Civil Liability to Stockholders under the Securities Act of 1933 and Remedy by Class Action

Jacob Green
CIVIL LIABILITY TO STOCKHOLDERS UNDER THE SECURITIES ACT OF 1933 AND REMEDY BY CLASS ACTION

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This article treats in some detail liabilities under the Securities Act of 1933. It should be noted that there are other private remedies that may be available to stockholders, including (1) those otherwise available at common law or in equity, (2) remedies, expressed or implied, under state blue sky laws, and (3) remedies, expressed or implied, under other federal securities statutes.¹ The Securities Act specifically provides that its remedies are additional to any other remedies at law or in equity,² and it has been stated that the various federal statutory remedies "are concurrent and not mutually exclusive."³

However, the most effective remedies, particularly in conjunction with the class action device, are those under the Securities Act.

A. THE CIVIL LIABILITY PROVISIONS OF THE SECURITIES ACT

The general policy of the Securities Act is to provide for "full disclosure of every essentially important element" attending a distribution of securities.⁴ The disclosure required is the registration with the Securities and Exchange Commission of all non-exempt⁵ primary⁶ offerings, as well as all non-exempt secondary distributions by persons who "control" the issuer of the security. The statute also requires the delivery of a prospectus, which is the principal part of the registration statement, to each prospective investor. Even in the case of a secondary distribution, it is the issuing corporation, rather than the seller of the securities, which files the registration statement. The statute thus makes no distinction between primary and secondary distributions insofar as civil, criminal or administrative sanctions

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5 The most important exemptions are (a) securities sold only to residents of a single state where the issuer is also located, (b) offerings of no more than $300,000 under S.E.C. Regulations and (c) private offerings. Exemptions are enumerated in §§ 3 and 4 of the Securities Act, 72 Stat. 694 (1958), 68 Stat. 684 (1954), 15 U.S.C. §§ 77 c and d (1958).

6 In a primary offering the proceeds of sale go to the corporation or "issuer." A secondary distribution involves outstanding securities and the proceeds of sale go to the holder thereof.
for misstatements or omissions in the registration statement are concerned.

1. Liability under Section 11

Congress enacted Section 11\(^7\) in order to insure both accuracy and care on the part of management and others who participate in the preparation of registration statements. It imposes civil liability in favor of a purchaser of a registered security if the registration statement contains an untrue statement of a material fact or omits to state a material fact required to be stated therein or necessary to make the statements therein not misleading, and if the purchaser did not know of such untruth or omission.

Essentially Section 11 creates a statutory deceit action, but with a number of important differences from common-law deceit:

(1) The plaintiff may be any person who acquired a registered security, even a buyer in the open market. There is no privity requirement, thus opening liability to an indefinite succession of buyers, subject only to the statute of limitations and other defenses.

(2) Those subject to suit include, (a) every person who signed the registration statement, which under Section 6\(^8\) consists of the issuer itself and its principal officers; (b) every director; (c) every underwriter; (d) if the misstatement or omission is within their respective fields, various participating experts such as accountants, attorneys, appraisers and engineers; and (e) persons who control any of the above persons.\(^9\) Here again there is no privity requirement.

(3) The plaintiff need not allege reliance, causation or scienter, except that reliance must be alleged (though it may be established without proof of the plaintiff having read the registration statement) in the case of a plaintiff who bought after the issuer "has made generally available to its security holders an earning statement covering a period of at least twelve months beginning after the effective date of the registration statement."\(^10\)

(4) Under a proviso in Section 11 (e), damages are reduced to the extent that the defendant affirmatively proves lack of causation, that is, to the extent that the defendant proves that the damages represent something other than depreciation in the value of the security resulting from the misstatement or omission complained of.

As a substitute for the traditional *scienter* element of common law deceit, certain affirmative defenses are available to defendant officers, directors and underwriters. Any such defendant may establish that "he had, after reasonable investigation, reasonable ground to believe and did believe, at the time . . . the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading." The standard of reasonableness for the above purposes is "that required of a prudent man in the management of his own property." This affirmative defense is to be contrasted with the traditional double negative form of defense to *scienter* alleged in a deceit action, namely, that the defendant had no reasonable ground to believe and did not believe, at the time the registration statement became effective, that the statements therein were untrue or that there was an omission of a material fact. This latter type of defense is available to an officer, director or underwriter only in regard to any part of the registration statement purporting to be made on the authority of an expert other than himself (for example, the certifying accountant). Thus Congress put an affirmative duty on officers, directors and underwriters "as regards any part of the registration statement not purporting to be made on the authority of an expert."

The issuer itself does not have even this limited defense of due care. The only defense available to the issuer (and it is also available to other defendants) is to prove affirmatively that the plaintiff knew of the untruth or omission at the time of his acquisition.

