Federal Judicial And Regulatory Responses To Santa Fe Industries, Inc. V. Green

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FEDERAL JUDICIAL AND REGULATORY RESPONSES TO *SANTA FE INDUSTRIES, INC. V. GREEN*

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I. Introduction

For more than a decade prior to the Supreme Court's ruling in *Santa Fe Industries, Inc. v. Green*[1] in 1977, the judicial expansion of Rule 10b-5 to include violations of fiduciary responsibility proceeded at an ever increasing pace.[2] Indeed, by the time the Second Circuit delivered its expansive reading of Rule 10b-5 in *Santa Fe*,[3] there already existed a long line of cases, particularly in the Second Circuit, which led to the almost inescapable conclusion that "fraud" under the Rule unquestionably encompassed fiduciary breaches in connection with a securities transaction.[4] In *Santa Fe* Judge Medina writing for the Second Circuit outlined the breadth of Rule 10b-5 in remedying corporate mismanagement:

> [I]n such cases [as *Santa Fe*] misrepresentation or lack of disclosure are not essential ingredients of the claim for relief by the minority. But, lest there be any lingering doubt on this point, we

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I wish to acknowledge and express my appreciation for the valuable contribution of Charles E. Gerdts in the preparation of this Article.

[1] 430 U.S. 462 (1977).

[2] For a general analysis of these developments, see Jacobs, *The Role of Securities Exchange Act Rule 10b-5 in the Regulation of Corporate Management*, 59 CORNELL L. REV. 27 (1973) [hereinafter cited as Jacobs]; Kaplan, *Fiduciary Responsibilities in the Management of the Corporation*, 31 BUS. LAW 883 (1976); Sherrard, *Fiduciaries and Fairness Under Rule 10b-5*, 29 VAND. L. REV. 1385 (1976).

[3] Green v. Santa Fe Industries, Inc., 533 F.2d 1283 (2d Cir. 1976), *rev'd*, 430 U.S. 462 (1977). An even more expansive opinion regarding Rule 10b-5 was rendered by another panel of the Second Circuit at the same time. In Marshel v. AFW Fabric Corp., 533 F.2d 1277 (2d Cir.), *vacated and remanded for consideration of mootness*, 429 U.S. 881 (1976), the court held that a cause of action for breach of fiduciary duty existed under Rule 10b-5 despite prior full and fair disclosure.

[4] *See, e.g.*, Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374 (2d Cir. 1974), *cert. denied*, 421 U.S. 976 (1975); Popkin v. Bishop, 464 F.2d 714 (2d Cir. 1972); Drachman v. Harvey, 453 F.2d 722 (2d Cir. 1972); Schoenbaum v. Firstbrook, 405 F.2d 215 (2d Cir. 1968) (*en banc*), *cert. denied sub nom.*, Manley v. Schoenbaum, 395 U.S. 906 (1969). *See also* Travis v. Anthes Imperial Ltd., 473 F.2d 515 (8th Cir. 1973); Dasho v. Susquehanna Corp., 461 F.2d 11 (7th Cir.), *cert. denied*, 408 U.S. 925 (1972).

> now hold that in such cases, including the one now before us, no allegation or proof of misrepresentation or non-disclosure is necessary . . . . We hold that a complaint alleges a claim under Rule 10b-5 when it charges, in connection with a Delaware short-form merger, that the majority has committed a breach of its fiduciary duties to deal fairly with minority shareholders by effecting the merger without any justifiable business purpose.[5]

The United States Supreme Court reversed. Following the mode of analysis used in *Blue Chip Stamps v. Manor Drug Stores*[6] and *Ernst & Ernst v. Hochfelder*,[7] the Court declared that the language of Section 10(b) must control any interpretation of Rule 10b-5, and "[t]he language of §10(b) gives no indication that Congress meant to prohibit any conduct not involving manipulation or deception. Nor have we been cited to any evidence in the legislative history that would support a departure from the language of the statute."[8] Because the allegations of the complaint contained no reference to misrepresentation or nondisclosure, the Court refused to recognize a federal cause of action. Furthermore, the statute's reference to manipulation was held by the Court to refer to practices "intended to mislead investors by artificially affecting market activity."[9] Manipulation, the Court declared, was a "term of art" and was to be given a very restricted interpretation.[10]

The Court could have disposed of *Sante Fe* with only the above analysis, but the majority went further to offer additional reasons for denying application of Rule 10b-5 to the facts. Since Congress did not expressly grant a private cause of action under Section 10(b), the Court reasoned that a private right of action should be implied only in special circumstances when it is absolutely necessary to fulfill a perceived congressional purpose behind the statute in question. The avowed purpose of the Securities Exchange Act of 1934 is that of disclosure; the Court suggested that fairness is at best only a tangential concern.[11] Additionally, the Court recognized that although breaches of fiduciary duties in the corporate setting have traditionally been within the ambit of state law, the existence of a state remedy should never preclude a cause of action under federal law. Moreover, the Court reasoned that the ambivalence of Section 10(b) with respect to fairness claims made it perfectly appropriate to consider questions of federalism in determining whether or not to expand the scope of Rule 10b-5.[12] In a broad sense, the import of the *Santa Fe* decision was unmistakably clear: without proof of deception or manipulation, breaches

[5] Green v. Santa Fe Industries, Inc., 533 F.2d 1283, 1287 (1976).
[6] 421 U.S. 723 (1975).
[7] 425 U.S. 185 (1976).
[8] 430 U.S. at 473.
[9] *Id.* at 477.
[10] *Id.* at 476.
[11] *Id.* at 478.
[12] *Id.* at 478-79.

of fiduciary responsibility, no matter how egregious, are not a matter of federal concern.

One of the primary purposes of this article is to test the soundness of the *Santa Fe* holding. Decisions by the lower federal courts subsequent to the *Santa Fe* opinion suggest that to some degree fiduciary duties are not irrelevant in allowing a federal cause of action under Rule 10b-5.[13] The Supreme Court actually left this question open in *Santa Fe* by failing to define "deception."[14] As will be discussed below, the lower federal courts have focused upon this lack of definition and have resurrected an earlier judicial interpretation of deception, first announced by the Second Circuit in *Schoenbaum v. Firstbrook.*[15]

The Securities and Exchange Commission also has responded to the *Santa Fe* decision in an innovative manner. The *Santa Fe* decision by the Supreme Court emphasized the importance of relying upon statutory language. This approach, while limiting the application of Rule 10b-5, arguably will permit a more expansive application of other sections under the federal securities law where the express statutory language may be susceptible to a broader reading. In proposing a new going private rule,[16] the SEC appears to have justified its regulatory reach upon the very rationale utilized by the Supreme Court. Whether such an administrative interpretation can be justified also will be discussed.

Finally, implicit in the *Santa Fe* decision is a challenge to the state courts and legislatures to rise to the occasion and deal adequately with breaches of fiduciary duties in the corporate setting. Commentators have for years decried the lamentable protection offered to minority shareholders under state statutory and case law.[17] Undeniably, a major reason for the expanded application of Rule 10b-5 over the last decade especially in the area of what has become known as "corporate mismanagement," has been the inability of the states to provide easy access to the courts and adequate relief in many cases involving misconduct by corporate fiduciaries. Whether the states will react positively to the challenge of *Santa Fe* is an interesting question, although beyond the scope of the article. At present, except for Delaware, no state court has responded specifically to the *Santa Fe* decision.[18] The fact that the case is little more than a year old

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[13] *See* text accompanying notes 41-60 *infra.*

[14] Although the Court failed to define "deception," the Court did define "manipulation" as "practices . . . intended to mislead investors by arbitrarily affecting market activity." 430 U.S. at 476.

[15] 405 F.2d 200 (2d Cir. 1968), *rev'd en banc,* 405 F.2d 215, *cert. denied sub nom.,* Manley v. Schoenbaum, 395 U.S. 906 (1969); *see* text accompanying notes 29-40 *infra.*

[16] *See* Proposed Rule 13e-3, *reprinted in* [1977] FED. SEC. L. REP. (CCH) ¶23,703A, SEC Securities Act Release No. 34-14185 (Nov. 17, 1977) (*see* text accompanying notes 113-43 *infra*).

[17] The most notable recent comment on the status of shareholder protection under state law is Cary, *Federalism and Corporate Law: Reflections Upon Delaware,* 83 YALE L.J. 663 (1974).

[18] The Delaware Supreme Court, in two cases decided after *Santa Fe,* apparently has decided to take a more active role in regulating corporate fiduciary behavior particularly in

undoubtedly accounts for the dearth of state court decisions. Thus, the analysis of *Santa Fe's* impact on state law must await further developments.

II. The Federal Judiciary's Response—Toward a New Theory of Disclosure

A. *Development Prior to* Santa Fe

Although the rule enunciated in *Santa Fe* expressly applies to the entire spectrum of transactions that fall under Rule 10b-5, the opinion does not discuss insider trading, misleading corporate publicity or market manipulation as such. Instead, the opinion addresses a line of judicial precedent which has dealt with certain kinds of misconduct in connection with the purchase or sale of securities generally referred to as internal corporate mismanagement.[19] One reason for the special focus in *Santa Fe* is the problem of applying a uniform deception test in corporate mismanagement cases arising under Rule 10b-5. On the one hand, a basic deception standard has proved capable of rather consistent application in the insider trading, market manipulation, and corporate publicity contexts where dis-

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a merger "squeeze-out" situation. In Singer v. Magnavox Co., 380 A.2d 969, 980 (Del. 1977), the court held that although the Delaware merger statute seemed to provide an exclusive appraisal remedy to minority shareholders objecting to a squeeze-out merger, the majority shareholders must have a bona fide business purpose for the merger and must treat the minority with "entire fairness." In *Singer*, the court clearly recognized the problems involved in going private and essentially imposed common law fiduciary principles upon what was thought to be a self-contained statutory scheme. In a footnote, the court discussed the then-recently decided *Santa Fe* decision, stating that *"Santa Fe* is a current confirmation by the Supreme Court of the responsibility of a State to govern the internal affairs of corporate life." *Id.* at 976. The *Singer* court then stated that "[C]orporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law expressly requires certain responsibilities of directors with respect to shareholders, state law will govern the internal affairs of the corporation." *Id., citing* Cort v. Ash, 422 U.S. 66, 84 (1975). Thus, it is clear that the Delaware Supreme Court recognized the significance of *Santa Fe* and probably responded to it. In Tanzer v. International General Indus., Inc., 379 A.2d 1121 (Del. 1977), the court elaborated on the valid business purpose requirement, holding that the purpose advanced may solely benefit the majority shareholder. *See also* Kemp v. Angel, 381 A.2d 241 (Del. Ch. 1977); *see generally* Note, *Assuring Fairness in Corporate Mergers: Recent State Trends*, 35 WASH. & LEE L. REV., 927 (1978).

