

CRIMINAL PROVISIONS OF THE SECURITIES ACT AND ANALOGIES TO SIMILAR CRIMINAL STATUTES

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IN common with previous legislative attempts to safeguard public participation in security offerings, the Federal Securities Act of 1933 includes criminal provisions designed especially to inflict punishment upon those malefactors who no longer possess property from which defrauded investors can seek satisfaction. By Section 24 criminal liability is imposed upon

- (1) "Any person who willfully violates any of the provisions of this title, or the rules and regulations promulgated by the Commission under authority thereof"; or
- (2) "Any person who willfully, in a registration statement filed under this title, makes any untrue statement of a material fact or omits to state any material fact required to be stated therein or necessary to make the statements therein not misleading . . ."¹

The acts coming within class (1), though plentifully specified in other provisions of the statute, are either clear-cut in nature or, when occurring under different circumstances, are defined in terms of the acts contemplated in class (2). Thus no new problems need arise from prohibiting, as unlawful, the use of the mails or interstate commerce to offer for sale, sell, or deliver after sale any security as to which no registration statement is in effect or which is not accompanied or preceded by a prospectus meeting the requirements of the Act.² A similar prohibition against prospectuses seems likewise uneventful legally, however important practically.³ A provision making unlawful the affixing of any signature to a registration statement without the authority of the purported signer requires no comment,⁴ nor does the provision that it is unlawful for anyone to represent that the registration statement is true and accurate and not misleading because it has been filed or is in effect or has not given rise to a stop order.⁵ Equally unequivocal is the statement that it is unlawful to describe a security for a consideration from

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1. P. L. No. 22, 73d Cong., 1st Sess. (1933) § 24. The penalty upon conviction is a fine of not more than \$5,000 or imprisonment for not more than five years, or both.

2. *Id.* §§ 5 (a) (1) (2), 5 (b) (2).

3. *Id.* § 5 (b) (1).

4. *Id.* § 6 (a).

5. *Id.* § 23. On the use of the stop order by the Federal Trade Commission, see Rodell, *Regulation of Securities by the Federal Trade Commission* (1933) 43 YALE L. J. 272.

an issuer, underwriter or dealer without disclosing such consideration.⁶ Some acts declared unlawful⁷ seem already made so by statutes now in force relating to the use of the mails to defraud,⁸ but prohibition as unlawful also is made to extend to use of the mails to engage in that which would operate as a fraud or deceit upon a purchaser,⁹ and to obtaining money or property "by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading."¹⁰

The acts embraced within class (2) are the more important both legally and practically. The pith of their definition is the consequence placed upon *an untrue statement of a material fact or the omission to state any material fact . . . necessary to make the statements not misleading*.¹¹ In this lies the core of criminal liability under the Act. It is, in fact, the heart of the whole statute, being, with qualifications differing from those used in its application to criminal liability, the main basis for civil liability for prospectuses¹² and registration statements.¹³ An untrue statement of a material fact has always been an ingredient of actions for fraudulent misrepresentation, and what is material has been, and presumably will continue to be, determined by reference to the standard of the reasonable man. The Act affects this situation only to the extent that the Federal Trade Commission may, under the powers granted it, facilitate this determination. If the Commission closely regulates the facts required to be stated in a registration statement, juries need merely take the responsibility for deciding whether, if some required facts have been omitted, the omitted facts are material. But in exacting penalties for failure to include in registration statements facts necessary to make the statements therein not misleading, the Act establishes new bases of criminal liability and requires new determinations in standards of reasonable conduct. Juries must now particularize statements that are misleading and determine inclusions necessary to render them not misleading. In this respect the Act is a legal jig-saw puzzle, whose pieces are labeled either "misleading material statements" or "correctives to the

6. *Id.* § 17 (b).

7. *Id.* § 17 (a) (1).

8. See p. 262 and note 53, *infra*.

9. Securities Act, *supra* note 1, § 17 (a) (3).

10. *Id.* § 17 (a) (2).

11. Here, as in the case of acts falling within class (1), the qualification that the action must have been taken "willfully" raises no new or difficult legal problems. *Cf. Legis.* (1933) 33 COL. L. REV. 1220, 1244. The similar restriction of the prohibitions under the second part of Section 24 to registration statements does not seem to create any additional legal questions.

12. Securities Act, *supra* note 1, § 12 (2).

13. *Id.* § 11.

misleading statements," and whose sizes, shapes and fittings are undetermined.

For its solution one must turn to a consideration of the rules which have been set up by other statutes and their application over a period of years. Criminal statutes predicating liability upon false and misleading prospectuses have abundant representation upon the statute books of this country, state and national, and of England. The controlling English statute is the Larceny Act of 1861,¹⁴ which imposes criminal liability upon any director or officer of a corporation who

" . . . shall make, circulate or publish . . . any written statement or account, which he shall know to be false in any material particular . . . with intent to induce any person . . . to intrust or advance any property to such body corporate or public company . . ." ¹⁵

This statute received its initial interpretation¹⁶ in the case of *Rex v. Kylsant*¹⁷ and was there construed as meaning that a prospectus may be tested as a whole and the authority responsible for it rendered criminally liable if it is misleading by the impression it creates in the reasonable average man or by the inference he would naturally draw from it.

The defendant, Baron Kylsant of Carmathen, was chairman of the Royal Mail Steam Packet Company which in 1931 was, if there be included all subsidiaries either owned or controlled by it, one of the largest shipping companies in the world. It has been estimated that 2,600,000 tons of shipping, thirty-five companies, and far more than £66,000,000 of capital are involved in the pyramid of maritime interests capped

14. 24 & 25 Vicr. c. 96, § 84 (1861).

