"Federal Corporation Law" and 10b-5: The Case for Codification

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"Fear and uncertainty pervade corporate and financial officers."

Unfortunately, these grim words aptly depict the current plight of corporate executives. The fear and hesitancy stem from the staggering potential liability which may result when corporate officers or directors engage in a transaction which, in some measure, involves securities. The precarious position of such corporate personnel was brought to the forefront in the famous Securities and Exchange Commission (SEC) proceeding instituted against the Texas Gulf Sulphur Company, where certain key executives were held liable for press release misstatements concerning the existence of an ore discovery in Ontario. In the midst of the major issues of disclosure and materiality, the real controversy arose in relation to disclosure obligations imposed upon corporate fiduciaries who act in behalf of the corporation. This issue received full relief in the Second Circuit decision, Schoenbaum v. Firstbrook, which presaged a new era for director liability and further emphasized the growth of an independent corpus of "federal corporation law."

Schoenbaum is the most outstanding recent example of the debate concerning the existence of a federal corporation law. This controversy...
is primarily attributable to the spate of litigation arising under the antifraud provisions of the securities acts. These provisions, section 10(b) of the 1934 Act and rule 10b-5 promulgated thereunder by the SEC, are broad antifraud measures prohibiting deceptive devices, schemes, untrue statements of material facts and practices which operate as a fraud in connection with the purchase or sale of any security. Despite the existence of express remedies, private actions


The acts referred to are the Securities Act of 1933, 15 U.S.C. § 77a-aa (1964), and the Securities Exchange Act of 1934, 15 U.S.C. § 78 (1964). Fundamental to both acts is the notion that a securities transaction, whether it is a purchase or a sale, should be a rational process in which the investor can make an informed decision in light of all the relevant facts. H.R. Doc. No. 95, 88th Cong., 1st Sess., pt. 3, at 1-10 (1963).

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, to use or to 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 . . .

Section 10(b) of the 1934 Act created the Securities and Exchange Commission and granted the Commission power to promulgate rules prohibiting deceptive devices. In essence, it was to assure fair dealing in all securities trading practices. 15 U.S.C. § 78(j)(b) further provides that the "Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors" rules and regulations. This was to provide the SEC with broad discretion to prevent the defrauding of stockholders. H.R. Rep. No. 1383, 73d Cong., 2d Sess. 6-7 (1934).

Rule 10b-5 was promulgated by the SEC pursuant to the authority granted to it by Congress in section 10(b) of the 1934 Act. See note 9 supra.

One of the most important questions under 10b-5 is the issue of materiality. With the decline of the common-law concepts of privity and scienter, materiality remains as one of the most important limiting doctrines of 10b-5. Address by Alan Bromberg, Practising Law Institute, First Annual Securities Regulation Institute, New York City, New York, Nov. 6, 1969. At the heart of the materiality issue is the threshold question of just what should be disclosed. Corporate officers are on the horns of a dilemma—must every conceivable significant future event be disclosed or should disclosure be limited to probabilities? Such questions indicate that this is an area which does not admit of a simplistic resolution. The Second Circuit has derived a workable test of materiality:

the basic test of "materiality" . . . is whether "a reasonable man would attach importance [to the fact misrepresented] in determining his choice of action in the transaction in question."


The 1933 Act provisions providing civil relief for fraud violations are: § 11, 48 Stat.
brought under the securities acts have invoked section 10(b) and rule 10b-5 as jurisdictional predicates. It is this anomaly — the burgeoning number of federal cases determining the fiduciary obligations of management — that "seems to be taking over the universe gradually."\(^\text{13}\)

**The Problem: Federal-State Conflict**

The increase of federal activity in the realm of corporate fiduciary duties has sown the seeds of potential conflict between federal securities laws and state law.\(^\text{14}\) To what extent should federal securities laws be instrumental in forging the fiduciary standards of officers and directors when their conduct relates to their own corporations? How effective is 10b-5 as a regulator of such intracorporate conduct? What implications are raised by the expansive growth of federal corporation law? Finally, is 10b-5, as interpreted by the judiciary, a meaningful standard by which corporate officials can gauge their conduct?

These questions indicate the enormous complexity of the role of a federal remedy in this area. It is the purpose of this note to trace the growth of 10b-5 in regulating the affairs of management and to high-

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\(^\text{14}\) One authority on state law asserted that:

The problem is not whether the parallel systems of federal and state securities regulation are advisable, but whether such systems can accomplish their respective objectives without unnecessary duplication and without imposing an undue burden upon legitimate business activities.

light the new dimensions of federal regulation as exemplified in the Schoenbaum decision. The growth will be traced by an analysis of the case law applying 10b-5 to management's fiduciary duties. Then the effect of this growth will be discussed in comparison with the common-law and state law theories holding management liable for breaches of fiduciary duty. The implications of a "federal corporation law" will be examined, culminating in a discussion of the need for legislative revision.

THE IMPLIED RIGHT OF ACTION — AND ITS CONSEQUENCES

The existence of a private remedy for defrauded investors under 10(b) and rule 10b-5, established in the landmark decision of Kardon v. National Gypsum Co., has affected litigation in ways which could not have been anticipated by its author. Curiously, while the court dockets continue to grow by leaps and bounds with 10b-5 actions, it still remains one of the most elusive concepts in federal law.

This analysis will concentrate on the barriers that were erected to prevent the unchecked growth of 10b-5 liability. Briefly, they are the purchaser-seller limitation, the deception requirement and causation. Despite the acceptance of a private right of action, it has been contended that since Congress did not provide expressly for such a remedy, its will should be followed. An exposition of this point of view may be found in Ruder, supra note 2.


For extensive comment of this development, see A. Bromberg, Securities Laws Fraud — SEC Rule 10b-5 § 2.4 (1969) [hereinafter Bromberg]; Fleischer, supra note 6. For a list of commentators favoring a private right of action, see Joseph, Civil Liability Under Rule 10b-5 — A Reply, 59 Nw. U. L. Rev. 171, 177 n.38 (1964).

The elusive character of a 10b-5 action can be demonstrated by citing the problems
Indeed, ever mindful of the policy of deterring fraudulent practices attending securities transactions, it may appropriately be said that since Kardon the federal judiciary has desperately struggled to define the scope of a 10b-5 action. The origins of the “search for limiting” doctrine can be traced to the Second Circuit’s decision in Birnbaum v. Newport Steel Corp.

Birnbaum involved a shareholder suit against the controlling stockholder of Newport Steel alleging that, as controlling stockholder, he sold his 40 percent stock interest at a premium attributable to the fact that it represented a controlling interest and, hence, commanded a higher price on the market. Plaintiffs’ derivative suit charged a 10b-5 violation since the directors had previously advised against a merger with another company although the merger was purportedly a good move for Newport shareholders. In affirming the district court’s dismissal of the complaint, Judge Augustus Hand enunciated what has now achieved doctrinal status, the so-called Birnbaum Doctrine.

the courts have had with such concepts as reliance, causation, privity, scienter and materiality. Each of these concepts alone deserves full treatment and a discussion of them is beyond the scope of this note. Nevertheless, it must be borne in mind that these issues are subtly woven into the problem of management’s breach of a fiduciary duty. For an excellent analysis of the elements of a rule 10b-5 action, see Jennings, Insider Trading in Corporate Securities: A Survey of Hazards and Disclosure Under Rule 10b-5, 62 NW. U.L. REV. 809, 816-26 (1968).

19 See Fratt v. Robinson, 203 F.2d 627, 632 (9th Cir. 1953).
20 At this juncture, it should be noted that the majority of decisions concerning the scope of 10b-5 are decided on defendants’ motions to dismiss the complaint pursuant to Fed. R. Civ. P. 12 (b)(6) (failure to state a claim upon which relief can be granted). 15 U.S.C. Rule 12(b)(6) (1964). In this vein, Professor Bromberg has written that “the typical 10b-5 ‘victory’ is only a holding that a cause of action has been stated, good enough to withstand a motion to dismiss.” BROMBERG § 1.3(2), at 10.
22 193 F.2d 461 (2d Cir.), cert. denied, 343 U.S. 956 (1952).
23 Mr. Feldmann, the individual defendant in Birnbaum, not only was the controlling stockholder but also was president of the company and chairman of its board of directors.
24 It must be noted, however, that when a cause of action inures to a corporation, the primary right to decide whether to prosecute belongs to the board of directors. If a shareholder seeks to challenge a director decision (to abstain from prosecution) through use of a derivative suit, he is, in effect, challenging the judgment of the directors. The most troublesome obstacle for such a shareholder to overcome is the business judgment rule. Essentially, this rule protects the directors in the conduct of a corporation’s business and is the judicial recognition of the court’s lack of authority to substitute its judgment for that of the directors. See, e.g., Gamble v. Queens County Water Co., 123 N.Y. 91, 25 N.E. 201 (1890); Carson, Current Phases of Derivative Actions Against Directors, 40 Mich. L. Rev. 1125, 1128-35 (1942). This protection is afforded to directors so as to encourage individuals to participate in management of corporate affairs. Note, Corporate Indemnification for 10b-5 Violations, 70 COLUM. L. REV. 504, 508 (1970).