The measure of damages, subject to mitigation on proof by a defendant of lack of causation as mentioned in (4) above, is, in substance, the buyer's purchase price less the value at the time of suit, except that the purchase price is limited to the price at which the security was offered to the public when the registration statement became effective.

The statute of limitations provides that the action must be brought within one year after the untrue statement or omission was

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discovered or should have been discovered by the exercise of reasonable diligence, and in any event within three years after the security "was bona fide offered to the public."  

(9) Under Section 22 (a) there is a nationwide service of process.

Section 11 has essentially an in terrorem purpose—to make directors assert positive control over the preparation and content of registration statements, under the risk of substantial civil liability unless they can affirmatively establish that they exercised due care. This is also true of the other persons who are potential defendants under Section 11.

2. Liability under Section 12 (1)

Section 12 (1) imposes a civil liability, in rescission or for damages, on any person who offers or sells a security in interstate commerce before a registration statement has been filed and has become effective, or if he fails to send a proper prospectus to the purchaser. This liability is virtually absolute, unless the defendant can prove that the security or transaction was exempt from the registration requirements of Section 5. The seller's intent and knowledge of the violation are entirely irrelevant in an action under Section 12 (1). However, only the immediate seller or a person who controls a seller is liable, and he is so whether he sells directly or through a broker. Hence, although liability under this section is extremely strict, Section 12 (1) applies to a much smaller group of persons than Section 11.

An action under this section must be brought within one year after the violation upon which it is based, and in no event more than three years after the security was "bona fide offered to the public," which presumably means first offered to the public.

3. Liability under Section 12 (2)

Section 12 (2) is broader than Section 11 as to the transactions included in that it applies to all sales made by use of the mails or interstate facilities, whether or not the security has been registered.

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22 Loss, Securities Regulation 1693 (1961) and cases cited.
25 Loss, op. cit. supra note 22, 1742.
But it is narrower than Section 11 as to the parties affected in that it contemplates an action simply by the buyer against his seller. It is traceable to the traditional actions of rescission and deceit, but again with important modifications.

Section 12 (2) provides:

Any person who—

... offers or sells a security ... by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission,

shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to receive the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.26

Section 12 (2) thus differs from Section 11 in the following important respects:

(1) Once more the plaintiff need not allege reliance, causation or 
\textit{scienter}. But, presumably as a substitute for the required allegation of reliance at common law, or to a limited extent the reliance required under the last paragraph of Section 11 (a), the plaintiff does have to allege his own lack of knowledge of the untruth or omission. Under Section 11 this is a matter of affirmative defense.

(2) Every defendant has available the affirmative defense that he personally did not know, and in the exercise of reasonable care could not have known, of the untruth or omission.

(3) There is no affirmative defense of lack of causation, or provision for mitigation of damages by reason of any such showing, as in Section 11.

(4) No measure of damages is specified when the plaintiff no longer owns the security. However, since damages are a substitute for rescission, in such a situation “damages are to be measured so as to result in the substantial equivalent of rescission—namely, the

difference between the purchase price and the plaintiff's resale price, plus interest, and less any income or return of capital received on the security by the plaintiff.\(^{27}\) Hence, the purchase price used to measure damages is the actual price paid by the plaintiff, as in Section 11.

(5) The one-year statute of limitations is the same under Section 12 (2) as under Section 11. It runs from the date the untrue statement or omission was discovered or reasonably should have been discovered. However, the three-year maximum period runs from the date of the particular sale rather than the date that the security "was bona fide offered to the public."\(^{28}\)

In summary, it may be stated that although liability under Section 12 applies to a smaller group of persons than Section 11, the defenses available under this section are not as extensive as those under Section 11.

4. Provisions common to Section 11, 12 (1) and 12 (2)

Suit may be brought under any of the above sections "either at law or in equity, any court of competent jurisdiction," which includes the district courts of the United States and state courts. "Any such suit or action may be brought in the district wherein the defendant is found or is an inhabitant or transacts business, or in the district where the offer or sale took place, if the defendant participated therein," and there is nationwide service of process.\(^{29}\)

It has been held that an action under the Securities Act survived the death of an officer, where the complaint alleged personal wrongdoing on his part.\(^{30}\) It should be noted that the SEC statutes contain no specific provision nor is there any general federal provision on the question of whether these actions survive the death of a plaintiff or defendant or whether they are assignable.

If judgment is obtained the court may assess costs, including reasonable attorney's fees, against the unsuccessful litigant. The court may also in its discretion at the outset of the suit require an undertaking by the plaintiff for the payment of the defendant's costs, including reasonable attorney's fees, if the court believes the suit to be without merit.\(^{31}\) It thus behooves a stockholder or former stock-

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\(^{27}\) Loss, op. cit supra note 22, 1721.


holder to think twice before bringing an action under the Securities Act.

