

BOSTON COLLEGE LAW REVIEW

VOLUME XX

JULY 1979

NUMBER 5

CORPORATE MISMANAGEMENT AND THE FEDERAL SECURITIES ACT'S ANTIFRAUD PROVISIONS: A FAMILIAR PATH WITH SOME NEW DETOURS

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I. INTRODUCTION

In recent years, the Supreme Court has limited¹ greatly the once feared spectre of S.E.C. rule 10b-5² as an enforcement weapon in the hands of private parties. Once both hailed and assailed as the seed of a developing federal

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¹ *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975).

² 17 C.F.R. § 240.10b-5 (1979). The rule 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,

(a) To employ any device, scheme, or artifice to defraud,

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

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

The rule was promulgated under section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78a *et. seq.* (1976) which 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-

* * *

(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.

15 U.S.C. § 78j(b) (1976).

Although there is no express remedy, courts have long recognized an implied private right of action. *E.g.*, *Speed v. Transamerica Corp.*, 99 F. Supp. 808 (D. Del.

corporate law,³ the scope of rule 10b-5 has been cut back significantly by these decisions. First, implied private actions under rule 10b-5 have been limited to conduct involving scienter, thus clearly eliminating this federal remedy as a basis for challenging negligent mismanagement.⁴ Second, the private damage plaintiff must have been a purchaser or seller of securities.⁵ And, third, as a result of the Supreme Court's decision in *Santa Fe Industries, Inc. v. Green*,⁶ such purchase or sale and resultant injury must have been induced by the defendant's deception of the plaintiff⁷ or have arisen as a result of market manipulation.⁸

This article will review the effects of the Supreme Court's limiting decisions. Particular attention will be given to the *Santa Fe* decision, which has been interpreted by some courts as a relatively minor limitation,⁹ and by others as a more substantial stumbling block to private suits.¹⁰ The article

1951); *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946). See generally A. BROMBERG, *SECURITIES LAW: FRAUD—SEC RULE 10b-5* (1977); L. LOSS, *SECURITIES REGULATION* chs. 6C, 9C (2d ed. 1961 & Supp. 1969).

³ E.g., Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974); Cox, *Fraud is in the Eyes of the Beholder: Rule 10b-5's Applications to Acts of Corporate Mismanagement*, 47 N.Y.U. L. REV. 674 (1972); Fleischer, "Federal Corporation Law": An Assessment, 78 HARV. L. REV. 1146 (1965); Jacobs, *The Role of Securities Exchange Act Rule 10b-5 in the Regulation of Corporate Management*, 59 CORNELL L. REV. 27 (1973).

⁴ See, Block & Schwarzfeld, *Corporate Mismanagement and Breach of Fiduciary Duty After Santa Fe v. Green*, 2 CORP. L. REV. 91 (1979); Hazen, *Corporate Chartering and the Securities Markets: Shareholder Suffrage, Corporate Responsibility and Managerial Accountability*, 1978 WISC. L. REV. 391, 413-27; Jacobs, *How Santa Fe Affects 10b-5's Proscriptions Against Corporate Mismanagement*, 6 SEC. REG. L.J. 3 (1978); Jacobs, *Rule 10b-5 and Self Dealing by Corporate Fiduciaries: An Analysis*, 48 U. CIN. L. REV. 643 (1979); Sherrard, *Federal Judicial and Regulatory Responses to Santa Fe Industries, Inc. v. Green*, 35 WASH. & LEE L. REV. 695 (1978); Campbell, *Santa Fe Industries, Inc. v. Green: An Analysis Two Years Later*, 30 MAINE L. REV. 187 (1979); Note, *Suits for Breach of Fiduciary Duties Under Rule 10b-5 After Santa Fe Industries, Inc. v. Green*, 91 HARV. L. REV. 1874 (1978).

⁵ *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975).

⁶ 430 U.S. 462 (1977).

⁷ *Id.* at 474. Some appellate decisions have purported to minimize the deception requirement. See, e.g., *Goldberg v. Meridor*, 567 F.2d 209 (2d Cir. 1977), cert. denied, 434 U.S. 1069 (1978). The *Goldberg* court held that the deception requirement is satisfied at the pleading stage if the plaintiff alleges either that full disclosure could have given rise to an injunction under state law or that rather than airing its dirty linen, the offending management might have refrained from the conduct complained of. *Id.* at 220-21. However, other courts have not gone nearly as far. See, e.g., *Biesenbach v. Guenther*, 588 F.2d 400 (3d Cir. 1978). See text accompanying notes 106-111 *infra*.

⁸ 430 U.S. at 474. Manipulation as used in section 10(b) of the Exchange Act is a "term of art" limited to certain types of market conduct that are designed to artificially affect the price. *Id.* at 476; *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 (1976).

⁹ E.g., *Goldberg v. Meridor*, 567 F.2d 209 (2d Cir. 1977), cert. denied, 434 U.S. 1069 (1978); *Wright v. Heizer Corp.*, 560 F.2d 236 (7th Cir. 1977), cert. denied, 434 U.S. 1066 (1978).

¹⁰ E.g., *Biesenbach v. Guenther*, 588 F.2d 400 (3d Cir. 1978).

initially will explore the limits placed on the application of rule 10b-5 to corporate mismanagement actions. The discussion will focus on the impact of the *Santa Fe* decision¹¹ and on two other decisions limiting the applicability of rule 10b-5.¹² The discussion then will focus on alternative federal remedies that may be used to compensate for the limitations imposed on rule 10b-5 damage actions. These complementary remedies are available under the general antifraud provision of section 17(a) of the Securities Act of 1933,¹³ the proxy machinery of section 14(a) and rule 14a-9 of the Securities Exchange Act,¹⁴ the antifraud provision applying to the federal regulation of tender offers of section 14(e) of the Securities Exchange Act¹⁵ and the antifraud provision of section 18(a) of the Securities Exchange Act.¹⁶ The article will continue by examining the proper role of the SEC in attempting to control corporate mismanagement, especially in light of the restrictions imposed on private litigants by *Santa Fe*, and the article will conclude by considering the possible effects the proposed Federal Securities Code will have on the problem of corporate mismanagement. It will be submitted that the proposed Federal Securities Code, if enacted, will not work to clarify the ambiguities existing with regard to private remedies for corporate mismanagement, and the resolution of the proper role for private remedies under rule 10b-5 will be left to the courts. The limitations imposed by the Supreme Court, therefore, will remain applicable to curtail the use of a rule 10b-5 remedy.

¹¹ It goes without saying that *Santa Fe*, like its two predecessors in the Supreme Court, may have significant impact upon SEC enforcement actions. However, this issue goes beyond the scope of the instant discussion. For a discussion of this issue, see generally, Berner & Franklin, *Scienter and Securities Exchange Commission Rule 10b-5 Injunctive Actions: A Reappraisal in Light of Hochfelder*, 51 N.Y.U. L. REV. 769 (1976); Lowenfels, *Scienter or Negligence Required for SEC Injunctions Under Section 10(b) and Rule 10b-5: A Fascinating Paradox*, 33 BUS. LAW. 789 (1978); Maher & Blasi, *Lessons from Ernst & Ernst—Enforcement Proceedings and the Uncommon Law of Rule 10b-5*, 82 DICK. L. REV. 1 (1977); Note, *Scienter and Injunctive Relief Under Rule 10b-5*, 11 GA. L. REV. 879 (1977); Note, *SEC Enforcement Actions to Enjoin Violations of Section 10(b) and Rule 10b-5: The Scienter Question*, 5 HOFSTRA L. REV. 831 (1977); Note, *New Light on an Old Debate: Negligence v. Scienter in an SEC Fraud Injunctive Suit*, 51 ST. JOHN'S L. REV. 759 (1977). The Supreme Court is about to decide the issue of whether scienter must be proved in SEC injunctive actions in *SEC v. E.L. Aaron & Co.*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,800 (2d Cir. March 12, 1979), cert. granted, 48 U.S.L.W. 3253 (Oct. 15, 1979).

Similarly, this article will not deal with 10b-5 as it applies to insider trading. For a discussion of that issue, see generally, W. PAINTER, *FEDERAL REGULATION OF INSIDER TRADING* (1968); Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322 (1979); Jennings, *Insider Trading in Corporate Securities: A Survey of Hazards and Disclosure Obligations Under Rule 10b-5*, 62 NW. L. REV. 809 (1968); Rapp & Loeb, *Tippee Liability and Rule 10b-5*, 1971 U. ILL. L.F. 55.

¹² *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

¹³ 15 U.S.C. §§ 77(a) et. seq., § 77q(a) (1976).

¹⁴ 15 U.S.C. § 78n(a) (1976); 17 C.F.R. § 240.14a-9 (1979).

¹⁵ 15 U.S.C. § 78n(e) (1976).

¹⁶ 15 U.S.C. § 78r(a) (1976).

It is the author's position that a proper interpretation of the rule announced by the Court in *Santa Fe* will not sound the death knell for private remedies under rule 10b-5. *Santa Fe*, if properly interpreted, stands for the proposition that a federal remedy can exist, that the deception requirement of rule 10b-5 is fulfilled where the corporate management fails to disclose information required to be disclosed by state as well as federal law. The federal remedy under rule 10b-5 should be barred only in instances where state or federal law does not require disclosure of the information at issue. If the *Santa Fe* decision is not interpreted properly, and if federal courts are precluded from enforcing disclosures required by state law, alternatives to rule 10b-5 will have to be explored to supplement the newly restricted rule 10b-5 action. In this way, private parties may yet be afforded meaningful federal recourse in appropriate cases for corporate mismanagement.

II. THE LIMITATIONS ON RULE 10b-5 PRIVATE ACTIONS

A. *The Stage is Set: Mismanagement Cases Prior to Santa Fe*

Prior to the Supreme Court's decision in *Santa Fe* many lower courts had imposed liability under rule 10b-5, despite the absence of a causal misstatement or material omission made in connection with the plaintiff's purchase of securities. Since the *Santa Fe* decision may have been a reaction to what the Court felt was an undue expansion of rule 10b-5 by the lower courts in imposing liability in these instances,¹⁷ it is necessary to examine some selected earlier deception and mismanagement cases to fully understand the impact of the *Santa Fe* decision.

In *Ruckle v. Roto American Corp.*,¹⁸ the Second Circuit was confronted with a situation in which the defendant directors, who were in control of the board, had withheld information from an outside director.¹⁹ The court sustained the rule 10b-5 claim and held that even though the outside director could not have blocked the board's action, his deception could be imputed to the corporation.²⁰ A short time later, the Second Circuit in *O'Neill v. Maytag*²¹ seemingly rejected the broad dicta that appeared in the *Ruckle* decision. In *O'Neill* the court held that where all of the directors were fully informed and no shareholder action was necessary to approve the action of the board the corporation had not been deceived, and no rule 10b-5 action existed.²²

In 1968, the Third Circuit was willing to take a broader view of rule 10b-5, just four years after the Second Circuit decision in *O'Neill*. In *Pappas v. Moss*,²³ the directors authorized the issuance of stock to themselves at a dis-

¹⁷ See note 3, *supra*.

¹⁸ 339 F.2d 24 (2d Cir. 1964).

¹⁹ *Id.* at 25-26.

²⁰ *Id.* at 28-29.

²¹ 339 F.2d 764 (2d Cir. 1964).

²² *Id.* at 768.

²³ 393 F.2d 865 (3d Cir. 1968). *But see, e.g.,* *Rekant v. Dresser*, 425 F.2d 872 (5th Cir. 1970), where the director induced the corporation to issue securities to the

count.²⁴ The authorizing resolution contained material misstatements of fact and, although each of the decisionmakers had been fully informed, the court held that misleading the shareholders was sufficient deception of the injured corporation.²⁵ While no shareholder action was required²⁶ to approve the directors' issuance of stock, it is possible that the *Pappas* court was concerned with providing the shareholders with sufficient information to enable them to redress the issuance of shares by obtaining an injunction in state court.²⁷

The leading decision in the pre-*Santa Fe* line of cases, *Schoenbaum v. Firstbrook*,²⁸ was handed down by the Second Circuit in the same year as *Pappas v. Moss*. In *Schoenbaum* the defendants, exercising control over a partially owned subsidiary in which the plaintiff was a shareholder, caused the subsidiary to issue additional shares to the defendants at a deflated price.²⁹ The Second Circuit altered its earlier position in *O'Neill* and held that the plaintiffs stated a rule 10b-5 cause of action where they were able to point to material misstatements concerning the value of the subsidiary's shares.³⁰ In essence, the court ruled that deception of the decisionmakers is not a prerequisite to a rule 10b-5 claim if the plaintiff can show that a controlling shareholder, who was benefitted by the transaction, dominated the board.³¹

The *Schoenbaum* rule was elucidated further in *Shell v. Hensley*³² by the Fifth Circuit, which had previously taken a narrower view of rule 10b-5's deception requirement.³³ *Shell* involved allegations of misstatements in the

president at a deflated price. There were subsequent misstatements to the shareholders but not to decision-makers. The court denied the existence of a 10b-5 claim although there were causes of action under state law. 425 F.2d at 881.

²⁴ 393 F.2d at 866.

²⁵ *Id.* at 869.

²⁶ *Id.* Under the Model Business Corporations Act, once the shares have been authorized by the shareholders, their issuance is up to the board of directors. ABA-ALI MODEL BUS. CORP. ACT §§ 16-19. The Model Act also provides: "In the absence of fraud in the transaction, the judgment of the board of directors or the shareholders, as the case may be, as to the value of the consideration received for shares shall be conclusive." *Id.* § 19.

²⁷ Presumably, had there been full disclosure, the shareholders could have sought and secured an injunction under state law. See *Goldberg v. Meridor*, 567 F.2d 209 (2d Cir. 1977), *cert. denied*, 434 U.S. 1069 (1978).

²⁸ 405 F.2d 215 (2d Cir. 1968), *cert. denied*, 395 U.S. 906 (1969).

²⁹ *Id.* at 217-18.

³⁰ *Id.* at 219. See generally, Folk, *Corporation Law Developments-1969*, 56 U. VA. L. REV. 755, 806-11 (1970); Note, *The Controlling Influence Standard in Rule 10b-5 Corporate Mismanagement Cases*, 86 HARV. L. REV. 1007 (1973); Comment, *Schoenbaum v. Firstbrook, the 'New Fraud' Expands Federal Corporation Law*, 55 U. VA. L. REV. 1103 (1969).

³¹ This is analogous to the recognition of a duty under state law running from the majority shareholder to the minority where the board's action is so dominated. See, e.g., *Zahn v. Transamerica Corp.*, 162 F.2d 36 (3d Cir. 1947). Notwithstanding the questionable presence of deception at least one court believes *Schoenbaum* survives *Santa Fe*. *Goldberg v. Meridor*, 567 F.2d 209 (2d Cir. 1977), *cert. denied*, 434 U.S. 1069 (1978). Not surprisingly this pronouncement came from the same circuit that decided *Schoenbaum* and was reversed in *Santa Fe*.

³² 430 F.2d 819 (5th Cir. 1970).

³³ See *Rekant v. Dresser*, 425 F.2d 872 (5th Cir. 1970) which is discussed in note 23 *supra*.

proxy materials concerning an employment contract. The plaintiff based his claim, however, in terms of rule 10b-5 rather than on the proxy rules since the president's employment contract being challenged did not require shareholder approval.³⁴ The court held that deception of the shareholders was sufficient, even though they were not decisionmakers and thus not in a position to affect the transactions at issue.³⁵ In reaching this result, the court utilized the "controlling influence" test of *Schoenbaum*. The Fifth Circuit stated:

when the other party to the securities transaction controls the judgment of all the corporation's board members or conspires with them or the one controlling them to profit mutually at the expense of the corporation . . . the corporation's choice of action . . . is not made as a reasonable man would make it possessed of all the material information known to the other party to the transaction.³⁶

The *Shell* court determined, therefore that the plaintiff alleged an actionable claim of deception.

The next significant development in the area of corporate mismanagement was rule 10b-5's high watermark case: *Superintendent of Insurance v. Bankers Life & Cas. Co.*³⁷ Defendants, the management of an insurance company, caused the company to part with its assets consisting of securities.³⁸ Although the defendants' activities had been characterized as pure mismanagement, and nothing more than theft or embezzlement, the Supreme Court upheld the rule 10b-5 claim on the grounds that there was fraud touching the sale of securities.³⁹ The Court found the required deception by the management describing this as a case where the "seller was duped into believing that it . . . would receive the proceeds."⁴⁰ Since the corporation was deceived, the Court determined that a sufficient basis existed for a rule 10b-5 claim.

The *Bankers Life* decision not only set the stage for the Supreme Court's recent restrictions on rule 10b-5 actions,⁴¹ it also temporarily gave a green light to the lower courts for further expansion of the availability of rule 10b-5 to redress corporate mismanagement. For example, in *Drachman v. Harvey*,⁴²

³⁴ *Id.* at 822-824.

³⁵ 430 F.2d at 827.

³⁶ *Id.* It has been suggested that this "analogy" to deception "is not totally convincing" and that since it "is grounded essentially in a breach of fiduciary responsibility, the test appears to have been overruled . . . in *Santa Fe*." Sherrard, *Federal Judicial and Regulatory Responses to Santa Fe Industries, Inc. v. Green*, 35 WASH. & LEE L. REV. 695, 701, 702 (1978).

³⁷ 404 U.S. 6 (1971).

³⁸ *Id.* at 7-8.

³⁹ *Id.* at 12 n.10.

⁴⁰ *Id.* at 9.

⁴¹ See Lowenfels, *Recent Supreme Court Decisions Under the Federal Securities Laws: The Pendulum Swings*, 65 GEO. L. J. 891 (1977).

⁴² 453 F.2d 722, rev'd on rehearing, 453 F.2d 736 (2d Cir. 1972) (*en banc*). Another significant pre-*Santa Fe* decision was handed down in *Bailey v. Meister Brau, Inc.*, 535 F.2d 982 (7th Cir. 1976), where the plaintiffs, minority shareholders, complained of the sale of the corporation's assets in exchange for the stock of the acquiring company. The complaint alleged that the exchange was at an unfair ratio and furthermore that, as part of the deal, the target company's controlling shareholders

the Second Circuit implicitly applied rule 10b-5's "new fraud" principles to find an actionable violation under the "controlling influence" doctrine.⁴³ In *Drachman*, the defendants sold a portion of their controlling shares in a corporation at a premium, and then caused the corporation to redeem convertible debentures pursuant to the defendants' plan to perpetuate their control.⁴⁴ Citing *Schoenbaum* and *Bankers Life* the court found actionable deception, despite the fact that the plaintiffs were not in a position to prevent this course of action.⁴⁵ The court, in essence, concluded that the majority shareholders exercised the requisite deception by virtue of their domination of the board and failure to disclose the true intent of their dealings.⁴⁶

The cases decided prior to *Santa Fe* demonstrate an expansion in the scope of the rule 10b-5 remedy available to injured investors. The development in *Schoenbaum* and the continuation in *Shell* and *Drachman* of a policy that recognized requisite deception of a corporation in instances where certain shareholders exercised a controlling influence over the corporation, was a significant step in providing shareholders with a remedy for corporate mismanagement. No longer did the investor face the hurdle of showing actual deception of a decisionmaker through misstatement or omission by the management. As the Supreme Court stated in *Bankers Life*, deception of the corporation could be found in the failure to publicly disclose material information.

