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### III. Rule 10B-5

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would make compliance with the Rule easier when a small securities offering is involved. In addition, commentators have suggested that Rule 144 should be amended to allow investors to resell a larger volume of restricted securities once the investor has assumed the risk of the investment. Enactment of these amendments would encourage issuers to take advantage of the private placement exemption and lessen the restrictions imposed on the resale of restricted securities without substantially sacrificing the confidence and protection of the investing public.

A. PETER GREGORY

### III. RULE 10b-5

#### A. Purchaser-Seller Requirement

In 1975, the Supreme Court in *Blue Chip Stamps v. Manor Drug Stores*<sup>1</sup>

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<sup>1</sup> 421 U.S. 723 (1975). The *Blue Chip* decision reflects a reversal of the expansive and flexible approach to Rule 10b-5 litigation which in the past afforded plaintiffs greater access to federal courts to remedy securities fraud. See generally Lowenfels, *Recent Supreme Court Decisions Under the Federal Securities Laws: The Pendulum Swings*, 65 GEO. L. J. 891 (1977) [hereinafter cited as Lowenfels]; Note, *The Supreme Court's Trimming of the Section 10(b) Tree: The Cultivation of a New Securities Law Perspective*, 3 J. CORP. L. 112 (1977) [hereinafter cited as *New Securities Law Perspective*]. Prior to *Blue Chip*, lower courts that had refused to strictly apply the purchaser-seller requirement cited as policy rationales the broad remedial purposes of the Securities Exchange Act of 1934 ('34 Act), the primacy of the need to protect the investing public, and the flexible nature of the federal securities laws. *New Securities Law Perspective*, *supra* at 121. In recent years, however, the trend has shifted to a more conservative and restrictive approach to 10b-5 litigation. See e.g., *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977) (breach of fiduciary duty by majority stockholders, absent deception, manipulation or nondisclosure, not actionable under 10b-5); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) (no 10b-5 action for negligent conduct); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975) (only actual purchasers and sellers of securities have standing to bring 10b-5 private actions).

These cases are consistent with other recent Supreme Court decisions restricting the scope of protection that the federal securities laws provide the investing public. See, e.g., *Piper v. Chris-Craft Indus., Inc.*, 430 U.S. 1 (1977) (tender offeror does not have standing to sue under § 14(e), '34 Act, 15 U.S.C. § 78n (1970)); *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438 (1976) (standard of materiality in Rule 14a-9 action, 17 C.F.R. § 240.14a-9 (1976), requires substantial likelihood that reasonable shareholder would consider omitted fact significant in voting shares); *Foremost-McKesson, Inc. v. Provident Securities Co.*, 423 U.S. 232 (1976) (limits liability under § 16(b), 15 U.S.C. § 78p(b)(1970), to purchasers and sellers who are beneficial owners of 10 percent of stock both before and after the transaction); *Rondeau v. Mosinee Paper Corp.*, 422 U.S. 49 (1975) (plaintiff must show irreparable injury to obtain injunctive relief under § 13(d), '34 Act, 15 U.S.C. § 78m(d) (1970)); *United Hous. Foundation, Inc. v. Forman*, 421 U.S. 837 (1975) (definition of "securities" does not include shares of cooperative housing project); *Securities Investor Protection Corp. v. Barbour*, 421 U.S. 412 (1975) (no implied private right of action under Securities Investor Protection Act., 15 U.S.C. § 78aaa (1970)). In these recent cases, the Supreme Court has focused primarily upon the specific statutory language involved, the legislative history, the new found interrelationship between the civil liability provisions of the securities laws, and the availability of alternative state law remedies. See generally, Lowenfels, *supra*; *New Securities Perspective*, *supra* at 132. In the last three years the Supreme Court has "consistently decided in favor of the defendants

reaffirmed the purchaser-seller requirement, or *Birnbaum* rule,<sup>2</sup> as a limitation on standing to sue under section 10(b) of the Securities Exchange Act of 1934 ('34 Act) and Rule 10b-5.<sup>3</sup> Consequently, plaintiffs must prove that they actually purchased or sold securities in connection with the alleged fraud.<sup>4</sup> In the three years since *Blue Chip*, lower courts have strug-

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and has enunciated principles that may circumscribe the rights of plaintiffs under the federal securities laws for many years to come." Lowenfels, *supra* at 892.

<sup>2</sup> The rule that only a person who has been defrauded in connection with his own purchase or sale of securities has standing to sue in a private Rule 10b-5 action was announced in *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461, 464 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952). The *Birnbaum* rule had been criticized as an arbitrary restriction inconsistent with the broad antifraud purposes of Rule 10b-5. *See, e.g.*, *Young v. Seaboard Corp.*, 360 F. Supp. 490 (D. Utah 1973); *Tully v. Mott Supermarkets, Inc.*, 337 F. Supp. 834 (D.N.J. 1972); Lowenfels, *The Demise of the Birnbaum Doctrine: A New Era for Rule 10b-5*, 54 VA. L. REV. 268 (1968). Prior to the *Blue Chip* decision several lower courts had modified or even rejected the *Birnbaum* rule. *See, e.g.*, *Eason v. General Motors Acceptance Corp.*, 490 F.2d 654, 659 (7th Cir. 1973), *cert. denied*, 416 U.S. 960 (1974).

<sup>3</sup> Rule 10b-5 was promulgated by the Securities and Exchange Commission pursuant to the Securities Exchange Act of 1934 § 10b, 15 U.S.C. § 78(b)(1970). Section 10(b) provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange - . . .

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 10b-5, 17 C.F.R. § 240.10b-5 (1976) provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange.

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

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

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

<sup>4</sup> Although the *Blue Chip* Court recognized the legislative history and statutory analysis provide less than conclusive guidance in determining the class of plaintiffs that has standing under Rule 10b-5, the Court was persuaded that as a matter of policy, further dilution or rejection of the *Birnbaum* rule was undesirable. 421 U.S. at 730-49. Despite the arbitrary character of the rule, the Court feared that abolition of the purchaser-seller requirement would result in a proliferation of strike suits and vexatious litigation in which undeserving plaintiffs would seek speculative damages. *Id.* at 740. Such litigation occurs when nonmeritorious suits cannot be disposed of without a trial. *Id.* The threat of extensive discovery and litigation disrupting normal business operations creates a settlement value far out of proportion to the actual merit of the suit. *See id.* at 740-43. Furthermore, without the purchaser-seller requirement, courts would have great difficulty in accurately assessing injury to nonpurchasers and nonsellers. In the absence of a documented securities transaction, the role of oral testimony would be crucial in such suits. *Id.* at 743. Reaffirmation of the purchaser-seller requirement would, in the view of the *Blue Chip* Court: 1) provide the "objectively demonstrable fact," i.e., the purchase or sale of securities, that would obviate the dangers of suits based upon uncorroborated oral testimony; 2) preclude bystanders to the securities markets from

gled with the application of the purchaser-seller requirement to various fact patterns and with the continued validity of various exceptions that had evolved prior to *Blue Chip*.<sup>5</sup> During the past year courts have contin-

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resorting to Rule 10b-5 as a check against poor investment decisions not to trade; and, 3) avoid indeterminant liability since the number of shares and the price at which they were traded are objective facts. *Id.* at 747. The Court reasoned that, on balance, the advantages of a limited and identifiable plaintiffs' class and accurate assessment of actual damages outweigh the disadvantages of denying a federal remedy to defrauded nonpurchasers and nonsellers of securities. *Id.* at 738-39. *See generally*, Gallagher, *10b-5 After Blue Chip: How Stands The Judicial Oak?*, 80 DICK. L. REV. 1 (1975) [hereinafter cited as Gallagher]; Note, *Standing Under Rule 10b-5 After Blue Chip Stamps*, 75 MICH. L. REV. 413 (1977) [hereinafter cited as *Standing Under Rule 10b-5*].

<sup>5</sup> Prior to recent Supreme Court cases circumscribing the scope of federal securities laws, lower courts were receptive to new and imaginative causes of action under Rule 10b-5 in an attempt to effectuate what were perceived to be the broad antifraud and remedial purposes of the rule. *See, e.g.*, *White v. Abrams*, 495 F.2d 724 (9th Cir. 1974); *Eason v. General Motors Acceptance Corp.*, 490 F.2d 654 (7th Cir. 1973). However, the "repeated modification, circumvention, and outright rejection of the *Birnbaum* rule by the lower courts clearly undermined its force . . ." *Standing Under Rule 10b-5*, *supra* note 4, at 414. The Court in *Blue Chip* called for a straight-forward application of the *Birnbaum* rule to end the "case-by-case erosion" of the purchaser-seller requirement. 421 U.S. at 755. Although the *Blue Chip* decision failed to clarify the status of each of the judicially created exceptions, clearly the Court added a measure of rigidity to the purchaser-seller requirement. *See Standing Under Rule 10b-5*, *supra* note 4, at 428-30 (arguing that the Court intended to limit further expansion of standing rather than cut back accepted exceptions); *1976-1977 Securities Law Developments: Rule 10b-5*, 34 WASH. & LEE L. REV. 882, 893 n.67 (1977) [hereinafter cited as *1976-1977 Developments*]. In general, lower courts have not applied the *Blue Chip* mandate rigorously; some courts continue to cite the expansive language of pre-*Blue Chip* decisions when considering exceptions to the purchaser-seller requirement. *See text* accompanying notes 62-105 *infra*.

The five principal exceptions to the *Birnbaum* rule which had developed prior to *Blue Chip* were the forced seller exception, the aborted transaction exception, the de facto seller exception, the derivative action exception and the injunctive relief exception.

Courts have treated a nonselling plaintiff as a "forced seller" for the purpose of the purchaser-seller requirement where his investment has been converted by defendant's fraud, usually in connection with a short form merger or corporate liquidation, into a claim for money. Since plaintiff has lost control over the disposition of his securities, requiring proof of an actual sale as a prerequisite to standing would be a "needless formality." *Vine v. Beneficial Fin. Co.*, 374 F.2d 627, (2d Cir.), *cert. denied*, 389 U.S. 970 (1967) (fraudulently executed short-form merger forced minority shareholders to sell at greatly reduced price or retain stock in nonexistent company). Several post-*Blue Chip* decisions have recognized the continuing validity of the forced seller exception. *See note 75 infra*. Two recent decisions have cast doubt, however, on the availability of forced seller status to frustrated tender offerors. *See Piper v. Chris-Craft Indus., Inc.*, 430 U.S. 1 (1977); *Crane v. American Std. Co., Inc.*, 439 F. Supp. 945 (S.D.N.Y. 1977). For differing viewpoints on the potential impact of *Blue Chip* on the forced seller exception, compare Gallagher, *supra* note 4, at 36-37 with *Standing Under Rule 10b-5*, *supra* note 4, at 431-37 and *1976-1977 Developments*, *supra* at 893-97; *see text* accompanying notes 63-78 *infra*.

Nonpurchasers and nonsellers who would have consummated a securities transaction but for defendants' breach of contract or agreement to purchase or sell securities have standing under the aborted transaction exception. *See, e.g.*, *Commerce Reporting Co. v. Puretec*, 290 F. Supp. 715 (S.D.N.Y. 1968). The holder of contractual rights to purchase or sell securities is, however, a purchaser or seller within the meaning of the '34 Act. *See* 15 U.S.C. §§ 78c(a)(13) & (14) (1970). The aborted transaction exception is not a true judicially created

exception although courts and commentators have consistently used this terminology. Courts since *Blue Chip* have taken a restrictive approach to the nature of the contractual rights required to satisfy the purchaser-seller requirement. See text accompanying notes 9-61 *infra*.

The de facto seller exception has been applied where the real party in interest, i.e., the party whose economic interests are harmed or benefitted by the transaction, is not the legal titleholder of the securities at the time of the sale, and, therefore, is not the actual seller. See *James v. Gerber Prod. Co.*, 483 F.2d 944 (6th Cir. 1973); *Heyman v. Heyman*, 356 F. Supp. 958 (S.D.N.Y. 1973). Although several post-*Blue Chip* decisions have recognized the continued vitality of the de facto seller exception, see *Blackmar v. Lichenstien*, 438 F. Supp. 803 (E.D. Mo. 1977); *Gross v. Diversified Mortgage Investors*, 431 F. Supp. 1080 (S.D.N.Y. 1977); *O'Brien v. Continental Illinois Nat'l Bank & Trust Co.*, 431 F. Supp. 292 (N.D. Ill. 1977); *Klamberg v. Roth*, 425 F. Supp. 440 (S.D.N.Y. 1976); text accompanying notes 79-105 *infra*, commentators have split on whether the exception can be justified in light of *Blue Chip*. Compare *Gallagher*, *supra* note 4, at 37-38 and *Standing Under Rule 10b-5*, *supra* note 4, at 430 n.104 with 1975-1976 *Securities Law Developments: Rule 10b-5*, 33 WASH. & LEE L. REV. 935, 951 n.84 (1976) and Comment, *Blue Chip Stamps v. Manor Drug Stores: Failure to Solve The Purchaser-Seller Problem*, 70 Nw. U. L. REV. 965, 993 (1976) [hereinafter cited as *Failure to Solve*]. See 1976-1977 *Developments*, *supra* this note, at 895-97 (criticizing *Klamberg* decision).

Under the derivative action exception, shareholders who bring suit on behalf of a corporation meet the purchaser-seller requirement of *Birnbaum* where the corporation itself has brought or sold securities. See, e.g., *Herpich v. Wallace*, 430 F.2d 792 (5th Cir. 1970). Although a variety of corporate transactions have been held to constitute a purchase or sale under Rule 10b-5, see *Failure to Solve*, *supra* at 989-90, this exception has been widely accepted by the courts. See *Herpich v. Wallace*, 430 F.2d 792 (5th Cir. 1970); *Schoenbaum v. Firstbrook*, 405 F.2d 215 (2d Cir. 1968) *cert. denied*, 395 U.S. 906 (1969); *Dasho v. Susquehanna Corp.*, 380 F.2d 262 (7th Cir.), *cert. denied*, 389 U.S. 977 (1967). Because the derivative action exception requires a determination whether the corporation was a purchaser or seller, the evidentiary considerations of *Blue Chip* are fulfilled. The exception has been acknowledged as consistent with the mandate of *Blue Chip*. *Wright v. Heizer Corp.*, 411 F. Supp. 23, 31-32 (N.D. Ill. 1975), *aff'd in part, vacated in part with direction to modify*, 560 F.2d 235 (7th Cir. 1977), *cert. denied*, 46 U.S.L.W. 3521 (U.S. Feb. 21, 1978) (No. 77-814); *Walner v. Friedman*, 410 F. Supp. 29 (S.D.N.Y. 1975).

Prior to *Blue Chip*, a number of courts had applied the injunctive relief exception, holding that the elements necessary to maintain an action to enjoin continuing or future violations of Rule 10b-5 differ from those required to bring a suit for damages. See *Sargent v. Genesco, Inc.*, 492 F.2d 750, 760 (5th Cir. 1974); *Kahan v. Rosenstiel*, 424 F.2d 161 (3d Cir.), *cert. denied*, 398 U.S. 950 (1970); *Mutual Shares Corp. v. Genesco, Inc.*, 348 F.2d 540 (2d Cir. 1967). Status as a purchaser or seller has been held not to be a requisite for standing when injunctive relief is sought. See, e.g., *Mutual Shares Corp. v. Genesco, Inc.*, 348 F.2d 540, 546-47 (2d Cir. 1967) (minority shareholders have standing although neither they nor corporation were purchasers or sellers in allegedly fraudulent transaction).

The future of the injunctive relief exception after *Blue Chip* is in doubt. Although the standing limitation announced in *Blue Chip* applied expressly to private actions for damages, the policy concerns apply with some force to suits for injunctive relief. To the extent that an injunctive action disrupts normal business operations and affects activities such as mergers and acquisitions, such an action may contribute to the vexatious litigation feared in *Blue Chip*. However, the principle objective of some strike suits, a disproportionate settlement value, is not present where equitable relief is sought. Furthermore, actions for injunctive relief are an effective means of preventing prospective securities fraud. See *Kahan v. Rosenstiel*, 524 F.2d 161, 173 (3d Cir. 1970).

Post *Blue Chip* decisions have recognized the continuing validity of the injunctive relief exception. See *Wright v. Heizer*, 560 F.2d 236, 255-56 (7th Cir. 1977); *Davis v. Davis*, 526 F.2d 1286 (5th Cir. 1976); *Harriman v. E. I. du Pont Nemours & Co.*, 411 F. Supp. 133 (D. Del. 1975). Commentators, however, disagree on whether this exception can be justified in light of *Blue Chip*. Compare *Bauman, The Future of Rule 10b-5: A Comment on Jacobs, The Impact of Rule 10b-5*, 4 SEC. REG. L. J. 332, 338-39 (1976); *Gallagher*, *supra* note 4, at 39-41,

ued the process of determining the nature of contractual rights to purchase or sell securities,<sup>6</sup> the validity of judicially created exceptions to the *Birnbaum* rule,<sup>7</sup> and the meaning of the requirement that fraud challenged in a Rule 10b-5 action be "in connection with" the purchase or sale of securities.<sup>8</sup>

### *Contractual Rights to Purchase or Sell Securities*

The '34 Act expressly defines the terms "purchase" and "sale" to include any contract to purchase or sell securities.<sup>9</sup> Thus, a plaintiff alleging fraud in connection with a contract to purchase or sell securities<sup>10</sup> satisfies the purchaser-seller requirement.<sup>11</sup> Under the rubric of the "aborted transaction" exception<sup>12</sup> to the *Birnbaum* rule, courts have held that nonpurchasers and nonsellers who would have consummated securities transactions but for defendants' breach of contracts have standing to sue under Rule 10b-5.<sup>13</sup> A finding that plaintiffs whose contractual rights to purchase or sell securities have been breached have standing is not, however, so much an exception to the purchaser-seller requirement as it is an application of the statutory language conferring standing on the holders of such rights. Within the past year, courts have examined whether plaintiffs having contract rights in oral stock-purchase orders,<sup>14</sup> stock registration rights provided in employment contracts,<sup>15</sup> and conversion rights in convertible debentures<sup>16</sup> are holders of contractual rights sufficient for such plaintiffs to meet the purchaser-seller requirement.