[19] Internal corporate mismanagement has been characterized as the third major classification of Rule 10b-5 cases, the others being insider trading and corporate publicity. Although the Second Circuit in Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952) found it inappropriate to apply Rule 10b-5 to claims that involved traditional allegations of mismanagement by corporate fiduciaries, the succeeding decades witnessed a reversal of this position culminating in the Second Circuit's holding in *Santa Fe*. The Supreme Court, however, in rejecting the Second Circuit's approach in *Santa Fe*, did not renounce its position, taken in Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6 (1971), that claims of corporate mismanagement touching the purchase or sale of a security were not immune from the grasp of Rule 10b-5. For a discussion of this developing area see Jacobs, *supra* note 2. A discussion of the impact of *Santa Fe* upon corporate mismanagement may be found in Jacobs, *How* Santa Fe *Affects 10b-5's Proscriptions Against Corporate Mismanagement*, 6 SEC. REG. L.J. 3 (1978).

closure of material facts and the absence of manipulation generally assures equal footing and an informed choice on both sides of the securities transactions. In these market transactions, the party to whom a duty of non-deceptive or non-manipulative conduct is owed is usually easy to determine. However, applying a consistent rule of deception in the corporate mismanagement cases has proved to be a more difficult problem.

The difficulty in applying a uniform rule of deception results from the nature of misconduct viewed as corporate mismanagement and from the very concept of the corporate entity. As an artificial person, the corporation must act only through shareholders, directors or their agents depending upon state statutes, articles of incorporation, and bylaws. Indeed, unlike the principal in a typical agency relationship, the corporation can never enjoy the luxury of bypassing the agent and acting on its own behalf. Logically, then, the corporation can only be deceived if the appropriate "decision-making body," as determined by state law and internal corporate procedures, itself is deceived.[20] If state corporate law declares that certain transactions need only be approved by the board of directors of the corporation, then any duty to disclose logically should run to the members of the board. Likewise, if state law requires that mergers be approved by the shareholders of the corporation, any duty to make full and fair disclosure under federal or state law exists in favor of the shareholders, the appropriate decision-making body.

The above guidelines for applying a deception rule in corporate mismanagement cases are difficult to apply when a breach of fiduciary responsibility by the board of directors causes harm to the corporation. Assume, for example, that a securities transaction requires only board approval and that a majority of all of the board of directors have interests which conflict with those of the corporation, thus making it impossible for the corporation to receive the independent, disinterested judgment of the board members to which it is entitled. The issue raised by such a factual situation is whether, if the directors act to benefit themselves and harm the corporation, such conduct can be construed as "deception" of the corporation for purposes of applying Rule 10b-5. A pair of cases decided by the Second Circuit in 1964 illustrates the two basic approaches that can be taken to resolve this question. In *Ruckle v. Roto American Corp.*[21] a three-judge panel found that the corporation had been a victim of deception because all but one of the directors, acting to perpetuate their control of the corporation, had concealed material facts about a securities transaction from the remaining director. The court had little difficulty in characterizing this active concealment of material facts from one director as deception of the corporation in a traditional sense,[22] although one might suggest that if the

[20] Discussion of "decisionmaking body" may be found in Fleischer, *"Federal Corporation Law": An Assessment,* 78 HARV. L. REV. 1146, 1163 (1965); Note, *The Controlling Influence Standard in Rule 10b-5 Corporate Mismanagement Cases,* 86 HARV. L. REV., 1007, 1026 (1973) [hereinafter cited as *The Controlling Influence Standard*].

[21] 339 F.2d 24 (2d Cir. 1964).

[22] *Id.* at 29.

transaction could have been approved by a majority of the board, then only the majority need be fully informed, and nondisclosure or misrepresentation to other board members would not amount to deception of the corporation. More importantly, the court, in dictum, suggested that a corporation could be deceived even though the entire board is fully informed if all the directors have an interest adverse to that of the corporation.[23] Less than four weeks after the *Ruckle* decision a different panel within the Second Circuit approved the *Ruckle* holding but rejected the dictum. In *O'Neill v. Maytag*,[24] the court held that although the corporation may have been harmed by the efforts of all the directors to protect their positions at the expense of the corporation, all the directors were nonetheless fully informed. Thus the court held that the allegations presented "no serious claim of deceit" which was necessary to invoke Rule 10b-5.[25]

The analytical battle lines were drawn by these two decisions. The rationale of *O'Neill* is two pronged. First, the court seems to have concluded that if the thrust of Rule 10b-5 depends upon the nature of the conduct rather than its harmful effect, then the entity cannot be deceived in the traditional sense if none of its directors were deceived. Second, the *O'Neill* panel appears to have adopted a somewhat narrow construction of the traditional agency rule that the knowledge of an agent will be imputed to the principal.[26] Since the transaction was disclosed fully to all directors, the directors' knowledge was imputed to the corporate entity and thus the corporation could not have been deceived.

The dictum in *Ruckle* may be distinguished from the *O'Neill* holding in two respects. First, the *Ruckle* dictum finds support from an exception to the agency rule apparently relied upon by *O'Neill*. That exception holds that the knowledge of an agent, (director), although customarily imputed to the principal (corporation), will not be so imputed if the agent is acting adversely to the interest of the principal.[27] Secondly, the dictum in *Ruckle* suggests that the court utilized a result-oriented analysis. In essence, the court reasoned that the harm to the corporation is the same whether or not traditional deception was involved.[28]

The traditional, restrictive approach of *O'Neill v. Maytag* was short-lived even in the Second Circuit. In 1968, in the en banc decision of *Schoenbaum v. Firstbrook*,[29] the court clearly approved the dictum in *Ruckle*. *Schoenbaum* was a derivative action in which Aquitaine Company

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[23] *Id.*

[24] 339 F.2d 764 (2d Cir. 1964).

[25] *Id.* at 767.

[26] *See* RESTATEMENT (SECOND) OF AGENCY §268 (1958).

[27] *Id.* at §282.

[28] A result-oriented approach to the application of Rule 10b-5 was employed by many courts and the SEC prior to Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976). *Ernst & Ernst* rejected such an approach, holding instead that the nature of the conduct must be emphasized. *Id.* at 197.

[29] 405 F.2d 215 (2d Cir. 1968).

of Canada, Ltd., the controlling shareholder of Banff Oil, Ltd., was charged with using its control to cause an issuance of a large block of treasury stock to itself at an unreasonably low price.[30] The price was allegedly unfair because at the time of the transaction Aquitaine possessed inside information about a substantial oil discovery which, if made public, would have vastly increased the value of the treasury shares sold to it. The court held that the plaintiff could establish a cause of action under Rule 10b-5 if he showed that the defendant exercised a "controlling influence" over the entire board of directors which prevented the directors from exercising their independent, disinterested judgment in approving the issuance of stock.[31] Most importantly for our purposes, the *Schoenbaum* court also stated an alternative theory for its ruling: "Aquitaine and the directors of Banff were guilty of deceiving the stockholders of Banff (other than Aquitaine)."[32]

Decisions in other circuits soon adopted what came to be known as the "controlling influence" test of *Schoenbaum*.[33] Perhaps the rationale behind the controlling influence test was most persuasively stated by the Fifth Circuit in *Shell v. Hensley*.[34]

> When the other party to the securities transaction controls the judgment of all the corporation's board members or conspires with them or the one controlling them to profit mutually at the expense of the corporation, the corporation is no less disabled from availing itself of an informed judgment than if the outsider had simply lied to the board. In both situations the determination of the corporation's choice of action in the transaction in question is not made as a reasonable man would make it if possessed of all the material information known to the party to the transaction.[35]

Despite such attempts to equate controlling influence with deception, the analogy is not totally convincing. Indeed, the controlling influence test might be characterized more accurately as rejecting the traditional deception rationale of earlier cases and creating liability purely for breach of fiduciary duty.

The alternate holding of *Schoenbaum*, declaring that the defendants' conduct constituted deception of the independent shareholders, was based

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[30] *Id.* at 218.

[31] *Id.* at 219-20.

[32] *Id.* at 220.

[33] *See, e.g.*, Travis v. Anthes Imperial, Ltd., 473 F.2d 515 (8th Cir. 1973); Herpich v. Wallace, 430 F.2d 792 (5th Cir. 1970); Shell v. Hensley, 430 F.2d 819 (5th Cir. 1970); Swanson v. American Consumer Indus., Inc., 415 F.2d 1326 (7th Cir. 1969); Dasho v. Susquehanna Corp., 380 F.2d 262 (7th Cir. 1967). This test was characterized as the "new fraud" by many commentators. *See, e.g.*, Bloomenthal, *From Birnbaum to Schoenbaum: The Exchange Act and Self-Aggrandizement*, 15 N.Y.L.F. 332 (1969); Patrick, *Rule 10b-5, Equitable Fraud and Schoenbaum v. Firstbrook*, 21 ALA. L. REV. 457 (1969); Comment, Schoenbaum v. Firstbrook: *The "New Fraud" Expands Federal Corporation Law*, 55 VA. L. REV. 1103 (1969).

[34] 430 F.2d 819 (5th Cir. 1970).

[35] *Id.* at 827.

on an earlier opinion by the Third Circuit in *Pappas v. Moss.*[36] On facts quite similar to *Schoenbaum,* the *Pappas* court stated that "deception . . . [could be] . . . fairly found by viewing this fraud as though the 'independent' stockholders were standing in the place of the defrauded corporate entity . . . ."

It seems clear that the language in *Pappas* is quite different from previous rationales employed to impose Rule 10b-5 liability in conflict of interest transactions. The *Pappas* court undeniably spoke of deception in the traditional sense. But in order to find traditional deception, the court was compelled to create a duty to disclose to the shareholders. Prior to the *Pappas* decision, however, it was understood that since the shareholders were not empowered with decision-making authority in such situations, they were not entitled to any disclosure. If no duty of disclosure ran to the independent shareholders, logically they would have no right to claim they had been deceived. By declaring that the independent stockholders were in reality the deceived parties, the opinions in *Pappas* and *Schoenbaum* seem to be arguing that the formal requirements imposed upon decision-making bodies within the corporation should give way to a realistic appraisal of the circumstances. After all, how else would a corporation be able to protect itself from harm inflicted by self-dealing insiders?

