by the Court of Appeals for the Second Circuit in *Oppenheimer v. F.J. Young & Co.*⁴⁰ where the court said that there was no need to go beyond the face of the complaint to determine adequacy. The court recognized, however, that some circuit courts view the spurious class action as binding on all members of the class.⁴¹ In this case, adequacy of representation would be highly important. Because of this divergence within the federal system, a plaintiff bringing a representative suit under rule 23(a)(3) must be prepared to show that he adequately represents the class, or be able to muster sufficient

³⁶ 3 MOORE, FEDERAL PRACTICE ¶23.10 at 3442 (2d ed. 1948) [hereinafter 3 MOORE].

³⁷ See *Zahn v. Transamerica Corp.*, 162 F.2d 36 (3d Cir. 1947); *Speed v. Transamerica Corp.*, 99 F. Supp. 808 (D. Del. 1951). See also 3 MOORE, ¶ 23.10 at 3448-50; 3 Loss at 1820-21.

³⁸ See *Pennsylvania Co. v. Deckert*, 123 F.2d 979 (3d Cir. 1941), where the court found that 49 shareholders whose aggregate investment did not exceed \$10,000 (in a corporation whose total investors were about 13,000 with an investment of several million dollars) were not representative of the class of plaintiffs. In *Pelelas v. Caterpillar Tractor Co.*, 113 F.2d 629 (7th Cir.), cert. denied, 311 U.S. 700 (1940), the court denied a class suit brought by a former employee of the defendant on a claim concerning a group insurance certificate which was issued to him as an employee. The court found that plaintiff was not representative of the whole group of employees.

³⁹ 3 MOORE ¶ 23.10 at 3442. See *Newberg v. American Dryer Corp.*, 195 F. Supp. 345 (E.D. Pa. 1961).

⁴⁰ 144 F.2d 387 (2d Cir. 1944).

⁴¹ *Id.* at 390. See *Weeks v. Bareco Oil Co.*, 125 F.2d 84, 91 (7th Cir. 1941); *Cherner v. Transitron Elect. Corp.*, 221 F. Supp. 48 (D. Mass. 1963), where the court, after citing authority for both the "binding" and "non-binding" decisions consented to approve a compromise agreement between the parties which included a statement that would "bind with respect to 'any claim embraced in the pleadings herein' persons who do not become parties." *Id.* at 53.

co-plaintiffs to ensure adequate representation. Failing this, his suit may be dismissed.

There should be less difficulty in establishing the existence of a common question of law or fact. Although the earlier cases based upon fraud denied the use of a spurious class action because of the subjective nature of the tort, such a result may not be dictated by rule 10b-5.⁴²

The requirement that common relief be sought presents the question of whether an action for money damages will suffice. Each individual will be hurt in proportion to the number of corporate shares he holds. Once the defendant's liability is established, each plaintiff must prove his own damages. Nevertheless, the majority holds that this qualifies as "common relief."⁴³

The most difficult current problem in using the spurious class suit lies, not in satisfying the minimal requirements of the rule, but in the purely mechanical task of contacting other defrauded investors. If the small stockholder cannot locate other similarly defrauded stockholders, he may be unable to proceed because of insufficient resources or an inability to show adequate representation of the class.⁴⁴

In *York v. Guaranty Trust Co.*,⁴⁵ a class action brought on behalf of various noteholders, the circuit court, in reversing a summary judgment, made a suggestion which bears on this problem. It suggested that if the lower court finds against the defendant, then the absent members of the class may be notified to share in the judgment.⁴⁶ If this approach were followed, it would allow absent members of the class to share in the defendant's established liability without being bound by a decision unfavorable to them.⁴⁷ This result hardly seems favorable to the defendant who would be forced to litigate his innocence repeatedly but who would be precluded from testing his liability more than once.⁴⁸ The better approach might be to allow a plaintiff who seeks to represent a spurious class to secure the names of other similarly defrauded investors so that they may join him in the action. This could be accomplished through the use of Rule 34 of the Federal Rules of Civil Procedure which allows the discovery and production of documents upon the motion of any party showing good cause. Another possible method by which the prospective litigant may secure the names of other defrauded investors is by a direct examination of the corporate stock registry books. The common law right of a stockholder to inspect the books of a corporation in which

⁴² See 3 Loss at 1764. See text at note 14 *supra*.