In *Horst v. W.T. Cabe & Co.*,<sup>17</sup> the court considered whether a broker's oral agreement to purchase securities for an investor constitutes a contract

and 1975-1976 Developments, *supra*, at 953-56 (injunctive relief exception cannot survive *Blue Chip*) with Jacobs, *Standing to Sue Under 10b-5 After Blue Chip Stamps*, 3 SEC. REG. L. J. 387, 401-03 (1976); *Standing Under Rule 10b-5*, *supra* note 4, at 441-44 and *Failure to Solve*, *supra*, at 986-87.

<sup>6</sup> See text accompanying notes 9-61 *infra*.

<sup>7</sup> See text accompanying notes 62-105 *infra*.

<sup>8</sup> See text accompanying notes 106-137 *infra*.

<sup>9</sup> The terms "buy" and "purchase" each include any contract to buy, purchase, or otherwise acquire. '34 Act § 3(a)(13), 15 U.S.C. § 78c(a)(13)(1970). The terms "sale" and "sell" each include "any contract to sell or otherwise dispose of." '34 Act § 3(a)(14), 15 U.S.C. § 78c(a)(14)(1970).

<sup>10</sup> The requirement that the alleged fraud must have occurred "in connection with" the purchase or sale of securities is discussed *infra*. See text accompanying notes 106-137 *infra*.

<sup>11</sup> See 5 A. JACOBS, *THE IMPACT OF RULE 10B-5* § 38.02[b], at 2-67, 2-68 (1976) [hereinafter cited as A. JACOBS].

<sup>12</sup> See note 5 *supra*.

<sup>13</sup> See generally *Standing Under Rule 10b-5*, *supra* note 4, at 437-41; Comment, *10b-5 Standing Under Birnbaum: The Case of the Missing Remedy*, 24 HASTINGS L. J. 1007, 1016-24 (1973).

<sup>14</sup> See text accompanying notes 17-24 *infra*.

<sup>15</sup> See text accompanying notes 25-39 *infra*.

<sup>16</sup> See text accompanying notes 40-46 *infra*.

<sup>17</sup> [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96, 213 (S.D.N.Y. Oct. 31, 1977).

for the purpose of the purchaser-seller requirement. Plaintiff placed a stock-purchase order by telephone with the defendant brokerage firm. The broker never purchased the stock and the defendants allegedly misrepresented their intention to execute the purchase order.<sup>18</sup> The defendants argued that since the contract asserted as the basis of standing was oral, the lack of documentary corroboration raised the same policy considerations which undergirded the *Blue Chip* decision.<sup>19</sup> In *Blue Chip*, the Supreme Court expressed concern that allowing plaintiffs to base Rule 10b-5 suits on uncorroborated oral testimony would increase the likelihood of vexatious litigation since defendants could not rebut such testimony and any damages assessed would be speculative.<sup>20</sup>

The court in *Horst* noted that in *Blue Chip* the Supreme Court relied upon policy considerations because the legislative history of section 10(b) did not reveal a clear congressional intent either to include nonpurchasers and nonsellers within the scope of section 10(b) or exclude them.<sup>21</sup> Since the statute expressly confers standing, however, upon holders of contractual rights to purchase or sell,<sup>22</sup> the *Horst* court found inapplicable the policy considerations relevant to the exclusion of nonpurchasers and nonsellers.<sup>23</sup> Given the express wording of the '34 Act, the court held that an oral purchase order is a contract to buy securities since the definitional provisions of the statute make no distinction between oral and written contracts.<sup>24</sup>

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<sup>18</sup> *Id.* at 92,462. During the weeks following placement of the order, the defendants continued to assure plaintiff that the stock would be purchased and that confirmation slips would be sent. *Id.* The complaint alleged also that defendants' fraudulent conduct was part of a scheme to convert plaintiffs' "free credit balance" which the brokerage firm carried for plaintiffs' account. *Id.* Investors commonly maintain such accounts to facilitate financing securities transactions.

<sup>19</sup> *Id.* at 92,463.

<sup>20</sup> See note 4 *supra*.

<sup>21</sup> [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,213 at 92,463; see 421 U.S. at 737.

<sup>22</sup> See §§ 3(a)(13) & (14), '34 Act, 15 U.S.C. § 78c(a)(13) & (14) (1970); note 9 *supra*.

<sup>23</sup> [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,213 at 92,463-64. The *Horst* court did not feel compelled to analyze the issue whether the plaintiff was a statutory purchaser in light of the policy considerations of the *Blue Chip* decision. The court found, nonetheless, that contractual rights to purchase or sell securities based upon oral agreements do not appear to raise the same problem of uncorroborated oral testimony as when no contractual rights are asserted by nontrading plaintiffs. *Id.* at 96,464. In the first instance, a plaintiff presents to the trier of fact a concrete factual claim of the existence of a contractual relationship. In the latter situation, a plaintiff alleging defendant's fraud as the motive for failure to enter into a contract to buy or sell securities presents testimony as to "circumstances wholly within the subjective realm, 'unknown and unknowable to the defendant.'" *Id.*, quoting 421 U.S. at 746. The jury then "does not even have the benefit of weighing plaintiffs' version against the defendants'." *Id.*

<sup>24</sup> [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,213 at 92,463-64. In denying defendant's motion for summary judgment, the court did not reach the question whether an oral contract must be enforceable to support standing. The oral purchase order appeared to be unenforceable as a contract for the purchase of securities under the state statute of frauds. See N.Y. U.C.C. LAW § 8-319 (McKinney 1964). Decisions are split as to the applica-

The federal district court for the Southern District of New York took a more restrictive approach in *Tucker v. National Student Marketing Corp.*<sup>25</sup> when considering what contractual rights to purchase or sell securities are required to support standing under Rule 10b-5. *Tucker* involved registration rights provided in an employment contract executed between the plaintiff and the defendant corporation. Under the contract, the corporation retained an option to repurchase decreasing quantities of its unregistered and nontransferable common stock delivered to plaintiff as compensation for his services.<sup>26</sup> The contract granted the plaintiff the right to have any stock released from the repurchase option registered by the defendant at defendant's expense.<sup>27</sup> The plaintiff alleged that as part of a scheme to prevent him from disposing of his shares on the open market, the defendant fraudulently breached its contractual obligation to register plaintiff's shares.<sup>28</sup> The plaintiff eventually sold a portion of his stock through private placements<sup>29</sup> at a substantial loss.<sup>30</sup>

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bility of state contract law in determining the existence or enforceability of contract rights relied upon for jurisdictional purposes in Rule 10b-5 actions. *Compare* *Ohashi v. Verit Indus. Inc.*, 536 F.2d 849 (9th Cir.), *cert. denied*, 429 U.S. 1004 (1976) (state contract law applied to find contract enforceable) *with* *Desser v. Ashton*, 408 F. Supp. 1174 (S.D.N.Y. 1975) (court refused to apply state statute of fraud to an oral contract). *See generally*, *1976-1977 Developments*, *supra* note 5, at 889-92.

<sup>25</sup> [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,181 (S.D.N.Y. Sept. 20, 1977).

<sup>26</sup> *Id.* at 92,331. Pursuant to the employment contract, the plaintiff received five thousand shares of the corporation's unregistered and nontransferable common stock. The number of shares subject to the repurchase option was reduced to zero over a three year period. *Id.* Shares released from the repurchasing option could be transferred by plaintiff only if registered under the '33 Act which prohibits the offering or selling of a security without compliance with the registration requirements of the Act. 15 U.S.C. § 77(e) (1970). *See generally* 1 L. LOSS, SECURITIES REGULATION ch. 3 (2d ed. Supp. 1969).

<sup>27</sup> Section 3(g) of the contract provided:

Tucker shall at all times, have the option to have any stock of NSMS which shall have been released from the option to repurchase granted to NSMS, registered at the expense of NSMS, at any time NSMS shall apply for a registration of any NSMS stock, subsequent to the initial registration, "initial registration" being deemed to mean the first registration for a public offering of any stock of NSMS.

[1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,181 at 92,331.

<sup>28</sup> The defendant allegedly failed to notify the plaintiff when it registered 54,285 shares with the SEC in October 1969. The plaintiff learned of the registration and inquired whether his shares were to be registered. The plaintiff claimed that an officer of the corporation told him that plaintiff's shares could not be included in the October registration, but that the shares would be included in a subsequent registration statement. A further registration statement was never filed. *Id.* at 92,331. The plaintiff alleged that the defendants prevented registration of his shares as part of a scheme to sell their own shares at a high market price through numerous private placements. *Id.* In addition to 10b-5 violations, the plaintiff asserted breach of contract and common law fraud theories for recovery. *Id.*

<sup>29</sup> § 4(2) of the '33 Act, 15 U.S.C. § 77d(2) (1970), provides an exemption from the registration requirements for transactions by an issuer not involving any public offering. *See generally* S. GOLDBERG, PRIVATE PLACEMENTS AND RESTRICTED SECURITIES (1975); Schwartz, *The Private Offering Exemption-Recent Developments*, 37 OHIO L.J. 1 (1976).

<sup>30</sup> On the effective date of the registration, the defendant corporation's stock sold for an average price of \$46 per share on the over the counter market. Plaintiff claimed that had his



Although the employment contract could have been considered as a contract for the purchase of securities,<sup>31</sup> the court in *Tucker* held that the securities registration rights did not constitute such a contract. The defendant's breach of its obligation to register plaintiff's shares, therefore, did not constitute a breach of a contractual agreement to purchase or sell securities.<sup>32</sup> Since the plaintiff's retention of stock was not the result of a breached contract to sell,<sup>33</sup> the court held that the plaintiff failed to meet the purchase-seller requirement and dismissed the complaint for lack of standing.<sup>34</sup>

The decision in *Tucker* is consistent with the import of *Blue Chip* that where contract rights are asserted, only actual contractual relationships<sup>35</sup> that confer enforceable legal rights to purchase or sell securities<sup>36</sup> satisfy

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shares been included in the October 1969 registration statement he would have sold his shares for \$460,000. Plaintiff eventually realized \$28,312 from private placements and sales approved by the SEC. [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,181 at 92,331.

<sup>31</sup> See *Rukin v. Collins*, 342 F. Supp. 1282 (D. Mass. 1972) (stock option agreement granted plaintiff to induce him to enter employ of corporation constitutes a sale of securities to plaintiff under 1934 Act); cf. *Daniel v. International Bhd. of Teamsters*, 561 F. 2d 1223, 1242-43 (7th Cir. 1977), cert. granted, 46 U.S.L.W. 3512 (U.S. Feb. 21, 1978) (Nos. 77-753, 77-754) (union member's interest in an involuntary non-contributory pension plan is a security and decision to take employment offering such a plan is an investment decision).

<sup>32</sup> [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,181 at 92,332.

<sup>33</sup> Plaintiff actually did sell a portion of his shares through private placements and other exempt transactions. Even though the value of plaintiff's shares had diminished substantially, such sales were unrelated to the alleged fraud. *Id.* In dictum in *Blue Chip*, the Supreme Court expressly doubted that nonselling shareholders whose investments suffer loss in value due to corporate or insider activities have standing to sue under Rule 10b-5. 421 U.S. at 738; see *Ohashi v. Verit Indus., Inc.*, 536 F.2d 849, 852-53 (9th Cir. 1976). The plaintiff in *Tucker* could maintain a 10b-5 claim only as an aborted seller because "mere retention of a security, even if induced by defendant's fraud, does not state a claim under section 10(b)." [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,181 at 332; see *O'Brien v. Continental Ill. Nat'l Bank & Trust Co.*, 431 F. Supp. 292 (N.D. Ill. 1977); *Ingenito v. Bermeo Corp.*, 376 F. Supp. 1154, 1174 (S.D.N.Y. 1974).

<sup>34</sup> [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,181 at 92,332.

<sup>35</sup> In *Blue Chip*, the Supreme Court rejected the Ninth Circuit's holding that an offer to purchase securities made pursuant to a judicial decree was functionally equivalent to a contractual right to purchase or sell securities within the meaning of the definitional provisions of the '34 Act. 15 U.S.C. §§ 78a(c)(13) & (14)(1970); see note 9 *supra*. The plaintiffs asserted that, but for defendant's fraud, they would have participated in securities transactions as purchasers and sellers pursuant to an antitrust consent decree intended for their benefit. See *Manor Drug Stores v. Blue Chip Stamps*, 492 F.2d 136, 140 (9th Cir. 1973), *rev'd* 421 U.S. 723 (1975). Judge Hufstедler, dissenting in *Manor Drug Stores*, stated that "the unifying link among cases granting standing to persons who did not buy or sell 'is the existence of a contractual relationship between the parties which elevated the plaintiffs to the status of statutory purchasers or sellers.'" 492 F.2d at 143-44 (Hufstедler, J., dissenting), quoting *Mount Clemens Indus. Inc. v. Bell*, 464 F.2d 339, 345 (9th Cir. 1973). Requiring that plaintiffs be party to an actual contractual agreement for the purchase or sale of securities will limit the number of breach of contract actions that will be allowed under Rule 10b-5.

<sup>36</sup> After *Blue Chip*, a plaintiff must be party to a contractual agreement for the purchase or sale of securities for purposes of standing under Rule 10b-5. The *Blue Chip* Court recognized that contractual purchasers and sellers within the meaning of the definitional provi-

the purchaser-seller requirement. Limitation of standing to frustrated holders of rights to purchase and sell securities furthers the policy expressed in *Blue Chip* of structuring the rules of standing under Rule 10b-5 so as to avoid speculative and vexatious litigation.<sup>37</sup> The existence of a contract furnishes objectively demonstrable facts such as price, quantity, and time of purchase or sale of securities.<sup>38</sup> A contract further evinces plaintiff's intention to trade, thus providing evidence of causation. Finally, the contract requirement limits defendant's liability to an easily identifiable class of plaintiffs, thereby reducing the possibility of strike suits founded on speculative claims.<sup>39</sup>

The district court for the Southern District of New York determined in *Green v. Hamilton International Corp.*<sup>40</sup> that holders of convertible debentures had contractual rights sufficient for them to satisfy the purchaser-seller requirement. In *Green*, the plaintiffs redeemed their convertible debentures in the defendant corporation at maturity. The plaintiffs claimed that they were defrauded by defendants' failure to disclose merger negotiations and an impending merger offer until after plaintiffs elected to redeem rather than convert.<sup>41</sup> The court denied defendants' motion to dismiss, holding that the redemption transaction itself constituted a purchase and sale of securities within the meaning of Rule 10b-5.<sup>42</sup> Further, the court concluded that as owners of convertible debentures, the plaintiffs possessed contractual rights to acquire stock in the defendant corporation throughout the period during which plaintiffs could have redeemed prior

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sions of the '34 Act include "holders of puts, calls, options, and other contractual rights or duties to purchase or sell securities . . ." 421 U.S. at 751; see *Gauer v. Genesco, Inc.* [1975-1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,344 (N.D. Cal. 1975). In *Gauer*, the court held that a contractual right to participate in a "come along" registration of securities did not constitute a contractual right to sell securities within the meaning of the statutory definition of "sale". *Id.* at 98,710; see 15 U.S.C. § 78c(a)(14)(1970). A "come along" registration occurs when a shareholder joins his shares with those of the issuer for the purpose of registration under the '33 Act.

<sup>37</sup> See note 4 *supra*.

<sup>38</sup> See 421 U.S. at 747; *Gauer v. Genesco, Inc.*, [1975-1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,344 at 98,710 (N.D. Cal. Aug. 1, 1975).

<sup>39</sup> *Manor Drug Stores v. Blue Chip Stamps*, 492 F.2d 136, 141-43 (9th Cir. 1973).

<sup>40</sup> 437 F. Supp. 723 (S.D.N.Y. 1977).

<sup>41</sup> Plaintiffs could have converted their debentures into shares of common stock at the conversion rate of \$2.25 per share on October 31, 1976, the redemption date. *Id.* at 726. During the two week period prior to the redemption date, defendant's common stock traded publicly "well below" the conversion rate. *Id.* Plaintiffs actually redeemed on November 1. On that same day, defendant received a written offer proposing to acquire defendant by purchasing defendant's outstanding stock at \$4.00 per share. *Id.*

The court noted a twofold financial advantage that accrued to the defendants due to plaintiff's election to redeem rather than convert. First, defendant did not have to issue shares to cover the conversion. Second, the acquiring corporation did not have to consider the value of those shares when calculating the merger offer price. *Id.*

<sup>42</sup> 437 F. Supp. at 727; see *Drachman v. Harvey*, 453 F.2d 722, 737 (2d Cir. 1972)(en banc). Section 3(a)(10) of the '34 Act defines "security" as including any debenture. 15 U.S.C. § 78c(a)(10)(1970).

to actual redemption.<sup>43</sup> Since this contract right met the statutory definitions of "purchase" and "sale",<sup>44</sup> the plaintiffs satisfied the purchaser-seller requirement. Plaintiffs had standing to sue, therefore, for any fraudulent nondisclosure occurring before the redemption date because such fraud occurred in connection with a purchase or sale of securities.<sup>45</sup> Although a retained contractual right to convert, which is exercisable over a period of time, does not furnish all the objectively demonstrable facts sought in *Blue Chip*,<sup>46</sup> such a right does fall within the statutory definition of purchase. Further, this result comports with the policy objective of averting vexatious litigation since the plaintiffs' class was limited to holders of convertible debentures.