The most significant aspect of this new analysis of deception is that it can be viewed as imposing a duty upon insiders to make full and fair disclosure to independent shareholders in all situations where self-dealing or conflicting interests on the part of the board of directors may bring harm to the corporation, even though state law or internal corporate policies otherwise would not require such disclosure. Unfortunately, the decisions in the federal courts subsequent to *Schoenbaum* failed to develop this new theory of disclosure. Rather than adopt the initial holding of *Schoenbaum,* these later cases tended instead to adopt the initial holding in *Schoenbaum,* a test that was heralded as the "new fraud" under Rule 10b-5.[38]

Since the controlling influence test is grounded essentially in a breach of fiduciary responsibility, the test appears clearly to have been overruled by the Supreme Court's decision in *Santa Fe.*[39] More than a mere controlling influence and a breach of fiduciary duty is required to impose liability under Rule 10b-5. It is not entirely clear, however, that the *Santa Fe* opinion also rejected the alternative holding in *Schoenbaum,* since the alternative rationale was based on a finding of deception, albeit by creating a new duty of disclosure to shareholders. Subsequent to the decision in

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[36] 393 F.2d 865 (3d Cir. 1968).

[37] *Id.* at 869.

[38] *See* note 33 *supra.*

[39] Judge Friendly concluded as much in Goldberg v. Meridor, 567 F.2d 209 (2d Cir. 1977), *cert. denied,* 98 S. Ct. 1249 (1978) when he assumed that "in light of the decision in [*Santa Fe*] the existence of 'controlling influence' and 'wholly inadequate consideration'—an aspect of the *Schoenbaum* decision that perhaps attracted more attention . . .—can no longer alone form the basis for Rule 10b-5 liability . . . ." *Id.* at 217.

Santa Fe several lower federal court decisions have held that the new deception theory developed in *Schoenbaum* was not overruled by *Santa Fe.*[40] These decisions by necessity have embellished this novel theory of disclosure, thus raising a number of questions about the nature and the extent of this new duty imposed on insiders to make potentially wide-ranging disclosures to shareholders.

B. Goldberg v. Meridor *and the Scope of the Duty to Disclose*

This new theory of deception, recognized first by *Pappas* and *Schoenbaum,* was most clearly articulated by Judge Friendly in the Second Circuit case of *Goldberg v. Meridor.*[41] In *Goldberg,* a minority shareholder of Universal Gas & Oil Company, Inc. (UGO) brought a derivative suit against the directors of UGO, the controlling parent corporations, and the investment banking and accounting firms involved in a transaction which was allegedly unfair to the corporation.[42] Goldberg complained that in 1972 the defendants caused UGO to make a public offering of common stock and convertible debentures, and represented that the proceeds from the offering would be employed to finance the construction and purchase of three tankers for the transportion of liquified gas and that thereafter UGO would be engaged in the transportation of liquified gas. In 1974 the defendants, through the board of directors of UGO, allegedly forced the company to sell two of the vessels for $25 million, thereby realizing a profit of $14 million. In August 1975, the defendants, again through the UGO board of directors, caused the company to loan $7 million to its controlling parent, Maritimecor, S.A., a Panamanian corporation.[43] Apparently, at the time of the loan Maritimercor's liabilities exceeded its assets. Within the same month, the defendants caused UGO to enter into an agreement with Maritimecor which provided that UGO would acquire all the parent's assets and assume all its liabilities, including the debt owed to UGO, in return for more than four million shares of UGO's stock. The plaintiff further claimed that the defendant directors had reason to believe that the transaction was unfair to UGO since the net asset value of Maritimecor bore no relation to the value of the UGO stock that was exchanged.[44] The plaintiff alleged that as a result of this transaction, UGO defaulted on its obligations and that its major assets had been seized by creditors.

The district court considered *Goldberg* while *Santa Fe* was still pending before the Supreme Court. Nonetheless, the district court refused to apply the Second Circuit's holding in *Santa Fe,* declaring that the Second Circuit's holding was limited to going private transactions.[45] The trial court then dismissed Goldberg's complaint, stating that it failed to set forth a

[40] *See* text accompanying notes 41-60 *infra.*
[41] 567 F.2d 209 (2d Cir. 1977).
[42] *Id.* at 211.
[43] *Id.*
[44] *Id.*
[45] Goldberg v. Meridor, 426 F. Supp. 1059, 1063 (S.D.N.Y. 1977).

cause of action under Rule 10b-5 because it failed to allege any form of deceit.[46]

On appeal, the Second Circuit treated the case as if the plaintiff had amended the complaint to include allegations of deceit.[47] In effect, the allegations were that the minority shareholders of UGO had been deceived by certain misrepresentations and concealments relating to the transactions. This novel theory of deception was necessary since the facts of the case indicated that all or nearly all the directors of UGO had been fully informed of the nature and impact of the transactions.[48] Because Panamanian law only required approval by the board of directors, the traditional argument could be made that the corporation was not deceived because the relevant decision-making body had the benefit of full disclosure.[49] The court rejected this traditional argument, however, declaring instead that the real parties in interest, the minority shareholders, had been deceived because the nature of the transaction had been misrepresented to them. The court then specifically adopted the alternative holding in *Schoenbaum v. Firstbrook.*[50]

Having determined that the alternative ruling in *Schoenbaum* would control in the Second Circuit, the *Goldberg* court then determined whether the Supreme Court's decision in *Santa Fe* precluded the application of such a rule. Judge Friendly answered in the negative.[51] Admitting that the existence of a controlling influence by any shareholder coupled with unfairness to the corporation or the minority in a given transaction alone would not form the basis for liability under Rule 10b-5, the court held that such liability would indeed be found "when the corporation is influenced by its controlling shareholder to engage in a transaction adverse to the corporation's interest (in effect, the minority shareholders' interest) and there is nondisclosure or misleading disclosure as to the material facts of the transaction."[52] Moreover, Judge Friendly took comfort in certain language in *Santa Fe* which not only appeared implicitly to approve the alternative holding in *Schoenbaum,* but also suggested that the Supreme Court intended in *Santa Fe* to define deception in the broadest possible terms.[53]

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[46] *Id.* at 1064.

[47] 567 F.2d at 213.

[48] The Court of Appeals noted that, upon discovery, one of UGO's directors had claimed he had been deceived or at least had not received full disclosure of the facts surrounding the transaction. *Id.* Of course, if this allegation had been made, Judge Friendly arguably could have grounded the opinion on the prior holding of Ruckle v. Roto American Corp., 339 F.2d 24 (2d Cir. 1964), where the allegation claimed that one member of the board had been deceived.

[49] 567 F.2d at 222 (Meskill, J., dissenting).

[50] 405 F.2d at 220.

[51] 567 F.2d at 217-18.

[52] *Id.* at 217.

[53] *See* 430 U.S. at 474-75 n. 15 (1977). In *Goldberg* Judge Friendly argued:

> It was because "the complaint failed to allege a material misrepresentation or material failure to disclose" that the Court found "inapposite the cases [including *Schoenbaum*] relied upon by respondents and the court below, in which the

Whether or not the principles enunciated in *Goldberg* were sanctioned by the *Santa Fe* opinion is somewhat speculative since Justice White's language in *Santa Fe* is decidedly vague on the issue of deception. It seems fair to observe that Judge Friendly's interpretation of *Santa Fe* may well be correct, especially since the Supreme Court chose not to review the *Goldberg* decision.[54] More significant, given the likelihood that the *Goldberg* rule will be adopted by other courts, is the creation of a new set of responsibilities under federal law to be imposed upon controlling shareholders and directors. Unquestionably, *Goldberg* imposes a duty of disclosure upon controlling shareholders and directors which appears to extend directly to all independent shareholders. Unfortunately, the opinions fails to analyze completely the many problems raised.

In *Wright v. Heizer Corp.*,[55] the Seventh Circuit adopted a rule of disclosure similar to the holding in *Goldberg.*[56] In *Wright,* International Digisonics Corp. (IDC) was a closely held corporation organized to develop a process for the electronic monitoring of television commercials. Seeking a sizeable capital contribution from a private investor as a preliminary step to going public, IDC entered into an arrangement with Heizer, a venture capital corporation, whereby Heizer made loans to IDC of substantial sums and also invested in equity securities of IDC.[57]

The intended public offering did not take place as scheduled, and, over a period of several years, Heizer found itself extending greater amounts of funds to IDC in order to keep it afloat. Over that period, Heizer's position changed from that of a creditor with a limited amount of equity interest to that of controlling shareholder of IDC.[58]

The crux of the plaintiff's complaint was that Heizer, in dealing with IDC, utilized its position of control to obtain benefits detrimental to IDC. Moreover, the plaintiffs complained that Heizer, as a controlling shareholder, had a duty to disclose the material facts concerning the self-dealing transactions to the minority and that failure to make disclosure consti-

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breaches of fiduciary duty held violative of Rule 10b-5 included some element of deception" [citation omitted]. While appellant is wrong in saying that the Court "approved" these cases, there is no indication that the Court would have casually overturned such an impressive and unanimous body of decisions by courts of appeals. To the contrary, the Court used rather benign language about them, saying that they "forcefully reflect the principle that '[s]ection 10(b) must be read flexibly not restrictively' and that the statute provides a cause of action for any plaintiff who 'suffer[s] an injury as a result of deceptive practices touching its sale [or purchase] of securities. . . .' "

Id. at 218.

[54] The Supreme Court denied a petition for writ of certiorari. Meridor v. Goldberg, 98 S. Ct. 1249 (1978).

[55] 560 F.2d 236 (7th Cir. 1977).

[56] In *Wright,* the court stated that "[w]hen an entire board of directors is controlled by a self-dealing director or shareholder the corporation can only be represented by the independent shareholders to whom full disclosure must be made." 560 F.2d at 249.

[57] *Id.* at 241-42.

[58] *Id.* at 242-44.

tuted deception for purposes of Rule 10b-5. The Court of Appeals agreed with the plaintiffs, holding that a duty rested upon the controlling shareholder and upon the directors to make full disclosure of all material facts to the independent shareholders.[59] In this case, as in *Goldberg*, the analysis of the many issues raised by the creation of a federal obligation to disclose was not complete.[60]

C. *Ramifications of the Theory*

Widespread adoption of this new duty of disclosure should concern the management of nearly every corporation, large or small, publicly or closely held. When does a duty to disclose occur? What must be disclosed? How and to whom must disclosure be made? What defenses are available and how will they be applied? These and related questions are dealt with below.