B. The Santa Fe Decision

The trend in the earlier cases toward expanding the availability of the rule 10b-5 remedy to private claimants was brought to a halt by the Supreme Court's decision in *Santa Fe Industries, Inc. v. Green*.⁴⁷ In *Santa Fe*, the Court determined that the federal securities regulation should be interpreted with a view toward deference for state legislation regulating corporate action. The Court found that in *Santa Fe* the defendant had disclosed all information required to be disclosed by Delaware law, and that policy reasons of deference to the state control in this area precluded the Court from expanding the scope of information required to be disclosed. The element of deception required for a rule 10b-5 action did not exist and therefore, the plaintiff's action failed.

The defendant in *Santa Fe*, Santa Fe Industries, owned a ninety-five percent controlling interest in Kirby Lumber, a Delaware corporation in which the plaintiff was a minority stockholder.⁴⁸ In order to convert its holdings

were to receive a premium for their shares. *Id.* at 985. The court held that nondisclosure of the controlling shareholders' conflict of interest when considering the sale of assets constituted sufficient deception under 10b-5. *Id.* at 994. For a post-*Santa Fe* analog to *Bailey*, see *Wright v. Heizer Co.*, 560 F.2d 236 (7th Cir. 1977), *cert. denied* 434 U.S. 1066 (1978), discussed in the text accompanying notes 77-87 *infra*.

⁴³ 453 F.2d at 737.

⁴⁴ *Id.* at 724-25.

⁴⁵ *Id.* at 737-38.

⁴⁶ *Id.* at 736-37.

⁴⁷ 430 U.S. 462 (1977).

⁴⁸ *Id.* at 465.

into complete control, the parent corporation decided to utilize the Delaware "short form" merger statute.⁴⁹ Under the terms of the Delaware procedure, a 90% majority can force the minority into a "cash out" merger, provided that the minority receives notice of dissenting shareholders' appraisal rights within ten days of the effective date.⁵⁰ Pursuant to the terms of the merger, the Kirby shareholders were to receive one hundred and fifty dollars per share.⁵¹ The defendant complied with the merger statute, and the minority interests were given the ten days advance notice of their right to dissent, as well as notice of an investment banking firm's valuation of one hundred and twenty-five dollars per share.⁵²

After the consummation of the merger, the plaintiffs brought suit under rule 10b-5, alleging that the proper valuation should have been based on a going concern value of seven hundred and seventy-two dollars per share.⁵³ The plaintiff's theory was based on two types of alleged rule 10b-5 violations. First, the plaintiffs claimed that the lack of a valid business purpose and the absence of prior notice of this fact to the minority was a material non-disclosure.⁵⁴ Second, the plaintiffs maintained that the defendant's appraisal and offer were so grossly undervalued as to amount to fraud.⁵⁵

⁴⁹ DEL. CODE tit. 8, § 253 (Supp. 1978).

⁵⁰ *Id.* § 262.

⁵¹ 430 U.S. at 466.

⁵² *Id.*

⁵³ *Id.* at 467.

⁵⁴ *Id.* at 467-68. The claim that the minority has been unfairly frozen out has been used as the basis of recovery in both federal and state courts. *See, e.g.,* Marshel v. AFW Fabric Corp., 533 F.2d 1277 (2d Cir. 1976), *vacated as moot*, 429 U.S. 881 (1976) (allowing a 10b-5 remedy for freezing out the minority); Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374 (2d Cir. 1974), *cert. denied*, 421 U.S. 976 (1975) (upholding a 10b-5 market manipulation claim in connection with a statutory merger); Bryan v. Brock & Blevins Co., 490 F.2d 563 (5th Cir. 1974), *cert. denied*, 419 U.S. 844 (1974) (striking down a freeze-out merger under both state law and rule 10b-5 for the lack of a valid business purpose). *Cf.* SEC v. Parklane Hosiery Co., 558 F.2d 1083 (2d Cir. 1977) (finding violations of the proxy rules with respect to a going-private merger but refusing to issue an injunction due to the absence of a "reasonable likelihood of recurrence"). *But see* Polin v. Conduction Corp., 552 F.2d 797 (8th Cir. 1977), *cert. denied*, 434 U.S. 857 (1978) (finding a valid purpose to support a going-private merger).

The debate over the existence of such a shareholder remedy has not been limited to rule 10b-5 but has taken place in the state courts as well. *See, e.g.,* Lebold v. Inland Steel Co., 125 F.2d 369 (7th Cir. 1941), *cert. denied*, 316 U.S. 675 (1942) (awarding damages under a state law claim attacking a freeze-out effected by a voluntary dissolution); Singer v. Magnavox Co., 380 A.2d 969 (Del. 1977) (upholding complaint against a merger whose sole purpose was allegedly to freeze out the minority); Tanzer v. International Gen. Indus., Inc., 379 A.2d 1121 (Del. 1977) (denying preliminary injunction); David J. Green & Co. v. Schenley Indus. Inc., 281 A.2d 30 (Del. 1971) (denying preliminary injunction); Stauffer v. Standard Brands, Inc., 41 Del. Ch. 7, 187 A.2d 78 (1962) (limiting the dissenter to the statutory appraisal remedy); Gabhart v. Gabhart, 267 Ind. 370, 370 N.E.2d 345 (1977) (refusing to limit the shareholder's remedy to statutory appraisal where there was no showing of legitimate corporate purpose); People v. Concord Fabrics, Inc., 50 App. Div. 2d 787, 377 N.Y.S.2d 84 (1975), *aff'g* 83 Misc. 2d 120, 371 N.Y.S.2d 550 (1975) (enjoining merger on the grounds of unfairness in freezing out the minority); Blumenthal v. Roosevelt Hotel, Inc., 202 Misc. 988, 115 N.Y.S.2d 52 (1952) (holding the statutory appraisal right to be

The district court dismissed the complaint reasoning that rule 10b-5 did not override the express terms of the Delaware statute that permitted the transaction at issue.⁵⁶ The court went on to note that although the defendant's valuations were low, absent nondisclosure or misstatements to the appraiser, they did not amount to fraud.⁵⁷ On appeal, the Second Circuit reversed the district court dismissal. The appeals court stated:

We hold that a complaint alleges a claim under Rule 10b-5 when it charges, in connection with a Delaware short-form merger, that the majority has committed a breach of its fiduciary duty to deal fairly with minority shareholders by effecting the merger without any justifiable business purpose. The minority shareholders are given no prior notice of the merger, thus having no opportunity to apply for injunctive relief and the proposed price to be paid is substantially lower than the appraised value. . . . We do not hold that the charge of excessively low valuation by itself satisfies the requirements of Rule 10b-5 because that is not the case before us.⁵⁸

This holding necessarily portended an expansive federal remedy for mismanagement, but its days were short lived since the decision was reversed by the Supreme Court.⁵⁹

The Supreme Court began its analysis by looking to the terms of rule 10b-5's authorizing statute, section 10(b) of the Securities Exchange Act of 1934.⁶⁰ The Court pointed out that the statute requires "manipulative or deceptive" conduct.⁶¹ Any reliance on the manipulation requirement was quickly ruled out by the Court based on the *Santa Fe* facts.⁶² As for deception, the Court note that the earlier mismanagement cases upon which the plaintiff relied, all involved material misstatements or omissions that deceived

plaintiff's exclusive remedy). See generally Borden, *Going Private—Old Tort, New Tort or No Tort?*, 49 N.Y.U. L. REV. 987 (1974); Brudney & Chirelstein, *Fair Shares in Corporate Mergers and Takeovers*, 88 HARV. L. REV. 297 (1974); Brudney & Chirelstein, *A Restatement of Corporate Freezeouts*, 87 YALE L. J. 1354 (1978); Greene, *Corporate Freeze-Out Mergers: A Proposed Analysis*, 28 STAN. L. REV. 487 (1976); Kessler, *Elimination of Minority Interests by Cash Merger: Two Recent Cases*, 30 BUS. LAW. 699 (1975); Rothschild, *Going Private, Singer and Rule 13e-3: What Are The Standards for Fiduciaries*, 7 SEC REG. L.J. 195 (1979). Vorenberg, *Exclusiveness of the Dissenting Stockholder's Appraisal Right*, 77 HARV. L. REV. 1189 (1964).

⁵⁵ 430 U.S. 467-68.

⁵⁶ 391 F. Supp. 849, 852 (S.D.N.Y. 1975).

⁵⁷ *Id.* at 855.

⁵⁸ 533 F.2d 1283, 1291 (2d Cir. 1976). See also *Marshall v. AFW Fabric Corp.*, 533 F.2d 1277 (2d Cir.), *vacated*, 429 U.S. 881 (1976), *on remand*, 441 F. Supp. 299 (S.D.N.Y. 1977) (complaint dismissed in light of *Santa Fe*); *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374 (2d Cir. 1975), *cert. denied*, 421 U.S. 976 (1975). For the appeal on remand, see 551 F.2d 531 (2d Cir. 1977) (dismissing the suit).

⁵⁹ 430 U.S. at 471.

⁶⁰ 15. U.S.C. § 78j(b) (1976), set out in full at note 2 *supra*.

⁶¹ 430 U.S. at 473. The Court stated, "The language of section 10(b) gives no indication that Congress meant to prohibit any conduct not involving manipulation or deception." *Id.*

⁶² *Id.* at 476-77; see note 8 *supra*.

investors in connection with the transaction in question.⁶³ The Court found that no such facts were alleged in the complaint before the Court. Santa Fe had complied with the Delaware statute and disclosed all required information to both the minority and the independent appraiser.⁶⁴ Since Santa Fe had disclosed all the information it was required to disclose, there was no valid basis for a claim of deception. Thus, by the terms of the Act itself, the complaint was deficient on its face.⁶⁵

A second aspect of the *Santa Fe* decision departs from a literal reading of the statute and looks to broader-based policy considerations. The Court noted that utilizing rule 10b-5 to scrutinize the fairness of the underlying transaction is "at best a subsidiary purpose" of the federal securities laws, and that, in any event, to extend the rule 10b-5 private remedy would be inconsistent with the Court's general approach to implied remedies.⁶⁶ The substantive effect of recognizing the *Santa Fe* plaintiff's rule 10b-5 claim would have been an incursion upon the province of state corporate chartering statutes regulating corporate conduct.⁶⁷ The Court was particularly concerned with such state/federal tensions since, at the time of the *Santa Fe* decision, Delaware, unlike some other states, did not require a valid business purpose for short form mergers and other freeze-out tactics.⁶⁸ The Court therefore determined that

⁶³ *Id.* at 475 n.15. See, e.g., *Sup't of Insurance v. Bankers Life & Cas. Co.*, 404 U.S. 6 (1971); *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374 (2d Cir. 1974), *cert. denied*, 421 U.S. 976 (1975); *Drachman v. Harvey*, 453 F.2d 722 (2d Cir. 1972).

⁶⁴ 430 U.S. at 474. The Court stated,

On the basis of the information provided, minority shareholders could either accept the price offered or reject it and seek an appraisal in the Delaware Court of Chancery. Their choice was fairly presented, and they were furnished with all relevant information on which to base their decision.

Id.

⁶⁵ One question that remains, however, is whether the deception issue is of wide ranging significance or merely a pleading problem. The proper answer lies somewhere in the middle.

⁶⁶ 430 U.S. at 478, citing *Cort v. Ash*, 422 U.S. 66 (1975). See also *Cannon v. Univ. of Chicago*, 99 S. Ct. 1946 (1979); *Touche Ross & Co. v. Reddington*, 99 S. Ct. 2479 (1979); *Piper v. Chris-Craft Indus., Inc.*, 430 U.S. 1 (1977).

⁶⁷ 430 U.S. at 479. The Court also stated,

There may well be a need for uniform federal fiduciary standards to govern mergers such as that challenged in the complaint. But those standards should not be supplied by judicial extensions of § 10(b) and Rule 10b-5 to "cover the corporate universe."

Id. at 480, quoting Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 700 (1974).

⁶⁸ 430 U.S. at 479 n.16. See note 54, *supra*. Delaware has since recognized such a remedy under its state law. See *Majjar v. Roland International Corp.*, 387 A.2d 709 (Del. Ch. Ct. 1978); *Young v. Valhi, Inc.*, 382 A.2d 1372 (Ch. 1978); *Kemp v. Angel*, 381 A.2d 241 (Del. Ch. Ct. 1977); *Lynch v. Vickers Energy Corp.*, 383 A.2d 278 (Del. Super. Ct. 1978); *Singer v. Magnavox Co.*, 380 A.2d 969 (Del. Super. Ct. 1977); *Tanzer v. International Gen'l Indus., Inc.*, 379 A.2d 1121 (Del. Super. Ct. 1977). See generally text accompanying note 70 *infra*. Hence, *Santa Fe* might well come out differently today. See, e.g., *Goldberg v. Meridor*, 567 F.2d 209 (2d Cir. 1977); *cert. denied*, 434 U.S. 1069 (1978). See also *Healey v. Catalyst Recovery of Pa., Inc.*, 463 F. Supp. 740 (W.D. Pa. 1979) *rev'd on other grounds* [Current] FED. SEC. L. REP. (CCH) ¶ 97,268

policy considerations did not militate in favor of expanding the scope of required disclosures. The Court deferred to the Delaware law and reasserted that deception is required in rule 10b-5 actions.

C. Rule 10b-5 In The Post-Santa Fe Era

As was to be expected, commentators were quick to predict that *Santa Fe* would have a significant limiting effect upon the permissible parameters of rule 10b-5 litigation within the sphere of corporate mismanagement.⁶⁹ It also was suggested that the burden was now upon the state judiciary to tighten up corporate law standards of fiduciary responsibility.⁷⁰ Delaware, traditionally the most pro-management jurisdiction,⁷¹ was quick to respond by recognizing a cause of action for a minority freeze out that is unfair to the minority and serves no valid business purpose.⁷² This reversal by the Delaware Supreme Court indicates that *Santa Fe* on its facts might be decided differently today. More importantly, and quite ironically, the expansion of shareholder rights under state law may in turn result in an expansion of rule 10b-5 liability.⁷³ It is submitted that this result is not as anomalous as it might appear. Rather, it is perfectly consistent with the desired dichotomy favored by the *Santa Fe* Court between federal securities regulation and the corporate chartering function that is presently left to the states.⁷⁴

The following section will examine the effect of the *Santa Fe* decision on the interplay between state corporate law and federal securities regulation in subsequent cases dealing with corporate mismanagement. In so doing, the discussion will review five circuit court cases which have interpreted liberally the

(3d Cir. 1980) (both holding that nondisclosure of facts that would give rise to an injunction under state law is sufficient to satisfy rule 10b-5's deception requirement). But see *Biesenback v. Guenther*, 588 F.2d 400 (3d Cir. 1978) and Section III *infra*.

⁶⁹ See note 4 *supra*.

⁷⁰ See Hazen, *Corporate Chartering and the Securities Markets: Shareholder Suffrage, Corporate Responsibility and Managerial Accountability*, 1978 WISC. L. REV. 391, 416-17.

⁷¹ See Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L. J. 663 (1974); Murdock, *Delaware: The Race to the Bottom—Is the End in Sight?*, 9 LOY. CHI. L. J. 643 (1978); Comment, *Law for Sale: A Study of the Delaware Corporation Law of 1967*, 117 U. PA. L. REV. 861 (1969).

⁷² See *Lynch v. Vickers Energy Corp.*, 383 A.2d 278 (Del. Super. Ct. 1978), and other cases cited in note 68 *supra*.

⁷³ See *Goldberg v. Meridor*, 567 F.2d 209 (2d Cir. 1977), *cert. denied*, 434 U.S. 1069 (1978). See also note 64 *supra*.

⁷⁴ While several commentators have urged the federal chartering of corporations, such proposals have made no headway in Congress. See Berlack, *Federal Incorporation and Securities Regulation*, 49 HARV. L. REV. 396 (1936); Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663 (1974); Cary, *A Proposed Federal Corporate Minimum Standards Act*, 29 BUS. LAW. 1101 (1974); Fleisher, "Federal Corporation Law": An Assessment, 78 HARV. L. REV. 1146 (1965); Henning, *Federal Corporate Chartering for Big Business: An Idea Whose Time Has Come?*, 21 DE PAUL L. REV. 915 (1972); Schwartz, *Federal Chartering of Corporations: An Introduction*, 61 GEO. L. J. 71 (1972); Stevens, *Uniform Corporation Laws Through Interstate Compacts and Federal Legislation*, 34 MICH. L. REV. 1063 (1936); Note, *Federal Chartering of Corporations: A Proposal*, 61 GEO. L. J. 89 (1972).

Court's decision in *Santa Fe* to impose a lenient deception requirement.⁷⁵ This discussion will be followed by an examination of other cases which have interpreted *Santa Fe* in a much more restrictive manner, and which have limited severely the rule 10b-5 remedy.⁷⁶

There have been five post-*Santa Fe* circuit court decisions that have presented an extremely liberal approach in defining the deception requirement as enunciated by the Supreme Court. The first of these cases arose before the Seventh Circuit in *Wright v. Heizer Corp.*⁷⁷ In *Wright*, a minority shareholder brought suit derivatively claiming rule 10b-5 violations in a series of transactions in which the defendant, a controlling shareholder, had caused the corporation to issue shares and convertible bonds at less than full value.⁷⁸ The first three claims arose prior to the defendant's acquiring control and had been approved by a disinterested majority of the board of directors.⁷⁹ The district court dismissed these three claims and that part of its decision was not appealed.⁸⁰ The circuit court discussed the three claims, however, viewing them as pure self-dealing without any element of deception, since no decisionmakers had been deceived.⁸¹ Second, the appellate court concluded that the requisite causation was not present, since the shareholders were not in a position to have prevented the three transactions.⁸² Hence, the Seventh Circuit apparently would have affirmed the district court's dismissal of the first three claims had these been appealed.

The fourth transaction, initiated by the majority shareholder, required authorization by the shareholders to issue additional shares, and this requirement triggered a duty of disclosure of all material facts.⁸³ Since there were omissions from the proxy statement directed toward authorizing additional shares, and since the corporation parted with these shares at less than full value, the court held that the failure to disclose was actionable.⁸⁴ The fifth

⁷⁵ *Healey v. Catalyst Recovery of Pa.* [Current] FED. SEC. L. REP. (CCH) ¶ 97,268 (3d Cir. 1980); *Kidwell v. Meikle*, 597 F.2d 1273 (9th Cir. 1979); *Alabama Farm Bureau; Mutual Casualty Insurance Co. v. American Fidelity Life Insurance Co.*, 606 F.2d 602 (5th Cir. 1979); *Wright v. Heizer Corp.* 560 F.2d 236 (7th Cir. 1977), *cert. denied* 434 U.S. 1066 (1978); *Goldberg v. Meridor*, 567 F.2d 209 (2d Cir. 1977), *cert. denied* 434 U.S. 1069 (1978).

⁷⁶ *Biesenbach v. Guenther*, 588 F.2d 400 (3d Cir. 1978); *Valente v. Pepsi Co., Inc.*, 454 F. Supp. 1228 (S.D.N.Y. 1978).

⁷⁷ 560 F.2d 236 (7th Cir. 1977), *cert. denied*, 434 U.S. 1066 (1978).