The court considered an additional element in analyzing whether contractual rights to purchase or sell securities provided a basis for standing in *Neiderhoffer, Cross & Zeckhauser, Inc. v. Telstat Systems, Inc.*<sup>47</sup> Despite finding that the plaintiff was a contractual purchaser within the meaning of section 10(b) of the '34 Act, the court held that the plaintiff failed to demonstrate that the suit would serve an investment or public interest promoted by section 10(b).<sup>48</sup> In *Neiderhoffer*, the plaintiff was an "acquisition finder" assisting companies that desire to sell their assets.<sup>49</sup> The defendant hired the plaintiff to find a buyer interested in acquiring the defendant corporation and agreed that if an acquisition occurred, defendant would transfer a portion of the securities received from the buyer to the plaintiff as compensation for plaintiff's services.<sup>50</sup> Although acquisi-

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<sup>43</sup> 437 F. Supp. at 727. See also *Camp v. Genesco*, [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,679 (S.D.N.Y. Aug. 6, 1976) (owners of convertible debentures are holders of retained contractual rights to purchase and sell securities).

<sup>44</sup> 15 U.S.C. §§ 78c(a)(13) & (14)(1970); see note 9 *supra*. In support of its finding that the plaintiffs possessed a contractual right sufficient to confer standing under Rule 10b-5, the court cited the distinction drawn in *Blue Chip* between the holders of puts, calls, options or other contractual rights to purchase and sell securities and nonpurchasing offerees who have no such rights. 437 F. Supp. at 727; see 421 U.S. at 751.

<sup>45</sup> The decision in *Green* comports with the policies of strict statutory construction and restriction of the size of plaintiff's class expressed in *Blue Chip*. The court in *Green* could have found that the plaintiffs properly alleged fraud in connection with the purchase and sale of securities without reaching the contractual rights issue. The redemption transaction itself was an actual purchase and sale of securities. 437 F. Supp. at 727. The fraudulent nondisclosure that allegedly had occurred before the date of redemption was in connection with that transaction. In fact, the nondisclosure preventing plaintiffs from acquiring information which would have encouraged them to convert rather than redeem was the core of the alleged fraud. 437 F. Supp. at 727.

<sup>46</sup> See note 4 *supra*.

<sup>47</sup> 436 F. Supp. 180 (S.D.N.Y. 1977).

<sup>48</sup> *Id.* at 185.

<sup>49</sup> Typically, an acquisition finder selects a pool of potential buyers, provides them with detailed reports describing his client's business operations, arranges meetings between the client and interested buyers, and advises his client on acquisition strategies. *Id.* at 182, 185.

<sup>50</sup> *Id.* at 181. The compensation agreement was not reduced to writing, but the court treated the oral agreement as an enforceable oral contract for the purpose of considering defendant's motion to dismiss. *Id.* at 181 n.1 Such an agreement may not satisfy the state statute of frauds. Compare N.Y. GEN. OBLIG. § 5-701a(10) (McKinney 1964 & 1977 Cum.

tion of the defendant was consummated, the plaintiff was neither responsible for the introduction of the buyer to the defendant nor a participant in the acquisition negotiations.<sup>51</sup> The defendant refused to compensate the plaintiff under the agreement. The plaintiff charged that defendant's refusal to deliver stock was part of a fraudulent scheme to exploit plaintiff's advice and services as a means of independently obtaining an acquisition offer.<sup>52</sup>

Absent an actual purchase or sale of securities, a plaintiff who asserts standing as a frustrated contractual purchaser must possess contractual rights which meet the statutory definitions. Section 3(a)(13) of the '34 Act defines the terms "buy" and "purchase" as including "any contract to buy, or purchase, or otherwise acquire" securities.<sup>53</sup> The court in *Neiderhoffer* acknowledged that the existence of an enforceable employment contract conferred on the plaintiff a contractual right to receive securities.<sup>54</sup> The court declared, however, that to establish standing under section 10(b) and Rule 10b-5, a plaintiff must prove more than literal compliance with the statutory definitions. In analyzing whether the plaintiff had standing, the court noted that the parameters of the judicially created right of action under section 10(b) are established by the congressional purposes of protecting investors and the public interest.<sup>55</sup> Relying on recent Supreme Court decisions restricting the scope of Rule 10b-5 actions,<sup>56</sup> the *Neiderhoffer* court reasoned that in private actions for damages, only litigants whose suits will serve an "investment interest" or a "public interest" under the '34 Act have standing to sue.<sup>57</sup>

The *Neiderhoffer* court did not elaborate, however, on what constitutes investor or public interest and how the requirement of such an interest affects the purchaser-seller requirement. The court merely concluded that

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Supp.) (statute of frauds provision applicable to employment contracts) *with* N.Y. U.C.C. Law. § 8-319 (McKinney 1964) (statute of frauds applicable to sale of securities). Furthermore, the court expressed concern that the compensation term, "a portion of the securities" of the acquiring corporation, might be too indefinite, thus rendering the contract unenforceable. 436 F. Supp. at 183 n.3.

<sup>51</sup> 436 F. Supp. at 182.

<sup>52</sup> *Id.*

<sup>53</sup> 15 U.S.C. § 78c(a)(13)(1970); *see note 9 supra*.

<sup>54</sup> 436 F. Supp. at 183.

<sup>55</sup> *Id.* at 183-84. The court noted that pursuant to § 10(b) of the '34 Act, the SEC is authorized to promulgate rules and regulations in the public interest or for the protection of investors. 15 U.S.C. § 78j(1970); *see A.T. Brod & Co. v. Perlow*, 375 F.2d 393, 396 (2d Cir. 1967). The *Neiderhoffer* court read this language as limiting the reach of Rule 10b-5. *See text accompanying notes 56-57 infra*.

<sup>56</sup> *See Lowenfels, supra note 1.*

<sup>57</sup> 436 F. Supp. at 187. In ruling that the plaintiff did not have standing to sue, the court relied on language in *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977), stating that the judicially created private right of action under § 10(b) should not be implied where it is unnecessary to ensure fulfillment of the congressional purpose. *Id.* at 477. *See also Piper v. Chris-Craft Indus., Inc.*, 430 U.S. 1, 41 (1977). The *Santa Fe* Court described the fundamental purpose of the '34 Act as the implementation of a philosophy of full disclosure. 430 U.S. at 478.

although the acquisition finder was a statutory purchaser, the plaintiff had no investment interest in identifiable securities,<sup>58</sup> and that plaintiff's suit, which bespoke the frustration of a private contractual expectancy, did not advance the public interest.<sup>59</sup> The *Neiderhoffer* decision demonstrates the extent to which lower courts considering the standing issue can be expected to retrench in the face of recent Supreme Court decisions which have taken a restrictive and conservative approach to the Rule 10b-5 private action.<sup>60</sup> Prior to *Blue Chip*, finding an investment interest or public interest, in the absence of an actual purchase or sale of securities, provided the means by which courts circumvented the *Birnbaum* limitation on standing so as to effect a broad policy of remedying securities fraud.<sup>61</sup> The *Blue Chip* decision required strict fidelity to the statutory language as a means of cutting back the increasing amount of Rule 10b-5 litigation. By requiring proof of an investor or public interest apart from proof of purchaser-seller status, the *Neiderhoffer* court has appended an additional element, not specifically mandated by *Blue Chip*, onto the purchaser-seller requirement.

### *Exceptions to the Purchaser-Seller Requirement*

During the past year, lower courts have continued the case-by-case process of determining the validity of judicially created exceptions to the *Birnbaum* rule.<sup>62</sup> The forced seller and de facto seller exceptions both received judicial approval.<sup>63</sup> The forced seller doctrine provides that a non-

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<sup>58</sup> 436 F. Supp. at 185. The court found that the acquisition finder's role as "marriage-broker" between corporations could not have given rise to an investment interest in identified securities. *Id.* The court concluded that the plaintiff neither made an investment decision nor assumed any investment risk with respect to the securities of the defendant corporation. *Id.* Furthermore, the plaintiff was not an independent investor, but simply defendant's agent. *Id.* at 186. The acquisition finder argued, however, that its situation was indistinguishable from the line of cases in which plaintiffs who had bargained to receive securities had standing because their bargains had been aborted by defendant sellers who had no intention of fulfilling the contractual agreements. *See, e.g., Fenstermacher v. Philadelphia Nat'l Bank*, 493 F.2d 333, 336 n.4. (3d Cir. 1974); *Walling v. Beverly Enterprises*, 476 F.2d 393 (9th Cir. 1973); *Collins v. Rukin*, 342 F. Supp. 1282 (D. Mass. 1972); *Commerce Reporting Co. v. Puretec, Inc.*, 290 F. Supp. 715 (S.D.N.Y. 1968). The plaintiffs in these cases, however, acted independently and exercised considerable investment discretion. 436 F. Supp. at 185.

<sup>59</sup> Where the fraudulent conduct threatened the integrity of "free and open securities markets nurtured in a climate of free dealing", *Herpich v. Wallace*, 430 F.2d 792 (5th Cir. 1970), several pre-*Blue Chip* courts found that noninvestors had standing because their suits advanced a significant public interest within the protective purpose of § 10(b). *See, e.g., Walling v. Beverly Enterprises*, 476 F.2d 393 (9th Cir. 1973) (shareholders permitted to sue where defendant entered into contract for purpose of speculating on fluctuations in stock price); *A.T. Brod & Co. v. Perlow*, 375 F.2d 393 (2d Cir. 1967) (investment broker had standing to sue customers who placed purchase orders intending to pay for stock only if market price increased); *Hooper v. Mountain States Securities Corp.*, 282 F.2d 195 (5th Cir. 1960) (corporation fraudulently induced to issue overvalued or worthless stock permitted to sue).

<sup>60</sup> *See* note 1 *supra*.

<sup>61</sup> *See* Lowenfels *supra* note 1.

<sup>62</sup> *See* note 5 *supra*.

<sup>63</sup> *See* text accompanying notes 64-78 *infra* (forced seller exception); text accompanying

trading investor will be treated as a seller for purposes of the purchaser-seller requirement when the nature of his investment has been fundamentally changed from an interest in a going enterprise into a right to receive a payment of money.<sup>64</sup> In *Houlihan v. Anderson-Stokes, Inc.*,<sup>65</sup> the court invoked the forced seller exception to grant standing to limited partners of a partnership<sup>66</sup> formed to construct and sell a highrise condominium building.<sup>67</sup> The plaintiffs alleged that through the fraudulent conveyance of substantially all of the partnership assets,<sup>68</sup> the defendant general partners transformed plaintiffs' investment interest in a functioning enterprise into a right to receive cash.<sup>69</sup> In denying defendants' motion to dismiss, the court held that although the plaintiffs did not actually sell securities, they were within the scope of the forced seller exception.

The court rejected defendant's contention that the plaintiffs did not fit the forced seller exception.<sup>70</sup> The defendants asserted that in all previous

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notes 79-105 *infra* (de facto seller exception).

<sup>64</sup> *Dudley v. Southeastern Factor and Fin. Corp.*, 446 F.2d 303, 307 (5th Cir.), *cert. denied*, 404 U.S. 858 (1971); *see, e.g., Vine v. Beneficial Fin. Co.*, 374 F.2d 627 (2d Cir.), *cert. denied*, 389 U.S. 970 (1967) (fraudulently executed short-form merger forced minority shareholders either to sell at greatly reduced price or retain stock in nonexistent company); *Coffee v. Permian Corp.*, 434 F.2d 383 (5th Cir. 1970) (fraudulent liquidation of corporation converted shares into limited claims for cash).

<sup>65</sup> 434 F. Supp. 1330 (D.D.C. 1977).

<sup>66</sup> Both the '33 and '34 Acts include in the definition of "security" an "investment contract." *See* '33 Act § 2(1), 15 U.S.C. § 77(b)(1970); '34 Act § 3(a)(10), 15 U.S.C. § 78c(a)(10)(1970). Although the *Houlihan* court did not explain how plaintiff's investment interest fit the definition of security, under the investment contract approach courts and the SEC have treated limited partnership interests as securities for purposes of the federal securities laws. *See generally* 3 H. BLOOMENTHAL, *SECURITIES AND FEDERAL CORPORATE LAW* § 2.12[2] (1976). Hannan & Thomas, *The Importance of Economic Reality and Risk in Defining Federal Securities*, 25 HASTINGS L.J. 219 (1974).

<sup>67</sup> The 1972 partnership agreement required the general partners to obtain approval of at least sixty percent of the total partnership interests before disposing of the partnership assets which consisted of the land and improvements. 434 F. Supp. at 1332. By June, 1974, the condominium project faced severe financial and construction problems. Pursuant to the partnership agreement, the general partners resigned their interests in the project on June 30, 1974, in favor of the limited partners, who had received no return on their original investment. *Id.* In August, 1974, the general contractor filed a mechanics lien for payment due on the project. *Id.*

<sup>68</sup> Plaintiffs alleged that the general partners conspired to liquidate all or substantially all the partnership assets contrary to the rights and interests of the limited partners as set forth in the partnership agreement. 434 F. Supp. at 1333. Plaintiffs were excluded from the negotiation and settlement of claims against the condominium project. *Id.* at 1332-33. By the terms of the settlement agreement, the general partners conveyed, apparently without obtaining the approval of sixty percent of the partnership interests, the partnership land and building to the construction lender, the holder of the purchase money mortgage, the general contractor and a general partner. *Id.* at 1333.

<sup>69</sup> Under the settlement agreement negotiated between the general partners and the creditors of the project, *see note 68 supra*, the limited partners were granted a conditional right to purchase condominium units when completed. Rejecting the conditions as unacceptable, the limited partners argued that defendants' fraud converted their interests into a right to receive payments of money. 434 F. Supp. at 1333.

<sup>70</sup> Defendant argued that the forced seller exception applies only if the plaintiff is forced

decisions applying the forced seller doctrine, the fraudulent activities of defendants defeated plaintiffs' expectation that the enterprise in which they had invested would have continuing vitality.<sup>71</sup> The defendants in *Houlihan* argued that without such an expectation the forced seller exception could not apply. Since the partnership was formed for the limited purpose of developing a single condominium project, the defendants argued that the plaintiffs could not have had any expectation that the enterprise would continue.<sup>72</sup> The *Houlihan* court refused to read an "expectation of continuing vitality" requirement into the forced seller exception. The plaintiffs' expectation that the enterprise would terminate upon the sale of the condominium units was held irrelevant to the question whether plaintiffs' ownership interests had been fundamentally and involuntarily transformed.<sup>73</sup> The condominium project was a going enterprise at the time the limited partners invested. The plaintiffs had no expectation that their investment interest would be disposed of fraudulently and prematurely before they had an opportunity to realize a return on their investment.<sup>74</sup>

The *Houlihan* court properly applied the forced seller exception in finding that the limited partners had standing. The court failed, however, to consider the effect of *Blue Chip* on the forced seller doctrine. The court relied on several pre-*Blue Chip* cases and assumed that the forced seller exception has all its pre-*Blue Chip* vitality.<sup>75</sup> Although the *Houlihan* court did not analyze the forced seller exception in the light of *Blue Chip*, finding that the limited partners had standing as forced sellers was consistent with

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to dispose of his securities at some ascertainable point in time. 434 F. Supp. at 1333. Even though the limited partners eventually tendered their partnership interests, they were not compelled to do so. *Id.* The court rejected this argument, pointing out that compulsion inheres where a plaintiff is left with only the alternatives of exchanging his securities for grossly inadequate consideration or retaining stock in a nonexistent or nonfunctioning entity. *Id.*; see *Vine v. Beneficial Fin. Co.*, 374 F.2d 627, 634 (2d Cir. 1967). Requiring plaintiffs to dispose of their securities at some point as a pre-requisite to gaining forced seller status would be a "needless formality." 374 F.2d at 634. The court also rejected the contention that plaintiffs' investments were not fundamentally changed, but merely suffered a diminution in value which does not constitute a forced sale. 343 F.2d at 1338; see *In Re Penn Central Sec. Litigation*, 494 F.2d 528 (3d Cir. 1974); *Sargent v. Genesco, Inc.* 492 F.2d 750 (5th Cir. 1974).

<sup>71</sup> 434 F. Supp. at 1338.

<sup>72</sup> *Id.* at 1338-39.

<sup>73</sup> *Id.* at 1339.

<sup>74</sup> *Id.*

<sup>75</sup> *Id.* at 1337. The court relied on several forced seller cases that were decided at a time when lower courts interpreted the *Birnbaum* rule flexibly. See *Dudley v. Southeastern Factor and Fin. Corp.*, 446 F.2d 303 (5th Cir. 1971); *Vine v. Beneficial Fin. Co.*, 374 F.2d 627 (2d Cir. 1967); note 64 *supra*. The weakness of the *Houlihan* court's analysis lies in the failure to discuss the impact of *Blue Chip* on the forced seller claim before the court. Other decisions have validated the forced seller exception after *Blue Chip*. See *Weisman v. Darneille*, [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,278 (S.D.N.Y. Jan. 6, 1978); *Alpex Computer Corp. v. Pitney-Bowes, Inc.*, 417 F. Supp. 328 (S.D.N.Y. 1976); *Rich v. Touche Ross & Co.*, 415 F. Supp. 95 (S.D.N.Y. 1976); *Murphey v. Hillwood Villa Assoc.*, 411 F. Supp. 287 (S.D.N.Y. 1976).

the policy objectives announced in *Blue Chip*. Although there was no actual sale of securities in *Houlihan*, the impending sale caused by the conversion of plaintiffs' securities from investments in a going enterprise into claims for money, provided the objective facts required by *Blue Chip*.<sup>76</sup> The trier of fact can determine from the alleged forced sale the number of shares involved, the price paid for each and their value at the time of the forced sale. The dangers of an unlimited class of plaintiffs and speculative claims based on uncorroborated testimony do not arise.<sup>77</sup> Thus, the application of the forced seller exception to the plaintiffs in *Houlihan* would not encourage strike suits or vexatious litigation.<sup>78</sup>

Courts have also recently considered the de facto seller exception, which permits the beneficial owner of securities to sue when strict application of the purchaser-seller requirement would confer standing only upon the legal titleholder who actually purchased or sold securities.<sup>79</sup> In the past, the de facto seller exception has been applied where the fraudulent conduct of a fiduciary has directly affected the investment interests of the nontransacting party.<sup>80</sup> Although the exception developed in cases involving sales of securities, hence the phrase "de facto seller," the rationale of the exception applies equally to purchases of securities. Recent decisions have applied the de facto seller exception; however, the extent to which the exception remains valid after *Blue Chip* is not clear.