1. *When Does the Duty Arise?*

The initial question when applying this new rule of disclosure is when and under what circumstances will the duty to disclose arise. Insofar as controlling shareholders are concerned, the Seventh Circuit declared in *Wright* that no duty is created until the shareholder acquires control over the corporation:

> In the first three transactions Heizer was a lender to, and shareholder of, a corporation that it did not control and on whose board it was not represented. We may assume that as such it was entitled to act solely in its own interest in dealing with IDC's management, whose responsibility it was to advise the shareholders. By the time of the fourth transaction, however, Heizer had gained voting control of IDC and had placed two of its officers on IDC's board of directors. Thus it stood in a fiduciary position and could no longer act for itself alone. When Heizer chose to continue its participation in communications to the IDC shareholders, it owed them the duty of full disclosure . . . .[61]

The above quotation has the familiar ring of many state fiduciary duty cases dealing with controlling shareholders.[62] Control is the condition precedent to imposing a duty to disclose upon the shareholder, and control in

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[59] *Id.* at 247-48.

[60] The lower court decisions in the Third Circuit, however, have refused to follow *Goldberg*. *See, e.g.*, Biesenbach v. Guenther, 446 F. Supp. 98 (E.D. Pa. 1978); Tyco Lab., Inc. v. Kimball, 444 F.Supp. 282 (E.D. Pa. 1977).

[61] 560 F.2d at 248.

[62] The fiduciary responsibility of a controlling shareholder to the corporation and minority shareholders has long been recognized under state law. *See, e.g.*, Jones v. H.F. Ahmanson & Co., 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969); Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971); Sterling v. Mayflower Hotel Corp., 93 A.2d 107 (Del. 1952); Kavanaugh v. Kavanaugh, 226 N.Y. 185, 123 N.E. 148 (1919).

this instance undoubtedly means control over the board of directors. Determining whether shareholder control exists will require a factual inquiry although in most cases control should be easily determined since the shareholder will have nominated the majority, if not all, of the board of directors. Yet control may be construed more broadly, as where the directors of a corporation, perhaps intially independent, fall under the control and influence of a particular shareholder. In this instance, the power to control is no less real even though the shareholder did not elect or was not able to elect a majority of directors.

In addition to imposing a disclosure obligation upon controlling shareholders, the decisions impose a similar obligation on directors who act to benefit themselves or a controlling shareholder to the detriment of the corporation and the minority shareholders. Since the directors have participated in the wrong being done to the corporation, the duty upon them to disclose to the independent shareholders should be no less than that imposed upon the self-dealing shareholders. In the *Schoenbaum* opinion, the Second Circuit expressly declared that, if the alleged facts were true, the directors were guilty of deceiving the independent shareholders.[63]

Whether or not a controlling shareholder is involved, the federal duty imposed by *Goldberg* to disclose the facts of a transaction to the independent shareholders at the very least requires a finding that all or a majority of the board of directors were tainted with a conflict of interest, thus compromising their responsibility to the corporate entity. Two additional questions exist. First, it is not clear from the opinions whether the conflicting interest on the part of the directors must be pecuniary in nature. In other words, does the federal duty of disclosure depend upon whether the directors are to receive some kind of financial gain from their breach of fiduciary duty? A second question is whether this duty of disclosure to the independent shareholders depends upon a finding that the entire board of directors has breached its fiduciary responsibility. Will the same obligation exist where the breach is by less than all?

As to the first question, whether the conflict of interest may be pecuniary in nature, the decisions after *Santa Fe* are not in agreement. The *Goldberg* opinion does not address this point directly, but the facts suggest that a mere division of loyalities on behalf of the board of directors is sufficient to create a duty to disclose to independent shareholders.[64] This

[63] 405 F.2d at 220.

[64] Although the controlling parent, Maritimecor, stood to gain financially from the transaction in question, 567 F.2d at 217, the defendant directors had no apparent pecunicary interest in the transaction. Instead, the directors' breach of duty apparently resulted from a desire to promote the interests of the parent at the expense of its subsidiary.

result was also implicit in the en banc opinion in *Schoenbaum*[65] where the facts indicated that although the controlling shareholders stood to gain financially from the transaction, the directors apparently did not share this opportunity.[66] In addition, the opinion in *Wright*[67] is silent as to what constitutes a conflict of interest, although the facts indicate that the interested directors did not stand to realize financial gain from the transaction.[68]

Some state law decisions have observed that the term "interested director" for purposes of fiduciary breaches is a director who stands to benefit financially from the transaction.[69] Several federal decisions after *Santa Fe* have likewise held that a director is disinterested so long as he receives no pecuniary gain from the transaction he approves.[70] Of course, a finding that the directors are disinterested ultimately means that no duty of disclosure to the independent shareholders will be imposed beause the corporation presumable had the benefit of the independent, reasoned judgment of the board. In *Tyco Laboratories, Inc. v. Kimball*,[71] the district court for the Eastern District of Pennsylvania distinguished *Goldberg* and *Pappas* solely on the ground that the directors received no financial gain from their conduct. In that decision, two corporations, whose attempt to take over a third company, Leeds, had failed because of allegedly improper conduct by the directors of Leeds, claimed that the directors had defrauded the independent minority shareholders. The complaint alleged that the entire

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[65] Schoenbaum v. Firstbrook, 405 F.2d 215 (2d Cir. 1968).

[66] Indeed, in the panel opinion in *Schoenbaum* not only were the directors not in a position to gain financially from the transaction, but the directors who actually approved the sale of treasury shares to Aquitaine were not even nominees of Aquitaine. 405 F.2d at 212.

[67] 560 F.2d 236 (7th Cir. 1977).

[68] In *Wright*, the controlling shareholder's financial interest was directed toward demanding and receiving allegedly greater than necessary collateral security for obligations due it. The directors, of whom only two of seven were nominees of the controlling shareholder, apparently had no reason to expect personal pecuniary gain from the transaction they approved. 560 F.2d at 243, 248.

[69] In Cheff v. Mathes, 41 Del. Ch. 494, 508, 199 A.2d 548 (1964), the court observed:

> To say that the burden of proof is upon the defendants is not to indicate, however, that the directors have the same "self-dealing interest" as is present, for example, when a director sells property to the corporation. The only clear pecuniary interest shown on the record was held by Mr. Cheff, as an executive of the corporation, and Trenkamp, as its attorney. The mere fact that some of the other directors were substantial shareholders does not create a personal pecuniary interest in the decisions made by the board of directors, since all shareholders would presumably share the benefit flowing to the substantial shareholder . . . . Accordingly, these directors other than Trenkamp and Cheff, while called upon to justify their actions, will not be held to the same standard of proof required of those directors having personal and pecuniary interest in the transaction.

Id. at 554-55. *See also The Controlling Influence Standard, supra* note 20, at 1037-38.

[70] District court opinions in both the Second and Third Circuits have held that federal law should apply only in cases where the directors have a pecunicary interest in the transaction. *See, e.g.*, Maldonado v. Flynn, 448 F.Supp. 1032 (S.D.N.Y. 1978); Falkenberg v. Baldwin, [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,086 (S.D.N.Y. 1977); Tyco Lab., Inc. v. Kimball, 444 F.Supp 292 (E.D. Pa. 1977).

[71] 444 F. Supp. 292 (E.D. Pa. 1977).

board of directors, led by two inside directors, who clearly wished to perpetuate their control over the company, thwarted the plaintiffs' take-over of control by authorizing the sale of a large block of Leeds' stock to a third party.[72] The sale of stock was allegedly at an unfair price since it was less than the plaintiffs would have paid for the shares and less than their fair market value.[73]

The focus of the trial court's opinion was upon those directors other than the two inside directors.[74] The plaintiffs alleged that these outside directors had breached their fiduciary duty in approving the stock sale because their real purpose was to perpetuate their membership on the board of Leeds, and thus their control over the company.

Following the traditional approach, the district court recognized that the appropriate decision-making body in this instance was the board of directors, and, since all the directors presumably had full knowledge of the material facts in question, the corporation could not have been deceived.[75] The plaintiffs contended that the conflict of interest on the part of the entire board imposed upon them the duty to make full disclosure of the material facts of the transaction to the shareholders. The district court refused to accept this argument. Relying on the rationale of *Santa Fe*, the court declared that ample state law remedies were available to protect the plaintiffs from such conduct of the directors.[76] *Goldberg* and *Pappas* were distinguished on the grounds that the directors of Leeds did not receive financial benefits as a result of their approval of the transaction.[77] According to the court, an allegation that the directors of the company had acted merely to preserve their control could not be sufficient to invoke Rule 10b-5 under the deception rationale of *Goldberg*.[78]

Pragmatically, it is difficult to understand the distinction made by the court in *Tyco*. In fact, the court has created a presumption that directors who stand to gain financially will compromise their independent judgment but that benefits of a nonfinancial nature are presumably insufficient to sway the ordinary director from acting in the best interest of the corpora-

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[72] *Id.* at 294-95.

[73] *Id.* at 294.

[74] *Id.* at 296-97.

[75] *Id.*

[76] *Id.* at 298.

[77] The *Tyco* court stated that "the directors' interest in retaining control is not a sufficient interest to permit this court to change the formula." 444 F. Supp. at 298. The court relied on Falkenberg v. Baldwin, [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶96,086 (S.D.N.Y. 1977), which reached the same result because the "control interest may be attributed universally to directors and officers of corporations [and] to decide otherwise would allow a wide variety of claims for breach of fiduciary duty to be brought under Section 10(b)." 444 F. Supp. at 298.

[78] Interestingly, the *Tyco* court expressed some doubt whether after *Santa Fe* a Section 10(b) cause of action is stated at all "when the directors of a corporation, in order to enhance their *financial position*, take actions to cause the corporation to enter an unfair or unfavorable transaction and fail to disclose or misstate the purpose behind the transaction." 444 F. Supp. at 297. Apparently, the court construed *Santa Fe*'s reference to *Schoenbaum* and similar cases as a possible disapproval of that line of authority. *Cf.* note 53 *supra* and accompanying text.

tion. Of course, the compromise of the director's independent judgment will not occur in every conflict of interest transaction. On the other hand, it is quite likely that the persuasiveness of the controlling shareholder or the desire to continue as a director may have more influence over a director than the possibility of financial gain. Presumptions as to courses of conduct may be necessary if they can be justified, but the presumption created by the *Tyco* court as well as by other state and federal courts does not appear on its face to be justifiable.[79]

A second issue raised by the imposition of a new duty to disclose to independent shareholders is whether the duty arises when less than all the directors of a corporation have comprised their independent judgment. In *Goldberg*, the entire board of directors apparently was aware of the adverse effects of the transaction.[80] Two other recent cases, however, have held that if a majority of the board of directors has breached a duty of loyalty, there is an obligation to disclose to the independent shareholders.[81] This analysis assumes that in cases where a majority does have a conflict of interest but where a minority of the board are independent, the minority directors are nonetheless impotent to represent the best interests of the corporation and the minority shareholders. Of course, if the disinterested minority directors have in fact been deceived by the interested majority, a more traditional deception argument may be applied, as was done in *Ruckle v. Roto American Corp.*[82] But if the minority group has received full disclosure, is it necessary to require disclosure to shareholders? An alternative would be to impose a duty upon those independent minority directors to take such action as would be necessary to protect a corporation and thus the independent shareholders. Indeed, inaction by a minority director on such a case may be deemed negligence. Of course, where the entire board of directors has a conflict of interest, the only alternative would be to require disclosure to the shareholders of the material facts surrounding the transaction.[83]

2. *The Mechanics of Disclosure*

Once it is established that a duty of disclosure exists in favor of independent minority shareholders when a majority of the board of directors is interested in a transaction, we are faced with a more difficult question of determining what precisely must be disclosed in order to avoid liability under Rule 10b-5. From a practical standpoint this question will be of greatest concern to corporate managers. Assuming arguendo that corporate

[79] Although the presumption adopted by the *Tyco* court may be unjustified as a hard rule, the judgment of an officer or director could be more easily compromised by the promise of personal financial gain than for other reasons. *See* Cheff v. Mathes, 41 Del. Ch. 494, 199 A.2d 548, note 69 *supra*.

