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THE ROLE OF SECURITIES-EXCHANGE ACT RULE 10b-5 IN THE REGULATION OF CORPORATE MANAGEMENT*

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In response to the 1929 collapse of the securities industry, Congress enacted two principal pieces of New Deal legislation—the Securities Act of 1933 and the Securities Exchange Act of 1934. The 1933 Act regulates the initial distribution of securities to the public primarily by requiring extensive public disclosure of information affecting the issuer of a new security. The 1934 Act is designed to regulate already-issued securities primarily through controls over securities markets and broker-dealers. Although both acts contain broad “anti-fraud” provisions, the Exchange Act’s Section 10(b) is

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6 Securities Act § 17(a), 15 U.S.C. § 77q(a) (1970), provides:
   (a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—
   (1) to employ any device, scheme, or artifice to defraud, or
   (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
   (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.
Exchange Act § 10(b), 15 U.S.C. § 78j(b) (1970), in pertinent part 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
normally a more useful tool for defrauded plaintiffs. Nevertheless, this highly significant section, which is now the most widely litigated securities provision in the nation, remained in relative obscurity in the years immediately following its enactment. Indeed, the Securities and Exchange Commission (SEC) did not promulgate 10b-5 under this section until eight years after enactment of the 1934 Act.

SEC Rule 10b-5 constitutes the major implementing regulation of the Exchange Act's anti-fraud provisions. It governs six distinct factual patterns in the securities industry: trading on the basis of undisclosed material information; issuing misleading corporate publicity; selectively disclosing important nonpublic data, referred to as "tipping"; manipulating a securities market; trading and other activities of broker-dealers; and—the subject of this article—mismanaging a corporation.

The role of Rule 10b-5 in the regulation of securities is an emerging one. The Supreme Court did not recognize a private right of action under the Rule until 1971, and the application of the Rule to the regulation of corporate mismanagement is, for the most part,
of fairly recent origin. Nevertheless, the importance of Rule 10b-5 in the regulation of corporate mismanagement is great and, in view of these recent Supreme Court pronouncements, is likely to become greater.

This was not always the case, however. Indeed, in 1952, the Second Circuit decision in Birnbaum v. Newport Steel Corp. dealt a chilling blow to the effective employment of 10b-5 to redress mismanagement wrongs. A single sentence contains Birnbaum's key holdings:

[Section 10(b)] was directed solely at that type of misrepresentation or fraudulent practice usually associated with the sale or purchase of securities rather than at fraudulent mismanagement of corporate affairs, and that Rule [10b-5] extended protection only to the defrauded purchaser or seller.

Judge Augustus Hand, speaking for the court, made three distinct rulings in that singular, oft-quoted pronouncement: (1) Rule 10b-5 reaches only practices which are ordinarily part of securities transactions; (2) the Rule does not embrace mismanagement; and (3) only a defrauded buyer or seller can invoke the Rule.

All three holdings have been attacked, and the first two have been considerably weakened by subsequent court decisions. With this erosion of the Birnbaum doctrines, federal regulation of corporate mismanagement has expanded substantially. For example, Rule 10b-5 now affords mismanagement victims a federal forum whether or not the fraudulent scheme is ordinarily associated with a securities transaction. Furthermore, as this Article seeks to demonstrate, Rule 10b-5 also regulates corporate mismanagement.

I

Scope of Rule 10b-5

A. Relationship to State Law

Although the relationship between the owners of a corporate enterprise and its managers is traditionally a state concern, a body

16 Id. at 10; see Wolf v. Frank, 477 F.2d 467, 477 (5th Cir. 1973); Zeller v. Bogue Elec. Mfg. Co., 476 F.2d 795, 801 n.8 (2d Cir. 1973). See also Hanraty v. Ostertag, 470 F.2d 1096, 1098 (10th Cir. 1972) (mismanagement within 10b-5).
17 193 F.2d 461 (2d Cir.), cert. denied, 343 U.S. 956 (1952).
18 Id. at 464.
19 As to the third aspect of the Birnbaum holding, see notes 83-101 and accompanying text infra.
21 See notes 56-66 and accompanying text infra.
22 The authorities generally speak in terms of a corporation and its stockholders, a custom
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The law of mismanagement regarding securities transactions by private trusts is not as well developed as that concerning corporations and partnerships. According to one court, a threshold question when the trust is a buyer or seller is whether it is a "person." Rippey v. Denver United States Nat’l Bank, 260 F. Supp. 704, 714 (D. Colo. 1966). There seems to be no justification for this concern. The Rule’s first clause prohibits “any person” from engaging in fraudulent conduct, but does not demand that the plaintiff be a “person.” Nor is this construction required by the definition of “purchase” or “sale.” Rippey held that a trust is not a person (id.), ignoring the Supreme Court’s admonition to construe the securities laws liberally. See, e.g., Tcherepnin v. Knight, 389 U.S. 332, 336 (1967). See also Exchange Act § 3(a), 15 U.S.C. § 78c(a) (1970) (definitions apply “unless the context otherwise requires”). A trust has been construed to be a person under § 16(a) of the Exchange Act. See Exchange Act Rule 16a-8(c), 17 C.F.R. § 240.16a-8(c) (1973); SEC Securities Exchange Act Release No. 1965 (Dec. 21, 1938). Only the most restrictive and erroneously narrow reading of the word “person” would justify the result in Rippey. Bosche v. Louart Corp., [1967-1969 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,231, at 97,067 (N.D. Cal. 1968).

Quite apart from the above issue, courts have been hesitant to grant remedies for breach of a trustee’s duties. This is reminiscent of the courts’ reluctance, stemming from Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir.), cert. denied, 343 U.S. 956 (1952), to delve into corporate mismanagement matters. With the virtual abandonment of the latter position as a strong analogy, one would expect that Rule 10b-5 applicability to trust mismanagement would enjoy a similar growth. But the results to date have been disappointing to plaintiffs. See American Cancer Soc’y, Inc. v. Fulton County Nat’l Bank & Trust Co., 72 Civil No. 576 (S.D.N.Y., May 1, 1972), opinion summarized in [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,464 (court noted in passing that claim seems no more than estate mismanagement; reciprocal business arrangements by trustee-bank); Schaffner v. Chemical Bank, 339 F. Supp. 329, 335-337 (S.D.N.Y. 1972) (class action by trust beneficiaries not maintainable; plaintiff allowed to bring individual claim); Manus v. Bank of Bermuda, Ltd., [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,299, at 91,649-50 (S.D.N.Y. 1971) (question if beneficiary authorized trust to make purchase; in absence of requisite form of scienter, merely breach of fiduciary duty).

On the other hand, the court, in Heyman v. Heyman, 356 F. Supp. 958 (S.D.N.Y. 1973), correctly applied 10b-5 to a claim brought by a trust beneficiary for self-dealing by the trustee. The court treated the beneficiary as the seller of stock in the trust. It also distinguished the following quotation of the Second Circuit both because it was dicta and because self interest was present in Heyman:

[T]he beneficiary of a trust agreement does not have an implied civil cause of action under § 10(b) and Rule 10b-5 against a trustee who, with full knowledge of all material information, sells shares from the trust corpus in an arm’s length transaction for what the beneficiary considers to be inadequate consideration.

Schoenbaum v. Firstbrook, 405 F.2d 200, 212 (2d Cir.), rev’d on other grounds on rehearing en banc,
sale of any security."\(^{23}\) Indeed, as the Second Circuit has recently stated: "We are concerned here with an important enforcement provision of a federal statute [Section 10(b) and Rule 10b-5] intended not only to expand the common law but to create new, far-reaching and uniform law of shareholder-management relations in congressionally designated areas of substantive corporation law . . . ."\(^{24}\)

Some evidence exists that Congress did not intend to govern all internal corporate affairs;\(^{25}\) however, Congress did affirmatively enter the field in mandating controls upon the solicitation of stockholder votes\(^ {26}\) and the use of inside information.\(^ {27}\) Similarly, although the Rule does not purport to govern the entire range of fiduciary obligations between stockholders on the one hand and directors, officers, and controlling shareholders on the other,\(^ {28}\) it may apply even though a securities transaction is only part of a larger scheme of mismanagement.\(^ {29}\)

One result of this latter development is that Rule 10b-5 and state common law often provide concurrent avenues of redress.\(^ {30}\) This

\(^{23}\) 405 F.2d 215 (2d Cir. 1968), cert. denied, 395 U.S. 906 (1969). But the trial judge in Heyman questioned whether a beneficiary could maintain a derivative suit on behalf of the estate. 356 F. Supp. at 966 n.10.


\(^{24}\) 17 C.F.R. § 240.10b-5 (1973); see note 82 and accompanying text infra.


federal-state overlap poses a central policy question: to what extent should the Rule provide a remedy parallel to state law, the traditional fountainhead of law in this field? A desire to permit state policy determinations to predominate may explain the reluctance of some courts to expand further the application of Rule 10b-5 to mismanagement.  

Moreover, courts construing the Rule refer to state law to resolve a number of issues. For example, the laws of the jurisdiction of incorporation determine whether a transaction is a merger or a sale of assets, as well as whether redemption terms must appear in the corporate charter. State law governs the ability of a merged corporation to sue for illegal acts arising from the merger, and it also may dictate whether the approval of a receivership court must be obtained before a company can commence an action. In addition, Rule 10b-5 itself embodies many common-law principles.

Nevertheless, federal law governs most issues in 10b-5 litigation; the role of state law is quite limited. Issues such as directors’ conflicts of interest, the validity of exculpatory provisions, and the effectiveness of a ratification are not resolved according to state standards. A 10b-5 case cannot be successfully defended on the ground...
that the alleged wrong is unassailable under state law. In fact, if the Rule applied merely to acts cognizable at common law or to those for which state law provides no redress, the desired uniformity of results under the Rule would be seriously impaired.

B. Relationship With Parties Involved in the Mismanagement Claim

Despite the Birnbaum restrictions, it is now clear that transactions are not insulated from attack merely because insiders committed the fraud, i.e., merely because the claim is based on mismanagement. In one of its few 10b-5 decisions, the Supreme Court, in 1971, held that "the controlling stockholder owes the corporation a fiduciary obligation—'one designed for the protection of the entire community of interests in the corporation—creditors as well as stockholders.' " In the same case, the Court also held that a corporation is an investor protected by the Rule even though the fraudulent


42 The Rule reaches a number of areas which common law does not. See SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 855 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969).

43 The district court in Beury v. Beury, 127 F. Supp. 786, 789-90 (S.D.W. Va. 1954), held that 10b-5 reaches only those situations in which state law cannot aid the plaintiff, but the Fourth Circuit seemed to go out of its way in a per curiam decision to disagree on this point. 222 F.2d 464, 465 (4th Cir. 1955).

44 See Drachman v. Harvey, 453 F.2d 722, 728 (2d Cir. 1971), rev'd on other grounds on rehearing en banc, 453 F.2d 736 (2d Cir. 1972).

45 See notes 17-18 and accompanying text supra.


48 Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 12 (1971). The Fifth Circuit in Coffee v. Permian Corp. has gone further, holding that "as majority stockholders they were under a duty to act in the best interest of the minority stockholders." Coffee v. Permian Corp., 474 F.2d 1040, 1044 (5th Cir. 1973). Compare id. at 1045 (dissenting opinion). The dissent in Coffee concluded that the majority overstated the rule: "While a majority shareholder's dealings with a corporation are subject to vigorous scrutiny for basic fairness, an inherently fair transaction should be upheld even though it not be in the best interest of the minority." Id.; accord, Grace v. Grace Nat'l Bank, 465 F.2d 1068, 1072-73 (2d Cir. 1972) (unclear if state law or 10b-5 controlling) (merger unassailable if gives equitable treatment to minority stockholders even though treatment favors parent).
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scheme involved does not impair the integrity of a stock market. Nor is the scope of 10b-5 liability limited to insider-defendants who buy or sell securities in transactions with their own corporation.

C. Parties to a Rule 10b-5 Mismanagement Action

Rule 10b-5 suits to redress corporate mismanagement can be brought by three types of plaintiffs. The injured corporation may sue either directly or by means of a stockholders’ derivative action. A stockholder may seek redress individually when he is personally hurt (e.g., when he receives less than he should in a merger between two corporations under common control). A stockholder may also bring an action as a representative of all other stockholders similarly situated, provided the requirements of a class action are met. A corporate creditor is the final potential plaintiff, and under the Rule suit is not precluded when the fraud injures only creditors.

The class of accountable defendants in a 10b-5 mismanagement action depends on the facts of each case.

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51 In a stockholders’ derivative suit, a cause of action belonging to the corporation is asserted on its behalf by a stockholder.

52 See notes 388-412 and accompanying text infra.


55 The class of defendants in misrepresentation and concealment cases is different.

56 See, e.g., Drachman v. Harvey, 453 F.2d 722, 724 (2d Cir. 1971), rev’d on rehearing en banc, 453 F.2d 736 (2d Cir. 1972); Rekant v. Desser, 425 F.2d 872, 874, 876 (5th Cir. 1970); Pappas v. Moss, 393 F.2d 865, 869 (3d Cir. 1968); Loeb v. Whittaker Corp., 333 F. Supp. 484, 485 (S.D.N.Y. 1971). When two corporations under the same control merge or engage in other proscribed conduct, directors of both corporations would be appropriate defendants. See Travis v. Anthes Imperial Ltd., 473 F.2d 515, 518 (8th Cir. 1973).
cers, and controlling stockholders can be liable under certain circumstances. Third parties may also be answerable when they are active wrongdoers, aid and abet a breach, or join in a conspiracy to violate the Rule.

When the board of directors approves an action which constitutes a 10b-5 infraction, the individual directors might be personally liable. Directors who vote in favor of the proposition should be answerable unless they can demonstrate that their vote was procured by material misrepresentations or omissions and that a reasonably prudent director would not have discovered the falsity. Directors who misrepresent facts to or conceal information from their fellow board members would also be liable. Indeed, directors who ab

Lewis v. Spiral Metal Co., [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 92,919 (S.D.N.Y. 1971), seems wrongly decided. There directors were held liable although no cause of action was made out against the person alleged to have purchased securities for inadequate consideration.

See, e.g., Drachman v. Harvey, 453 F.2d 722, 724 (2d Cir. 1971), rev'd on rehearing en banc, 453 F.2d 736 (2d Cir. 1972); Condon v. Richardson, 411 F.2d 489, 490 (7th Cir. 1969); Ruckle v. Roto Am. Corp., 339 F.2d 24, 26 (2d Cir. 1964) (officers also directors).


Under state corporate law, issuance of stock and securities convertible into stock must be authorized by the board of directors, a committee of the board, or the stockholders. See, e.g., Del. Code Ann. tit. 8, § 153 (Supp. 1970); N.Y. Bus. Corp. Law §§ 504(c),(d), 505(a) (McKinney 1963). A large percentage of the 10b-5 mismanagement frauds involve issuances of a security, so the directors are apt to be defendants in those cases. See SEC v. Fifth Ave. Coach Lines, Inc., 289 F. Supp. 3, 39-40 (S.D.N.Y. 1968), aff'd, 435 F.2d 510 (2d Cir. 1970); notes 175-76 and accompanying text infra (specifies instances in which officers have power to act and when actions ultra vires).


See Mader v. Armel, [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 93,027, at 90,790-91, 90,796 (S.D. Ohio 1971), aff'd, 461 F.2d 1123 (6th Cir.), cert. denied, 409 U.S. 1021 (1972) (not liable if did not know of wrongdoing and should not have known of wrong; exonerated even though made no investigation); Aronstam v. Tenney Corp., [1967-1969 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 92,337, at 97,087-88 (S.D.N.Y. 1968) (not liable if did not participate in decisions). The element of discovery by a reasonably prudent director may be apt only when a negligence standard applies. Recklessness by a reasonably prudent director may have to be shown when negligence is too low a general standard on which to impose liability.

See notes 164-65 and accompanying text infra.
stained from a vote were not exonerated in a famous case. Directors who vote against a matter may nevertheless be answerable if they do not sufficiently disassociate themselves from the fraud. Interested directors would be responsible as well. Of course, directors are not accountable for actions taken by the board after their resignation.

D. Integration of Transactions

The Rule's use as a means of providing redress for complicated fraudulent schemes involving a series of transactions is one of its most important features. Under certain circumstances, courts will view schemes involving many transactions as though they were one plan. This approach is suggested by the broad terms of the Rule, e.g., “scheme,” “course of business,” and “in connection with the purchase or sale of any security.”

Integration of a number of transactional steps has two consequences. First, the scheme may be viewed as a single entity to determine whether a fraud has been committed even though no single transaction was a violation. The Second Circuit has made clear its view in this regard in Drachman v. Harvey: “[T]he allegation of a multi-


64 This type of action is similar to conspiracy. See United States v. Goldberg, 401 F.2d 644, 648-49 (2d Cir. 1968), cert. denied, 393 U.S. 1099 (1969). In Segal v. Gordon, 467 F.2d 602, 605 (2d Cir. 1972), the Second Circuit dismissed a complaint as to two directors who claimed that they had not participated in any proposed transaction with Colonial as alleged in the complaint, that they were never members of [the corporation's] executive committee, never voted for any proposed sale to Colonial of [the corporation's] accounts receivable, that they were never officers of [the corporation], and had voiced their opposition to any sale until further information was furnished to enable a proper evaluation thereof.

65 See note 173 and accompanying text infra.

66 Dasho v. Susquehanna Corp., 461 F.2d 11, 33 (7th Cir.), cert. denied, 408 U.S. 925 (1972). But see notes 430-35 and accompanying text infra (looting of corporate assets). A director should be liable for the foreseeable effects of actions he approved if he is no longer a director.

67 See generally Bromberg, Integration, 5 REV. SEC. REG. 877 (1972).

68 Herpich v. Wallace, 430 F.2d 792, 808 (5th Cir. 1970) (court looks at entire scheme in certain circumstances).

The Supreme Court's broad reading of 10b-5 in the Bankers Life case should also encourage lower courts to integrate transactions. In finding a violation of the Rule, the Court stated: "The crux of the present case is that [the corporation] suffered an injury as a result of deceptive practices touching its sale of securities as an investor." Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 12-13 (1971) (emphasis added).

69 453 F.2d 722, 731 (2d Cir. 1971), rev'd on rehearing en banc, 453 F.2d 736 (2d Cir. 1972),
transactional, pervasive and fraudulent conspiracy cannot create a right of action under § 10(b) merely by linking two transactions *neither* of which standing alone would violate that section." This is the clearest wording of any court on this subject, but opinions in two other circuits could be construed as reaching the opposite conclusion.\(^7\)

Second, actions which are not assailable by themselves are nevertheless redressible if they are part of a scheme containing at least one transaction which breaches the Rule. The *Drachman* case is again the clearest example. The plaintiff in that case sought to recover for the issuer a premium paid for a controlling block; the claim by itself could not have been prosecuted successfully.\(^7\) But the plaintiff alleged that the corporation had been injured by being forced to redeem debentures as part of a plan to insure the buyer's control. The redemption was deemed fraudulent, and the claim for the control premium was upheld by construing the sale of control and the redemption as part of the same scheme.\(^7\) The court thus permitted recovery under the Rule for an unassailable transaction (the sale of control), and accepting the contention that the transactions were two phases of the same scheme, tied damages in that transaction to an unlawful second transaction (the redemption).