5. Possible Action under Securities and Exchange Commission Rule 10 b-5

Section 10 (b) of the Securities Exchange Act of 1934 makes it unlawful for any person in interstate commerce or by the mails or on any national securities exchange to use or employ, in connection with the purchase or sale of any security, any manipulative or deceptive device or contrivance in contravention of such rules as the Securities and Exchange Commission (SEC) may prescribe.32

SEC Rule 10 b-5 under the above section requires only proof of fraud or material misstatement or omission in connection with the purchase or sale of a security in any of the situations mentioned above. Many courts have now recognized the existence of a private implied remedy under Rule 10 b-5.33 However, there is a split of authority as to whether an action can be brought under Rule 10 b-5 by a buyer as well as a seller. One court has held that Section 10 (b) of the 1934 Act was not intended to supplant Section 11 of the 1933 Act and that an action for alleged misstatements in a Securities Act registration statement could be brought only under Section 11 of the Securities Act.34 However, other courts have allowed suit by a buyer under Rule 10 b-5, so long as fraud was alleged, without applying the restrictions of Sections 11, 12 and 13 of the Securities Act.35

Hence, one should not lose sight of the possibility that an action under Rule 10 b-5 may rescue a purchaser who alleges and proves fraud from several important restrictions imposed upon him in actions under the Securities Act of 1933:

(1) He is not limited to rescission or a rescission measure of damages.36

(2) He is not bound by the short statute of limitations imposed by Section 13 of the Securities Act. Rather, he can enjoy the substantially longer period usually granted by state law, since the 1934 Act is silent concerning the statute of limitations.37

(3) There is no provision applying to Section 10 (b) of the 1934 Act under which he may be required to post security for costs or to

33 See Loss, op. cit. supra note 22, 1763 and cases cited.
35 Fischman v. Raytheon Mfg. Co., 188 F.2d 783, 786-88 (2nd Cir. 1961); Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961).
36 See Loss, op. cit. supra note 22, 1792-96.
pay defendant's counsel fees, as there is in actions under the Securities Act.

One possible justification for allowing Rule 10 b-5 actions by a purchaser to supplant the Securities Act provisions is that actions under the Securities Act may be brought by a purchaser where there is mere negligence or innocent misrepresentation as well as where there is fraud, whereas actions under Rule 10 b-5, under most decisions, can be brought by a purchaser only where there is fraud.38

B. CLASS ACTIONS UNDER THE SECURITIES ACT

As we have seen, although the exposure to liabilities under the Securities Act is great, there are numerous defenses available and the task of the aggrieved stockholder in protecting and enforcing his rights is not always an easy one. This is particularly true in the case of a small stockholder who may have lost at most several thousand dollars which, although a lot of money to the particular individual, would not begin to cover counsel fees and expenses in an action where he is pitted against a large corporation, or a group of underwriters, or controlling stockholders who recently have realized millions from the public offering in question, or all of the above.

Hence, as a practical matter unless the aggrieved stockholder can induce other stockholders similarly situated to join with him, or unless he can bring suit on behalf of such other stockholders, the Securities Act would be virtually ineffective except in the case of a very large investor. Thus, in a nation of small investors, without the class suit device, Section 11 in particular could hardly play the \textit{interrorem} role which Congress envisaged for it.39

1. Propriety of the Class Action

An action may be brought under the Securities Act in either the state or federal courts and there is nationwide service of process.40 Rule 23 (a) of the Federal Rules of Civil Procedure is applicable in the federal courts and in those state courts which have adopted the Federal Rules.41 This rule provides as follows:

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

38 But see Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961) in which the court stated that a complaint under Clause (2) of Rule 10 b-5 did not have to allege "genuine fraud" as distinct from a mere misstatement or omission. 291 F.2d at 274.
39 S. REP. No. 47, 73d Cong., 1st Sess. 5 (1933); Loss, \textit{op. cit. supra} note 22, 1819.
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 (1) joint, or
common, or secondary in the sense that the owner of a primary
right refuses to enforce the right and a member of the class thereby
becomes entitled to enforce it; (2) several, and the object of the
action is the adjudication of claims which do or may affect specific
property involved in the action; or (3) several, and there is a
common question of law or fact affecting the several rights and
a common relief is sought.

The above categories of class actions have been termed "true,”
"hybrid” and “spurious” respectively, although it is submitted that
a more definitive term for the third category would be “common
question” class action.

Class actions under the Securities statutes must be brought, if at
all, as common question class actions under Federal Rule 23 (a) (3),
or its equivalent in those states which have adopted the Federal
Rules.