Additionally, the shareholder is usually required by statute to set forth his efforts to initiate board action. See, e.g., N.Y. Bus. CORP. LAw § 626(c) (McKinney 1965).
Section 10(b) . . . was directed solely at that type of misrepresentation or fraudulent practice usually associated with the sale or purchase of securities rather than at fraudulent mismanagement of corporate affairs, and that Rule X-10b-5 extended protection only to the defrauded purchaser or seller.26

These words constructed a formidable obstacle to a 10b-5 action and set the tenor for future interpretation of the rule. In the wake of Birnbaum,27 a consistent theme developed in the federal courts28 that rule 10b-5 proscribed only the fraud attending a purchase or sale,29 and was not intended to regulate acts of corporate mismanagement as such.30

As previously indicated, the derivative suit is one of the most potent weapons possessed by the shareholder.31 In this respect, Hooper v. Mountain State Securities Corp.32 looms as one of the most significant cases interpreting 10b-5. While presenting a classical case of promoter fraud,33 the operative facts in Hooper did not present that species of

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26 193 F.2d at 464 (emphasis added).

In Iroquois, the previous Second Circuit decisions were sought to be reconciled and the language in Greenstein was to the effect that Birnbaum was “still the rule at least insofar as actions for damages are concerned.” 400 F.2d at 581.


29 The definitions of “purchase” and “sale” are contained in 15 U.S.C. § 78c, a(13), (14) (1964).
31 See discussion at note 24 supra.
33 The facts in Hooper are relatively simpler: defendants were members of corporate management, who, through false representations, misled the corporation into issuing its
fraud generally associated with the sale of securities, but rather involved the adequacy of consideration received by the corporation. In holding the transaction a "sale" within the limits of Birnbaum, the Court of Appeals for the Fifth Circuit provided further impetus for derivative suits under the rule, thus representing a crucial step in the rise of 10b-5 litigation. The thrust of the Hooper rationale is to expand investor protection and insulate against impairment of the corporate decision-making process due to the deception of trusted agents. Thus, the problem posed for the judiciary was how to treat breaches of fiduciary duty by corporate management, traditionally the domain of state law. For many years, the Second Circuit, influenced by the stringencies of Birnbaum, evinced a cautious skepticism in grappling with instances of corporate mismanagement.

In light of this reliance upon Birnbaum, there gradually grew a need for a thorough explanation of the type of relationship between a securities transaction and the acts of management misconduct which would necessarily create 10b-5 liability. The Second Circuit, in attempting to clarify the area, only succeeded in adding to the confusion with two apparently conflicting decisions.

Within a very short time span, the Second Circuit decided Ruckle v. Roto American Corp. and O'Neill v. Maytag. The many attempts at reconciling these decisions, and the disparate views which they reflect, have resulted in uncertainty for those who hold key positions within the corporate framework. In Ruckle, a complaint was held to state a claim under 10b-5 which alleged that the corporation had

stock in return for spurious assets. The significance of Hooper lies in the fact that it held that a corporation issuing its own shares was a seller.

34 Cases holding that a corporation purchasing worthless assets to be a buyer are: Rogen v. Ilikon, 361 F.2d 260 (1st Cir. 1966); Kohler v. Kohler, 319 F.2d 654 (7th Cir. 1963).
35 282 F.2d at 206-07.
36 Since it is the federal appellate court for New York City, the financial capital of the world, the Second Circuit is, undoubtedly, the most influential circuit in the realm of "federal corporation law." Note, Texas Gulf Sulphur: Expanding Concepts of Corporate Disclosure Under SEC Rule 10b-5, 43 ST. JOHN'S L. REV. 655, 685 (1969).
37 The Birnbaum doctrine mandates that there be a fraud in connection with the purchase or sale of a security. The definitions of "purchase" and "sale" have expanded and the Southern District Court of New York has ruled that it is unnecessary to prove a consummated purchase or sale of securities in order to invoke 10b-5. Commerce Reporting Co. v. Puretec, Inc., 290 F. Supp. 715 (S.D.N.Y. 1968). For discussion of the Commerce case, see Note, Inroads on the Necessity for a Consummated Purchase or Sale Under Rule 10b-5, 1969 DUKE L.J. 349.
38 Ruckle was decided on Dec. 4, 1964 and O'Neill on Dec. 29, 1964.
39 339 F.2d 24 (2d Cir. 1964).
40 339 F.2d 764 (2d Cir. 1964).
41 See, e.g., 6 L. Loss, SECURITIES REGULATION 3637 (2d ed. 1961) [hereinafter Loss]; Fleischer, supra note 6, at 1164-66.
fraudulently issued 75,000 shares to insiders\textsuperscript{42} through the failure of a majority of directors to disclose to the other directors (a minority of the board) material facts concerning the transaction.\textsuperscript{43} The fact that it occurred within the corporate structure did not prevent the invocation of rule 10b-5 and the court permitted the derivative suit. What is more vital to the development of a federal regulatory scheme is the court's dicta in \textit{Ruckle} referring to the expansive scope of 10b-5:

We note at the outset that in other contexts, such as embezzlement and \textit{conflict of interest}, a majority or even the \textit{entire board of directors} may be held to have defrauded their corporation.\textsuperscript{44}

In light of the \textit{Ruckle} holding,\textsuperscript{46} and more particularly, in light of the above quoted dicta, the result reached in \textit{O'Neill} posed considerable consternation — among judges and commentators alike.

In \textit{O'Neill}, plaintiff, a shareholder of National Airlines, brought a derivative action on behalf of National against its directors and also against Pan American World Airways, Inc., alleging that the exchange of stock between Pan American and National in compliance with a CAB directive was at a ratio highly unfavorable to National.\textsuperscript{46} The plaintiff accused the defendant directors of paying a premium when the stock was reexchanged so as to retain their control of National. (Significantly, all the directors participated in the transaction — each possessing full knowledge of all the material facts.) In affirming the district court's dismissal of the 10b-5 allegation,\textsuperscript{47} Chief Judge Lum-

\begin{itemize}
\item \textsuperscript{42} The term "insider" is used throughout the text. Insider connotes more than a director, officer or controlling stockholder. The most lucid insight of an insider may be found in Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961), wherein, discussing the obligation to disclose relevant information, the Commission said:
\begin{quote}
Analytically, the obligation rests on two principal elements: first, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing.
\end{quote}
\end{itemize}

\begin{itemize}
\item \textsuperscript{43} The material facts were held to be: the latest financial statements of the corporation and "information pertinent to a proposed stock issuance." 339 F.2d at 27.
\item \textsuperscript{44} Id. at 29 (emphasis added).
\item \textsuperscript{45} \textit{Accord}, Weitzen v. Kearns, 271 F. Supp. 616, 620-21 (S.D.N.Y. 1967); Heilbrunn v. Hanover Equities Corp., 259 F. Supp. 936, 938 (S.D.N.Y. 1966). In \textit{Heilbrunn}, it was held that a corporation may be defrauded when all its directors know the material facts — and such knowledge does not preclude shareholder relief on any imputation theory based on agency principles. As will be seen, agency principles were at the core of the \textit{O'Neill} rationale. In \textit{Weitzen}, Judge Bonsai, after distinguishing \textit{O'Neill} on its facts, held that under certain circumstances, it is possible for all directors to defraud a corporation. 271 F. Supp. at 620-22.
\item \textsuperscript{46} National and Pan American had cross-owned 400,000 shares of stock, each issuing the shares to a trustee. However, the Civil Aeronautics Board found such cross-ownership violative of the public interests, and ordered them either to resell or reexchange the stock. 339 F.2d at 766.
\item \textsuperscript{47} 230 F. Supp. 235 (S.D.N.Y. 1964). In finding for the defendants, District Judge
bard, relying upon the *Birnbaum* rationale, declared "no cause of action is stated under Rule 10b-5 unless there is an allegation of facts amounting to deception." While recognizing that a corporation's ordinary remedy against directors acting adversely to its interest would be under *state law*, the thrust of *O'Neill* is to the effect that *deception* must be practiced upon the aggrieved party in some manner for rule 10b-5 to come into play, and mere concealment of improper motives, without more, is not a material omission under rule 10b-5. For as emphasized in *Ruckle*, the thrust of rule 10b-5 is directed at misrepresentation or omission of material facts relating to the value of securities.