[80] 567 F.2d at 219.

[81] Wright v. Heizer Corp., 560 F.2d 236 (7th Cir. 1977); Maldonado v. Flynn, [Current] FED. SEC. L. REP. (CCH) ¶96,356 (S.D.N.Y. March 16, 1978).

[82] See notes 21-23 *supra* and accompanying text.

[83] *See* Goldberg v. Meridor, 567 F.2d 209 (2d Cir. 1977).

managers will always know when a conflict of interest exists, what must the shareholders be told? Must they be informed that a breach of duty has occurred or is likely to happen? It seems fanciful to believe that insiders would be willing to disclose that have engaged in a self-dealing transaction. Nor is it realistic to expect directors to declare that a transaction that they have approved is in fact unfair to the corporation. The cases recognize this as well. For example, in *Popkin v. Bishop*[84] the Second Circuit observed:

> In many, if not most, corporate self-dealing transactions touching securities, state law does not demand prior shareholder approval. In those situations, it makes sense to concentrate on the impropriety of the conduct itself rather than on the "failure to disclose" it because full and fair disclosure in a real sense will rarely occur.[85]

Even if it were otherwise appropriate to require that such information be disclosed, it may well be difficult, if not impossible, for a person to judge objectively whether or not he is a victim of divided loyalties, or whether the transaction in question is fair or unfair. Indeed, such a test might even backfire. For example, assuming insiders were required to give their opinions as to the fairness of a transaction to the corporation, a statement to that effect would be indisputable since it is only an opinion.[86] The problem, of course, is that this kind of requirement is purely subjective and is not capable of consistent or predictable application. Judge Friendly apparently recognized this fact in his opinion in *Goldberg:*

> We do not mean to suggest that § 10(b) or 10b-5 requires insiders to characterize conflict of interest transactions with pejorative nouns or adjectives. However, if Maritimecor was in the parlous financial condition alleged in the opposing affidavit of plaintiff's counsel, a disclosure of the acquisition of Maritimecor that omitted these *facts* would be seriously misleading.[87]

If an objective standard is chosen, then it must be one which requires disclosure of all material facts surrounding a transaction where conflicts

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[84] 464 F.2d 714 (2d Cir. 1972).

[85] *Id.* at 719.

[86] *See, e.g.,* Biesenbach v. Guenther, 446 F. Supp. 98 (E.D. Pa. 1978). In *Biesenbach* the plaintiffs alleged that "the individual defendants at all times represented to the shareholders that the transactions were in the best interests of the shareholders and [the corporation]". *Id.* at 99. Is this a misrepresentation? Arguably it could not be since it constitutes an opinion. Perhaps it could be considered a misrepresentation if the court found that no reasonable person would have entertained an opinion that the corporation's best interests were served by the transaction.

[87] 567 F.2d at 218 n.8. *See also* Golub v. PPD Corp., 576 F.2d 759 (8th Cir. 1978) (defendants not required under Rule 10b-5 to disclose the "true motivation" behind a transaction); Browning Debenture Holders' Comm. v. DASA Corp., 560 F.2d 1078 (2d Cir. 1977) (no duty to disclose conflicts of interest or unfairness of a transaction); Bailey v. Meister Brau, Inc., 535 F.2d 982, 993 (7th Cir. 1976) (controlling shareholder "has the obligation to disclose to the other stockholders information in its possession which reflects on the fairness of the transaction").

of interest exist. According to the Supreme Court in *TSC Industries, Inc. v. Northway, Inc.*,[88] facts would be material "if there is a substantial likelihood that a reasonable shareholder would consider [them] important in deciding how to vote."[89] In *Northway,* this test of materiality was applied to the nondisclosure of the facts of a transaction that required shareholder approval under state law. In *Goldberg,* however, were it not for the conflict of interest, the responsibility for deciding the matter in question would devolve upon the board of directors alone. Consequently, it is somewhat incongruous in these kinds of cases to define materiality in terms of significance to a reasonable shareholder. Judge Friendly in *Goldberg* foresaw the conceptual problem and modified the materiality test in the following manner:

> When, as in a derivative action, the deception is alleged to have been practiced on the corporation, even though all the directors were parties to it, the test must be whether the facts that were not disclosed or were misleadingly disclosed to the shareholders "would have assumed actual significance in the deliberations" of reasonable and disinterested directors or created "a substantial likelihood" that such directors would have considered the "total mix" of information available to have been "significantly altered."[90]

The *Goldberg* standard does present difficulties, conceptual and otherwise. If the shareholders are the parties entitled to disclosure pursuant to this new federal duty, then should not materiality be defined in terms of a reasonable shareholder? For example, the fact that the majority of directors are nominees of a controlling shareholder may well be considered significant to independent shareholders. It may demonstrate to them that the recommendations of the board should not be accepted. On the other hand, the mere existence of a conflict of interest on the part of many of the board members may not so disturb an independent member of the board of directors.

The issue of materiality is significant in yet another way. The very definition of materiality presumes that the shareholder has an alternative course of action.[91] If a shareholder is helpless to alter a given transaction despite full disclosure, disclosure is immaterial and no federal liability should be imposed. From a standpoint of state corporation law, disclosure to a shareholder in conflict of interest cases should not result in liability since state law gives the shareholder no voice in the matter. However, as

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[88] 426 U.S. 438 (1976).

[89] *Id.* at 449.

[90] 567 F.2d at 219.

[91] If the transaction in question would occur despite the protest of an informed shareholder, the fact that the shareholder had been misled or had not been informed would not make a difference in the outcome. Thus, the information could never be considered "material" to the outcome of the transaction. *See* Fershtman v. Schectman, 450 F.2d 1357 (2d Cir. 1971), *cert. denied,* 405 U.S. 1066 (1972).

the court in *Goldberg* observed, a shareholder, armed with the true facts of a transaction, may be able to enjoin the transaction on behalf of the corporation.[92] To the extent a shareholder possesses such extra-corporate remedies, the issue of materiality would appear to be satisfied.

The Seventh Circuit in *Wright* gave an additional wrinkle to the question of materiality. Assuming, as was done in *Mills v. Electric Auto-Lite Co.*,[93] that proof of materiality will also establish reliance, the court in *Wright* held that materiality would be presumed if the defendant could not demonstrate that the transaction was fair to the corporation.[94] This statement is puzzling because it seems to fly directly in the face of *Mills* where the Supreme Court rejected fairness as an appropriate test of reliance under the proxy rules on the ground that a determination of fairness would bypass shareholder prerogatives. The Supreme Court found this objectionable because it reduced the importance of shareholder suffrage.[95] Moreover, from a conceptual standpoint, it is not clear that fairness could ever be a valid consideration under a disclosure standard. Either information is disclosed fully and adequately or it is not. After *Mills*, it must be asked whether an after-the-fact judicial determination of fairness can ever be an acceptable substitute for full disclosure. Directors may be faced with several alternatives, all of which are fair to the corporation. Likewise the fairness of the transaction may be only one of several elements to be weighed by the board in choosing a course of action. Finally, fairness can be viewed in several contexts. Transactions may be fair in some respects but not in others, or fair in the long run but unfair in the immediate future.[96] Therefore, the fairness analysis adopted in *Wright* appears unsupportable from the combined standpoints of precedent, logic and experience.

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[92] 567 F.2d at 219.

[93] 396 U.S. 375 (1970).

[94] In *Wright* the Seventh Circuit characterized the directors' burden of proof as follows:

> Thus . . . in a 10b-5 action brought derivatively on behalf of the corporation by minority shareholders to whom the self-dealing controlling shareholder failed to make disclosure, if the controlling shareholder cannot demonstrate that the transaction is fair to the corporation, the requisite materially is shown and reliance is to be presumed. The minority shareholders are thus afforded the same right they would have had if full disclosure had been made, *i.e.*, the right to obtain a judicial determination of the fairness of a transaction forced upon the corporation by a controlling shareholder with a conflict of interest. The existence of a causal link between Heizer's technical violation of Rule 10b-5 and the consummation of the pledge transaction depends, therefore, on the fairness of the transaction.

560 F. 2d at 250 [footnotes omitted].

[95] 396 U.S. at 382-83.

[96] In one sense it might be argued that the fairness test of *Wright* is really quite similar to *Goldberg*. In *Goldberg*, materiality, reliance and transaction causation is judged by the impact of the misrepresented or undisclosed facts to a hypothetical independent director. Presumably, such a director will only approve transactions that are fair to the corporation. Hence, a finding of fairness may be viewed as a shortcut to the materiality test of *Goldberg*. One must ask, however, if it is appropriate to assume that directors will only approve fair transactions. "Fairness" in this sense is by no means synonymous with "most profitable," clearly a concern of any director.

Closely related to the question of what must be disclosed pursuant to this new duty is the issue of how disclosures to shareholders should be made. The courts have been silent regarding the method of disclosing the material facts of a transaction. Since no shareholder approval is required otherwise under state or federal law, no formal vehicle for making disclosures to all shareholders presently exists. It might be suggested that a press release would be the appropriate means of making disclosure in such situations. The problem with the press release is that it is not likely to reach all shareholders. For that reason, an alternative suggestion would be to require a mailing of the material information to all shareholders of record. Clearly, this would be difficult for larger corporations although perhaps not so for corporations with fewer than a thousand shareholders. Nonetheless, because the duty of disclosure exists in favor of all independent shareholders, caution dictates a communication designed to reach all shareholders, despite the potential cost involved.