Whatever may have been the case when Federal Rule 23 (a) (3),
was adopted, by now it has been applied in so many actions in the
securities field, both under the SEC statutes and otherwise, that its
availability to buyers or sellers of securities is not to be doubted.

(a) There Is a Common Question of Law or Fact.

The questions of misstatement, materiality, and reasonable care
under Sections 11 and 12 (2) and causation under Section 11 are
certainly common questions of both law and fact as required by the
Rule. Non-statutory class actions in the securities field also have
been allowed.

Similarly the question of violation of the registration or prospec-
tus requirements under Section 12 (1) would be a common question
or law or fact with respect to all purchasers who bought prior to
the requirements being complied with. Obviously, there will be some
stockholders who will not be in an identical position with the par-
ticular plaintiff. There will be still others who will be excluded from

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42 3 MOORE, FEDERAL PRACTICE ¶ 23.03, (2d ed. 1948).
43 For actions under the SEC statutes, see Independence Shares Corp. v. Deckert, 108
F.2d 51, 55 (3d Cir. 1940), rev'd on other grounds, 311 U.S. 282 (1940); Oppenheimer v. F. J. Young & Co., 144 F.2d 387, 389-90 (2d Cir. 1944);
1951).
44 For examples of non-statutory class actions in the securities field, see York v.
Guaranty Trust Co., 143 F.2d 503, 528-29 (2d Cir. 1944), rev'd on other
grounds, 326 U.S. 99 (1945); Zahn v. Transamerica Corp., 162 F.2d 36, 49 (3d
Cir. 1947), on the merits, 99 F. Supp. 808, 845-49 (D. Del. 1951); Amen v.
Black, 234 F.2d 12, 16 (10th Cir. 1956), remanded for dismissal pursuant to
the class, such as purchasers who knew or should have known of the misstatement in an action under Section 12 (2). It has been stated, "Since each party may have a different claim or defense, it is doubtful if any party ever adequately represents any other in all phases of the case." As Professor Chafee put it with his usual felicity of expression, "[T]he ideal situation for a representative suit is one in which the resemblances among members of the class are strong and the differences among them slight." As previously stated, in cases under the Securities Act there is a strong policy argument that the ultimate effectiveness of the civil

(b) Common Relief Is Sought

It has been held in several cases under the Securities Act, as well as under the Securities Exchange Act, that "common relief" may be sought by buyers or sellers of securities, within the meaning of the Rule, notwithstanding the obvious fact that individual plaintiffs may have suffered losses differing in amount.

In Oppenheimer v. F. J. Young & Co., the Second Circuit said that, if "it were to read into the rule a requirement that each bondholder must recover damages at the same rate as seems to have been done by the Circuit Court of Appeals of the Eighth Circuit in Farmers Co-op. Oil Co. v. Socony-Vacuum Oil Co., 133 F.2d 101, 105, there would be few situations to which the action would apply." If the requirements of the Rule are otherwise satisfied and the case goes to judgment for the plaintiffs (as to the common questions of law and fact) on the merits, the question of the precise amount of damages can be referred to a special master.

(c) Persons Constituting [the] Class Are So Numerous as to Make It Impractical to Bring Them All Before the Court.

This would be true in almost every public offering of securities subject to the Securities Act. It has been held that forty holders of notes constituted a group large enough to permit a class action on their behalf. Another court has held that twenty-nine (29) potential plaintiffs would not be too numerous to bring them all before the court.

As previously stated, in cases under the Securities Act there is a strong policy argument that the ultimate effectiveness of the civil

46 CHAFFER, SOME PROBLEMS OF EQUITY 208 (1930).
48 144 F.2d 387, 390.
50 Citizens Banking Co. v. Monticello State Bank, 143 F.2d 261, 264 (8th Cir. 1944).
liability provisions may depend in large measure on the applicability of the class action device. Hence, numbers alone should not be the controlling consideration.

In Section 302 (a) (1) of the Trust Indenture Act of 1939, another in the series of SEC statutes, Congress found that the national public interest was adversely affected when individual action by investors "for the purpose of protecting and enforcing their rights is rendered impracticable by reason of the disproportionate expense of taking such action." And under the antitrust laws it has been said that "to permit the defendants to contest liability with each claimant in a single, separate suit, would in many cases give defendants an advantage which would be almost equivalent to closing the door of justice to all small claimants."

