St. John's Law Review

Volume 46
Number 3 *Volume 46, March 1972, Number 3*

Article 27

Retraction of an Exchange Offer–No Compensable Losses (Levine v. Seilon, Inc.)

St. John's Law Review

might be projecting.[44] In such a case, the investor should be permitted to evaluate the total situation through appropriate disclosures.[45] The court of appeals concluded that

> in this situation, failure to inform the customer fully of its possible conflict of interest — in that it was a market-maker in the securities which it strongly recommended for purchase by him was an omission of material fact in violation of Rule 10b-5.[46]

The requisite reliance to be shown in a 10b-5 violation was self-evident here. The plaintiff clearly bought the stock upon defendant's recommendation, without any disclosure, and suffered a loss in their resale. The damages which were assessed were correct. In a 10b-5 violation, the innocent party is entitled to recover his damages resulting from the violation.[47] The court rejected the defendant's contention that the damages should only be the difference between the price the purchaser paid less the market price on the purchase date.[48] Perhaps one real problem with this case is that it was given a narrow application by the court which wished to limit the case to its set of facts.[49]

RETRACTION OF AN EXCHANGE OFFER — NO COMPENSABLE LOSSES

In an action for alleged misrepresentations by a corporation that it would honor an invitation to exchange stock, when in fact it never intended to do so but rather intended to sell certain assets in order to raise enough cash to redeem said stock, the court of appeals affirmed a district court order dismissing the action on the grounds that the

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44 The defendant might have been caught in either a "short" or "long" position because of erroneous judgment as to supply and demand in a certain security. If the defendant were over-supplied, it would have been to its advantage to unload the stock. Under these circumstances, the defendant's motivations might affect the advice it gives to a client. The investor must be permitted to evaluate a broker's motivations. The only way to give the investor such notice is through appropriate disclosure. Chasins v. Smith, Barney & Co., Inc., 438 F.2d 1167, 1172 (2d Cir. 1970).

45 *Id.*

46 *Id.* The court went on to explain that it did not want to encroach on studies presently being conducted by the SEC as to the advisability and method of disclosing market making activities. They only went so far as to hold that in this case withholding information was a failure to disclose a material fact. *Id.*

47 *See*, J. I. Case Co. v. Borak, 377 U.S. 426 (1964).

48 438 F.2d at 1173:

> the evil is not the price at which Chasins bought but the fact of being induced to buy and invest for some future growth in these stocks without disclosure of Smith, Barney's interest. . . .

49 *Id.* at 1174 (Friendly, J., dissenting). The dissent was not as upset with the holding per se as it was with the retroactive effect accorded to rule 15cl-4, note 35 *supra*. The dissenters felt that in 1961, the time when the alleged violations took place, there was no requirement that one must disclose market-making activities. The dissent also felt that there was no basis to the finding that the plaintiff might not have bought the stocks had a disclosure been made. *Id.* at 1174-77.

plaintiff failed to state a claim upon which relief could be granted.[50] The plaintiff[51] alleged that he was misled into retaining stock which could have been sold when the market price had advanced to reflect the anticipated exchange. Plaintiff alleged that the market price had risen above the redemption acquisition price. The court of appeals held that the complaint, as framed, disclosed no "actual damages" which would be compensable under the Securities Exchange Act of 1934[52] or the rule promulgated thereunder.[53]

On May 31, 1968, the defendant corporation had outstanding 18,792 shares of Class A Preferred stock. This stock had a $5.00 cumulative dividend and was redeemable at any time for $102 plus any unpaid earned dividends.[54] The plaintiff owned 500 shares of this stock on this date and continued to own 500 shares until the defendant redeemed them in January 1969.[55] The plaintiff alleged that the defendant's certificate of incorporation contained various restrictions for the benefit of preferred shareholders,[56] and in order to relieve itself of the burdens of these restrictions, the defendant devised a scheme whereby it represented that it would exchange all preferred shares for common shares in the ratio of 6½ shares of common for 1 share of preferred. They further promised not to redeem any preferred shares prior to the effectiveness of the exchange offer and the termination of the period for acceptance of the offer.[57] In exchange for this commitment, the preferred shareholders permitted the defendent to proceed with a program of new funded debt.[58]

The plaintiff complained of three transactions.[59] However, it should be noted that all three of these transactions could and were carried out without the consent of the preferred stockholders. These were not restrictive acts due to any conditions of the certificate of in-

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50 Levine v. Seilon, Inc., 439 F.2d 328 (2d Cir. 1971).

51 Originally, this action was commenced by one Irving Levine. Florence K. Levine, his executrix, was substituted as plaintiff on this appeal due to Mr. Levine's death. The court in their opinion simplified matters by disregarding his death. 439 F.2d at 329.

52 15 U.S.C. § 78(a) *et seq.* (1970).