15. Cf. the criminal liability provision of the English Companies Act of 1929 which is applicable to non-chartered companies: "If any person in any return, report, certificate, balance sheet, or other document, required by . . . this Act . . . , willfully makes a statement false in any material particular, knowing it to be false, he shall be guilty of a misdemeanor . . ." 19 & 20 Geo. V, c. 23, § 362 (1929).

16. Criminal prosecutions under this statute have been rare. *Rex v. Lawson*, [1905] 1 K. B. 541, turned, not upon any consideration of falsity in statement, for there were direct positive falsehoods, but upon whether or not the defendant was a "manager" within the purview of Section 84. Only one case, and that a civil one, was referred to by judge or counsel in the trial of the *Kylsant* case, which is discussed at length *infra*. *Aaron's Reef v. Twiss*, [1896] A. C. 273, wherein the defendants successfully defended an action to enforce a subscription contract brought on the grounds of inducement to enter the contract through a fraudulent prospectus which did not disclose the terms on which the plaintiff company bought its properties and concessions.

17. 23 Crim. App. 83 (1931), *aff'g* trial court judgment rendered July 30, 1931. There are no official English reports of original criminal trials. Informal reports of this trial were given in the *London Times*, July 21-25, 28-31, 1931. There is available, however, an official Transcript of Trial, a copy of which is to be found in the Yale Law Library. References will be made to this as the *Kylsant* Transcript. The *Kylsant* case is noted in (1932) 45 HARV. L. REV. 1078.

by the Royal Mail Steam Packet Company.¹⁸ A man of exceptional personality, great industry and fine background,¹⁹ Lord Kysant had for the most part personally created this great concern. Moreover, he was not only chairman of the Royal Mail but also chairman of or director in about forty shipping companies, and at one time or another a member of Parliament, President of the London Chamber of Commerce, and President of the Federation of Chambers of Commerce of the British Empire. Socially, equal distinction had come his way—admission to the peerage, Lord Lieutenant of Hereford, Vice-Admiral of North Wales, and Vice-Chairman of the Representative Body of the Church of Wales.

Superficially the Royal Mail Company was prospering in the period of 1921 to 1928; actually it was not making a trading profit from year to year. The public and investors would be confronted, if information was sought, by a pleasant series of dividend percentages and rather esoteric financial accounts.²⁰ That such a policy of nondisclosure was deliberately followed by Lord Kysant may be surmised from his testimony at the trial where he very emphatically stated that "We have never practically told the shareholders how the profit and loss account is made up."²¹ That was indeed a policy to which strict adherence was paid, and since the Company was not within the purview of the Companies Act²²

18. See (1931) 112 *THE ECONOMIST* 300; Kysant Transcript, 267; London Times, June 12, 1930, at 14, 19.

19. An article in the N. Y. Times, July 26, 1931, at IX-2, not only recounts the fact that the Phillipses, the family of Lord Kysant, had held a baronetcy since the time of Edward I, but also that Lord Kysant could trace his ancestry to both the Emperor Maximus and Vortigen, King of the Bretons.

20. Thus see *MOODY'S INDUSTRIALS* (1930) 2917, where there is given a skeletonized comparative balance sheet which, on the liability side, contains a vaguely important item "sundry balances" varying in extent between \$7,500,000 and \$13,000,000 over a period of years. No specifications as to the ramified interests of the company, are given, and the only contingent liability disclosed is that of the guaranty of \$25,000,000 of White Star Preference shares. The 5% Debentures floated on the strength of the prospectus that led to Kysant's conviction are given a rating of A. To a similar effect, see *POOR'S INDUSTRIALS* (1931) 2945.

21. Kysant Transcript, 272.

22. Since the Company operated under a Royal Charter, it was exempt from all provisions of the Companies Acts of 1908 and 1929.

By Sections 35, 38, 40, and 354 of the Companies Act of 1929, *supra* note 15, there are required in every prospectus certain specific disclosures, e.g., the amount to be paid any promoter and the consideration therefor; the date and parties to every material contract entered into by a company in the ordinary course of business or within two years of the issuance of the prospectus, and the location of a copy of every such contract; profit and loss accounts for the preceding three years and the accounts of any business which a company contemplates purchasing. By Sections 123 and 124 the directors of a company must each year furnish to the stockholders a profit and loss account and a particularized balance sheet, the latter being positively required to contain "its liabilities and assets, together with such particulars as are necessary to disclose the general nature of the liabilities and the assets of the company and to distinguish between the amounts respectively of the

its only duty, so far as its accounts were concerned, was that contained in the Royal Charter of 1839, under which, with modifications, it operated and which provided that previous to every yearly general meeting an account should be prepared by the "court of directors" of the debts and assets of the corporation with an account of the profits made in the year ending the thirty-first of December preceding such general meeting.²³ Little did the stockholders of this Company or the public realize from the published accounts from 1921 onwards, and more especially those of 1926 and 1927,²⁴ that the Company was not making nearly sufficient trading profit to pay its dividends, but was only able to do so because of vast hidden reserves on which it drew.²⁵ These hidden reserves were of two classes—those which were refunds from payments made to the government, such as £800,000 on excess profits taxes repaid in installments between 1921 and 1927,²⁶ and those which were retained on the books at all times, no payment ever being made from them. These latter masqueraded in the accounts under the misleading liability "Sundry balances, accounts not closed and debts owing by the Co."²⁷ Some £1,100,000 of a £2,200,000 excess profits duty reserve fund built up during the war was secreted under this liability item and never drawn upon for payment to the government, but utilized to the extent of £800,000 for the benefit of different profit and loss accounts and £300,000 for investment depreciation.²⁸ Other reserve funds carried on the books but never openly divulged, from which transfers to profit and loss were made, were an income tax reserve account, a corporation profits tax reserve account and a fleet depreciation fund.²⁹ During this same period of 1921 to 1927 debenture interest, dividends on preferred stock, and dividends on the ordinary stock never lower than 4% were paid, undoubtedly an impossibility without the use of these secret reserves.³⁰ The

fixed assets and of the floating assets, and shall state how the value of the fixed assets have been arrived at."