When there are a great many parties plaintiff, this undesirable result can be avoided only by bringing a single (class) action. Although it has been stated that Rule 23 (a) (3) is merely a permissive joinder device, and Rules 20 (a) and 24 (b), with respect to joinder and intervention, provide means for the determination in a single action of a common question of fact or law involved in causes of action belonging to different persons, the latter rules may not be effective where, as is often the situation in Securities Act cases, the parties are unknown to each other. It would appear that there is inherent in Rule 23 a supervisory power in the court to protect the rights of all members of the class. If the common question class action was intended to have as its only function an alternative method of permissive joinder, there would be no logical reason for its being made a part of Rule 23 instead of another means of joinder under Rule 20. As stated in Union Carbide and Carbon Corp. v. Nisley, Rule 23 (a) (3) has 'a broader purpose—to allow a final determination of common questions of law and fact. Otherwise . . . we would . . . be brought to the point of saying, . . . that where it is impracticable to bring all the parties before the court they must nevertheless be brought before the court.'

(d) Fairly Insure the Adequate Representation of All.

The plaintiff and his counsel must fairly insure the adequate representation of the class. It has been held in the leading case of

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53 Weeks v. Bareco Oil Co., 125 F.2d 84, 90 (7th Cir. 1941).
54 3 MOORE, op. cit. supra note 42, ¶ 23.10.
55 With respect to necessity of court approval of settlements, see FED. R. CIV. P. 23(c).
56 Union Carbide and Carbon Corp. v. Nisley, 300 F.2d 561, 589 (10th Cir. 1962).
57 300 F.2d 561 (10th Cir. 1962).
58 300 F.2d 561, 589; See also Kalven and Rosenfeld, The Contemporary Function of the Class Suit, 8 U. CHI. L. REV. 684 (1941).
O ppenheimer v. F. J. Young & Co.,\(^{59}\) that there is no need to go beyond the face of the complaint in determining the adequacy of the representation. "If it shall later appear that the plaintiffs are not able within a reasonable time to obtain others to intervene in the class action," the court added, "it may properly be dismissed as a class action . . . ."\(^{60}\)

There is certainly no magic in numbers. It has been said, "conceivably a single plaintiff with competent counsel may afford better representation to the class than a great number of parties and a multitude of counsel."\(^{61}\) In York v. Guaranty Trust Co.,\(^{62}\) the plaintiff held notes in the face amount of only $6,000. In the Oppenheimer\(^ {63}\) case the plaintiffs themselves held only $10,000 in principal amount of bonds compared to more than $3,000,000 repurchased from investors in alleged violation of a fraud rule of the SEC. In Cherner v. Transitron Electronic Corp.,\(^ {64}\) the named plaintiffs were holders of 200 shares of stock, with a loss of $3,200, out of a total number of 2,250,000 shares offered by the two registration statements complained of in the suit, although twenty-two other persons represented by the same attorneys were allowed to intervene prior to settlement negotiations.\(^ {65}\)

2. The Composition of the Class

As previously discussed, the class under Section 11 consists of every person who purchased a security from either an underwriter or in the open market on or after the effective date of the registration statement which contains the material misstatement or omission. It thus includes an indefinite succession of buyers, subject only to exclusion of (1) possibly those who are subject to the defense of the state of limitations\(^ {66}\) or (2) those who purchased after the issuing corporation had published an "earning statement covering a period of at least twelve months beginning after the effective date of the registration statement" and who do not allege and prove reliance on the misstatement or omission.\(^ {67}\)

The class under Section 12 (1) would include those persons who (1) purchased a security offered in interstate commerce before a

\(^{59}\) 144 F.2d 387, (2d Cir. 1944).
\(^{61}\) 2 BARRON & HOLTZOFF, FEDERAL PRACTICE AND PROCEDURE, 305-06 (Wright rev. 1961).
\(^{62}\) 143 F.2d 503 (2d Cir. 1944), rev'd on other grounds, 326 U.S. 99 (1945).
\(^{63}\) 144 F.2d 387.
proper registration statement had been filed (2) from an immediate seller who should have filed the proper registration statement. It thus would not include a person who purchased on the open market after a proper registration statement was filed or who purchased from a person who was not required to file a registration statement.

The class under Section 12 (2) would normally include those persons who bought directly from the underwriter or other person furnishing the prospectus where the prospectus contained a material misstatement or omission, subject to the exclusion of all those purchasers who do not allege and prove lack of knowledge of the untruth or omission. Hence, the class here is considerably narrower than that under Section 11. A class action under this section could be extremely important, nevertheless, because of the absence in Section 12 (2) of (1) a defense of lack of causation and (2) the limited reliance requirement of Section 11 (a). If the misstatement or omission was oral, the members of the class would be limited to those to whom it was communicated in substantially the same manner.

3. Statute of Limitations

The statute of limitations with respect to Securities Act cases has already been discussed in connection with each particular section of the Act. It should be added that since the period of limitations is contained in the same statute which creates the cause of action it is a limitation on the continuation of the right and compliance with the statute must be alleged in the complaint and proved.