⁷⁸ *Id.* at 242-43.

⁷⁹ *Id.*

⁸⁰ *Id.* at 245.

⁸¹ *Id.* at 250.

⁸² *Id.* The court stated:

If these shareholders would have been powerless to prevent the proposed self dealing by the controlling shareholder even if they had possessed knowledge of all the facts, the failure to disclose to them would presumably be immaterial and reliance could not be shown.

Id. This type of causal approach to deception is well taken as it embodies the concept that the deceptive conduct must have actively deceived the complaining party.

⁸³ *Id.* at 247.

⁸⁴ *Id.* at 247-48.

transaction involved the directors' pledge of securities held by the corporation, a decision made by a board that was controlled by the defendant.⁸⁵ The court concluded that since Delaware law required ratification by the shareholders, there was actionable nondisclosure. The Seventh Circuit stated, "[w]hen an entire board of directors is controlled by a self-dealing director or shareholder, the corporation can only be represented by the independent shareholders, to whom full disclosure must be made."⁸⁶ In so ruling, the circuit court acknowledged that this rationale constituted a rejection of the black letter corporate law maxim that "[w]here disinterested directors constituted a majority . . . disclosure to the board is sufficient."⁸⁷

In reaching its decision on the fourth and fifth claims the *Wright* court may have applied incorrectly the standard enunciated by the Supreme Court in *Santa Fe*. The Seventh Circuit concluded that, despite the controlling shareholders' ability to secure the necessary shareholder vote, the minority's ability to seek an injunction in state court provided the necessary causation to make the deception actionable.⁸⁸ It is arguable that such a finding of causa-

⁸⁵ *Id.* at 244-45.

⁸⁶ *Id.* at 249. Compare the approach taken by the Second Circuit in *Maldonado v. Flynn*, 597 F.2d 789 (2d Cir. 1979), discussed in the text at notes 128-31 *infra*.

⁸⁷ 560 F.2d at 249, *See, e.g.*, ABA-ALI MODEL BUS. CORP. ACT § 41, which provides:

No contract or other transaction between a corporation and one or more of its directors or any other corporation, firm, association or entity in which one or more of its directors are directors or officers or are financially interested, shall be either void or voidable because of such relationship or interest or because such director or directors are present at the meeting of the board of directors or a committee thereof which authorizes, approves or ratifies such contract or transaction or because his or their votes are counted for such purposes, If:

(a) the fact of such relationship or interest is disclosed or known to the board of directors or committee which authorizes, approves or ratifies the contract or transaction by a vote or consent sufficient for the purpose without counting the votes or consents of such interested directors; or

(b) the fact of such relationship or interest is disclosed or known to the shareholders entitled to vote and they authorize, approve or ratify such contract or transaction by vote or written consent; or

(c) the contract or transaction is fair and reasonable to the corporation.

Common or interested directors may be counted in determining the presence of a quorum at a meeting of the board of directors or a committee thereof which authorizes, approves or ratifies such contract or transaction.

⁸⁸ 560 F.2d at 250. A federal action would have been cognizable under the proxy rules. *See, e.g.*, *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375 (1970); *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374 (2d Cir. 1974), *cert. denied*, 421 U.S. 976 (1975). Since the Heizer Corporation was not a 1934 Act reporting company it was not subject to the proscriptions under the proxy rules. Rule 14-9 is the 10b-5 counterpart for the proxy machinery, however, by virtue of section 14(a) of the Securities Exchange Act, its application is limited to issuers who are subject to the Act's periodic reporting requirements. 15 U.S.C. § 78n(a) (1976); 17 C.F.R. § 240.14a-9 (1979). Section 12(g)(1) of the Act makes the reporting requirements applicable to issuers which are

tion may be inappropriate since, although touching the sale of a security, the transaction complained of was essentially a matter of corporate governance which can be viewed as not having involved the federal securities issue of deception of investors, or of the market in general.⁸⁹ Under the rule of *Santa Fe*, on the other hand, a rule 10b-5 claim properly is cognizable in *Wright* to the extent that the defendant's conduct had involved violations of state law that would have been discoverable upon full disclosure. This state law violation rationale was more fully developed by the court in *Goldberg v. Meridor*,⁹⁰ the second expansive circuit court reading of *Santa Fe*.

In evaluating the *Goldberg* decision it must be kept in mind that the case was decided by the Second Circuit, which also had handed down the *Schoenbaum* decision, and which authored the opinion that was reversed in *Santa Fe*. The consistent policy of these decisions indicate an interpretation by the Second Circuit in favor of maintaining private remedies under the rule 10b-5. In *Goldberg*, the defendant parent corporations controlled a subsidiary in which plaintiff was a minority shareholder.⁹¹ After a public offering of the subsidiary's common stock and convertible debentures, the defendants caused the subsidiary to loan seven million dollars to its direct parent and to enter into various contracts with the parent corporation on terms favorable to the defendants.⁹² This action was followed by the issuance of the subsidiary's shares to its direct parent corporation, which, in turn, was controlled by the other defendant parent corporation, in exchange for the assets and liabilities of the direct parent.⁹³ After the transactions were completed the direct parent was left with assets consisting solely of the stock in the subsidiary, and the subsidiary had acquired all the assets and liabilities of the parent, including the seven million dollar debt to itself.

The essence of the plaintiff's derivative rule 10b-5 claim was that the defendants had caused the subsidiary to raise money for the benefit of its controlling parents and for the subsequent exchange of assets, and that this action constituted a fraud against the subsidiary.⁹⁴ The defendant moved to dismiss the claim for failure to allege deception or nondisclosure in the trans-

(A) Within one hundred and twenty days after the last day of its first fiscal year ended after July 1, 1964, on which the issuer has total assets exceeding \$1,000,000 and a class of equity security (other than an exempted security) held of record by seven hundred and fifty or more persons; and

(B) within one hundred and twenty days after the last day of its first fiscal year ended after two years from July 1, 1964, on which the issuer has total assets exceeding \$1,000,000 and a class of equity security (other than an exempted security) held of record by five hundred or more but less than seven hundred and fifty persons.

15 U.S.C. § 78l(g)(1) (1976).

⁸⁹ See *Hazen*, *supra* note 68, at 422-25.

⁹⁰ 567 F.2d 209 (2d Cir. 1977), *cert. denied*, 434 U.S. 1069 (1978).

⁹¹ *Id.* at 211.

⁹² *Id.*

⁹³ *Id.*

⁹⁴ *Id.*

actions; in response, the plaintiff pointed to the nondisclosure of the defendants' conflicts of interest as a sufficient basis to constitute deception.⁹⁵ The court held that the plaintiff stated a valid rule 10b-5 claim.⁹⁶ The Second Circuit pointed to *Schoenbaum* and to its progeny concerning the controlling influence doctrine and asked whether they survived the *Santa Fe* decision.⁹⁷ The court found that *Schoenbaum* does survive *Santa Fe* as long as there is misleading disclosure or nondisclosure in addition to "a controlling influence" and "wholly inadequate consideration."⁹⁸ Although the decisionmakers in the instant case were not deceived, the court noted that public disclosure might have shamed the subsidiary's directors into voting against the transactions with its parents.⁹⁹

The concept of utilizing disclosure to encourage the directors into different, more reasonable conduct is an echo of a pre-*Santa Fe* causation analysis taken by the same court in *Schlick v. Penn-Dixie Cement Corp.*¹⁰⁰ In *Schlick* the Second Circuit stated:

The minority shareholders, aside, there are two other purposes served by the disclosure requirements which make a strict causation rule—whether under a 10(b) or a 14(a) claim—antithetical to it:

1. By disclosure the market will be informed so as to permit well-based decisions about buying, selling and holding the securities involved in the transaction. . . .

2. By virtue of the disclosure either modification or reconsideration of the terms of the merger by those in control might be effectuated.¹⁰¹

⁹⁵ *Id.* at 212.

⁹⁶ *Id.* at 221.

⁹⁷ *Id.* at 214-15.

⁹⁸ *Id.* at 217-19.

⁹⁹ *Id.* at 218-19. The court stated:

In *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449, 96 S. Ct. 2126, 2133, 48 L.Ed.2d 757 (1976), a case arising under Rule 14a-9, the Court laid down the standard of materiality as "a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder" or, putting the matter in another way, "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." When, as in a derivative action, the deception is alleged to have been practiced on the corporation, even though all the directors were parties to it, the test must be whether the facts that were not disclosed or were misleadingly disclosed to the shareholders "would have assumed actual significance in the deliberations" of reasonable and disinterested directors or created "a substantial likelihood" that such directors would have considered the "total mix" of information available to have been "significantly altered."

In essence the *Goldberg* court is requiring that interested directors live up to the standard of a reasonable outside director—an issue that has generally been left to the states in regulating corporate government.

Id.

¹⁰⁰ 507 F.2d 374 (2d Cir. 1974), *cert. denied*, 421 U.S. 976 (1975).

¹⁰¹ *Id.* at 384.

This dirty linen rationale for upholding the complaint in *Goldberg* at best treads a fine line with the state/federal tensions that concerned the Court in *Santa Fe*. The alternative basis for the Second Circuit's decision, however, is easier to reconcile with these *Santa Fe* concerns. The *Goldberg* court pointed out that the unfair exchange would have been the basis for an injunction under New York law, and that the plaintiffs were deceived into not seeking such an injunction.¹⁰² This factor was held not only to satisfy *Santa Fe*'s deception requirement, but also the concern of undue interference with transactions that are valid under state law.¹⁰³ In short, the *Santa Fe* defendants had complied with state law while the *Goldberg* defendants did not. Thus, the *Goldberg* plaintiff was on solid ground under the *Santa Fe* rule in attacking the procedure of the transaction.

More recently in *Kidwell v. Meikle*,¹⁰⁴ the third post-*Santa Fe* decision giving a liberal interpretation to the deception requirement, the Ninth Circuit followed the lead of the Second and Seventh Circuits in *Goldberg* and *Wright*, and recognized that the rule 10b-5 remedy still has a role to play in appropriate breach of fiduciary responsibility cases. In *Kidwell*, four defendant directors voted to transfer the assets of the Grand Targhee Resort, Incorporated to a "sister corporation" in which those directors had an ownership interest.¹⁰⁵ The derivative plaintiff alleged that the transfer was too favorable to the sister corporation.¹⁰⁶ Since Grand Targhee was a not-for-profit membership corporation, no vote of the members was required to approve the sale of corporate assets,¹⁰⁷ and accordingly, in response to the rule 10b-5 claim brought on the membership's behalf, the defendants maintained that the absence of deception of the decision-makers in connection with the reorganization precluded the private remedy.¹⁰⁸

With regard to the four interested directors, the Ninth Circuit rejected the claim that *Santa Fe* requires deception of the decisionmakers.¹⁰⁹ In the court's view it was sufficient that the nondisclosure of the conflict of interest precluded the members from securing an injunction against the transfer. The court stated,

[T]here is room for Rule 10b-5 liability after *Santa Fe Industries* even when the only deceived parties are shareholders who are not entitled to vote on the transaction in question, and even though there may be a breach of fiduciary duty under state law. Indeed, under the *Goldberg* rationale, it is precisely because there are state-law remedies that a deception can be found.¹¹⁰

¹⁰² 567 F.2d at 219-20.

¹⁰³ *Id.* at 219-21.

¹⁰⁴ 597 F.2d 1273 (9th Cir. 1979).

¹⁰⁵ *Id.* at 1280-83.

¹⁰⁶ *Id.* at 1285.

¹⁰⁷ *Id.* at 1282.

¹⁰⁸ 597 F.2d at 1290-91.

¹⁰⁹ *Id.* at 1292.

¹¹⁰ *Id.*

The court went on to point out that under the requisite test of causation the plaintiff could have no rule 10b-5 remedy "unless a minority shareholder would have succeeded in getting permanent injunctive relief or damages in excess of an appraisal remedy in the state law action."¹¹¹ These considerations acknowledge that *Santa Fe* did not sound the death knell for rule 10b-5 in mismanagement cases. Indeed, the *Kidwell* opinion, like *Wright* and *Goldberg*, stands as an example of striking the balance advocated between the federal state law remedies.

Even more recently, the Fifth Circuit has followed suit in *Alabama Farm Bureau Mutual Casualty Insurance Co. v. American Fidelity Life Insurance Co.*¹¹² In that case, the court ruled that it is not necessary to prove the success of the state law action, but rather merely to make out a *prima facie* case. The cause of action alleged in *Alabama Farm Bureau* arose out of a company stock repurchase plan at artificially inflated prices, thus resulting in personal benefit to certain inside directors by allowing them to maintain their positions. The Fifth Circuit decision thus bears a striking resemblance to the pre-*Santa Fe* decision of *Schoenbaum*. The current court, therefore, gives five circuits with an expansive reading of rule 10b-5 in the wake of *Santa Fe*.

In considering the precedential effect of the foregoing decisions it is important to keep in mind the factual settings in which they arose. *Wright*, *Goldberg*, *Kidwell*, *Alabama Farm Bureau* and *Healey* all involved actual or the potential for self-dealing. It has been held, in contrast, that where there is an independent board, the *Santa Fe* deception requirement will bar recovery absent deception of the decisionmakers.¹¹³ For example, the unfairness or inequity of a merger ratio or tender offer will not, standing alone, give rise to a rule 10b-5 claim.¹¹⁴ Where a conflict of interest is disclosed to a disinterested board that approved the transaction, and where no shareholder action is required, the corporation has not been deceived notwithstanding non-disclosure to the shareholders.¹¹⁵ It also has been held that self-dealing by the parent of a wholly-owned insurance subsidiary, with resulting injury to the policyholders did not give rise to a rule 10b-5 claim as there was no deception

¹¹¹ *Id.* at 1294.

¹¹² 606 F.2d 602 (5th Cir. 1979). See also *Meyers v. Moodey*, 475 F. Supp. 232, 244-46 (N.D. Tex. 1979). Most recently the Third Circuit in *Healey v. Catalyst Recovery of Pa.*, [Current] FED. SEC. L. REP. (CCH) ¶ 97,268 (3d Cir. 1980), expressly adopted the *Goldberg* state court injunction rationale. In *Healey* prior to the consummation of a merger, the defendants refused to show the plaintiffs certain requested information which they claimed would have provided the basis for a state court injunction against the merger. See notes 132-37 *infra* and accompanying text.

¹¹³ See *Tyco Labs. Inc. v. Kimball*, 444 F. Supp. 292 (E.D. Pa. 1977); See also *Maldonado v. Flynn*, 448 F. Supp. 1032 (S.D.N.Y. 1978), *aff'd in part & rev'd in part*, 597 F.2d 789 (2d Cir. 1979); *Browning Debenture Holders' Committee v. D.A.S.A. Corp.*, 560 F.2d 1078 (2d Cir. 1977).

¹¹⁴ *Halle & Stieglitz, Filor, Bullard, Inc. v. Engress International, Ltd.*, 442 F. Supp. 217 (D. Del. 1977), *Altman v. Knight*, 431 F. Supp. 309, (S.D.N.Y. 1977).

¹¹⁵ *Goldberger v. Baker*, 442 F. Supp. 659 (S.D.N.Y. 1977).

of the corporation within the meaning of *Santa Fe*.¹¹⁶ In that case the court also noted that the policyholders were not injured in connection with the purchase or sale of a security.¹¹⁷ It thus appears that the liberal interpretation of the deception requirement may be limited to those instances involving self-dealing by interested directors. It is interesting to note, in this regard, the pre-*Santa Fe* decisions employed a similar test in upholding corporate mismanagement actions.¹¹⁸

In contrast to *Wright, Goldberg, Kidwell, Alabama Farm Bureau and Healey*, the Third Circuit in *Biesenbach v. Guenther*¹¹⁹ interpreted *Santa Fe* as a much more significant limitation on private actions under rule 10b-5. In *Biesenbach*, the defendants constituted a majority of the directors of Heidelberg, Inc. and entered into two loan transactions.¹²⁰ In the first transaction the defendants loaned \$500,000 to the corporation, secured by a second lien on assets; they were to receive a 10% interest rate which, over the minority's objection, was raised to 4% above the prime rate.¹²¹ The second loan of more than \$226,000 had a 15% interest rate.¹²² The defendants also decreased the size of the board to tighten their control and authorized issuance of an additional million shares, notwithstanding their stated intent to issue only half that much.¹²³

In affirming dismissal of the complaint, the *Biesenbach* court ruled that cognizance of a rule 10b-5 claim, based solely on nondisclosure of breaches of fiduciary duties "would clearly circumvent the Supreme Court's holding in *Santa Fe*."¹²⁴ This rationale is in direct conflict with the Second Circuit's approach in *Goldberg*, which premised the rule 10b-5 violation upon the underlying state law. The *Biesenbach* approach is also, unlike the *Goldberg* approach, not in the best interest of investor protection. The *Goldberg* view furthers investor protection without unduly infringing upon the corporate chartering function. Unlike the factual setting in *Santa Fe*, recognition of a federal remedy under rule 10b-5, in *Biesenbach* would not undercut the state chartering scheme. To the contrary, the force of the law of the chartering jurisdiction is significantly strengthened by the supplemental federal remedy. Investors have

¹¹⁶ *Superintendent of Ins. v. Freedman*, 443 F. Supp. 628 (S.D.N.Y. 1977). In *Falkenberg v. Baldwin* [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,086 (S.D.N.Y. June 17, 1977), the nondisclosure of certain corporate liabilities allegedly inflated the price of the stock repurchased by the corporation. The court dismissed the complaint since all of the officers and directors had knowledge of the liabilities. The court imputed their knowledge to the corporation and hence concluded that the corporation had not been deceived. *Id.* See also *Kaplan v. Bennett*, 465 F. Supp. 555 (S.D.N.Y. 1979).

¹¹⁷ *Id.* at 637.

¹¹⁸ See text at notes 26-34 *supra*.

¹¹⁹ 588 F.2d 400 (3d Cir. 1978).

¹²⁰ *Id.* at 401.

¹²¹ *Id.*

¹²² *Id.*

¹²³ *Id.*

¹²⁴ *Id.* at 402. For another case denying a 10b-5 claim on similar facts, see *Goldberger v. Baker*, 442 F. Supp. 659 (S.D.N.Y. 1977), discussed in the text at note 115 *supra*.

an interest in—and an honest trading market demands—full disclosure of adverse information that could affect the market price. Disclosure of facts that would reveal possible violations of state law will enable prevention of improper transactions rather than forcing an after-the-fact challenge to the transaction which, if successful, will necessarily result in disruption of the normal market forces governing securities trading.¹²⁵ Examination of selected additional post-*Santa Fe* decisions will point further to the correctness of the approach taken by *Goldberg* and its progeny.