*Gross v. Diversified Mortgage Investors*,<sup>81</sup> involved a Rule 10b-5 action against a real estate investment trust. The plaintiff Duban, who was the sole beneficiary of a retirement investment trust, had instructed the trustee, pursuant to his reserved powers under the retirement trust agreement,<sup>82</sup> to purchase the defendant's securities. The plaintiff claimed that the defendant's misrepresentations and omissions caused overvaluation of the DMI securities and concealed the true financial condition of the defendant from the public, thereby causing the plaintiff to buy the securities at inflated prices.<sup>83</sup> Noting that the purchaser-seller requirement has been construed flexibly in the past, the court relied on several pre-*Blue Chip* decisions and concluded that the plaintiffs had standing to sue as a de facto buyer.<sup>84</sup>

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<sup>76</sup> See 421 U.S. at 747.

<sup>77</sup> See note 4 *supra*.

<sup>78</sup> See *Standing Under Rule 10b-5*, *supra* note 4, at 434-35; *1976-1977 Developments*, *supra* note 5, at 895 n.77; *Failure to Solve*, *supra* note 5, at 987-89. *But see* Gallagher, *supra* note 4, at 36-37.

<sup>79</sup> See note 5 *supra*.

<sup>80</sup> See *James v. Gerber Prod. Co.*, 483 F.2d 944 (6th Cir. 1973), *Heyman v. Heyman*, 356 F. Supp. 958 (S.D.N.Y. 1973).

<sup>81</sup> 431 F. Supp. 1080 (S.D.N.Y. 1977).

<sup>82</sup> Notwithstanding the power and authority of the trustee to make investment decisions for the benefit of the beneficiary, the trust agreement provided that the beneficiary reserved the right and power to control the investment of trust funds. 431 F. Supp. at 1092. The trustee was absolved from liability when acting at the beneficiary's direction. *Id.* at 1092-93.

<sup>83</sup> *Id.* at 1085.

<sup>84</sup> The *Gross* court cited *James v. Gerber Prod. Co.*, 483 F.2d 944 (6th Cir. 1973) and



In another de facto buyer case the district court refused to grant standing to a trust beneficiary who sued the trustee. In *O'Brien v. Continental Illinois National Bank & Trust Co.*,<sup>85</sup> the trustee had complete discretion to purchase or sell securities,<sup>86</sup> subject only to the beneficiaries' right to ratify or disapprove the investment decision.<sup>87</sup> In analyzing the standing issue, the court noted that recent Supreme Court decisions require courts to scrutinize carefully whether granting a remedy under the federal securities laws is appropriate.<sup>88</sup> Although the court concluded that the plaintiff did not have standing, it refused to accept the defendant's contention that after *Blue Chip* a trust beneficiary lacks standing in all cases to sue his trustee under Rule 10b-5.<sup>89</sup>

Judicial acceptance or rejection of the de facto seller exception cannot be justified, however, without clear analysis of the mandate of *Blue Chip* and other recent Supreme Court decisions. Unfortunately, neither the *Gross* nor the *O'Brien* decisions developed any rationale for the continued

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*Heyman v. Heyman*, 356 F. Supp. 958 (S.D.N.Y. 1973), as authority for finding that a trust beneficiary can be a de facto seller. In both *James* and *Heyman* the plaintiffs were trust beneficiaries who sued their trustees for fraudulently selling securities from the trusts. In each case, the court looked beyond the distinction between technical and beneficial ownership of securities and granted the beneficiary standing to sue as a de facto seller. See 483 F.2d at 948; 356 F. Supp. at 966. Both courts emphasized that the *Birnbaum* purchaser-seller requirement should be construed flexibly in order to achieve the anti-fraud purpose of the securities laws to protect the investing public and ensure honest dealings in securities transactions. See 483 F.2d at 948; 356 F. Supp. at 966. The *Gross* court failed, however, to discuss the impact of *Blue Chip* upon the precedential value of the *James* and *Heyman* decisions. Any analysis of the de facto seller exception which does not consider the clear mandate of *Blue Chip* to construe strictly the purchaser-seller requirement must be considered inadequate.

<sup>85</sup> 431 F. Supp. 292 (N.D. Ill. 1977).

<sup>86</sup> *Id.* at 294.

<sup>87</sup> *Id.* at 296.

<sup>88</sup> *Id.* at 295; see note 1 *supra*.

<sup>89</sup> The court cited without analysis *James v. Gerber Prod. Co.*, 483 F.2d 944 (6th Cir. 1973), see note 84 *supra*, and *Klamberg v. Roth*, 425 F. Supp. 440 (S.D.N.Y. 1976), as authority for the continued validity of the de facto seller exception. 431 F. Supp. at 295. In *Klamberg*, the beneficiary of an employee profit-sharing retirement plan brought a Rule 10b-5 action against the successor trustees. The plaintiff alleged that the trustees reinvested more than seventy percent of the trust assets in the successor corporation despite the steady decline of the market price of the company's stock. *Id.* at 441. The court noted that in "unconventional situations", such as the one before the court, pre-*Blue Chip* exceptions to the *Birnbaum* rule are valid precedent. *Id.* at 442. Relying on several pre-*Blue Chip* cases, the *Klamberg* court concluded that the beneficiary of a trust has standing to assert a rule 10b-5 claim against a trustee, "at least where the actions challenged are not arms-length transactions by the trustee." *Id.*, quoting *Selzer v. Bank of Bermuda, Ltd.*, 385 F. Supp. 415 (S.D.N.Y. 1974). The court did not, however, reevaluate the de facto seller doctrine in light of the *Blue Chip* Court's careful attention to the statutory language of the '34 Act and concern for the need to limit the potential class of plaintiffs in Rule 10b-5 actions. See *1976-1977 Developments*, *supra* note 5, at 895-97.

Despite the *Klamberg* court's failure to mention *Blue Chip* in upholding the de facto seller exception, subsequent courts have cited the case with approval. See, e.g., *Daniel v. International Bhd. of Teamsters*, 561 F.2d 1273 (7th Cir. 1977) (right to receive benefits under a noncontributory pension plan constitutes a security); *Blackmar v. Lichtenstein*, 438 F. Supp. 803 (E.D. Mo. 1977) (beneficiary has standing to sue trustee for Rule 10b-5 violation).

validity of the de facto seller exception other than that offered by pre-*Blue Chip* decisions.<sup>90</sup> Two principal objections to the de facto seller exception have been raised in light of *Blue Chip*. First, the *Blue Chip* Court's emphasis on the statutory definitions of "purchase" and "sale" indicates an unwillingness to allow the purchaser-seller requirement to be circumvented.<sup>92</sup> Second, recent Supreme Court decisions indicate that plaintiffs who have an adequate state law remedy should not be found to have standing under the federal securities laws.<sup>93</sup>

These objections can be effectively answered. First, the de facto seller exception is an equitable doctrine which operates to satisfy the purchaser-seller requirement in situations where the plaintiff has not actually purchased or sold securities within the meaning of the definitional provisions of the '34 Act. But like the shareholder derivative action exception,<sup>94</sup> in which the corporation actually trades, and the forced seller exception in which there is a constructive sale,<sup>95</sup> the de facto seller exception involves a purchase or sale of securities that supplies the demonstrable evidence necessary to avoid problems associated with oral testimony and speculative damages.<sup>96</sup> Furthermore, the economic interest of a de facto seller in an actual purchase or sale of securities by the fiduciary is sufficiently distinct that vexatious litigation or strike suits will not be encouraged by finding that this limited class of plaintiffs has standing.<sup>97</sup> Second, in cases where a trust beneficiary brings a Rule 10b-5 action against his trustee for breach of a fiduciary obligation or for corporate mismanagement in connection with a securities transaction, dismissal from federal court is appropriate. The Supreme Court recently held in *Santa Fe Industries, Inc. v. Green*<sup>98</sup> that allegations of breaches of fiduciary duty which involve no "deceptions" or "manipulations" do not state a Rule 10b-5 cause of action.<sup>99</sup> Since breach of fiduciary duty is a matter traditionally relegated to state regulation,<sup>100</sup> the plaintiff should be required to challenge the transaction complained of in state court. The Supreme Court's decision in *Santa Fe* compels this result, however, not the purchaser-seller requirement

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<sup>90</sup> See note 84 *supra*.

<sup>91</sup> A de facto seller has neither actually purchased or sold securities, nor possessed contractual rights to purchase or sell, see note 5 *supra*, within the meaning of the statutory provisions of the '34 Act. See note 9 *supra*.

<sup>92</sup> In addition to denying standing to a nonpurchasing offeree, the *Blue Chip* majority indicated in dictum that nontrading shareholders, creditors and *others related* to the issuer whose investments diminished in value as a result of fraudulent insider or corporate activity do not have standing under Rule 10b-5. 421 U.S. at 738. Arguably, trust beneficiaries are covered by this broad exclusion. See *id.*

<sup>93</sup> See *Santa Fe Indus., Inc. v. Green*, 430 U.S. 426 (1977); *Piper v. Chris-Craft Indus., Inc.*, 430 U.S. 1 (1977). See generally 1976-1977 *Developments*, *supra* note 5, at 896-97.

<sup>94</sup> See note 5 *supra*.

<sup>95</sup> *Id.*; see text accompanying notes 64-83 *supra*.

<sup>96</sup> See note 4 *supra*.

<sup>97</sup> See Gallagher, *supra* note 4, at 37-38.

<sup>98</sup> 430 U.S. 462 (1977).

<sup>99</sup> *Id.* at 476. See generally 1976-1977 *Developments*, *supra* note 5, at 929-37.

<sup>100</sup> 430 U.S. at 478.

adopted in its *Blue Chip* decision. Under the *Santa Fe* analysis, deception by the trustee is actionable under Rule 10b-5 only if the trustee has an obligation to disclose investment decisions to the beneficiary before the transaction.<sup>101</sup> Applying this analysis to *O'Brien*, the district court found that the beneficiary failed to state a cause of action because the complaint against the trustee alleging breach of fiduciary duty did not involve deception within the meaning of Rule 10b-5.<sup>102</sup> In *Gross*, however, the court found that the plaintiff had standing as a de facto buyer. There the plaintiff did not allege any breach of fiduciary duty or fraudulent activity by the trustee, who was in fact absolved from any liability.<sup>103</sup> Rather, the plaintiff made the investment decision and undertook an investment risk when he instructed the trustee, in reliance on defendant's misrepresentations,<sup>104</sup> to purchase shares in the defendant trust. In cases such as *Gross*, the policy of the de facto seller exception to permit the real party in interest to protect his investment interests under Rule 10b-5 should remain valid.<sup>105</sup>

### *The "In Connection With" Requirement*

Section 10(b) of the '34 Act and Rule 10b-5 reach only fraud "in connection with the purchase or sale of securities."<sup>106</sup> Distinct from the purchaser-seller requirement contained in this language is the requirement that the alleged fraud be connected with a securities transaction.<sup>107</sup> In the absence of statutory or congressional guidance as to how close or direct a connection is necessary, courts have developed several approaches to the connection requirement.<sup>108</sup> Recent decisions have split on the degree of connection

<sup>101</sup> See *O'Brien v. Continental Ill. Nat'l Bank & Trust*, 431 F. Supp. 292, 296 (N.D. Ill. 1977).

<sup>102</sup> *Id.* at 297. The court held that since the defendants as trustees of a discretionary trust, owed no duty to disclose the investment decisions, they did not engage in any deception. *Id.* at 292. Furthermore, no manipulation within the meaning of *Santa Fe* was alleged since the fiduciary's purchase of high risk securities to protect its own loans to the issuing corporations would not artificially affect market activity. *Id.*; see 430 U.S. at 476.

Under similar analysis, the case of *Klamberg v. Roth*, 425 F. Supp. 440 (S.D.N.Y. 1976), see note 89 *supra*, was decided incorrectly. There, the plaintiff's allegations were based strictly on a breach of fiduciary duty. Such allegations are insufficient in light of *Santa Fe*. See generally *1976-1977 Developments, supra* note 5, at 895-97.

<sup>103</sup> 431 F. Supp. at 1092-93.

<sup>104</sup> *Id.* at 1086.

<sup>105</sup> Cf. *Neiderhoffer, Cross & Zeckhauser, Inc. v. Telstat Sys., Inc.*, 436 F. Supp. 180 (S.D.N.Y. 1977) (holder of contractual right to purchase or sell securities must prove an investment interest as prerequisite to standing under 10b-5). See also *Fitzsimmons v. Old Security Life Ins. Co.*, [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,236 (N.D. Ill. Nov. 2, 1977) (representatives of trust beneficiaries denied standing after *Blue Chip*).

<sup>106</sup> Section 10(b) of the '34 Act and Rule 10b-5 both contain the "in connection with" language. 15 U.S.C. § 78(b)(1970); 17 C.F.R. § 240.10b-5 (1976).

<sup>107</sup> See generally 1 A. BROMBERG, *SECURITIES LAW: FRAUD—SEC RULE 10B-5*, § 4.7 (570)-(577) (1972-73) [hereinafter cited as BROMBERG]; A. JACOBS, *supra* note 11, at § 38.01; Note, *SEC Rule 10b-5—"In Connection With The Purchase or Sale of Any Security" Restriction: The Need for Analytical Precision*, 5 COLUM. J. L. & SOC. PROB. 28 (1969).

<sup>108</sup> The broadest interpretation to date of the "in connection with" language was an-

necessary to satisfy the statutory language.

In *Halperin v. Edwards & Hanly*,<sup>109</sup> the "in connection with" requirement was considered in light of the *Blue Chip* decision. Although the Supreme Court in *Blue Chip* did not address the connection requirement, the *Halperin* court held that reaffirmation of the *Birnbaum* rule dictates that only fraud preceding or accompanying a securities transaction is "in

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nounced by the Supreme Court in *Superintendent of Life Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6 (1971). The Court construed the connection requirement to reach deceptive practices "touching" the purchase or sale of securities. *Id.* at 12-13. Subsequent decisions have consistently applied the touching standard broadly and have found the requisite connection even where the fraudulent conduct only tangentially involved a securities transaction. See, e.g., *Jannes v. Microwave Communications Inc.*, 461 F.2d 525 (7th Cir. 1972) (purpose of sale of securities was to give color of legitimacy to fraudulent misrepresentations); *Drachman v. Harvey*, 453 F.2d 722, 736-38 (2d Cir. 1972) (en banc) (redemption of convertible debentures to prevent dilution of control position in a takeover bid). See generally Note, *The Controlling Influence Standard In Rule 10b-5 Corporate Mismanagement Cases*, 86 HARV. L. REV. 1007, 1013-14 (1973); *The Supreme Court, 1971 Term*, 86 HARV. L. REV. 50, 263-64 (1972).

The Supreme Court's failure to delineate the limits of the touching standard has led some courts to define the degree of connection necessary to sustain a Rule 10b-5 action. The phrase "in connection with" has been interpreted to mean that fraudulent conduct must occur prior to or contemporaneously with the securities transaction. See *Halperin v. Edwards & Hanly*, 430 F. Supp. 121 (E.D.N.Y. 1977); *Kogan v. National Bank*, 402 F. Supp. 359, 361 (E.D.N.Y. 1975); *Pepsico, Inc., v. W. R. Grace & Co.*, 307 F. Supp. 713, 720 (S.D.N.Y. 1969). Where the alleged fraud occurs, however, after the execution of a contract to purchase or sell securities and the fraud results in the breach of the contract, courts have held the fraud to be in connection with a purchase or sale of securities. See *Ohashi v. Verit Indus.*, 536 F.2d 849 (1976); *Horst v. W. T. Cabe & Co.*, [1977-1978 Transfer Binder] FED. SEC. L. REP. ¶ 96,213 (CCH) (S.D.N.Y. Oct. 31, 1977).