⁴³ See, e.g., *Oppenheimer v. F. J. Young & Co.*, 144 F.2d 387 (2d Cir. 1944); *Independence Shares Corp. v. Deckert*, 108 F.2d 51, 55 (3d Cir. 1939), *rev'd on other grounds*, 311 U.S. 282 (1940).

⁴⁴ It is assumed that the class which must be represented is that of the original purchasers. The right of a subsequent purchaser to maintain an action against the promoter is beyond the scope of this Comment. Some of the difficulties which a subsequent purchaser faces are seen in *Texas Continental Life Ins. Co. v. Bankers Bond Co.*, 187 F. Supp. 14 (W.D. Ky. 1960), *rev'd on other grounds*, 307 F.2d 242 (6th Cir. 1962).

⁴⁵ 143 F.2d 503 (2d Cir. 1944), *rev'd on other grounds*, 326 U.S. 99 (1945).

⁴⁶ *Id.* at 529 (dictum). See cases collected in *Developments in the Law—Multiparty Litigation in the Federal Courts*, 71 HARV. L. REV. 874, 935 n.442 (1958).

⁴⁷ *Id.* at 935.

⁴⁸ Another apparent detriment for the defendant is that the statute of limitations may be tolled for dilatory members of the class when the more aggressive members commence the action. All the dilatory claimants need do is appear and prove their claims. See *Deckert v. Independence Shares Corp.*, 39 F. Supp. 592 (E.D. Pa.), *rev'd on other grounds*, 123 F.2d 979 (3d Cir. 1941). *But see* *Cherner v. Transitron Elect. Corp.*, 221 F. Supp. 48 (D. Mass. 1963).

he holds stock, for proper purposes and at reasonable times is well established.⁴⁹ The right of inspection extends to lists of current stockholders and may be exercised for the purpose of garnering information in anticipation of litigation with the corporation or its officers or directors.⁵⁰ This right of inspection, however, is of limited value, unless the original purchasers retain the stock. Any subsequent sale by them would cause the new owner's name to be substituted in the corporate stockholder lists, thereby eliminating the possibility of using this device to discover the identities of the original, defrauded purchasers. By allowing discovery of the identities of these defrauded investors, either by common law examination or rule 34 discovery procedure, the defendant might be better protected because of the binding effect of the judgment upon those who would presumably join with the original plaintiff in order to pool their financial resources.

A federal district court disagrees. In *Cherner v. Transitron Electronic Corp.*,⁵¹ a suit brought under the express liability sections of the Securities Act by the purchasers of 200 shares of the defendant's stock, the plaintiffs requested by an appropriate rule 34 motion that the court direct the defendant to produce documents that would have allowed discovery of defendant's stockholders. The plaintiffs further requested an order, or in the alternative, authority, to give notice of the litigation to the class which they claimed to represent. The court assumed that:

under the present version of the Federal Rules of Civil Procedure a court in which a spurious class action has been pleaded has the *power* to order at any stage of the case that notice of the pendency of the action be given to "absent persons that they may come in and present claims and defenses if they so desire."⁵²

The motion was denied. In justifying its decision, the court recounted the centuries old doctrine which prohibits counsel and their clients from stirring up litigation. To allow plaintiff's motion would substitute a doctrine of social welfare in place of the familiar professional restraints and the frugal use of legal machinery.⁵³

It seems that the opinion in *Cherner* may itself run counter to the trend which the Federal Rules of Civil Procedure seem to have encouraged—liberal use of the spurious class suit and discovery. The court apparently was repelled by the thought of the possible litigation which would be stirred up, and probably realized that if discovery were allowed, the need to request authority to give notice would be unnecessary. In striking down the motion, then, with language designed to discredit the notice request, the court seemed to give inadequate consideration to the request for discovery. The court's fear of stirring up litigation admittedly has

⁴⁹ *Guthrie v. Harkness*, 199 U.S. 148, 153 (1905). See generally, *LATTIN, CORPORATIONS* 286-94 (1959); *Annot.*, 174 A.L.R. 262 (1948). This common law right has been regulated in many states by specific statutes. These are generally construed as not abrogating the shareholder's common law right but merely supplementing it. *Soreno Hotel Co. v. State*, 107 Fla. 195, 144 So. 339 (1932). See *LATTIN, op. cit. supra* at 288 n.10; *Annot.*, 174 A.L.R. 262, 269 (1948).