A 1978 Southern District of New York decision underscores the complementary effect of recognizing the federal rule 10b-5 remedy where there has been a violation of state law. In *Valente v. Pepsi Co., Inc.*,¹²⁶ the defendants embarked upon a tender offer which was to be followed by a merger.¹²⁷ The tender offeror did not mention the availability of appraisal rights under state law as an alternative to the merger.¹²⁸ The tender offeror also failed to state that the target company's debentures had a redemption price higher than the tender offer price.¹²⁹ In addition, there was no mention of the improved earnings of the target company.¹³⁰ The district court upheld the rule 10b-5 claim, reasoning that these omissions were a sufficient deception to satisfy *Santa Fe*.¹³¹

While one could give *Santa Fe* a restrictive reading in order to rule that so long as appraisal rights were available under state law, there is no federal rule 10b-5 claim, such a result in *Valente* would have ignored the necessary overlap between federal and state regulation. The presence of appraisal rights that are designed to assure fairness is a question of state law, going to the nature of the shareholders' proprietary interest. Full disclosure of all relevant information goes to their investment decision with respect to the securities in question. Within the one situation, therefore, there are aspects of both federal and state regulatory interests. Although the presence of the appraisal rights standing alone, without a federally related investment decision issue, clearly would involve only the application of state law, the presence of both aspects within

¹²⁵ For a more complete discussion of market impact, see, e.g., Werner, *Management, Stock Market and Corporate Reform: Berle and Means Reconsidered*, 77 COLUM. L. REV. 388 (1977).

¹²⁶ 454 F. Supp. 1228 (S.D.N.Y. 1978).

¹²⁷ *Id.* at 1233.

¹²⁸ *Id.* at 1239.

¹²⁹ *Id.* at 1242.

¹³⁰ *Id.* at 1243.

¹³¹ *Id.* at 1254. Presumably, even the Third Circuit would agree with the court's analysis in *Valente* since, in connection with their decision whether to tender their shares, the plaintiffs were decisionmakers with respect to the transaction in question. Furthermore, their decision to tender can readily be seen as due to the deception caused by the material nondisclosures. The nondisclosures could be equally deceptive with respect to the nontendering shareholders but their 10b-5 claim would be barred by the requirement that plaintiffs be either purchasers or sellers of securities. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975). However, such a claim might be cognizable under section 14(c)'s antifraud proscriptions for tender offers. 15 U.S.C. § 78n(c) (1976). See *Piper v. Chris-Craft Indus., Inc.*, 430 U.S. 1 (1977), discussed in the text at notes 223-25 *infra*.

the situation militates in favor of recognizing complementary jurisdiction. In this way both the federal and the state interests may be protected.

The narrow approach of *Biesenbach* has not been universally accepted by all courts in the Third Circuit. In *Healey v. Catalyst Recovery of Pa.*,¹³² the defendants, controlling shareholders who collectively owned eighty percent of CRSI stock, utilized a statutory merger to freeze out the remaining 20 percent shareholder at a "grossly inadequate *quid pro quo*."¹³³ The district court in Pennsylvania sustained the jury verdict in the plaintiff's favor.¹³⁴ Although the defendants' eighty percent was sufficient to assure the success of the merger vote, the availability of an injunction in state court, had the plaintiff been fully informed, was sufficient to satisfy both rule 10b-5's deception and causation requirements.¹³⁵ The district court noted that rule 10b-5 can be used in connection with a merger and the accompanying utilization of the proxy machinery to ensure "that shareholder approval is fairly sought and freely given."¹³⁶ The *Healey* district court supported its decision by pointing to the proper significance of the lesson to be learned from *Santa Fe*. The court stated, "once there has been full disclosure . . . the wisdom or fairness of the transaction does not implicate federal law."¹³⁷ In the case before it, however, such disclosure was lacking and the federal remedy of rule 10b-5 was available to supplement the state law. In *Healey*, as in *Goldberg, Kidwell, Wright and Alabama Farm Bureau*, the court, therefore, was willing to adopt the approach that rule 10b-5 can complement, and thus help preserve state law rights while still fulfilling its proper objective of investor protection. Although adopting the *Goldberg* rationale neither the district nor circuit court in *Healey* expressly rejected the earlier *Biesenbach* ruling.

The preceding discussion, however, should not be taken to indicate that *Santa Fe*'s deception requirement and concern over state/federal tensions have no significant impact upon preventing the abuse of the rule 10b-5 remedy to address mere corporate mismanagement. Two recent circuit court decisions highlight this point. *O'Brien v. Continental Illinois National Bank*¹³⁸ is an excellent example of the necessity that the rule 10b-5 claim be tied to investor protection and, more specifically, to the plaintiff's investment decision. In *O'Brien* the defendant trustee had been given discretionary authority to purchase and sell securities on behalf of the plaintiff pension trust funds.¹³⁹ The rule 10b-5 claim arose out of the defendant's purchase, for the plaintiff's

¹³² [Current] FED. SEC. L. REP. (CCH) ¶ 97,238 (3d Cir. 1980) reversing only on the issue of materiality. 463 F. Supp. 740 (W.D. Pa. 1979). See also *Jacobs v. Hanson*, 464 F. Supp. 777, 779, 784 (D. Del. 1979) (where misstatements concerning the sale of the corporation's assets followed by liquidation were sufficient to state a 10b-5 claim where a fully informed plaintiff might have been able to secure injunctive relief).

¹³³ 463 F. Supp. at 742.

¹³⁴ *Id.* at 744-45.

¹³⁵ *Id.* at 744.

¹³⁶ *Id.* at 743, quoting from the pre-*Santa Fe*, Second Circuit decision in *Popkin v. Bishop*, 464 F.2d 714, 720 (2d Cir. 1972).

¹³⁷ 463 F. Supp. at 743.

¹³⁸ 593 F.2d 54 (7th Cir. 1979).

¹³⁹ *Id.* at 57.

account, of securities of companies of which the defendant was a creditor.¹⁴⁰ The plaintiffs further claimed that had the conflict of interest been disclosed they would have terminated the trust relationship with the defendant.¹⁴¹ The Seventh Circuit held that no rule 10b-5 action was stated,¹⁴² and gave two bases for its ruling. First, the decision whether to terminate or to bring an action with respect to the trust agreement was not within rule 10b-5's scope since such termination is not a security transaction.¹⁴³ Second, rule 10b-5 was meant to assure the availability of full information to decisionmakers in securities transactions. Where one has entrusted those decisions to others, breaches of fiduciary duties are left to state law.¹⁴⁴

While the court in *O'Brien* could have stretched the facts to fit within the rule 10b-5 remedy; wisely it did not. The argument the court could have used is that the plaintiff was an investor, and that its derivative purchase of the securities in question was effectuated as a result of the defendant's nondisclosures. The problem with such an approach is that the plaintiff here was one step removed from the marketplace as compared with *Goldberg* and *Healey*. It follows that in attempting to be watchful for state/federal tensions, this additional element of remoteness quite properly tips the scale and mitigates against recognition of rule 10b-5 claims.

The next illustrative case demonstrates that even the Second Circuit recognizes the proper limits of the rule 10b-5 private remedy. In *Maldonado v. Flynn*¹⁴⁵ the plaintiffs alleged violations of rule 10b-5 and section 14(a) with regard to the administration of the stock option plan in a manner that benefitted certain senior officers.¹⁴⁶ The court began its analysis by stating that the requisite deception was missing in this instance.¹⁴⁷ Modification of the plan by four disinterested directors precluded a rule 10b-5 claim; there was no deception since no shareholder vote was required.¹⁴⁸ Because this procedure complied with the state law, *Santa Fe* was directly on point and the *Goldberg* decision was inapposite. The court then remanded the decision to determine whether there were material misstatements, concluding that the absence of shareholder approval did not preclude a section 14(a), rule 14a-9 claim for material misstatements in connection with the utilization of the proxy machinery.¹⁴⁹

¹⁴⁰ *Id.*

¹⁴¹ *Id.*

¹⁴² *Id.*

¹⁴³ *Id.* at 60.

¹⁴⁴ *Id.* at 63.

¹⁴⁵ 597 F.2d 789 (2d Cir. 1979). See also *Kaplan v. Bennett*, 465 F. Supp. 555 (S.D.N.Y. 1979), where the plaintiffs challenged alleged foreign and domestic bribes made by the management of GTE Corp. Although the shareholders had not been informed, knowledge of the entire board precluded a finding of the necessary deception. 465 F. Supp. at 565-66.

¹⁴⁶ 597 F.2d at 791.

¹⁴⁷ *Id.* at 793.

¹⁴⁸ *Id.* at 793-94. Compare the approach taken by the Seventh Circuit in *Wright v. Heizer Corp.*, 560 F.2d 236 (7th Cir. 1977), cert. denied, 434 U.S. 1066 (1978), discussed in the text at notes 77-87 *supra*.

¹⁴⁹ 597 F.2d at 791. See also *Weisberg v. Coastal State Gas Corp.*, [1979] FED. SEC. L. REP. (CCH) ¶ 97,168 (2d Cir. Nov. 8, 1979).

The *Maldonado* decision recognized that if the alleged improprieties arose with respect to required disclosure, the federal private remedies have a valid role to play. In subsequent years the proxy material concerning the election of directors failed to disclose the true events surrounding the amendment to the stock option plan. The Second Circuit determined that if the statements were material, this nondisclosure was actionable under the proxy rules since it related to the directors' fitness in connection with their continued reelection by the plaintiff shareholders.¹⁵⁰ This aspect of the *Maldonado* ruling is significant for two reasons. First, it correctly indicates that past violations of state law can be a valid concern of the federal securities laws as well as the future violations and the availability of prospective relief that were at issue in *Goldberg*. Second, as developed more fully below,¹⁵¹ the proxy rules and their correlative implied private right of action have an important role to play in corporate mismanagement cases.

As was previously demonstrated, the *Santa Fe* decision does not sound the death-knell for rule 10b-5 remedies in corporate mismanagement cases. Nevertheless, it is now evident that plaintiffs cannot manufacture a federal claim simply because they were injured by mismanagement that happened to touch their purchase or sale of securities.¹⁵² In particular, the post *Santa Fe* cases require that there be a substantial nexus between the injury, investor protection and the securities markets. Such a reading of rule 10b-5 both preserves the Supreme Court's concerns in *Santa Fe* and the very important enforcement and compensatory mechanism provided by the rule 10b-5 private damage action.

D. Some Additional Limiting Factors in Rule 10b-5 Mismanagement Actions

Having concluded that the courts should refrain from extending *Santa Fe* to limit even further the efficacy of the rule 10b-5 private remedy, it is useful to mention some other limiting factors, primarily concerning standing and scienter, that combine to prevent undue expansion of the implied remedy, while at the same time allowing meaningful relief in appropriate cases. The limits these factors place on the rule 10b-5 cause of action, in conjunction with an overly zealous extension of *Santa Fe*, as in *Biesenbach*,¹⁵³ demonstrate the potential unfortunate threat to the continuing vitality of this private remedy. These factors also illustrate the need to utilize complementary private remedies under the securities laws to provide a means of ensuring some continuing federal redress for corporate mismanagement. Since some of the restrictions of rule 10b-5 do not apply to these alternative remedies, such remedies may provide a meaningful way to compensate for the rule 10b-5 limitations. These alternatives will be explored later in this article.

¹⁵⁰ 597 F.2d at 791. Not every aspect of managerial misconduct is material. See, e.g., *Lewis v. Valley*, 476 F. Supp. 62 (S.D.N.Y. 1979); *Amalgamated Clothing & Textile Workers Union, AFL-CIO v. J.P. Stevens Co.*, 475 F. Supp. 328 (S.D.N.Y. 1979).

¹⁵¹ See Section III-B, *infra*.

¹⁵² *But see*, *Houlihan v. Anderson-Stokes, Inc.* 434 F. Supp. 1330 (D.D.C. 1977).

¹⁵³ 588 F.2d 400 (3rd Cir. 1978).

In addition to the limits imposed by *Santa Fe*, there are two major judicially imposed restrictions on the availability of a rule 10b-5 remedy. The first of these limits, the purchaser/seller limitation of *Blue Chip Stamps v. Manor Drug Stores*¹⁵⁴ provides that only actual purchasers or sellers of securities may avail themselves of the rule 10b-5 remedy.¹⁵⁵ Offerees who are discouraged from buying a security by fraudulent misrepresentation are not proper rule 10b-5 plaintiffs.¹⁵⁶ This limitation ensures that the rule 10b-5 remedy is limited to investors who are directly injured by fraud or nondisclosure in the marketplace.¹⁵⁷ The claims of defrauded offerees and offerors are inherently speculative; their injury does not impinge as directly on the securities markets as injury done to actual purchasers and sellers. The claims of offerors and offerees are best left to resolution by state law.

The second significant 10b-5 restriction is the requirement, imposed in *Ernst & Ernst v. Hochfelder*,¹⁵⁸ that the private damage plaintiff prove that the defendant acted with scienter.¹⁵⁹ This excludes from the rule 10b-5 private remedy a significant area of corporate mismanagement: breaches of duties of care based on merely negligent acts or omissions. Such acts and omissions do not have the required substantial nexus between injury, investor protection and the securities markets to warrant incursion into the state chartering function. The *Hochfelder* limitation serves the purpose of preserving the rule 10b-5 action in the large area of intentional wrongdoing, while at the same time ensuring that federal law does not wholly preempt the states in dealing with mere mismanagement. The scienter requirement thus relegates merely negligent offenses to the state forums or to other provisions of the federal regulatory scheme.

The *Hochfelder* decision raises a number of unanswered questions that are worth noting. To begin with, the Supreme Court did not address the issue of whether reckless conduct can satisfy the scienter requirement or whether scienter is limited to the defendant who has acted intentionally.¹⁶⁰ Nevertheless,

¹⁵⁴ 421 U.S. 723 (1975). *Blue Chip* represented the unequivocal adoption of the Second Circuit's *Birnbaum* rule which had been increasingly eroded and rejected over time. See *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir.), cert. denied, 343 U.S. 956 (1952). See generally, Fuller, *Another Demise of the Birnbaum Doctrine: "Tolls the Knell of the Parting Day?"* 25 U. MIAMI L. REV. 131 (1970); Lowenfels, *The Demise of the Birnbaum Doctrine: A New Era For Rule 10b-5*, 54 VA. L. REV. 268 (1968); Note, *Rule 10b-5: The Rejection of the Birnbaum Doctrine by Eason v. General Motors Acceptance Corp. and the Need for a New Limitation on Damages*, 1974 DUKE L. J. 610.

¹⁵⁵ 421 U.S. at 730-31.

¹⁵⁶ *Id.* at 754-55.

¹⁵⁷ The reader may wish to contrast the respective differences between rule 10b-5, the proxy rules, the Williams Act's regulation of tender offers, the Securities Act of 1933's general antifraud provision—section 17(a). See section III, *infra*.

¹⁵⁸ 425 U.S. 185 (1976).

¹⁵⁹ *Id.* at 193.

¹⁶⁰ 425 U.S. at 193-94 & n.12. See e.g., *McLean v. Alexander*, 599 F.2d 1190, 1198 (3d Cir. 1979) (in certain cases reckless conduct will satisfy the scienter requirement); *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017 (6th Cir. 1979) (recklessness will suffice).

the majority of lower courts that have dealt with the issue have opted in favor of a recklessness threshold.¹⁶¹

A second issue raised by *Hochfelder* which bears upon corporate management norms is whether the scienter limitations apply to SEC enforcement actions.¹⁶² A majority of courts have held that the limitation does not apply.¹⁶³ This conclusion conceivably could be extended to formulate an argument that *Santa Fe's* deception requirement, on its facts, is also limited to private damage actions. Such a reading of *Santa Fe*, however, would be too literal and too narrow, and would ignore the import of the *Santa Fe* Court's concerns. The importance of SEC enforcement actions should not be underestimated as a weapon against corporate mismanagement, especially in light of the Commission's ability to secure ancillary relief.¹⁶⁴ But, whereas the Commission probably should have the ability to enjoin negligent conduct, its power should not extend to conduct that is not deceptive. Negligent deceptive con-

¹⁶¹ See, e.g., *Nelson v. Serwold*, 576 F.2d 1332 (9th Cir.), cert. denied 99 S. Ct. 464 (1978); *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38 (2d Cir.), cert. denied, 99 S. Ct. 642 (1978); *Coleco Indus., Inc. v. Berman*, 567 F.2d 569 (3d Cir. 1977), cert. denied, 99 S. Ct. 106 (1978); *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1044 (7th Cir.), cert. denied, 434 U.S. 875 (1977) (all holding that recklessness will suffice). See generally, Branson, *Statutory Securities Fraud in the Post-Hochfelder Era: The Continued Viability of Modes of Flexible Analysis*, 52 TUL. L. REV. 50 (1977); Bucklo, *The Supreme Court Attempts to Define Scienter Under Rule 10b-5: Ernst & Ernst v. Hochfelder*, 29 STAN. L. REV. 213 (1977).

¹⁶² The Court expressly left this issue for future determination. 425 U.S. at 193-94 n.12. However, such a determination should be forthcoming in the near future. See *SEC v. E.L. Aaron & Co.*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,800 (2d Cir. March 12, 1979), cert. granted, 48 U.S.L.W. 3253 (Oct. 15, 1979).

¹⁶³ E.g., *SEC v. E.L. Aaron & Co.*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,800 (2d Cir. March 12, 1979), cert. granted 18 U.S.L.W. 3253 (Oct. 15, 1979); *SEC v. Savoy Indus., Inc.*, 587 F.2d 1149 (D.C. Cir. 1978), cert. denied, 99 S. Ct. 1227 (1979); *SEC v. American Realty Trust*, 586 F.2d 1001 (4th Cir. 1978); *SEC v. World Radio Mission*, 544 F.2d 535 (1st Cir. 1976); *SEC v. Universal Major Indus. Corp.*, 546 F.2d 1044 (2d Cir. 1976) cert. denied, 434 U.S. 834 (1978); *SEC v. Spectrum Ltd.*, 489 F.2d 535 (2d Cir. 1973); *SEC v. Shiell* [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,190 (N.D. Fla. 1977); But see, e.g., *SEC v. Blatt*, 583 F.2d 1325 (5th Cir. 1978).

See generally Berner & Franklin, *Scienter and Securities and Exchange Commission Rule 10b-5 Injunctive Actions: A Reappraisal in Light of Hochfelder*, 51 N.Y.U. L. REV. 769 (1976); Lowenfels, *Scienter or Negligence Required for SEC Injunctions Under Section 10(b) and Rule 10b-5: A Fascinating Paradox*, 33 BUS. LAW. 789 (1978); Maher & Blasi, *Lessons from Ernst & Ernst—Enforcement Proceedings and the Uncommon Law of 10b-5*, 82 DICK. L. REV. 1 (1977); Note, *New Light on an Old Debate: Negligence v. Scienter in an SEC Fraud Injunctive Suit*, 51 ST. JOHN'S L. REV. 759 (1977); Note, *Scienter and SEC Injunctive Actions Under Securities Act Section 17(a)*, 63 IOWA L. REV. 1248 (1978); Note, *Scienter and Injunctive Relief Under Rule 10b-5*, 11 GA. L. REV. 879 (1977); Note, *SEC Enforcement Actions to Enjoin Violations of Section 10(b) and Rule 10b-5: The Scienter Question*, 5 HOFSTRA L. REV. 831 (1977); Note, *SEC Injunctive Actions: A Negligence Standard Under Rule 10b-5*, 28 SYRACUSE L. REV. 763 (1977).