Rarely is the integration concept applied as distinctly as in *Drachman*; however, most other courts confronting this problem concur in the *Drachman* result.\(^7\) Under an integration approach, damages may


\(^{71}\) Coffee v. Permian Corp., 434 F.2d 383 (5th Cir. 1970) (mismanagement prior to liquidation); Herpich v. Wallace, 430 F.2d 792, 798, 803-10 (5th Cir. 1970); Dasho v. Susquehanna Corp., 380 F.2d 262, 269-70 (7th Cir.), cert. denied, 389 U.S. 977 (1967).

\(^{72}\) Although the plaintiff requested damages related only to the sale of control, damages from the fraudulent redemption were also recoverable. *See generally* notes 457-63 and accompanying text infra.

\(^{73}\) Authorities reaching the same conclusion include: Coffee v. Permian Corp., 434 F.2d 383 (5th Cir. 1970) (unclear what relief requested and no reference to transactions as one scheme; uphold whole complaint by individual stockholder although has standing on only one transaction); Shell v. Hensley, 430 F.2d 819 (5th Cir. 1970) (one scheme although not so stated in opinion; unclear what relief requested, but uphold corporation's cause of action including nonsecurity transactions when some actionable and others not); Herpich v. Wallace, 430 F.2d 792, 810 (5th Cir. 1970) ("broad scheme," "overall conspiracy," and "consistent course of conduct"; corporation allowed to sue for all transactions although some breaches and others not); Dasho v. Susquehanna Corp., 380 F.2d 262 (7th Cir.), cert. denied, 389 U.S. 977 (1967) (no mention of single scheme, although clearly such case; victim corporation has cause of action to recover control premium when defendants propose to merge corporate buyer of control into victim corporation and cause victim corporation to pay for control premium in that manner); Boggess v. Hogan, 328 F. Supp. 1048, 1050, 1052-53 (N.D. Ill. 1971) (tenderor for corporation A's stock buys from management of corporation A stock in corporation B at premium as
be recovered not only for the transaction which violates the Rule, but also for the other transaction, which, standing alone, would not be actionable or for both transactions.

Integration has myriad applications. For instance, if a person sells control to someone who he knows or should know will loot the corporation or waste its assets, the seller should be liable for both the control premium and the injury arising from the looting and waste, assuming that any transaction constituting the looting or waste is a breach of Rule 10b-5. The integration doctrine also encompasses mismanagement designed to injure stockholders individually. For example, recovery might be permitted for the type of looting which normally is not actionable under the Rule, including actions undertaken (1) to reduce the amount that stockholders will receive in a liquidation or in a merger between their corporation and another company under common control, or (2) to permit the issuer, insid-

Other cases have not integrated transactions. See, e.g., Haberman v. Murchison, 468 F.2d 1305, 1312-13 (2d Cir. 1972); Schoenbaum v. Firstbrook, 268 F. Supp. 385, 390 (S.D.N.Y. 1967), aff'd on other grounds, 405 F.2d 200 (2d Cir.), rev'd on rehearing en banc, 405 F.2d 215 (2d Cir. 1968) (integration principle accepted on rehearing), cert. denied, 395 U.S. 906 (1969) (waste after change of control not cause of action; waste consisted of selling securities for inadequate consideration); see Erling v. Powell, 429 F.2d 795, 797, 800 (8th Cir. 1970) (no cause of action if control sold to looter who wastes assets because neither corporation nor minority shareholders are buyers or sellers; whether waste included securities transactions not stated); Hoover v. Allen, 241 F. Supp. 213, 228-29 (S.D.N.Y. 1965) (no claim of conspiracy to waste assets; waste by new controlling persons not causally related to change of control; whether waste involved securities trading not mentioned); Note, Current Problems Under the Securities Acts: The Expanding Uses of Rule 10b-5, 10 B.C. Ind. & Com. L. Rev. 313, 320 (1969).

See, e.g., Drachman v. Harvey, 453 F.2d 736 (2d Cir. 1972) (en banc).


See Drachman v. Harvey, 453 F.2d 736 (2d Cir. 1972) (en banc).

Swanson v. American Consumer Indus., Inc., 415 F.2d 1326, 1332 (7th Cir. 1969) (corporate opportunity allegedly taken, and if true, injured corporation entitled to receive better ratio in sale of all its assets). Whether an unfair merger is a 10b-5 violation per se is discussed in the text accompanying notes 395-403 infra.
ers, or their associates to purchase the company's securities from the public at depressed prices.79

Because of its vast potential, integration could be applied to inappropriate situations. Unless forced to prove by a preponderance of evidence that the questionable transactions are part of one scheme, conspiracy, or course of conduct, plaintiffs could attack a plethora of actions unrelated to a 10b-5 breach for a defendant's single violation of the Rule.80 Attempts to limit integration to appropriate situations account for most of the divergent results in this area.81

An analysis of the applicability of Rule 10b-5 to specific acts of corporate mismanagement naturally divides into two parts: the applicability of the various general elements of the Rule to mismanagement claims and the relationship to the Rule of specific acts of corporate mismanagement. These two aspects of the application of the Rule to mismanagement are treated separately below with emphasis upon the current status of decisional law in the mismanagement area.

II

ELEMENTS OF RULE 10b-5 VIOLATIONS

A. "In Connection With the Purchase or Sale of any Security"

The last clause of Rule 10b-5 requires that proscribed activities be "in connection with the purchase or sale of any security."82 This requirement is considered here in two segments. First, what is the meaning of the "in connection with" clause? Second, under what circumstances is a stockholder or a corporation a purchaser or seller?

1. The "In Connection With" Clause

The words "in connection with" have been construed to require that the plaintiff be a buyer or seller, and that the fraud be related to the securities transaction. The 1952 case of Birnbaum v. Newport Steel Corp.83 established the principle that a plaintiff must be a buyer or

79 This practice is quite similar to manipulation accomplished by mismanagement. See Jacobs, supra note 12, at 349-51.
80 A similar problem exists in connection with imposing the proper limit on a manipulation claim arising out of corporate mismanagement. Id. at 550-51.
81 Except for the Schoenbaum district court decision, the cases cited in note 69 & notes 73-76 supra, involve such situations. Similar to the Schoenbaum district court decision in this regard is Smith v. Murchison, 310 F. Supp. 1079, 1084-86 (S.D.N.Y. 1970) (sale of control when issuer purchases stock of corporation and two partially-owned subsidiaries to bolster price of corporation's stock; insufficient connection between sale of control and other purchases).
83 193 F.2d 461 (2d Cir.), cert. denied, 343 U.S. 956 (1952).
seller before he has standing to challenge a transaction under Rule 10b-5. In a derivative suit, the corporation must be a purchaser or seller, although the stockholder bringing the action on the company’s behalf need not be. A stockholder suing individually or as a representative of a class must demonstrate that he and members of the class bought or sold. Only parties to a “purchase” or “sale” transaction can be classified as “purchasers” or “sellers.” It is not enough that the plaintiff was deprived of a chance to buy or sell or that the defendant offered to buy the plaintiff’s securities. In actions for injunctive relief, however, most courts distinguish Birnbaum and do not require trading by the plaintiff corporation or stockholder.

The required relationship between the fraud and the securities transaction poses knottier questions. Superintendent of Insurance v. Bankers Life & Casualty Co. provides a vehicle for discussion. The action brought on behalf of the corporation was based on misappropriation by looters of the proceeds from the sale of the corporation’s United States treasury bonds. The district court held that no claim was stated:

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89 Cooper v. Garza, 431 F.2d 578, 580 (5th Cir. 1970).


91 It is no defense that a transaction could be accomplished without the use of securities if a securities transaction was used and there was fraud “in connection with” it. Bailey v. Meister Brau, Inc., 320 F. Supp. 599, 543 (N.D. Ill. 1970).

The broad phrasing of the “in connection with” clause is also partially responsible for the integrated treatment of a series of transactions as a part of one scheme. See notes 67-81 and accompanying text supra.


93 Id. at 8.
In order to sustain a complaint alleging fraud under section 10(b) of the 1934 Act, it must appear with reasonable clarity from the face of the complaint either (1) that a purchase or sale of securities is at the crux of a fraudulent scheme; or (2) that inducing a purchase or sale of securities is the object of a fraudulent scheme; or (3) that fraudulent statements, misstatements, or omissions are made in a manner which is reasonably calculated to influence the investing public, or are of the sort which the reasonable investing public might rely upon; or (4) that the trading process is abused through potential market manipulation or the spread of watered stock.

... Rule 10b-5 requires the employment of fraud in connection with a security transaction, which is essentially different from the effectuation of a security transaction in connection with a fraudulent activity.\textsuperscript{94}

This statement appeared accurately to represent the law at that time, and subsequent cases reached the same conclusion.\textsuperscript{95} The Second Circuit affirmed the district court's decision,\textsuperscript{96} only to be reversed by the Supreme Court. The Court rejected the district court's reasoning in one sentence: "The crux of the present case is that [the corporation] suffered an injury as a result of deceptive practices touching its sale of securities as an investor."\textsuperscript{97}

The Supreme Court's broad language indicates that Rule 10b-5 proscribes fraud with which a securities transaction is only tangentially involved. Other courts had refused to recognize a cause of action when fraud occurred in one securities transaction and stand-

\textsuperscript{94} 300 F. Supp. 1083, 1101 (S.D.N.Y. 1969).

The point of view expressed by the district court in Bankers Life still retains some vitality, notwithstanding the Supreme Court's direction. See Seeburg-Commonwealth United Litigation, [1972-1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 93,802, at 93,450-51 (S.D.N.Y. 1973). Denial of recovery in the later case, however, was not based solely on the ground that the violation is merely part of a larger scheme of mismanagement. See note 45 and accompanying text supra.

\textsuperscript{96} 430 F.2d 355, 360-61 (2d Cir. 1970).
\textsuperscript{97} 404 U.S. 6, 12-13 (1971).
ing was predicated on another. Recent cases reflect a changed view of the "in connection with" requirement in response to the Supreme Court's direction in the Bankers Life case. Application of the Supreme Court's test on an ad hoc basis, however, will be necessary to determine whether, in a given case, the relationship between the fraud and the securities transaction is too attenuated to support a 10b-5 claim.

A number of decisions have interpreted "in connection with" as requiring the fraud to be perpetrated upon the plaintiff. The Fifth Circuit, on the other hand, has indicated that a corporation can recover for frauds practiced on others.

2. The "Purchase or Sale" Requirement

Courts have not yet precisely outlined the scope of "purchase or sale" for purposes of the Rule. It is clear, however, that these words are construed broadly and can be satisfied in transactions which are not common-law "purchases" or "sales."


99 See notes 67-81 and accompanying text supra. In Jannes v. Microwave Communications, Inc., 461 F.2d 525, 529 (7th Cir. 1972), the court indicated that the fairly direct nexus between the alleged fraud and a sale or purchase of securities, which formerly was required, was no longer necessary. See also Feldberg v. O'Connell, 338 F. Supp. 744, 747 (D. Mass. 1972) (dissolution of limited partnership—sale for purposes of 10b-5—delayed by misrepresentations held to state claim), relying on Stockwell v. Reynolds & Co., 252 F. Supp. 215 (S.D.N.Y. 1965); Voege v. American Sumatra Tobacco Corp., 241 F. Supp. 369, 374 (D. Del. 1965) (promise implied at date of purchase; fraud related to sale). Relating a subsequent fraud back to the original purchase is done only rarely. See Cooper v. Garza, 431 F.2d 578, 580 (5th Cir. 1970).


102 The statutory definitions are broad, but they are also vague. "The terms 'buy' and 'purchase' each include any contract to buy, purchase, or otherwise acquire." Exchange Act § 3(a)(13), 15 U.S.C. § 78c(a)(13) (1970). "The terms 'sell' and 'sell' each include any contract to sell or otherwise dispose of:" Id. § 3(a)(14), 15 U.S.C. § 78c(a)(14).


Some transactions clearly are purchases or sales. This is true, for instance, of a corporation's purchase or sale of securities of another enterprise or a purchase of its own securities. Issuance by a corporation of its own securities is also considered a sale. In addition, any transaction fitting the common-law concept of "purchase" or "sale" qualifies under the Rule.

One of the more difficult problems in this area is ascertaining the status of mergers. The Supreme Court and numerous lower tribunals have held that a completed merger is a sale. Some cases indiscriminately apply this conclusion to all persons and entities affected by the merger, but a more refined analysis is necessary. A merger can be analyzed from the point of view of the parties affected by the transaction, i.e., the constituent corporations and their respective stockholders. In a merger, the surviving corporation sells its securities to stockholders of the disappearing entity and buys


See generally notes 379-87 and accompanying text infra.

See generally notes 368-78 infra. For a discussion of redemptions, see note 140 and accompanying text infra.

See notes 299-302 and accompanying text infra. A sale of treasury shares would also be a "sale" for 10b-5 purposes.

A particular merger could be classified as either an ordinary, long-form merger, in which stockholders of both corporations must vote to approve the transaction, or as a short-form merger, permitted under state statutes, between a parent company and its almost wholly-owned subsidiary, in which no stockholder vote is required. The analysis in the text applies to both types of mergers. Arguably, minority stockholders in short-form mergers have no investment discretion, and hence no sale should arise with respect to their shares. However, the courts and the SEC have not adopted this rationale. See, e.g., Vine v. Beneficial Fin. Co., 374 F.2d 627, 633-35 (2d Cir.), cert. denied, 389 U.S. 970 (1967); SEC Securities Act Release No. 5316, at 7 (Oct. 6, 1972).


Of course, some creditors, like stockholders, are security holders. In a merger, the status of such creditors as buyers or sellers is indistinguishable from that of stockholders.
their shares. Stockholders of the disappearing entity therefore buy securities of the surviving corporation and sell their stock in the disappearing company. The disappearing corporation is neither a buyer nor a seller unless it sells its treasury stock, other securities owned as investments, or shares of subsidiaries. The question of


A fair number of mergers now are accomplished by the merger of a wholly-owned subsidiary of the surviving corporation into a second corporation. This transaction is more in the nature of an acquisition, but the surviving corporation is a seller and the second corporation's stockholders are buyers.

The laws of some states permit a merger even though the stockholders of the disappearing entity receive only cash. See, e.g., Del. Code Ann. tit. 8, § 251(b)(5) (Supp. 1968); N.Y. Bus. Corp. Law § 902(a)(3) (McKinney 1963). In that situation, the surviving corporation is obviously not a "seller" of its securities, although stockholders of the disappearing entity are sellers. See also note 126 and accompanying text infra.


Neither the status of these stockholders as sellers or buyers nor their ability to bring suit is dependent upon whether they have rights of appraisal under state law or whether they have exercised such rights as they may have. Vine v. Beneficial Fin. Co., 374 F.2d 627, 634-35 (2d Cir.), cert. denied, 389 U.S. 970 (1967) (appraisal rights available, but plaintiff did not surrender stock); Weisman v. MCA, Inc., 45 F.R.D. 258, 264 n.8 (D. Del. 1968) (shares surrendered after merger, but plaintiff still allowed to sue); Miller v. Steinbach, 268 F. Supp. 255, 269-72 (S.D.N.Y. 1967) (appraisal not sole remedy); Voege v. American Sumatra Tobacco Corp., 241 F. Supp. 369, 373, 375 (D. Del. 1965) (appraisal demanded, but not yet processed; can sue even if demand appraisal without knowing of fraud); Eagle v. Horvath, 241 F. Supp. 341, 344-45 (S.D.N.Y. 1965) (stockholder not limited to right of appraisal); see Voege v. Smith, 329 F. Supp. 180, 184 (S.D.N.Y. 1971) (no appraisal rights available, but that alone not grounds or dismissal); cf. Swanson v. American Consumer Indus., Inc., 415 F.2d 1326, 1332-33 (7th Cir. 1969) (sale of assets) (10b-5 remedies not affected by failure to exercise, or nonexistence of, appraisal rights). See also In re Penn Cent. Sec. Litigation, 357 F. Supp. 869, 875 (E.D. Pa. 1973) (hinting that transaction in which appraisal rights lost may constitute purchase or sale).


114 Another approach is to focus upon the merger agreement, signed by the constituent corporations, which may fall within the statutory definition of "sale." The terms 'sale' and 'sell' each include any contract to sell or otherwise dispose of." Exchange Act § 5(a)(14), 15 U.S.C. § 78c(a)(14) (1970). The merger agreement is a contract pursuant to which the surviving
the standing of the disappearing corporation is somewhat academic because a class action by persons who were stockholders of the disappearing corporation at the time of the merger can fully redress any fraud perpetrated upon the corporate entity. Stockholders of the corporation that survives the merger retain their certificates and usually are not considered purchasers or sellers, but two approaches might lead to an opposite conclusion. First, one case seems to hold that stockholders of the surviving corporation are purchasers when they receive new or additional securities of the surviving corporation or when the terms of the securities they hold are modified as part of the merger. Second, it is arguable that such stockholders are investors in a different enterprise after the merger. The surviving corporation could sue to redress fraud perpetrated on it in co-

corporation sells its stock to stockholders of the disappearing entity, and the stockholders of the disappearing corporation sell their stock to the surviving enterprise. Another avenue reaching the conclusion that the disappearing corporation is a seller is suggested in note 128 infra.  


For instance, if a very large corporation merges into a very small company, the stockholders of the surviving corporation are, economically speaking, investors in an entirely different enterprise, and they could be considered sellers. See notes 134-36 and accompanying text infra; cf. note 127 infra. This rationale may explain why stockholders of the surviving corporation were permitted to sue in Lewis v. Bogin, 337 F. Supp. 331, 339 (S.D.N.Y. 1972) (merger or parent owning 87% into subsidiary; point not discussed). See also In re Penn Cent. Sec. Litigation, 347 F. Supp. 1327. 1334 (E.D. Pa. 1972) (because of combination of two sets of assets, ordinary merger deemed sale).  

Another way to reach the conclusion that stockholders of the surviving corporation are sellers would be to focus on a sale by the stockholders pursuant to dissenters' rights. See Nanfito v. Tekseed Hybrid Co., 341 F. Supp. 234, 238 (D. Neb. 1972).
connection with the merger. Absent an equitable lien, however, recovery would benefit all stockholders at the time of judgment (including former stockholders of the disappearing entity who profited from the fraud), rather than those who were injured, namely the stockholders of the surviving entity immediately prior to the merger.

Another subject of litigation is the point at which the merger has sufficiently progressed for a sale to take place. In a long-form merger, both boards of directors approve the merger, a merger agreement is executed, stockholders of each company adopt the agreement, and appropriate documents are then filed with the states of incorporation. The merger is not effective under state law until all these steps are taken. The merger is considered a sale by most courts when the documents are filed, even if a shareholder of the disappearing corporation has not yet surrendered his stock certificates.

Furthermore, a board of directors resolution approving a merger has been held to render the corporation a buyer or seller when the parties to the merger are controlled by the same persons.

The merger analysis applies also to consolidations in which the consolidating corporations “merge” into a new entity whose securities are issued to their respective stockholders. The consolidating corporations and their stockholders are equivalent, in this context, to the disappearing partner in a merger and its shareholders. The new entity in a consolidation is treated in the same way as the surviving company in a merger.