Since in *O'Neill*, all relevant material facts were known to the entire board, to require disclosure of motive would not necessarily maintain the integrity of the securities market.

Upon examining the underlying philosophy of federal securities laws, the distinction made by the Second Circuit between *Ruckle* and *O'Neill* is difficult to justify. As Professor Loss has suggested, the holdings of these two cases approximate an untenable distinction between false statements and complete nondisclosure. Simply, then, *O'Neill*

McLean stated that conduct which violates rule 10b-5 "must amount to either fraud or deceit" or intentional misrepresentations of material facts. *Id.* at 239. *See also* Fischman v. Raytheon Mfg. Co., 188 F.2d 783 (2d Cir. 1951); 3 Loss 1764-65.

*See notes 22-30 and accompanying text supra.*

*393 F.2d* at 768.

*See, e.g.,* Guth v. Loft, Inc., 23 Del. 255, 5 A.2d 503 (1939); Commonwealth Title Ins. & Trust Co. v. Seltzer, 227 Pa. 410, 76 A. 77 (1900).

*Accord,* Cohen v. Colvin, 266 F. Supp. 677 (S.D.N.Y. 1967) (a complaint merely alleging a breach of a common-law fiduciary duty is not cognizable in federal courts); Robbins v. Banner Indus., Inc., 285 F. Supp. 758 (S.D.N.Y. 1966) (merely alleging issuance of stock to interested directors for inadequate consideration did not state a claim under 10b-5); Carliner v. Fair Lanes, Inc., 244 F. Supp. 25 (D. Md. 1965) (a failure to reveal to the stockholders that the purpose of a repurchase of stock was to preserve insiders' control did not constitute a sufficient allegation to establish the requirement of deception as mandated by *O'Neill*). *But see* Condon v. Richardson, 411 F.2d 489 (7th Cir. 1969) (allegation of a scheme whereby officers purchased shares at a low price and later sold them to the corporation at a higher one may give rise to a 10b-5 claim); Pappas v. Moss, 393 F.2d 865 (3d Cir. 1968) (requisite deception found by viewing the fraud as though the independent stockholders were standing in the place of the defrauded corporate entity); Dasho v. Susquehanna Corp., 380 F.2d 262 (7th Cir.), cert. denied sub nom. Bard v. Dasho, 389 U.S. 977 (1967) (issuance of securities at an excessive price in order to promote a personal interest of directors is a valid claim under rule 10b-5).

*See discussion of materiality, note 11 supra.*

One possible interpretation of the *ratio decidendi* of *O'Neill* is that since all the directors possessed the relevant information, the corporation cannot be defrauded under rules of agency whereby the knowledge of the agents is imputed to the principal. 3 W. FLETCHER, *Cyclopedia of the Law of Private Corporations* § 790 (1965). However, when directors act adversely to the interests of the corporation, the imputation doctrine is generally not applied. *Id.* § 819. *See also* RESTATEMENT (SECOND) OF AGENCY § 282(1) (1958).

A principal is not affected by the knowledge of an agent in a transaction in which the agent secretly is acting adversely to the principal and entirely for his own or another's purposes. . . .

6 *Loss* 5637.
can be reduced to the proposition that a derivative suit cannot be maintain in the absence of a showing of some form of deception, further illustrating the Second Circuit’s restraint in applying 10b-5 in cases where plaintiffs merely allege fraudulent mismanagement or breach of fiduciary duty.

The real problem of the Ruckle-O’Neill conflict subsists in the fact that no concrete definition of deception was articulated. Clearly, O’Neill does not hold that mismanagement is never actionable under rule 10b-5; indeed an action is maintainable upon any allegation of deceit. Since the court failed to define the deception necessary for management to incur liability under 10b-5, the years subsequent to these decisions have witnessed a discordant growth in federal regulation. The progeny of Ruckle and O’Neill have followed divergent paths, further evidencing the difficulty in establishing the exact purview of 10b-5.

In Barnett v. Anaconda Co., plaintiff’s derivative suit alleged that defendant’s proxy statements contained material omissions of fact, which had induced the minority shareholders to sell for less than the full value of the stock. The court emphasized the fact that the defendant controlled more than 73 percent of the stock and could have carried out the proposed transaction regardless of any minority opposition. As a result, plaintiff’s complaint was dismissed and causation was formulated as a third obstacle to the successful invocation of rule 10b-5.

The Barnett result is to be compared with the decision reached in Hoover v. Allen, wherein plaintiff’s derivative suit alleged that defendants caused the corporation to make misleading statements to the shareholders, thereby fraudulently inducing the stockholders to sell their shares to the defendant directors. (Ostensibly, this sale was engineered to give defendants control of the corporation.) Subsequent
to assuming control, the defendants allegedly committed acts of mis-
management which resulted in the diminution of corporate assets. In
dismissing the complaint, the court refused to view the corporation
as the victim of the fraud, and held that directors who acquire con-
trol by means of fraud and then perpetrate acts of corporate waste are
unaccountable under 10b-5.

To alleviate fears of a large influx of federal claims, the court thus
followed the Barnett proximate cause requirement and mandated that
legally redressable injury to the corporation be demonstrated in the
assertion of a 10b-5 cause of claim. It is noteworthy, in this context,
that in Hoover, District Judge Herlands opined that had a fraudulent
scheme been pleaded in O'Neill, the claimant would have asserted an
actionable claim. The court justified this opinion by saying that a
distinction must be made between injuries independent of acquiring
and injuries following the acquisition of control (Hoover). It will be
recalled that in Ruckle the fact that a minority of the board of direc-
tors was deceived was not dispositive of the plaintiff's claims and a
similar result was reached in Globus, Inc. v. Jaroff.

60 Since the gravamen of plaintiffs' complaint was acts of corporate waste by the
directors, to sustain the complaint would have thrust the federal government into the
regulation of the daily affairs of corporate management. Such an allegation of waste is
a typical common-law charge of breach of fiduciary duty and the sale of securities is only
incidental to the major mismanagement issue covered by state law. Accord, Lester v. Preco
Indus., Inc., 282 F. Supp. 459 (S.D.N.Y. 1965) (rule 10b-5 complaint charging corporate
waste dismissed).

61 Id. at 228.

62 Id. at 227-28. The point made by Judge Herlands is contentious. For even if the
plaintiff had alleged deception, the O'Neill court still might have denied a right of action,
determined to maintain a "hands-off" policy in the corporate mismanagement area and
thus cling to the Birnbaum rationale. As one commentator has expressed it, the
deception "present in O'Neill is not of the type that Congress intended to deal with..."
Comment, Shareholder's Derivative Suit to Enforce a Corporate Right of Action Under

63 266 F. Supp. 524 (S.D.N.Y. 1967). In Globus, a derivative suit initiated by minority
shareholders was sustained largely upon the Ruckle rationale. Additionally, the court
adopted the "decision-making body" theory as articulated in Simon v. New Haven Board &
Carton Co., 250 F. Supp. 297 (D. Conn. 1966). In Simon, plaintiff alleged a merger
transaction contravened 10b-5 in that more than the fair value of the stock was allowed in
the merger. The thrust of the defense was since the directors of both "buyer" and "seller"
knew all the material facts, no one was deceived. The court saw no merit in the
defendant's contentions and found misleading statements in the proxy materials con-
cerning the assets of the proposed acquiree were violative of 10b-5. Such statements
deceived the corporation, in that, the stockholders as "decision-making body" were
deceived. "All information reasonably relevant to a rational investment must be disclosed
to the decision-making body, whether that body be composed of directors, officers or share-
(S.D.N.Y. 1968). In Kaminsky there was language to the effect that if the decision-making
body fails to protect the shareholder's interests, it would be conceivable that such action
SECOND CIRCUIT — INROADS ON O'NEILL

After O'Neill, there followed a trilogy of cases in the Second Circuit which did much to undermine the restrictions of Birnbaum and O'Neill. In Vine v. Beneficial Finance Co., the court went far to find the deception necessary to impose liability under 10b-5, thus applying the new federal corporate law to embrace minority shareholders. The court in Vine held that as a result of a short form merger, plaintiff was a forced seller and hence a party to the sale. The significance of Vine lies in the court's rejection of the defendant's contention that the deception did not relate to the plaintiff but only to the shareholders who actually sold their stock. The court found that the deception was part of a larger scheme to defraud the selling shareholders and did not require plaintiff to sell his stock in order to bring an action under the rule. While Vine can be viewed as a serious crack in the Birnbaum wall, it is noteworthy for its demonstration of the court's receptiveness to an expansive definition of deception.