Several courts have interpreted the connection language as requiring a causal relationship between the alleged fraud and the securities transaction. See, e.g., *Tully v. Mott Supermarkets, Inc.*, 540 F.2d 187, 194 (3d Cir. 1976) (connection requirement involves causal connection between fraud and securities transaction); *Raschio v. Sinclair*, 486 F.2d 1029, 1030 (9th Cir. 1973) (connection requirement not satisfied because plaintiffs did not purchase or sell in reasonable reliance upon the alleged misrepresentations). In analyzing the connection requirement in terms of causation, several courts have distinguished between loss causation and transaction causation. See *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374, 380-81 (2d Cir.), cert. denied, 421 U.S. 976 (1974); *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 238-40 (2d Cir. 1974). See generally BROMBERG, *supra* note 107, at §§ 4.7 (551), 8.7; Note, *Loss and Transaction Causation: The Second Circuit Resolves the Causation Controversy in Majority Control Situations*, 32 WASH. & LEE L. REV. 683 (1975). Loss causation establishes that the fraud caused, in fact, the plaintiff's economic injury. BROMBERG, *supra* note 107, at § 4.7 (511). Transaction causation analysis determines whether the causal connection between the fraud and the purchase or sale of securities was sufficient to satisfy the language of section 10(b). *Id.* Courts have not always found a clear distinction between loss causation and transaction causation. See, e.g., *Horst v. W. T. Cabe & Co.*, [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,213, at 92,465 (term "transaction causation" applied to relationship between fraud and plaintiff's injury). Analysis of the connection requirement in terms of causation may be merely an alternative method of incorporating the elements of materiality and reliance, which have traditionally constituted causation, into the Rule 10b-5 cause of action. See *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374, 380 n.11 (2d Cir. 1974). Although the concepts of causation and connection are closely intertwined, one commentator has urged that proof of causation should not be an absolute prerequisite to establishing connection. A. JACOBS, *supra* note 11, at § 38.01.

<sup>109</sup> 430 F. Supp. 121 (E.D.N.Y. 1977).

connection with" a purchase or sale of securities.<sup>110</sup> In *Halperin*, the plaintiff alleged that defendants violated Rule 10b-5 by fraudulently inducing him to invest in a limited partnership and to retain his investment.<sup>111</sup> Although the court held that the plaintiff properly alleged fraud in connection with his investment, it dismissed claims against several defendants who had joined the partnership after plaintiff's investment because their fraudulent conduct could not have been in connection with the original investment.<sup>112</sup> The district court's dismissal of the claims was consistent with dictum in *Blue Chip* to the effect that shareholders who simply retain their shares because of fraudulent misrepresentation or nondisclosure concerning the desirability of their investment do not have standing under Rule 10b-5.<sup>113</sup>

In *Horst v. W. T. Cabe & Co.*<sup>114</sup> the district court for the Southern District of New York held that the connection language of Rule 10b-5 covers fraud committed after the execution of a contract for the purchase or sale of securities.<sup>115</sup> In *Horst*, the plaintiff placed a stock-purchase order with the defendant brokerage firm. The order, which created a contractual right to purchase securities,<sup>116</sup> was never executed and the defendants allegedly misrepresented their intention to execute the order, thereby violating Rule 10b-5. The defendants' fraud neither preceded the contractual relationship nor induced formation of the contract; the fraud occurred during the course of the contractual relationship.<sup>117</sup> The *Horst* court held that although the "in connection with" language requires a reasonable "transactional nexus" between the defendant's fraud and the plaintiff's

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<sup>110</sup> *Id.* at 125; see *Kogan v. National Bank*, 402 F. Supp. 359, 361 (E.D.N.Y. 1975).

<sup>111</sup> 430 F. Supp. at 124. Plaintiff claimed that the defendants, partners in a limited partnership, failed to inform him that his investment in their firm would be speculative and risky in view of plaintiff's lack of sophistication in financial matters. *Id.* at 122-23. Plaintiff alleged further that defendant's continuing failure to reveal the true risks until several years later fraudulently induced plaintiff to retain his investment. *Id.* at 123.

<sup>112</sup> *Id.* at 123-24. The plaintiff argued that alterations of the partnership agreement executed subsequent to the original investment amounted to a "purchase" of securities. *Id.* at 124; see *Ingenito v. Bermeo Corp.*, 376 F. Supp. 1154, 1179-82 (S.D.N.Y. 1974). The court held, however, that modification of the rights of the plaintiff did not significantly change the nature of the investment of the investment risks and, thus, qualify as a purchase of a new security. 430 F. Supp. at 124; see *Abrahamson v. Fleschner*, 568 F.2d 862, 868 (2d Cir. 1977). The three defendants who became partners after the original investment, therefore, could not be held liable under *Blue Chip* for fraud in connection with plaintiff's retention of his investment. 430 F. Supp. at 124.

<sup>113</sup> 421 U.S. at 737-38. See, e.g., *Williams v. Sinclair*, 529 F.2d 1383, 1389 (9th Cir.), cert. denied, 426 U.S. 936 (1976) (pre-prospectus shareholders who retained their shares denied standing to sue for fraudulent misrepresentations contained in prospectus); *Marsh v. Armada Corp.*, 533 F.2d 978 (6th Cir. 1976), cert. denied, 430 U.S. 954 (1977) (nontendering shareholders do not have standing to complain of a fraudulent tender offer).

<sup>114</sup> [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,213 (S.D.N.Y. Oct. 31, 1977).

<sup>115</sup> *Id.* at 92,466.

<sup>116</sup> *Id.*

<sup>117</sup> See text accompanying notes 17-26 *supra*.

injury,<sup>118</sup> the connection requirement was met because the contract to purchase securities remained executory during the period of defendant's misrepresentations.<sup>119</sup> In the court's view, the transaction was a continuing one, and thus the requisite transactional nexus was present.<sup>120</sup>

The Third Circuit, in *Ketchum v. Green*,<sup>121</sup> recently addressed the question of the degree of "connection" required to satisfy the "in connection with" language. In *Ketchum*, a group of officers and directors of a close corporation conspired successfully to wrest control of the corporation away from the plaintiffs.<sup>122</sup> After ouster of the plaintiffs from the board of directors, the board voted to terminate the plaintiffs as employees of the corporation.<sup>123</sup> Upon termination, the plaintiffs were compelled to resell their shares to the corporation<sup>124</sup> pursuant to a stock retirement agreement. The district court held that the connection between the alleged fraud<sup>125</sup> and the

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<sup>118</sup> [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,213 at 92,464-65.

<sup>119</sup> *Id.* at 92,465.

<sup>120</sup> The court noted that in cases where the securities transaction has been completed, fraud following the transaction does not occur in connection with the purchase or sale of securities. Relying on the Ninth Circuit's decision in *Ohashi v. Verit Indus., Inc.*, 536 F.2d 849 (9th Cir. 1976), the *Horst* court refused to apply, however, a strict transaction causation analysis, *see note 108 supra*, which would have required the plaintiff to prove that defendant's fraud caused the securities transaction to occur. [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,213 at 92,466. The *Ohashi* court stated the rule that if a contract is still executory when the fraudulent activity occurs, and if the activities affect the unperformed part of the bargain, the fraud will be considered to be in connection with the contract to purchase or sell securities. 536 F.2d at 853. *See also* *Davis v. Davis*, 526 F.2d 1286 (5th Cir. 1976). Applying *Ohashi*, the *Horst* court held that the defendant's misrepresentations were "intrinsic" to the breach of contract to purchase securities. Although the connection requirement could not be satisfied under a transactional causation analysis, the court found the link between the fraud and plaintiff's injury sufficient under the *Ohashi* rule. [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,213 at 92,466. Extending Rule 10b-5 to reach fraudulent conduct which was intrinsic to the securities transaction in issue, precipitated the breach of contract, and caused plaintiff's loss, served the policy of the "in connection with" requirement to insure a reasonable relationship between fraud and the purchase or sale of securities.

<sup>121</sup> 557 F.2d 1022 (3d Cir. 1977).

<sup>122</sup> Plaintiffs were the former President and former Chairman of the Board of Babb, Inc., a closely held corporation. *Id.* at 1023. The seven defendants were other officers and directors who conspired to dislodge the plaintiffs as officers of the corporation. Pursuant to their plan, the entire board was nominated for re-election at the annual shareholders' meeting. Because the plaintiffs possessed the controlling bloc of stock, the defendants revealed nothing at the annual meeting about their intention to oppose the re-election of the plaintiffs as officers. After the shareholders returned all the directors to the board, thus returning the defendants to their dominant position, the board rejected the nominating committee's recommendations and ousted the plaintiffs. The board voted subsequently to terminate plaintiffs as employees as well. *Id.* at 1024.

<sup>123</sup> *Id.*

<sup>124</sup> *Id.* at 1023. The stock retirement agreement provided for compulsory sale to and repurchase by the corporation of all shares held by a terminated employee. 415 F. Supp. 1367, 1369 (W.D. Pa. 1976). Although plaintiffs refused to surrender their stock certificates or accept payment for their shares, *id.* at 1369-70, plaintiffs had standing to sue as forced sellers. *See id.* at 1372; *note 7 supra*.

<sup>125</sup> The plaintiffs alleged that defendant's nondisclosure and tacit misrepresentation to the shareholders of their intention with respect to the officerships fraudulently induced the

forced sale of plaintiff's shares was too attenuated to satisfy the "in connection with" requirement of the statute.<sup>126</sup> Although the Third Circuit accepted the lower court's conclusion and affirmed dismissal of the Rule 10b-5 action, the court did not adopt the trial judge's analysis of the connection issue.<sup>127</sup>

The court of appeals in *Ketchum* stated that the Supreme Court in *Superintendent of Life Insurance v. Bankers Life and Casualty Co.*<sup>128</sup> set forth the basic rule regarding connection: deceptive practices "touching" the purchase or sale of securities are within the coverage of Rule 10b-5.<sup>129</sup> The *Ketchum* court acknowledged that this standard could be interpreted to reach virtually all intracorporate conflicts that might involve deception.<sup>130</sup> Rather than fix the outer limits of the *Bankers Life* "touching" standard, the court set out several factors to be weighed in determining what constitutes a sufficient connection. The court examined the nature of the deception alleged, the directness of the connection, and the causal relationship between the alleged fraud and the securities transaction.<sup>131</sup> Applying this analysis to the facts, the court found that the plaintiffs' allegations concerned principally an internal corporate power struggle rather than securities fraud.<sup>132</sup> Furthermore, the court noted that a sub-

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plaintiffs to vote for their own demise. 557 F.2d at 1024. For the purpose of analyzing the "in connection with" requirement, the district court and the circuit court assumed that the deception constituted actionable fraud within the meaning of § 10(b) and Rule 10b-5. 415 F. Supp. at 1371 n.6; 557 F.2d at 1025-26.

<sup>126</sup> 415 F. Supp. at 1372.

<sup>127</sup> The trial court's analysis of the connection requirement focused solely on whether the alleged fraud caused the forced sale of stock. *Id.* at 1371. The court's causation analysis relied primarily upon the application of materiality and reliance tests which traditionally have been employed to determine whether defendant's fraud caused plaintiff's injury. *See id.* Apparently unconvinced that the connection and causation issues are analytically synonymous, the Third Circuit reconsidered fully the connection requirement. *See text accompanying notes 128-37 infra.*

<sup>128</sup> 404 U.S. 6 (1971).

<sup>129</sup> *Id.* at 12-13. In *Bankers Life*, the defendants employed an intricate scheme to deplete the assets of the corporation. Bankers Life had agreed to sell all its stock in Manhattan Life Insurance Co. The purchaser and his co-conspirators induced Manhattan to sell its treasury bond holdings, the proceeds of which were used to finance the purchase of Manhattan's stock. The depletion of assets was concealed by the fraudulent issuance of a certificate of deposit, ostensibly in exchange for the proceeds of the bond sale. *Id.* at 7-9: Both the district court and the Second Circuit held that since the deception involved in converting the bond proceeds occurred after their receipt by the corporation, the sale of the treasury bonds was not connected with the alleged fraud. 430 F.2d 355, 360-61 (2d Cir. 1970); 300 F. Supp. 1083, 1101-02 (S.D.N.Y. 1969). The Supreme Court reversed, holding that fraud was sufficiently connected with the securities transaction to bring the misappropriation of the proceeds within the reach of Rule 10b-5. 404 U.S. at 12-13. One commentator has suggested that the Supreme Court should have narrowed its interpretation of the connection language to require that the securities transaction be an "essential link" in the fraudulent scheme and be undertaken for the purpose of effectuating the fraud. Note, *The Supreme Court, 1971 Term*, 86 HARV. L. REV. 50, 264 (1972).

<sup>130</sup> 557 F.2d at 1027.

<sup>131</sup> *Id.* at 1028-29.

<sup>132</sup> In *Ketchum*, the central element of the controversy was plaintiff's ouster as a result

stantial number of intermediate events occurred between the fraud and the ultimate forced sale of stock.<sup>133</sup> Because these events lacked a tight linkage,<sup>134</sup> the requisite directness was missing. Finally, the court found that operation of the stock retirement agreement caused the forced sale of stock, rather than the alleged fraud.<sup>135</sup> The court concluded, therefore, that plaintiffs failed to establish that the fraud was in connection with a purchase or sale of securities.

Suits arising out of corporate conflicts or mismanagement which may only incidentally involve a securities transaction have traditionally been regulated by state corporation law. Realistically, many corporate decisions may touch the purchase or sale of securities.<sup>136</sup> In view of the potentially broad reach of the touching standard into internal corporate affairs, the Third Circuit's analysis of the connection requirement in *Ketchum* is consistent with the trend of recent decisions restricting the scope of actionable fraud under Rule 10b-5.<sup>137</sup>

### B. *The Culpability Standards*

Lower courts continue to struggle with the questions left unresolved by the Supreme Court in *Ernst & Ernst v. Hochfelder*.<sup>138</sup> Rejecting the contention that Rule 10b-5 liability could be founded on negligent misrepresentations or omissions<sup>139</sup> the *Hochfelder* Court held that a private action for damages based on Rule 10b-5 would not lie absent an allegation of intent to deceive, manipulate or defraud.<sup>140</sup> The Court labeled the culpability

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of an internal contest for control of the corporation. 557 F.2d at 1027. The court distinguished the facts in *Bankers Life* where the securities transaction "undergirded" defendant's fraudulent conduct. *Id.* at 1028. The Court in *Bankers Life* stated that § 10(b) was not intended to reach securities transactions which constitute no more than corporate mismanagement, even if the "in connection with" requirement is construed flexibly. 404 U.S. at 12. Because the *Ketchum* court viewed the alleged fraud as connected with the struggle for control, the court held that the "internal corporate mismanagement" exception in *Bankers Life* should apply. 557 F.2d at 1028.

<sup>133</sup> The intermediate steps between the fraud and the forced sale included the shareholders' vote subsequent to the misrepresentation, the removal of plaintiffs as officers, and the termination of the plaintiffs as employees of the corporation. *Id.*

<sup>134</sup> *Id.* The court contrasted the *Bankers Life* case in which the bond transaction was essential to the misappropriation of the proceeds and the ensuing deception. *Id.*; see note 129 *supra*.

<sup>135</sup> 557 F.2d at 1029. Relying on *Tully v. Mott Supermarkets, Inc.*, 540 F.2d 187 (3d Cir. 1976), the *Ketchum* court perceived the connection problem in terms of causation. The court noted, however, that requiring a showing of causation may prove too much in light of *Bankers Life* since the bond sale in that case "only made possible the accomplishment of the fraud as opposed to having caused it." *Id.* at 1029 (emphasis in original). The court's view that connection is not strictly a matter of causation is consistent with the broad touching standard announced in *Bankers Life*.

<sup>136</sup> 557 F.2d at 1029.

<sup>137</sup> See note 1 *supra*.

<sup>138</sup> 425 U.S. 185 (1976).

<sup>139</sup> *Id.* at 201, 214.

<sup>140</sup> *Id.* at 193. The *Hochfelder* case grew out of a fraudulent scheme by Leston Nay,



requirement for Rule 10b-5 liability as "scienter,"<sup>141</sup> but specifically reserved the question whether recklessness, which has been recognized as a form of intentional behavior,<sup>142</sup> would support Rule 10b-5 civil liability.<sup>143</sup> Further, because *Hochfelder* was a private action for compensatory damages, the decision left open the issue whether the SEC would be required to prove scienter as a prerequisite to issuance of an injunction in its enforcement actions.<sup>144</sup>

### *SEC Enforcement Actions*

Courts during the last year have reached conflicting results on whether proof of scienter is a prerequisite for SEC injunctive relief.<sup>145</sup> In *SEC v.*

president and majority stockholder of First Securities Company, a small brokerage firm. Ernst & Ernst performed periodic audits of First Securities. The audits failed to reveal the existence of a "mail rule" whereby Nay's mail could not be opened in his absence. This "mail rule" allowed Nay to maintain a fraudulent scheme whereby he induced respondents to invest in escrow accounts, which supposedly yielded high rates of return, when actually no such accounts existed and Nay was simply converting the money to his own use. The gravamen of the complaint was that Ernst & Ernst had aided and abetted Nay's violation of section 10(b) and Rule 10b-5 by negligently failing to detect or report the irregular mail rule. *Id.* at 188-90.

<sup>141</sup> 425 U.S. at 193. The *Hochfelder* court, for purposes of the opinion, defined scienter as "a mental state embracing intent to deceive, manipulate or defraud." *Id.* at 194 n.12.

<sup>142</sup> See *Ultramares v. Touche, Niven & Co.*, 255 N.Y. 170, 174 N.E. 441, 448-49 (1931); W. PROSSER, *HANDBOOK OF THE LAW OF TORTS* § 34 at 184-85 (4th ed. 1971); text accompanying notes 168-93 *infra*.

<sup>143</sup> 425 U.S. at 194 n.12.

<sup>144</sup> The *Hochfelder* Court framed the issue of the case as "whether a *private* cause of action for damages" would lie in the absence of any allegation of scienter. *Id.* at 193 (emphasis added). The Court made it clear that a determination of the role of scienter in a section 10(b) action for damages was not determinative of the issue whether scienter is a necessary element in an action for injunctive relief. *Id.* at 194 n.12. *SEC v. Capital Gains Bureau*, 375 U.S. 180 (1963), illustrates that a decision requiring a showing of scienter in an action for damages may not be determinative of the need to show scienter in injunctive actions. *Capital Gains* involved an injunctive action against a broker based on the Investment Advisors Act of 1940, 15 U.S.C. §§ 80a-1—80b-21 (1970), an Act with a fundamental purpose of full disclosure similar to the '33 and '34 Act. 375 U.S. at 186; see 15 U.S.C. § 80a-1 (1970). Interpreting the words "fraud" and "deceit" as they appeared in the Advisors Act, the Court concluded that in the context of injunctive relief proof of intent to injure was not required and that to require proof of intent would frustrate the remedial purpose of the Act. 375 U.S. at 186-95.