⁵⁰ *Wittnebel v. Loughman*, 9 F. Supp. 465 (S.D.N.Y. 1933), *aff'd*, 80 F.2d 222 (2d Cir. 1935), *cert. denied*, 297 U.S. 716 (1936).

⁵¹ 201 F. Supp. 934 (D. Mass. 1962).

⁵² *Id.* at 935. (Emphasis by court.)

⁵³ *Id.* at 937. *Cf. Baim & Blank Inc. v. Warren-Connelly Co.*, 19 F.R.D. 108 (S.D.N.Y. 1956). "The permissive use of class action permitted by Rule 23 of the Rules of Civil Procedure was never intended as a device to enable client solicitation, nor should it be permitted to be used for that purpose." *Id.* at 111.

some merit. On the other hand, if the suggestion of *York v. Guaranty Trust Co.*⁵⁴ is followed, and unbound shareholders are allowed to join in the spoils after the fact, it would appear that multiple litigation is being encouraged without extending to the defendant the protection of a binding non-liability decision.

If one of the reasons for the recognition of a corporate cause of action under rule 10b-5 by *Hooper* and *Pettit* was the unsatisfactory nature of the class action device, and if by relaxing the rule of no discovery laid down in *Cherner* this inadequacy might be eliminated, then the need to extend the corporate cause of action to the promoter's fraud situation would be lessened. Whether a district court, in the exercise of the discretion granted it by Rule 34 of the Federal Rules of Civil Procedure, will take this step remains to be seen.

III

USE OF THE STOCKHOLDER'S DERIVATIVE SUIT

When a corporation has a cause of action but refuses to bring it, a stockholder may initiate a derivative suit if the necessary conditions exist.⁵⁵ Therefore, by finding a corporate cause of action under SEC rule 10b-5, the courts in *Hooper* and *Pettit* created an additional method by which a defrauded investor may seek redress. If the investor decides against using an individual or class action suit based on his private cause of action, he may now bring suit derivatively on the corporate cause of action. In addition to offering another possible route of recovery, the derivative suit has a distinct financial advantage: since it is brought by a stockholder on behalf of a reluctant corporation, the corporation must typically pay the expenses of the suit.⁵⁶

Finding a corporate cause of action in a promoter's fraud situation, however, may not be as easy as it was in the *Hooper* and *Pettit* cases. In those cases the fraud was committed by insiders upon going corporations with numerous stockholders. If in the promoter's fraud situation there are stockholders other than the defrauders at the time of the fraudulent stock transfer, then the analogy to the *Hooper* and *Pettit* cases is clear. But what of the typical case where the fraud is perpetrated when the defrauders are the only shareholders? That was the difficulty that the *Bigelow* and *Lewisohn* courts faced. The Massachusetts court found a corporate cause of action by looking at the entire promotional scheme, thereby rejecting the defense of corporate consent. On the other hand, the Supreme Court in *Lewisohn* chose to limit its view to the specific act of transferring the

⁵⁴ See note 47 *supra* and accompanying text.

⁵⁵ FED. R. CIV. P. 23(b):

Secondary Action by Shareholders. In an action brought to enforce a secondary right on the part of one or more shareholders in an association, incorporated or unincorporated, because the association refuses to enforce rights which may properly be asserted by it, the complaint shall be verified by oath and shall aver (1) that the plaintiff was a shareholder at the time of the transaction of which he complains or that his share thereafter devolved on him by operation of law and (2) that the action is not a collusive one to confer on a court of the United States jurisdiction. The complaint shall also set forth with particularity the efforts of the plaintiff to secure from the managing directors or trustees and, if necessary, from the shareholders such action as he desires, and the reasons for his failure to obtain such action or the reasons for not making such effort.