Further evidencing a judicial predilection to such an expansive definition of deception is A.T. Brod & Co. v. Perlow. In Brod, a broker had alleged that defendants had ordered securities with the intention of paying for them only if their market value increased. District Court Judge Bonsal dismissed the complaint stating "[p]laintiff is not an investor, and no fraud is alleged as to the investment value of the securities nor any fraud usually associated with the sale or purchase of securities." In reversing, the Second Circuit evinced a more

would constitute a breach of state-imposed fiduciary obligation albeit no federal law is violated.

5 A short form merger allows a parent corporation which owns a specified percentage of the subsidiary's outstanding stock to merge with the subsidiary without the approval of the shareholders whose stock is being converted into securities of the parent corporation. Thus, any shares which remain outstanding are converted into the shares of the surviving corporation. See N.Y. Bus. Corp. Law § 905 (McKinney 1965) wherein the required percentage is set out as 95 percent. Cf. Mader v. Armell, 402 F.2d 158 (6th Cir. 1968). For treatment of mergers as satisfying the "purchase or sale" requirement of the statute, see 4 Loss 2563-65.

6 The thrust of the Birnbaum decision was the "purchaser-seller" limitation. While cases like Voege and Vine can be interpreted as impairing the Birnbaum doctrine, they can be also viewed as indicia of the court's increased awareness of the predicament of minority shareholders.

This practice has been called free-riding. It involves the purchase of shares of a new issue at the public offering price. If the securities subsequently sell at a price in excess of the offering price, the purchaser has realized a gain without ever paying for the securities. Such a practice is permissible under credit regulations which allow four to seven days for payment. Bloomenthal, supra note 56, at 342-43.

70 375 F.2d at 396.
liberal attitude toward applying 10b-5. While *Brod* should be confined to its own factual setting, its rationale has generated far-reaching tremors in the regulation of corporate mismanagement. Of particular significance is the court's language permitting the complaint:

> We believe that 10(b) and Rule 10b-5 prohibit all fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception. Novel or atypical methods should not provide immunity from the securities laws.

To apply such reasoning to mismanagement opens the door to a wide variety of claims — claims which previously would have been dismissed because of failure to meet the *O'Neill* requirement of deception. Once again, however, we see the court's reluctance to elaborate as to the *kind* of deceit which will definitely be actionable. This failure to articulate led to the surprising result reached in the district court case *Entel v. Allen*, the last of the trilogy.

In *Entel*, strong doubts were cast upon the validity of *O'Neill*. Essentially, plaintiff's complaint alleged that insiders had violated their duty to the corporation. The facts in *Entel* are complicated but what was primarily involved was director mismanagement. Directors of Atlas, which owned Northeast Airlines, were allegedly influenced by Howard Hughes, who owned Toolco and 10 percent of Atlas, to sell Northeast to Toolco for an inadequate price. Plaintiffs, Atlas shareholders, thus brought suit alleging that Hughes had breached his fiduciary duty to Atlas by permitting the sale for an inadequate consideration.

Reversing himself on reargument, Judge Bonsal held that insofar as *Vine* and *Brod* had virtually eliminated the deception requirement of *O'Neill*, 10b-5 provided protection against "an undisclosed scheme to breach State corporate fiduciary law." Thus, the danger of applying the *Brod* rationale to cases involving mismanagement came to bear in *Entel*, and, while it is highly questionable whether such reasoning should be so applied, the conflict with state law is readily apparent.

Other circuit courts, not constrained by the *Birnbaum* and *O'Neill*
decisions have evidenced a more liberal attitude toward redressing shareholder claims involving breach of a fiduciary duty. *Dasho v. Susquehanna Corp.* is worthy of note for its interpretation of the *Ruckle-O'Neill* paradox. In *Dasho*, plaintiff alleged that the defendant officers and directors defrauded the corporation in a merger which involved the subsequent reacquisition of the corporation's stock at inflated prices. Circuit Judge Fairchild, in his concurring opinion, addressing himself to the issue of "[m]isuse of director's power as fraud" probed the possible material differences between *Ruckle* (majority participation in the fraud) and *O'Neill* (unanimous wrongdoing), and concluded that

the failure of the defendant directors to perform their duty presumably injured the corporation, and I do not believe it is sound to differentiate between situations where the directors were unanimous in wrongdoing and those where less than all were involved.

The Seventh Circuit thus displayed serious misgivings for the Second Circuit's early mandate that the knowledge of the agents be imputed to the principal — the basis of the *O'Neill* result.

The Third Circuit's venture into the realm of corporate mismanagement was in *Pappas v. Moss*, where shareholders in a derivative suit alleged that the directors had authorized an issuance of shares to themselves and outsiders at depressed prices. While the resolution did not require stockholder approval, the directors, nevertheless, sought the ratification of the shareholders. It was misrepresentations and fraud contained in the resolution which plaintiff charged was violative of the federal securities laws. The defendants contended that since a corporation can act only through its agents and, here, all agents knew the relevant facts, no deception of the corporation could be found. The court rejected the defense and held that plaintiffs stated a valid claim under rule 10b-5. In answering the argument posed by the defendants — that there had been no deception — the court observed:

if a "deception" is required in the present context, it is fairly found

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78 380 F.2d at 269.
79 Id. at 270.
80 See note 53 supra.
81 393 F.2d 865 (3d Cir. 1968).
82 The board action of defendants unanimously authorized the issuance of 100,000 shares to themselves and a few outsiders. 393 F.2d at 867.
83 Id. at 869.
by viewing this fraud as though the "independent" stockholders were standing in the place of the defrauded corporate entity.\textsuperscript{84}

By viewing the stockholders as the deceived party, \textit{Pappas} paid homage to the deception requirement — but did not burden plaintiff with stringent allegations of causation or deception. This diminution of deception as a limiting principle further advanced the rights of minority shareholders.

A Summary of the Case Law — The Alternatives

Prior to treating the \textit{Schoenbaum} decision and its ramifications, it would be beneficial to examine the various approaches to the problem of management's breach of duty which may be culled from the Second Circuit's decisions and the views expressed in the \textit{Dasho} and \textit{Pappas} cases.

Upon examination, three distinct approaches may be extracted from the case law — the rationales of \textit{O'Neill}, \textit{Entel} and \textit{Pappas} each reflecting a different jurisprudential resolution of the question of breach of fiduciary duty. By far, the most restrictive is the view espoused by Chief Judge Lumbard in \textit{O'Neill}.\textsuperscript{85} While conceding a common-law action for waste, \textit{O'Neill} refused to interpose 10b-5 into the daily affairs of management unless some form of deception was alleged. The federal judiciary grappled to define the requisite deception, and Judge Bonsal, who had never been very receptive to plaintiff's suits, paradoxically expressed the liberal attitude by noting that 10b-5 now extended to undisclosed breaches of state law.\textsuperscript{86} Judge Seitz's opinion in \textit{Pappas} not only served to fulfill the deception requirement of \textit{O'Neill} but also recognized that, in essence, it was the stockholders, the real parties in interest, who were being deceived by such acts of corporate management.\textsuperscript{87} Thus when \textit{Schoenbaum} came to the Second Circuit, the question naturally arose: which way would they go?\textsuperscript{88}

\textsuperscript{84} Id. Judge Seitz relied upon the \textit{Dasho} rationale in permitting plaintiff to maintain his cause of action.

\textsuperscript{85} 359 F.2d at 768.

\textsuperscript{86} 270 F. Supp. at 70.

\textsuperscript{87} 393 F.2d at 889.