¹⁶⁴ See generally Ellsworth, *Disgorgement in Securities Fraud Actions Brought by the SEC*, 1977 DUKE L. J. 641; Farrand, *Ancillary Remedies in SEC Civil Enforcement Suits*, 89 HARV. L. REV. 1779 (1976); Note, *SEC Injunctive and Ancillary Relief Under Rule 10b-5: A Scienter Requirement?*, 1977 U. ILL. L. F. 872.

duct is still a proper concern of federal law to some extent. Conduct that does not meet the *Santa Fe* deception requirement, on the other hand, relates to problems of ordinary corporate governance which are best left to the states.¹⁶⁵

The factors discussed in this section combine with the deception requirement to define the appropriate parameters of the role of rule 10b-5 in regulating internal corporate matters. These factors combine to impose substantial limits on the availability of the rule 10b-5 remedy. The issue that remains to be considered is the effect of other implied remedies that have been recognized under the federal securities laws and the desirability of extending or limiting these remedies to provide proper recourse for wronged investors. It will be shown that many of these alternative remedies quite properly can redress wrongs that formerly were redressed under rule 10b-5, and that several of these alternatives ought to be developed to compensate for the limits placed on rule 10b-5.

III. FEDERAL ALTERNATIVES TO RULE 10b-5 ACTIONS FOR REDRESSING BREACHES OF CORPORATE FIDUCIARY DUTIES

The preceding material demonstrates that the Supreme Court in recent years has curtailed drastically the applicability of rule 10b-5 to various types of corporate mismanagement cases. Whereas some of this narrowing of the scope of the private remedy is desirable, this trend threatens to go too far and to eviscerate the ability of the federal courts to play a role in redressing breaches of corporate fiduciary duties which impinge on the securities markets. It is desirable, therefore, to examine other sections of the securities laws to see if they can fill the void left by the restriction of the rule 10b-5 action. This article will now discuss four sections of the securities laws which have played a secondary role in policing corporate mismanagement in the past: first, section 17(a) of the Securities Act of 1933—the general antifraud provi-

¹⁶⁵ *Santa Fe's* deception limitation is found in the express terms of section 10(b) whereas *Hochfelder's* scienter requirement was derived by implication from the same section; thus, *Hochfelder* leaves more room for interpretation and refinement in connection with enforcement actions. It is, therefore, possible that the scienter requirement does not apply to enforcement actions, while the deception limitation does. The Commission, however, does not appear to acquiesce in this view. See section IV *infra*. There are two other limitations on rule 10b-5's implied remedy that deserve mention. These are: (1) that the omissions or misstatements be material; and (2) that there be a sufficient causal link between the omissions or misstatements and the injury complained of. 17 C.F.R. § 240. 10b-5. In the corporate deception cases, assuming that the decisionmakers are fully informed, the causation requirement is not met where the shareholders could not have taken any preventive steps. See, e.g., *Wright v. Heizer Corp.*, 560 F.2d 236 (7th Cir. 1977), *cert. denied*, 434 U.S. 1066 (1978); *Altman v. Knight*, 431 F. Supp. 309 (S.D.N.Y. 1977). See also *Hazen, Corporate Chartering and the Securities Markets: Shareholder Suffrage, Corporate Responsibility, and Management Accountability*, 1978 Wisc. L. REV. 391, 418-27. Conversely, if the shareholders could have enjoined the transaction, there is sufficient causal link between the nondisclosure and the alleged injury to permit recovery under rule 10b-5. See, e.g., *Goldberg v. Meridor*, 567 F.2d 209 (2d Cir. 1977), *cert. denied*, 434 U.S. 1069 (1978); *SEC v. Parklane Hosiery Co.*, 558 F.2d 1083 (2d Cir. 1977); *Jacobs v. Hanson*, 464 F. Supp. 777 (D. Del. 1979); *Healey v. Catalyst Recovery of Pennsylvania*, 463 F. Supp. 740 (W.D. Pa. 1979).

sion,¹⁶⁶ second, section 14(a) of the Securities Exchange Act of 1934¹⁶⁷—which prohibits fraud in connection with the solicitation of proxies and rule 14a-9 developed thereunder,¹⁶⁸ third, section 14(e) of the Securities Exchange Act¹⁶⁹—the antifraud provision in the tender offer area, and fourth, section 18(a) of the 1934 Act¹⁷⁰—an antifraud provision explicitly giving a private civil remedy. These alternative remedies will be examined to see how they are, or are not, bound by the aforementioned limitations on the rule 10b-5 action—the purchaser/seller, scienter and deception requirements. This section will discuss whether an expansion of private rights under these statutes is both possible and desirable in view of the Supreme Court's concern with federal/state tensions. The limitations that are inherent in these remedies will bring into focus the undesirability of further restriction of the rule 10b-5 remedy, and of blindly carrying over the restrictions to other federal remedies.

A. Section 17(a) of The Securities Act of 1933:
The General Antifraud Provision

When the SEC promulgated rule 10b-5, it patterned the rule on section 17(a)'s general antifraud proscriptions.¹⁷¹ Although the Supreme Court has not decided the question, the overwhelming majority of lower courts that have considered the issue have recognized an implied private remedy under section 17(a).¹⁷² Since the Supreme Court's rule 10b-5 limitations are relatively recent the courts are just beginning to consider the potential of section 17(a) as a meaningful alternative and supplement to rule 10b-5.

¹⁶⁶ 15 U.S.C. § 77q(a) (1976). For a more extensive treatment of section 17(a) remedies, see Hazen, *A Look Beyond the Pruning of Rule 10b-5: Implied Remedies and Section 17(a) of the Securities Act of 1933*, 64 VA. L. REV. 641 (1978); Horton, *Section 17(a) of the 1933 Securities Act—The Wrong Place for a Private Right*, 68 NW. U. L. REV. 44 (1973); Comment, *Section 17(a) of the 1933 Securities Act: An Alternative to the Recently Restricted Rule 10b-5*, 9 RUT. CAM. L.J. 340 (1978).

¹⁶⁷ 15 U.S.C. § 78n(a) (1976).

¹⁶⁸ 17 C.F.R. § 240.14a(9) (1979).

¹⁶⁹ 15 U.S.C. § 78n(e) (1976).

¹⁷⁰ 15 U.S.C. § 78r(a) (1976). In addition to these four general antifraud remedies, the more limited remedies of the Securities Act of 1933 deserve mention: Section 11 of the 1933 Act gives an express private remedy to purchasers injured by misstatements in connection with prospectuses required by § 5 of the Act. 15 U.S.C. 77k (1976). Similarly, section 12 provides two express remedies for defrauded purchasers. Section 12(1) grants a cause of action to purchasers of securities sold in violation of § 5 of the Act, 15 U.S.C. § 77e (1976)—the Act's registration requirement. 15 U.S.C. § 77i (1) (1976). Section 12(2) provides an express fraud remedy for even negligent misconduct but imposes a strict privity requirement. 15 U.S.C. 77l(2) (1976).

¹⁷¹ See 1 A. BROMBERG, *SECURITIES LAW FRAUD: SEC RULE 10b-5* § 2.2(410) (1970).

¹⁷² See, e.g., *Daniel v. International Bhd. of Teamsters*, 561 F.2d 1223 (7th Cir. 1978), *rev'd on other grounds*, 99 S. Ct. 570 (1979); *Newman v. Prior*, 518 F.2d 97 (4th Cir. 1975); *Lanza v. Drexel & Co.*, 479 F.2d 1277, 1280 n.2 (2d Cir. 1973); *Smith v. Jackson Tool & Die, Inc.*, 419 F.2d 152 (5th Cir. 1969). See also *Cook v. Avien, Inc.*, 573 F.2d 685, 698 n.30 (1st Cir. 1978). But see, e.g., *Shull v. Dain, Kalman & Quail, Inc.*, 561 F.2d 152, 155, 159 (8th Cir. 1977), *cert. denied*, 434 U.S. 1086 (1978).

There are three significant differences between the 1933 Act section and the 1934 Act rule. First, section 17(a) on its face applies to offers and sales,¹⁷³ while rule 10b-5 speaks in terms of a "purchase or sale."¹⁷⁴ It was this language in rule 10b-5 that led the Court in *Blue Chip Stamps* to adopt its standing limitation.¹⁷⁵ Section 17(a)'s different wording indicates that it has a different standing limitation. In fact, post-*Blue Chip Stamps* decisions have held that an offeree who does not purchase the securities may maintain a private damage action under section 17(a).¹⁷⁶ The policies underlying the securities laws as well as the implying of private remedies thereunder both favor such a result.¹⁷⁷ This rule necessarily enlarges the number of potential plaintiffs and, if section 17(a) is applicable to corporate mismanagement cases, increases the scope of the federal remedy to the extent that the plaintiff is either directly or derivatively an offeree of securities. While section 17(a) applies to offerees, however, it would not appear to apply to sellers of securities. They, of course, can rely on rule 10b-5. Therefore, instead of a purchaser/seller limitation, section 17(a) has a purchaser/offeree limitation. Nevertheless, in its application to offerees, section 17(a) can, perhaps, be used to fill a portion of the gap in rule 10b-5 coverage created by *Blue Chip Stamps*.

The second divergence between the language of section 17(a) and rule 10b-5 allows for a similar expansion of the 1933 Act remedy. Section 17(a), unlike Section 10(b) of the Exchange Act, does not contain the requirement that the proscribed conduct be manipulative or deceptive. Indeed, the *Hochfelder* Court observed that the text of rule 10b-5 itself does not appear to mandate a scienter requirement.¹⁷⁸ The scienter limitation was found implicit in rule 10b-5 in order to bring it into conformity with section 10(b).¹⁷⁹ Since the language of section 17(a) is identical to that in rule 10b-5, it also does not mandate a scienter requirement.¹⁸⁰ While a number of courts have used this reasoning to find that there is no scienter requirement in SEC enforcement actions under section 17(a),¹⁸¹ only one court has expressly adopted this approach in private suits.¹⁸² It goes without saying that such a no-scienter rule, if accepted, would, like the more relaxed standing rule, be a substantial boon to the private plaintiff in section 17(a) cases.

¹⁷³ 15 U.S.C. § 77q(a) (1976).

¹⁷⁴ 15 U.S.C. § 77j(b) (1976).

¹⁷⁵ 421 U.S. at 733-36.

¹⁷⁶ See *Bosse v. Crowell Collier & MacMillan*, 565 F.2d 602, 610 n.12 (9th Cir. 1977) (dicta); *Reid v. Madison*, 438 F. Supp. 332 (E.D.Va. 1977); *Wulc v. Gulf & Western Indus., Inc.*, 400 F. Supp. 99 (E.D.Pa. 1975).

¹⁷⁷ See *Hazen*, *supra* note 166, at 659-66.

¹⁷⁸ 425 U.S. at 195-201.

¹⁷⁹ *Id.*

¹⁸⁰ See, e.g., *Nassar & Co. v. SEC*, 566 F.2d 790, 793-94, (D.C. Cir. 1977).

¹⁸¹ See, e.g., *SEC v. Coven*, [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,462 (2d Cir. June 2, 1978); *SEC v. American Realty Trust Co.*, 586 F.2d 1001 (4th Cir. 1978); *Nassar & Co. v. SEC*, 566 F.2d 790 (D.C. Cir. 1977); *SEC v. World Radio Mission, Inc.*, 544 F.2d 535, 541 n.10 (1st Cir. 1976).

¹⁸² *Campito v. McManus*, [Current] FED. SEC. L. REP. (CCH) ¶ 96,874 at 95,574-75 (N.D.N.Y. April 20, 1979) (indicating that this is the accepted rule of the Second Circuit); *contra*, *Sanders v. John Nuveen & Co.*, 554 F.2d 790 (7th Cir. 1977);

The third difference between section 17(a) and rule 10b-5 is that because of differing jurisdictional provisions in the 1933 and 1934 Acts, there is concurrent jurisdiction in the state courts for section 17(a) suits, while rule 10b-5 claims remain exclusively federal.¹⁸³ This is significant to the issue at hand in light of the *Santa Fe* Court's concern over state/federal tensions.¹⁸⁴ The duality of jurisdictional approaches is a two-edged sword. On the one hand it could be argued that the concurrent jurisdiction of section 17(a) would exacerbate the tension since federal courts would be mandating state court rules in mismanagement cases. It then would follow that the concerns of *Santa Fe* would be safeguarded by keeping the federal courts out of the section 17(a) arena and by allowing the state courts to fashion their own section 17(a) mismanagement remedies, should they so desire. On the other hand, limiting the federal mismanagement remedy to rule 10b-5 arguably would close the door to a potentially helpful input from the states in terms of their section 17(a) jurisprudence. In view of the Court's concern for state input in regulating corporate management, this result would not be beneficial. These three considerations demonstrate, therefore, that section 17(a) could become a valuable tool in compensating for the limitations placed on rule 10b-5 actions, while also complying with the spirit of the rule in *Santa Fe*.

There are, however, two factors which militate against using section 17(a) to fill the gap left by the recent limitations imposed on the rule 10b-5 cause of action. First, while section 17(a) has an important role to play as a private remedy, its availability should be limited to the securities distribution process, as distinct from rule 10b-5's broader trading concerns.¹⁸⁵ The 1933 Act is concerned solely with the securities distribution process, while the 1934 Act deals with trading. Section 17(a) should not be expanded beyond the parameters of the general design of which it is but a part.¹⁸⁶

Wiener v. Oppenheimer & Co., FED. SEC. L. REP. (CCH) ¶ 96,764 (S.D.N.Y. Feb. 5, 1979); Malik v. Universal Resources, Corp., 425 F. Supp. 350 (S.D. Cal. 1976). See generally, Hazen, *supra* note 166 at 666-77.

¹⁸³ Compare 15 U.S.C. § 77v (1976) with 15 U.S.C. § 78a(a) (1976) (§ 26 of the 1934 Act). A number of state courts have exercised section 17(a) jurisdiction and recognized the private remedy. See, Wolfson v. Ubile, [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,280 (N.Y. Sup. Ct. 1977); Alloys Unlimited v. Raesler, [1976-77 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,639 (N.Y. Sup. Ct. 1976), *aff'd*, 55 App. Div.2d 893, 391 N.Y.S.2d 371 (1977); Unit, Inc. v. Kentucky Fried Chicken Corp., 304 A.2d 320 (Del. Super. Ct. 1973); Barnes v. Peat, Marwick, Mitchell & Co., 64 Misc. 2d 1068, 332 N.Y.S.2d 281 (Sup. Ct. 1972), *modified on other grounds*, 42 App. Div.2d 15, 344 N.Y.S.2d 645 (1973).

¹⁸⁴ See text accompanying notes 67-68 *supra*.

¹⁸⁵ See Hazen, *supra* note 166, at 688.

¹⁸⁶ *Id.* A section 17(a) ruling that deserves mention is the Supreme Court's recent decision in *U.S. v. Naftalin*, 99 S. Ct. 2077 (1979). The *Naftalin* Court ruled that section 17(a) can be utilized where the ultimate injury was suffered by broker-dealers rather than investors. This at first seems to be a drastic departure from the Court's earlier concerns of limiting the applicability of statutory remedies to investor protection situations. See, e.g., *Piper v. Chris-Craft, Inc.* 430 U.S. 1 (1977). However, the Securities Exchange Act also regulates the brokerage industry (e.g., 15 U.S.C. § 780 (1976)). There is thus an additional interest to be protected in governmental enforce-

Second, the recent case of *Touche Ross v. Reddington*¹⁸⁷ can be taken to indicate that if the issue were put to it today, the Supreme Court very well might limit severely, if not altogether deny, the implied remedy under section 17(a) of the 1933 Act. The *Touche Ross* opinion severely cut back on the prior jurisprudence in the field, declaring that the implication of a private remedy is purely a question of statutory construction. The Court indicated that there is a presumption against implying a private remedy unless it affirmatively appeared that Congress intended to create one.¹⁸⁸ Since the Court has recognized the 10b-5 remedy, however, the same congressional intent that justifies relief based on this administrative rule would call equally for recognition of a right of action under the parent statutory provision that was legislatively adopted in section 17(a) of the 1933 Act.¹⁸⁹

There can be no question that the recent Supreme Court decisions under the securities laws,¹⁹⁰ as well as in other areas,¹⁹¹ demonstrate that private remedies will not be lightly implied from federal criminal statutes. This should not be taken, however, as an indication that the Court has placed a moratorium on implied remedies. The Court in *Touche Ross* was concerned with the creation of a wholly new area of liability when viewed in conjunction with the express and implied remedies that now exist.¹⁹² In contrast, the remedy provided by section 17(a) of the 1933 Act complements those provided by the other antifraud provisions, and, thus, its recognition would be consistent with the Court's recent teachings.

Nevertheless, section 17(a)'s viability as an alternative to the rule 10b-5 remedy has not been tested yet by a sufficient number of courts or by the Supreme Court. Although it certainly would be premature at this time to discount its potential relevance to corporate mismanagement cases, all that safely can be said now is that it is a factor that should be considered. Section 17(a) could have a valuable role to play as an implied remedy. Indeed, this potential was recently realized by the District Court for the Southern District of New York which noted that "[T]he absence of deceptive conduct does not dispose of all the securities law claims, because section 17(a) of the 1933 Act is in many respects broader than section 10(b) of the 1934 Act."¹⁹³

ment suits that is not implicated in private damage actions. See *Touche Ross & Co. v. Reddington*, 99 S. Ct. 2479 (1979) (denying the existence of an implied remedy under section 17(a) of the 1934 Securities Exchange Act).

¹⁸⁷ 99 S. Ct. 2479 (1979).

¹⁸⁸ 99 S. Ct. at 2485-86.

¹⁸⁹ See *Cannon v. University of Chicago*, 99 S. Ct. 1946 (1979).

¹⁹⁰ See, e.g., *Touche Ross v. Reddington*, 99 S. Ct. 2479 (1979); *Piper v. Chris-Craft Industries, Inc.*, 430 U.S. 1 (1977).

¹⁹¹ See, e.g., *Cannon v. University of Chicago*, 99 S. Ct. 1946 (1979). See generally Note, *Implying Private Causes of Action from Federal Statutes: Amtrack and Cort Apply the Brakes*, 17 B.C. IND. & COMM. L. REV. 53 (1975).

¹⁹² 99 S. Ct. at 2486-88. Similarly, in *Cannon* the opinion merely showed a refusal to tread into new areas without a sufficient indication of legislative intent or remedial benefits to be gained from such a venture. 99 S. Ct. at 1960-61, 1967-68.

¹⁹³ *Klamberg v. Roth*, 473 F. Supp. 544, 556 (S.D.N.Y. 1979). The court went on to dismiss the section 17(a) claim for failure to satisfy that section's "in connection with" requirement. *Id.* at 556.

*B. Rule 14a-9¹⁹⁴ and Section 14(a)¹⁹⁵ of the
Exchange Act: The Role of the Proxy Rules
in Regulating Mismanagement*

In comparison with the uncertain role of section 17(a), the implied private remedy under the antifraud provisions that cover the federal regulation of the proxy machinery already have an identifiable, significant impact upon corporate conduct.¹⁹⁶ Section 14(a), and, hence, any private remedy thereunder, is limited in scope to issuers whose securities are subject to the Exchange Act's periodic reporting requirements.¹⁹⁷ This limitation is in contrast to the more general antifraud provisions contained in section 17(a) of the 1933 Act, rule 10b-5 and section 14(e), of the Exchange Act,¹⁹⁸ which all

¹⁹⁴ 17 C.F.R. § 240.14a-9 (1979).