⁵⁶ *Taussig v. Wellington Fund., Inc.*, 187 F. Supp. 179 (D. Del. 1960).

stock to the promoters and held that there was no corporate cause of action because all of the then stockholders consented.

The *Lewisohn* doctrine, established long before rule 10b-5, need not limit the finding of a corporate cause of action under that rule. A reading of the broad language used by the Securities and Exchange Commission in rule 10b-5—"to employ any . . . scheme . . . to engage in any . . . course of business. . . ."—indicates that more than the specific act of fraud is to be examined. The entire fraudulent transaction should be viewed as the wrong that the rule proscribes. A second possible basis that would justify the finding of a corporate cause of action might be established by recognizing the corporation as an entity, separate and apart from the promoters even though the promoters are the only stockholders. The Massachusetts court used this approach in the *Bigelow* case.⁵⁷

Assuming for the moment that the federal courts will recognize a corporate cause of action in the promoter's fraud situation, the prerequisites which Rule 23(b) of the Federal Rules of Civil Procedure imposes upon a stockholder who brings an action under SEC rule 10b-5 are that (1) the plaintiff show that he was a stockholder at the time the transaction complained of occurred (contemporaneous ownership); and (2) the shareholder make demand of the directors of the corporation to prosecute the suit in the name of the corporation, and also if necessary make demand of the shareholders for the action he desires (exhaustion of intracorporate remedies).⁵⁸ Unfortunately, the application of these prerequisites to actual controversies in the federal courts has not always been uniform.

The requirement of contemporaneous ownership apparently originated in *Hawes v. Oakland*,⁵⁹ a suit based on diversity jurisdiction. It was there thought that the requirement would prevent the transfer of corporate stock to a non-resident solely for the purpose of creating the necessary diversity.⁶⁰ Since this original basis of the requirement was to prevent collusive jurisdiction, it is arguable that the requisite is inapplicable to suits which have as their jurisdictional basis a federal question and not diversity.⁶¹ On the other hand, since rule 23(b) also contains the requirement that no collusion be pleaded,⁶² it seems that the contemporaneous ownership requirement is more than a jurisdictional concept. This view was supported in *Venner v. Great No. Ry.*⁶³ where the Supreme

⁵⁷ See note 24 *supra* and accompanying text.

⁵⁸ The additional requirement of rule 23(b) that the plaintiff aver the action is not collusive for the purposes of bringing the parties within federal diversity jurisdiction has no application in a suit under the Exchange Act which confers exclusive jurisdiction on the federal courts. Section 27, Exchange Act, 15 U.S.C. § 78aa (1958).

⁵⁹ 104 U.S. (14 Otto) 450 (1881). This rule was later codified in Equity Rule 94, 104 U.S. (14 Otto) ix (1881), which through intermediary changes became clause 1 of Fed. R. Civ. P. 23(b).

⁶⁰ *Hawes v. Oakland*, *supra* note 59. "If no non-resident stockholder exists, a transfer of a few shares is made to some citizen of another State, who then brings the suit. . . . [T]he overburdened courts of the United States have this additional important litigation imposed upon them by a simulated and conventional arrangement, unauthorized by the facts of the case or by the sound principles of equity jurisdiction." *Id.* at 453.

⁶¹ *Hand v. Kansas City So. Ry.*, 55 F.2d 712 (S.D.N.Y. 1931); *Jablow v. Agnew*, 30 F.Supp. 718 (S.D.N.Y. 1940). These cases were later restricted to their particular facts, respectively by *Jacobson v. General Motors Corp.*, 22 F. Supp. 255 (S.D.N.Y. 1938) and *Piccard v. Sperry Corp.*, 36 F. Supp. 1006 (S.D.N.Y.), *aff'd per curiam*, 120 F.2d 328 (2d Cir. 1941).

⁶² See note 58 *supra*.

⁶³ 209 U.S. 24 (1908).