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123 A fortiori, a resolution of the board of directors should have the same consequences in a short-form merger.
Acquisitions can be analyzed along similar lines. The acquiring corporation is a seller when the consideration it pays consists entirely or partly of securities. It is also a buyer if it purchases stock of the acquired entity or if it buys the assets of the acquired corporation and these consist partly of stock of subsidiaries, treasury stock, or investments in other enterprises. Stockholders of the acquiring corporation are not buyers or sellers unless they are able to convince a court that the acquisition so radically changed their corporation that in effect they sold the shares they owned and bought stock in a new enterprise. If the acquired corporation sells its assets, it is a seller only if some of its assets consist of securities; it is a buyer if at least part of the consideration paid for its assets consists of securities; but it is neither a buyer nor a seller when the acquiring corporation buys its outstanding stock. Shareholders of the acquired corporation are sellers when their shares are purchased by the acquiring corporation and are buyers as well if securities are issued in exchange. Although shareholders of the acquired corporation are not ordinarily sellers when corporate assets are sold, the result should be different when liquidation of the acquired corporation is part of the acquisition plan. In a liquidation, the shareholders of the acquired corporation are sellers of their shares, and if securities form a portion of the consideration for the assets, they are purchasers of the securities distributed in liquidation.

124 See generally Lockwood, supra note 113, at 372-75.
126 The acquiring corporation should also be considered a buyer if it assumes any obligations evidenced by a note or bond.
127 Dyer v. Eastern Trust & Banking Co., 336 F. Supp. 890, 911-13 (D. Me. 1971), in which the acquisition reduced the interests of the original stockholders from 100% to 35%, rejected this approach. Nevertheless, form should not prevail over substance, and stockholders of a small company should be deemed sellers if in the “acquisition” their company “acquired” a large conglomerate by issuing shares equal to many hundreds of times the previously outstanding total. Cf. note 118 supra.
128 The acquired enterprise should also be considered a seller if the acquiring corporation assumes debt evidenced by notes or bonds.
129 Swanson v. American Consumer Indus., Inc., 415 F.2d 1326, 1330 (7th Cir. 1969) (stock-for-assets transaction).
130 Hanraty v. Ostertag, 470 F.2d 1096, 1098 (10th Cir. 1972).
131 Arguably, a stockholder is a seller when he seeks appraisal. See note 118 supra & notes 134-36 and accompanying text infra. The existence of an appraisal remedy depends on state corporation law, however. Compare Del. Code Ann. tit. 8, §§ 269, 271 (1967) (appraisal rights only in mergers and consolidations, but not in sales, leases, or exchanges) with N.Y. Bus. Corp. Law. § 910(a)(1)(B) (McKinney 1963) (appraisal rights in mergers, consolidations, sales, leases and exchanges).
132 There are tax reasons for a liquidation following a sale of assets. See Int. Rev. Code of 1954, § 337.
133 Swanson v. American Consumer Indus., Inc., 415 F.2d 1326, 1330 (7th Cir. 1969)
C O R P O R A T E  M I S M A N A G E M E N T

Several cases have attempted to define when a purchase or sale takes place in the mismanagement context. According to the Fifth Circuit, "a shareholder should be treated as a seller when the nature of his investment has been fundamentally changed from an interest in a going enterprise into a right solely to a payment of money for his shares." During the previous year, that court had opined that a shareholder is a seller if he "as a practical matter has no choice but to surrender his interest in the corporation and to exchange his shares for cash." The Seventh Circuit expressed a broader rule: "[T]he fraudulent substitution of shareholder status in one company for the same status in another may constitute a cognizable legal injury in and of itself." The two courts of appeals relied on merger cases to justify their tests.

These expansive definitions of a securities sale bring a number of transactions within the purchase or sale provision of the Rule. For example, a corporate liquidation, in which stockholders are entitled to their corporation's assets, constitutes a sale by them of their shares even if the statutory liquidation procedure is not followed, and the liquidation is only substantially completed. Likewise, dissolution or termination of a limited partnership is a sale by the limited partners. Similarly, an issuer's call for redemption of a security is a sale by the security holder, and a redemption is a purchase by the corporation. A recapitalization, however, is not a purchase or sale because each stockholder's economic interest remains unchanged. (stock-for-assets transaction). Even without a liquidation, a sale and purchase may be consummated. See notes 134-36 and accompanying text infra. See also note 138 and accompanying text infra (liquidation). Stockholders are purchasers when their corporation sells its assets and they have the option of receiving an initial consideration or a pay-out. Fidelis Corp. v. Litton Indus., Inc., 293 F. Supp. 164, 169 (S.D.N.Y. 1968).


136 Swanson v. American Consumer Indus., Inc., 415 F.2d 1326, 1332 (7th Cir. 1969).

137 See notes 109-19 and accompanying text supra.

138 Dudley v. Southeastern Factor & Fin. Corp., 446 F.2d 303, 307-08 (5th Cir.), cert. denied, 404 U.S. 858 (1971); Coffee v. Permian Corp., 434 F.2d 383, 386 (5th Cir. 1970). The question of whether the stockholder "purchases" securities distributed to him in the liquidation was left open by the Fifth Circuit in Dudley although the district court had held that no purchase took place. 315 F. Supp. 1019, 1021 (N.D. Ga. 1970). The district court appears to be incorrect. See notes 132-33 and accompanying text supra.


140 Drachman v. Harvey, 453 F.2d 736, 737 n.2 (2d Cir. 1972) (en banc).

The question of whether a purchase by a corporation of forty percent of the outstanding shares from one holder transforms the other stockholders into purchasers in a new enterprise was left open by the Court of Appeals for the Fifth Circuit in *Coffee v. Permian Corp.* The district court had held that the remaining stockholders were not purchasers. Another district court refused to equate dilution of the equity of the old stockholders resulting from a series of acquisitions to a purchase or sale by those stockholders.

A 1971 decision held that stockholders of a target company became investors in a new enterprise and hence "sellers" when their management was secretly bribed in connection with a tender offer and the tenderor planned to loot their corporation.

B. The Element of Fraud

A plaintiff must prove deception, "new fraud," or negligence to make out a mismanagement claim under Rule 10b-5. This re-


142 434 F.2d 383, 384, 386 (5th Cir. 1970).


144 See *Dyer v. Eastern Trust & Banking Co.*, 336 F. Supp. 890, 912 (D. Me. 1971); accord, *Wolf v. Frank*, 477 F.2d 467, 478 (5th Cir. 1973) (dilution of equity interest held not to constitute cause of action although other cases in different circuits support opposite conclusion). This reasoning indicates that existing stockholders are not buyers or sellers when the corporation sells stock for inadequate consideration, even though the reduction in the value of their stock is sufficient contact to justify federal jurisdiction. See *Travis v. Anthes Imperial Ltd.*, 473 F.2d 515, 527-28 (5th Cir. 1973); *Schoenbaum v. Firstbrook*, 405 F.2d 200, 208-09 (2d Cir.), rev'd on other grounds on rehearing en banc, 405 F.2d 215 (2d Cir. 1968), cert. denied, 395 U.S. 906 (1969). Other cases have discussed this concept in the buyer-seller context. See *Rekant v. Desser*, 425 F.2d 872, 880-81 (5th Cir. 1970); *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 300 F. Supp. 1083, 1103 (S.D.N.Y. 1969), aff'd, 430 F.2d 555 (2d Cir. 1970), rev'd on other grounds, 404 U.S. 6 (1971).


requirement is comparable to the scienter or intent element which must be shown in other fields policed by the Rule.\textsuperscript{147}

1. Deception

In several cases, violations of Rule 10b-5 have been found without discussions of deception, "new fraud," or negligence.\textsuperscript{148} A greater number, however, reflect judicial awareness of the scienter element and require the plaintiffs to prove deception on the part of the defendants.\textsuperscript{149} This raises conceptual difficulties for, as one commen-


tator noted, it is as difficult to think of a corporation being deceived as being in love. 150

The basic test of "deception" is whether the corporation's investment judgment is impaired. 151 The deception can be nonverbal 152 and "need not be deception in any restricted common law sense." 153 On the other hand, deception does not arise merely because a transaction has an improper purpose, 154 nor is bad judgment considered a form of deception actionable under the Rule. 155 A distillation of the cases applying these principles indicates that "deception" exists if (1) material facts are concealed from the corporation or from some or all members of the decision-making body, (2) misrepresentations of material facts are made to the company or to some or all members of the decision-making body, or (3) one or more of the directors or officers who are members of the decision-making body participate in the questioned transactions by selling securities to or buying them from the corporation. 156 Depending upon whose approval is required, the decision-making body can be an officer, the board of directors, a committee of the board, or the stockholders.

Opinions frequently refer to the concealment of inside information. Concealment by an insider from some or all members of the corporate decision-making body brings the case into the area of

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151 Herpich v. Wallace, 430 F.2d 792, 809-10 (5th Cir. 1970), quoting Shell v. Hensley, 430 F.2d 819, 824-27 (5th Cir. 1970) (fits within rationale of en banc Schoenbaum case so deception not necessary); Rekant v. Desser, 425 F.2d 872, 879-82 (5th Cir. 1970) (rationale of second Schoenbaum decision adopted so deception not necessary under circumstances).


154 See notes 260-62 and accompanying text infra.

155 See notes 200-01 and accompanying text infra (negligence standard under the Rule discussed).

156 See Bailes v. Colonial Press, Inc., 444 F.2d 1241, 1249 (5th Cir. 1971) (concurring opinion) (regarding time relationship between sale and deception).
CORPORATE MISMANAGEMENT

mismanagement. Mismanagement concepts do not apply, of course, when there is no misrepresentation or concealment among members of the decision-making body and false statements or omissions to that body do not stem from an officer, director, or controlling stockholder. In such a case, the principles governing misrepresentations and omissions in securities transactions generally would control.¹⁵⁷

If a controlling stockholder misstates or omits to state a material fact to the board of directors, leaving one or more of the directors ignorant of the truth, deception is practiced on the corporation.¹⁵⁸ More often all directors know the relevant data. Nevertheless, courts have had little trouble in holding that all directors can defraud the corporation.¹⁵⁹ “Concealment” from the company is not really an apt expression under this fact pattern. The real issue is whether the directors’ knowledge will be imputed to the corporate entity,¹⁶⁰ and this is determined by agency principles.¹⁶¹ Even if all directors have the information, agency law will deny imputation of a director’s

¹⁵⁸ Hoff v. Sprayregen, 339 F. Supp. 369, 373-74 (S.D.N.Y. 1971); see SEC v. Fifth Ave. Coach Lines, Inc., 435 F.2d 510, 517 (2d Cir. 1970) (controlling persons caused sale of asset without full disclosure to board or approval of board). The controlling person may have problems even if all directors know the truth. See notes 177-99 and accompanying text infra (discussing "new fraud").

When an officer’s or employee’s knowledge would be imputed to the corporation under agency principles, but the directors are not actually aware of the true facts when the board acts, deception occurs because in such a situation the judgment of the decision-making body is impaired. Although somewhat inconsistent with cases questioning whether directors’ knowledge is imputed to the corporation, this result seems proper when an unbiased assessment of the situation by the decision-making body is sought. See Cox, Fraud Is in the Eyes of the Beholder: Rule 10b-5’s Application to Acts of Corporate Mismanagement, 47 N.Y.U.L. Rev. 674, 685 n.49 (1972).
knowledge if some or all directors have a conflict of interest, i.e., are interested\textsuperscript{162} in the transaction.\textsuperscript{163}

If some directors conceal information from or misrepresent facts to the other directors,\textsuperscript{164} a cause of action then accrues to the corporation based on an impairment of its investment judgment. Whether knowledge is imputed to the corporation in such cases is irrelevant.\textsuperscript{165} It follows that deception is not practiced if directors do

\textsuperscript{162} Dasho v. Susquehanna Corp., 461 F.2d 11, 26 n.36 (7th Cir.), cert. denied, 408 U.S. 925 (1972), contains an excellent discussion of what constitutes a conflict of interest. The court in \textit{Dasho} was concerned about \textit{any} interest of a director "of sufficient importance to influence his action as a director" or which would "conflict with [his] status as [a] shareholder or director." In reaching a determination on the conflict of interest question, it is permissible to weigh a director's conflict against his substantial stock interest and conclude that his independence is not compromised. \textit{Id.} A person should not be considered interested in a transaction merely because he receives a benefit from it other than that received by stockholders on a pro rata basis. See note 174 and accompanying text \textit{infra}. Compare Exchange Act § 14(a), Schedule A, Item 7 (f), Instruction 2(d).


\textsuperscript{164} The interrelationship between causation and participation by a majority of the board in the fraud is discussed in note 210 and accompanying text \textit{infra}.

not take part in the transaction, the board is fully informed, and no conflict prevents the information from being imputed to the corporation.\textsuperscript{166}

Facts may also be concealed from or misrepresented to stockholders. When stockholders vote, they are the decision-making body, analogous to the board of directors.\textsuperscript{167} A cause of action therefore arises when facts are misrepresented to or concealed from voting stockholders.\textsuperscript{168} On the other hand, information known by stockholders when they are \textit{not} voting is irrelevant.\textsuperscript{169} In dealing with deception by directors, some courts view the stockholders as being the corporate entity. This avoids what those courts see as a conceptual trap—directors being equated with the corporation and the corporation therefore defrauding itself.\textsuperscript{170} Application of this approach,
however, reaches the wrong conclusion when directors vote and deceive the company while nonvoting shareholders are aware of the information yet cannot block the action without resort to the courts. Rule 10b-5 protects creditors against fraud perpetrated on a corporation by directors and shareholders.\(^ \text{171} \) It follows that when the rights of creditors or stockholders are at issue the corporation must be viewed as an entity comprising a community of interests—stockholders, creditors, and others dealing with the corporation.\(^ \text{172} \)

Deception has also been found when some or all of the directors bought the securities in question from the issuer or sold them to the corporation. Such trading is itself a form of deception even though the board was fully informed and no misrepresentation or concealment occurred.\(^ \text{173} \) This type of director involvement could render a transaction objectionable, even if the director did not have a conflict of interest which would have prohibited imputation of his knowledge to the corporation.\(^ \text{174} \)


\(^{172}\) See Bailes v. Colonial Press, Inc., 444 F.2d 1241, 1246 (5th Cir. 1971) (future stockholders and creditors, persons contracting with corporation, and tax authorities defrauded).


In Cohen v. Colvin, 266 F. Supp. 677, 680-83 (S.D.N.Y. 1967), directors of Fairchild purchased Republic stock knowing that Fairchild intended to make a tender offer for Republic stock. Republic then sold some assets to Fairchild, received Fairchild stock as partial payment, and distributed the Fairchild stock it received to its stockholders, including the Fairchild directors. The court rejected the plaintiff's claim that this was essentially equivalent to the Fairchild directors' purchasing the Fairchild stock from Fairchild for inadequate consideration.\(^ {174} \) In Schoenbaum v. Firstbrook, 405 F.2d 200, 211-13 (2d Cir.), rev'd on rehearing en banc, 405 F.2d 215 (2d Cir. 1968), cert. denied, 395 U.S. 906 (1969), the trading and imputation of knowledge concepts are treated separately. See notes 162-63 and accompanying text supra. The difference is clearly illustrated by reference to common law. An agent's knowledge is not imputed if he "secretly is acting adversely to the principal and entirely for his own or another's purpose ...." Restatement (Second) of Agency § 282(1) (1958). But the information is imputed if the agent has more than one purpose, one of which is to aid his company. Id. § 282,
When officers are in charge of the relevant corporate transactions, they are the decision-making group and the above-mentioned deception principles apply to them. Officers have authority under state corporation law to perform certain actions without board approval. For example, a senior officer can sell securities of another enterprise held by his employer as an investment. The Rule prohibits him from personally buying those securities for inadequate consideration. If an officer purports to act for the corporation beyond his real and apparent authority, the transaction will be ineffective under state law. Nevertheless, a purchase or sale may take place for purposes of 10b-5 since the scope of "purchase" and "sale" are broader under federal law. The officer should be held responsible under the Rule for any injury if the "in connection with the purchase or sale of any security" clause can be satisfied and his actions are proscribed by the Rule.

2. "New Fraud"

In 1968, the Court of Appeals for the Second Circuit, in whose jurisdiction almost all deception-oriented cases have arisen, handed down its decision in Schoenbaum v. Firstbrook. In so doing, the court enunciated a concept of liability which has come to be popularly known as "new fraud." Deception no longer must be demonstrated if "new fraud" can be shown.  

Comment c at 613. Thus, the knowledge of a director is imputed to his corporation if one of his purposes in buying stock from the corporation is to supply it with needed working capital. Nevertheless, some courts confuse the two concepts. See, e.g., Continental Bank & Trust Co. v. Garfinkle, 292 F. Supp. 709, 711 (S.D.N.Y. 1968) (conflict of interest discussed, but director actually buying shares). The confusion is justifiable since the two concepts are so closely allied. The corporation would not be imputed with knowledge in a case like Garfinkle because any directorial conflict negates imputation, so the results of the two approaches are the same. Trading as deception is also distinguishable from the "new fraud" approach. Deception cases concern only the directors' trading with the company, whereas the "new fraud" approach applies to situations in which the directors have no direct economic interest.

The principles applicable to deception of the board should also apply to a committee of the board. See Lewis v. Adler, 331 F. Supp. 1258, 1263 (S.D.N.Y. 1971) (applying same approach to board's stock option committee).


See notes 82-145 and accompanying text supra.


See Shell v. Hensley, 430 F.2d 819, 825-27 (5th Cir. 1970); Herpich v. Wallace, 430 F.2d 792, 809-11 (5th Cir. 1970); Bloomenthal, supra note 76, at 347; Patrick, supra note 150, at
In *Schoenbaum*, the Banff board of directors consisted of five independent directors and three representatives of Aquitaine Corporation, the controlling stockholder. The Banff board issued stock to Aquitaine and Paribas Corporation, an unrelated third party. Both purchasers were alleged to have had inside information about Banff. A panel decision applying deception principles found for the defendants.\(^1\) Then the en banc court upheld the claims based on the sale to Aquitaine for inadequate consideration, even though the three Aquitaine representatives on the board abstained from voting on the Aquitaine sale.\(^2\) The court reasoned that a cause of action existed because Aquitaine "exercised a controlling influence over the issuance to it of treasury stock of Banff for a wholly inadequate consideration."\(^3\) Approval of a majority of the board, who are not representatives of the controlling stockholder, therefore affords no defense in a case under "new fraud."\(^4\) However, the plaintiff in *Schoenbaum* was unsuccessful in his attack upon the sale to Paribas for inadequate consideration because Paribas was not "in any position to influence the judgment of the [corporation's] directors by any improper means."\(^5\)

Several decisions have construed the italicized language of *Schoenbaum* quoted above.\(^6\) A district court in the Southern District of New York opined that the Second Circuit's test of improper influence did not encompass the bargaining power of an unaffiliated stock purchaser.\(^7\) Another case compared the stockholdings of a prospective stock optionee with those of the stock option committee to determine whether the optionee had the required influence.\(^8\)

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457; Comment, *supra* note 178, at 1103; see Popkin v. Bishop, 464 F.2d 714, 719 (2d Cir. 1972).

\(^1\) 405 F.2d at 213-14. On rehearing, the en banc court noted that summary judgment should rarely be granted to insiders in derivative suits before discovery is completed. *Id.* at 218.

\(^2\) *Id.* at 218-20.

\(^3\) *Id.* at 219. The court, noting what is apparently another ground sufficient unto itself to support the decision, observed without elaboration: "Moreover, Aquitaine and the directors of Banff were guilty of deceiving the stockholders of Banff (other than Aquitaine)." *Id.* at 220; see note 170 and accompanying text *supra*. District courts in the Second Circuit have not relied on this holding.