\textsuperscript{88} Professor Bloomenthal suggests that the \textit{Schoenbaum} court had five ways it could have handled the problem. In addition to the \textit{O'Neill} approach (state corporate laws were applicable), the \textit{Pappas} approach (shareholders were defrauded), and the \textit{Entel} approach (nondisclosure as a breach of fiduciary law), Mr. Bloomenthal posited two more avenues for resolution: (1) 10b-5 would be inapplicable because the transaction was approved by a disinterested majority of the directors, and (2) that even absent deception, for controlling shareholders to cause the corporation to issue shares for inadequate consideration is fraud. Bloomenthal, \textit{supra} note 56, at 346-47.
THE SCHOENBAUM DECISION

Schoenbaum v. Firstbrook represents the Second Circuit's consideration of the above discussed alternatives. In Schoenbaum, the court was confronted with all the problems embraced by the previous cases, i.e., a breach of fiduciary duty which involved knowledge of all the directors and a resultant bilking of the corporation's assets. Instead of adopting previously determined principles, the Schoenbaum court embarked on uncharted seas and molded new criteria of responsibility for the corporate community.

Schoenbaum

In February 1964, Aquitaine of Canada, Ltd. (Aquitaine), by means of a tender offer, acquired control of Banff Oil Ltd. (Banff) and placed three directors on its eight-member board. A month later, the two corporations agreed to conduct joint oil explorations in the Rainbow Lake Area of Alberta, Canada. In order to alleviate the rising cost of exploratory drilling, Banff's board of directors, the three Aquitaine members abstaining, voted to offer Aquitaine 500,000 shares of Banff treasury stock. Pursuant to Aquitaine's acceptance of the offer, Banff withheld information concerning the progress of the oil explorations in order to reduce potential competition for the purchase of land in the Rainbow Area. Subsequently, upon discovering the area was laden with oil, Banff's board of directors sought to finance construction by authorizing sales of treasury stock to the Paribas Corporation. The sales to Aquitaine and Paribas were effectuated at the then prevailing market prices of the stock. Invoking 10b-5 as the jurisdictional predicate, plaintiff, a shareholder of Banff, brought a derivative suit against Aquitaine and Paribas, alleging that the individual defendants,


90 In the interest of clarity, the panel decision (405 F.2d 200 (2d Cir.)) and the en banc consideration (405 F.2d 215 (2d Cir. 1968)) will be analyzed separately. They will be entitled Schoenbaum I and Schoenbaum II respectively.

91 405 F.2d at 204.

92 The withholding of such information was authorized by Alberta law, which permits the withholding of such facts for one year from completion of exploratory drilling. 405 F.2d at 205. Unlike the situation presented in Texas Gulf, the plaintiff stockholder did not contend that this failure to disclose was violative of the federal securities laws.

93 500,000 shares were sold to Aquitaine in December 1964 at $1.35 per share; 270,000 shares were negotiated to Paribas in November 1965 at $7.30 per share.

94 The text of rule 10b-5 appears in note 10 supra.
directors of Banff, conspired with the corporate defendants to induce Banff to sell treasury shares at a price which defendants knew did not adequately represent the true value of the stocks. These transactions allegedly defrauded Banff of millions of dollars. The district court, with Judge Cooper presiding, denied plaintiff's request for discovery and granted summary judgment for the defendant. On appeal, the panel court overruled the dismissal on the jurisdictional question, but affirmed the district court determination that plaintiff did not state a valid cause of action under rule 10b-5. Chief Judge Lumbard, the author of the panel court opinion, reasoned that in the absence of evidence to the contrary, Banff's sales must be regarded as arm's length transactions. With that as a premise, the court employed traditional agency principles to strike down plaintiff's complaint for failure to show any deception of the corporation. Judge Hays, dissenting, severely criticized the majority's application of wooden agency principles to a plain case of fraud. Characterizing such principles as a "trap for the unwary," he stated:

What the majority is actually saying is that since the directors were the corporation for the purposes of the questioned transactions the corporation must have known what the directors knew, or, in other words, the directors knew what the directors knew.

Schoenbaum II

In the en banc consideration, Judge Hays was vindicated as the Second Circuit substantially adopted the position he propounded in the Schoenbaum I dissent. The court upheld the 10b-5 claim against

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85 268 F. Supp. 385 (S.D.N.Y. 1967). The district court ruled that the court did not have subject matter jurisdiction, and secondarily, that plaintiff failed to sustain a viable claim under rule 10b-5. Judge Cooper primarily relied upon rule 56(e) of the Federal Rules of Civil Procedure which provides in pertinent part:

Supporting and opposing affidavits shall be made on personal knowledge, shall set forth such facts as would be admissible in evidence, and shall show affirmatively that the affiant is competent to testify to the matters stated therein.

Judge Cooper gave summary judgment for the defendant when the plaintiff failed to reply with affidavits based on personal knowledge. 268 F. Supp. at 397.


87 "Plaintiff has failed to make the necessary showing that those authorized to act on behalf of the corporation were deceived or that their knowledge should not be deemed the corporation's knowledge." 405 F.2d at 213.

88 Id. at 214-15 (Hayes, J., dissenting opinion).

89 Id. at 215.

90 The en banc court consisted of Chief Judge Lumbard, Circuit Court Judges.
the individual defendants and Aquitaine, but affirmed the dismissal of the complaint as to the Paribas Corporation. It is important to note that between the panel and en banc decisions, the Second Circuit handed down its momentous decision in *Texas Gulf*, wherein were found rumblings that 10b-5 had possibly gone too far in such intimate management affairs.101

Confronted with all the alternatives,102 and with the *Texas Gulf* result fresh in their minds, the Second Circuit went further than was necessary in holding defendants liable for fraud in *Schoenbaum*. Now, Judge Hays, writing for the en banc court, found two bases for rejecting the panel court opinion. Upholding plaintiff's allegation "that Aquitaine exercised a controlling influence over the issuance to it of treasury stock of Banff for a wholly inadequate consideration,"103 the majority held this to be a practice which would operate as a fraud even in the absence of deception.104 Approving the *Ruckle* dicta — that in certain contexts, such as embezzlement and conflict of interest, a majority or even an entire board of directors could defraud a corporation — Judge Hays went beyond a simple deception requirement in holding that the defendants' conduct was violative of 10b-5.105 The secondary grounds for sustaining the 10b-5 claim adopted the *Pappas* rationale, i.e., defendants deceived the stockholders (the true owners of the corporation).106 This *ratio deciden di* would have sufficed to encompass the directors' action under the 10b-5 umbrella, and, at the same time, would have fulfilled the *O'Neill* requirement of some form of deception. However, the primary ground for the result was the conflict of interest approach, and thus the real significance of the *Schoenbaum* decision emerges.107

Judge Medina dissented strongly on policy grounds.108 Fearing that

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Medina, Waterman, Moore, Friendly, Smith, Kaufman, Hays, Anderson and Feinberg. With the exception of Judge Medina, these same judges decided the *Texas Gulf* litigation

101 Cf. Judge Friendly's concurrence in *Texas Gulf*, 401 F.2d at 854. Judge Friendly expressed grave doubts about the viability of the *Ruckle* approach and was of the opinion that such problems should be handled under state law. Interestingly, however, Judge Friendly concurred in the *Schoenbaum* result.

102 See note 88 and accompanying text supra.

103 405 F.2d at 219.

104 Thus the en banc court relied upon the language of clause three of rule 10b-5 which stresses fraud practices which occur in the course of business. See note 10 supra for the precise wording of clause three.

105 399 F.2d at 29.

106 405 F.2d at 220.

107 The significance and implications of *Schoenbaum* will be discussed at pp. 292-94 infra.

108 Chief Judge Lumbard and Judge Moore concurred in the dissenting opinion. It is interesting to note that it was Chief Judge Lumbard who authored the *O'Neill* opinion.
the decision would bestow upon stockholders the almost unlimited right to challenge any corporate action when they thought the price was inadequate, Judge Medina expressed grave concern that this would "open the floodgates" to federal litigation. He assailed the majority opinion, declaring that such a result amounted to "giving carte blanche to every holder of a few shares . . . to give his imagination full rein" in trying to invent novel theories of management liability, thus increasing the congestion in the federal courts with an inundation of 10b-5 claims.

**THE IMPLICATIONS OF SCHOENBAUM: CONFLICT OF INTEREST TO THE FOREFRONT**

While it has traditionally been recognized that conflicts of interest pose knotty problems for corporate personnel, such questions of propriety were usually considered to be within the purview of state law. Federal securities law had remained "pure" by mandating the allegation of some form of deception before a breach of management's fiduciary duty could be considered within the prohibition of 10b-5. However, an analysis of Schoenbaum will vividly demonstrate the intrusion of federal law into the deep recesses of state law.

This intrusion can be exemplified by comparing the en banc court's treatment of the Aquitaine and Paribas corporate defendants. It will be recalled that the court upheld the dismissal of the complaint as to

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109 405 F.2d at 220 (Medina, J. dissenting). Paradoxically, it was Judge Medina who penned the *Ruckel* opinion.