Court held that even though the requisite diversity existed, the suit must nevertheless be dismissed if the plaintiff failed to meet the contemporaneous ownership requirement of what was then Equity Rule 94.⁶⁴

The non-jurisdictional view of the contemporaneous ownership requirement is given some support by an examination of the state court decisions which have adopted the requirement even though diversity problems do not exist there.⁶⁵ The precise point of whether the contemporaneous ownership rule applies when original jurisdiction in a federal court is based on a federal question has only recently been decided. In *Gottesman v. General Motors Corp.*,⁶⁶ a stockholder's derivative action based on federal antitrust laws, the court said:

While one of the purposes behind clause (1) of Rule 23(b) and its predecessors was to prevent the conferring of collusive jurisdiction on the federal courts . . . it is clear that the rule relates to more than a jurisdictional requirement and is designed to prohibit a *subsequent* purchaser from speculating in litigation. . . . As such it must apply to suits in the federal court where jurisdiction is based on a federal question as well as suits where jurisdiction is based on diversity of citizenship.⁶⁷

A possibility remains that the requirement will be found inapplicable to a suit under rule 10b-5. If the speculation in litigation concept recognized in *Gottesman* is the true sustaining force behind the contemporaneous ownership requirement in the federal courts, then it would have no application when, far from being a *subsequent* purchaser of stock, the defrauded investor is the *first* purchaser. The promoters should not be heard to complain that the defrauded investor was speculating in litigation when the very success of the fraudulent promotional scheme depended upon the purchase in the first instance. Whether the *Gottesman* decision is the definitive word in this controversy remains to be seen. If it is, then the defrauded investor who brings a derivative suit against the promoter must show that he was a stockholder at the time of the transaction of which he complains. In determining the stockholder's status at the time of the fraud, the courts will be required to look to federal law.⁶⁸

⁶⁴ *Id.* at 33-35.

⁶⁵ See 3 MOORE ¶ 23.15 at 3494 n.14 for a list of states which have judicially adopted the requirement. While there may be many reasons why the states have adopted the requirement, the most frequently mentioned seems to be that it was used to prevent speculation in litigation. *E.g.*, *Dimpfell v. Ohio & Miss. Ry.*, 110 U.S. 209, 210 (1884); *Jacobson v. General Motors Corp.*, 22 F. Supp. 225, 257 (S.D.N.Y. 1938); *Home Fire Ins. Co. v. Barber*, 67 Neb. 644, 658, 93 N.W. 1024, 1029-30 (1903).

⁶⁶ 28 F.R.D. 325 (S.D.N.Y. 1961).

⁶⁷ *Id.* at 326. (Emphasis added.)

⁶⁸ *McClure v. Borne Chem. Co.*, 292 F.2d 824 (3d Cir.), *cert. denied*, 368 U.S. 939 (1961), a derivative suit under rule 10b-5, was concerned with the applicability of a state's security for expense statute to a suit in the federal court. Several states conditioned a small shareholder's right to bring a derivative suit on the posting of security. By this prerequisite the states hoped to avoid strike suits. The court held that federal law must be applied. This view is particularly reinforced in an action under rule 10b-5, for Congress gave exclusive jurisdiction to the federal courts indicating a legislative desire that suits under the Exchange Act be accorded uniform treatment. In cases founded on diversity, however, state law is generally applied on the basis of *Erie R.R. v. Tompkins*, 304 U.S. 63 (1938), and its progeny, the determination of who was a contemporaneous owner being thought of as substantive. This is not a firm rule, however, since much conflict may be found. See, *e.g.*, *H.F.G. Co. v. Pioneer Publishing Co.*, 162 F.2d 536 (7th Cir. 1947) (procedural in majority opinion, substantive in concurring opinion). Compare *Gallup v. Caldwell*, 120 F.2d 90 (3d Cir. 1941) (substantive). See *Bankers Nat'l Corp. v. Barr*, 7 F.R.D. 305 (S.D.N.Y. 1945) (substantive as to imposition of requirement of contemporaneous ownership but procedural as to determination of such ownership). See generally 3 MOORE ¶ 23.15 at 3496-502.