\(^5\) 405 F.2d at 219 (emphasis added). The court also concluded that Paribas was "unable through ownership of Banff stock or otherwise to bring any pressure on Banff to sell its stock at a price below true value." *Id.*

\(^6\) See Note, *Breach of Fiduciary Duty Involving Full Director Knowledge Held 10b-5 Violation*, 1969 Duke L.J. 383, 395 n.54 (includes, *e.g.*, bribery and blackmail).

\(^7\) Penn Mart Realty Co. v. Becker, 300 F. Supp. 731, 736 (S.D.N.Y. 1969). This result is true even if the buyer is an institutional purchaser. *Id.*

And one decision has gone so far as to hold that an investment banking house was not within the proscribed class of purchasers, even though it bought convertible debentures from the issuer after advising the board that the terms of the purchase were fair to the company. Every controlling person, however, is in a position to exert the requisite influence.

By permitting recovery for transactions with persons who could improperly influence the directors' judgment, the Schoenbaum en banc decision expanded the area of actionable mismanagement beyond the limits of the deception approach, i.e., misrepresentation, concealment, and transactions with interested directors. In other words, full and fair disclosure to the board does not protect a transaction from attack under Rule 10b-5 when improper influence is present. The "new fraud" cases can also be viewed as expanding the categories of deception to include situations in which the board of directors is influenced by outsiders or in which insiders receive some indirect benefit on the rationale that the board is not competent to represent the stockholders and the directors' knowledge is not imputed to the corporation.

The Second Circuit added a wrinkle to the "new fraud" concept in 1972. The court of appeals held that when state law requires a stockholders' vote, full and fair disclosure to the shareholders—the decision-making body as to the matter upon which the vote is taken—ordinarily satisfies the Rule's requirements. Although there is some merit to this approach, it does ignore the Supreme Court's emphasis on the importance of disclosure and ratification.

188 Lewis v. Spiral Metal Co., 317 F. Supp. 905, 908-09 (S.D.N.Y. 1970). A sequel to this decision, brought on motion of the corporation's directors and officers to dismiss the complaint, reached an equally strange conclusion, perhaps to offset what the second judge considered to be an unfortunate result in the first decision. The second judge held that if the investment banker is not liable, as a corollary, the directors must be. Lewis v. Spiral Metal Co., [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 92,919, at 90,405 (S.D.N.Y. 1971). This result, however, is inconsistent with the en banc Schoenbaum court's treatment of Paribas, on which the second judge relied.


191 Popkin v. Bishop, 464 F.2d 714, 719 (2d Cir. 1972). The topics of disclosure and ratification are discussed in the text accompanying notes 264-94 infra. See notes 279-82 and accompanying text infra (special emphasis on disclosure).
Court's view that 10b-5 protects the whole community of corporate interests—creditors as well as stockholders.192

The Third,193 Fifth,194 and Seventh195 Circuits have adopted their own "new fraud" approaches which are broader than Schoenbaum.196 Some Third and Seventh Circuit cases can be read as imposing liability on directors for mismanagement in corporate securities dealings with anyone.197 And the Fifth Circuit would extend the 10b-5 net at least to transactions with officers, directors, and "others in league with them or the one controlling them."198 The

192 See Superintendent of Ins. v. BankersLife & Cas. Co., 404 U.S. 6, 12 (1971). This is particularly true when creditors are injured although stockholders receive full information.

193 Shell v. Hensley, 430 F.2d 819, 826-27 (5th Cir. 1970) (sale of control); Herpich v. Wallace, 430 F.2d 792, 811 (5th Cir. 1970) (purchase of assets at excessive price); Rekant v. Desser, 425 F.2d 872, 881-82 (5th Cir. 1970) (sale of securities for inadequate consideration).

194 Swanson v. American Consumer Indus., Inc., 415 F.2d 1326, 1333-34 (7th Cir. 1969) (derivative action proper when "directors in position of conflicting interest or loyalty" and know of unfairness to corporation); Dasho v. Susquehanna Corp., 380 F.2d 262, 269-70 (7th Cir.) (concurring opinion of two of three judges; corporate acquisition of own stock for excessive price), cert. denied, 389 U.S. 977 (1967). Although the district court in Dasho found no misrepresentation or concealment (267 F. Supp. 508, 512 (N.D. Ill. 1966)), the concurring court of appeals judges found fraud in the defendants' failure "to disclose [their] adverse personal interest." 380 F.2d at 266. One of the most important considerations underlying the court's holding was the inadequacy of the consideration paid for the stock. Read from this perspective, Dasho is broader than Swanson. However, when Dasho was appealed to the Seventh Circuit a second time, the court of appeals analyzed the case in terms of deception. See Dasho v. Susquehanna Corp., 461 F.2d 11, 25-26 (7th Cir.), cert. denied, 408 U.S. 925 (1972). Condon v. Richardson, 411 F.2d 489, 492 (7th Cir. 1969), can be viewed as either a "new fraud" case or as a deception case in which one director was selling securities to the issuer. Significantly, the court stated that 10b-5 violations may arise even though the board is fully informed. Id.

In view of these cases and Schoenbaum, Ross v. Longchamps, Inc., 336 F. Supp. 434, 439 (E.D. Mo. 1971), involving the dismissal of a case based on a transaction between a parent and a 53%-owned subsidiary on the ground of no deception, was decided incorrectly.

196 Each of the cases cited in notes 193-95 supra involved a benefit, although not necessarily a monetary one, to the defendants. Judge Smith's dissenting opinion in Drachman v. Harvey, 453 F.2d 722, 735 (2d Cir. 1971), rev'd on rehearing en banc, 453 F.2d 736 (2d Cir. 1972), appears to expand the Second Circuit's "new fraud" concept to include any purchases that benefit the controlling stockholder.

197 The Third Circuit case involved a sale for inadequate consideration to directors and other purchasers. The directors were held responsible for damages with respect to all shares. Pappas v. Moss, 393 F.2d 865, 869 (3d Cir. 1968), on remand, 303 F. Supp. 1257, 1279, 1281 (D.N.J. 1969). Dasho v. Susquehanna Corp., 380 F.2d 262, 269-70 (7th Cir.), cert. denied, 389 U.S. 977 (1967), involved a sale by the corporation to a dissident stockholder group. The sale, made for inadequate consideration in order to silence the dissenting group's objections, was held to be a Rule 10b-5 violation.

One early district court decision in the Second Circuit seems to have gone this far as well. See New Park Mining Co. v. Cranmer, 225 F. Supp. 261, 264-65, 267 (S.D.N.Y. 1965).

198 Rekant v. Desser, 425 F.2d 872, 882 (5th Cir. 1970), quoted in Wolf v. Frank, 477 F.2d 467, 477 (5th Cir. 1973); cf. Shell v. Hensley, 430 F.2d 819, 827 (5th Cir. 1970) (purchase of assets for excessive consideration; no deceit necessary if other party to transaction controls board or conspires with board).
Eighth Circuit also has adopted a far-reaching rule which condemns any securities transaction in which self-dealing violative of fiduciary obligations can be found, even if the insiders' benefits arise indirectly out of a trade between the issuer and outsiders.199

"New fraud" principles should, of course, apply to an alleged violation emanating from actions of officers or a committee of the board.

3. Negligence

Negligence is a possible alternative to deception and "new fraud." There is some authority for the proposition that negligent mismanagement is actionable under the Rule.200 But this reasoning is somewhat inconsistent with cases holding that Rule 10b-5 does not reach all breaches of fiduciary obligation.201

C. The Causation and Reliance Elements

Analyses of causation and reliance are often intermingled in mismanagement decisions.202 Even when discussed separately, their individual roles are unclear. Although causation is a necessary element in all 10b-5 suits,203 a less stringent standard suffices for injunct-
tive suits than for actions seeking damages. This bifurcation is a result of the Supreme Court’s opinion in SEC v. Capital Gains Research Bureau, Inc., which held that all elements of a case for monetary damages need not be proven to obtain equitable or prophylactic relief. In damage actions, the fraudulent securities transaction must cause the plaintiff’s injury. Indeed, the Supreme Court applied a causation-in-fact test in a 10b-5 concealment case. This approach will probably be adopted in mismanagement cases as well, despite the fact that earlier cases employed different standards.


Britt v. Cyril Bath Co., 417 F.2d 433, 435-36 (6th Cir. 1969) (relaxed causation-reliance test in suit for injunctive relief); Mutual Shares Corp. v. Genesco, Inc., 384 F.2d 540, 547 (2d Cir. 1967) (causation unnecessary in injunction actions). This standard should also apply to suits brought by the SEC.


Id. at 193.


If proximate cause is the test, cause-in-fact must be established and then the policies of the 1934 Act must be employed to determine whether the proximate cause criteria are satisfied. Note, supra note 25, at 490 n.65; Note, supra note 202, at 121.

Common-law causation exists if the fraud is a substantial factor in causing the injury. Note, supra note 161, at 801-02.

Courts are hesitant to grant relief in the absence of direct dealings between the plaintiff and the defendant, because causation is then not readily apparent. Rekant v. Desser, 425 F.2d 872,
Troublesome issues of causation arise when defendants hold a majority of the voting power of the decision-making body. Courts consistently uphold complaints alleging that a majority or all of the corporation's directors participated in the fraud. But the district court decisions in the Second Circuit reveal a split on whether causation exists when defendants control sufficient votes to pass a resolution. In 1969, the Seventh Circuit approved a damage action even though defendants had the necessary votes to approve a sale of assets. The Second Circuit has concurred with the Seventh Circuit by concluding, without elaboration, that minority stockholders' inability to block an action by internal corporate procedures does not defeat their suit for injunctive relief. This case probably reflects the

881 (5th Cir. 1970).

As to the efficacy of an interested stockholder's vote in ratification, see note 278 and accompanying text infra. Causation is more easily proven if a series of steps is part of the same scheme or conspiracy. See notes 67-81 and accompanying text supra.


213 Reasons in favor of the Second Circuit's approach are set forth in Note, supra note 202, at 114-23.

Second Circuit's views toward damage actions as well.  The Supreme Court has not yet resolved this issue.

Most decisions do not refer to reliance at all. A few opinions do mention reliance, but not in the context of deception of the decision-making body, where it is most relevant. If directors receive false or incomplete information, the plaintiff should have to prove that the directors relied on the misinformation to the same extent as claimants in a general 10b-5 misrepresentation or concealment case. Reliance is irrelevant when no misrepresentation or omission is made. When stockholders have the choice of action, the plaintiff should also be required to demonstrate the same degree of reliance as is necessary in the usual misrepresentation and concealment cases. This requirement applies, for instance, when the fraud arises out of misstatements or omissions in a proxy statement. But reliance is not a prerequisite for fraud on stockholders who can exercise no volition. Whatever reliance requirements are applicable to damage actions, they are relaxed in injunctive proceedings.

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Whatever rule governs a stockholders' meeting and vote should also apply to stockholders' consent in writing to an action without a meeting. See Del. Code Ann. tit. 8, § 228 (Supp. 1968). See also Exchange Act § 14(c), 15 U.S.C. § 78n(c) (1970) (must send information statement if subject to proxy rules). For a commentator's discussion of this topic, see Cox, supra note 160, at 691-97.


217 When commentators attempt to fit the reliance element of misrepresentation and concealment decisions into mismanagement cases, they either manufacture fictional types of reliance or conclude that no reliance is required. See, e.g., DeLancy, Rule 10b-5-A Recent Profile, 25 Bus. Law. 1355, 1372 (1970); Lockwood, supra note 113, at 373, 377; Note, supra note 175, at 516.

218 The signal cases on reliance on misrepresentations and omissions are Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-54 (1972) (if material fact omitted when defendant under duty to disclose, no showing of reliance necessary) and List v. Fashion Park, Inc., 340 F.2d 457, 463 (2d Cir.), cert. denied, 382 U.S. 811 (1965) (to show reliance need only show that disclosure would have influenced plaintiff to act differently).


220 See, e.g., Mader v. Armel, 402 F.2d 158, 162 (6th Cir. 1968), cert. denied, 394 U.S. 930 (1969). This type of claim appears to be a "misrepresentation" claim as distinguished from a "mismanagement" cause of action.


In addition to short-form mergers, which are the subject matter of the three cases cited
D. The Necessity of Injury

Injury to the plaintiff is a prerequisite to monetary recovery, whether suit is brought by stockholders or by the corporation. The requirement may arise from Exchange Act section 28(a), which limits recovery to "actual damages." But injury is not necessary in injunction actions or SEC suits.

Whether or not the plaintiff is injured is a question of fact. Courts have become increasingly lenient in finding injury. For instance, claims have been upheld when the following were alleged or above, a security holder lacks volition in certain other transactions, such as a redemption, exercise by a corporation of an option to repurchase, and termination of a partnership by general partners when the plaintiff is a limited partner. Even if voluntary action is not required, there must nevertheless be some causal connection between the fraud—the misrepresentation or omission, for example—and the injury. Decisions such as Ryan v. J. Walter Thompson Co., 453 F.2d 444, 446-47 (2d Cir. 1971), cert. denied, 406 U.S. 907 (1972) (company exercised option to repurchase shares without revealing that public offering was forthcoming), may be justified on the ground that the misrepresentation, omission, or other fraud did not cause the plaintiff's loss.

See notes 204-05 and accompanying text supra.


15 U.S.C. § 78bb(a) (1970). Section 28(a) applies to a "person permitted to maintain a suit for damages under the provisions of" the 1934 Act. An issue underlying the problem of recovery under the Rule is whether the genesis of 10b-5 damage actions is general tort law or the Exchange Act.


The determination of injury should be made on the basis of facts existing at the time of the transaction. Cf. note 316 and accompanying text infra. The Second Circuit's method of utilizing subsequent market values to demonstrate lack of injury, as in Haberman v. Murchison, 468 F.2d 1305, 1313 (2d Cir. 1972), is clearly erroneous. The court should have ignored later market performance.
shown, sometimes in combination with other injuries: working capital was expended; borrowing at higher interest rates were made necessary; an opportunity to obtain new equity funds without expense was lost; the value assigned to stock was not received; a corporation was forced to assume debt it should not have acquired and to make misrepresentations to persons buying its securities; stock was sold for inadequate consideration or was purchased for an excessive price; assets were purchased for too much or sold for too little; and executive in-fighting between the controlling and controlled corporations occurred, executives left, management time was expended in defensive actions, and attorney fees were incurred.

The improper purpose of a transaction may also injure the issuer, and it is unnecessary that the defendant make a profit from the transaction in order to hold him liable under 10b-5.

It does not follow, however, that injury is equivalent to actionable fraud. Neither dilution of a shareholder's equity by an option plan


229 Drachman v. Harvey, 453 F.2d 722, 725 (2d Cir. 1971), rev'd on other grounds on rehearing en banc, 453 F.2d 736 (2d Cir. 1972).


233 See generally notes 368-78 and accompanying text infra.

234 See generally notes 379-87 and accompanying text infra.


236 See Note, supra note 146, at 327-38.


approved by stockholders\textsuperscript{239} nor reduction of nontrading stockholders' equity by acts of mismanagement,\textsuperscript{240} nor a fraudulent sale of control\textsuperscript{241} is a cognizable injury under the rule.\textsuperscript{242}

\section*{III

CONCEALMENT, DISCLOSURE, AND RATIFICATION}

Concealment, disclosure, and ratification are pervasive concepts, applying to innumerable problems arising under both general corporation law and the federal securities laws. Because of the breadth of these terms, it is tempting to use them, and authorities construing them, indiscriminately in differing contexts. For example, some cases attempt to apply concealment, disclosure, and ratification principles, as developed and utilized in other areas covered by 10b-5, to mismanagement situations.\textsuperscript{243} This is, however, a futile and confusing exercise; mismanagement is governed by its own rules.\textsuperscript{244} Thus, 10b-5 decisions dealing with other abuses are generally of little help in determining the outcome of mismanagement matters.

\textsuperscript{239} Review 71 v. Alloys Unlimited, Inc., 450 F.2d 482, 485-86 (10th Cir. 1971).
\textsuperscript{240} See note 144 supra.
\textsuperscript{242} The New York Court of Appeals assumed that a corporation was injured in a common-law insider trading case:

\begin{quotation}
[It] is pertinent to observe that, despite the lack of any specific allegation of damage, it may well be inferred that the defendants' actions might have caused some harm to the enterprise. Although the corporation may have little concern with the day-to-day transactions in its shares, it has a great interest in maintaining a reputation of integrity, an image of probity, for its management and in insuring the continued public acceptance and marketability of its stock. When officers and directors abuse their position in order to gain personal profits, the effect may be to cast a cloud on the corporation's name, injure stockholder relations and undermine public regard for the corporation's securities. As Presiding Justice Botein aptly put it, in the course of his opinion for the Appellate Division, "[t]he prestige and good will of a corporation, so vital to its prosperity, may be undermined by the revelation that its chief officers had been making personal profits out of corporate events which they had not disclosed to the community of stockholders."
\end{quotation}


\textsuperscript{243} Epstein v. Kearns, [1972-1973 Transfer Binder] CCH Fed. Sec. L. Rep. \textsuperscript{\textdagger} 93,625 (S.D.N.Y. 1972), is one example of a case which might have been decided for the plaintiff on mismanagement grounds, but which reached the opposite conclusion applying misrepresentation and omission concepts.

\textsuperscript{244} DeLancy, supra note 217, at 1378; see Note, Shareholder Derivative Suits Under Sections 10(b) and 14(a) of the Securities Exchange Act, 18 Stan. L. Rev. 1339, 132-43 (1966).
A. Concealment

Concealment is related to mismanagement in many ways. Concealment is one type of deception, an alternative element in mismanagement cases. An act of mismanagement, whether cognizable under federal law, state law, or both, which substantially and adversely affects a corporation, is a material fact. A purchaser of a security who is ignorant of such mismanagement has a cause of action against his seller who concealed the fact in violation of a duty to disclose all material information. However, a district court decision allowing a corporation and nontrading security holders to sue for an undisclosed breach of state corporate fiduciary law is of questionable validity.

Plaintiffs have attempted to recover, with uniform lack of success, on the ground that they would not have purchased their securities had defendants disclosed an intent to mismanage. The Second Circuit aptly noted: "[I]f plaintiffs' proposition were accepted, it would convert any instance of corporate mismanagement into a Rule 10b-5 case. ... We regard such a result as unjustified." However, concealment of certain types of intent by defendants under a duty to disclose is actionable in other 10b-5 areas, and the same rationale should apply to mismanagement cases. Perhaps the Second Circuit's concern could be allayed by an investigation of each set of facts, with particular attention paid to the time lag between the duty of disclosure and the mismanagement, to determine when the intent to

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245 For a discussion of concealment by management of a better offer, see notes 391 & 420 infra.
246 See notes 148-76 and accompanying text supra.
252 The duty to disclose might arise, for instance, when an exchange offer is made for the
mismanage was formed. A similar approach is embodied in the
theory of an implied representation not to mismanage made by
insiders at the time of plaintiff's purchase.\textsuperscript{253} The difficulty with the
implied representation theory is that it also converts every type of
mismanagement claim into a Rule 10b-5 cause of action, and it has
been rejected by all courts except the federal district court of
Delaware.\textsuperscript{254} The majority view does not, of course, preclude claims
based on misstatements by defendants or representations implied
from their remarks.\textsuperscript{255}

Courts have generally refused to hold defendants liable under
10b-5 for failing to state that a transaction was unfair to the corpora-
tion or its stockholders.\textsuperscript{256} This line of holdings is a bit questionable
even when facts demonstrating the inequity are public knowledge\textsuperscript{257}
or are otherwise known to the plaintiff.\textsuperscript{258} These cases are clearly
wrong when enough information from other sources is not available
to the investing public. If the misleading assertion occurs in the
context of shareholder action, a 10b-5 claim is generally upheld
target company's stock. There would seem to be no basis yet developed in the cases for imposing
a continuous duty to disclose mismanagement. Therefore, the Second Circuit's statement (see
text accompanying note 250 \textit{supra}) is overly broad since every case of mismanagement does not
automatically become a 10b-5 problem; only when some duty to disclose arises, is Rule 10b-5
potentially applicable under this theory.