A third related issue concerns when disclosure should be made. From the shareholders' standpoint, for the disclosure to serve its intended purpose, it must be made prior to the transaction in question. If a press release is the disclosure vehicle, it might be appropriate to require such a press release to precede the transaction in question by a specified minimum period of time to insure the widest possible dissemination.[97] But dissemination alone is not enough. There must also be a reasonable period of time for the shareholder to act upon the information. Since no formal shareholder action is required under state law, the expected response may be the filing of a lawsuit to enjoin the transaction. If this is the expected response of the shareholder, then time must be allowed for reaction to the disclosure and for filing of the suit. From the standpoint of the insider who has a duty to disclose, the timeliness of the disclosure may also involve the question of ripeness. Information may well be material but for the fact that it must be verified, and until it is verified the information may not be considered ripe for disclosure.[98]

One of the more nagging concerns about imposing this wide ranging duty to disclose is that of making the duty compatible with those transactions which require urgent action by the board of directors. In such cases, conflicts of interest may well exist but other factors may require that a decision be made quickly. Disclosure to the shareholders may not be possible prior to the necessary director action. Should directors or insiders be penalized for failing to make disclosure in such situations?

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[97] *See* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied,* 394 U.S. 976 (1969). In *Texas Gulf Sulphur,* the Second Circuit held that material information must be disclosed in a manner sufficient to ensure its availability to the investing public. *See also* Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90, 100 (10th Cir.), *cert. denied,* 404 U.S. 1004 (1971) (when material information is available and ripe for publication the difficulties inherent in formulating a release cannot overbear the accuracy of the statements contained therein).

[98] *See* Financial Indus. Fund, Inc. v. McDonnell Douglas Corp. 474 F.2d 514 (10th Cir.), *cert. denied,* 414 U.S. 874 (1973).

Perhaps this problem could be solved by requiring directors to seek ratification of the transaction. Although disgruntled shareholders who believe that directors have compromised their independent judgment and have harmed the corporation in most cases will not be able to compel an unscrambling of the transactions, in egregious cases ratification may be a possibility. Similarly, in close corporations, to which this rule also applies, a forced return to the status quo ante may cause only a slight disruption. Significantly, it would make the shareholders aware of facts surrounding a potential breach of duty by the directors and other insiders thus allowing them to sue for damages if any harm occurred to the corporation. The deterrent impact of this kind of subsequent disclosure may make it an effective preventative measure. On the other hand, one might argue that subsequent disclosure merely invites lawsuits against the insiders for an admitted breach of duty under state law, and since the measure of damages may well be the same whether or not disclosure had been made, a strong impetus exists not to disclose after the fact. Furthermore, if post-transaction disclosure is made to the shareholders and the shareholders ratify the transaction with full knowledge of the facts, this ratification certainly would preclude those approving shareholders from bringing an action. Finally, it would be appropriate to create a rule precluding even those objecting shareholders from maintaining an action against the insiders if the transaction is ratified by a majority of the independent shareholders. Because ratification might have the effect of preventing any lawsuits against insiders for breach of duty, such a rule might encourage disclosure in order to avoid liability.

3. *Standards of Conduct*

An analysis of the possible defenses available to insiders charged with deceiving the independent shareholders depends initially upon an appreciation for the fact that multiple standards of conduct are being used in the imposition of this federal duty. It is the existence of a conflict of interest, which may or may not be actionable under state law, that gives rise to the duty of disclosure under federal law.

The interrelationship between fiduciary duty and deception causes some conceptual difficulty in determining what defenses are available to defendants charged with deception of independent shareholders. Defendants charged with intentional deceit in connection with a securities transaction may offer proof of good faith as a defense. Also, nonrecklessness is a defense to allegations of gross negligence or reckless disregard for the truth in a Rule 10b-5 action.[99] After *Santa Fe,* proof of fairness would seem to be irrelevant as a defense to a claim of deception.[100] However, the inno-

[99] *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976). Currently the circuits are split as to whether recklessness is adequate to impose 10b-5 liability. *1977-1978 Securities Law Developments—Rule 10b-5,* 35 WASH. & LEE L. REV. 821-32 (1978) [hereinafter cited as *Developments—Rule 10b-5*].

[100] 430 U.S. at 478 (1977).

vations of the courts in *Goldberg* and *Wright* have revived the issue of fairness to some degree. According to *Wright*, proof of fairness of a transaction negates materiality and reliance and thus constitutes an absolute defense to liability under federal law.[101] Under the *Goldberg* rule, however, when materiality depends upon the significance of the facts to a hypothetical independent director, proof of fairness may not have the same effect. Judge Friendly focused upon the significance of the facts rather than the substantive fairness of the transaction.[102] This interpretation is more consistent with a deception theory.

In addition to the incongruity of imposing a fairness standard upon a deception rationale, the *Wright* decision places the burden of proof upon the defendant to establish fairness.[103] In the final analysis, the task of proving fairness is nearly impossible. In most cases, all that can be argued is that the challenged transaction was entered into because there was no alternative and that it was necessary to the corporation regardless of the detriment that it caused.[104] It is highly unlikely that a defense of fairness would withstand proof that the directors benefitted from a transaction that in some way injured the corporation.

The standard of conduct applicable in cases such as *Goldberg* is scienter, which may conceivably range from intentional misrepresentation to reckless disregard of the truth.[105] If affirmative misrepresentations in fact are made to the shareholders, the defendants should find little solace in even a gross negligence standard since courts are likely to presume that affirmative misrepresentations constitute more than mere negligence. On the other hand, nondisclosure of material facts may not receive the same harsh scrutiny from the courts. In any event, the existence of scienter, however defined, is primarily a factual issue. To the extent that good faith serves to vitiate allegations of scienter,[106] insiders should be encouraged, in all such self-dealing transactions, to seek the judgment of independent appraisers, investment bankers, engineers and similar experts as to the fairness of the transaction. In this sense a finding of fairness may be a factor in avoiding 10b-5 liability. The fact that the board acted only after such an opinion may negate a recklessness charge as well.[107]

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[101] *See* note 61 *supra*.

[102] 567 F.2d at 218-19.

[103] 560 F.2d at 250.

[104] Judge Traynor offered the argument that the inherent fairness of a transaction can be established by evidence of good faith or compelling business purpose. Jones v. H.F. Ahmanson & Co., 1 Cal. 3d 93, 114, 460 P.2d 464, 476, 81 Cal. Rptr. 592, 604 (1969). This argument is more akin to a defense of necessity rather than fairness.

[105] *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976). *See generally* Floor, *The Scienter Requirement under Rule 10b-5 and Reliance on Advice of Counsel After Hochfelder*, 12 NEW ENG. L. REV. 191 (1976); Lowenfels, *Recent Supreme Court Decisions under the Federal Securities Laws: The Pendulum Swings*, 65 GEO. L. J. 891 (1976); *Developments—Rule 10b-5*, *supra* note 99 at 821.

[106] *See* Hawes & Sherrard, *Reliance on Advice of Counsel as a Defense in Corporate and Securities Cases*, 62 VA. L. REV. 1, 13-16, 126-34 (1976).

[107] *Id.*

D. *Conclusion*

It is undeniable that cases such as *Schoenbaum* and *Goldberg* demonstrate the kinds of abuses which, without an innovative theory of disclosure, would be beyond the scope of federal regulation. On the other hand, the very conduct which forms the basis of a duty to disclose should in most cases also give rise to a cause of action for a breach of fiduciary responsibility under state law. Indeed, it is difficult to think of a situation in which facts deemed material for purposes of federal law would not also be central to a breach of fiduciary duty under state law. This, of course, raises the question whether concomitant relief in the federal courts is necessary or desirable. It is important to recall the injunction of Justice White in *Santa Fe* that important considerations of federalism may weigh heavily against permitting a cause of action under Rule 10b-5.[108] One consideration is whether it is necessary to imply a cause of action in order to fulfill the congressional purpose, or whether the cause of action is traditionally relegated to state law.[109]

One must ask, therefore, whether the purpose served by creating this novel theory of disclosure is necessary to accomplish the congressional objective. There is no clear answer. It might be suggested that the opinion in *Santa Fe* is schizophrenic. On the one hand, the court makes the expansive suggestion that Rule 10b-5 will be imposed upon breaches of fiduciary duty that include "some element of deception"[110] and then cites the *Schoenbaum* decision apparently with favor. On the other hand, the language of Part IV of the *Santa Fe* opinion would tend toward an opposing view. In the final analysis the creation of an elaborate theory of disclosure in order to provide a federal remedy seems to be a rejection of the Supreme Court's position in *Cort v. Ash*[111] and *Santa Fe*. The potential burden imposed upon corporate insiders under federal law makes the theory of *Goldberg* inappropriate so long as a cause of action for the same conduct exists at the state level.[112]

III. The SEC'S Response—Utilizing *Santa Fe* to Expand its Powers

On November 17, 1977 the Securities and Exchange Commission (SEC) proposed a rule designed to regulate "going private" transactions.[113] In addition to requiring broad disclosure pertaining to the transaction, the

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108 430 U.S. at 478-79.

109 *Id.*

110 *Id.*

111 422 U.S. 66 (1975).

112 According to the Reporter's Revision of the text of Tentative Drafts Nos. 1-3 (October 1, 1974) at 106, "The *Ruckle-Schoenbaum* doctrine—that knowledge even of all the directors is not necessarily attributable to the corporate plaintiff—is codified in §1402(c)." *See* ALI Federal Securities Code §1402(c), Tent. Draft No. 2 (March 1973). However, it is not clear that the new duty of disclosure imposed by *Goldberg* is also included in the codification.

113 Proposed Rule §240.13e-3, 42 Fed. Reg. 60,090 (1977) [hereinafter cited as Proposed Rule 13e-3].

rule would require that the transaction be fair to unaffiliated securityholders. The Supreme Court in *Santa Fe,* however, in effect declared that the fairness of a going private transaction accomplished by a short-form merger was not a matter of federal concern under Rule 10b-5.[114] Given the apparent aversion of the Supreme Court to the regulation of fairness under Rule 10b-5, one wonders at the boldness of the SEC in attempting to regulate the substantive fairness of all going private transactions. The SEC's analysis that accompanied the proposed rule demonstrated the Commission's sensitivity to the holding in *Santa Fe* as well as its precursor, *Cort v. Ash.*[115] This part of the article reviews the content of the proposed rule, the statutory authority upon which it is grounded, and its philosophical compatibility with the position adopted by the Supreme Court in *Santa Fe* and other recent decisions.