SEC injunctive relief can be likened to certain equitable remedies available at common law. To obtain rescission for misrepresentation, only a showing of the materiality of the misrepresentation and reliance by the plaintiff was required. See *Canadian Agency, Ltd. v. Assets Realization Co.*, 165 App. Div. 96, 150 N.Y.S. 758 (Sup. Ct. 1914). One commentator suggests that if SEC injunctive relief is analogized to common law equitable rescission an argument can be made that neither scienter nor specific intent should be a prerequisite to SEC injunctive relief. See Maher & Blasi, *Lessons From Ernst & Ernst—Enforcement Proceedings and the Uncommon Law of 10b-5*, 82 DICK L. REV. 1, 10-11 (1977) [hereinafter cited as Maher & Blasi].

<sup>145</sup> Prior to the *Hochfelder* decision courts had generally held that a showing of negligence was sufficient to support an injunction. See, e.g., *SEC v. Management Dynamics, Inc.*, 515 F.2d 801, 809 (2d Cir. 1975); *SEC v. Dolnick*, 501 F.2d 1279, 1284 (7th Cir. 1974); *SEC v. Manor Nursing Centers, Inc.*, 458 F.2d 1082, 1096 (2d Cir. 1972); *SEC v. Pearson*, 426 F.2d

*American Realty Trust*,<sup>146</sup> a Virginia federal district court found that the defendants had omitted material information from a prospectus filed in conjunction with the sale of debentures,<sup>147</sup> but refused to hold that they had violated section 10(b) or Rule 10b-5 because the SEC had failed to prove that the defendants acted with intent to deceive, manipulate or defraud.<sup>148</sup> The court found persuasive the fact that the Supreme Court derived the scienter requirement from the language and legislative history of section 10(b).<sup>149</sup> The court reasoned that since the requirement of scienter derived from the wording of the statute, it was necessarily an element of all actions under that statute.<sup>150</sup> The court noted that while SEC injunc-

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1339, 1343 (10th Cir. 1970); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 854-55 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969); *SEC v. Van Horn*, 371 F.2d 181, 186 (7th Cir. 1966); *SEC v. M. A. Lundy Assocs.*, 362 F. Supp. 226, 234 (D.R.I. 1973). *But see SEC v. Coffey*, 493 F.2d 1304, 1314 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975).

Since *Hochfelder*, courts have been sharply split on the issue whether scienter must be proved in Rule 10b-5 injunctive actions. The first two courts considering this question reached directly opposite results. In *SEC v. World Radio Mission, Inc.*, 544 F.2d 535 (1st Cir. 1976) the First Circuit held that because SEC injunctions are designed to protect the public against injurious violations that courts find are likely to persist, the state of mind of the defendant is irrelevant. The *World Radio* court therefore limited *Hochfelder* to the proposition that good faith is a defense to a private suit for past misrepresentations. *Id.* at 540. *See generally 1976-1977 Developments, supra* note 5, at 913-18.

In *SEC v. Bausch & Lomb, Inc.*, 420 F. Supp. 1226 (S.D.N.Y. 1976), *aff'd on other grounds*, 565 F.2d 8 (2d Cir. 1977), a district court faced the same issue and concluded that *Hochfelder* mandated a finding of scienter as a condition of liability in all actions based on section 10(b) and Rule 10b-5. The court reasoned that since the *Hochfelder* Court rested its decision on the language and history of section 10(b), and since both injunctive and private actions are derived from that statute, there should be no distinction in requirements between private and injunctive actions. *Id.* at 1240-41. *See also*, 425 U.S. at 217-18 (Blackmun, J., dissenting). The court indicated that although private and SEC injunctive actions had traditionally been distinguished on policy grounds, since the history and language of section 10(b) was dispositive of the standard for liability, discussion of policy considerations was unwarranted. 420 F. Supp. at 1241, *quoting Ernst & Ernst v. Hochfelder*, 425 U.S. at 214 n.33. The Second Circuit affirmed the district court's decision but did not consider the validity of the lower courts holding that *Hochfelder* required a showing of scienter in SEC injunctive actions. 565 F.2d 8, 14 (1977).

<sup>146</sup> 429 F. Supp. 1148 (E.D. Va. 1977).

<sup>147</sup> The defendants distributed a prospectus as part of an offering and sale of \$3.4 million dollars of debentures. The SEC alleged that American Realty Trust failed to disclose properly five material business transactions. *Id.* at 1153. The court found no material misrepresentation had been made about four of the transactions, but that an omission concerning the circumstances surrounding one loan was material. *Id.* at 1170.

<sup>148</sup> *Id.* at 1170-71. The *American Realty* court reasoned that since the *Hochfelder* Court derived the requirement of scienter from the wording of section 10(b) that SEC injunctive suits and private actions for damages, being based on the same statute, both require a showing of scienter. *Id.* at 1171.

<sup>149</sup> 429 F. Supp. at 1171. The court cited the *Hochfelder* dissent's contention that the majority's analysis of section 10(b) and Rule 10b-5 eliminated any appropriate basis for distinguishing between standards to be applied in private actions and SEC injunctive actions. *Id.* at 1171 n.4, *citing, Ernst & Ernst v. Hochfelder*, 425 U.S. at 217-18 (Blackman, J., dissenting).

<sup>150</sup> *Id.* at 1171; *see note 8 supra*.

tive actions and private damage actions under section 10(b) could be distinguished on the ground that differing policy considerations underlie each,<sup>151</sup> examination of these considerations was precluded by the force of the statutory language.<sup>152</sup>

The *Hochfelder* decision was similarly construed in *SEC v. Southwest Coal & Energy Co.*<sup>153</sup> There, a Louisiana federal district court found that the defendants had omitted material information from offering circulars distributed pursuant to their business of selling undivided interests in oil and gas leases.<sup>154</sup> The court, however, held that the omissions did not constitute a violation of section 10(b) or Rule 10b-5 because the Commission had failed to establish that the defendants either intended to deceive or defraud, or acted with reckless disregard for the truth.<sup>155</sup> Noting the division of authority over whether *Hochfelder* requires proof of scienter in SEC enforcement actions,<sup>156</sup> the court relied on the analysis of *American Realty Trust*. The court reasoned that if the language of section 10(b) mandated a finding of scienter to establish a Rule 10b-5 violation in private actions, the SEC, acting under the same statutory authority, would be similarly bound by the statutory limits of that section.<sup>157</sup>

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<sup>151</sup> 429 F. Supp. at 1171. Judge Friendly, in *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 864 (2d Cir. 1968) (Friendly, J., concurring) while considering the propriety of issuing an injunction, noted a policy consideration which would support application of different culpability standards for private damage actions and SEC injunctive actions. He argued that to have less than a scienter standard for private Rule 10b-5 actions would put tremendous burdens on those issuing corporate news releases and work directly counter to the trend toward immediate disclosure to the investing public of important business and financial developments. *Id.* at 866-67. Judge Friendly reasoned, however, that one of the most important purposes of the securities acts was to eliminate disclosure of misleading information and, therefore, the SEC should be able to protect the public by obtaining injunctions without being required to show scienter. *Id.* at 868.

<sup>152</sup> 429 F. Supp. at 1171.

<sup>153</sup> 439 F. Supp. 820 (W.D. La. 1977).

<sup>154</sup> Defendants Cash, Heflin and Parsons incorporated Southwest Coal and Energy to sell oil and gas leases for exploration. Oil and gas leases are securities as defined by § 2(1) of '33 Act, 15 U.S.C. § 77b(1)(1970). They also owned large interests in many other corporations, organized and acting for the same purpose as Southwest. The other corporations were developing wells on land contiguous to Southwest's holdings. The major misrepresentations were in maps of the available lease areas that were distributed as circulars which showed other development in adjacent areas without properly revealing the affiliation between Southwest and these other corporations. Consequently, the maps gave the impression that several other companies had investigated the area and decided to drill in the area. 439 F. Supp. at 824.

<sup>155</sup> Cash and Heflin were not directly involved with the sales of the leases; rather, they were in charge of the drilling operation. The court found no evidence indicating that Cash and Heflin intended to deceive, or that their delegating supervision of the sales operation to Parsons constituted reckless disregard of the truth, in that there was no indication that they were aware that Parson's inability and lack of knowledge of the field would result in material misrepresentations or omissions. *Id.* at 824.

<sup>156</sup> *Id.* at 825.

<sup>157</sup> The court did find, however, that § 17(a)(2) of the '33 Act, 15 U.S.C. § 77q(a)(2)(1970), which prohibits omissions and misrepresentations of material facts in connection with a public offering of securities did not require a showing of scienter as a prerequisite to establishing a violation. 439 F. Supp. at 826-27. Section 17(a), 15 U.S.C. §

77q(a), states:

It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

- (1) to employ any device, scheme, or artifice to defraud, or
- (2) to obtain money or property by means of any untrue statement of material fact or any omission to state a material fact necessary in order to make the statement made, in light of the circumstances under which they were made, not misleading, or
- (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

The language of § 17(a) and Rule 10b-5 are very similar and their respective applicability differs only in that the prohibitions of § 17(a) are limited to public offerings of securities while Rule 10b-5 is applicable to all sales and purchases of securities. Because of the similarity between these provisions the SEC and plaintiff purchasers have begun to advance their claims against sellers under § 17(a) as well as Rule 10b-5 when both are applicable. These attempts to circumvent *Hochfelder* raise the issue whether scienter must be shown to establish a violation of § 17(a). Courts have differed on the answer to this question. The *Southwest Coal* court employed a four step analysis concluding that a violation of § 17(a)(2) requires no showing of scienter. First, the court rejected the conclusion that the similarity between the language of § 17(a) and that of Rule 10b-5 mandated a finding that scienter is a necessary element of a violation of § 17(a). The *Southwest Coal* court reasoned that the *Hochfelder* analysis called for examination of each section of the '33 and '34 Act independently to determine the appropriate standard of culpability. The court stated that "[t]he standard of care under § 17(a) must be determined by reference to § 17(a), not to § 10(b) of the 1934 Act." 439 F. Supp. at 826.

Rejecting the similarity in language between § 17(a) and Rule 10b-5 as a basis of decision is well founded. The *Hochfelder* Court found that the requirement of scienter in Rule 10b-5 actions derived not from the Rule itself but from the language of its enabling statute, section 10(b). Therefore *Hochfelder* does not compel a finding that the language of Rule 10b-5 or language similar to it requires a showing of scienter. *Id.* at 826.

Analyzing the language of § 17(a) the *Southwest Coal* court next reasoned that since § 17a(1) clearly required a showing of scienter, § 17a(2) could not logically require scienter. If both sections required scienter all violations of § 17a(2) would also be violations of § 17a(1) and thus § 17a(2) would be superfluous, a result the court felt Congress could not have intended. *Id.* *Accord* Maher & Blasi, *supra* note 144 at 14-16, 25-26.

Third, the court likened the language of § 17a(2) to that of § 11 of the '33 Act, 15 U.S.C. § 77k(1970), which creates an absolute liability for material misstatements or omissions in a registration statement. *See* Ernst & Ernst v. Hochfelder, 425 U.S. at 0; Escott v. Barchris Construction Corp., 283 F. Supp. 643 (S.D.N.Y. 1968). Since the operative language of the two sections is nearly identical the court reasoned that, as with 11, § 17a(2) does not require a showing of scienter. 439. F. Supp. at 826.

Finally *Southwest* distinguished the purposes of the '33 and '34 Acts. While the '33 Act was intended to promote disclosure, the '34 Act was largely an antifraud measure and it is thus entirely consistent with the purposes of the '34 Act that § 10b would place emphasis on the state of mind of a defendant while § 17a(2) would have no such restriction. *Id.*

Other courts analyzing § 17(a) have reached contradictory conclusions. *Compare Sanders v. John Nuveen & Co.*, 554 F.2d 790, 795 (7th Cir. 1977) (scienter necessary element of § 17(a) violation) with *SEC v. Geotek*, 426 F. Supp. 715, 726 (N.D. Cal. 1976) (scienter not necessary for injunctive relief under § 10(b) or § 17(a)). *See generally* Mahler & Blasi, *supra* note 144, at 14-16 (concluding a showing of negligence sufficient for action based on § 17a(2)).

In contrast, a Florida federal district court, in *SEC v. Shiell*,<sup>158</sup> rejected the reasoning of *American Realty Trust* and held that *Hochfelder* did not require the SEC to allege scienter in an injunctive action under Rule 10b-5.<sup>159</sup> Resting its decision on policy grounds, the court reasoned that injunctive relief is intended to protect the public against injurious conduct. Consequently, to require the SEC to prove intentional fraud might seriously impair the Commission's ability to police securities transactions and, therefore, reduce the Commission's ability to protect the public.<sup>160</sup> The *Shiell* court did not attempt to reconcile the *Hochfelder* Court's reading of the language of section 10(b)<sup>161</sup> with their own policy analysis. The *Shiell* court relied instead on pre-*Hochfelder* decisions requiring a showing of scienter in private actions for damages, but advocating issuance of injunctions in enforcement actions without regard to the defendant's state of mind.<sup>162</sup> Recognizing the uncertainty of the law in this area, the court qualified its decision stating that even if scienter must be alleged, their decision would stand because the allegations of the complaint were sufficient to allege recklessness, which the court recognized as satisfying the scienter requirement.<sup>163</sup>

While the *Shiell* court did not consider the *Hochfelder* Court's statutory construction of section 10(b), it reached the better result. The *Hochfelder* decision should not be read to require a showing of scienter in SEC enforcement actions under Rule 10b-5.<sup>164</sup> First, the *Hochfelder* Court was careful to limit its decision to private damage actions. This indicates that the Court either did not consider the question of what standard of culpability should apply in enforcement actions or did not intend *Hochfelder* to resolve the issue.<sup>165</sup> Second, it is generally unnecessary to establish all ele-

<sup>158</sup> [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,190 (N.D. Fla. Sept 27, 1977).

<sup>159</sup> *SEC v. Shiell*, [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶96,190 at 92,386. The issue of the need to show scienter in injunctive actions arose on a motion for summary judgment. The defendant asserted that it was entitled to a judgment on the ground that the SEC had failed to make an adequate allegation of scienter. *Id.* at 92,385-86. For a discussion of the complaint filed in the *Shiell* case see Cohen, *The Outside Director—Selection, Responsibilities, And Contribution To The Public Corporation*, 34 WASH. & LEE L. REV. 837, 843-47 (1977).

<sup>160</sup> *Id.* at 92,386. The *Shiell* court also noted that the Second Circuit, which had correctly anticipated *Hochfelder* by requiring a showing of scienter in private actions, had always distinguished enforcement actions, requiring only a showing of negligence. *Id.* at 92,386 n.2.

<sup>161</sup> See note 145 *supra* for a discussion of the *Bausch & Lomb* analysis of the *Hochfelder* decision.

<sup>162</sup> [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶96,190 at 92,386 n.2.

<sup>163</sup> *Id.*

<sup>164</sup> See, e.g., Maher & Blasi, *supra* note 144; Note, *SEC Enforcement Actions to Enjoin Violations of Section 10(b) and Rule 10b-5: The Scienter Question*, 5 HOFSTRA L. REV. 831 (1977). But see Berner & Franklin, *Scienter and Securities and Exchange Commission Rule 10b-5 Injunctive Actions: A Reappraisal In Light of Hochfelder*, 51 N.Y. U.L. REV. 769 (1976); Goldwasser, Ernst & Ernst v. Hochfelder: An Anti-Landmark Decision, 22 N.Y. L. SCHOOL L. REV. 29 (1976).

<sup>165</sup> The *Hochfelder* decision considered only the role of scienter in private actions for damages. While the scope was limited, the Court rested its decision on an analysis of the

ments of a suit for monetary damages in a suit for prophylactic relief.<sup>165</sup> A lighter burden in enforcement actions would allow more effective fulfillment of the investor protection policy which underlies the Securities Acts.<sup>167</sup> Decisions like *American Realty Trust*, requiring the SEC to show intentional conduct, might seriously hinder the Commission in its efforts to protect the investing public.

### *Recklessness*

While the *Hochfelder* Court held that scienter—intent to deceive, manipulate, or defraud—was a necessary element of Rule 10b-5 liability,<sup>168</sup> the Court did not address the question whether a showing of reckless behavior would be sufficient to sustain civil liability under section 10(b) and Rule 10b-5.<sup>169</sup> Since *Hochfelder*, courts have uniformly held that reckless conduct constitutes scienter and is sufficient to support Rule 10b-5 liability.<sup>170</sup>

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statutory language of Section 10(b). Because the Court derived the scienter requirement from the language of Section 10(b) it is difficult to argue that the same statute does not mandate a showing of scienter when the SEC is seeking an injunction. The language argument is especially compelling since section 10(b) makes no mention of a private right of action. Thus, Congress must have contemplated that the language of the statute should be a guide to the SEC in enforcing the proscriptions of the Act. See *SEC v. Bausch & Lomb, Inc.*, 420 F. Supp. 1226 (S.D.N.Y. 1976).