If the requirement of contemporaneous ownership is strictly applied, then in the case of a promoter's fraud where the fraudulent stock transfer occurred while the promoters were the sole shareholders, the later purchasing investor would be denied status as a contemporaneous owner. This would create an anomalous situation: the corporation, if still controlled by the promoters, would possess a potential cause of action against the defrauders, but the defrauded stockholders would be unable to bring a derivative action to enforce it because of the lack of contemporaneous ownership. Of course, if at a later time the promoters relinquish control, an independent board of directors could cause the corporation to bring suit against them, provided it was not barred by the lapse of time.⁶⁹ A solution to this anomaly would be to interpret contemporaneous ownership broadly—to extend the transaction complained of to include the contemplated later sale of stock to the public as the Massachusetts court did in *Bigelow*.⁷⁰

Whether federal law will permit a court to go as far as the *Bigelow* court did in finding the requisite contemporaneous ownership in the context of a derivative suit based on a federal right apparently has not been decided. Contemporaneous ownership, however, has been considered by federal courts in other situations. Those courts conclude that an equitable interest is sufficient ownership,⁷¹ and that prolonged courses of conduct may fall within the same transaction.⁷² If, then, the promoter is careless, and offers the corporate stock to the public so that the purchasers have an equitable interest in it prior to completing the fraudulent transfer of stock, or after the fraudulent transfer but before the controlled directors ratify the act, or any other physical act which the court can use to establish an extended transaction, he would seem to have made a disastrous error.

To base a shareholder's right to bring a secondary suit for his corporation upon such technical distinctions seems unwarranted. It was just such distinctions that prompted the court in *Bigelow* to cut through the penumbra of technicality and declare that if sales to the unsuspecting public were contemplated as part of the promotional scheme, then the requisite contemporaneous ownership was present. In view of the willingness of the federal courts to look towards substance rather than form in defining a transaction,⁷³ and their recent recognition of a corporate cause of action, it is suggested that a pragmatic approach, such as in *Bigelow*, is in order in the federal system.⁷⁴

⁶⁹ See Frohling, *The Promoter and Rule 10b-5; Basis for Accountability*, 48 CORNELL L. Q. 274, 296-97 (1962).

⁷⁰ *Old Dominion Copper Mining & Smelting Co. v. Bigelow*, 203 Mass. 159, 89 N.E. 193 (1909).

⁷¹ *E.g.*, *Hurt v. Cotton States Fertilizer Co.*, 145 F.2d 293 (5th Cir. 1944), *cert. denied*, 324 U.S. 844 (1945); *Craftsman Fin. & Mortgage Co. v. Brown*, 64 F. Supp. 168 (S.D.N.Y. 1945).

⁷² *E.g.*, *Palmer v. Morris*, 316 F.2d 649 (5th Cir. 1963). An interesting case is *Maclary v. Pleasant Hills, Inc.*, 35 Del. Ch. 39, 109 A.2d 830 (1954), where a Delaware court was required to interpret the Delaware derivative action statute which is essentially the same as FED. R. CIV. P. 23(b). In that derivative suit brought against the promoter of a corporation the court held that, although the corporation authorized issuance of stock to the promoter in 1940, the transaction was not complete until 1943 when the certificates were finally issued.

⁷³ See *Pettit v. American Stock Exch.*, 217 F. Supp. 21, 25-26 (S.D.N.Y. 1963).

⁷⁴ The federal cases that have rejected contemporaneous ownership status for those who purchase shares after the fraud has been committed, even though such purchase was contemplated in the original promotional scheme, have used this device to deny a corporate cause of action. Their reasoning is that all the shareholders at the time of the fraud consented, there-

If the hurdle of contemporaneous ownership is overcome, the investor must face the second burden imposed by 23(b) of the Federal Rules of Civil Procedure.

The complaint shall also set forth with particularity the efforts of the plaintiff to secure from the managing directors or trustees and, if necessary, from the shareholders such action as he desires, and the reasons for his failure to obtain such action or the reasons for not making such effort.