¹⁹⁵ 15 U.S.C. § 78n(a) (1976).

¹⁹⁶ Rule 14a-9 provides:

(a) No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting, or other communication, written or oral, containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading.

(b) The fact that a proxy statement, form of proxy or other soliciting material has been filed with or examined by the Commission shall not be deemed a finding by the Commission that such material is accurate or complete or not false or misleading, or that the Commission has passed upon the merits of or approved any statement contained therein or any matter to be acted upon by security holders. No representation contrary to the foregoing shall be made.

NOTE: The following are some examples of what depending upon particular facts and circumstances may be misleading within the meaning of this section.

(a) Predictions as to specific future market values or dividends.

(b) Material which directly or indirectly impugns character, integrity, or personal reputation, or directly or indirectly makes charges concerning improper, illegal or immoral conduct or associations, without factual foundation.

(c) Failure to so identify a proxy statement, form of proxy and other soliciting material as to clearly distinguish it from the soliciting material of any other person or persons soliciting for the same meeting or subject matter.

(d) Claims made prior to a meeting regarding the results of a solicitation.

17 C.F.R. § 240.14a-9 (1979).

It is now beyond question that an implied private remedy exists under rule 14a-9. *See, e.g.,* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438 (1976); Mills v. Electric Auto-Lite Co., 396 U.S. 375 (1970); J.I. Case Co. v. Borak, 377 U.S. 426 (1964). *See generally* E. ARANOW & H. EINHORN, PROXY CONTESTS FOR CORPORATE CONTROL (2d ed. 1968); 2 L. LOSS, SECURITIES REGULATION 931-1019 (2d ed. 1961).

¹⁹⁷ *See* note 88 *supra*.

¹⁹⁸ Section 14(e) applies 10b-5 type proscriptions to communications sent in connection with a tender offer. 15 U.S.C. § 78n(e). *See* text accompanying notes 222-43 *infra*.

apply to any issuer whose securities are traded through instrumentalities of interstate commerce.¹⁹⁹ This narrower scope of section 14(a) limits its efficacy as a replacement for rule 10b-5 and underscores the danger in overly limiting the rule 10b-5 private remedy. On the other hand, it will be demonstrated that section 14(a) is not subject to some of the limitations that recently have been imposed on rule 10b-5. Accordingly, section 14(a) can serve as a complement to rule 10b-5 actions to preserve a role for federal intervention in the area of corporate mismanagement that avoids the scylla of federal abdication and the charibdis of creating an unwarranted federal corporate law.

In their regulation of shareholder suffrage, federal proxy rules come into close contact with the corporate chartering function.²⁰⁰ It follows that the state/federal tensions that concerned the Supreme Court in *Santa Fe* are most sensitive when dealing with the implied private remedy under rule 14a-9. Because of its concern with shareholder democracy and the investors' right to full information when voting their shares, a rule 14a-9 action is not subject to the *Blue Chip Stamps* purchaser/seller standing limitation.²⁰¹ Similarly, there have been both pre²⁰² and post²⁰³ *Hochfelder* decisions that have upheld a negligence standard in a rule 14a-9 action, notwithstanding the more stringent scienter requirement of rule 10b-5. Finally as is the case with section 17(a) of the 1933 Act, there is no statutory requirement that the conduct at issue be either "manipulative" or "deceptive."²⁰⁴ Hence, at least with its most literal reading *Santa Fe*, as well as *Hochfelder*, has no applicability to rule 14a-9 actions,²⁰⁵ and although the Supreme Court's concerns regarding federal/state tensions necessarily spill over to the proxy rules, the utility of the 14a-9 remedy for corporate mismanagement should not be undercut, especially in view of the weakening of the rule 10b-5 cause of action.

It is important to bear in mind that the areas covered by the proxy rules are limited. In addition to applying only to Exchange Act reporting issuers,²⁰⁶ section 14(a) necessarily applies only to the types of questions that are brought to the shareholder for a vote. Corporate statutes all contain a mandate to the

¹⁹⁹ See generally R. JENNINGS & H. MARSH, *SECURITIES REGULATION: CASES AND MATERIALS* 857-58, 872-75 (4th ed. 1977).

²⁰⁰ See generally E. ARANOW & H. EINHORN, *supra* note 196; ARMSTRONG, *Regulation of Proxy Contests by the SEC*, 42 VA. L. REV. 1975 (1956); EMERSON & LATCHAM, *The SEC Proxy Proposal Rule: The Corporate Gadfly*, 19 U. CHI. L. REV. 807 (1952); HAZEN, *Corporate Chartering and the Securities Markets: Shareholder Suffrage, Corporate Responsibility and Managerial Accountability*, 1978 WIS. L. REV. 391; SCHWARTZ, *The Public Interest Proxy Context: Reflections on Campaign GM*, 69 MICH. L. REV. 419 (1971); SCHWARTZ & WEISS, *An Assessment of the SEC Shareholder Proposal Rule*, 65 GEO. L.J. 635 (1977).

²⁰¹ See authorities cited in note 196 *supra*.

²⁰² *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281 (2d Cir. 1973).

²⁰³ *Gould v. American-Hawaiian Steamship Co.*, 535 F.2d 761 (3d Cir. 1976).

²⁰⁴ 15 U.S.C. § 78n(a) (1976).

²⁰⁵ *Id.* See note 88 *supra*. The same can be said of section 14(e)'s tender offer proscriptions which are discussed in the text at notes 222-43 *infra*. See note 228 *infra*.

²⁰⁶ See 15 U.S.C. § 78l (1976).

effect that the business of the corporation is managed by the board of directors.²⁰⁷ This mandate excludes a large number of mismanagement cases from the rule 14a-9 remedy. Though these limitations on rule 14a-9 illustrate the need for preserving the effectiveness of rule 10b-5, there are several important areas of corporate mismanagement that properly can be redressed by the proxy rules. The following discussion illustrates the different areas in which the proxy rules have a valuable role to play.

Most of the important proxy cases have arisen within the context of organic corporate changes, such as merger or consolidation, which require a shareholder vote.²⁰⁸ Since such corporate reorganizations generally provide for an exchange or other disposition of the stockholders' shares, rule 10b-5's proscriptions also will apply to the reorganization. It is quite common, therefore, for injured shareholders to seek relief under both rules.²⁰⁹ Since the rule 14a-9 remedy has different standing and fault requirements, this implied remedy may give relief where a rule 10b-5 claim may fail. Also, since mergers and other organic corporate changes frequently involve statutory appraisal rights for dissenting shareholders,²¹⁰ the actions will bring the *Santa Fe* state law issue into sharp focus. Specifically, the federal/state tension which underlies much of the *Santa Fe* holding attaches to any proxy related claim in which the minority does not receive its fair share. In contrast to *Santa Fe*, however, the proxy related issue should be resolved in favor of the plaintiff due to the absence in section 14(a) of a requirement of "manipulative" or "deceptive" conduct.

Beyond the merger context, the proxy machinery can be important in another area of organic corporate changes—the issuance of additional shares. In order to issue stock, such shares must be authorized by the shareholder-

²⁰⁷ ABA-ALI MODEL BUS. CORP. ACT § 35.

²⁰⁸ See, e.g., *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438 (1976); *Nills v. Electric Auto-Lite Co.*, 396 U.S. 375 (1970); *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374 (1974), *cert. denied*, 421 U.S. 976 (1975); *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281 (2d Cir. 1973). See generally E. ARANOW & H. EINHORN, note 196 *supra*.

It is universal that shareholders have the right to vote in such transactions. See, e.g., ABA-ALI MODEL BUS. CORP. ACT §§ 73, 79, 84; DEL. CODE tit. 8, § 251 (Cum. Supp. 1978) (requiring a majority vote); N.Y. BUS. CORP. LAW § 903 (McKinney Cum. Supp. 1978-79) (requiring a two-thirds majority for approval). Cf. ABA-ALI MODEL BUS. CORP. ACT § 75 (the "short form" merger provision, providing that no shareholder vote is necessary when merging on a ninety percent owned subsidiary into its parent corporation; Delaware's counterpart to this provision was at issue in *Santa Fe*).

²⁰⁹ See, e.g., *Schlick v. Penn-Dixie Cement Co.*, 507 F.2d 374 (1974), *cert. denied*, 421 U.S. 976 (1975). The complimentary effect of these provisions has been recognized by the Supreme Court:

[T]he existence or nonexistence of regulation under § 14 would not affect the scope of § 10(b) and Rule 10b-5. The two sections of the Act apply to different sets of situations. Section 10(b) applies to all proscribed conduct in connection with a purchase or sale of any security; § 14 applies to all proxy solicitations [involving Exchange Act reporting companies], whether or not in connection with a purchase or sale. *The fact that there may well be some overlap is neither unusual nor unfortunate.*

SEC v. National Securities, Inc., 393 U.S. 453, 468 (1969) (emphasis supplied).

²¹⁰ ABA-ALI MODEL BUS. CORP. ACT § 81.

ers;²¹¹ only after this authorization does control over the issuance of the stock rest in the hands of the directors.²¹² In many instances, in order to give the directors a freer hand in managing the business affairs, corporations have adopted a policy of retaining a substantial reserve of authorized but unissued shares. When this is not the case, however, rule 14a-9 may come into play if the directors attempt to raise corporate capital by increasing equity ownership.

The next area in which the proxy rules' antifraud remedy has a valuable role to play is with respect to the election of directors. This area clearly illustrates the thesis that private remedies under the federal securities laws are not appropriate in every instance of corporate misconduct, but only in instances where that misconduct is the result of deception in regard to required disclosure. In its recent decision in *Maldonado v. Flynn*,²¹³ the Second Circuit recognized a rule 14a-9 mismanagement claim for management's failure to disclose past misconduct by the directors standing for reelection.²¹⁴ Significantly, the misconduct creating the basis for the proxy rule claim in itself did not give rise to either a rule 10b-5 or a rule 14a-9 claim at the time of the occurrence.²¹⁵ The effect of this reasoning on federal corporate mismanagement litigation should not be underplayed. Since all directors who desire to continue in office must stand for reelection by the shareholders, all past acts of mismanagement or, perhaps more broadly, those acts that are merely questionable would be subject to required disclosure, provided they met the necessary materiality threshold.²¹⁶ Since the directors' past performance is germane to their reelection, materiality would seem to be easy to prove in many such situations.

The use of director elections as the basis for federal mismanagement claims is an especially timely issue in light of the SEC's new corporate governance rules that compel disclosure of specific information relating to the directors' past conduct in office.²¹⁷ The command for affirmative disclosure resolves any doubt as to materiality of the past conduct, and since a rule 14a-9 remedy does not have the stringent but-for causation requirement²¹⁸ con-

²¹¹ ABA-ALI MODEL BUS. CORP. ACT § 15. In contrast to equity securities, such shareholder action is not required to issue bonds or other debt instruments.

²¹² ABA-ALI MODEL BUS. CORP. ACT §§ 16, 18, 19.

²¹³ 597 F.2d 789 (2d Cir. 1979). See text at notes 145-51 *supra*.

²¹⁴ *Id.* at 796-98.

²¹⁵ *Id.* at 795.

²¹⁶ See text at notes 153-165 *supra*.

²¹⁷ See, e.g., Sec. Act. Rel. No. 33-5949 (July 28, 1978); Sec. Exch. Act. Rel. No. 34-14970 (July 17, 1978). For example, it is now required that the proxy materials contain disclosure of director committee membership and attendance. See Schedule 14A Item 6(d) 3 FED. SEC. L. REP. (CCH) ¶ 24,037.

²¹⁸ It is no defense that the defendant controlled sufficient votes to assure the success of the proposal in question; the key is the integrity of the voting process. See, e.g., *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 382-83 (1970); *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374, 382-84 (2d Cir. 1974), *cert. denied*, 421 U.S. 976 (1975); *Eymar Corp. v. Getty Oil Co.*, [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,358 (C.D. Cal. 1978).

tained in rule 10b-5, rule 14a-9 should become an extremely important weapon against mismanagement that may be utilized more frequently due to the restrictions on the rule 10b-5 remedy.²¹⁹

In light of the existence of rule 14a-9's more expansive standing²²⁰ and causation²²¹ requirements, coupled with the no-scienter trend, the proxy rule's implied remedy may prove most significant in permitting federal corporate mismanagement claims to survive *Santa Fe*. As was pointed out at the outset of this section, however, since the proxy regulation has a larger overlap with corporate management norms than does rule 10b-5, the potential for conflict between the proxy regulations and state corporate norms is even greater. Accordingly, in dealing with the proxy rules, the courts should be especially vigilant to look for investor protection issues, and not to utilize rule 14a-9 as a back-door to creating a body of federal corporate law. Actions

In order to be actionable the violation must result in injury connected *directly* to the proxy system for a 14a-9 action or in connection with a purchase or sale in a 10b-5 action. That is, collateral breaches of fiduciaries will not suffice. See *Cramer v. Gen'l Tel. & Elec. Co.*, 582 F.2d 259 (3d Cir. 1978), *cert. denied*, 99 S. Ct. 1948 (1979); *Ketchum v. Green*, 557 F.2d 1022 (3d Cir. 1977), *cert. denied*, 434 U.S. 940 (1977), (insufficient connection); *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374 (2d Cir. 1974), *cert. denied*, 421 U.S. 976 (1975) (sufficient connection); *In re Tenneco Securities Litigation*, 449 F. Supp. 528 (S.D. Tex. 1978) (insufficient connection); *Sup't of Ins. v. Freedman*, 443 F. Supp. 628 (S.D.N.Y. 1977) (insufficient connection); *Herman v. Beretta*, [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,574 (S.D.N.Y. Oct. 10, 1978) (same). See text at note 101 *supra*.

²¹⁹ Section 13(b)(2) of the Securities Exchange Act, 15 U.S.C. § 78m(b)(2) (1976, Supp. 1979), poses similar disclosure problems. See generally ABA Committee on Corporate Law and Accounting, *A Guide to the New Section 13(b)(2) Accounting Requirements of the Securities Exchange Act of 1934*, 34 BUS. LAW. 307 (1978). See also Akesson, Bialkin, Chenok, Ferrara, Pitt, Richard & Stevenson, *Foreign Corrupt Practices of 1977 and The Regulation of Questionable Payments*, 34 BUS. L. 623 (1979). Section 13(b)(2), which is not limited to foreign involvement, requires accurate accounting of corporate assets and their disposition as well as the imposition of internal controls to assure that management's policies are being carried out. Even though the question of an implied 13(b)(2) remedy is at best a speculative one, particularly in light of *Touche Ross*, (see Akesson *et al. supra*, at 639), disclosure may be required through the proxy machinery as well as by any periodic reports required by the Act. While any 10b-5 claim based upon related misstatements in an annual report would require a causally related purchase or sale, misstatements of 13(b)(2) issues in the proxy process make 14a-9's mismanagement remedy even more meaningful. See text at notes 264-68 *infra*.

One final aspect of the proxy process that deserves mention is the treatment of shareholder proposals. Rule 14a-8, while purporting to defer to state law on the issue of what constitutes a proper shareholder matter, gives specific guides for management's treatment of shareholder sponsored resolutions. 17 C.F.R. § 240.14a-8 (1979). Although there has been no recognition of a private remedy under the shareholder proposal rules, the potential rule 14a-8 cause of action has a role to play. In deciding whether to omit a shareholder proposal from the proxy materials, there is the question whether such omission would be material under the antifraud rules. Secondly, when management does include such a proposal and states its opposition, the reasons advanced therefore are subject to rule 14a-9 scrutiny. Once again, the interplay between the implied federal remedy and internal corporate governance becomes evident.

²²⁰ See text at note 201 *supra*. Any shareholder who has a right to participate in the proxy process is a potential plaintiff.

²²¹ See note 218 *supra*, and accompanying text.

under rule 14a-9, therefore, should be used to prevent undue restriction of the federal securities law's private remedies, but such action should be limited so as not to infringe on the states' regulation of corporate activity.

*C. Section 14(e):²²² The Antifraud Proscriptions
in the Tender Offer Area*

Section 14(e) essentially prescribes rule 10b-5 penalties for fraud in required disclosure in the tender offer area. Like sections 17(a) and 14(a), section 14(e) may not be subject to the recent limitations imposed on the rule 10b-5 remedy. Accordingly, section 14(e), to some extent, also can be used to fill the gap created by these limitations. On the other hand, section 14(e)'s viability as an alternative to rule 10b-5 is limited by virtue of its applicability only in the tender offer area. The following section will explore the issues raised by section 14(e) and evaluate its potential to compensate for the restrictions placed on rule 10b-5.

In *Piper v. Chris-Craft Industries, Inc.*²²³ the Supreme Court ruled that section 14(e) does not provide a cause of action in the hands of a defeated competing tender offeror.²²⁴ Although the Court did not decide the issue, its opinion holds out much hope for the recognition of a section 14(e) claim in the hands of the shareholders of the target company. The essence of the Court's rationale was that the securities laws' purpose was to further investor protection and that the target company shareholders, not the plaintiff competing tender offeror were within the ambit of the intended protection.²²⁵ With the desirable recognition of such a claim²²⁶ there are definite ramifications

²²² 15 U.S.C. § 78n(e) (1976):

It shall be unlawful for any person to make any untrue statement of a material fact or to omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer or request or invitation for tenders, or any solicitation of security holders in opposition to or in favor of any such offer, request, or invitation. The Commission shall, for the purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative.

²²³ 430 U.S. 1 (1977).

²²⁴ *Id.* at 41-42.

²²⁵ *Id.* at 31-34. The court held that recognized principles of implying federal rights of action did not warrant the remedy sought by the *Piper* plaintiff. *Id.* at 33. See generally, Hazen, *Corporate Chartering and The Securities Markets: Shareholder Suffrage, Corporate Responsibility and Managerial Accountability*, 1978 WIS. L. REV. 391; Pitt, *Standing to Sue Under the Williams Act After Chris-Craft: A Leaky Ship on Troubled Waters*, 34 BUS. LAW. 117 (1978).

²²⁶ See, e.g., *Seaboard World Airlines, Inc. v. Tiger International, Inc.*, [current] FED. SEC. L. REP. (CCH) ¶ 96,877 (2d Cir. May 18, 1979) (recognizing the 14(e) remedy but finding no substantive violation). See also *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579 (5th Cir.) cert. denied 419 U.S. 873 (1974); *H.K. Potter Co. v. Nicholson File Co.*, 482 F.2d 421 (1st Cir. 1973); *Electronic Specialty Co. v. International Controls Corp.*, 409 F.2d 937 (2d Cir. 1969); *Crane v. American Standards, Inc.*, 439 F. Supp. 945 (S.D.N.Y. 1977). See generally Pitt, *supra* note 207, at 129-33, 186-91.

with regard to the regulation of corporate mismanagement. In the first instance, since section 14(e) requires the claim to arise in connection with tender offers, in contrast to rule 10b-5's concern for purchases and sales of securities, the *Blue Chip Stamps* purchaser/seller limitation would not apply. Instead, a section 14(e) claim is based on whether the plaintiff was the target of a tender offer solicitation or was in opposition to a tender offer.²²⁷

Similarly, as is the case with both section 17(a) of the 1933 Act and rule 14a-9, the language of section 14(e) arguably could cover merely negligent conduct, even in light of *Hochfelder's* rule 10b-5 scienter requirement.²²⁸ While courts have applied a negligence standard under both section 17(a)²²⁹ and rule 14a-9,²³⁰ this does not appear to be happening with section 14(e).²³¹ Unlike sections 17(a) and 14(a), section 14(e) contains the "manipulative and deceptive" language²³² that the *Hochfelder* court felt mandated a scienter requirement for section 10(b) and rule 10b-5, promulgated thereunder. It is likely, therefore, that a scienter standard should apply to section 14(e). For similar reasons the deception requirement also should apply here. In fact, there has been at least one court that has applied the *Santa Fe* deception requirement to a section 14(e) private damage claim.²³³ Nevertheless, despite these potential limits, there are a number of areas in which section 14(e) has a valid role to play.