The *Hochfelder* decision was another of a series of decisions aimed at limiting the class of plaintiffs able to sue under the securities laws. See generally Note, *Judicial Retrenchment Under Rule 10b-5: An End to the Rule as Law?*, 1976 DUKE L. J. 789. Fear of extending the "frontiers" of the hazards of rendering expert advice was clearly a factor in the Courts decision to require a showing of more than negligence in damage actions. See 425 U.S. at 214-15 n.33. If one of the major aims of the *Hochfelder* decision was to limit the class of plaintiffs able to sue and protect professionals involved in the securities field from realizing tremendous liability for negligent errors, the decision should not be construed as placing a greater burden on the SEC whose only function is to act in the public interest.

<sup>165</sup> See *SEC v. Capital Gains Bureau*, 375 U.S. 180, 193 (1963); *Mutual Shares Corp. v. Genesco, Inc.*, 384 F.2d 540, 547 (2d Cir. 1967). In *SEC v. Capital Gains Bureau* the Court, construing the Investment Advisors Act of 1940, 15 U.S.C. § 80b-1-80b-21 (1976), drew a sharp distinction between private damage suits and SEC actions for prophylactic relief. The Court reasoned that at common law it was not necessary in an action for prophylactic or equitable relief to establish all elements required in a suit for monetary damages. The Court concluded that the SEC could obtain an injunction without proving intent to injure or actual injury. 375 U.S. at 192-93.

<sup>167</sup> The role of the SEC as a litigant for injunctive relief is to protect the public interest. *SEC v. World Radio Mission, Inc.*, 544 F.2d 535, 541 (1st Cir. 1976); *SEC v. Management Dynamics, Inc.*, 515 F.2d 801, 808 (2d Cir. 1975). Investors may be injured by negligent deception as well as by wilful deception. Therefore, the functions and purposes of the SEC should allow it to enjoin negligent action within the bounds of Rule 10b-5.

<sup>168</sup> 425 U.S. at 193.

<sup>169</sup> *Id.* at 194 n.12.

<sup>170</sup> See *Wright v. Heizer Corp.*, 560 F.2d 236 (7th Cir. 1977); *Sanders v. John Nuveen & Co.*, 554 F.2d 790 (7th Cir. 1977); *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033 (7th Cir. 1977); *Herzfeld v. Laventhal, Krekstein, Horwath & Horwath*, 540 F.2d 27 (2d Cir. 1976); *Bailey v. Meister Brau, Inc.*, 535 F.2d 982 (7th Cir. 1976); *SEC v. Cenco, Inc.*, 436 F. Supp. 193 (N.D. Ill. 1977); *Coleco Indus., Inc. v. Berman*, [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶96,253 (3d Cir. Nov. 25, 1977); *Continental Assurance Co. v. American*

This result accords with common law precepts that liability for fraud or deceit can be based on a showing of either willful misrepresentation or misrepresentation made with reckless disregard for the truth.<sup>171</sup> Because it appears settled that defendants are liable under Rule 10b-5 for reckless conduct, the principal issue to be resolved is the proper standard for defining "recklessness." The resolution of this question will largely determine the true importance of *Hochfelder*. If courts define recklessness as a form of behavior closer to negligence than to intentional fraud the impact of the *Hochfelder* scienter requirement will be greatly reduced.<sup>172</sup>

In the last year, the Seventh Circuit recognized recklessness as a form of scienter and developed a definition of recklessness against which a defendant's behavior may be tested.<sup>173</sup> In *Sundstrand Corp. v. Sun Chemical Corp.*,<sup>174</sup> the court adopted and analyzed a two part test of recklessness. The case grew out of Sundstrand Corp's attempt to merge with a company called SKI. The defendant Meers, an outside director of SKI and a former investment counselor for Sundstrand, acted as intermediary for the purchase of SKI stock.<sup>175</sup> Of key importance to Sundstrand were SKI's projected earnings. During the merger negotiations one SKI director and a private auditing firm indicated to Meers that SKI's accounting procedures might be faulty and therefore misleading as to projected earnings for the year.<sup>176</sup> The merger subsequently fell through after Sundstrand had pur-

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Bankshares Corp., [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶96,274 (E.D. Wis. Nov. 7, 1977); Bucklo, *The Supreme Court Attempts to Define Scienter Under Rule 10b-5: Ernst & Ernst v. Hochfelder*, 29 STAN. L. REV. 213, 235 (1977).

In adopting recklessness as a form of scienter courts have relied primarily on analogy to the common law where reckless behavior was sufficient to support causes of action sounding in fraud or deceit. Courts have professed doubt that the *Hochfelder* Court intended Rule 10b-5 to be construed more narrowly than its common law analogs. See, e.g., *McLean v. Alexander*, 420 F. Supp. 1057, 1080-81 (D. Del. 1976). See generally Haimoff, *Holmes Looks at Hochfelder and 10b-5*, 32 BUS. LAW. 147 (1976) [hereinafter cited as Haimoff].

<sup>171</sup> See *Derry v. Peek*, [1889] 14 A.C. 337, 374; W. PROSSER, *HANDBOOK OF THE LAW OF TORTS* 699-714 (4th ed. 1971) [hereinafter cited as PROSSER].

<sup>172</sup> The certainty engendered by the relative clarity of the scienter standard of culpability may disappear as a result of inconsistent interpretations of recklessness. Thus, a court, desiring to hold a particular defendant liable, need only label his neglect as reckless. Fleischer, Marsh & Anderson, *The Impact of Recent Supreme Court Decisions: Ernst & Ernst v. Hochfelder And TSC Industries, Inc. v. Northway, Inc.*, in P.L.I., *EIGHTH ANNUAL INSTITUTE ON SECURITIES REGULATION* (Fleisher, Mundheim, & Vandegrift eds.) 309, 317-20.

<sup>173</sup> See note 170 *supra*.

<sup>174</sup> 553 F.2d 1033 (7th Cir. 1977).

<sup>175</sup> *Id.* at 1038. The stock purchased by Sundstrand was owned by the Burke family, founders of SKI, and Mr. Huarisa, then chairman of the board and president of SKI. Mr. Huarisa owned 172,000 shares and had a right to first refusal on 233,190 shares and had a right to first refusal on 223,190 shares held by the Burke family. *Id.* at 1037. Huarisa was also a defendant in the instant case and was found liable for reckless misrepresentations. *Id.* at 1039-40.

<sup>176</sup> *Id.* at 1041. Burke, a director of SKI, filed a report questioning the accounting practices of SKI, centering on SKI's continuing deferral of certain preproduction costs. Burke also filed a supporting report from the accounting firm of Ernst & Ernst. The questionable accounting practices were discussed at 25 board meetings in 1968. Due to Burke's complaints

chased a large block of SKI stock. When it became apparent that SKI's earnings would not approach those projected, Sundstrand sued Meers.<sup>177</sup> The court found that Meers had a quasi-fiduciary duty of disclosure to Sundstrand<sup>178</sup> and had recklessly failed to disclose the accounting reports that raised doubts about SKI's earning projections.<sup>179</sup>

In finding Meers' conduct was reckless as a matter of law the court adopted the definition of recklessness first stated in *Franke v. Midwestern Oklahoma Development Authority*:<sup>180</sup>

reckless conduct may be defined as a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.

The court divided the *Franke* definition into a two part test consisting of an objective and subjective element. Under the objective element of the test, the danger of misleading purchasers must either be known to or so obvious that any reasonable man would be legally bound as knowing.<sup>181</sup> Under this test the court reasoned that even if Meers had no actual knowledge of the danger of misleading Sundstrand by failing to inform it of SKI's questionable accounting practices he would be bound as knowing because the repeated and vehement discussion of the matter at board meetings would have made the danger clear to any reasonable man.

To fulfill the second part of the *Franke* recklessness test, the subjective element, an omission must derive from something more extraordinary than inexcusable neglect. Under this rationale had Meers simply forgotten to reveal the information the subjective element of the recklessness test would not have been fulfilled, thereby precluding a finding of liability.<sup>182</sup>

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SKI consulted the SEC about the problem. The SEC concluded that the 1967 report was not improper. After meeting with the SEC, SKI's accounting firm assured the SEC that it would re-evaluate the situation when the 1968 report was prepared. *Id.*

<sup>177</sup> During the merger negotiations, in December of 1968, and before SKI annual report had been filed, Sundstrand was assured that SKI's earnings would be about \$1.16 per share. After SKI's accountants decided they could no longer defer preproduction costs but had to write them off, see note 39 *supra*, they calculated that SKI would lose 15 cents per share for 1968. 553 F.2d at 1041.

<sup>178</sup> Meers had performed investment banking services for Sundstrand and Sundstrand officers had confidence in him. From this relationship the court found Meers to be a quasi-fiduciary and thus under a common law duty to disclose material facts pertinent to the merger. 553 F.2d at 1043; see PROSSER, *supra* note 171, at 697; Haimoff, *supra* note 170, at 164-66.

<sup>179</sup> *Id.* at 1047.

<sup>180</sup> 428 F. Supp. 719, 725 (W.D. Okl. 1976).

<sup>181</sup> The *Sundstrand* court noted that the objective test must be administered by viewing the facts in "their contemporaneous configuration rather than in the blazing light of hindsight." 553 F.2d at 1045, n.19.

<sup>182</sup> According to the *Sundstrand* court, *Hochfelder* required a subjective test with a requirement of something more than "inexcusable negligence." *Id.* at 1045 n.20; see Ernst &



In applying the subjective element the court found that Meers must have consciously decided not to disclose the difficulty in the accounting procedures.<sup>183</sup> Thus, having fulfilled both elements of the two part test, consciously failing to reveal an objectively obvious and important material fact, omission of which presents great danger of misleading the purchaser, Meers was found reckless as a matter of law.<sup>184</sup>

The Seventh Circuit again applied the *Franke* definition of recklessness, reaching a different result, in *Sanders v. John Nuveen & Co.*<sup>185</sup> In that case the question was whether an "underwriter of short term commercial paper who acted in the mistaken but honest belief that financial statements prepared by certified public accountants correctly represented the condition of the issuer was liable to its customers for losses sustained as a

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*Ernst v. Hochfelder*, 425 U.S. at 190 n.5. The effect of the subjective test, the court reasoned, would be to absolve a defendant from liability if he forgot to disclose information or if it never came to his mind. 553 F.2d 1045 n.20 & 1047. This part of the test assures that only misconduct which is close to intentional misconduct will be held to be reckless. Under this test only a conscious decision not to reveal facts will be held reckless while neglectful omissions will not result in liability. See Haimoff, *supra* note 170, at 150-54.

<sup>183</sup> 553 F.2d at 1047-48.

<sup>184</sup> *Id.* at 1048. The Seventh Circuit also applied the *Franke* definition of recklessness in *Wright v. Heizer Corp.*, 560 F.2d 236 (7th Cir. 1977), finding that the fiduciary defendant had violated Rule 10b-5. Plaintiffs, shareholders of IDC Corp., through a stockholders derivative action, accused defendant Heizer Corp. of defrauding IDC in a series of five transactions. Heizer Corp. began its relationship with IDC by financing the corporation. In return for its loans Heizer received rights to convert outstanding loans into common IDC stock. After consummation of the third loan Heizer controlled or had the right to control through exercise of its options, 61% of IDC's equity and had two representatives on the board of directors. *Id.* at 243. When Heizer entered into the fourth and fifth loan transactions it required that if the loans were not repaid on time the outstanding debts would become convertible to common stock at \$1 per share. *Id.* at 243 n.7. In order to increase the outstanding stock to cover this contingency the charter had to be amended, a procedure requiring stockholder approval. In obtaining the written consent from the majority of IDC stockholders Heizer failed to disclose the numerous detrimental implications such a transaction could have on the stockholder's position in IDC. *Id.* at 247. Noting that Heizer was a fiduciary during the fourth and fifth transactions and had a duty to make fair and full disclosure to the shareholders, the court found that the disclosures made in obtaining the consents for the charter amendment were inadequate. *Id.* at 249. In finding Heizer's failure to inform the stockholders of the specific terms of the fourth and fifth transactions a reckless omission within the *Franke* definition, the court relied on the fact that Heizer was well aware of the controversial nature of the transactions in that one major stockholders had already objected to the fairness of the deal. *Id.* at 252. The court reasoned that due to the controversial nature of the transaction, Heizer must have been aware or any reasonable person would have been aware of the high probability of misleading the stockholders by failing to disclose the exact terms of the transaction. *Id.* The court also found that Heizer fulfilled the subjective portion of the *Franke* test because Heizer was conscious of the fact that full disclosure would not be made. *Id.* at 253.

In both *Sundstrand* and *Heizer* the courts imposed an affirmative duty on the defendants to make a full and fair disclosure because of their fiduciary positions. See *Wright v. Heizer Corp.*, 560 F.2d 236, 248; *Sundstrand v. Sun Chemical Corp.*, 553 F.2d 1033, 1043. Implication of a duty of disclosure when a special quasi-fiduciary or fiduciary relationship exists between transacting parties is well supported in the common law. See Prosser, *supra* note 171, at 697; Haimoff, *supra* note 170, at 164-66.

<sup>185</sup> 554 F.2d 790 (7th Cir. 1977).

result of the issuer's default."<sup>186</sup> Evidence at trial revealed that the issuer of the commercial paper, in collusion with its auditing firm, had fraudulently concealed its insolvent condition from the public.<sup>187</sup> The court found that Nuveen had breached its duty to its customers by failing to investigate the issuer or its auditing firm. In holding that Nuveen's breach was not reckless the court reasoned that its failure to investigate, which led to the omission, was not highly unreasonable because the danger of misleading customers by failing to investigate was neither known to the defendant nor so obvious that knowledge of the danger should be imputed.<sup>188</sup> Thus, the court's holding that Nuveen was not reckless was based on a finding that Nuveen's conduct did not fulfill the objective element of the *Franke* test. The danger of misleading buyers by failing to investigate the issuer was not so obvious and important that a reasonable man would have known of its significance.<sup>189</sup>

The Seventh Circuit's acceptance of recklessness as a form of scienter sufficient to support Rule 10b-5 liability is in accord with post-*Hochfelder* decisions,<sup>190</sup> and is well-supported by policy and common law analogy. The common law treated recklessness as a form of intentional behavior.<sup>191</sup> Continuation of this common law rule in 10b-5 cases will discourage reckless conduct, protect investors, and eliminate the possibility that professionals involved in securities transactions will incur tremendous liability for careless or inadvertent errors.

The *Franke* definition of recklessness as applied in *Sanders* and *Sundstrand* is well suited to distinguish conduct which is so highly unreasonable as to be a form of intentional behavior from that conduct which conceptually is closer to negligence. In *Sundstrand* the defendant neglected fiduciary duties<sup>192</sup> to disclose relatively obvious and important information and stood to benefit personally from the transaction.<sup>193</sup> By comparison, in

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<sup>186</sup> *Id.* at 792. This decision represented the Seventh Circuit's third consideration of the *Sanders* case. The Court had already held John Nuveen Company liable in *Sanders II*, 524 F.2d 1064 (7th Cir. 1975). The United States Supreme Court vacated that order and remanded the case for consideration in light of *Hochfelder*. *John Nuveen Co. v. Sanders*, 425 U.S. 929 (1976).

<sup>187</sup> The issuer, Winter & Hirsch, Inc., a finance company, was in collusion with its accounting firm Leiber, Bleiweis & Company. When a new accounting firm was employed to audit the issuer it was discovered that no federal income tax return had been filed for the previous year, that there was a \$14,000,000 deficiency in accounts receivable and unrecorded indebtedness of \$1,750,000. This fraud had been perpetrated over the course of ten years. *Sanders II*, 524 F.2d 1064, 1066-68 (7th Cir. 1975).

<sup>188</sup> 554 F.2d 790, 793.

<sup>189</sup> *Cf. Bucklo, Scienter And Rule 10b-5*, 67 Nw. U. L. Rev. 562, 567-71 (1973). In the context of material misrepresentations scienter should be interpreted to mean either actual or constructive knowledge of the facts. *Id.* at 569. Constructive knowledge should be found when a defendant's lack of knowledge results from conduct sufficiently unreasonable that knowledge will be attributed. *Id.* at 570.

<sup>190</sup> See note 170 *supra*.

<sup>191</sup> See PROSSER, note 171 *supra*, at 697 & 700-704.

<sup>192</sup> See note 176 *supra*.

<sup>193</sup> In *Sundstrand* Meers was to receive a \$150,000 fee as broker if the transaction was

*Sanders*, the defendant simply failed to investigate thoroughly enough to discover fraudulent activities that had already been successfully concealed for ten years. The fraudulent activities were not known or obvious to anyone nor was there ever a conscious decision not to reveal them. Thus the *Franke* two part test would impose liability for omissions and misrepresentations only where the danger of misleading others would be obvious to a reasonable man and the defendant's omission or misrepresentation is not accidental.

### C. Plaintiff's Duty of Due Care

While private actions under Rule 10b-5 are concerned primarily with a defendant's conduct in a securities transaction,<sup>194</sup> courts require that a plaintiff, in order to recover, act with reasonable care to protect himself. Courts have adopted four different approaches in imposing this duty of due care on a plaintiff. Some courts require a plaintiff to show affirmatively that his reliance on the misrepresentations of the defendant was reasonable or justifiable.<sup>195</sup> The second approach incorporates the plaintiff's duty of

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consummated. 553 F.2d at 1043. In *Heizer*, had IDC been unable to repay the loans, Heizer Corp. would have become entitled to 87% of the equity in the corporation. 560 F.2d at 244.