The key question is whether the timely filing of a “common question” class action tolls the statute of limitations with respect to other members of the class so that they may appear and prove their claims afterward, even though the statute otherwise would have run as to their claims. It has been uniformly held that “true” and “hybrid” class actions, i.e. under Federal Rule 23 (a) (1) and (2), toll the statute, but until recently there was some doubt with respect to “common question” class actions. The doubt was due to the statement by Professor Moore that this type of class action was merely a permissive joinder device. However, in the Union Carbide case the court in a well-reasoned opinion squarely held that in a Rule 23 (a) (3) action maintainable as such, “it is incongruous to say that

68 § 4(1), 68 Stat. 684 (1954), 15 U.S.C. § 77d(1) (1958), in effect provides that a prospectus must be delivered to every purchaser for the first forty days (or such shorter period as the SEC may prescribe) after the effective date of the registration statement.


70 Goodwin v. Townsend, 197 F.2d 970, 971 (3d Cir. 1952).

71 3 Moore, op. cit. supra note 42, ¶ 23.10.
the absent members, who are represented by those present may not rely upon the commencement of the action by their brethren to toll the running of the statute. This would only serve to 'convert the rule into a trap' for those who have expeditiously allowed their rights to be maintained by a class action." Other recent cases and articles appear to be virtually unanimous in favor of the tolling of the statute.\(^2\)

Nevertheless, there never has been a United States Supreme Court ruling precisely on this point (nor on the availability of Rule 23 \((a)(3)\) to actions under the Securities Act, for that matter) so the only absolutely safe course is for as many aggrieved stockholders as possible to intervene in the class action "within one year after the discovery of the untrue statement or omission or after discovery should have been made by the exercise of reasonable diligence," but in no event more than three years after the security was offered for sale.

4. Notice to the Class

In view of the disproportionate costs of prosecuting an action under the Securities Act in comparison to the loss the particular stockholder may have incurred, it is important that other injured stockholders participate in the action. The ethical problems of giving notice to the class without court approval are beyond the scope of this article. However, there are some who think that such a problem may exist, and included in that category most assuredly will be counsel for the defendant.

One court has stated that "under the present version of the Federal Rules . . . 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,'" citing Moore, Federal Practice and Official Forms 562-64 (1961).\(^7\) However, this same court refused to direct or authorize the plaintiffs to give notice of the action under the Securities Act to the appropriate classes of stockholders at the outset of the suit because of the fear that such notice would result in the inference that the court thought that the action was well-founded.\(^7^4\)


\(^7^4\) Cf. Weeks v. Bareco Oil Co., 125 F.2d 84 (7th Cir. 1941). There the court, having held that there was not adequate representation because, \textit{inter alia}, there was lack of notice to the class, said, "Affirmative notice could have been given by them to others in the class, showing that they had, by letter or by newspaper, brought the existence of the present suit to the attention of others of the class." 125 F.2d at 94.
In the *Union Carbide* case, the court ordered notice to the class after a favorable jury verdict for the plaintiffs was obtained. The opinion of the court does not indicate whether authorization of notice prior to trial was requested.

It is submitted that, in order to carry out the intent of Congress in enacting the Securities Act and providing a deterrent effect on wrongdoers, notice should be authorized by the court no later than at the time of a favorable ruling for the plaintiff on a motion for summary judgment, or at a pre-trial hearing after a reasonable amount of discovery proceedings. Otherwise many meritorious securities actions could well "die on the vine" for lack of funds to prosecute them properly.

5. Intervention

Rule 24 (b) of the Federal Rules of Civil Procedure provides, "Upon timely application anyone may be permitted to intervene in an action . . . (2) when an applicant's claim or defense and the main action have a question of law or fact in common." It should be noted that intervention in class actions will not introduce any new legal or factual issues, and thus would neither unduly delay the proceedings nor prejudice the rights of the original parties.

With respect to intervention in class actions it has been stated:

Once it has been determined that an action is a class action, there seems little justification for denying intervention by other members of the class. This is especially true if the action is thought not binding on persons not named since intervention will permit them to share the benefits of the judgment.

Since a common question class action has been held in some jurisdictions to be binding only upon those persons who are actual parties, no member of the class can be absolutely sure of benefiting from a favorable judgment unless he is allowed to intervene. It is not believed that this application of the doctrine of mutuality of estoppel is good law and most courts have rejected it. However, there is respectable authority to the contrary.