110 *Id.* at 221.

111 The judiciary had previously expressed similar displeasure with plaintiff's desire to invent novel types of management liability. See, e.g., Barnett v. Anaconda, 238 F. Supp. 766, 770 (S.D.N.Y. 1965). In noting the increasing regularity of minority shareholder suits initiated under the aegis of the federal securities laws, Judge van Pelt Bryan quoted Mr. Justice Cardozo: "[n]ot every question of federal law emerging in a suit is proof that a federal law is the basis of the suit." *Id.* quoting Gully v. First Natl Bank, 299 U.S. 109, 115 (1936).


113 For a thorough analysis of state law remedies, see 3 LOSS 1631-82; L. LOSS & E. COWETT, BLUE SKY LAW 129-71 (1958). Recently, a case was decided in a state court involving breach of fiduciary duties. In Diamond v. Oreamuno, 24 N.Y.2d 494, 248 N.E.2d 210, 301 N.Y.S.2d 78 (1969), the Court of Appeals for the State of New York unanimously held that an officer and director are accountable to their corporation for their acts of misconduct under state law, regardless of any federal liabilities. In so holding, the Court used common-law theories of fiduciary duty—an area almost preempted by federal legislation. Significantly, the Court of Appeals indicated that it was not necessary to show any corporate harm to recover the profits gained by an insider. *Diamond* is a refreshing example of state court activity in corporation law. *See Note, Diamond v. Oreamuno: A Fresh Approach to Insider Trading and The Duties of The Corporate Fiduciary*, 31 U. PIT. L. REV. 296 (1969).
Paribas, stating "there is no reason to believe that Paribas was in any position to influence the judgment of the Banff directors by any improper means." Impliedly, then, the Second Circuit was adopting a "position of influence" test to determine the existence of violations of federal law. The court found such influence on the part of Aquitaine, who controlled Banff and had placed three members on Banff's board of directors.115 Escaping any attempt to articulate how a corporation could be deceived by all its agents, the court based the 10b-5 violation on the fact that Aquitaine, Banff's controlling shareholder, caused the corporation to issue stock for an inadequate consideration—a traditional breach of fiduciary duty. Hence, the Second Circuit focused on the question of whether the defendant was in a position to exert "controlling influence" in the transaction.

The new attitude evidenced by the Second Circuit toward breaches of fiduciary duty virtually eliminates the deception requirement in securities cases where one of the parties to the transaction is in a position to influence the directors. Thus, in Schoenbaum, by permitting the plaintiff to pursue his course of discovery on the mere allegation of potential conflict of interest, the Second Circuit seems to be recognizing a type of fraud without "deceit."116 Schoenbaum is simply the fruition of the federal policy that protection be afforded to all investors.117 Of course, this emphasis enhances the position of minority shareholders. To ensure such investor protection, the court subtly shifted emphasis from deception to those practices

114 405 F.2d at 219 (en banc).
115 The panel court conceded that a corporation could be defrauded even when all its directors know all material facts, if there exists a conflict of interests between the directors and the corporation which would prevent the transmission of relevant information to the corporation. However, the panel court noted that the Aquitaine representatives abstained from voting, and refused to label the transaction as one with "a conflicting personal interest." 405 F.2d at 212 (panel).
116 This was the position taken by the commentator in Comment, Schoenbaum v. Firstbrook: The "New Fraud" Expands Federal Corporation Law, 55 Va. L. Rev. 1103, 1116-19 (1969). The commentator postulates that the initial question raised sub rosa in Schoenbaum is whether minority shareholders are entitled to any special protection under 10b-5. He concludes that Schoenbaum is the fruition of judicial recognition of the vulnerability of minority shareholders since such shareholders can be hurt even though no deception is involved. "But the Schoenbaum decision illustrates that a corporate investment decision can also be impaired when directors are controlled by a person having interests adverse to those of the shareholders." Id. at 1119.
117 At the core of the federal securities law is the desire to make available to the investing public all the material facts necessary to reach an intelligent investment decision. Thus, failure to disclose material information amounts to "fraud"; presumably, if the investor had known all the relevant facts, he would not have participated in the transaction. This policy was emphasized in Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961), wherein the Commission stressed "the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing."
which "operate as a fraud" on the investor. Correlatively, management personnel were warned that the problems of "conflicts of interests" in the securities industry were becoming "more acute and more subtle."\textsuperscript{118} Clearly then, the true spirit of Schoenbaum — the new judicial recognition of a type of "fraud"\textsuperscript{119} which impugns the integrity of the trading process without being deceptive per se — expands "federal corporation law" further.

**Case Law After Schoenbaum**

Although the case law on conflict of interest since Schoenbaum has been sparse, it nevertheless affirms the new judicial emphasis on the protection of minority shareholders through recognition of director conflict of interest as violative of the federal securities laws. For instance, in *Penn Mart Realty Co. v. Becker*,\textsuperscript{120} plaintiff alleged that the defendant defrauded the corporation of thousands of dollars by negotiating several stock transactions at a loss to the corporation. As in Schoenbaum, all directors knew the material facts, and, once again, the court was confronted with the question of when full director knowledge of material inside information adequately protects the shareholders from the deceptive practices prohibited by 10b-5.\textsuperscript{121} The Southern District Court of New York dismissed the complaint for failure to state a federal cause of action, but added rather significant dicta, stating if "all directors are aware of all the facts, but a majority of the board . . . has a conflict of interests in the transaction, shareholders are not protected."\textsuperscript{122} Thus, *Penn Mart* asserts that if a majority of the board is controlled by the purchaser or has other conflict of interests in the transaction, a 10b-5 action would lie because the shareholder's interests have not been adequately protected.

In another important case interpreting Schoenbaum, *Swanson v. American Consumer Industries, Inc.*,\textsuperscript{123} the Court of Appeals for the Seventh Circuit considered allegations that proxy materials were misleading in that they failed to reveal material information to the minority shareholders. Judge Cummings, cognizant of a trend toward more protection of minority shareholder interests by the federal secu-

\textsuperscript{118} Address by Manuel F. Cohen, Federal Bar Association, Washington, D.C., Sept. 29, 1969. The former chairman of the SEC expressed concern over whether 10b-5 can deal effectively with the problems which are posed by the daily affairs of corporate management.

\textsuperscript{119} See Comment, supra note 116, at 1119.

\textsuperscript{120} 800 F. Supp. 731 (S.D.N.Y. 1969).

\textsuperscript{121} Id. at 735-36.

\textsuperscript{122} Id. at 736.

\textsuperscript{123} 415 F.2d 1326 (7th Cir. 1969).
rities laws, openly approved the Schoenbaum rationale. Judge Cummings opined that derivative actions are potent weapons against a corporation whose directors have a conflict of interest and know that a transaction is injurious to the interests of the corporation. The Seventh Circuit thus impliedly sanctioned the Schoenbaum concept of fraud.

**THE PROBLEM IN PERSPECTIVE**

**Common Law**

To appreciate the underlying complexities which recent federal case law has created, one must first realize how the common law has been preempted in the management area. The common-law cause of action was comprised of the following elements: materiality, misrepresentation, privity, scienter, reliance and damage. The courts evinced a rather rigorous attitude toward these elements and plaintiffs found it rather difficult to establish a cause of action. Features such as scienter, reliance and causation proved particularly troublesome in securities cases.10b-5 claimants, however, have not been compelled to comply with such a strict standard; thus the attractiveness of a 10b-5 action, and the concomitant decline of the common-law cause of action.