During the course of a takeover attempt there are a number of ways in which the directors of the target company can be implicated for mismanagement in such a manner as to give the target's shareholders a potential section 14(e) claim. In the first instance there is the situation where a take-over attempt, to which existing management is friendly, comes in the form of a tender offer.²³⁴ In such a case, as with management supported mergers and the

²²⁷ See authorities cited in note 208 *supra*.

²²⁸ 15 U.S.C. § 78n(e) (1976). The Supreme Court based its decision in *Hochfelder* at least partially upon the manipulative and deceptive acts or practices limitation of section 10(b) which necessarily applies to 10b-5, including 10b-5(2)'s prohibition against misrepresentations or omissions, which standing alone would seem to permit a negligence standard. See text and notes at notes 158-61, 178-82, 202-03 *supra*. While neither section 17(a) of the 1933 Act, section 14(a) of the Securities Exchange Act, nor rule 14a-9 contain this language, section 14(e) does. However, section 14(e) literally precludes both omissions and misrepresentations as well as "fraudulent, deceptive, or manipulative acts or practices." 15 U.S.C. § 78n(e) (1978). Thus, the tender offer provision can be read in the alternative, in contrast to section 10(b)'s pervasive requirement. This bears not only upon *Hochfelder's* application, but also on *Santa Fe's* deception requirement. See generally R. JENNINGS & H. MARSH, *SECURITIES REGULATION: CASES & MATERIALS* 997 (4th ed. 1977).

²²⁹ See notes 178-82 *supra* and accompanying text.

²³⁰ See notes 202-03 *supra* and accompanying text.

²³¹ See *In re Commonwealth Oil/Tesoro Petroleum Corp. Securities Litigation*, 467 F. Supp. 227, 245 (W.D. Tex. 1979).

²³² 15 U.S.C. § 78n(e) (1976).

²³³ *Altman v. Knight*, 431 F. Supp. 309 (S.D.N.Y. 1978). See note 228 *supra*. See also *In re Sunshine Mining Co. Securities Litigation*, 509 SEC. REG. & L. REP. (BNA) A-9 (S.D.N.Y. May 25, 1979), where the court applied the deception requirement in a section 14(e) case.

²³⁴ Although once disputed, it is now clear that a takeover attempt need not be hostile in order to qualify as a "tender offer" within the act's nebulous definition. See

proxy rules involved therein²³⁵ any statements in support of the offer will come under section 14(e) scrutiny and will give rise to an appropriate private remedy. Since tender offers necessarily arise in connection with a transfer of corporate control,²³⁶ the potential management abuses and opportunities for self-dealing are rampant.²³⁷ When put within the disclosure context of section 14(e), such potential abuses accompanying transfers of control include direct as well as indirect premiums to the incumbent management; these premiums may, for example, take the form of long-term employment and consultation contracts. Any materiality standard under section 14(e) would seem to require that such arrangements be fully disclosed and explained to the target's shareholders. Given this affirmative duty of disclosure, the concomitant liability for misstatements and omissions necessarily follows. These and other control related abuses²³⁸ present the same desirable complementary relationship between the relevant state law of fiduciary duties and section 14(e) that the Second Circuit found to exist with respect to rule 10b-5 in its decision in *Goldberg v. Meridor*.²³⁹ In these instances, misconduct alone does not give rise to a federal private remedy, but the failure to disclose such misconduct at the appropriate time does.

Section 14(e) also has a valuable role to play in the case of the hostile takeover attempt by an outsider where there is an equally great potential for internal mismanagement. In such a case the target company's management is in a conflict-of-interest situation; they stand to lose their jobs if the tender offer is successful. As is the case with rule 10b-5, the conflict-of-interest issue raises its own disclosure problems.²⁴⁰ Over time an increasing number of defensive takeover tactics have developed, all of which involve potential claims of mismanagement.²⁴¹ It is desirable that section 14(e) be available to the

Smallwood v. Pearl Brewing Co., 489 F.2d 579, 598 (5th Cir. 1974), *cert. denied*, 419 U.S. 873 (1974). See generally R. JENNINGS & H. MARSH, *supra* note 228; Note, *The Developing Meaning of "Tender Offer" Under the Securities Exchange Act of 1934*, 86 HARV. L. REV. 1250 (1973).

²³⁵ See Section III-B *supra*.

²³⁶ In fact in defining the term "tender offer" the courts require a shift in control. *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579, 599 (5th Cir.), *cert. denied*, 419 U.S. 873 (1974); *Dyer v. Eastern Trust & Banking Co.*, 336 F. Supp. 890, 907 (N.D. Me. 1971).

²³⁷ See, e.g., Berle, *The Price of Power: Sale of Corporate Control*, 50 CORNELL L.Q. 628 (1965); Hazen, *Transfers of Corporate Control and Duties of Controlling Shareholders—Common Law, Tender Offers, Investment Companies—and a Proposal for Reform*, 125 U. PA. L. REV. 1023 (1977); Jennings, *Trading in Corporate Control*, 44 CALIF. L. REV. 1 (1956); O'Neal, *Sale of a Controlling Corporate Interest: Bases of Possible Seller Liability*, 38 U. PITT. L. REV. 9 (1976).

²³⁸ See authorities cited in note 237 *supra*.

²³⁹ 567 F.2d 209 (2d Cir. 1977), *cert. denied*, 434 U.S. 1069 (1978). See text at notes 90-99 *supra*.

²⁴⁰ See, Klink, *Management's Role in Recommending for or Against an Offer*, 25 BUS. LAW. 845 (1970). See text at notes 28-36, 77-103 *supra*.

²⁴¹ See generally, A. FLEISCHER, *THE TENDER OFFERS: DEFENSES, RESPONSES AND PLANNING* (1978); Fleischer, *Defensive Tactics in Tender Offers*, 9 SEC. REG. L. REV. 853 (1976); McIntyre, *Shareholders' Recourse Under the Federal Securities Laws Against Management for Opposing Advantageous Tender Offers*, 34 BUS. LAW. 1283 (1979). R. JENNINGS & H. MARSH, *supra* note 228 at 744-48; Cary, *Corporate Devices Used to Insulate Management*

target company's shareholders to require management to disclose these conflicts of interest, lest it suffer the resulting liability for failure to do so.

It is easy to see how defensive tactics can give rise to disclosure related section 14(e) questions. For example, how specific must the target company's management be about its reasons for opposing the takeover? At what point does the opposition overstep the bounds of the business judgment rule and involve a waste of corporate assets? Are there any collateral activities that the target management engages in primarily to thwart the takeover? And, at what point need defensive merger negotiations be disclosed? The answers to all of these questions are relevant to the target company's shareholders in deciding whether to tender their shares. Accordingly, each of these illustrative questions gives rise to section 14(e) issues.

Section 14(c), like the other federal antifraud remedies discussed above, is not necessarily subject to some of the limitations imposed on rule 10b-5, especially those within the sphere of internal corporate management. Both the tender offer movement and the corresponding federal regulation are relatively recent, however, and have resulted in few cases and thus give little guidance for the future. It is clear, though, that in refining the section 14(e) remedy, especially in the mismanagement sphere, the courts must be mindful of the *Santa Fe* Court's concern for state/federal tensions,²⁴² a concern which also is emphasized by the Court's opinion in *Piper*.²⁴³ It is the author's view that this difficult line should be drawn in the following manner. Those abuses that do not impinge directly upon investor protection and the orderly functioning of the securities markets should be left to the states. Such matters are issues of ordinary corporate mismanagement. Those abuses which rise above that threshold should be subject to the disclosure deception rule and, accordingly, liability under the federal securities laws is appropriate.

From Attack, 25 BUS. LAW. 839 (1970); Kennedy, *Defensive Take-Over Procedures Since the Williams Act*, 19 CATHOLIC U. L. REV. 158 (1969). The long history of events that formed the basis of the *Piper* suit gives an example of the use of those tactics. See *Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 516 F.2d 172 (2d Cir. 1975), *rev'd*, 430 U.S. 1 (1977).

²⁴² An interesting twist on these tensions has arisen in the tender offer regulation arena as the states have enacted their own legislation limiting tender offers. This legislation may well conflict with the Williams Act. Moreover, these laws have been challenged as unconstitutional under the commerce clause and alleged to have been preempted by the Williams Act. The Fifth Circuit held the Idaho statute unconstitutional and the Supreme Court, while foregoing comment on the merits, reversed on venue grounds. See *Great Western United Corp. v. Kidwell*, 577 F.2d 1256 (5th Cir. 1978), *rev'd on other grounds*, 99 S. Ct. 1494 (1979). See generally Wilner & Landy, *The Tender Trap: State Takeover Statutes and Their Constitutionality*, 45 FORDHAM L. REV. 1 (1976); Report, *State Takeover Statutes and The Williams Act*, 32 BUS. LAW. 187 (1976).

²⁴³ See text at notes 223-28 *supra*. This concern, however, particularly in light of *Touche Ross*, could lead the court to deny the existence of any implied private remedy under § 14(e), even to shareholders of the target company.

D. Section 18(a) of the Exchange Act and
its Relevance to Implied Remedies

In addition to the rule 10b-5 ramifications of requiring affirmative disclosure in the 10k²⁴⁴ and annual reports, section 18(a) of the Exchange Act²⁴⁵ provides an express remedy to the investor who purchases or sells a security in reliance upon misinformation contained in any document that is required to be filed with the SEC. Section 18(a) is narrower than the rule 10b-5 action in that it has an "eyeball" requirement. This requirement provides that the plaintiff trading on the information must see the filed document, and not merely the same information gathered somewhere else, such as in the annual report.²⁴⁶ Section 18(a) does not expressly impose scienter but shifts the burden to the defendant to prove good faith and lack of knowledge.²⁴⁷ Accordingly, the express remedy provided by section 18(a) sometimes can be used to circumvent the *Hochfelder* limitation imposed on rule 10b-5. On the other hand, not all rule 10b-5 plaintiffs will be able to use section 18(a) because of the "eyeball" requirement. This difficulty would be partially ameliorated if section 18(a) were found not to be an exclusive remedy. Although one district court has found the section 18(a) remedy to be exclusive,²⁴⁸ the better view is that it is not, and, thus, that all federal remedies are cumulative.²⁴⁹ While, in light of *Touche Ross*, the existence of section 18(a) may lead some courts incorrectly to deny the existence of an implied remedy under section

²⁴⁴ 4 FED. SEC. L. REP. (CCH) ¶ 31,101. Form 10K is the document by which reporting companies satisfy the disclosure requirements of Sections 13 and 15(d) of the Securities Exchange Act of 1934. 15 U.S.C. §§ 78m, 78o(d) (1976). For what constitutes a reporting company, see footnote 88 *supra*.

²⁴⁵ 15 U.S.C. § 78r(a) (1976):

Any person who shall make or cause to be made any statement in any application, report, or document filed pursuant to this title or any rule or regulation thereunder or any undertaking contained in a registration statement as provided in subsection (d) of section 15 of this title, which statement was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, shall be liable to any person (not knowing that such statement was false or misleading) who, in reliance upon such statement, shall have purchased or sold a security at a price which was affected by such statement, for damages caused by such reliance, unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading. A person seeking to enforce such liability may sue at law or in equity in any court of competent jurisdiction. In any such suit the court may, in its discretion, require an undertaking for the payment of the costs of such suit, and assess reasonable costs, including reasonable attorney's fees, against either party litigant.

²⁴⁶ See *Heit v. Weitzen*, 402 F.2d 909 (2d Cir. 1968), *cert. denied*, 395 U.S. 903 (1968); *Jacobson v. Peat, Marwick, Mitchell & Co.*, 445 F. Supp. 518 (S.D.N.Y. 1977); *Gross v. Diversified Mortgage Investors*, [1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,170 (S.D.N.Y. September 14, 1977).

²⁴⁷ 15 U.S.C. § 78r(a) (1976).

²⁴⁸ *Ross v. A.H. Robbins Co.*, 491 SEC. REG. L. REP. (BNA) A-6 (S.D.N.Y. Jan. 8, 1979), *rev'd on other grounds*, 607 F.2d 545 (2d Cir. 1979).

²⁴⁹ See authorities cited in note 246 *supra*.

17(a) or 14(e), at least with regard to rule 10b-5 and rule 14(a) actions the section 18(a) remedy should not be exclusive. Section 18(a) was developed expressly to provide a remedy for a certain wrong. It should not be used to cut off other avenues of redress that potential plaintiffs might have or to force them to forego use of section 18(a). In keeping with this interpretation, the Second Circuit recently has adopted the position that section 18(a) can and does co-exist with implied remedies under rule 10b-5.²⁵⁰

The presence of section 18(a), combined with the implied remedies discussed earlier, underscores the rightful place of disclosure as the touchstone for applying remedies under the federal securities laws. To the extent that disclosure requirements continue to creep into internal governance matters, the viability of the antifraud provisions as weapons against corporate mismanagement will remain potent. These remedies have the potential to do much to combat fraud in the area of corporate mismanagement. As such, they may fulfill an important role in filling the void left by the restrictions on rule 10b-5, and may afford meaningful remedies for wronged investors while at the same time supplementing rather than invading the province of the state chartering law.

IV. THE SEC: DISCLOSURE AND CORPORATE MISMANAGEMENT

The discussion thus far has been limited to private remedies under the securities laws which redress mismanagement, and thereby affect corporate governance. The role that the SEC plays in enforcing the various disclosure provisions is also relevant to understanding and evaluating the role that the federal securities laws do and should play in remedying corporate mismanagement. The SEC claims that its enforcement actions are not subject to the limitations that have been placed recently on private actions under rule 10b-5 and under other sections of the securities laws that may serve as alternatives to rule 10b-5. This section will examine some key recent developments²⁵¹ that illustrate the extent of the SEC's intrusion into the field of corporate governance. It will be shown that the SEC should be limited, and generally is limited to enforcing corporate responsibility only where there has been deception in connection with a required disclosure. On the other hand, the SEC has and should have a slightly freer hand than the private litigant, since there is less potential for exacerbating federal/state tensions in enforcement actions.

²⁵⁰ *Ross v. A.H. Robbins Co.*, 607 F.2d 545 (2d Cir. 1979).

²⁵¹ For an in depth treatment of the philosophy behind this type of SEC involvement, see, e.g., Berlack, *Federal Incorporation and Securities Regulation*, 49 HARV. L. REV. 396 (1936); Fleisher, "Federal Corporation Law": An Assessment, 78 HARV. L. REV. 1146 (1965); Knauss, *A Reappraisal of the Role of Disclosure*, 62 MICH. L. REV. 607 (1964); Schoenbaum, *The Relationship Between Corporate Disclosure and Corporate Responsibility*, 40 FORDHAM L. REV. 565 (1972).

It is clear that the SEC is not subject to some of the limitations on private litigants discussed earlier. As the civil enforcer of the antifraud provisions the Commission is held to a lower standard of proof in litigation than is a private party seeking damages. The SEC is not subject to any of the standing restrictions, such as the purchaser/seller limitation of *Blue Chip Stamps*.²⁵² In addition, most courts have held that the scienter requirement does not apply to the SEC.²⁵³ The Commission also does not feel that it is affected by the deception requirement of *Santa Fe*. This stance is an issue worth exploring, since it is far from clear that the SEC is correct in its position regarding the scope of *Santa Fe*.

Prior to the *Santa Fe* decision the SEC promulgated a series of going private rules which, *inter alia*, would have given the Commission the power to halt such transactions on the basis of fairness to the shareholders.²⁵⁴ One might think that *Santa Fe* quite explicitly held that there is no remedy under the federal securities laws for unfair transactions and breaches of fiduciary duty without some deception in disclosure.²⁵⁵ Nevertheless, the Commission continues to maintain that it has the power to regulate the fairness of such transactions. Specifically, in 1977 the Commission presented its post-*Santa Fe* proposed going private rules and noted that the fairness requirements can be and were contained in the new version.²⁵⁶ However, when the new going private rules were adopted, the Commission deleted the fairness requirement noting it "believes that the question of regulation should be deferred until there is an opportunity to determine the efficacy of [the rules as adopted]." ²⁵⁷ Although the Commission has postponed enforcement of its fairness standard, it is clear that the SEC continues to interpret the scope of its authority as encompassing the enforcement of a fairness standard. It is unclear whether the SEC is right or wrong in this interpretation. While the *Santa Fe* requirement was based on a statutory interpretation that section 10(b) is limited to abuses that are deceptive, not just unfair,²⁵⁸ the going private rules are not promulgated under section 10(b), but rather under section 13(e).²⁵⁹ Although *Santa Fe* may be extended to this section as well, it has not been so extended to date. In considering this issue, however, the SEC should note that it has not been chartered to create a federal body of corporate law, and thus should proceed cautiously if at all.

²⁵² The SEC cannot be a purchaser or seller of securities.

²⁵³ See text and notes at notes 162-63 *supra*.

²⁵⁴ Sec. Act Rel. No. 33-5567 (Feb. 6, 1975). See generally Note, "Going Private": Establishing Federal Standards for the Forced Elimination of Public Investors, 1975 U. ILL. L. F. 638; Note, *Going Private: An Analysis of Federal and State Remedies*, 44 FORDHAM L. REV. 796 (1976); Comment, *SEC Rulemaking Authority and the Protection of Investors: A Comment on the Proposed "Going Private" Rules*, 51 IND. L. REV. 433 (1976).

²⁵⁵ 430 U.S. at 474-77.

²⁵⁶ Sec. Act Rel. No. 33-5884, [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,366 (Nov. 17, 1977).

²⁵⁷ Sec. Act Rel. No. 33-6100, 515 SEC. REG. & L. REP. (BNA) E-1 (Aug. 2, 1979).

²⁵⁸ 430 U.S. at 473-74.

²⁵⁹ See Note, *An Appraisal of Authority for the Fairness Standard Contained in the SEC's Proposed "Going Private" Regulations*, 28 EMORY L.J. 111 (1979).