This exhaustion of intracorporate remedies requirement is also troublesome. If the corporation brings the suit directly, then the shareholder will be barred from enforcing the cause of action derivatively. Therefore, demand on the directors seems reasonable. This reasonableness disappears, however, when the directors are the defrauders in a promoter's fraud situation. In that case demand is a useless act and consequently it is generally excused.⁷⁵

A similar demand upon the shareholders, based upon the theory that they may ratify the promoter's wrong or may furnish other relief, is sometimes said to be necessary.⁷⁶ In most cases, where the stock is widely held, this prerequisite imposes a heavy burden upon a single shareholder. The financial resources necessary to contact all the shareholders may frequently be beyond the individual investor. In some cases such demand has been excused because of the widely held nature of the stock,⁷⁷ but this does not seem to be the general practice.⁷⁸

If the shareholder manages to bring a successful stockholder's derivative suit to redress the wrong done by fraudulent promoters, he must still face the problem of what recovery will be allowed. Since the corporation is the entity for whom the suit was maintained, it would be entitled to recover.⁷⁹ Normally this would be the method used, and the shareholder would find satisfaction by an increase in the proportionate value of his equity in the corporation. Corporate recovery,

fore no breach of fiduciary duty was involved. See, e.g., *Old Dominion Copper Mining & Smelting Co. v. Lewisohn*, 210 U.S. 206 (1908); *Arn v. Dunnett*, 93 F.2d 634 (10th Cir. 1937), cert. denied, 304 U.S. 577 (1938) (see note 27 *supra*). They have, therefore, not met the question of contemporaneous ownership in the context of determining the ability of a shareholder, who purchases after the fraud, to bring suit on a previously recognized corporate cause of action. Actions under rule 10b-5 may not be limited to ordinary, common law types of fraud or traditional fiduciary bounds. See *Kohler v. Kohler Co.*, 319 F.2d 634 (7th Cir. 1963); *Slavin v. Germantown Fire Ins. Co.*, 174 F.2d 799, 810 (3d Cir. 1949) (dissenting opinion); *Matter of Cady, Roberts & Co.*, CCH FED. SEC. L. REP. ¶ 76803 (Nov. 8, 1961). Since under 10b-5 a cause of action might be found to reside in the corporate entity, independent and apart from the promoters, note 24 *supra* and accompanying text, it seems that a new approach will be necessary in determining the extent of contemporaneous ownership. Because of the distinction between the older cases cited and the new conditions which might arise under 10b-5, it seems that the federal courts will be free to adopt a more liberal approach to the problem. It is evident that they are leaning in this direction from the treatment accorded such cases in the Tenth Circuit which have done much to limit the old *Lewisohn* doctrine. See note 27 *supra*.

⁷⁵ E.g., *Smith v. Sperling*, 354 U.S. 91 (1957); *Cathedral Estates, Inc. v. Taft Realty Corp.*, 228 F.2d 85 (2d Cir. 1955).

⁷⁶ See *Continental Sec. Co. v. Belmont*, 206 N.Y. 7, 99 N.E. 138 (1912). Cf. *Rogers v. American Can Co.*, 187 F. Supp. 532 (D.N.J. 1960); *Abraham v. Parkins*, 36 F. Supp. 238 (W.D. Pa. 1940).

⁷⁷ See *Pergament v. Frazer*, 93 F. Supp. 9 (E.D. Mich. 1949); *Gottesman v. General Motors Corp.*, 28 F.R.D. 325 (S.D.N.Y. 1961).

⁷⁸ See *Quirke v. St. Louis-S.F. Ry.*, 277 F.2d 705 (8th Cir.), cert. denied, 363 U.S. 845 (1960); *Haffer v. Voit*, 219 F.2d 704 (6th Cir.), cert. denied sub. nom., *Ames v. Mengel Co.*, 350 U.S. 832 (1955).

⁷⁹ See *Clarke v. Greenberg*, 296 N.Y. 146, 71 N.E.2d 443 (1947).

however, might be unsatisfactory in the promoter's fraud situation. If the device of a derivative suit were necessary in the first instance, it might indicate that the promoters still controlled the corporation, and recovery would place the money back into the control of those from whom it was recovered.⁸⁰ Further, other shareholders who either were accomplices to the original fraud or who later acquiesced, would share equally with the innocent if corporate recovery were allowed.⁸¹

To prevent such results the device of prorata recovery by individual shareholders has been allowed when the wrongdoers were still in control and the plaintiff was able to show clear danger that the corporate funds would be dissipated.⁸² Prorata recovery has also been permitted where guilty shareholders would receive a share of the recovery.⁸³ Similarly, if the corporation is defunct or in the process of dissolution, it has been allowed to prevent a needless processing of the funds through the corporate entity to the shareholders.⁸⁴ While specific recovery procedures may be molded to the individual case, the mode of recovery requested by the plaintiff must be planned and executed with care in order to avoid conflict with other stockholders.