53 439 F.2d at 335. Authority for such a dismissal comes from F.R. CIV. P. 12(b)(6).

54 439 F.2d at 329. The defendant also had outstanding numerous shares of common and Prior Preferred stock. The latter carried a cumulative dividend and was redeemable at $100 per share plus any earned unpaid dividends. In the interest of brevity, these stocks will be ignored although it should be noted that the invitation to exchange was offered to the holders of Prior Preferred. *Id.* at 329, 330.

55 *Id.* at 329.

56 The restrictions are enumerated at length in the opinion. See 439 F.2d at 330 n.1, 2.

57 439 F.2d at 330.

58 The plaintiff complained that the preferred shareholders were induced into agreeing with the new debt program by defendant's misrepresentations. 439 F.2d at 330-31.

59 439 F.2d at 331.

corporation. By means of these three transactions, the corporation was able to acquire enough money to redeem the preferred shares, and on December 10, 1968, the corporation announced the redemption and an intention to make a public offering of the common shares which were originally intended to be used in the exchange.[60]

In his initial complaint, the plaintiff alleged violations of sections 10(b)[61] and 14(e)[62] of the Securities Exchange Act of 1934, as well as violations of rule 10b-5.[63] In his amended complaint, the one upon which this appeal was taken, the claim as to section 14(e) had been dropped.[64] The district court dismissed the plaintiff's 10(b) and 10b-5 claims on two grounds. First, under the authority of *SEC v. Sterling Precision Corp.*,[65] the court found that a redemption is not a "purchase" or "sale."[66] Second, the allegation that the intention to exchange was fraudulent, was unavailing, for that statement was not "in connection with" the redemption; even assuming the redemption to be a sale, the allegation was insufficient, since the defendant has an absolute right to redeem at any time.[67]

The court of appeals, in affirming the district court order, refused to overrule the *Sterling* case,[68] sensing the futility of concerning itself with this consideration at the present time since the plaintiff would fail in any event.[69] The court found the plaintiff's failure to

60 The plaintiff complained that the price of common stock had risen in December and that preferred stock prices had also risen to reflect the anticipated exchange. Therefore, at an exchange of 6½ for 1, his preferred stock would be worth about $139 per share as opposed to the redemption price of $102 per share. 439 F.2d at 331-32.

61 15 U.S.C. § 78j(b) (1970) provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
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> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

62 15 U.S.C. § 78n(e) (1970) provides:

> It shall be unlawful for any person to make any untrue statement of a material fact . . . or to engage in any fraudulent, deceptive or manipulative acts or practices, in connection with any tender offer or request or invitation for tenders. . . .

63 *See* note 34 *supra*.

64 Plaintiffs section 14(e) claim was dismissed without leave to amend by the district court because they found that no "offer, request or invitation for tenders" was actually made. 439 F.2d at 332; see also note 60 *supra*.

65 393 F.2d 214 (2d Cir. 1968). The plaintiff argued that the *Sterling* case was not applicable to his cause of action since it dealt with the Investment Company Act of 1940, 15 U.S.C. § 80a-1 *et seq*. (1970). 439 F.2d at 332.

66 See note 61 *supra*.

67 439 F.2d at 332.

68 *Id.*

69 *Id.*

plead the stockholder's approval of the various credit arrangements, allegedly induced by defendant's offer to exchange, were causally related to the accumulation of funds required for the redemption.[70] Second, the amended complaint did not allege, nor was there a showing that the preferred shares had an investment value exceeding their call price.[71]

The theory upon which the plaintiff sought to establish damages was that he suffered a loss by not selling during the period of inflated prices which pervaded the exchange. However, this theory was undermined by the fact that the plaintiff failed to allege that he had an intention to sell his shares during that period.[72] The rule on damages in federal courts is "that a defrauded buyer of securities is entitled to recover only the excess of what he paid over the value of what he got."[73] This is the same rule used in 10b-5 cases concerning defrauded buyers.[74] However, defrauded sellers have been held in a different spectrum. They have been permitted to recover not only the difference between the actual value and what [they] received at the time of the sale, but added profits which the buyer has realized through accretions in value subsequent thereto,[75] or which the seller would have realized had he retained the stock for a reasonable period after the disclosure.[76] Although the plaintiff in this case attempted to place himself in the category of a defrauded seller, the court disagreed with such a classification. The redemption by the corporation was clearly one which was within their powers. The exchange offer could have been withdrawn at any time because the corporation received no consideration for the

70 *Id.* In fact, just the opposite had been shown by the plaintiff. His complaint cited three transactions used to secure the case necessary for the redemption. However, all three transactions were capable of being carried out without first securing the consent of the preferred stockholders.