A. *The Proposed Rule*

The proposed rule and related schedule which would be promulgated under Section 13(e) of the Securities Exchange Act of 1934 is identified as Rule 13e-3. If adopted, the proposal would augment and implement the present statutory provisions by providing "definitions, specific disclosure and dissemination requirements, substantive regulatory protections and particular antifraud provisions with respect to going private transactions."[116] The substantive provisions of Proposed Rule 13e-3 would be applied to a specific class of securities transactions referred to as "Rule 13e-

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[114] 430 U.S. at 478.

[115] 422 U.S. 66 (1975). In its release accompanying the proposed rule, the Commission argued:

> The language of Section 13(e) of the Exchange Act proscribes any purchase by a Section 12 issuer and/or an affiliate of such issuer of any equity security of such issuer which violates rules or regulations promulgated by the Commission pursuant to that section. Since the section delineates the category of issuer, the type of purchase and the type of prescribed conduct relating to any such purchases by such persons, the Commission believes, particularly in light of the present status of remedies available under state law, that the implementation of the section through the rulemaking proposed herein is consistent with *Cort v. Ash.*

Securities and Exchange Act Rel. No. 34-14185 (Nov. 17, 1977), *reprinted in* [1977] FED. SEC. L. REP. (CCH) ¶81,366 at 88,744 [hereinafter referred to as the "1977 Release"]. And, with respect to the *Santa Fe* decision, the Commission stated:

> In the most recent case in which the Supreme Court examined Section 10(b) and Rule 10b-5, *Santa Fe Industries, Inc. v. Green,* the Court held that a majority shareholder's alleged breach of fiduciary duty by effecting a short form merger under the Delaware Corporation Law without any allegation of a material misrepresentation or a material failure to disclose did not state a claim under that section or rule. In so holding, the Court interpreted the language of Section 10(b) as giving "no indication that Congress meant to prohibit any conduct not involving manipulation or deception," but the Court intimated "no view as to the Commission's authority to promulgate . . . rules under other sections of the Act" with respect to going private transactions.

Id. at 88,742-43.

[116] 1977 Release, *supra* note 115, at 88,735.

3 transactions." Application would depend upon the kind of transaction, e.g., purchase, tender offer, reorganization, reclassification, reverse stock split, or similar transaction between an issuer and its affiliate,[117] and the effects that the transaction is likely to have. The proposed rule states that the transaction must have "either a reasonable likelihood or purpose" of producing any of several effects, including the delisting from a national exchange, the termination of registration under Section 12 of the Exchange Act and, in general, termination of the special rights and responsibilities of a company whose securities are publicly traded.[118] In short, the definition is comprehensive enough to apply to all instances of going private. Although the criteria primarily are objective, the "reasonable likelihood" or "purpose" tests could create problems when the focus is on the "purpose" aspect of the transaction. The use of these standards as alternatives apparently means that a transaction described in the definition could be challenged even if none of the specified effects occur. This challenge would require a judicial determination as to the motives of the insiders of the issuer. Since many going private transactions have several purposes, these parties would be faced with a degree of uncertainty whenever one of the included transactions took place.

Once a transaction falls within both parts of the outlined definition, the substantive provisions of the proposed rule become applicable. In essence, the substantive provisions declare that only those going private transactions that (1) are "fair" to the unaffiliated securityholders, (2) comply with the extensive disclosure and dissemination provisions of the section and, (3) are not otherwise fraudulent, deceptive, or manipulative will be above scrutiny by the Commission.[119]

The SEC's proposal, as anticipated, does not attempt to define the amorphous fairness requirement. A note to one of the provisions, however, sets forth several "considerations which may bear on the question of fairness in particular situations."[120] These nonexclusive considerations include approval, after full disclosure, by a majority of disinterested directors or unaffiliated shareholders, fairness of the consideration offered, and benefits to be received by a controlling shareholder as compared to those received by the corporation or unaffiliated securityholders.[121] These and

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[117] Proposed Rule 13e-3(a)(4), note 113 *supra*.

[118] *Id.*

[119] Proposed Rule 13e-3(b)(1), note 113 *supra*.

[120] *See* 1977 Release, *supra* note 115, at 88,747.

[121] In detail, considerations bearing on the issue of fairness are:

(A) Whether the Rule 13e-3 transaction has been approved by a majority of the unaffiliated securityholders after (1) delivery to such persons of a disclosure document containing the information required by Rule 13e-3(e) or a fair and adequate summary thereof; and (2) such persons have had a reasonable opportunity to consider such information;

(B) Whether the considerations offered to unaffiliated securityholders for the securities subject to the Rule 13e-3 transaction is fair in light of such factors as, for example, current market prices, historical market prices, net book value, going-concern value, liquidation value, previous purchases disclosed in Item 1(f) of other indicia of fairness are key components of the SEC's proposal, and are controversial on two grounds. First, it is unclear whether the SEC has the statutory authority to regulate the substantive fairness of securities transactions. Second, a fairness standard presumes that all unaffiliated shareholders have an identical and overriding concern with the objective fairness of the transaction. Not only is this a questionable assumption from a behaviorial standpoint as was suggested in *Mills v. Electric Auto-Lite Co.*,[122] but it also flies in the face of the philosophy of unfettered shareholder suffrage long espoused by both Congress and the Court.[123]

In addition to substantive regulation, the proposed rule imposes exhaustive disclosure requirements. It requires the filing of a "Rule 13e-3 Transaction Statement" to be filed on Schedule 13E-3.[124] The schedule in turn requires detailed item-by-item disclosure of twenty-one items.[125] Finally, the proposed rule describes how the information required to be disclosed should be disseminated to securityholders.[126]

Schedule 13E-3, and any report, opinion, or appraisal described in Item 10 of the Schedule 13E-3;

(C) Whether a majority of sufficiently disinterested directors, if any, of the issuer has voted to approve the transaction prior to (1) dissemination of the disclosure document containing the information required by proposed Rule 13e-3(e) or a fair and adequate summary thereof; and (2) any vote of unaffiliated securityholders of the issuer with respect to the Rule 13e-3 transaction;

(D) Whether a representative of the unaffiliated securityholders who is independent of the issuer and its affiliate has negotiated, and agreed to, the terms of the Rule 13e-3 transaction;

(E) Whether the terms and conditions of the Rule 13e-3 transaction are fair to unaffiliated securityholders in light of the terms and conditions of any offers made by third parties for securities of the class which is the subject of the Rule 13e-3 transaction;

(F) The purpose of the Rule 13e-3 transaction;

(G) The anticipated benefits to be derived from the Rule 13e-3 transaction by the issuer or affiliate, including consideration of the extent to which the issuer's funds or other assets are used in connection with the Rule 13e-3 transaction, vis-a-vis those to be derived by unaffiliated securityholders;

(H) The tax consequences likely to be incurred by unaffiliated securityholders of the issuer as a result of the timing of the Rule 13e-3 transaction;

(I) Whether the Rule 13e-3 transaction complies with the requirements of applicable laws and regulations of the state of incorporation of the issuer show securities are the subject of the Rule 13e-3 transaction;

(J) In certain Rule 13e-3 transactions (such as those involving the purchase of the equity securities of a subsidiary by its parent), whether the consideration offered to the unaffiliated securityholders for the securities which are the subject of the Rule 13e-3 transaction is comprised of securities of the surviving entity (such as the parent) which would enable such unaffiliated securityholders to maintain an equity interest in the continuing business enterprise.

Proposed Rule 13e-3(b), *supra* note 113, at 60,101.

[122] 296 U.S. 375, 382 n.5 (1970). *See also* ABA Committee on the Federal Regulation of Securities, Section of Corporation, Banking and Business Law, Comment Letter (1978) [hereinafter cited as ABA Committee Comment Letter].

[124] Proposed Rule 13e-3(d) note 113 *supra*.

[123] 396 U.S. at 382 n.5; J. I. Case Co. v. Borak, 337 U.S. 426 (1964).

[124] Proposed Rule 13e-3(d) note 114 *supra*.

[125] 17 C.F.R. § 240.13e-100 (1978).

[126] Proposed Rule 13e-3(f), note 113 *supra*.

The disclosure requirements prompt a significant inquiry. Is the SEC improperly attempting, through the imposition of burdensome disclosure provisions, to discourage going private transactions? Arguably, the Commission has exceeded the permissible boundaries for requiring disclosure by employing disclosure requirements as a means of regulating substantive corporate conduct rather than merely achieving equality of information on both sides of a securities transaction.[127] It might also be noted that the proposed disclosure requirements will often be duplicative of other disclosure provisions of the Exchange Act.[128]

B. *Statutory Authority for the Proposed Rule*

If the proposed rule is promulgated by the SEC, it probably will be challenged as beyond the scope of the Commission's statutory rulemaking authority. Such a challenge will be particularly important because the proposal represents the first attempt to regulate the fairness of a securities transaction under the 1934 Act.[129]

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[127] In a recent report by the Advisory Committee on Corporate Disclosure, the Committee recommended that "[t]he Commission should not use disclosure solely to regulate corporate conduct unless expressly authorized to do so by the Congress." Disclosure Study Report, [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶81,300, at 88,483 (Sept. 8, 1977).

[128] Obviously, any time a going private transaction involves a merger or tender offer, compliance with various disclosure provisions of Section 14 of the Exchange Act will be required.

[129] The 1977 proposal, however, is not the first proposal put forth by the Commission to regulate going private. In Securities Exchange Act Release No. 11231, FED. SEC. L. REP. (CCH) ¶80,104 (Feb. 6, 1975), the SEC announced that it had ordered a public fact-finding investigation and rulemaking proceeding in the matter of going private transactions. The rules proposed in the 1975 release were delineated as Proposed Rule 13e-3A and Proposed Rule 13e-3B, and were intended to be alternative methods of regulating going private transactions. Although the 1975 proposals presented basically the same definitional provisions as those in the 1977 proposed rule, the 1975 rules differed in the manner in which they regulated going private transactions. In addition to disclosure and dissemination requirements similar to those required by the 1977 proposals, Proposed Rule 13e-3A was concerned primarily with the consideration to be transferred to unaffiliated securityholders, requiring, for example, that the price "be no lower than that recommended jointly by two qualified independent persons." Proposed Rule 13e-3A(c)(2). The appraisers were required to submit reports regarding the basis for their recommendation, and these reports or a summary were to be disseminated to securityholders. Proposed Rule 13e-3B, by contrast, involved more substantive regulation in addition to disclosure requiring a "valid business purpose" for entering into the transaction, including that any consideration paid to any securityholder be fair. Proposed Rule 13e-3B(a). An appraisal was not mandatory under Proposed Rule 13e-3B.