There is yet another reason why there should be at least some interventions. In two leading class action cases involving violations

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76 300 F.2d 561, 587-90.
76 2 BARRON & HOLTZOFF, op. cit. supra note 61, § 568 at 315; see also Speed v. Transamerica Corp. 100 F. Supp. 461, 463 (D. Del. 1951).
77 Weeks v. Bareco Oil Co., 125 F.2d 84, 91 (7th Cir. 1941); Union Carbide and Carbon Corp. v. Nisley, 300 F.2d 561, 589 (10th Cir. 1962); Note, The Binding Effect of Class Actions, 67 Harv. L. Rev. 1059 (1954).
78 Oppenheimer v. F. J. Young & Co., 144 F.2d 387, 390 (2d Cir. 1944); see also Zachman v. Erwin, 186 F. Supp. 681, 689 (S.D. Tex. 1959); 3 MOORE, op. cit. supra note 42, ¶ 23.11 (3).
of the federal securities laws both courts strongly indicated that if there were no interventions the class action would be dismissed.\textsuperscript{79} In the \textit{Oppenheimer} case the court stated "... if it would later appear that the plaintiffs are not able within a reasonable time to obtain others to intervene in the class action it might properly be dismissed as a class action." This principle was reasserted in the \textit{Transitron} case. Neither court made any constructive suggestions as to how to "obtain" others to intervene. This question has been touched upon above under the heading \textit{Notice to the Class}.

In the \textit{Union Carbide} case, the court allowed intervention even after trial so that all members of the class, insofar as they could prove damages, could share in the judgment obtained by their representatives.

6. Dismissal and Compromise

Rule 23(c) of the Federal Rules requires approval of the court before a class action can be dismissed or compromised. Notice of the proposed dismissal or compromise to members of the class is not required in an action under Rule 23(a)(3), but most courts will probably insist on such notice, especially if it is held that the statute of limitations has been tolled and that the judgment is binding upon all members of the class.

7. Trial by Jury

(a) Individual Action

We have seen that the Securities Act provides that proceedings may be brought "either at law or in equity." Since the Securities Act was passed before the procedural merger of law and equity by the Federal Rules in 1938, it would appear that the above language intends to provide the plaintiff with the full panoply of otherwise available federal remedies, and, as far as it pertains to jury trial, refers to the pre-existing law under the Seventh Amendment; if the action is at law the plaintiff is constitutionally entitled to a jury trial; if it is in equity, he is not.\textsuperscript{80}

Several actions under the Securities Act have been tried to a jury.\textsuperscript{81} The fact that the action is founded solely on a statute passed since 1791 is irrelevant. The key is the remedy sought. If the plaintiff is suing for money damages, he is entitled to a jury trial, since this is "a claim wholly legal in its nature."\textsuperscript{82} Hence, a jury trial is available


\textsuperscript{81} See e.g., Martin v. Hull, 92 F.2d 208 (D.C. Cir. 1937), \textit{cert. denied}, 302 U.S. 726; Schiller v. H. Vaughn Clarke & Co., 134 F.2d 875, 878 (2d Cir. 1943).

in all actions under Section 11 and in those under Sections 12(1) and 12(2) where the plaintiff has sold his stock.

(b) Class Action

It would seem that since the plaintiff is entitled to a jury trial in an individual action, the class would be entitled to a jury trial in the class action. It might be argued that since the class action originally developed in equity, there is no right to jury trial, regardless of the nature of the underlying claim. One of the first class actions brought under Rule 23(a)(3) sought damages in an anti-trust action. The court refused to permit maintaining the suit as a class action because damages were a legal remedy properly triable to a jury and a class action was equitable in nature and not triable to a jury. This case has been criticized by both the commentators and the courts and has not been followed. Even Professor Moore, who has taken a conservative view with respect to Rule 23(a)(3) on several issues (and has given these actions the opprobrious designation "spurious"), agrees with the later cases, stating, "Where the issues presented in a class action are legal there is a right to jury trial... On the other hand, where the issues are equitable there is no right to jury trial."

Thus it has been established by virtually every case that a class action may be brought to enforce a legal claim. The courts have recognized the separate aspects of the common question class action and disallow a jury trial on the issues of the propriety of the class action and the size and composition of the class, but allow a jury trial on the underlying claim if the claim itself is legal.

The jury will not be concerned with the various questions about the size of the class under Sections 11 or 12, nor with the admission of individuals to those classes, nor with the calculation of the damages of each individual. The only basic issues the jury will be asked to consider in a case under Section 11 are (1) the truth and materiality of the statements in the prospectus, (2) the reasonable care.
of a defendant other than the issuer and (3) the causal connection between the untruths or omissions and the decline in value of the security if the defense of lack of causation is pleaded. None of these issues is beyond the competence of a jury. Since the damage to each member of the class could be ascertained by a special master after trial, the jury in the class action would have a function differing little in complexity from that which it would have in an individual action. Moreover, the availability of such devices as special verdicts, the use of a master, or the possibility of separate trials on various issues (such as the defense of lack of causation under Section 11) provide the court with powerful tools in shaping the litigation to avoid any problems which might arise.