71 *Id.* at 333. Often, redeemable securities can be shown to contain features that cause them to command a premium over the call price, *i.e.*, convertible or participating features. *See, e.g.*, Hanover Bank v. C.I.R. 369 U.S. 672 (1962).

72 439 F.2d at 333. The court further pointed out that had plaintiff sold his securities during the summer of 1968, after learning of the alleged deceit, he could not have claimed compensation for the premium he might have extracted from an innocent buyer who knew nothing of the alleged fraud. If this were the case, he would stand in the shoes of a tippee, so to speak, whose conduct would be reprehensible. *See* S.E.C. v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968).

73 439 F.2d at 334. *See also* J. I. Case Co. v. Borak, 377 U.S. 426 (1964); *accord*, Chasins v. Smith Barney & Co., 401 F.2d 1167 (2d Cir. 1970).

74 439 F.2d at 334, *citing* Janigan v. Taylor, 344 F.2d 781, 786 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965); 2 A. BROMBERG, SECURITIES LAWS: FRAUD — SEC. RULE 10b-5, § 9.1, at 226-27 (1969).

75 439 F.2d at 334, *citing* Janigan v. Taylor, 344 F.2d 781, 786-87 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965).

76 349 F.2d at 334, *citing* Myzel v. Fields, 386 F.2d 718, 744-47 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968); *see generally* Note, *Insiders Liability Under Rule 10b-5 for the Illegal Purchase of Actively Traded Securities*, 78 YALE L.J. 864, 878-91 (1969).

offer. The court noted that the only thing lost by the plaintiff was the "euphoria he doubtlessly experienced during the summer and fall of 1968"[77] in anticipation of the exchange. This did not constitute "actual damages"[78] compensable under 10(b) or rule 10b-5.[79]

FIDUCIARY DUTY

The problem of the fiduciary duty owed by an investment adviser to a mutual fund was presented in the case of *Rosenfeld v. Black.*[80] Here the plaintiff, a stockholder of the Lazard Fund, Inc. (the Fund) brought actions in both the federal and the state courts[81] on April 11 and 12, 1967 seeking an injunction and an accounting, since the complaint alleged that Lazard Freres & Co.[82] (Lazard), after having acted in

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77 439 F.2d at 335.

78 *See* 15 U.S.C. § 78bb (1970).

79 In concluding, the court made a number of noteworthy points. First, they upheld the district court's dismissal of the section 10(b) and rule 10b-5 complaint on the grounds that the plaintiff failed to meet the "in connection with the purchase or sale of any security" requirement. This is noteworthy because the SEC had filed an amicus brief urging the court to utilize this case as a vehicle for overruling the purchaser-seller requirement of Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir.), *cert. denied,* 343 U.S. 956 (1952); *accord,* Iroquois Industries, Inc. v. Syracuse China Corp., 417 F.2d 963 (2d Cir. 1969), *cert. denied,* 399 U.S. 909 (1970).

Second, the court expressed some dissatisfaction with the restrictive interpretation which the district court gave to section 14(e), "in connection with any tender offer." While it felt that the issues did not require it to give its interpretation of 14(e) at this time, the court of appeals, by expressing its dissatisfaction, intimated that it would favor a more lenient interpretation.

Finally, the court made it clear that had the plaintiff been a party who purchased securities in reliance on the defendant's alleged misrepresentations, a good cause of action would have arisen in his favor. 439 F.2d at 335.

80 445 F.2d 1337 (2d Cir. 1971).

81 The court was quite clear in its denunciation of the practice of bringing suit in both federal and state courts.

> We unreservedly condemn this practice which for reasons that are well understood, is so frequently utilized in stockholder actions in the Southern District of New York with respect to investment companies and in many other stockholder suits. A litigant is entitled to his day in one court, but not in two — a consideration of special moment in these times of serious delays in trials.

Id. at 1341 n.5. The court did observe that although a federal court was prohibited from enjoining the state proceeding by the ruling of Kline v. Burke Construction Co., 260 U.S. 226 (1922), nevertheless, it was capable of staying its own proceeding. This the court heartily recommended to avoid this "imposition."

82 The factual pattern of this case is rather complicated despite the fact that the final holding seems obvious. The operative facts began to occur in 1958 when the highly reputed investment banking firm of Lazard Freres organized the mutual fund known as The Lazard Fund under the Investment Companies Act of 1940, 15 U.S.C. § 80a (1970). The initial offering of the Fund was 8,500,000 shares at a price of $15 per share to the public. Lazard Freres which had organized the Fund was employed as its investment adviser. It was to render both investment advice as well as the necessary office facilities and personnel including corporate officers. As compensation for these services Lazard was to receive a certain percentage of the average daily net assets of the Fund.

Despite the fact that the Fund was originally organized as a closed-end investment company it, in essence, conformed to the definition given by the Investment Company Act