23. Kysant Transcript, 10.

24. The balance sheets and profit and loss accounts for both 1926 and 1927 are fully set out in (1931) 85 *THE ACCOUNTANT* 110, 111.

25. It appeared conclusively from uncontradicted evidence at the trial that between 1921 and 1927 £3,800,000 in hidden reserves had been brought into the profit and loss accounts. Kysant Transcript, 134, 430.

26. *Id.* at 151.

27. *Id.* at 134, 430.

28. *Id.* at 150, 436.

29. *Id.* at 33.

30. In each year there was paid 4½% on £1,400,000 of 1st Debentures and 5% on £3,100,000 Debentures amounting to £218,000; then 5% on £900,000 Preferred Stock and 6½% on £2,900,000 Preferred Stock totaling £233,500; and additionally at least 4% on £5,000,000 ordinary stock equalling £200,000. These minimum yearly payments amounted in total to £651,500. Inasmuch as the yearly profit and loss balances into which reserves were brought and from which these charges were primarily paid were, after deduction of operating costs and depreciation, £668,400 in 1921, £725,000 in 1922, £779,114 in 1923,

only hint as to their use was contained in the phrase "adjustment of taxation reserves" which first appeared in the profit and loss account for 1925³¹ and later in that for 1926 and 1927, in all of which years there was the statement "Balance for the year including dividends on shares in allied and other companies, adjustment of taxation reserves, less depreciation of fleet, etc."

It was by reason of this nondisclosure that the government brought its first two charges alleging that Lord Kysant had, with intent to deceive the stockholders of the Company, published annual reports in 1927 and 1928 which concealed the true financial position of the business and which he knew were false in a material particular.³² The defense rested upon two points: first, that the reserves in question were free for use for the first time in the particular year in which they were transferred;³³ and secondly, that their transference to profit and loss, if not their amount, was disclosed by the phrase "adjustment of taxation reserves."³⁴ The common jury, sitting under Mr. Justice Wright in the Central Criminal Court of London—the historic old Bailey,—was impressed by this defense to the point of acquittal despite the obviously misleading nature of the accounts wherein published reserves were decreased little or none and the use of secret reserves was disclosed only in the accountant's language and not the layman's.

Different considerations entered into the prospectus charge. The Company in 1928 found itself badly in need of money. There was an overdraft of £466,000 with Barclay's Bank and £471,000 with Coutt's.³⁵ Further liquid resources were needed to complete the new building of the Company on Leadenhall Street, London. Secret reserves and possible non-recurring refunds had been practically exhausted. Lord Kysant therefore determined to issue £2,000,000 of 5% Debentures. The prospectus, prominently published to attract subscribers, stated *inter alia* that³⁶

"Although this company in common with other shipping companies has suffered from the depression in the shipping industry, the audited accounts of the company show that during the past ten years the average annual balance available (including profits of the Insurance Fund) after providing for depreciation

£772,829 in 1924, £731,103 in 1925, £439,212 in 1926 and £657,000 in 1927, it is apparent that the capital charges could not have been paid without access to these special refunds and reserves.

31. Kysant Transcript, 28, 362.

32. For these charges, see *id.* at 3.

33. See *id.* at 77, 78, 79, 80, 390.

34. See *id.* at 55, 376.

35. *Id.* at 448.

36. This prospectus appeared in full in the London Times, July 3, 1928. It was later substantially reprinted in (1931) 85 THE ACCOUNTANT 112.

and interest on existing debenture stocks, has been sufficient to pay the interest on the present issue more than five times over . . ."

Such a glowing prospectus could not and did not fail to induce an oversubscription by a public emotionally stirred by a securities boom then in progress³⁷ and ignorant of the financial legerdemain whereby reserves and secret refunds now exhausted had substantially contributed to the "average annual balance" and ordinary dividends referred to in this optimistic document.³⁸

There is no doubt that this prospectus was issued under the personal direction of Lord Kylsant and he assumed responsibility for its wording upon the witness stand, but he denied that he ever had an intention to deceive or defraud any stockholder or creditor.³⁹ The defense rested its case upon the fact that the Larceny Act did not penalize economy of thought, that every statement made in the prospectus was true and would not be made false by any additional disclosures, that is to say, no possible additional information could have altered the fact that the dividends were paid and that the "average annual balance available" was at least £500,000, as stated. Sir John Simon, in his closing speech for the defense, upheld the practice of maintaining secret reserves and attempted to refute the possibility of an intent to defraud or deceive by reference to Lord Kylsant's avowed belief that the depression was cyclical, that affairs were on the mend in 1927 as shown by the increased earnings, and that the most which could be imputed to Lord Kylsant was misjudgment. The Attorney-General emphasized the careful way in which the prospectus had been drawn and contended that the document was false in a material particular in that it created in the minds of potential investors, considering the integrity of the Company, a false impression upon which they relied to their misfortune. Mr. Justice Wright, in summing up to the jury, accepted the interpretation of the statute advanced by the Attorney-General and charged them specifically, in interpreting the statutory words "false in a material particular," that "the document as a whole may be false not because of what it states but because of what it does not state, because of what it implies."⁴⁰ To the jurors, the conclusion seemed irresistible that under Lord Kylsant's direction the prospectus had been carefully worded in such a manner as to create a distinctly false impression. The accused was accordingly convicted and sentenced to prison for the term of one year.