\textsuperscript{253} The Second Circuit in the Genesco case equated an implied representation not to
mismanage with concealment of intent to mismanage, and held that neither was a cause of
action under 10b-5. Mutual Shares Corp. v. Genesco, Inc., 384 F.2d 540, 545 (2d Cir. 1967). But
these represent two different theories, the former being much broader. Cf. Ruder, \textit{Dangers in a
Corporation's Purchases of its Own Shares}, 13 \textit{Prac. Law.} 75, 90-91 (May 1967) (discussing case in
which plaintiff alleged implied promise that notice of redemption fair).

\textsuperscript{254} Mutual Shares Corp. v. Genesco, Inc., 384 F.2d 540, 545 (2d Cir. 1967); Britt v. Cyril
Bath Co., 290 F. Supp. 934, 938 (N.D. Ohio 1968), \textit{rest'd on other grounds}, 417 F.2d 433 (6th Cir.
implies that insiders will act in good faith and deal fairly) and Voege v. American Sumatra

Sec. L Rep. \textsection 91,288 (Baltimore City Cir. Ct. 1963) (statement of intent to list on New York
Stock Exchange successfully claimed to establish implied representation to continue listing).

\textsuperscript{256} See Popkin v. Bishop, 464 F.2d 714, 717-18 (2d Cir. 1972) (must prove violation;
unfairness insufficient); Mutual Shares Corp. v. Genesco, Inc., 266 F. Supp. 130, 132-33
(S.D.N.Y.), \textit{modified}, 384 F.2d 540 (2d Cir. 1967) (transaction fully disclosed, but plaintiff claims
would not have bought stock if plaintiff told deal unfair); notes 396-404 and accompanying text
\textit{infra} (unfair merger exchange ratio); cf. Laurenzano v. Einbender, 264 F. Supp. 356, 360-61
(E.D.N.Y. 1966) (proxy statement under Exchange Act \textsection 14(a), 15 U.S.C. \textsection 78n(a) (1970)). \textit{But see}
Note, \textit{supra} note 202, at 125.

\textsuperscript{257} This reasoning might account for the result in O'Neill v. Maytag, 339 F.2d 764 (2d Cir.
1964), in which the prices of the two securities exchanged were publicly available.

\textsuperscript{258} See note 282 and accompanying text \textit{infra}. However, one aim of federal securities laws is
to present all material facts fairly and let investors conclude whether or not to trade based on
their analysis of the data.
because misrepresentations or omissions often are embodied in the proxy statement in these instances.  

Defendants rarely disclose an improper motive for taking an action. For instance, a board of directors might approve a sale of stock at fair value without revealing that the purpose for the step was to enable the directors to retain control. In such a situation, the minority and better reasoned view supports a 10b-5 claim for concealment of the improper purpose, giving recognition to the fact that a corporation can be injured by transactions having an improper purpose. It follows from the majority view that plaintiffs cannot use the Rule to attack an activity merely because it serves no valid corporate purpose. Of course, a 10b-5 claim is valid if all elements of an


A transaction involving an improper purpose would usually involve deception or "new fraud," so the issue of whether or not concealment of an improper purpose is actionable is not overly important.

See also note 429 and accompanying text infra (schemes to maintain control).

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offense exist in addition to an improper motive or absence of a valid corporate purpose.  

B. Disclosure

Disclosure and concealment are opposite sides of the same coin. Faulty disclosure of a fair deal (and a fortiori of an unfair transaction) gives rise to a 10b-5 cause of action for misstatement or omission. The consequences of full disclosure are less clear. The Second Circuit at one time required only "honest disclosure" under Rule 10b-5, but that court abandoned this view four years later and further modified its holdings in a recent case.

The law now distinguishes between disclosure to directors and disclosure to stockholders. Many cases hold that the interests in a corporation to be protected are those of the shareholders. Directors' interests are not always synonymous with, and indeed are sometimes antagonistic to, those of the stockholders. Consequently, full disclosure to the stockholders when they vote should insulate more transactions from attack than possession by the board of all information when it acts.

Even full disclosure to directors is insufficient to meet the standards of the Rule if one or more directors are interested in the transaction or if the company is dealing with a director or controlling stockholder. But full disclosure to the board will insure against a 10b-5 claim when no director is interested or is trading with the corporation, and the party dealing with the company is not in a

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263 See, e.g., Ruckle v. Roto Am. Corp., 339 F.2d 24, 26, 29 (2d Cir. 1964) (sale of shares to president for inadequate consideration; reason for sale to retain control); Note, supra note 250, at 379-82.
270 The Popkin case, which first referred to "self-dealing," did not elaborate on the concept. See note 162 and accompanying text supra. See also notes 177-99 and accompanying text supra. A director may also be interested if he has an improper purpose in mind when he approves a transaction. See Dasho v. Susquehana Corp., 380 F.2d 262, 269-70 (7th Cir.), cert. denied, 389 U.S. 977 (1967).
“position to influence the judgment of the [corporation’s] directors by any improper means.”

Full disclosure to stockholders is more complicated. Stockholders, when acting in a decision-making capacity, are entitled to “full disclosure of all information which the ordinary investor of common business experience would require in making an informed investment decision.” They are deemed to know information which is in the public domain or in proxy solicitation material. But the availability of all information to stockholders should not bar an otherwise actionable claim when stockholders are not asked to vote.

When a shareholder vote is sought to ratify a proposition or to meet a requirement of state corporate law, the propriety of the vote, rather than any prior corporate action, is important for 10b-5 purposes. In other words, directors’ actions which are ordinarily objectionable do not violate Rule 10b-5 if such actions are subject to stockholder approval; the fraud must then be related to the shareholder vote. Shares held by persons interested in the transaction subject to a stockholders’ vote should not be counted to determine if a quorum is present or if a sufficient number of favorable votes is cast.

A transaction involving self-dealing of directors or controlling stockholders is immune from attack according to the Second Circuit’s decision in Popkin v. Bishop when shareholders are fully apprised

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274 Information disseminated to the same extent as that required to publicize inside information should be deemed to be known by stockholders, and facts already known to a stockholder need not be disclosed. Nanfito v. Tekseed Hybrid Co., 341 F. Supp. 240, 244-45 (D. Neb. 1972).


276 See notes 287-90 and accompanying text infra.

277 See Review 71 v. Alloys Unlimited, Inc., 450 F.2d 482, 485 (10th Cir. 1971) (stock option plan’s effectiveness subject to stockholder approval).

278 Bahlman, Rule 10b-5: The Case for Its Full Acceptance as Federal Corporation Law, 37 Cin. L. Rev. 727, 775 (1968). In Pappas v. Moss, 395 F.2d 865, 868, 870 (3d Cir. 1968), the Third Circuit concluded that effective ratification does not take place under New Jersey common law when a majority of the stockholders is interested in the transaction being ratified. The court then turned to the 10b-5 claim and never mentioned ratification. But cf. notes 211-15 supra (causation when majority stockholder votes).

279 464 F.2d 714 (2d Cir. 1972). The Popkin case involved a merger with a majority stockholder, but the reasoning of the case should apply equally to self-interested directors. The Popkin case overemphasizes the philosophy of disclosure and ignores other policies underlying the Rule such as fairness, fostering investor confidence, and protection of investors.
of the facts and state law requires a vote.280 Other authorities disagree.281 The same split of opinion exists when self-dealing is not alleged, but state law mandates shareholder approval. The Second Circuit's approach elevates the disclosure aspect of the Rule's second clause to the exclusion of the scheme to defraud and deceitful course of business provisions of clauses (1) and (3). This violates a Supreme Court directive handed down just two months before Popkin in a case reversing the Tenth Circuit.282

C. Ratification

Even if state statutory law does not require a stockholder vote, the approval of stockholders still might be sought as a matter of prudent


Although the Seventh Circuit did not directly address the issue the second time it decided the Dasho case, a fair reading of the opinion reveals its accord with Popkin. See Dasho v. Susquehanna Corp., 461 F.2d 11, 28-30 (7th Cir.), cert. denied, 408 U.S. 925 (1972).

280 Realistically, an attack will be made on a transaction in which stockholders have been fully informed only when the plaintiff believes the terms are unfair to the corporation. See notes 256-59 and accompanying text supra (concealment of unfairness).

Obviously, the Popkin rationale does not apply when state law requires a vote, but no vote is ever taken. An example of this type of case is Coffee v. Permian Corp., 474 F.2d 1040, 1042-44 (5th Cir. 1973).

281 Bloomenthal, supra note 76, at 360; Cox, supra note 160, at 698 & n.107; Marsh, What Lies Ahead Under Rule 10b-5?, 24 Bus. Law. 69, 71 & n.9 (1968); Patrick, supra note 153, at 457-58, 472; Comment, supra note 178, at 1122 (trial court should focus on fairness); see Dasho v. Susquehanna Corp., 380 F.2d 262, 269-70 (7th Cir.), cert. denied, 389 U.S. 977 (1967), rev'g 267 F. Supp. 508, 512 (N.D. Ill. 1966) (trial court requires full disclosure in merger proxy statement; concurring opinion of two of three circuit judges finds concealment, but essence is unfairness of merger); cf. Frohling, The Promoter and Rule 10b-5; Basis for Accountability, 48 CORNELL L.Q. 274, 299-307 (1963) (for promoter liability, 10b-5 should establish standard of fairness). Compare Loeb v. Whittaker Corp., 333 F. Supp. 484, 488 (S.D.N.Y. 1971). The Delaware cases achieve the same result by imputing to the corporation a representation that the terms of a merger will be fair. See cases cited in note 254 supra; Marsh, supra at 71 n.9. Other cases recognize a cause of action for an unfair merger without discussing disclosure to stockholders. See, e.g., Herpich v. Wallace, 430 F.2d 792, 799-800, 813 (5th Cir. 1970) (can obtain injunction to prevent unfair merger); Condon v. Richardson, 411 F.2d 489, 492 (7th Cir. 1969) (can enjoin proposed unfair merger); see Knauff v. Utah Constr. & Mining Co., 408 F.2d 958, 964 (10th Cir.), cert. denied, 396 U.S. 831 (1969), aff'd, 277 F. Supp. 564 (D. Wyo. 1967) (decides merger fair). The topic of unfair mergers is treated in notes 390-92 and accompanying text infra.

corporate practice or in order to conform to the company's certificate of incorporation, by-laws, or listing agreement with a stock exchange. A vote under such circumstances ratifies prior corporate actions and for purposes of Rule 10b-5 its effect is governed by federal law. Exchange Act section 29(a) provides that "[a]ny condition, stipulation, or provision binding any person to waive compliance with any provision of [the 1934 Act] or of any rule or regulation thereunder . . . shall be void." Hence, stockholders cannot waive their rights in a corporation's articles of incorporation or by-laws. However, shareholders may ratify an action of the board, a committee of the board, or the officers. Ratification is ineffective when stockholders do not receive all pertinent information. But ratification is valid when full disclosure is made. In fact, the Second Circuit apparently would sustain ratification of a fully-disclosed unfair transaction under the rationale of Popkin regardless of whether self-interest is in question. Some courts would not permit ratification under these circumstances.  

283 Regarding the effect of fraud in a directors' vote when ratification ensues, and the status of shares of interested stockholders, see notes 276-78 and accompanying text supra.
284 Popkin v. Bishop, 464 F.2d 714 (2d Cir. 1972) (semble). State courts applying state law have also established a set of guidelines, but these are inapplicable to 10b-5 cases.
285 15 U.S.C. § 78cc(a) (1970). By analogy, the spirit of this section is to prohibit ratifications in the absence of full disclosure.
287 Cf. notes 264 & 276-78 and accompanying text supra. The scope of full disclosure is discussed in notes 273-74 and accompanying text supra.
289 Popkin stressed that disclosure is a key element under the Rule and that full disclosure to stockholders is the "principal federal interest." Id. at 720. A case in a district court reached the same conclusion two years earlier. Abramson v. Nytronics, Inc., 312 F. Supp. 519, 526 (S.D.N.Y. 1970).

At common law, fraud may be ratified only by a unanimous vote of stockholders. But not all actions which run afoul of the Rule are frauds under the common-law test. Bahlman, supra note 278, at 775.


The Supreme Court has stressed that Rule 10b-5 protects creditors as well as stockholders. Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 12 (1971). A neat question is therefore raised whether ratification by all stockholders of a fraudulent scheme can divest creditors of their rights.

In his concurring opinion in Texas Gulf Sulphur, Judge Friendly indicated that the board of directors must know of the illegality before board ratification is effective. SEC v. Texas Gulf
Since directors' interests sometimes conflict with those of the stockholders,\textsuperscript{291} effective board ratification under the Rule should be limited to situations in which full disclosure is made, the board knows its prior action was illegal, and the ratifying act itself is legal.\textsuperscript{292} Under these guidelines, board ratification is permissible only when (1) the 10b-5 offense consisted solely of false or incomplete data being given to the board, the committee of the board, or the officers taking the original action, and (2) those data are fully and fairly disclosed to the board and imputed to the corporation when the board ratifies the action.\textsuperscript{293} Interested directors should not be counted for purposes of the quorum or the vote.\textsuperscript{294} The same rules governing ratification by the full board should also apply to ratification by a committee of the board.

IV

FORMS OF RULE 10B-5 CORPORATE MISMANAGEMENT SCHEMES

Plaintiffs have claimed that many actions violate the aspects of Rule 10b-5 governing mismanagement. Allegations of mismanagement fall into several categories: sales by a corporation of its securities for an inadequate price or insufficient consideration, mismanagement involving stock options, purchases by an issuer of its securities

\textsuperscript{290} Pappas v. Moss, 393 F.2d 865-68 (3d Cir. 1968) (stockholder approval obtained to conform to American Stock Exchange rules); Bloomenthal supra note 76, at 360; cf. note 281 and accompanying text supra. The Pappas case can also be explained on the ground that a majority of the shares were held by persons interested in the transaction.

\textsuperscript{291} See notes 268-69 and accompanying text supra.

\textsuperscript{292} See SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 865-66 n.2 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969). Four years later, Popkin, in the context of a stockholder vote, made no mention of this analysis. For a possible explanation of this result, see note 277 and accompanying text supra.

\textsuperscript{293} In Wolf v. Frank, 477 F.2d 467,477 (5th Cir. 1973), the court considered a purported ratification by directors of a purchase of assets by the issuer from officers and directors for excessive consideration and a purchase of the issuer's securities for an unsecured note. Three new directors were elected by the three directors who traded with the company. The three new directors voted to ratify the transactions while the trading directors abstained. The Fifth Circuit concluded:

\[\text{[T]he votes of the newly elected directors could not legally authorize defendants to breach their fiduciary duties by accepting ... stock for unsecured ... notes. ... Moreover, the votes of the newly constituted Board of Directors, in which defendants participated, could not constitute a valid ratification of defendants' illegal activities.} \]

\textit{Id.} The fraud in Wolf was substantive; no amount of disclosure could cure it.

\textsuperscript{294} See Dasho v. Susquehanna Corp., 461 F.2d 11, 25 (7th Cir.), cert. denied, 408 U.S. 925 (1972) (disinterested majority of directors acting with full knowledge and in good faith permissible); cf. note 278 and accompanying text supra (votes of interested stockholders).
too dearly, corporate purchases of assets for too much or sales of assets for too little, mergers and acquisitions, fraud in the sale of a controlling block of shares, waste of corporate assets and looting, misappropriation of corporate assets, and a few miscellaneous acts. A short treatment of each of these types of mismanagement follows, even though some principles apply to more than one category.

A. Sales by a Corporation of Its Own Securities for Inadequate Consideration

A corporation may have a claim against insiders and others when they cause it to sell its securities for inadequate consideration. Some decisions discuss misrepresentations or omissions, facts which are relevant to the elements of deceit and injury. The essential factual basis of the claim, however, is a sale from which the issuer receives too little. In early cases, the purchase of a corporation's stock was followed by a subsequent sale which defrauded the public. Later decisions demonstrate that a public distribution is not a sine qua non. In fact, although the Rule does apply to securities purchased from the issuer in a public offering, recent opinions deal more often with private placements in which subsequent resales are not in question. There is no longer any doubt that 10b-5 applies to stock, debt securities, warrants, or any other instrument fall-

295 See notes 148-76 & 223-42 and accompanying text supra.


300 See, e.g., Schoenbaum v. Firstbrook, 405 F.2d 215, 218-20 (2d Cir. 1968), cert. denied, 395 U.S. 906 (1969); Pappas v. Moss, 393 F.2d 865, 869-70 (3d Cir. 1968); Continental Bank &
ing within the 1934 Act's broad definition of a "security." And the definition of a "sale" is satisfied regardless of whether the company receives full or inadequate consideration or none at all.

The three most common types of fraud in this area proscribed by Rule 10b-5 are: (1) selling the securities at a price which is too low, although the value of the payment received is not in issue (e.g., when the buyer pays cash); (2) selling the securities at a price which is fair, but receiving consideration which has a misstated value (e.g., oil rights may be represented to be worth $100,000, which would be a fair price for the securities, but really they are worth only $20,000); and (3)


The term "security" means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.


Stock options are treated in the text accompanying notes 322-67 infra.


selling the securities at a price which is too low and receiving consideration with a misstated value.\textsuperscript{305} Courts have found causes of action in these situations without detailing the supportive reasoning. More recent decisions, however, have generally relied upon a showing of deception,\textsuperscript{306} "new fraud,"\textsuperscript{307} or perhaps negligence\textsuperscript{308} to justify their holdings for plaintiffs.