The Commission's aggressive attitude indicates that it will not be easily eliminated from the area of corporate governance. The most recent amendments to the proxy rules relating to directors' activities and relationships further illustrate this reality.²⁶⁰ These rules include disclosure guidelines relating to the composition of such important directors' delegations of authority as compensation and audit committees.²⁶¹ The SEC stands on firmer ground in the proxy area since it is merely enforcing and refining the concept of full disclosure. Since directors' decisions with regard to compensation and audit committees are materially relevant to shareholders decisions with regard to their reelection by proxy, the SEC is not overstepping its mandate here. It is requiring that management disclose practices of which it disapproves, not that these practices be changed. The rules thus focus on disclosure, rather than on mandating conduct. The disclosure requirements, however, may, in turn, coerce substantive changes in corporate conduct and organizational structure. An example is found with regard to independent audit committees, which the SEC generally views favorably.²⁶² Specifically, the Commission's General Counsel has taken the position that it has the power to require such committees for all Exchange Act reporting companies by administrative rule.²⁶³ Yet, to date, this asserted power has not been exercised, even though calling for disclosure of the non-existence of an audit committee might have the same effect. This type of encroachment upon internal corporate structure poses the same threat to state/federal relationships as does an unbridled expansion of the private remedies for mismanagement discussed earlier. Accordingly, the Commission should proceed cautiously in this area, and should rely on disclosure rather than on mandating actual changes in corporate structure.

The most critical recent commission activity emerges in its proposed rules under the Federal Corrupt Practices Act Amendments to the 1934 Exchange Act. Specifically, section 13(b) as amended imposes two new requirements on reporting companies: one, more accurate disclosure of corporate expenditures, and two, the institution of internal controls to assure compliance with management policies.²⁶⁴ These new statutory sections, in conjunction with the commission's proposed rules thereunder,²⁶⁵ will have a significant impact

²⁶⁰ See note 217 *supra*.

²⁶¹ Sec. Act Rel. No. 33-5949 (July 28, 1978); Sec. Exch. Act Rel. No. 34-14970 (July 17, 1978).

²⁶² All issuers with New York Stock Exchange listed securities are required to have such committees. Sec. Exch. Act Rel. No. 34-13346 (March 9, 1977). See Greene & Falk, *The Audit Committee—A Measured Contribution to Corporate Governance: A Realistic Appraisal of its Objectives and Functions*, 34 BUS. LAW. 1229 (1979).

²⁶³ Memorandum of General Counsel Harvey L. Pitt to Chairman Williams, [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,535 (March 2, 1978). Within the context of enforcement actions the SEC has in some cases required independent audit committees in its consent decrees. See, e.g., Woods Corp., Sec. Exch. Act Rel. No. 34-15337 (Nov. 16, 1978); Hycel, Inc., Sec. Exch. Act Rel. No. 34-14981 (July 20, 1978); but see, SEC v. Falstaff Brewing Corp., [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,583 (D.D.C. 1978). See Block & Schwarzfeld, *Corporate Mismanagement and Breach of Fiduciary Duty after Santa Fe v. Green*, 2 CORP. L. REV. 81 (1979).

²⁶⁴ 15 U.S.C. § 78m(b)(2) (1976 & Supp. 1978). See note 219 *supra*.

²⁶⁵ Sec. Exch. Act Rel. No. 34-15772 (April 30, 1979).

upon corporate internal structure and governance. Under these proposed rules, in the first year following their effective date, the Form 10-K that is filed with the SEC,²⁶⁶ the issuer's annual report, and the proxy materials would all contain:

1. Management's opinion as to whether, as of the date of such audited balance sheet, the systems of internal accounting control of the registrant and its subsidiaries provided reasonable assurances that specified objectives of internal accounting control were achieved; and
2. A description of any material weaknesses in internal accounting control communicated by the independent accountants of the registrant or its subsidiaries which have not been corrected, and a statement of the reasons why they have not been corrected.²⁶⁷

In subsequent years these opinions would include certifications as to the efficacy of such controls during the previous year:

the statement of management on internal accounting control would be required to include management's opinion as to whether, for such periods, the systems of internal accounting control of the registrant and its subsidiaries provided reasonable assurances that the specified objectives of internal accounting control were achieved. In addition, the statement of management on internal accounting control would be required to be examined and reported on by an independent public accountant for such periods.²⁶⁸

These proposed rules and their parent statutory section 13(b) are an example of a salutary effort by the SEC to improve corporate responsibility without creating a federal corporate law. On their face, they merely require disclosure and do not insist that the reporting companies change their practices. Nevertheless, many companies will have to do so unless they want to disclose the weaknesses of their internal accounting controls. These rules, therefore, should have a marked impact on corporate governance where charges are made against management, and in the litigation arena where the failure to make internal rule changes is not properly disclosed. Since the proposed SEC rules require proxy related disclosure, liability for omissions and misstatements under rule 14a-9 will be enhanced.²⁶⁹ The SEC's role in enforcing the corporate disclosure provisions, therefore, must not be discounted, but it should be limited to areas where there is deception with regard to disclosure.

V. FEDERAL REMEDIES FOR CORPORATE MISMANAGEMENT UNDER THE PROPOSED FEDERAL SECURITIES CODE

Last year the American Law Institute gave its official imprimatur to the final version of the Proposed Federal Securities Code that had been drafted

²⁶⁶ 4 FED. SEC. L. REP.(CCH) ¶ 31,101.

²⁶⁷ Sec. Exch. Act Rel. No. 34-15772 (April 30, 1979).

²⁶⁸ *Id.*

²⁶⁹ See Siegel, *The Implication Doctrine and the Foreign Corrupt Practices Act*, 79 COLUM. L. REV. 1085 (1979).

over a ten-year period.²⁷⁰ Although the SEC has not taken an official position regarding the Proposed Code, it is expected that the legislation will be introduced in Congress before long. It is thus desirable to examine what effects the Code would have on the present federal securities laws' remedy for corporate mismanagement, and whether those effects will be helpful. Unfortunately, an examination of the Code's relevant provisions makes it clear that the questions with regard to corporate mismanagement raised under current law would remain unanswered should the proposed statute be adopted. If anything, the Code would compound the problem by still allowing for implied remedies, while also giving express private rights of action for the counterparts to the current implied liability discussed earlier.²⁷¹

In its definition section the Code makes it explicit that "[t]he existence of a fraudulent act is not precluded by the fact that it constitutes company mismanagement."²⁷² This general statement indicates that the Code will not retreat from the recent trends toward a greater federal role in corporate governance. On the other hand, the express adoption of a scienter requirement when dealing with "fraudulent acts"²⁷³ continues much of the *Hochfelder* limitations presently existing. The general antifraud provision of section 1602(a), however, would prohibit fraudulent acts *or* misrepresentations:

[Purchases, sales, proxy solicitations, tender offers, and investment advice.] (a) [General.] It is unlawful for any person to engage in a fraudulent act or to make a misrepresentation in connection with (1) a sale or purchase of a security, an offer to buy or sell a security, or an inducement not to buy or sell a security, (2) a proxy solicitation or other circularization of security holders in respect of a security of a registrant, (3) a tender offer or a recommendation to security holders in favor of or opposition to a tender offer, or (4) activity or proposed activity as an investment adviser.²⁷⁴

The reporter's comments suggest that the section's language permits the SEC to employ a negligence standard in its enforcement actions, but that the express private remedies all provide for at least a semblance of a scienter requirement.²⁷⁵ If that it is true, the Code in this respect constitutes a continuation of the current trend of the cases.

Section 1703 of the Proposed Code provides an express remedy for the purchasers and sellers who are injured by violations of section 1602(a).²⁷⁶ Sec-

²⁷⁰ ALI PROPOSED FEDERAL SECURITIES CODE (1979) [hereinafter cited as PROPOSED CODE].

²⁷¹ Compare PROPOSED CODE §§ 1703, 1713 with PROPOSED CODE § 1722.

²⁷² PROPOSED CODE § 262(e). This fails to answer the question of where the *Santa Fe* line is to be drawn.

²⁷³ *Id.* § 262(c): "a person engages in a fraudulent act only if he acts with knowledge that his conduct is of a type specified in that section, or in reckless disregard of whether that is so."

²⁷⁴ *Id.* § 1602(a).

²⁷⁵ *Id.* comment 3: "The several private actions based on misrepresentation either require the plaintiff to prove scienter or afford various defenses going essentially to its absence." See, e.g., *id.* §§ 1703(f), 1704(f), and 1713. But see *id.* § 1722, discussed in text at notes 283-86 *infra*.

²⁷⁶ *Id.* § 1703(a) and (b) applying to transactions made both in and outside of the trading markets.

tion 1704 provides a private right analogous to, but broader than, section 18(a) of the Exchange Act.²⁷⁷ While the foregoing liability provisions incorporate both the *Blue Chip Stamps* and *Hochfelder* limitations, they do not in the least bit clarify the ambiguities left open by the *Santa Fe* decision,²⁷⁸ at least in the rule 10b-5 area.

The reason for this omission is perhaps suggested by the following comment. After noting the unresolved state of the cases, which would remain unaffected by the Code,²⁷⁹ the reporter, Professor Louis Loss, notes:

The Reporter is inclined to leave the "fairness" concept to another day—perhaps Professor Cary's federal standards ideas. See Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 Yale L.J. 663 (1974). That is to say, if there is to be federal law with respect to company-insider transactions that do not descend to the level of "fraud" or "deception," in principle the choice of federal versus state law should not depend on the happenstance of a security transaction.²⁸⁰

²⁷⁷ *Id.* § 1704, covering misstatements in SEC filings, including annual reports, registration statements and offering statements.

²⁷⁸ This is reflected in the reporter's comments: *Id.* § 1603, comments 2(y), 3(a)(vi) and 3(b).

²⁷⁹ *Id.* comments 3(a)(vi), and (b). This comment provides:

(vi) Nothing in the Code is inconsistent with any of the learning (though uncoded) of *Superintendent of Insurance v. Bankers Life & Casualty Co.*, 404 U.S. 6 (1971): (A) that "the fact that creditors of the defrauded corporate buyer or seller of securities may be the ultimate victims does not warrant disregard of the corporate entity" (404 U.S. at 12); and (B) that misappropriation of the proceeds of a sale of securities may be a fraudulent act creating liability for the misappropriator if "the seller was duped into believing that it, the seller, would receive the proceeds" (404 U.S. at 9), even though the sale is for full value and the misappropriator is neither a buyer nor a seller. Moreover, there can be no doubt that § 1703 covers a sale of a *portfolio* security.

(b) On the other hand, the Code is not overruling *Santa Fe Industries* (see Comment (2)(y)) by specifically endorsing the reading that a number of commentators gave *Schoenbaum v. Firstbrook*, 405 F.2d 215 (2d Cir. *en banc* 1968), *cert. denied* sub nom. *Manley v. Schoenbaum*, 395 U.S. 906: that inadequate (some would say "grossly unfair") price coupled with controlling influence establishes a 10b-5 violation regardless of disclosure. See, e.g., Note, *The Controlling Influence Standard in Rule 10b-5 Corporate Mismanagement Cases*, 86 HARV. L. REV. 1007 (1973). Others (including the Reporter) rationalized that case on the basis of the parent buyer's nondisclosure of an oil strike to "the corporation" as represented by the stockholders in the absence of a disinterested majority of directors. The opinion was so read by a panel of the same court in *Popkin v. Bishop*, 464 F.2d 714 (2d Cir. 1972), where the court assumed that the allegedly unfair exchange ratio had been fully disclosed to the stockholders in the course of soliciting their required approval. See also *Goldberg v. Meridor*, 567 F.2d 209 (2d Cir. 1977) (Friendly, J.). And the Supreme Court in *Santa Fe* cited *Schoenbaum* as a case that "involved an element of deception as part of the fiduciary misconduct." 97 S. Ct. at 1301, n.15.

²⁸⁰ PROPOSED CODE § 1603, comment 3(b).

Such a notion is commendable. The securities laws should not be used as a vehicle to create a body of federal corporate law. Until such a federal corporate law is created, remedies under the securities laws should be limited to cases where investor protection is the primary issue. The proposed code, like the current law, frames the question in terms of whether there is fraud or deception.

The new statute also would codify private rights of action for proxy related²⁸¹ and tender offer²⁸² violations. The new law therefore, would provide for the same interrelationships that exist today between these areas and the general antifraud remedy for purchasers and sellers. Similarly, there would be the same potential for state/federal tensions that exist under the 1933 Act and the Exchange Act. Again, that tension is desirable in the context of deception-in-disclosure, but not in the area of corporate misconduct. The Code would perpetuate the absence of a defined balance, and thus would not help resolve the issues under discussion herein.

In addition to the express liability provisions, the Code contains an explicit grant of power for the courts to imply supplemental private remedies:

Sec. 1722 [*Degree of exclusivity of part XVII.*] (a) [Implied actions.] A court, considering the nature of the defendant's conduct, the degree of his culpability, the injury suffered by the plaintiff, and the deterrent effect of recognizing a private action based on a violation of a provision of this Code (as defined in section 225), may recognize such an action even though it is not expressly created by part XVII, but only if (1) the action is not inconsistent with the conditions of

²⁸¹ *Id.* § 1713(a):

[*Proxy solicitations.*] On proof in an action by the issuer, or a security holder who has been or is about to be solicited or circularized within the meaning of section 603(a), that the defendant has violated, is violating, or is about to violate section 603, 604, 1602(a)(2), or 1602(b)(1)(B), a court may (1) enjoin a violation or further violation, (2) require compliance, (3) enjoin the use of proxies solicited or given in violation or the consummation of action authorized by their use, (4) set aside action so consummated, (5) award damages against the violator for any loss caused by his violation, or (6) grant other appropriate relief (preliminary or final), including a combination of the types of relief here specified.

²⁸² *Id.* § 1713(b):

[*Acquisitions and tender offer.*] On proof in an action by the issuer of a security that is the subject of a tender offer (or a proposed tender offer) or whose acquisition requires a filing under section 605(b), a holder of such a security (or of another security whose interests are adversely affected), a person who has tendered a security pursuant to a tender offer, or person who has made or proposes to make a tender offer, that the defendant has violated, is violating, or is about to violate section 605(b), 606, 607(d), 1602(a)(1) or (3), 1602(b)(1)(A) or (C), 1603(a), or 1613, a court may (1) enjoin a violation or further violation, (2) require compliance, (3) enjoin the voting of securities acquired in violation or the consummation of action authorized by their having been voted, (4) set aside action so consummated, (5) award damages against the violator for any loss caused by his violation, or (6) grant other appropriate relief (preliminary or final), including a combination or the types of relief here specified.

restrictions in any of the actions expressly created or with the scheme of the Code, (2) the provision, rule, or order is designed for the special benefit of a class of persons to which the plaintiff belongs against the kind of harm alleged, (3) the plaintiff satisfies the court that under the circumstances the type of remedy sought is not disproportionate to the alleged violation, and (4), in cases comparable to those dealt with in section 1702(e)(2) or 1709(c)(2) or a similar provision that specifies a maximum measure of damages, a comparable maximum is imposed.²⁸³

This provision was drafted with an eye toward preserving the Supreme Court's current test announced in *Cort v. Ash*²⁸⁴ and followed in subsequent securities law decisions.²⁸⁵ The Supreme Court's decision in *Touche Ross v. Reddington*²⁸⁶ might be viewed as severely undercutting the validity of the *Cort* test, and thus could be taken to indicate that the Court as presently constituted would recognize few if any new implied private remedies.²⁸⁷ In that sense, this section of the Code departs in a desirable direction from one view of what may be a current trend. The better view, however, is that *Cort* has survived its recent scrutiny in the Supreme Court.²⁸⁸

The consistency requirement of subsection 1 of section 1722, noted above, places limitations on implied remedies, but does not preclude the recognition of parallel cumulative remedies that would differ from, yet also complement, the express rights of action. This would give activist courts an opportunity to create remedies that are not limited by the standing and scienter requirements,²⁸⁹ while at the same time placing necessary limits on their ability to do so. The Code would return the law of implying private remedies to its state prior to *Touche Ross*.

The Code's open-endedness on all of the issues discussed herein is not carelessness, but, rather, represents a belief that the courts are better equipped than Congress to deal with those questions. The courts can give the needed flexibility over time to cope with realities in the market place. The present Supreme Court does not agree with this policy. It does not believe in judicial flexibility, and is unsympathetic to the defrauded litigant, incorrectly assuming that in almost all cases, if Congress did not provide an express remedy, there should not be one. The Code would redress this imbalance. It would restore to the federal judiciary its role as a common law court of equity designed to create flexible rules of law that change with the times and dispense justice.

²⁸³ *Id.* § 1722.

²⁸⁴ 422 U.S. 66 (1975).

²⁸⁵ Proposed Code § 1722, comment 3. See note 66 *supra*.

²⁸⁶ 99 S. Ct. 2479 (1979). But see PROPOSED CODE § 1603, comment 3(a)(ii).

²⁸⁷ See text accompanying notes 187-92 *supra*. The Supreme Court has recently decided that there is no implied remedy under § 206 of the Investment Adviser's Act. *Transamerica Mortgage Advisers, Inc. v. Lewis*, 100 S. Ct. 242 (1979). But at the same time, it implied a right of rescission under section 215 of the Act, 100 S. Ct. at 245.

²⁸⁸ See *id.*

²⁸⁹ See PROPOSED CODE § 1603, comment 3.

VI. CONCLUSION

It is now clear that the majority of circuit and district courts fortunately do not read the *Santa Fe* decision as having sounded the death knell for all federal mismanagement remedies. Rather, what appears to be evolving is a necessary refinement of the complementary role that the implied federal rights of action can play with respect to the state regulation of corporate affairs. The Supreme Court's concern over undue state/federal tensions is partially being met by federal and SEC rulings that preclude conflicts between the state and federal law at issue. This clearly was one result that was mandated by the Court's proper express refusal to "impose a stricter standard of fiduciary duty than that required by the law of some states."²⁹⁰

By way of example, the two most recent Second Circuit decisions reveal the ways in which the proper use of the implied federal antifraud remedies can aid the states on both a prospective and retrospective basis. In *Goldberg v. Meridor*,²⁹¹ the court used rule 10b-5 to require advance disclosure of facts that would give rise to a state law remedy. It properly realized that the federal securities laws have a role to play if there is any deception in regard to any disclosure, even if that disclosure is mandated only by state law. In *Maldonado v. Flynn*,²⁹² the court employed rule 14a-9 to require disclosure of past acts that would affect the reasonable shareholder's decision concerning the reelection of certain directors.²⁹³ In both of these cases the federal claim was properly dependent upon, rather than in conflict with, the applicable state law management norms. Similarly, sections 17(a) of the 1933 Act and section 14(e) of the Exchange Act also have a role to play in regulating corporate affairs, provided this is done consistently with the relevant corporate chartering rules of the states, rather than in conflict with them.

In its wave of new disclosure provisions, however, Congress and the Commission have opened the door to further potential conflict with the appropriate state law. As long as this conflict is the result of federal concern for full and honest disclosure and not the result of an attempt to create a back-door federal corporate law, these conflicts are unavoidable and should be resolved against the states. By following the trend of the Second Circuit, these provisions can play a necessary and valuable role in preventing corporate mismanagement while furthering the investor-protection policies of the securities law, and without running afoul of the lessons to be learned from the *Santa Fe* ruling.

²⁹⁰ 430 U.S. at 479 n.16.

²⁹¹ 567 F.2d 209 (2d Cir. 1977), *cert. denied*, 434 U.S. 1069 (1978). *See, e.g.*, *Wright v. Heizer Corp.*, 560 F.2d 236 (7th Cir. 1977), *cert. denied*, 434 U.S. 1066 (1978); *see text at notes 77-117 supra*.

²⁹² 597 F.2d 789 (2d Cir. 1979).

²⁹³ *Id.* at 796. *See text accompanying notes 145-50 supra*.