Appeal was heard in November, 1931, before the Court of Criminal Appeal. The grounds of appeal were that there was no evidence to

37. See (1931) 41 *ECON. J.* 577-583. According to the *London Times* of August 27, 1928, stocks were at their highest point since the War.

38. See the *London Times*, July 4, 1928, at 24.

39. *Kylsant Transcript*, 260, 261.

40. *Id.* at 428.

support the verdict, that there had been misdirection of the jury, and that sentence was excessive. But the appeal was dismissed.⁴¹ Mr. Justice Avory, giving the opinion of the court, upheld the direction of the trial judge that a prospectus which created a false impression was a document "false in a material particular" and declared that the evidence given was adequate to support a finding that the prospectus did convey a false impression. The precise words of the learned judge are highly important:

"the prospectus was false in a material particular in that it conveyed a false impression, the falsity in this case consisting in putting before intending investors as material upon which they could exercise a judgment about the existing position of the company, figures which apparently disclose the existing position but, in fact, conceal it. In other words, the document implied that the company was in a sound financial position, and that a prudent investor could safely invest in its debentures. This implication arises particularly from the statement that the dividends have been regularly paid over a term of years, although times have been bad, a statement which is entirely misleading when the fact that they were paid not out of current earnings but out of earnings in the abnormal war period is omitted."⁴²

The opinion then went on to find that

"If there was evidence that the document was false in the particulars already indicated, there was ample evidence upon which the jury could find that the appellant knew of its falsity, knowing as he did of the means by which the dividends had been paid; and it is not and cannot be disputed that the prospectus was published with intent to induce persons to entrust or advance money to the company which was sufficient to satisfy the section. . ."⁴³

The application for reduction of sentence was peremptorily denied.⁴⁴

Manifestly, the impact of this conviction upon the business world was as important as its effect upon legal circles.⁴⁵ Everywhere it was hailed

41. *Rex v. Kysant*, *supra* note 17.

42. *Id.* at 99.

43. *Id.* at 100.

44. *London Times*, Nov. 5, 1931, at 12.

45. It has been assumed that one effect of the *Kysant* case was to set the *civil* law for actionable misrepresentation. See Note (1932) 45 HARV. L. REV. 1078, 1079, n. 7. But although the judges may have felt that the civil law supported them and have been considerably swayed by consideration of the fiduciary-relationship doctrine derived from the superior knowledge and predominant position of one party to the transaction, it does not follow that a necessary corollary of the *Kysant* case would be the subjection of Lord *Kysant* to civil liability. That would be so only if the civil law allowed the "false impression" test in all fraudulent misrepresentation cases, or imposed a duty of disclosure not only upon promoter-directors but upon directors generally, so as to include directors of concerns engaging in sales of stock to prospective investors through prospectuses. It is doubtful, however, if the English civil law entertains either of these propositions. See Stiebel, *Inferences from a Prospectus* (1932) 48 L. Q. REV. 43.

as a step in the right direction. The staidest of financial journals were warmest in their praises.⁴⁶ The accountancy profession and the bar approved the results.⁴⁷ General opinion was, in fact, inclined to feel that, happy deterrent that this case might be, even further anticipatory preventive measures should be embodied in the law. The Stock Exchange in London favored making it obligatory upon directors of public companies to disclose in accounts the extent to which reserves are drawn upon to assist the profit and loss account, since it was felt that purely trading operations should not be veiled by special credits.⁴⁸ Accountants were of much the same view and suggested additionally that chartered companies should be on the same footing as other public companies.⁴⁹ Such criticism had been broached before, notably at the time when the Greene Committee was laboring upon the legislation which became the Companies Act of 1929. That Act does require that prospectuses shall contain a record of the profits and dividends of a company for the three years preceding the issuance, but has no provisions concerning the manner in which the profit statement shall be drawn up.⁵⁰ This was deemed an unfortunate omission at that time⁵¹ and, inevitably, it appeared even more unfortunate after the *Kylsant* case had focused attention upon accounting practice.⁵²

In the United States there existed before the enactment of the Federal Securities Act a number of statutes, state and federal, within the scope of which the malpractices of corporate directors and officers might fall or do fall. A federal law prohibits the use of the mails to defraud.⁵³ A violation of this statute can be established by proof that money was obtained in the sale of corporate stock through false representations,⁵⁴ and directors might well be so connected with such a violation as to become liable to conviction. But such liability seems limited to direct false representations—at most, false as the result of legal implications, i. e. dividends paid imply dividends earned.⁵⁵ Unless,

46. See (1931) 113 THE ECONOMIST 874.

47. See (1931) 75 SOL. J. 594, 595; (1931) 85 THE ACCOUNTANT 629.

48. N. Y. Times, Aug. 3, 1931, at 31.

49. See (1931) 85 THE ACCOUNTANT 193; *id.* at 249.

50. Companies Act, *supra* note 15, Fourth Schedule, Part II.

51. (1926) 102 THE ECONOMIST 1132.

52. It is to be noted, however, that although an interpretation of the relevant sections of the Companies Act, *supra* note 15, was not involved in the *Kylsant* decision, Mr. Justice Wright expressed the opinion that they could not be construed to allow "secret reserves," i. e. surplus hidden under such a liability item as "sundry balances." To the same effect see (1931) 172 LAW TIMES 161.