Another interesting contrast between the 1975 and 1977 proposals is the apparent change in the SEC attitude. In 1975, the SEC included in its release statements that indicated the tentative nature of the proposals:

> In announcing this proceeding, the Commission does not wish its position to be misunderstood. The phenomenon of "going private" is important and raises significant questions of investor protection which should be thoroughly explored . . . . The Commission, however, has reached no conclusions with respect to the proposed rules. They are included to provide a framework for the hearing and comments.

Securities Exchange Act Release No. 11231, [1974-75 Transfer Binder] FED. SEC. L. REP. (CCH) ¶80,104 at 85,090 (1975).

Although the SEC refers to several sections of the securities laws as providing statutory authority, the primary basis for the proposed rule is Section 13(e).[130] In its contention that Section 13(e) provides the statutory authority to regulate the substance of a going private transaction, the Commission has demonstrated its awareness of and sensitivity to *Santa Fe* and other recent Burger Court securities decisions. In its proposal, the Commission adopted the methodology of those decisions and emphasized the crucial nature of the precise statutory language as well as the legislative history. Then, in a fashion similar to that of *Santa Fe* and *Hochfelder,* the Commission set out to justify a more expansive reading of Section 13(e) than that given to Section 10(b) by those decisions. Emphasizing Section 13(e)'s inclusion of the word "fraudulent," the SEC declared:

> While Section 10(b) speaks in terms of "manipulative or deceptive," Section 13(e) refers to "fraudulent," "deceptive" or "manipulative". Thus, Section 13(e) speaks specifically in terms of fraudulent acts and practices. The language of Section 13(e) explicitly vests authority in the Commission to adopt rules and regulations to prescribe means reasonably designed to prevent fraudulent, deceptive or manipulative acts and practices in connection with a purchase by a Section 12 issuer or a purchase by an affiliate of such issuer of any equity security of such issuer. The specific language of and the rulemaking authority conferred by Section 13(e), which was part of legislation intended by Congress to close a gap in the Federal securities laws, is in sharp contrast to that of Section 10(b) which is directed at the purchase or sale of any security.[131]

Thus, in attempting to avoid the *Santa Fe* decision, the SEC has based its argument for statutory authority on the inclusion of the word

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In contrast, the 1977 release contains no exculpatory language, declaring instead:

> The Commission proposes for comment a new rule and related schedule relating to going private transactions by public companies or their affiliates. If adopted, these proposals would provide definitions, specific disclosure dissemination requirements, substantive regulatory protections and particular antifraud provisions with respect to going private transactions. These proposals are necessary and appropriate in the public interest and for the protection of investors . . . .

1977 Release, *supra* note 115, at 88,735.

In one sense, it could be expected that after two years in which to assess the impact of the going private phenomenon and the proposed rules, the Commission would be more certain of its position. Nonetheless, the boldness of the SEC in the 1977 release is noteworthy in light of *Santa Fe.*

Further evidence of the Commission's bold approach is its recommendation in the 1977 release that "should proposed Rule 13e-3 be adopted, it would be appropriate for the courts to construe its provisions in such a way as to imply a private right thereunder." *Id.* at 88,753. The ABA Committee Comment Letter attacks this suggestion as "unprecedented and inappropriate." *See* ABA Committee Comment Letter, *supra* note 122, at 26. The Commission appears to be trying to encourage the courts to give great weight to the administrative gloss it has provided.

[130] 1977 Release, *supra* note 115, at 88,740-44.

[131] *Id.* at 88,743.

"fraudulent" in Section 13(e) and the accompanying legislative history of the Williams Act. The crucial inquiry, then, is whether these two considerations support such broad expansion of the Commission's regulatory reach.

The SEC relied upon the legislative history of the Williams Act in general and of Section 13(e) in particular for the proposition that the provisions of the Williams Act were intended to correct a "gap" in the federal securities laws and that the SEC was not restricted solely to imposing disclosure requirements.[132] A close examination of the legislative history of the Williams Act reveals, however, that Congress never explicitly intended the legislation to permit substantive regulation. Instead, much of the controversy seems to have been centered on whether there was a need for any regulation at all. For example, the oft-quoted language that Section 13(e) was intended to fill a "current gap" in the securities laws is part of a Senate Report that stated:

> The bill would correct the current gap in our securities laws by amending the Securities Exchange Act of 1934 *to provide for full disclosure* in connection with cash tender offers and other techniques for accumulating large blocks of equity securities of publicly held companies.[133]

This quotation clarifies that the "gap" Congress intended to close related to types of transactions theretofore not covered by the 1934 Act rather than grant to the Commission the power to engage in substantive regulation.

As originally drafted, the bill gave the SEC rulemaking authority beyond merely prohibiting fraudulent, manipulative or deceptive practices. In testimony before the House Subcommittee on Commerce and Finance, then SEC Chairman Cohen outlined the broad powers granted in the bill.

> The provisions of this bill would make it unlawful for an issuer to purchase its own securities in contravention of rules or regulations which the Commission adopts because they are necessary or appropriate in the public interest, or to protect investors, irrespective of the question, whether, or our ability to prove that, such activity is or may be fraudulent, deceptive, or manipulative.[134]

Significantly, the House Committee altered the bill and amended Section 13(e)(1) to clarify that the Commission's rules were intended by Congress "solely (A) to define acts and practices which are fraudulent, deceptive, or manipulative, and (B) to prescribe means reasonably designed to prevent such acts and practices."[135] Thus, the Williams Act, as passed, was narrower than originally drafted and seems to have limited the SEC's rulemaking authority to that traditionally provided in the antifraud provisions.

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[132] *Id.*

[133] S. REP. No. 550, 90th Cong., 1st Sess. 4 (1967) (emphasis added).

[134] *Hearing on H.R. 14,475 Before the Comm. on Interstate and Foreign Commerce,* 90th Cong. 2d Sess. 15 (1968).

[135] H.R. REP. No. 1711, 90th Cong., 2d Sess. 6-7 (1968).

Finally, in its 1977 release the Commission treats the term "fraudulent" as if it were imbued with a special meaning that extends beyond deception and manipulation to include conduct that is oppressive or unfair.[136] While equity traditionally has given such an expansive interpretation to the term,[137] the Supreme Court has given no indication that it finds such an interpretation appropriate under the securities laws. Indeed, in *Santa Fe,* the Court analyzed the meaning of term "fraud" in Rule 10b-5 only in terms of deception or manipulation[138] and rejected an interpretation of fraud that reaches beyond the statutory language of Section 10(b) of the 1934 Act.[139] This suggests that the Supreme Court is not likely to agree with the SEC's view of the term "fraudulent."[140]

C. *The Relationship Between* Santa Fe *and the 1977 Proposed Rule*

The Supreme Court's statutory analysis in *Santa Fe* presented three guiding principles for the interpretation of the scope of antifraud rules promulgated by the SEC. First, the reach of the federal securities laws and regulations extends no further than the express statutory language and legislative history allow. Second, when the statute and history are inconclusive, courts must be guided by the fundamental purpose of the federal securities laws—full disclosure.[141] Fairness in securities transactions is "at most a tangential concern . . . ."[142] Third, absent clear statutory direction, considerations of federalism must be factored into a decision whether to expand the reach of federal securities laws into areas traditionally regulated by state corporation laws.

As discussed previously, the SEC was fully aware of the thrust of the *Santa Fe* decision when it issued the proposed rule. Indeed, the analysis of the proposal presented by the Commission cites specifically to the holding.[143] Although the difference in language between Section 10(b) and Section 13(e) prevents the direct application of *Santa Fe,* the Commission deftly utilizes the Court's dependence upon statutory language to construct an argument for an expansive reading of Section 13(e) to justify its

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[136] 1977 Release, *supra* note 115, at 88,742.

[137] In Moore v. Crawford, 130 U.S. 122, 128 (1889) the Supreme Court described the term "fraud" broadly:

> Fraud, indeed, in the sense of a court of equity properly includes all acts, omissions and concealments which involve a breach of legal or equitable duty, trust, or confidence, justly reposed, and are injurious to another, or by which an undue or an unconscientious advantage is taken of another.

[138] *See* 430 U.S. at 472. It should be noted also that in *Blue Chip* the majority described Section 10(b) as prohibiting "fraud" even though the section refers only to deception and manipulation. *See* 421 U.S. at 733. This suggests that the Court considered "fraud" under the securities laws to have a limited meaning.

[139] 15 U.S.C. 78j(b) (1970).

[140] *See, e.g.* Berman v. Gerber Prod. Co., [Current] FED. SEC. L. REP. (CCH) ¶96,506 (W.D. Mich. July 19, 1978).

[141] Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 478 (1977).

[142] *Id.*

[143] 1977 Release, *supra* note 115, at 88,742.

going private rule. To this extent, the Commission's methodology is wholly consistent with the Supreme Court's analysis. However, in attempting to create a federal fairness standard, the SEC has disregarded the ability of the states to regulate going private transactions, and breaks with the *Santa Fe* rationale.

In the final analysis, the *Santa Fe* opinion and the proposed going private rule cannot be effectively compared and contrasted on the basis of statutory language or congressional intent. Rather the issue is one of philosophy. While the SEC has borrowed the analysis of the *Santa Fe* decision to buttress its position that Section 13(e) must be read broadly, the proposed rule is not consistent with the philosophical underpinnings of the decision. This incompatability suggests that if the rule becomes final and is challenged, the Court would be inclined to follow its recent trend in restricting the scope of the federal securities laws and invalidate the rule.

IV. Conclusion

The position of the Supreme Court seemed unmistakably clear in the *Santa Fe* opinion. Drawing from the authority of *Hochfelder* and other recent decisions, the court presented both legal and jurisprudential arguments for restricting the scope of Rule 10b-5. Indeed, after presenting a clear and quite convincing argument that the express terms of Section 10(b) and the legislative history would not permit a federal remedy for breaches of fiduciary duty, the Court, almost gratuitously, stated that principles of federalism also mandated a limitation on the spread of federal regulation into an area customarily the subject of state law. Despite this rather forceful statement, however, neither the federal courts nor the SEC have been willing to accept *Santa Fe* as dispositive of any and all federal regulation of fiduciary duties and fairness. The rule adopted in the Second and Seventh Circuits, while ostensibly labeled as a type of deception, is really grounded in state law fiduciary duty concepts. In fact, but for such a breach of duty, no corresponding federal obligation to disclose to independent shareholders would be created. The Commission's proposed rule at least enjoys the distinction of resting upon another section of the securities laws. Even so, the effort by the SEC to regulate fairness seems to conflict directly with *Santa Fe's* rejection of such regulation as a federal concern. In the long run, neither the federal courts' interpretation nor the Commission's rulemaking effort may survive, not because they are without merit, but because they seek to impose a federal solution to what the Supreme Court in *Santa Fe* recognized as solely a matter of state concern.