**State Law**

Virtually all states have securities laws protecting investors through broad prohibitions of fraud. Traditionally, the regulation of corporations, including the fiduciary duties of management, devolved upon the states through the application of blue sky laws. However,

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124 Id. at 1332-33.
125 Id. at 1333.
126 See Bromberg § 2.7, at 55; W. Prosser, Torts §§ 100, 104 (3d ed. 1964).
127 The common law was slow in discerning the fiduciary obligations of directors and other insiders to shareholders, thereby heightening the rise of federal law into this area. Loss, Conference on Codification of the Federal Securities Laws, 22 Bus. Law. 793, 918 (1966), Bromberg § 2.7, at 55.
129 State securities laws have been termed "blue sky" laws because of their early Kansas origin. There, laws were enacted to protect the gullible plainmen from purchasing building lots in the "blue sky" from smooth talking promoters. L. Loss & E. Cowie, supra note 113, at 7. For a compilation of reasons for the promulgation of blue sky laws, see 14 W. Fletcher, Cyclopedia of the Law of Private Corporations § 6724 (1966). See also Bromberg § 2.7(2), at 56-57.
130 See generally Bayne, The Fiduciary Duty of Management: The Concept in the Courts, 35 U. Det. L.J. 561 (1958). An example of a state codification of a director's duty may be found in section 717 of the New York Business Corporation Law which provides in pertinent part:
over the years, state regulation did not prove itself entirely satisfactory, and Congress responded with the enactment of the securities acts. In reality, there has been a "federal corporation law" since the passage of those acts in the early 1930's. Aggrieved shareholders have demonstrated an affinity toward the federal cause of action, opting to bring their suits under the aegis of federal securities law, despite the existence of a common-law action for fraud and a state action for waste or mismanagement. Plaintiffs gravitate toward federal courts because of diverse advantages, such as jurisdiction, venue, process, investor sympathy, liberal discovery proceedings, and especially because the state remedies "rarely have the punch of 10b-5." The federal judiciary has shown cordiality for plaintiffs' claims without clearly delineating the elements of a 10b-5 action, favoring a flexible case-by-case approach. Thus, the predicament of management personnel comes to light. Just what actions will the courts consider violative of 10b-5? What are the standards to which directors will be held? If 10b-5 is to emerge as the regulator of such intracorporate conduct, just how effective an instrument is it?

Directors and officers shall discharge the duties of their respective positions in good faith and with that degree of diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in like positions.

The factors which manifested the need for federal intervention in securities regulation include: lack of adequate protective laws in all jurisdictions, a concomitant lack of uniformity, the possibility of evading state authorities by operating strictly on an interstate basis, and the generous exemptions offered by the blue sky laws of some states. E. McCormick, Understanding the Securities Act and the S.E.C. 12 (1948).

One of the biggest obstacles confronting shareholder litigation under state law is the typical "security for expenses" provision, which mandates that a stockholder who owns a small percentage of the outstanding shares and is bringing a derivative action in behalf of the corporation, be prepared to give security for the reasonable expenses which may be incurred by the corporation or other defendant parties. See, e.g., Cal. Corp. Code § 834 (West 1955); N.Y. Bus. Corp. Law § 627 (McKinney 1963). Such provisions are conceived to deter frivolous stockholders suits instituted by individuals who have no substantial interest in the corporation. See Dalva v. Bailey, 158 F. Supp. 204, 206 (S.D.N.Y. 1957).

See notes 126-27 and accompanying text supra.


Bromberg § 2.7(2), at 57.

The courts have been reluctant to define the exact elements of a 10b-5 cause of action. Professor Cary, former Chairman of the SEC, has contended that the developments of such a blueprint of fraud would encourage evasive techniques. Cary, Fleischer & Halloran, Inside Trading in Stocks, 21 Bus. Law. 1009, 1011-12 (1966).

Judicial recognition of the inadvisability of defining all the requisite elements of fraud was vividly portrayed some 45 years ago in State v. Whiteaker, 118 Ore. 656, 245 P. 1077 (1926). In Whiteaker, which dealt with the issuance of licenses for the sale of securities and possible violations of blue sky law, Judge Belt deemed it inadvisable to lay down any hard and fast rule, stating:

Were we to do so, a certain class of gentlemen of the "J. Rufus Wallingford" type—"they toil not neither do they spin"—would lie awake nights endeavoring
THE JURISPRUDENTIAL QUESTION

"The prophecies of what the courts will do in fact, and nothing more pretentious, are what I mean by the law." These words of the eminent jurist Oliver Wendell Holmes, Jr. are indicative of the plight of his classic "bad man," viz., what is the bad man to expect from the law—can he adequately judge the standards imposed by the law so as to evade its proscription? Extrapolating the problem of Holmes' bad man to the situation of the corporate fiduciary, what is the objective standard of conduct to which management must adhere? If deception or conflict of interests is to be the standard, how will such a standard be measured? For it is a fundamental premise, firmly embedded in our system of jurisprudence, that the citizens are entitled to know what the law demands.

Does the broad language of rule 10b-5 fulfill this requirement of due process—i.e., is it sufficiently clear just what conduct is proscribed by the rule? If the answer is in the negative, is further legislation by Congress in the securities area the solution?

UNRESOLVED ISSUES IN THE MANAGEMENT AREA

To further illustrate the problems of the corporate fiduciary, the emergence of 10b-5 as the most effective weapon in the investor's arsenal has subjected many types of corporate action to attack. For example, insider seizure of corporate opportunities, insider misuse of corporate assets for self-aggrandizement, insider sale of corporate control at a premium price, insider manipulation of combinations to cause mergers which are patently unfair to minority shareholders, and insider issuance of stock or options at unfair prices are illustrative of the conduct which has been held to violate 10b-5. Typically, plaintiff's claim alleges that a management fiduciary duty has been breached, and that as a result of such breach, plaintiff has suffered injury. Since the federal courts have proven receptive to the investor's dilemma, the effects on the general business community, and management in particular, cannot be underestimated. For, as more and more
management activity has come under the scrutiny of the federal judiciary, the delineation of meaningful standards has not kept pace with the expanding jurisdiction exercised by the federal courts. As a result of such decisions as Texas Gulf, Pappas, Dasho, and especially Schoenbaum, certain factual situations are in further need of clarification by the courts. For example, if recipients of stock know that in return for the stock, the corporation is receiving inadequate consideration and the transaction is approved by a disinterested board of directors, can 10b-5 be effectively invoked by the aggrieved shareholders? Similarly, if the executive committee of a corporation issues stock options for inadequate consideration, but for improper motives, are they within the prohibitions of 10b-5? More hypotheticals could be posed where, for example, the majority of an executive committee knows of material information and the recipient does not, or only a minority of the committee is aware of such information. Additional problems can be seen in the fluid merger market. For instance, must proposed acquisitions be heralded to the public in advance? If such acquisitions are heralded and the stock market thwarts the transaction, are the directors liable? Conversely, if the directors decide to withhold notification, can they be held liable for failing to provide the public with an opportunity to buy?

Closely allied with these hypothetical situations is the question of deception and the Ruckle-O'Neill controversy. Has 10b-5 become so expansive as to include any breach of fiduciary duty? The Schoenbaum result, representing a new type of “fraud,” would seem to dilute the deception requirement, but would still require some minimal allegation of conflict of interest before 10b-5 becomes operative. However, is such a standard, i.e., conflict of interest, as interpreted by the courts, a viable one? The hypotheticals involving corporate mismanagement illustrate that problems still remain and the question is simply reduced to this: should the concepts continue to be explored

141 See Bloomenthal, supra note 56, at 354-58.
142 Perhaps the best advice that can be given to directors faced with this dilemma is complete disclosure. The public and private interests are best served when an accurate and continuous flow of information is made available to the public. If directors heed this advice, the underlying philosophy of the securities acts will be served — that an investing public be informed fairly. Address by Manuel F. Cohen, Baltimore Security Analysts Society, Baltimore, Maryland, in (1967-1969 Transfer Binder), CCH FED. SEC. L. REP. ¶ 77,652, at 83,415 (Jan. 6, 1969).
143 See notes 38-47 and accompanying text supra.
144 It will be recalled that this was the extreme position espoused by Judge Bonsal in Entel. However, the Schoenbaum disposition of the corporate defendant Paribas would seem to indicate a judicial reluctance to adopt the Entel position.
145 See Comment, note 116 supra.
and advanced through judicial decisions or should legislation intervene?

**Legislative Revision?**

**Legislative Background**

At the root of the intrusion of rule 10b-5 into management affairs is the notion that the securities acts never purported to be a comprehensive “federal corporation law.” In fact, the Securities Act of 1933 was geared toward providing the public with pertinent investor information, and section 17 was the general prohibition against fraud by sellers of a security. A year later, Congress enacted section 10(b) of the 1934 Act, empowering the SEC to promulgate rules prohibiting deceptive devices or schemes in connection with the purchase or sale of securities. In 1942, pursuant to this grant of congressional authority, the SEC promulgated rule 10b-5 to prohibit fraudulent practices by purchasers of securities, thus closing the loophole left open by section 17.

With the private right of action recognized in *Kardon*, an Act initially limited in scope assumed a new dimension, and since 1946, that dimension has been developed almost exclusively by the federal judiciary. Professor Painter appropriately summarized the problem when he wrote: “what may be essentially a legislative task is being gradually transformed into a task which courts are performing under the stimulus of an administrative agency.”