53. 35 STAT. 1130 (1909), 18 U. S. C. § 338 (1926).

54. *Gold v. United States*, 36 F. (2d) 16 (C. C. A. 8th, 1929); *Corliss v. United States*, 7 F. (2d) 455 (C. C. A. 8th, 1925); *Pandolfo v. United States*, 286 Fed. 8 (C. C. A. 7th, 1922).

55. *Ibid.*

then, the "scheme to defraud" to which the statute refers includes within its substance not a document such as a prospectus, truthful in itself yet false in impression, but a document which contains a statement that is false, no liability will be imposed. Whether or not public pressure, prosecuting fervor, and judicial acquiescence can bring about an extension of interpretation of "scheme to defraud" so as to broaden liability along the lines suggested by the *Kylsant* case is problematical.

There are also two types of state laws which presumably could support convictions of directors responsible for prospectuses that are truthfully deceptive. One consists of those laws directed to the general prohibition of false statements to affect the market price of securities. These laws are very broad and in two states could, it is submitted, lead to the conviction of many directors who have subscribed to a prospectus for a stock issue which would be minutely truthful and yet grossly misleading, since all that is required is an intent to affect the market price of a security by circulating or publishing any "misleading writing."⁵⁶ The other three states having this type of law restrict liability to "false statements" or "fraudulent devices"⁵⁷ and the present state of judicial interpretation leads one at most to hope rather than to assert that liability so phrased covers fraud by misleading truth. No prosecutions have been initiated which raise the issue but the possibilities of broad interpretation are latent. The other type of statute, now lacking in only six states,⁵⁸ is that prohibiting false advertisements.⁵⁹ For present purposes it may be stated that if the reasonable assumption is made that a prospectus is an advertisement, then this type of statute will apply. Under it, liability is extended to "any assertion, representation, or statement of fact which is untrue, deceptive or misleading." While, no doubt, there is no possibility of imposing liability by testing the advertisement and prospectus as a whole, at least statements it contains do not have to be proved false, but merely misleading, and it would seem that because of this fact prosecutors have and have had a very handy weapon, as yet little used, with which to attack those who would deceive the investing public.

In addition to these state laws there are the statutes of twenty-four

56. 5 NEV. COMP. LAWS (Hillyer, 1929) § 10529; WASH. REV. STAT. (Remington, 1932) § 2622.

57. N. D. COMP. LAWS ANN. (1913) § 9787; OKLA. COMP. STAT. (Harlow, 1931) § 2105; S. D. COMP. LAWS (1929) § 3995.

58. Colo., Del., Ga., Me., Miss., N. M.

59. This legislation was first advocated by *PRINTER'S INK* and the "model statute" there proposed, directed to the drastic prohibition of untrue advertising without reference to knowledge of its untruth or intent to mislead, has been adopted in many states, while other states have adopted variations of this "model statute" which require knowledge of the deception or intent to deceive. The statutes are collected and discussed in detail in *Comment* (1927) 36 *YALE L. J.* 1155.

states which impose directly rather broad criminal liability upon directors and officers responsible for the issuance of false prospectuses. These statutes are divisible into two broad categories: first, those which, irrespective of divergent requirements, or lack of them, as to intent or knowledge, impose liability only for direct false statements contained in a prospectus; and second, those which, likewise without consideration of intent or knowledge requirements, impose liability for a prospectus that is, as a whole, false by its impression, as well as for one containing a positive false statement.

In the first category are sixteen state statutes of fifteen states.⁶⁰ All these laws restrict liability to prospectuses *containing* statements which are false,⁶¹ thus by their terms barring any broad liability through analogy to the wording of the English statute referring to prospectuses "false in a material particular." It is of course also true that the statutes in this category vary considerably in other respects. Ten require no intent to deceive or defraud.⁶² Of these ten, three contain specific provisions that the statement either is intended to, or does affect or enhance or depress the market or real value of securities in the company concerned,⁶³ while all but one require that the publishing or concurring in the publishing of the prospectus must be done "knowingly."⁶⁴ Six statutes within this first category postulate an intent to deceive or defraud. Of these six, three require additionally an intent to affect or depress or enhance the market value of securities of the company with which the person prosecuted is associated;⁶⁵ one requires an intent "to deceive any person as to the real value of any shares or bonds" in such company;⁶⁶ one provides that the statement or prospectus containing the material representation which is false shall be "as to the value or affecting the value of stocks or bonds" of a corporation;⁶⁷ and one simply makes it a crime to make knowingly or willfully any fraudulent mis-

60. CONN. GEN. STAT. (1930) § 6343; 1 IDAHO CODE ANN. (1932) § 17-4006; MD. ANN. CODE (Bagby, 1924) art. 27, § 170; MASS. GEN. LAWS (1921) c. 266, § 92; MINN. STAT. (Mason, 1927) § 10389; MONT. REV. CODE (Choate, 1921) § 11446; NEB. COMP. STAT. (1929) § 28-1217; (a) N. Y. PEN. LAW (McKinney, 1917) § 952; (b) *id.* § 665; N. D. COMP. LAWS ANN. (1913) § 10015; OHIO CREM. LAWS (Patterson, 1929) § 13175; S. C. CODE (1932) § 1238; S. D. COMP. LAWS (1929) § 4286; UTAH COMP. LAWS (1917) § 8371; WASH. REV. STAT. (Remington, 1932) § 2642; WYO. REV. STAT. (1931) § 32-907.