Two other allegations related to sales of securities for inadequate consideration have been made by plaintiffs in 10b-5 actions.\textsuperscript{309} The SEC attacked as fraudulent a sale for full value in which the buyer lacked capacity to pay and the seller retained no lien on the securities.\textsuperscript{310} And the Supreme Court upheld a cause of action when securities were sold for their true value, but the proceeds of the sale were misappropriated.\textsuperscript{311}

These mismanagement schemes are redressible in court only by the corporation since it is the defrauded seller. Security holders lack standing to sue because they did not sell as a result of the fraud, even though the corporation's injury decreased the value of their holdings.\textsuperscript{312} Furthermore, neither the corporation nor its existing

\begin{footnotes}
\item[305] Examples of these types of cases can be found in notes 148 & 149 supra.
\item[306] See notes 148-76 and accompanying text supra.
\item[307] See notes 177-99 and accompanying text supra.
\item[308] See notes 200-01 and accompanying text supra.
\item[309] Dilution of a stockholder's equity or voting rights occasioned only by the issuance of stock does not itself give rise to a cause of action. Review 71 v. Alloys Unlimited, Inc., 450 F.2d 482, 485-86 (10th Cir. 1971).
\item[310] Issuance of stock for less than par value does give rise to a corporate cause of action even if the consideration is not alleged to be unfair. Subsequent creditors and purchasers of stock would also have a Rule 10b-5 misrepresentation claim if the balance sheet did not accurately show the shareholders' equity. Bailes v. Colonial Press, Inc., 444 F.2d 1241, 1244-46 (5th Cir. 1971).
\item[312] See notes 83-101 and accompanying text supra ("in connection with" clause under mismanagement).
\end{footnotes}
stockholders can successfully sue persons who pay the corporation fair value for its stock and then defraud the public by reselling the stock at an inflated price.\textsuperscript{313} Members of the public who bought the stock would have a claim against such persons and, if the corporation participated in the scheme, against the company as well.\textsuperscript{314}

Establishing the value of the security sold and the consideration received is a difficulty inherent in these cases. While both issues are questions of fact,\textsuperscript{315} some guidelines have emerged. First, the security and consideration are valued when contracts are signed and not when the board of directors approves the sale.\textsuperscript{316} Second, payment of an amount equal to, or greater than, the market value does not insure that the price is fair when the purchaser is aware of favorable inside information.\textsuperscript{317} Third, a seller's disposition of a large percentage of the shares to finders should be viewed as evidence that the consideration was worth less than the securities.\textsuperscript{318} Finally, facts extrinsic to the security transaction should be evaluated in certain instances to determine the adequacy of the consideration. For instance, a buyer may purchase securities at a fair price, but receive an employment contract in connection with his purchase which is excessively generous. Here the securities sale and employment arrangements should be viewed as one package—the sales price and services to be rendered (what the buyer tenders) should be weighed against what the buyer receives (the value of the securities plus the salary and other employee benefits).\textsuperscript{319}
Sales of securities for inadequate consideration are sometimes involved when assets are bought for too much, an improvident merger is consummated, or corporate assets are wasted. These topics are discussed elsewhere, as are the related areas of redemptions and stock options.

B. Mismanagement Involving Stock Options

Granting stock options is similar in a number of respects to issuing securities for inadequate consideration: an option to purchase stock is a "security" for purposes of the Rule and, as with any other security, issuance by a corporation of a stock option is a "sale" to which 10b-5 applies. But the peculiar problems arising from the Rule's impact on stock options justify separate treatment. In addition to the sale that occurs when an option is granted, issuance of stock when the option is exercised constitutes a related but distinct sale of a security by the corporation. Each of these sales raises problems under the Rule.

The most troublesome questions involving the grant of a stock option arise when material inside information is withheld from, or is known by, the board of directors or a stock option committee of the board granting the option. Allegations of abuse of inside information in connection with the issuance of securities often camouflage the true basis of the complaint—the inadequacy of the consideration received by the corporation for the securities. Inside information assumes greater importance with stock options than with other securities, by giving overly generous employment contract to seller, overpayment in purchase of assets from buyer of control, and assumption by issuer of buyer's contract. See generally notes 67-81 and accompanying text supra.

See notes 379-412 & notes 430-35 and accompanying text infra.

See notes 462-63 and accompanying text infra. (redemptions); notes 322-67 and accompanying text infra (stock options).


For convenience, the stock option committee will be assumed to be the decision-making body.

See note 295 and accompanying text supra.
corporations, however, since the market value on the date the option is granted determines the exercise price of qualified stock options, the type most frequently issued.\textsuperscript{327} The definition of "material" in this context is the same as it is in cases involving insider trades with the public,\textsuperscript{328} and the relevant type of "inside information"\textsuperscript{329} is that which might affect the price of the underlying stock during the period in which the option can be exercised.\textsuperscript{330} Therefore, although questions concerning inside information arise in connection with the grant of an option, the real impact is on the adequacy of the consideration to be received on its exercise.

Whether the stock option committee, standing in the shoes of the corporation, has actual or constructive knowledge of the inside information is a question that requires the same analysis as that taken up above under the topic of deception.\textsuperscript{331} Any person receiving options for inadequate consideration who is within the ambit of the "new fraud" decisions\textsuperscript{332} might be violating the Rule even if he discloses the inside information to the committee or the committee itself has such information.\textsuperscript{333} However, prior stockholder approval of a typical employee benefit plan after full disclosure might alleviate any "new fraud" problem.\textsuperscript{334}

Eight factual patterns of grants of options accompanied by material inside information are derived from the permutations of whether the information is favorable or unfavorable and whether or not it is known by the committee or the optionee. The first pattern assumes that the stock option committee does not actually, or by...
imputation, know favorable material inside information. An optionee who is also ignorant of the facts would not run afoul of the Rule by receiving an option. But an optionee who is aware of the data and is granted an option, the exercise price of which is tied to market price, violates the Rule unless he makes disclosure to the committee or rejects the option.\(^{335}\)

Although speculation that "something good is in the offing" might arise from the mere rejection of an option,\(^{336}\) other alternatives for treating this problem also have objectionable features.\(^{337}\) The knowledgeable optionee could not defend a suit on the grounds that he later returned his option to the corporation or that the market price prior to public disclosure was used to set the option exercise price.\(^{338}\) An optionee's liability for nondisclosure could include damages arising not only from the granting of his options but also from grants to others at the same time.\(^{339}\) An optionee's failure to reveal his favorable nonpublic data could be a 10b-5 infraction whether or not the exercise price is based on the market. Even though the exercise price is determined by the par or book value of the shares, the committee might have issued fewer options had it anticipated a market price rise upon release of the inside information. The district court decision in SEC v. Texas Gulf Sulphur Co.,\(^{340}\) however,

\(^{335}\) SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 856-57 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969); id. at 865 (Friendly, J., concurring) (secrecy no defense). But see id. at 877-78 (Moore, J., dissenting) (optionee must refrain from exercising option until information publicized). As to the class of employees who have this obligation, see notes 340-47 and accompanying text infra.

\(^{336}\) See SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 857 n.24 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969) (in proper circumstances, could require optionee only to forego exercise until after subsequent disclosure and ratification). On the other hand, it might be assumed that the rejecting optionee had adverse material facts and hoped to get more, lower priced options later. See Int. Rev. CODE OF 1954, §§ 422(b)(5), 422(c)(6) (blockage rules).

\(^{337}\) It is somewhat naive to suggest that an optionee who conceals inside information should be forced only to delay exercise until the data are publicized. This was the contention of the dissenting judges in the Texas Gulf Sulphur case. 401 F.2d at 877-78. The fallacy of this approach is that the optionee then has the ability to exercise his option at an unfairly low price. Bromberg, Corporate Information: Texas Gulf Sulphur and Its Implications, 22 Sw. L.J. 731, 734 n.9 (1968); Comment, supra note 323, at 642. The proper response toward options granted in violation of 10b-5 is cancellation of the option or payment of damages upon its exercise. SEC v. Texas Gulf Sulphur Co., 331 F. Supp. 671, 672 (S.D.N.Y. 1971). Another possible remedy is raising the exercise price.

\(^{338}\) Both of these conditions existed in the Texas Gulf Sulphur case as to the company's president and executive vice-president, yet a violation was found. 401 F.2d at 856.

\(^{339}\) Id. at 865 (Friendly, J., concurring) (liable for all options if optionee got committee to include others as optionees who did not know).

\(^{340}\) 258 F. Supp. 262 (S.D.N.Y. 1966), modified, 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969). The Second Circuit never faced the issue because the SEC did not appeal the disposition as to the two low-level employees.
limited the class of optionees who must make disclosure, regardless of the type of option involved. Judge Bonsal imposed a duty to disclose on higher echelon optionees, but permitted lower level employees, who knew that their superiors also possessed the data, to assume that their superiors would inform the stock option committee.\textsuperscript{341} The president, executive vice-president, and general counsel, also a vice-president, were classified as higher echelon employees, while the chief geologist and a mining engineer-vice-president were not.\textsuperscript{342} Unfortunately, this approach limits the scope of the Rule's "any person" wording,\textsuperscript{343} which has been read broadly in every other context.\textsuperscript{344} Judge Bonsal's ruling also leaves some questions unanswered. Is a lower level employee responsible if he conceals data while ignorant of the fact that his superiors have made disclosure?\textsuperscript{345} Does a lower level employee violate the Rule if he refrains from disclosing and knows the upper level employees do not intend to inform the committee?\textsuperscript{346} Do a lower echelon employee's obligations change if he actively solicits the option?\textsuperscript{347}

In cases in which an employee is aware of unfavorable material inside data but the committee is not, the only question which arises is whether the employee incurs any liability if he rejects an option.\textsuperscript{348} A 10b-5 cause of action is difficult to construct on these facts even if the "in connection with the purchase or sale of any security" clause of the Rule is deemed satisfied.\textsuperscript{349} The same difficulty is encountered when

\textsuperscript{341} Id. at 291. The low-level employees either received the information from their superiors or told it to them. They therefore knew that the superiors were aware of the facts.

\textsuperscript{342} Id. at 292, modified, 401 F.2d at 856-57. The Instruction to Item 8, Securities Exchange Act Form 10-K, defines executive officers as follows: "The term 'executive officer' means the president, secretary, treasurer, any vice president in charge of a principal business function (such as sales, administration or finance) and any other officer who performs similar policy making functions . . . ."

\textsuperscript{343} Comment, supra note 323, at 645.

\textsuperscript{344} Even if this construction prevails concerning stock options, quaere whether it ought to be extended so far as to permit lower echelon employees to purchase stock from the issuer other than through the exercise of options without disclosing inside information known to their superiors?

\textsuperscript{345} The employee unsuccessfully tried to defraud the corporation, but no injury was suffered, so the company had no claim.

\textsuperscript{346} Judge Friendly, concurring in Texas Gulf Sulphur, indicated that this would violate 10b-5. 401 F.2d at 865; accord, Sandler & Conwill, Texas Gulf Sulphur: Reform in the Securities Marketplace, 30 Ohio St. L.J. 225, 261 (1969).

\textsuperscript{347} See SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 864-65 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969) (Friendly, J., concurring). The grant of the options in Texas Gulf Sulphur was initiated by the committee.

\textsuperscript{348} He might do so to avoid the blockage rule of the Internal Revenue Code or in the hope that he will receive more options later. See note 336 supra.

\textsuperscript{349} See Sandler & Conwill, supra note 347, at 262.
neither the committee nor the optionee is aware of unfavorable inside information.

The other side of the coin is seen when the stock option committee knows the material inside information. Since knowledge of the committee is usually regarded as coterminous with that of the corporation, granting options is not a 10b-5 infraction. But the committee may not grant options when it knows favorable inside information, and that information is not imputed to the company.

Finally, when the committee knows unfavorable material inside information, but nevertheless grants options, an employee who is also aware of the data could reject his option while his uninformed counterpart could be injured by accepting an option. It is not likely that the rejecting employee incurs any 10b-5 liability or that the accepting optionee has any claim under the Rule.

Certain other 10b-5 issues arising in connection with the grant of an option should be noted. First, if misrepresentations of material facts made by an optionee cause the stock option committee to grant options, the misrepresenting optionee is liable for damages flowing from the grant of his own options and probably other options issued as a result of his fraud. Second, the effect of stockholder approval of a single option or an option plan is negated by misrepresentations or omissions of material facts made to them when they approve the option or plan. Third, the grant of the option must be supported by consideration flowing from the optionee to the corporation. A recitation in an option plan adopted by stockholders to the effect that

350 But see note 333 and accompanying text supra. The result should not depend upon the knowledge or ignorance of the optionee. When stockholders (i.e., the corporation) know the "inside information," no cause of action should accrue because a fraud element does not exist (Lewis v. Adler, 331 F. Supp. 1258, 1265 (S.D.N.Y. 1971)) at least when "new fraud" is inapplicable.

351 This is equivalent to the committee having no knowledge of the data. See notes 335-49 and accompanying text supra. The result is the same regardless of whether the optionee has knowledge of the subject information.

352 The injury would arise out of the tax blockage rule. See note 336 supra.

353 See Sandler & Conwill, supra note 347, at 262.


355 Cf. Pappas v. Moss, 303 F. Supp. 1257, 1279 (D.N.J. 1969). This situation is no different from the more usual case of a buyer misrepresenting to the seller. Bloomenthal, supra note 76, at 354.

the plan is designed to provide incentive to the employees is ordinarily sufficient.\textsuperscript{357} The optionee must demonstrate adequate value when grants are not made under this type of plan.\textsuperscript{358}

The exercise of an option may also raise questions.\textsuperscript{359} Adequate consideration must support not only the option but also the issuance of the underlying stock.\textsuperscript{360} Moreover, a grossly unfair method of paying for the stock may breach the Rule.\textsuperscript{361} An optionee's inside information may have an impact on the exercise of his option as well as on the grant. The Rule should prohibit an optionee who has favorable inside information from exercising the option until the information is announced publicly and assimilated.\textsuperscript{362} This approach seems to be foreclosed, however, by a Second Circuit decision permitting a corporation to exercise its option to repurchase shares from a stockholder even though it conceals favorable material information.\textsuperscript{363} Analogously, an optionee ought to be able to exercise his option regardless of his knowledge.\textsuperscript{364} An optionee probably would not violate the Rule if he failed to exercise because he knew adverse inside information.\textsuperscript{365}

\textsuperscript{357} Lewis v. Adler, 331 F. Supp. 1258, 1266 (S.D.N.Y. 1971); see Trainor v. Berner, 334 F. Supp. 1143, 1144, 1147-49 (S.D.N.Y. 1971) (plaintiff alleges that must look at entire compensation to optionee to determine if option supported by adequate consideration; some weight accorded to fact that stockholders approved plan).


\textsuperscript{359} The analysis concerning exercise of a stock option should apply equally to conversion of a security, assuming the conversion is a "purchase" for purposes of the Rule.

\textsuperscript{360} See notes 295-321 and accompanying text supra (issuance of securities for inadequate consideration).

\textsuperscript{361} The plaintiff in Levine v. Bradlee, 378 F.2d 620, 621 (3d Cir. 1967) alleged that Rule 10b-5 was violated when the corporation's chief executive officer paid for the exercise of an option by giving a promissory note which bore less interest than the dividends on the stock.

\textsuperscript{362} Bromberg, supra note 337, at 734 n.9; Comment, supra note 323, at 646. This view does not, however, prevent exercise when the option is about to expire and the exercise price is less than the market. The incentive to exercise is obvious when the market is greater than the exercise price. Even if the market price is less than the exercise price, the anticipated appreciation in the market value resulting from the release of the data may still make exercise desirable if the option is nearing the end of its term. The optionee could not purchase shares in the open market because of his knowledge. See, e.g., SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969).


\textsuperscript{364} Sandler & Conwill, supra note 346, at 263-64. This is a sound result, for all Rule 10b-5 ever requires is that the buyer and seller in a transaction know the inside information. Were the law to require that the corporate seller be told the information, it would be a useless act because the optionee could still exercise on the same terms.

\textsuperscript{365} The "in connection with" clause of the Rule would not be satisfied. But see In re Faberge,
There are two related points. One case permitted a corporation to cancel an option when it was being injured by the optionee.\textsuperscript{366} Also, the trading public may have a cause of action if stock options are granted in violation of the Rule and the inside information known to the optionees is not announced.\textsuperscript{367}

C. Purchases by a Corporation of Its Own Securities for Excessive Consideration

Many of the considerations which govern a corporation's sales of its securities for inadequate consideration also apply to overpayment by a corporation for its own securities.\textsuperscript{368} The most common violations arise when (1) the purchase price is too high while the value of the consideration tendered by the corporation is not disputed (as when cash is paid), (2) the purchase price is fair but the consideration is worth more than its assigned value, and (3) the purchase price is too high and the consideration tendered is worth more than its assigned value.\textsuperscript{369} The legal consequences of these three alternatives are indistinguishable; a Rule 10b-5 cause of action will lie based on either deception\textsuperscript{370} or "new fraud."\textsuperscript{371}

A number of other types of repurchase schemes may involve 10b-5 fraud. For example, the Supreme Court has indicated that insiders who sell their shares to the corporation after manipulating the stock price upwards run afoul of Rule 10b-5.\textsuperscript{372} Even corporate purchases at a fair price which are so extensive that the cash drain impairs the corporation's ability to conduct business may give rise to a 10b-5 claim against insiders who directed the purchases.\textsuperscript{373} The Second Circuit has extended this concept to a situation in which a redemption of bonds decreased working capital and forced the cor-


\textsuperscript{366} Doelle v. Ireco Chem., 391 F.2d 6, 8 (10th Cir. 1968). Whether or not the terms of the option permitted this action is not clear.


\textsuperscript{368} See notes 295-321 and accompanying text supra.

\textsuperscript{369} Examples of these types of cases can be found in notes 148 & 149 supra.

\textsuperscript{370} See authorities cited in notes 148-76 supra.

\textsuperscript{371} See notes 177-99 and accompanying text supra. See also notes 200-01 and accompanying text supra (negligence).


corporation to pay higher interest rates. Nevertheless, most authorities would not permit recovery for repurchases at a fair price which are made for an improper purpose. Courts have dismissed claims brought on behalf of the issuer when it repurchased securities at less than fair value.

Repurchase of securities by issuers is fraught with other dangers. For example, state laws often prohibit repurchases except from surplus. A violation of this type of state-created restriction would not necessarily lead to a 10b-5 cause of action, however.

D. Mismanagement in Sales and Purchases of Corporate Assets

The same rules that apply to sales of corporate securities for too little also govern purchases of assets for too much. The present discussion concerns a purchase or sale by a corporation of less than substantially all of its assets; later comments focus on a transaction involving all or substantially all of a corporation's assets. In order to satisfy the Rule's "in connection with the purchase or sale of any security" clause, the assets or the consideration paid for them must consist at least partially of securities. Liability for deception or "new fraud" attaches when (1) the worth of the assets bought by the enterprise is not as much as purported, (2) the value of the consideration paid by the corporation for the assets is more than what was ascribed to it, and (3) a combination of (1) and (2) is found. Liability is similarly incurred when the corporation is defrauded in the sale of its assets.


See notes 260-62 and accompanying text infra.

Carringer v. Fair Lanes, Inc., 244 F. Supp. 25, 29 (D. Md. 1965). See also notes 223-42 and accompanying text supra (injury to corporation in mismanagement cases). It is arguable that a cause of action exists if the benefit from the repurchases is outweighed by increased interest expenses or other injury arising from the loss of working capital. See notes 374-75 and accompanying text supra (injury from loss of working capital).


See note 28 and accompanying text supra (not all state-cognizable mismanagement schemes covered by 10b-5).

See notes 388-412 and accompanying text infra. See also notes 464-66 and accompanying text infra (liquidations and dissolutions).

Cf. Errion v. Connell, 236 F.2d 447, 453-54 (9th Cir. 1956) (10b-5 covers sale of securities and nonsecurities in one scheme).

See notes 148-76 and accompanying text supra.

See notes 177-99 and accompanying text supra. See also notes 200-01 and accompanying text supra (negligence). Some cases uphold the claim without stating a reason. See cases cited in notes 148-76 and accompanying text supra.

Examples of these types of cases can be found in notes 148 & 149 supra.
A misappropriation of the assets purchased or of the proceeds of the asset sale is a cognizable 10b-5 injury. As discussed above, purchases and sales for improper purposes are probably not 10b-5 violations on that ground alone, but extensive purchases which injure a company's working capital and sales to buyers who are not in a position to complete payment are within the Rule's purview.

E. Mismanagement in Mergers and Acquisitions

The complexity of mergers and acquisitions and the large amounts of money at stake in these transactions make them ideal vehicles for fraud. The more frequently litigated fact pattern involves the merger. Objectionable actions arising from a merger can be divided chronologically: those occurring prior to the merger, those resulting from the merger itself, and those taking place after the merger.