8. Binding Effect of Judgment

The most perplexing question remaining with respect to Rule 23(a)(3) class actions is whether a judgment therein, either on the merits or by way of approving a settlement, binds members of the class who are not parties. This question has already been touched upon in the discussions of the tolling of the statute of limitations and necessity of intervention by members of the class.

Nearly all of the early cases have held that only those persons who are actually parties to the litigation are bound by a judgment in a common question class action. However, as early as 1941, the Seventh Circuit stated that all members of the alleged class whose interest was not adverse to that of the named plaintiffs would be bound by any judgment although at the same time it also formulated a strict test as to the adequacy of representation. The court in the Union Carbide case did not go so far as to meet the binding effect question head on. However, it held that the statute of limitations was tolled and that after the trial all members of the class should be given notice and be permitted to intervene and prove their claims, stating that “this . . . solution results in the more expeditious and efficient disposition of litigation and ought therefore to be favored.” It also stated that Rule 23 (a)(3) would serve “to allow a final determination of common questions of law and fact.”

Almost all of the commentators except Professor Moore maintain that a judgment in a common question class action should bind all members of the class as it does in a “true” class action under Rule

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89 In actions under § 12(1) or (2) there is no defense of lack of causation.
90 Unlike the common law action of deceit, neither causation nor scienter nor ordinarily reliance need be alleged. For discussion see para. A. 1. (3) supra.
91 Union Carbide and Carbon Corp. v. Nisley, 300 F.2d 561, 589 (10th Cir. 1962).
92 3 MOORE, FEDERAL PRACTICE § 23.11, at 3465 and cases cited.
93 Weeks v. Bueso Oil Co., 125 F.2d 84 (7th Cir. 1941).
Many point out that the Supreme Court decision in *Hansberry v. Lee* was handed down in 1940, while Professor Moore's views were formulated at the time the Federal Rules were adopted in 1938. The court in the *Lee* case stated that due process permits the judgment in a class action to be binding on absentees whenever the procedure adopted "fairly insures the protection of the interests of absent parties who are to be bound by it." The court further stated by way of dictum that even in a common question class action the judgment might be made binding on all members of the class "provided that the procedures were so devised and applied so as to insure that those present are of the same class as those absent and that the litigation is so conducted as to insure the full and fair consideration of the common issue."

If ultimately the rule is developed that the judgment binds the entire class, there will probably be a stricter rule as to what constitutes adequacy of representation sufficient to allow the particular common question class action at all. But if the court finds adequacy of representation under a strict test it would seem that due process has been satisfied and a judgment should then be *res judicata* as to all members of the class.

The present uncertainty in regard to the binding effect of a judgment in a common question class action also acts as a deterrent to the settlement of such an action. As long as a defendant cannot be certain (and he cannot, except possibly in the Seventh or Tenth Circuits) that other members of the class could not bring suit against him prior to the expiration of the statute of limitations, he will want to discount any settlement figure he otherwise would be willing to pay.

In the *Transitron* case, which was settled after extensive discovery proceedings but prior to trial for $5,300,000, the Court's judgment approving the settlement barred any further action upon "any claim
embraced in the pleadings herein" after providing for notice to all known members of the class by letter and by publication. However, the court stated that the second court (in a subsequent action by a member of the class who was not a party to the class action) will be better equipped to determine whether there was adequacy of representation with respect to the particular person bringing the action. In the present state of the law, this is as a practical matter about as far as a District Judge can go.

CONCLUSION

At the moment there are many unresolved questions with respect to common question class actions [Federal Rule 23 (a) (3)] brought under the Securities Act of 1933. In an action which treads in both of these areas there are more than the usual number of pitfalls. Counsel bringing such an action must plan his strategy most carefully, and his tactics must take into account all of the above uncertainties and more. Ethical problems and the possibility of intrusion of other counsel are ever present.

If it were certain that a judgment would bind absent members of the class, the problems of jurisdiction, of intervention and of the statute of limitations all would be solved. But other problems obviously would still remain.

The Advisory Committee on Civil Rules has recently proposed a complete redraft of Federal Rule 23. Under this proposal, as soon as practicable after the commencement of an action, the court would decide whether it is to be maintained as a class action. If the court so ordered, the judgment would bind all members of the class as defined. However, it would appear that even under the proposed Rule, whether the judgment were res judicata as to all members of the class, would not, as a practical matter, be determined by the court in the class action itself, but could be tested only in a subsequent action.