61. The Connecticut, Massachusetts, Minnesota, Ohio, Washington, and Wyoming statutes read "false or exaggerated."

62. Conn., Idaho, Minn., Mont., N. Y. (b), N. D., S. D., Utah, Wash., Wyo.

63. Conn., Minn., Wyo.

64. Connecticut is the one exception.

65. Md., Mass., Neb.

66. Ohio.

67. N. Y. (a).

representation as to the capital, property or resources of the corporation.⁶⁸

In the second category are ten state statutes.⁶⁹ Five of these are almost exactly similar to the English statute and capable of the same broad interpretation.⁷⁰ They concern prospectuses "false in a material particular," require knowledge of the falsity, and provide for an "intent to deceive or defraud any member, shareholder or creditor of said corporation (i. e. of which the accused is a director) or with intent to induce any person to become a shareholder or partner therein." These five states clearly afford punitive measures to force wide disclosures by corporations. Three other statutes within this category would seem to impose so broad a liability as to test a prospectus as a whole for its impression.⁷¹ On careful examination it will be seen that they create a criminal liability for reports containing material statements that are false, and also, alternatively, for "any untrue or willfully or fraudulently exaggerated prospectus" which is intended to produce or give, or has a tendency to produce or give the shares of stock in such corporation a greater value or a less apparent or market value than they really possess. It would seem reasonable for the courts to hold, by analogy to English interpretation and an application of common sense, that an "untrue prospectus" is one which as a whole creates a false impression, however true its details and inclusive statements, especially if it purports to set out a true financial picture while in fact concealing it. The remaining two statutes which may be construed to create broad liability are so exceptional in their wording as to warrant specific attention. One makes it unlawful for a director to make "any false statement in regard to the financial condition of such company."⁷² If we regard a prospectus as a statement in regard to the financial condition of a company, as seems at least possible, then the adjective "false" would apply to a prospectus taken in its entirety and a rule of impression might be allowable. The other statute is still more vague and unsatisfactory. It lays down the rule that "Intentional fraud . . . in deceiving the public . . . in relation to their liabilities, shall subject all directors . . . knowingly participating therein to the penalties of a misdemeanor."⁷³ At least this is capable of

68. S. C.

69. ARIZ. CODE (Struckmeyer, 1928) § 4806; CAL. PEN. CODE (Deering, 1931) § 564; IOWA CODE (1931) § 8404; NEV. COMP. LAWS (Hillyer, 1929) § 1765; N. J. COMP. STAT. (1910) p. 1797; ORE. CODE ANN. (1930) § 14-3109; PA. STAT. ANN. (Purdon, 1930) tit. 18, § 2632; S. C. CODE (1932) § 1353; TENN. CODE (1932) § 3764; WIS. STAT. (1931) § 343.37.

70. Nev., N. J., Ore., Pa., Wis.

71. Ariz., Cal., Iowa.

72. S. C.

73. Tenn.

being construed to cover means of deception, truthful in themselves but intended to deceive.

While many of these state statutes directly imposing criminal liability for false prospectuses thus possess potentially the adequacy of the English Larceny Act under the interpretation of the *Kylsant* case, there is not the slightest indication that these statutes have been pressed to the limit of their scope. Only eleven prosecutions under all these statutes are on record. The basic explanation of this, to which support is accorded by this paucity of prosecutions, lies in the ignorance of their existence and in indifference to them, when their existence is known, on the part of the public and legal authorities.⁷⁴ Even as public indifference nullified Blue Sky laws, so these laws have been rendered impotent through public apathy.

Of the eleven prosecutions which have been undertaken under these or similar earlier statutes, five turned upon the sufficiency and validity of the indictments. In *State v. Johnston*⁷⁵ the defendant had been convicted of publishing positive false statements concerning the financial condition of the bank of which he was a director. The controlling statute provided,⁷⁶ however, that the false statement must be made "to some other person with an intention to deceive the person to whom the false statement is made." On appeal it was held that damage need not be alleged but that a new trial must be had since there was no allegation as to whom the alleged false statement was made. *Commonwealth v. Rash*⁷⁷ held that an indictment under the Pennsylvania statute charging the defendant with making a false report of the corporation of which he was president, was properly quashed because it failed to charge that the statement related to the corporation and the evidence showed that it related to his personal benefit and credit. In *State v. Paulsen*⁷⁸ the appellate court refused to uphold a demurrer to an indictment of a director which alleged a false statement but not that it was intended to give or had a tendency to give a greater or less apparent value to the shares or property than actually possessed. The statute under which the indictment was brought⁷⁹ set up liability for "any statement which is false or

74. Only passing reference is made to these statutes in THOMPSON, CORPORATIONS (3d ed. 1927) § 5632; COOK, CORPORATIONS (8th ed. 1923) 2728; SPELLMAN, CORPORATE DIRECTORS (1931) 666. FIXEL, FALSE FINANCIAL STATEMENTS (1924) c. 8, overlooks this type of statute entirely, discussing only false-pretense and the concomitant false-statement-for-credit statutes.

75. 149 S. C. 195, 146 S. E. 657 (1928).

76. S. C. CRIM. CODE (1922) § 244. This section, considerably altered, has been incorporated into the present Code, *supra* note 69.

77. 97 Pa. Sup. Ct. 495 (1929).

78. 21 Idaho 687, 123 Pac. 588 (1912).