The exchange ratio, the crucial element in any merger, is established prior to the merger by the merger partners, and is usually based on such factors as the companies' respective net income and book value and the market price of their securities. It follows that

384 See note 311 and accompanying text supra.
385 See notes 260-62 and accompanying text supra.
386 See notes 373-74 and accompanying text supra.
387 See note 310 and accompanying text supra.
389 A merger is indisputably a sale within Rule 10b-5. See notes 108-23 and accompanying text supra.
390 The exchange ratio is the ratio of the number of the surviving corporation's shares a stockholder of the disappearing entity receives to the number of disappearing company's shares he surrenders.
391 Prior to the merger, the company may engage in negotiations with a number of potential merger partners. This, of course, can result in multiple offers, and the question that then arises concerns the extent to which competing offers must be disclosed to the shareholders of the merging party.

The plaintiff claimed that a corporation's recommendation of a merger, without disclosing a prior offer from a third corporation for an exchange of shares, was actionable in Alameda Oil Co. v. Ideal Basic Indus., Inc., 313 F. Supp. 164, 166 (W.D. Mo. 1970). After transfer, the United States District Court for the District of Colorado held that directors have no duty to convey a second merger offer to stockholders when recommending the first if the second is indefinite or its advantages over the first are not clear. Alameda Oil Co. v. Ideal Basic Indus., Inc., 337 F. Supp. 194, 195 (D. Colo. 1972). For a discussion of management's duty to inform stockholders of competing tender offers, see note 420 and accompanying text infra. In merger situations, management must have a reasonable basis for its recommendation. Crane Co. v. Westinghouse Air Brake Co., 419 F.2d 787, 803 (2d Cir. 1969), cert. denied, 400 U.S. 822 (1970). Disclosure of one offer is insufficient to reveal another offer having different terms which might be more advantageous. Lewis v. Marder, 343 F. Supp. 1050, 1057 (W.D. Pa. 1972).
certain actions which injure the corporation, and therefore indirectly affect the exchange ratio, are transgressions of the Rule even if such actions would not normally constitute 10b-5 violations.\textsuperscript{392} It is not clear whether these actions, in order to constitute transgressions of the Rule, must be undertaken with the primary purpose of influencing the ratio or whether a 10b-5 breach occurs when the injury is merely a foreseeable consequence of the actions.

The manipulation and insider trading aspects of Rule 10b-5 prohibit or at least bring into question purchases and sales of the stock of a party to a merger by the constituent companies or their insiders prior to the public announcement of the merger. Aside from those aspects of the Rule, trading by an officer or director of a merger partner might still be redressible; however, a constituent corporation's purchase or sale of the stock of either constituent would not be actionable.\textsuperscript{393} Misrepresentations contained in proxy material or otherwise conveyed to stockholders before they vote are actionable even if the merger is fair.\textsuperscript{394}

\textsuperscript{392} See Swanson v. American Consumer Indus., Inc., 415 F.2d 1326, 1332 (7th Cir. 1969) (should have received better exchange ratio); Knauff v. Utah Constr. & Mining Co., 408 F.2d 958, 961, 963 (10th Cir.), cert. denied, 396 U.S. 831 (1969) (premerger mismanagement relating to dealings between two merger partners, one of which was majority stockholder of other, intermingled with merger so treat together, but then decide no mismanagement and not in connection with purchase or sale of security, ignoring potential effect on merger ratio); Bogin, 337 F. Supp. 331, 339 (S.D.N.Y. 1972) (must determine if premerger acquisition undertaken to affect exchange ratio); Herpich v. Wallace, 430 F.2d 792, 810 (5th Cir. 1970) (merger part of fraudulent scheme). But see Review 71 v. Alloys Unlimited, Inc., 450 F.2d 482, 486 (10th Cir. 1971) (no cause of action arises if received less in subsequent merger because stockholders approved stock option plan); Heit v. Davis, [1964-1966 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 91,698, at 95,566 (S.D.N.Y. 1966) (exchange ratio approach not mentioned). Viewing actions which affect the exchange ratio as 10b-5 violations is similar to integrating a number of related transactions and treating them as components of a single scheme. See notes 67-81 and accompanying text supra. See also Vine v. Beneficial Fin. Co., 374 F.2d 627, 635 (2d Cir.), cert. denied, 389 U.S. 970 (1967) (misrepresentation occurring in prior tender offer which permitted allegedly injurious short-form merger to take place; held in connection with merger); Mader v. Armel, [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 93,027, at 90,796 (S.D. Ohio 1971), aff'd, 461 F.2d 1123 (6th Cir. 1972), cert. denied, 409 U.S. 1023 (1973) (liquidating value not only criterion in establishing exchange ratio). Compare Nanfito v. Tekseed Hybrid Crop., 341 F. Supp. 224 (D. Neb. 1972) (no cause of action although only book value used).

For similar reasons, acts done prior to a liquidation should be condemned as strongly as those occurring before a merger if they affect the amount to be distributed. See notes 279-82 and accompanying text supra (effects of disclosure to stockholders).


The main issue\textsuperscript{395} regarding objectionable conduct occurring in the consummation of the merger is whether an unconscionable exchange ratio gives rise to a cause of action under the Rule.\textsuperscript{396} At first blush, one might think that the rules applicable to selling securities for inadequate consideration would also govern fixing the exchange ratio. A corporation has a cause of action arising from selling its securities for too little if deception or "new fraud" can be shown;\textsuperscript{397} by analogy, an unfair merger ratio should be actionable upon proof of deception or "new fraud."\textsuperscript{398} Unlike a sale of securities, however, most mergers require stockholder approval.\textsuperscript{399} Although other circuits may disagree, in the Second Circuit this added element is crucial because full disclosure to stockholders before the vote insulates against a 10b-5 claim of an unfair merger.\textsuperscript{400} Thus, the distinction between the usual (or long-form) merger (in which stockholder votes of both corporations are necessary\textsuperscript{401}) and a short-form merger be-


\textsuperscript{396} Unfairness is a question of fact when it is recognized as a cause of action. In the event of a conflict of interest, it is therefore advisable to have negotiations on the exchange ratio conducted by a large stockholder of one company unconnected with the other merger partner. Knauff v. Utah Constr. & Mining Co., 408 F.2d 958, 964 (10th Cir.), cert. denied, 396 U.S. 831 (1969). Better still would be an evaluation by an independent expert.


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\textsuperscript{399} See notes 295-321 and accompanying text supra.

\textsuperscript{400} See notes 279-82 and accompanying text supra.

\textsuperscript{401} Some mergers take on the character of an acquisition with no vote of the "surviving" corporation's stockholders being required. In that type of merger, a wholly-owned subsidiary of the surviving entity is merged into the "disappearing" company, stockholders of the "disappear-
between a parent and subsidiary (which requires no stockholder action) assumes added importance. A short-form merger is therefore legally indistinguishable on this issue from a sale of securities for inadequate consideration and should be controlled by the same rules.\textsuperscript{402} Long-form mergers may also be governed by these same rules\textsuperscript{403} except in the Second Circuit, where full disclosure to stockholders renders an unfair transaction immune from attack. Actions undertaken by management after a merger are treated below.\textsuperscript{404}

Acquisitions involve the transfer of stock or assets of the acquired corporation. The Rule clearly applies when stock is sold,\textsuperscript{405} and a material omission or misstatement by one party to an acquisition is no different from the usual 10b-5 concealment or misrepresentation offense.\textsuperscript{406} Assuming that the assets or payment given consists at least

\textsuperscript{402} The two leading short-form merger cases reached the same result as the inadequate-consideration-for-securities decisions, but for different reasons. Both courts seemed to go to great lengths to construct a misrepresentation as a basis for finding the conduct objectionable. See Vine v. Beneficial Fin. Co., 374 F.2d 627, 635 (2d Cir.), cert. denied, 389 U.S. 970 (1967) (tender offer followed by short-form merger; misrepresentation in tender offer, which plaintiff did not accept, held in connection with merger since tender offer key to permitting short-form merger); Voege v. American Sumatra Tobacco Corp., 241 F. Supp. 369, 374 (D. Del. 1965) (representation of fair treatment to stockholder in merger 15 years after purchase of stock implied from corporate charter and Delaware law at time of purchase); accord, Weisman v. MCA, Inc., 45 F.R.D. 258, 264 (D. Del. 1968). Perhaps this exercise in logic was necessary in order to reach a just result because the "new fraud" cases, under which these mergers could be condemned, had not yet been decided. Bloomenthal, \textit{supra} note 76, at 375; Marsh, \textit{supra} note 281, at 71 n.9 (1968).

\textsuperscript{403} See Knauff v. Utah Constr. & Mining Co., 277 F. Supp. 564, 570, 577, 579 (D. Wyo. 1967), \textit{modified on other grounds and aff'd on this ground}, 408 F.2d 958, 964 (10th Cir.), cert. denied, 396 U.S. 831 (1969), is one case which indicates that a long-form merger must be fair even if full disclosure is made. The question is left open in deHaas v. Empire Petroleum Co., 300 F. Supp. 834, 837 (D. Colo. 1969). The exchange ratio may be set at an unfair number as a pay-off for prior transactions in which a party received a benefit.\textit{See}, e.g., Condon v. Richardson, 411 F.2d 489, 491-92 (7th Cir. 1969); Dasho v. Susquehanna Corp., 380 F.2d 262 (7th Cir.), \textit{cert. denied}, 389 U.S. 977 (1967).

\textsuperscript{404} Looting is the term usually applied to acts of mismanagement by new controlling persons. \textit{See} note 430-35 and accompanying text \textit{infra}.

\textsuperscript{405} \textit{See} note 49 \textit{supra}.

\textsuperscript{406} It is difficult for a seller of a business to claim successfully that the buyer misrepresented the value of the business; the seller is in the best position to determine its worth. Chiodo v. General Waterworks Corp., 380 F.2d 860, 867 (10th Cir.), \textit{cert. denied}, 389 U.S. 1004 (1967). Mismanagement claims in acquisitions would encompass such actions as inordinately high.
partially of securities, an asset acquisition should be treated in the same fashion as a stock acquisition for the acquiring company, and except for a wrinkle, it should be treated as a sale of assets for inadequate consideration for the acquired entity. It should be noted, however, that state corporation statutes require stockholder approval of sales of all or substantially all the corporation’s assets, raising again the question of whether full disclosure to stockholders avoids 10b-5 impropriety as regards the rights of such stockholders.

F. Mismanagement in the Sale of a Controlling Block of Shares

The sale of a controlling block of stock at a premium above the market price is often characterized as a breach of fiduciary duty. Such a sale involves a transfer of a large block of stock by one person or a small group of sellers, as opposed to purchases from numerous parties through open market transactions, a tender offer, or an exchange offer. The 10b-5 cases do not specify how many shares constitute a controlling block. Perhaps this is because control is usually indisputably transferred—old directors resign and the purchaser's designees fill their positions. An appropriate definition of a controlling block is “that number of shares which gives the holder payment by the acquiring corporation and concealment by some members of the board of one company from their fellow directors. Buying assets for excessive consideration is an apt analogy to these situations. See notes 379-87 and accompanying text supra. In Bredehoeft v. Cornell, 260 F. Supp. 557, 558-59 (D. Ore. 1966), a stockholder's claim, based on allegations that the management of his own company concealed material facts before all stockholders sold their shares to a third party, was upheld.


See notes 398-403 supra.

See, e.g., DEL. CODE ANN. tit. 8, § 271(a) (Supp. 1970); N.Y. BUS. CORP. LAW § 909(a) (McKinney 1963). Failure to obtain the required stockholder approval should be treated as a 10b-5 violation quite aside from any other grounds for complaint.

See notes 388-412 and accompanying text supra.
'the power to direct or cause the direction of the management and policies' of a corporation."415

Sales of control have been attacked on four fronts: by the corporation whose control is sold, by stockholders who are not invited to sell their shares with the controlling block, by the seller or buyer of control against the other party to the sale, and derivatively by a corporate seller receiving too little for control of another enterprise.

A corporation whose control is sold is neither a buyer nor a seller in the control transaction. It follows that such a corporation has no standing to recover from either the seller or buyer the premium above market (control premium) received by the seller.416 Even if the question of standing is bypassed, the fraudulent acquisition of control as such does not injure the corporation.417 However, companies have successfully challenged transfers of their control as part of a larger scheme involving another 10b-5 violation.418

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415 The quotation within the quotation comes from Exchange Act Rule 12b-2 (17 C.F.R. § 240.12b-2(f) (1973)) which defines the concept of "control." It was relied on to define control in Shell v. Hensley, 430 F.2d 819, 826 (5th Cir. 1970). Many other definitions have been used, however. See, e.g., H. Henn, Law of Corporations and Other Business Enterprises § 8241, at 478-79 (2d ed. 1970); Leech, Transactions in Corporate Control, 104 U. Pa. L. Rev. 725, 725 n.1 (1956). See generally Hill, The Sale of Controlling Shares, 70 Harv. L. Rev. 986 (1957). Control should be presumed if the block is sold and the directors resign in favor of the purchaser's nominees.


418 See notes 67-81 and accompanying text supra. Concerning the liability of a person buying control from another who purchased it by fraud, one court held: "[T]he purchaser, charged with knowledge or notice of [the original purchaser's] wrongdoing, surely would not be immunized from suit for damages and other relief by [the issuer] and the other aggrieved."
An attempt to recover the control premium by stockholders who do not sell their shares must also fail because they are neither buyers nor sellers. They have no claim under the Rule even if the controlling person rejects a favorable proposal made to all stockholders in order to accept a better offer relating only to his shares.

On the other hand, stockholders who retain their shares have been successful on a number of theories. One case may be construed as imposing a duty to invite all stockholders to sell their holdings if the...
controlling person permits any other shareholders to sell their shares to the purchaser on the same terms. In this same decision, the court held that the existence of negotiations to buy a controlling block is material inside information which must be disclosed to persons selling in the open market, even though they are not in privity of contract with the buyer or seller of control. There is a better reasoned line of authorities, however, which has reached the opposite conclusion regarding the controlling person's duties to invite and disclose in these circumstances. Another approach integrates the transfer of control with a liquidation of the issuer or any other event occurring after the transfer in which stockholders are buyers or sellers.

A buyer or seller of control may sue successfully on the basis of any misstatement, omission, or other fraud between buyers and sellers generally cognizable under the Rule.

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423 See Dasho v. Susquehanna Corp., 461 F.2d 11, 16 n.8, 32 (7th Cir.), cert. denied, 408 U.S. 925 (1972); Haberman v. Murchison, 331 F. Supp. 180, 188 (S.D.N.Y. 1971) (implying that Ferraioli incorrectly decided), aff'd, 468 F.2d 1305, 1312 (2d Cir. 1972) (in general, no obligation to invite); Chashin v. Mencher, 255 F. Supp. 545, 546-48 (S.D.N.Y. 1965) (stockholder has no standing to complain about inability to sell with controlling persons); Note, supra note 422, at 751 (criticizing this aspect of Ferraioli); Christophtides v. Porco, 289 F. Supp. 403, 405 (S.D.N.Y. 1968) (sale of control by one stockholder; not required to permit others to participate); Keers & Co. v. American Steel & Pump Corp., 234 F. Supp. 201, 203-04 (S.D.N.Y. 1964) (oral promise of controlling person not to sell unless others given chance to join in sale; death of promisor ended promise).


This situation must be distinguished from the case in which a sale of control is being negotiated or has been agreed upon, and the seller of control then begins purchasing in the market. Such conduct should constitute a violation of Rule 10b-5. See, e.g., Ward LaFrance Truck Corp., 13 S.E.C. 373, 375-76, 380 (1943); Fleischer, supra note 260, at 1167 (tender offer).


426 Condon v. Richardson, 411 F.2d 489, 492 (7th Cir. 1969) (controlling individual personally tried to buy control of another corporation, and when failed had his controlled corporation take over contract; two corporations controlled by same party agree jointly to
One opinion rebuffed an argument that it should hold directors of a corporation liable for selling control in another enterprise without a premium.\(^{427}\) Nevertheless, this result is not a foregone conclusion; analogies drawn from sales of securities or assets for inadequate consideration\(^{428}\) indicate that a breach may sometimes occur if too little is received for any security, including a controlling block in another enterprise.

Schemes by incumbents to maintain control are a species of transactions conducted for an improper purpose. Since most cases deny recovery when a transaction is attacked merely on the basis of an improper purpose,\(^{429}\) schemes to retain control are actionable only if the acts in furtherance of that purpose are themselves infractions of the Rule.

G. Waste of Corporate Assets and Looting

Claims based on "waste" of corporate assets and "looting" are often added in complaints as catch-alls. Waste refers to the use of corporate assets without sufficient justification. It is not generally a term connected with a change of control. Looting, by contrast, is usually charged against persons who obtain control of a corporation by merger or by acquisition of a controlling block of stock and then use corporate assets without justification.\(^{430}\) The term has also been used to describe unjustified depletions by lenders who have assumed control of corporate policy as a result of making a loan.\(^{431}\) Looting implies taking unfair advantage of a dominant position in a corporation by engaging in transactions which benefit the controlling persons and their associates at the corporation's expense.

The few authorities which have addressed looting and waste under Rule 10b-5 have quite properly indicated that neither claim is actionable by itself unless the acts which constitute waste or looting


\(^{428}\) See notes 295-321 & 379-87 and accompanying text supra.

\(^{429}\) See notes 260-62 and accompanying text supra.


\(^{431}\) An example of the latter situation is found in the allegations made in Wolf v. Ackerman, 308 F. Supp. 1057, 1058 n.1 (S.D.N.Y. 1969).
are independent breaches of the Rule. A charge of waste based on a sale of the corporation's securities for inadequate consideration, for example, is redressible under 10b-5. Yet such a claim is cognizable even if it is not labelled "waste"; therefore the "waste" or "looting" claim is mere surplusage. Applying a label of "waste" or "looting" to an action which is not otherwise a breach of the Rule does not aid the plaintiff. But relief can be obtained for acts of waste or looting which are part of a larger scheme involving a 10b-5 infraction, whether or not the acts are otherwise a violation of 10b-5 or common law. In addition, failure to disclose a plan to loot the target company in a tender offer for control can be actionable as an omission to state a material fact.

H. Misappropriation of Corporate Assets

Although there is a wide variety of actions which fall under the broad umbrella of misappropriation of corporate assets, this discussion is limited to diverting assets and usurping corporate opportunities. Plaintiffs have not been wholly successful in either area.

Misappropriation (or theft) of the proceeds from a sale of securities is the most clearly actionable type of diversion of assets. A number of cases alleging waste and involving conduct which would otherwise be actionable (e.g., sales of securities for inadequate consideration) were dismissed because deception was not present. Penn Mart Realty Co. v. Becker, 300 F. Supp. 731, 735-36 (S.D.N.Y. 1969) (deception not shown; "new fraud" also inapplicable); Heit v. Davis, [1964-1966 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 91,698, at 95,567 (S.D.N.Y. 1966); Carliner v. Fair Lanes, Inc., 244 F. Supp. 25, 27-28 (D. Md. 1965); O'Neill v. Maytag, 230 F. Supp. 235, 239 (S.D.N.Y.), aff'd, 339 F.2d 764 (2d Cir. 1964). But when deception or "new fraud" is present, a cause of action exists. Rekant v. Desser, 425 F.2d 872, 879-81 (5th Cir. 1970) (deception).

For example, a sale of securities to insiders for inadequate consideration, waste, looting, and conducting corporate affairs in a manner designed to manipulate its market price fall within this realm. These topics are covered elsewhere. See notes 295-321 & 431-35 and accompanying text supra & notes 480 and accompanying text infra.