**The Sources of Clarification**

Professor Painter’s quote concerning the regulation of management highlights the agents of possible clarification: Congress, the judiciary, or the SEC as the administrative agency. Whether the judiciary should have asserted such a dominant role in the development of “federal corporation law” is academic—for it is a *fait accompli*. What is of critical importance now is whether the judiciary should continue to amplify on management liability—or whether legislative revision of the various fraud provisions of the securities acts is now in order.

The most cogent argument for legislative revision at the present

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147 Id. § 77q (1964).
148 Id. § 78j(b) (1964).
150 W. Painter, FEDERAL REGULATION OF INSIDER TRADING 298 (1968).
152 Fleischer, *supra* note 6, at 1178-79. As far back as 1965, Mr. Fleischer suggested that legislative revision may be appropriate. The question is: is now an appropriate time?
time is the national character of the securities industry. Such revision would afford the opportunity for a more exhaustive study of the problems than is possible in the courts. The very nature of legislative enactment—intense public scrutiny, extensive hearings, congressional debate, and finally, legislative action—seems to lend itself to a more definitive standard of conduct than has been heretofore delineated by the courts.\(^{163}\) In addition, one might cogently contend that the courts are presently enforcing standards which are no longer applicable to the large corporation or to a society which is considerably more complex than the simple society in which those standards were first formulated.

The federal judiciary, as a source of clarification, would clearly prove inadequate. Indeed, it is the very fact that corporate fiduciary duties have been defined by the federal district and circuit courts that has given rise to the problems of corporate personnel. The discordant application of the federal securities laws and the exercise of expansive jurisdiction has led to conflict within the federal judiciary. To hope that that judiciary could evolve meaningful standards for director liability in the near future would be optimistic.

Perhaps the Supreme Court could author a unifying theory of liability, but it has evidenced little inclination to clarify the corporate law field by developing a comprehensive system of civil liability.

The last possible source of clarification is the SEC itself. Since it created rule 10b-5 in 1942, it would only seem appropriate that now, in 1970, the Commission rewrite it to amplify the concepts initially set forth in it.\(^{154}\) The simple language of the rule has given rise to numerous problems. If the SEC utilized its expertise and sophistica-

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\(^{163}\) Mr. David Henkel, a noted securities practitioner, has written that even though most of the securities law has been developed by the judiciary on a case-by-case basis, this does not mean that the Congress should not prescribe appropriate standards to guide the courts, practitioners, securities dealers and investors in this area. Loss, supra note 127, at 897.

\(^{154}\) In regard to the problems of management liability, Professor Knauss has suggested an interesting solution to the dilemma of enormous potential liability. It is Knauss' theory that no individual recoveries should be allowed to shareholders; rather, the SEC should take affirmative action and impose internal sanctions on the company involved. Such sanctions could largely be accomplished through the investigatory authority of the Commission. Mr. Knauss also recommends more SEC activity in seeking injunctive remedies in the federal courts. Correlatively, he urges that the courts should adopt a more flexible position, attempting to meet the particular type of fraud involved in each instance. As part of its injunction, the SEC should seek restitution for profits realized by guilty insiders. And finally, if the Commission finds willful violations of the securities laws, it should not hesitate to institute criminal sanctions. As can be seen, this approach casts a heavy burden on the SEC to enforce 10b-5, an approach which has not been fully accepted by the SEC itself. Knauss, Disclosure Requirements—Changing Concepts of Liability, 24 Bus. Law. 43, 57-59 (1968).
tion, perhaps a more meaningful rule would result. Paradoxically, however, the SEC has not shown the desire to do so and apparently is content in allowing the judiciary to develop 10b-5 liability.

Analysis of the possible sources of standardization results in a circuitous trip. No doubt, a meaningful effort by Congress to select the best from 10b-5 jurisprudence would go a long way in solving the problems which the broad language of rule 10b-5 presents. And predictably, a study of the leading securities specialists throughout the nation indicates that the long-range answer must come from the legislative realm. With the mounting concern which Congress has recently evinced in the corporate law realm, the long-hoped for solution to the subtle and complex problem of management liability may not be long in coming. 10b-5 will continue to be amplified by the judiciary on an ad hoc basis until public clamor for codification reaches the pressure point for Congress. Perhaps Professor Loss was regrettably correct when he concluded: "[i]n short, one mustn't expect too much in the 10b-5 area by way of codification." It can only be hoped that this expectation will be short-lived.

CONCLUSION

The judicial recognition of "conflict of interest" as violative of the federal securities laws undoubtedly resulted from "an awareness of a developing public mandate that executives conform to high standards of conduct." However, such an elusive "standard" of corporate conduct opens new vistas for disgruntled shareholders and raises subtle questions of propriety for high-echelon corporate personnel.

155 Loss, note 127 supra. The overwhelming majority of securities experts favor a legislative revision of the fraud provisions of the securities acts. But see Lowenfels, Codification and Rule 10b-5, 23 VAND. L. REV. 591 (1970). It is Mr. Lowenfels' contention that the expansive growth of rule 10b-5 has truly served the public interest. As a step in the furtherance of protecting the investing public, Mr. Lowenfels feels codification would be an inhibiting factor and concludes: "Fraud has many faces, many forms, and many names. Placed in the context of highly sophisticated securities markets, fraud can be regulated only by the judiciary, pragmatically, on a case by case basis." Id. at 597.

156 Such concern is evidenced by the recent promulgation of the Williams Act. Here, federal legislation was enacted to protect management from the aggressive practices of corporate raiders and to combat the recent conglomerate phenomena. Congress laid heavy emphasis on the goal of the act: investor protection. See Note, Closing the Disclosure Gap in Corporate Take-Overs: The Williams Amendments And The Wheat Report, 44 ST. JOHN'S L. REV. 484 (1970).

157 Loss, supra note 13, at 34-35.

158 Cary, supra note 112, at 417.

159 This was the thrust of Judge Medina's dissent in Schoenbaum II. Fearing more congestion in the federal courts, Judge Medina sharply criticized the majority's rationale that the mere circumstance of a "controlling interest" permits a shareholder to probe
At the core of corporate uncertainty has been the expansive use of rule 10b-5 as a jurisdictional predicate in probing the intracorporate affairs of management. The history of 10b-5 has been the development of limiting doctrines, e.g., the purchaser-seller requirement of *Birnbaum*, the deception mandate of *O'Neill* and the causation prescription of *Barnett*. Such doctrines were initially formulated by the judiciary to limit the potentially unlimited growth of 10b-5. However, the failure to articulate a definitive standard of conduct, as well as the judicial emphasis on investor and market protection, has posed an awesome burden for directors and similar officials. 10b-5 has emerged as the predominant regulator of intimate management affairs, and through such decisions as *Texas Gulf* and *Schoenbaum*, has forged a new framework of director liability. One can only wonder, however, if the result reached in *Schoenbaum* will ultimately lead to more problems than it has solved. The major weakness of the implementation of 10b-5 in the daily affairs of management is that it is highly doubtful that it was ever intended to regulate such affairs. And the increasing reliance by the judiciary on rule 10b-5 to solve fiduciary problems can only result in further confusion in the area.

Undoubtedly, the goal of a "pure" securities industry is laudable. Through continued judicial emphasis on full and complete disclosure, insiders will be further deterred from abusing their position of trust. By recognizing fraud without deceit, the courts have evinced a more liberal attitude toward securities-related frauds within the corporate framework. The significance of such an expansion cannot be underestimated; the effects on the corporate community cannot be accurately predicted. This clear judicial trend in the regulation of internal affairs, although not foreseen or anticipated by Congress 35 years ago, will serve to further the broad purposes embodied in the securities acts and in the rules protecting the investing public. While the concepts of insider liability should be further explored by the judiciary on an ad hoc basis, legislative clarification is the long-range solution to an already strained interpretation of rule 10b-5.

**corporate motives through full discovery proceedings. Such a situation, he concluded, is "a standing invitation to blackmail and extortion." 405 F.2d at 221.**

160 See Mutual Shares Corp. v. Genesco, Inc., 584 F.2d 540 (2d Cir. 1967).


In the formulation of relief, however, concepts of fairness to those who are expected to govern their conduct under Rule 10b-5 should be considered. Protection for investors is of primary importance, but it must be kept in mind that the nation's welfare depends upon the maintenance of a viable, vigorous business community. Considered alone, the sweeping language of Rule 10b-5 creates an almost completely undefined liability.