79. IDAHO REV. CODE (1909) § 7128, repealed by Idaho Laws 1913, c. 117, but incorporated in substance in the present Code, *supra* note 60.

wilfully exaggerated or which is intended to give or has a tendency to give a greater or less apparent value to the shares or property than actually possessed," and the trial court ruling was that the "or" between "exaggerated" and "which" should be read "and," thus requiring for conviction both falsity and intention. *State v. Merchant*⁸⁰ reversed the judgment of a trial court which had allowed, under a statute,⁸¹ the conviction of a director for indorsing the publication to a person dealing with the corporation of a wilfully untrue report of operations. The evidence was directed to showing that the report in question not only affected his judgment in negotiating for a job with the company but in buying its stock. Dealing in the corporation's stock in the market was held to be not synonymous with dealing with the corporation and evidence as to the former was deemed erroneously admitted. *State v. O'Brien*⁸² constituted an appeal from a conviction for making a false and exaggerated report of a corporation to its stockholders, contrary to a section of the penal code then in force.⁸³ There was no question but that a false statement had been made by the defendant as to the surplus and undivided profits of the company, but the grounds of the appeal were that no intention to deceive had been alleged or proved and that, since the evidence showed that the prosecutor was a shareholder at the time of the issuance of the false statement, the offense disclosed came under another section of the law which covered reports to shareholders and required such intention.⁸⁴ The appeal was upheld on that ground.

The remaining six instances of prosecutions turn upon the validity of exclusion and inclusion of evidence under indictments properly drawn, containing all necessary allegations and properly related to the precise statute establishing the crime alleged. In *People v. Merritt*⁸⁵ defendant appealed from a conviction for issuing a false prospectus in violation of a California statute,⁸⁶ but the conviction was affirmed.⁸⁷ *People v.*

80. 48 Wash. 69, 92 Pac. 890 (1907).

81. Wash. Laws 1903, c. 93, § 1, repealed by Wash. Laws 1927, c. 43, § 2. But see the present Washington Code, *supra* note 60.

82. 143 Wash. 636, 255 Pac. 952 (1927).

83. See the present Washington Code, *supra* note 60.

84. See WASH. REV. STAT. (Remington, 1932) § 3829.

85. 18 Cal. App. 58, 122 Pac. 839 (1912).

86. Cal. Laws 1905, c. 583. This provision, considerably altered but directed to the same basic purpose, is now incorporated into the present Penal Code, *supra* note 69.

87. The prospectus purported to describe the holdings of Haiwee Pacific Oil Company whose stock it was intended to propagandize for sale and of which the defendant was manager and secretary. This document stated: "We have since added to our holdings until we now own 6,080 acres located about ten miles south of Owens Lake. This land is made up of more certain indications of oil than any other field in California." It was admitted at the trial that the title to this land remained in the United States government. Defendant tried to justify the statements by giving evidence of making two locations under the United States mineral laws, and objected to the evidence of additional work as

Youtz,⁸⁸ determined under the present California statute, was an appeal from a conviction by a director of a holding company charged with issuing a report "false in a material particular," the same descriptive phrase used in the English Larceny Act. The appeal was upheld.⁸⁹ *State v. Ware*⁹⁰ was prosecuted under the present New Jersey statute, which is similar to that of England. The defendant director of the North American Realty Company was convicted of publishing a statement he knew to be false in a material particular, the falsity consisting in the fact that the prospectus of the company referred to two farms that had been "purchased" when in reality there existed only agreements to buy in installments to begin after the prospectus was issued. An appeal was upheld.⁹¹ *State v. Clements*,⁹² prosecuted under the Montana statute, involved the question whether or not a statement in a report that capital stock had been paid in to the extent of \$100,000 made that report one "containing any material statement which is false" within the statute when the \$100,000 consisted of only \$5,000 in cash and the balance in notes rather than \$100,000 in cash, which the government claimed was necessary to justify the statement. The defendant's contentions were upheld.

*State v. McDougal*⁹³ was a prosecution under the Iowa statute, which is similar to that of Montana. The case turned upon whether or not a statement in the financial report of the Associated Packing Com-

harmful, but on appeal it was ruled that no harm had been done the defendant as in the absence of the evidence of additional work it would have been assumed that the only work of protection done was in sinking two wells which would only have justified claims to 320 acres.

88. 26 Cal. App. 440, 147 Pac. 222 (1922).

89. The statement so alleged to be false was an item within the asset account "Stocks, bonds, and secured notes—\$558,360.48" consisting of stock in the Arizona Fire Insurance Company carried at twice its par value. If this stock were worth only par, it was conceded that the asset account would be overvalued by \$200,000. The stock was not on the market and the accused testified it was worth twice par but the jury found otherwise and convicted. Appeal was based on the ground that, conceding the statement untrue in fact, it was only an expression of opinion as to value and not a statement of definite fact, but the court held that the value affixed was applied to property, the worth of which is not generally of such a speculative nature as to excuse a statement in appraisal thereof as a matter of opinion only.

90. 71 N. J. L. 53, 58 Atl. 595 (1904).

91. One ground of appeal was that evidence of defendant's association with the fraudulent real estate company which was the predecessor of the North American was erroneously admitted to his prejudice and that no evidence was adduced to support a finding that he knew of the false statements. A further ground of appeal, that it was necessary to allege and prove that certain particular people entrusted their money or property to the corporation, was not upheld as it was deemed sufficient if the allegation and proof related to the public generally.

92. 37 Mont. 314, 96 Pac. 498 (1908).

93. 193 Iowa 286, 186 N. W. 929 (1922).

pany for which the defendant was responsible, that the cost of selling 35,728 shares of stock was 4.032 per cent., was false and also if the amount stated as cash in bank was false. The cash-in-bank account proved to be correct, but the court excluded evidence of the state directed to show that other assets were overvalued, and since the percentage cost of selling the stock was found by dividing the number of shares into the balance sheet deficit, it was held on appeal that the evidence had been wrongly excluded, as such evidence might have shown that the deficit was larger than stated and therefore that the percentage cost of selling the stock was misstated. In *State v. Bolyn*⁹⁴ the defendant director of a bank appealed a conviction under the South Carolina law, for knowingly making a fraudulent misrepresentation as to the resources of the bank. The particular false representation proved was an exaggerated statement of the amount of the bank's overdrafts but, on appeal, it was held that this false representation was proved by evidence improperly admitted, and the conviction was reversed.