Diverting assets and engaging in transactions for an improper purpose (see notes 260-62 and accompanying text supra) are similar in that assets are used for the insider's own purposes. Unlike diversion, however, in transactions for an improper purpose, the insiders do not obtain the assets for their own—the assets still remain corporate property. Bloomenthal, supra note 76, at 358.

loan by a corporation to an insider or his designee is another example of asset diversion. Although one case found for the plaintiff on the basis of an insider loan, the Birnbaum purchaser-seller requirement usually bars recovery unless the loan is considered a purchase of the insider’s note. Another complaint which has been upheld is the use of A company’s funds to purchase control of B company for the benefit of C company when A company and C company are under common control. In addition, a stockholder has a legitimate grievance if he is ignorant of a misappropriation of assets and consequently receives less when he sells his shares. Using the assets of an acquired company to pay the purchase price of the acquisition has also been held to be redressible, and an insider may violate the Rule if by means of a recapitalization he usurps for himself voting control of some subsidiaries. On the other hand, no cause of action from subordinated loan account of broker-dealer; fraud on customers who dealt with firm on basis of subordination agreement, but no reference to fraud on firm itself; Bush v. Masiello, [1971-1972 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 93,417, at 92,050 (S.D.N.Y. 1972) (conversion actionable, but unclear from case what was converted). But cf. Schoenbaum v. Firstbrook, 268 F. Supp. 385, 396 (S.D.N.Y. 1967), aff’d, 405 F.2d 200 (2d Cir.), rev’d in part on rehearing en banc, 405 F.2d 215 (2d Cir. 1968), cert. denied, 395 U.S. 906 (1969) (10b-5 does not reach misappropriation of assets). Misappropriation should be actionable whether the securities are issued by the corporate seller or are issued by another entity and held as an investment.

In the Bankers Life case, the Supreme Court apparently did not consider whether deceit or “new fraud” is an essential element of a successful 10b-5 action. The facts, however, were within the parameters of “new fraud.” The sole stockholder appropriated corporate assets, so “new fraud” was available. Another case held that deception is required. Cohen v. Colvin, 266 F. Supp. 677, 682-83 (S.D.N.Y. 1967) (corporate opportunity). See generally notes 146-47 and accompanying text supra.

In Shell v. Hensley, 430 F.2d 819, 822-23 (5th Cir. 1970), P company, a parent of S company, bought A, and A received P company’s note in return. S company then loaned P company money to pay interest on the note. Thereafter, and as part of a separate transaction, S company loaned money to another corporation under P company’s control so such corporation or A could buy shares of P company from another controlling person.

See notes 83-101 and accompanying text supra.

See 1 L. Loss, SECURITIES REGULATION 546 (2d ed. 1961); 4 id. at 2574 (Supp. 1969).

Condon v. Richardson, 411 F.2d 489, 492 (7th Cir. 1969).

Bredehoeft v. Cornell, 260 F. Supp. 557, 558-59 (D. Ore. 1966). However, this is a concealment of mismanagement situation. Implicit in the case is the fact that the purchaser was aware of the diversion of assets.


The integration theory may be used to attack otherwise unassailable transactions. See generally notes 67-81 and accompanying text supra. This presumably justifies the holding in Braasch v. Muscat, [1967-1969 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 92,148 (S.D.N.Y. 1968) (following acts held to constitute cause of action: making unsupported disbursements,
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arises under the Rule for diverting cash,\(^4\) wrongfully using funds to defeat a tender offer,\(^4\) or giving a mortgage on a corporation's assets to another entity owned by a stockholder of the corporation because such actions are not undertaken "in connection with the purchase or sale of any security."\(^4\)

Insiders are precluded at common law from usurping an opportunity in which their corporation has a right, property interest, or expectancy, or one which in justice belongs to the company.\(^4\) The Birnbaum rule, requiring the plaintiff to be a buyer or seller\(^4\) of securities, is the major stumbling block to recovery under the Rule for usurpation of corporate opportunities. Thus, the corporation cannot attack the most obviously unfair practices—insiders purchasing their corporation's shares from stockholders without first offering the opportunity to the issuer and insiders competing with their corporation by purchasing shares of a company targeted for a corporate tender offer.\(^4\)

However, a valid 10b-5 claim exists whenever the losing alleged deposit of $250,000, loaning $300,000 to controlling person without board approval, borrowing from bank and relending to another corporation under common control which then defaults, paying $427,500 commitment fee to insider for future loan although corporation could borrow elsewhere, paying $427,500 commitment fee to insider for future loan although corporation could borrow elsewhere, lending to insiders through bank bought by corporation, and mistakenly transferring funds to another corporation under common control). The facts were less complicated in Young v. Seaboard Corp., [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,942, at 94,198 (D. Utah 1973). There, the defendants deposited $1,000,000 into a bank and used the leverage of the deposit to direct the bank to loan $450,000 to defendants' designees. The loans went bad and caused the bank's collapse.


\(^4\) Cooper v. Garza, 431 F.2d 578, 580-81 (5th Cir. 1970) (not in connection with purchase or sale of security).

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\(^4\) Cooper v. Garza, 431 F.2d 578, 580-81 (5th Cir. 1970) (not in connection with purchase or sale of security).

\(^5\) See H. HENN, supra note 415, at 462-65.

\(^6\) See notes 83-101 and accompanying text supra.

\(^7\) Erling v. Powell, 429 F.2d 795, 797-800 (8th Cir. 1970) (buying shares of issuer); Cohen v. Colvin, 266 F. Supp. 677, 680-83 (S.D.N.Y. 1967) (shares of tender offer target; not alleged that insiders tendered); see Polakoff v. Delaware Steeplechase & Race Ass'n, 254 F. Supp. 574, 580 (D. Del. 1966) (seizure of corporate opportunity not alleged; corporation not injured). But see Shell v. Hensley, 430 F.2d 819, 822 (5th Cir. 1970) (cause of action when insider caused corporation to loan money to other corporation under his control for purchase of shares of corporation's parent from stockholder).

Plaintiffs have alleged that certain other unfair practices are 10b-5 violations. Knauff v. Utah Constr. & Mining Co., 408 F.2d 958, 963 (10th Cir.), cert. denied, 396 U.S. 831 (1969) (seizure of piece of property for mining claim labelled as usurpation of corporate opportunity; no claim under 10b-5 because not in connection with purchase or sale of security); Wolf v. Ackerman, 308 F. Supp. 1057, 1058 n.1 (S.D.N.Y. 1969) (controlling corporation allegedly caused customer to switch business from injured corporation to controlling corporation); see Herpich v. Wallace, 430 F.2d 792, 803 (5th Cir. 1970) (sale of control alleged diversion of corporate opportunity; court upholds claim on other grounds).
common-law corporate opportunity doctrine is breached and the corporation is a purchaser or seller. For instance, a cause of action arises when a corporation purchases stock from another company and the purchaser's insiders receive seller's stock from the seller for little or no consideration.\textsuperscript{453} Rule 10b-5 liability has also been found when, as part of a larger scheme, one controlling person borrowed funds from the corporation to buy shares from another controlling person, and did not account to the corporation for the premium he received on the subsequent resale of those shares.\textsuperscript{454} Finally, courts have condemned a parent for acquiring a partially-owned subsidiary by merger or purchase of assets in order to take advantage of the subsidiary's corporate opportunity.\textsuperscript{455}

I. Miscellaneous Acts of Mismanagement

A number of other actions have been assailed as Rule 10b-5 mismanagement violations.\textsuperscript{456} For example, several attacks have been made on corporate redemptions of securities. When plaintiffs have contended that the issuer concealed or misrepresented material facts in connection with the redemption of their securities, courts have found for the defendants on the grounds that the issuer has an absolute right to redeem and the security holders' knowledge is therefore irrelevant.\textsuperscript{457} This reasoning has validity for redemptions


Swanson v. American Consumer Indus., Inc., 415 F.2d 1326, 1331-32 (7th Cir. 1969) (deception in proxy statement; subsidiary should have received better exchange ratio); see Voege v. American Sumatra Tobacco Corp., 241 F. Supp. 369, 373 (D. Del. 1965) (concealment of seizure of corporate opportunity in tender offer through which defendant received sufficient stock to use short-form merger statute; plaintiff objecting to merger). See also Jannes v. Microwave Communications, Inc., 461 F.2d 525, 527, 529 (7th Cir. 1972) (cause of action stated when assets and corporate opportunities sold for too little).

\textsuperscript{455} In addition to these problems, there is the question of whether failure to remove from a security a legend restricting transfer is a Rule 10b-5 offense. See Coenen v. R.W. Pressprich & Co., 453 F.2d 1209 (2d Cir.), cert. denied, 466 U.S. 949 (1972) (allegations of refusal to remove legend; case decided on procedural point). Also, the Commission's staff has taken the position that a tender offer designed to reduce the number of record holders below 300 so periodic reports do not have to be filed under the 1934 Act could violate 10b-5. See House of Adler, Inc., [1971-1972 Transfer Binder] CCH Fed. Sec. L. Rep. § 78,515 (no-action letter of Sept. 30, 1971). But it is difficult to see the basis for this conclusion.

\textsuperscript{457} See 35 Mo. L. Rev. 119, 122 (1970); cf. Fershtman v. Schectman, 450 F.2d 1357, 1360 (2d Cir. 1971), cert. denied, 405 U.S. 1066 (1972) (termination of limited partnership in accord-
of nonconvertible securities because the plaintiff cannot demonstrate that the fraud caused injury.458 The opposite result might be proper when convertible securities are redeemed459 because the stockholder then has to make an investment decision—whether or not to convert—and he is therefore entitled to full disclosure.

When an issuer buys back any security pursuant to a contractual right460 or exercises an option to repurchase any security461 the security holder has no right to receive disclosure. This situation is analogous to a redemption of nonconvertible securities.

A redemption involves a breach of Rule 10b-5 if it is undertaken as part of a scheme to obtain control (even if the redemption is made in accordance with the terms of the security),462 or if it is made in violation of a promise to secure the security holders' consent.463

Rule 10b-5 infractions may be committed in liquidating a corporation.464 A stockholder has a 10b-5 claim if he receives less than he is entitled to in a liquidation,465 or a liquidation is pursued for the benefit of the controlling stockholder.466

459 See Latty, supra note 312, at 530; Note, supra note 458, at 1151. The rationale behind the distinction is that the holder of a convertible security must know the true state of affairs before he can intelligently decide whether to convert. But even to a convertible security holder, a concealment or misrepresentation will not always be actionable. For example, no claim arises when the conversion price of a debenture is $55 per share, the underlying common stock is trading at $13 per share, and material information is concealed which, under any standard, could result in a rise of the common stock price to no more than $20 per share. This rationale is also applicable to options or warrants which are about to expire.
460 Doelle v. Ireco Chem., 391 F.2d 6, 8 (10th Cir. 1968).
462 Drachman v. Harvey, 453 F.2d 736, 737-38 (2d Cir. 1972). This case reversed an earlier panel decision (453 F.2d 722, 732 (2d Cir. 1971)) which had dismissed the complaint in part on grounds that the redemption was in accordance with the terms of the debentures.
466 Coffee v. Permian Corp., 474 F.2d 1040, 1043-44 (5th Cir. 1973); Coffee v. Permian Corp., 434 F.2d 383, 384 (5th Cir. 1970) (deciding that shareholder was seller in liquidation).
A 10b-5 violation rarely, if ever, occurs in the course of amending the certificate of incorporation; an amendment changing stockholders' rights does not constitute a purchase or sale of securities.\textsuperscript{467} A change of a stock's par value is not a violation of the Rule,\textsuperscript{468} and a stock dividend or stock split ordinarily does not result in 10b-5 liability.\textsuperscript{469}

Few cases have examined promoters' liability under the Rule, primarily because the incentive for fraud is considerably lessened by the disclosures required in registration statements by the Securities Act of 1933.\textsuperscript{470} A leading case dealing with promoters' liability is\textit{Bailes v. Colonial Press, Inc.},\textsuperscript{471} in which a corporation had issued stock to promoters for inadequate consideration. Although all directors, officers, and stockholders of the company at the time of the stock issuance were aware of the defect and, indeed, were defendants, the Fifth Circuit, finding that the issuance was the first step in a scheme to defraud the public, held that Rule 10b-5 had been violated. The court did not decide whether a claim exists when there is no intention to defraud the public or when full public disclosure is made.\textsuperscript{472} The \textit{Bailes} court emphasized too strongly the public distribution aspect of the promoters' fraud. This development is analogous to the early cases involving a corporation's issuance of securities for inadequate

\textsuperscript{467} \textit{In re Penn Cent. Sec. Litigation}, 347 F. Supp. 1327, 1336-38 (E.D. Pa. 1972) (reorganization by merger created new preferred stock, eliminated pre-emptive rights and cumulative voting; and changed par value and number and terms of directors). See note 141 and accompanying text supra.

\textsuperscript{468} Knauff v. Utah Constr. & Mining Co., 408 F.2d 958, 962 (10th Cir.), cert. denied, 396 U.S. 831 (1969), aff'g 277 F. Supp. 564, 568 (D. Wyo. 1967). See also note 141 and accompanying text supra (recapitalization not stockholder's purchase or sale).

\textsuperscript{469} \textit{But see SEC Securities Exchange Act Release No. 9618} (June 1, 1972) (stock dividend and some stock splits require transfer to capital account; possible 10b-5 violation if transfer not made or if dividend or split declared without sufficiently large retained earnings and current earnings). A stock split or stock dividend has no intrinsic value. Hafner v. Forest Laboratories, Inc., 345 F.2d 167, 168 (2d Cir. 1965). The following is, however, a manipulative device: stock of \textit{A} company is selling at about $1.00 per share and many times the real price-earnings ratio. The stock is hovering around $1.00 because the market value at a true price-earnings ratio would be too low to facilitate trading. Directors of \textit{A} company authorize a reverse stock split so that one-fifth of the number of shares is outstanding and the price of each goes to about $5.00 initially. They know that the price will decline to a true price-earnings ratio and then \textit{B} company (a corporation under common control with \textit{A} company) could be merged into \textit{A} company at a more favorable exchange ratio than if no reverse stock split were undertaken.


\textsuperscript{472} 444 F.2d at 1245 n.10.
consideration which relied on the fraud perpetrated on the public by the subsequent resale of the watered stock. The Supreme Court has held that the effect of Rule 10b-5 is not limited to insuring the integrity of the securities markets, and more recent lower-court cases condemning sales of securities for too little have not required a public redistribution. Courts should consider promoters' acts analogous to acts performed by directors after the corporation's formation and should apply the general mismanagement standards discussed in this Article to such actions. Under this approach, the corporation, as a defrauded entity, would have a cause of action even if all directors, officers, and stockholders at the time of the fraud participated in the objectionable conduct, although suit by the individual participants might be barred on equitable principles. In short, there should be no requirement that the promoters have contrived a scheme to defraud the public through a public distribution.

The Supreme Court has also held that misappropriation of the proceeds from a securities sale is actionable. Hence, stealing securities from a corporation is also a breach of Rule 10b-5.

Directing corporate affairs in an effort to manipulate security prices is also a violation of the Rule. Similarly, the purchase by an issuer of its own stock is viewed by the Securities and Exchange Commission as a 10b-5 violation if no dividends are paid by the issuer and funds are available for that purpose. Although the SEC's expression is limited to investment companies, the underlying principle is broad enough to apply to any entity.

Finally, the Rule may play a role when management acts in its own interests and to the detriment of stockholders. For instance, a

473 See note 296 and accompanying text supra.
475 See notes 297-99 and accompanying text supra.
477 This approach has the virtue of protecting creditors and other persons dealing with the corporation.
479 If the securities are authorized but unissued or are treasury shares, the grant is equivalent to issuing shares for no consideration. See note 304 and accompanying text supra. If the securities are those of another issuer, it is analogous to selling assets for no consideration. See notes 379-87 and accompanying text supra. Theft of cash immediately following a public offering of securities may be attacked on the grounds that the "use of proceeds" section of the registration statement was misleading. See Securities Act Form S-1, Item 3.
cause of action exists against insiders who receive undisclosed special
treatment while outsider stockholders buy or sell.\(^{481}\) Also an illegal
benefit, such as a bribe, will not be enforced even when stockholders
do not trade.\(^{482}\) Perhaps this approach explains the Seventh Circuit's
holding that persons controlling one corporation may have violated
Rule 10b-5 by first purchasing from stockholders rights received in a
rights offering, and then selling the shares underlying the rights to
another company under the same control.\(^{483}\) There is a split of
opinion on the question of whether squeezing out minority stock-
holders is actionable in the absence of some other fraud.\(^{484}\)

**Conclusion**

This Article has outlined the Rule 10b-5 liability of a corporation
and its management for acts of corporate mismanagement. This
discussion may not be exhaustive because the breadth of Rule 10b-5,
one of its chief assets, has not yet been precisely determined. Nor is it
likely that the specific areas of mismanagement liability discussed will

\(^{481}\) Boggess v. Hogan, 328 F. Supp. 1048, 1052 (N.D. Ill. 1971) (must disclose bribe by
tenderor to management of target company). A stockholder who is not a buyer or seller does not
have standing to assert the breach. Birnbaum v. Newport Steel Corp., 193 F.2d 461, 462-63 (2d
Cir.), *cert. denied*, 343 U.S. 956 (1952) (sale of control although better offer); Chashin v.
Mencher, 255 F. Supp. 545, 546-48 (S.D.N.Y. 1965) (sale of control; better offer for all
stockholders not accepted). See also notes 391 & 395 *supra* (competing offers and favored
treatment).

\(^{482}\) Hogan v. Teledyne, Inc., 328 F. Supp. 1043, 1046-47 (N.D. Ill. 1971) (bribe to man-
gagement of target company); see Fleischer & Mundheim, *supra* note 260, at 358-59 (improper
to induce target company management to acquiesce in tender offer by giving favorable contracts
conditioned upon success of tender; management cannot secretly sell its own stock to tenderor
at higher price).

\(^{483}\) Condon v. Richardson, 411 F.2d 489, 491 (7th Cir. 1969). Compare Slavin v. German-

1972) (actionable) with Krafcisin v. LaSalle Madison Hotel Co., [1972-1973 Transfer Binder]
described in the above cases can be used, but a tax loss carry forward of a partially-held
subsidiary can be preserved by a different procedure: forming a shell corporation wholly owned
by the parent, merging the shell into the publicly-held subsidiary of the parent, paying stock-
holders of the publicly-held subsidiary cash, and in the merger converting the stock of the shell
into stock of the publicly-held subsidiary. As a result, the publicly-held subsidiary becomes
wholly owned and the minority stockholders receive only cash. This can be accomplished
without a stockholders' vote of the parent, without a proxy statement or information statement
(unless the partially-owned subsidiary has a class of securities registered under the 1934 Act),
without soliciting proxies (if the parent has the requisite number of shares), and without
granting appraisal rights (at least in New York State, where the face of the statute does not give
minority stockholders appraisal rights).
remain comprehensive over a lengthy period of time. Future developments will undoubtedly bring into question other practices,\footnote{Cf. Chasins v. Smith, Barney & Co., 438 F.2d 1167, 1171 (2d Cir. 1971) (substituted opinion) permissible to outlaw violation in first litigation on issue); accord, Opper v. Hancock Sec. Corp., 250 F. Supp. 668, 676 (S.D.N.Y.), aff'd per curiam, 367 F.2d 157 (2d Cir. 1966).} even some that are now customary in corporate management.