CONCLUSION

If the federal courts recognize a corporate cause of action under rule 10b-5 in the promoter's fraud situation, the problem of defining contemporaneous ownership will arise. If it is viewed narrowly, and the courts refuse to find the requisite interest at the time the fraud was perpetrated, then, since the requirement probably must be applied even to a suit based upon a federal question, the defrauded stockholder will not be allowed to maintain a derivative action. In such a case he would be forced to bring either an individual suit or a spurious class action to seek redress.

On the other hand, if, after recognizing the corporate cause of action, the courts allow a type of *Bigelow* contemporaneous ownership concept to create the requisite interest, then a derivative suit may be maintained. Should this be the case, the individual investor will have three possible modes of recovery: (1) an individual suit; (2) a class action; and (3) a secondary, stockholder's derivative suit.

It has been assumed that the first choice is impractical. The second, that of a class suit, seems ideally suited for the promoter's fraud situation, with but one exception: that of sufficient contact with the class represented. If the court in

⁸⁰ It is possible that an independent board of directors would refuse to bring suit against the promoters for other business reasons. This would also force the individual stockholder to resort to the derivative device even though the promoters themselves were no longer involved with the corporate management.

⁸¹ See generally Grenier, *Prorata Recovery by Shareholders on Corporate Causes of Action as a Means of Achieving Corporate Justice*, 19 WASH. & LEE L. REV. 165 (1962); *Developments in the Law—Multiparty Litigation in the Federal Courts*, 71 HARV. L. REV. 874, 946-50 (1958); Note, 69 HARV. L. REV. 1314 (1956).

⁸² See, e.g., *Backus v. Finkelstein*, 23 F.2d 357 (D. Minn. 1927).

⁸³ See, e.g., *Young v. Columbia Oil Co.*, 110 W. Va. 364, 158 S.E. 678 (1931); but see *Overfield v. Pennroad Corp.*, 48 F. Supp. 1008, 1018 (E.D. Pa. 1943), *rev'd in part on other grounds*, 146 F.2d 889 (3d Cir. 1944).

⁸⁴ See, e.g., *May v. Midwest Ref. Co.*, 121 F.2d 431 (1st Cir.), *cert. denied*, 314 U.S. 668 (1941). Cf. *Sale v. Ambler*, 335 Pa. 165, 6 A.2d 519 (1939).

*Cherner v. Transitron Electronic Corp.*⁸⁵ were correct in assuming it had the power under Rule 34 of the Federal Rules of Civil Procedure to grant plaintiff's motion to allow discovery of similarly defrauded stockholders, then a ready-made vehicle for adequate individual recovery is at hand. All that would be necessary to put this vehicle in motion would be for a court, in the exercise of its discretion, to grant such a request. In addition, if the situation permits, the prospective litigant may use his stockholder's right to examine the corporate records for the purpose of discovering the identities of other defrauded stockholders.

The third possibility, that of a stockholder's derivative suit, if recognized and allowed, also presents problems of contact with the other defrauded shareholders because of the need to make demand upon them. Problems of the method of recovery are also present. Nevertheless, the derivative suit presents an attractive lure in that the expenses of litigation are borne by the corporation. The need for adequate representation is also eliminated, which would allow a single stockholder to commence the suit.

At the present time, however, because of the lack of any clear-cut recognition of a corporate remedy for promoter's fraud under rule 10b-5, and the lack of any definitive pronouncement of how strictly the requirement of contemporaneous ownership will be applied, it seems that a defrauded investor seeking redress for the promoter's fraudulent acts would best be advised to place most of his reliance in the spurious class suit.⁸⁶

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⁸⁵ 201 F. Supp. 934 (D. Mass. 1962).

⁸⁶ Note should be made of FED. R. CIV. P. 18 which allows joinder of claims. Should the plaintiff desire he may proceed on both a class action and a derivative suit basis. See, e.g., *McClure v. Borne Chem. Co.*, 292 F.2d 824 (3d Cir.), *cert. denied*, 368 U.S. 939 (1961).