It will be noted at once that in all these cases the prosecution either proved or tried to prove a direct false statement. Moreover, the convictions only covered blatantly dishonest methods, i. e. gross overvaluation of assets or unashamed lying without any pretence of subtlety. A few traps in the matter of drawing up indictments are disclosed and rather minute contribution to the law of evidence is made. But no intricate and subtle financial wizardry on a large scale has been combatted by prosecutors eager to extend the statutes to their remedial and punitive limits, nor has there been any attempt to press upon the courts the adoption of the "false impression" test which is now the law of England.

Yet outright fraud is the least difficult to prosecute. Civil liability of responsible directors is clear in such instances⁹⁵ and so is their criminal liability under these various statutes. Other statutes such as false pretense statutes⁹⁶ might cover frauds of directors upon prospectuses where they have personally received money or property.⁹⁷ Statutes covering

94. 143 S. C. 63, 141 S. E. 165 (1927).

95. See Shulman, *Civil Liability and the Securities Act* (1933) 43 YALE L. J. 227.

96. See FIXEL, *op. cit. supra* note 74, Appendix A, where they are collected, and §§ 93-95, where their general scope is discussed.

97. See *Commonwealth v. Langley*, 169 Mass. 89, 47 N. E. 511 (1897) (for officer of corporation to sell its stock by false statements and personally to receive payment for it constituted obtaining money by false pretenses); *People v. Smith*, 239 Ill. 91, 87 N. E. 885 (1909) (defendant directors of bank convicted of conspiracy to obtain by false pretenses, defendants selling their bank stock through false statements as to the paid-in capital); *In re Crane*, 40 Nev. 338, 163 Pac. 246 (1917) (officer of corporation making false statement relating thereto and selling stock thereby to prosecutrix, convicted of obtaining money by false pretenses and habeas corpus denied).

false statements to obtain money and credit⁹⁸ might also convict directors in baldly dishonest transactions.⁹⁹ The federal statute prohibiting the use of the mails to defraud¹⁰⁰ can serve as a means to convict where prospectuses contain positive misstatements of fact.¹⁰¹ Considerations of what is a false representation under such prosecutions have even led to investigation of the validity of valuation of stocks¹⁰² and the setting up of a rule that if dividends are paid there is a legal implication that they have been earned, with consequent inquiry into accounting methods.¹⁰³ This legal implication is not to be minimized, for it might be capable of leading to a conviction when dividends have been paid out of capital or from stock premiums,¹⁰⁴ or from surplus created through undue appreciation of assets.¹⁰⁵

But there are methods to be considered other than those of direct falsehood. Far more subtle and insidious practices are prevalent which may not be labeled as false but which are distinctly misleading. While other means and methods are available to those who would thus mislead, the two media which best facilitate the myriad of deceptive though perhaps truthful accounting practices are balance sheets and profit and loss statements. The Federal Securities Act recognizes this fact in vesting the Federal Trade Commission with power to require those issuing securities to submit balance sheets and profit and loss statements,¹⁰⁶ as well as such additional information as the Commission deems essential to the public interest.¹⁰⁷ In this and in other respects, the Securities Act is the most comprehensive of the American statutes.

98. See note 96, *supra*.

99. *Sate v. Rommel*, 3 N. J. Misc. 204, 127 Atl. 598 (1925) (defendant president of corporation convicted of falsely stating corporation's assets to deceive creditors and stockholders).

100. *Pandolfo v. United States*, *supra* note 54.

101. *Moore v. United States*, 2 F. (2d) 839 (C. C. A. 7th, 1924); *Pandolfo v. United States*, *supra* note 54; *Sparks v. United States*, 241 Fed. 777 (C. C. A. 6th, 1917); *Wilson v. United States*, 190 Fed. 427 (C. C. A. 2d, 1911).

102. *Hynney v. United States*, 44 F. (2d) 134 (C. C. A. 6th, 1930).

103. *Gold v. United States*; *Corliss v. United States*, both *supra* note 54.

104. In *Gold v. United States*, *supra* note 54, the court found dividends had not been paid out of stock premiums and inferentially one may assume that it might have found that dividends had not been earned, with resulting false representation and possible conviction.

105. See *Hill v. International Products Co.*, 129 N. Y. Misc. 25, 50, 51, 220 N. Y. Supp. 711, 735, 736 (Sup. Ct. 1925), where the court found unwarranted appreciation of assets making certain dividends that were paid unearned, though the defendants were absolved by lack of connection with the consequent false representations and on other grounds. If, however, such responsible connection was shown with the statement as to dividends paid made in a prospectus, the responsible directors might well be convicted of using the mails to defraud.

106. Securities Act, *supra* note 1, Schedule A, (25) and (26).

107. *Id.* § 7.

Yet despite its potentially extensive scope of liability, failure to adopt the English test of the impression created by a prospectus or registration statement as a whole will materially influence the effectiveness of the Act in imposing liability in all instances of deceptive truth. Content can be given to its concepts only if prosecutions are brought, and the substance of that content will depend upon the temper of the American people and the inclinations of the judiciary. The fate of the statute thus lies, fundamentally, within the power of prosecutor, judge and jury.