<sup>194</sup> To establish liability in a private action under Rule 10b-5, the plaintiff must show that the defendant made a material omission or misrepresentation, e.g., *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374 (2d Cir. 1974), *cert. denied*, 421 U.S. 976 (1975), and that the statement or omission was made with intent to defraud or with reckless disregard for the truth. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976). In the case of misrepresentation the plaintiff must show that he actually relied on the statement of the defendant, e.g., *Titan Group, Inc. v. Faggen*, 513 F.2d 234 (2d Cir.), *cert. denied*, 423 U.S. 840 (1975), while in cases involving omissions, once the omission is shown to be material, reliance is presumed. *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972). Additionally, many courts have imposed a duty of care on the plaintiff, which, if breached, bars the plaintiff from recovery. E.g., *Dupuy v. Dupuy*, 551 F.2d 1005 (5th Cir.), *cert. denied*, 98 S. Ct. 312 (1977); *Straub v. Viasman & Co.*, 540 F.2d 591 (3d Cir. 1976); *Vohs v. Dickson*, 495 F.2d 607 (5th Cir. 1974); *Rochez Bros. v. Rhoades*, 491 F.2d 402 (3d Cir. 1974); *Clement A. Evans & Co. v. McAlpine*, 434 F.2d 100 (5th Cir. 1970), *cert. denied*, 402 U.S. 988 (1971).

<sup>195</sup> See *City Nat'l Bank v. Vanderboom*, 422 F.2d 221 (8th Cir.), *cert. denied*, 399 U.S. 905 (1970). This case was based on alleged misrepresentations. The court reasoned that in order for a misrepresentation or omission to fall within the prohibitions of section 10(b) and Rule 10b-5 it must be made *in connection with* the purchase or sale of a security. *Id.* at 229. In order to satisfy the causation requirement, a misrepresentation must be one on which a reasonable investor, in light of the facts existing at the time of the misrepresentation and in the exercise of due care, would have been entitled to rely. *Id.* at 230. The court stated the test of causation for cases involving omissions as whether a reasonable investor, in light of the facts existing at the time of the omission and in the exercise of due care, would have been entitled to obtain full disclosure from the defendant and would have acted differently had the omission not occurred. *Id.* Under the *Vanderboom* analysis if a reasonable investor, with the knowledge of and in the circumstances of the plaintiff, would not have been entitled to rely on the defendant's misrepresentation by virtue of his ability to readily ascertain the truth, the misrepresentation would not be covered by section 10(b) even though the plaintiff might have actually relied on the misrepresentation. *Id.* at 230-31; see *Wheeler, Plaintiff's*

due care into the definition of the scope of the defendant's Rule 10b-5 duty of disclosure.<sup>196</sup> Thus, the defendant's duty to disclose will vary with plaintiff experience, knowledge and ability to protect himself. A third approach requires the plaintiff to show affirmatively, as a element of his prima facie case, that he acted with due care.<sup>197</sup> Finally, a fourth approach requires the defendant to raise the issue of the plaintiff's due diligence as an affirmative defense.<sup>198</sup> While each of these approaches is aimed at encouraging investor care in the securities market, disagreement over the better analysis continues.

Until recently, negligent conduct on the part of the plaintiff constituted a breach of his duty of due care and generally barred his recovery.<sup>199</sup> Because of the Supreme Court's recent holding in *Ernst & Ernst v. Hochfelder*,<sup>200</sup> that a plaintiff must show that a defendant's misleading conduct was either intentional or in reckless disregard of the truth,<sup>201</sup> seri-

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*Duty of Due Care Under Rule 10b-5: An Implied Defense to An Implied Remedy*, 70 Nw. U. L. Rev. 561, 570-71 (1976) [hereinafter cited as Wheeler].

The effect of this approach is to make the existence of a section 10(b) and Rule 10b-5 violation dependent on the relative business sophistication, acumen, or access to facts of the particular plaintiff. 422 F.2d at 230 n.10. The *Vanderboom* approach also imposes on the plaintiff a duty to investigate in order to ascertain the truth. See Wheeler, *supra* note 195, at 571.

<sup>196</sup> See *White v. Abrams*, 495 F.2d 724 (9th Cir. 1974); *Aber v. Essex Wire Corp.*, 490 F.2d 414 (6th Cir.), cert. denied, 419 U.S. 830 (1974). In *Essex Wire Corp.*, sellers of stock in a closely held corporation alleged that the purchaser of the stock, who was the president of the corporation, had failed to disclose the book value of the stock. The court held that the president had no affirmative duty to disclose or direct the seller's attention to readily available information which is not of an extraordinary nature. *Id.* at 420. The language of the court limited the defendant's duty to disclose where the investor had access to facts and made no inquiry. *Id.* By implication, the court's analysis leads to the conclusion that the defendant would have had a duty to disclose the information in question to plaintiffs who did not have ready access to the information. See *Id.* at 420-21. Thus, the variable duty of disclosure approach, like the justifiable reliance approach, see note 195 *supra*, premises the existence of a Rule 10b-5 violation on the position and status of the plaintiff.

<sup>197</sup> See *Dupuy v. Dupuy*, 551 F.2d 1005 (5th Cir. 1977); *Clement A. Evans & Co. v. McAlpine*, 434 F.2d 100 (5th Cir. 1970). In *Dupuy* the Fifth Circuit reaffirmed its adherence to the *McAlpine* approach. 551 F.2d at 1016. The *McAlpine* approach as adopted by the *Dupuy* court does not specifically label the plaintiff's duty of due care as an affirmative defense. Thus, it appears that in the Fifth Circuit, after *Dupuy*, the plaintiff must bear the burdens of production and proof in showing his own behavior was not reckless. *But see* Wheeler, *supra* note 195, at 590 (suggesting *McAlpine* adopts due care as an affirmative defense).

<sup>198</sup> See *Straub v. Viasman & Co.*, 540 F.2d 591, 598 (3d Cir. 1976).

<sup>199</sup> See, e.g., *Clement A. Evans & Co. v. McAlpine*, 434 F.2d 100 (5th Cir. 1970) (plaintiff denied recovery for failure to investigate series of bounced checks in scheme where investors intentionally defrauded plaintiff); *City Nat'l Bank v. Vanderboom*, 422 F.2d 221 (8th Cir. 1970) (purchasers of corporation denied recovery where seller intentionally made misleading statements but plaintiffs had failed to avail themselves of the opportunity to obtain concealed and misrepresented information).

<sup>200</sup> 425 U.S. 185 (1976).

<sup>201</sup> The *Hochfelder* Court specifically held that Rule 10b-5 liability must be founded on an allegation of intent to deceive, manipulate or defraud. *Id.* at 214. While the Court ruled out negligence as a basis for Rule 10b-5 liability, it expressly reserved the question whether

ous objections have been raised concerning whether the due care requirement is equitable.<sup>202</sup> The objections are founded on the apparent unfairness of requiring a plaintiff to prove that the defendant's misconduct was intentional, but foreclosing the plaintiff from recovery if he acted negligently. The countervailing policy supporting the apparent inequity is encouragement of investor care and self-protection in the securities market.

Recently, in *Dupuy v. Dupuy*,<sup>203</sup> the Fifth Circuit evaluated the state of the law concerning a plaintiff's duty of due care. The court carefully analyzed the various approaches courts have adopted to impose a duty of due care on the plaintiff.<sup>204</sup> The court also evaluated the policy of barring negligent plaintiffs from recovery when they had been intentionally or recklessly defrauded.<sup>205</sup>

*Dupuy* involved a suit between two brothers who had been business partners in a number of ventures.<sup>206</sup> The case arose as a result of a transaction whereby Clarence Dupuy purchased Milton Dupuy's half interest in Lori Corporation.<sup>207</sup> The jury found that Clarence Dupuy had intentionally misrepresented the financial prospects of Lori Corporation in order to purchase his brother's interest for a depressed price.<sup>208</sup> The jury also found that Milton Dupuy, the plaintiff, had exercised due care in the sale of his stock.<sup>209</sup> The trial judge granted judgment n.o.v., ruling that there was no

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misrepresentations or omissions made with reckless disregard of the truth would support Rule 10b-5 liability. *Id.* at 194 n.12. Courts that have addressed the question have uniformly held that Rule 10b-5 liability could be founded on an allegation of recklessness. *See, e.g.,* *Wright v. Heizer Corp.*, 560 F.2d 236 (7th Cir. 1977); *Bailey v. Meister Brau, Inc.*, 535 F.2d 982 (7th Cir. 1976); *Herzfeld v. Laventhal, Krekstein, Horwath & Horwath*, 540 F.2d 22 (2d Cir. 1976); *see* text accompanying notes 168-93 *supra*.

<sup>202</sup> *See* *Holdsworth v. Strong*, 545 F.2d 687, 689-93 (10th Cir. 1976); *Straub v. Vaisman & Co.*, 540 F.2d 591, 597 (3d Cir. 1976); *McLean v. Alexander*, 420 F. Supp. 1057, 1078 (D. Del. 1976); Comment, *Due Care: Still a Limitation on 10b-5 Recovery?*, 61 MARQ. L. REV. 122, 125 (1977).

<sup>203</sup> 551 F.2d 1005 (5th Cir. 1977).

<sup>204</sup> *Id.* at 1013-16.

<sup>205</sup> *Id.* at 1017-20.

<sup>206</sup> In 1971 the Dupuy brothers were involved in four business associations as partners or major stockholders, mostly involving real estate. Clarence, the older of the two, generally dominated both their personal and business relationships. *Id.* at 1008.

<sup>207</sup> In 1971 the brothers formed Lori Corporation, each contributing \$1,880 and receiving 47 percent of its stock. Their mother received the other 6 percent. Milton was president, Clarence was secretary-treasurer and their mother was vice-president. The corporation acquired a long-term lease on a lot intending to build a hotel on it. Milton supervised the venture, dealing with the architects and bankers involved in the project. In 1972, Clarence, who controlled the check book, discontinued Milton's salary. At about the same time Milton began to experience serious health problems. Lacking income from his business ventures and in need of money, Milton asked Clarence to purchase his interest in Lori Corporation. Subsequently, Clarence obtained financing beginning with the hotel project but did not inform Milton of this development, instead representing to him that the project was in financial trouble. Finally Milton sold his stock to Clarence for \$45,000. Two months earlier, after obtaining financing, Clarence had estimated the value of his own interest in the corporation at \$493,250. 551 F.2d at 1008-11.

<sup>208</sup> *Id.* at 1007.

<sup>209</sup> *Id.* at 1007-08.

evidence from which the jury could have inferred that Milton had acted with diligence.<sup>210</sup> The case was appealed on the issue whether Milton, who was president of Lori Corporation, exercised due care in the transaction.

The Fifth Circuit first considered the approaches adopted by other courts to impose a duty of due care on the plaintiffs. One approach employed by several courts has made the scope of the defendant's Rule 10b-5 duty of disclosure dependent upon the relative sophistication and knowledge of the plaintiff.<sup>211</sup> Essentially, this approach imposes a high duty of due care on the sophisticated investor and a lesser duty on the unsophisticated investor. This result, however, is accomplished by imposing a lesser Rule 10b-5 duty of disclosure on defendant's dealing with sophisticated and knowledgeable investors. Thus, under this analysis, whether a defendant has violated Rule 10b-5 by failing to disclose material information hinges on the relative sophistication of the plaintiff.<sup>212</sup> The *Dupuy* court rejected this approach reasoning that a duty of disclosure that varied with the sophistication of the plaintiff would engender uncertainty as to the duty imposed by Rule 10b-5.<sup>213</sup>

The second approach rejected by the *Dupuy* court requires that a plaintiff demonstrate that his reliance on the misrepresentations of the defendant was "justifiable."<sup>214</sup> This approach was applied in a material misrepresentation case and is based on the "in connection with the purchase or sale" clause of Rule 10b-5.<sup>215</sup> The "in connection with" language of Rule 10b-5 requires that the plaintiff, as part of his prima facie case, show that the defendant's misrepresentations affected or caused his behavior.<sup>216</sup> This

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<sup>210</sup> *Id.*

<sup>211</sup> See *White v. Abrams*, 495 F.2d 724 (9th Cir. 1974); *Arber v. Essex Wire Corp.*, 490 F.2d 414 (6th Cir.), *cert. denied*, 419 U.S. 830 (1974); note 196 *supra*. In *White* the court applied a flexible duty approach. Under a flexible duty approach a defendant's Rule 10b-5 duty to disclose would depend on such factors as the relationship of the defendant to the plaintiff, the defendant's access to the information as compared to the plaintiff's access, the benefit that the defendant derives from the relationship, and the defendant's awareness of whether the plaintiff was relying upon their relationship in making his investment decisions. 495 F.2d at 735.

<sup>212</sup> Under the flexible duty analysis, if a defendant failed to disclose information which a sophisticated plaintiff was easily able to obtain and understand, the defendant would not have violated Rule 10b-5. Yet, if a defendant failed to disclose the same information to an unsophisticated plaintiff unaware of its existence, there would be a violation of the Rule. Thus, whether Rule 10b-5 is violated depends on the knowledge and status of the plaintiff. See *Wheeler*, *supra* note 195, at 572-73.

<sup>213</sup> 551 F.2d at 1015. The court also noted that a flexible standard approach would promote a degree of gamesmanship in securities transactions by permitting the securities investor to vary his disclosures depending upon the sophistication of the party with whom he is dealing. *Id.* Finally the court reasoned that creation of a clear and unified Rule 10b-5 standard of disclosure is clearly a desirable result benefitting both those involved in securities transactions and courts that must administer the Rule. *Id.*

<sup>214</sup> See *Holdsworth v. Strong*, 545 F.2d 687 (10th Cir. 1976); *City Nat'l Bank v. Vanderboom*, 422 F.2d 221 (8th Cir. 1970); note 195 *supra*.

<sup>215</sup> See § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j (1976), *quoted in* note 3 *supra*.

<sup>216</sup> See *Heit v. Weitzen*, 402 F.2d 909, 913 (2d Cir. 1968), *cert. denied*, 395 U.S. 903 (1969).

is a reliance or causation requirement. In order to establish causation the plaintiff must also show that his reliance was reasonable or justifiable in view of his own knowledge and information readily available to him.<sup>217</sup> If the plaintiff's reliance is not justifiable the plaintiff has, under this analysis, failed to establish the reliance required by the "in connection with" clause of Rule 10b-5 and thus, the defendant's misrepresentations do not fall within the statutory coverage of Rule 10b-5.<sup>218</sup> The difficulty with analyzing plaintiff's behavior in terms of reliance, as the *Dupuy* court perceived it, was that such an approach would lead to an unwarranted distinction between misrepresentation and omission cases. In omission cases the plaintiff is not required to prove reliance; if a plaintiff shows a material omission, reliance is presumed.<sup>219</sup> The Fifth Circuit reasoned that since positive proof of reliance is no longer required in omission cases, courts are precluded from determining whether a plaintiff's reliance is justifiable. Therefore, under the justifiable reliance approach, plaintiffs in omission cases would be relieved of the burden of showing due care. In light of the purposes of the due care requirement in Rule 10b-5 actions, the court reasoned that a plaintiff should be held to the same standard of conduct regardless of whether the action was founded on a misrepresentation or an omission.<sup>220</sup> Another more compelling reason to reject the justifiable reliance approach is that it effectively conditions the existence of Rule 10b-5 violations on the knowledge and availability of facts to the plaintiff,<sup>221</sup> a result that creates uncertainty as to the standards imposed by Rule 10b-5.

A third approach implicitly rejected by *Dupuy* treated the issue of the plaintiff's duty of due care as an affirmative defense.<sup>222</sup> Under this approach a plaintiff need not show due care as an element of his cause of action and the defendant bears the burdens of production and proof in showing the plaintiff failed to exercise the requisite due care.<sup>223</sup>

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<sup>217</sup> The justifiable reliance approach imposes an affirmative duty on the investor make a reasonable investigation of sources and materials available. If facts in the available information would have put the plaintiff on notice of the alleged misrepresentation, he will be barred from recovery. See Wheeler, *supra* note 195, at 571.

<sup>218</sup> See City Nat'l Bank v. Vanderboom, 422 F.2d 221, 229 (8th Cir. 1970); note 195 *supra*.

<sup>219</sup> See *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972). In *Affiliated Ute* the Court specifically held that in Rule 10b-5 cases involving a failure to disclose, positive proof of reliance is not a prerequisite to recovery. The plaintiff need only show that the undisclosed facts were material. Once materiality is shown, causation is presumed. *Id.* at 150-54. See generally Note, *The Reliance Requirement in Private Actions Under SEC Rule 10b-5*, 88 HARV. L. REV. 584 (1975); 29 VAND. L. REV. 287 (1976).

<sup>220</sup> 551 F.2d at 1015-16.

<sup>221</sup> See City Nat'l Bank v. Vanderboom, 422 F.2d 221, 229-31 n.10 (8th Cir. 1970); note 195 *supra*. For example, if a defendant made a fraudulent misrepresentation as to a material fact and the plaintiffs had ready access to the truth it would seem clear that the defendants had violated Rule 10b-5; yet under the reasonable reliance analysis if the court found that the plaintiff's reliance was not reasonable, the statutory causation requirement would not be fulfilled and there would be no violation of Rule 10b-5. See Wheeler, *supra* note 195, at 591.

<sup>222</sup> See *Straub v. Vaisman*, 540 F.2d 591 (3d Cir. 1976).

<sup>223</sup> See 1976-1977 *Developments*, *supra* note 5, at 926-27.

The *Dupuy* court chose to treat the element of the plaintiff's duty of due care as a separate part of the plaintiff's prima facie case, thus requiring the plaintiff to bear the burdens of production and proof on the issue whether he acted with due care. This approach, the court reasoned, would allow a court to assess independently the plaintiff's conduct without engendering the distinction between misrepresentation and omission cases which characterized the justifiable reliance approach.<sup>224</sup> This distinction would be avoided because the plaintiff would have to show due care regardless of whether he had to show reliance. The court also noted that an independent assessment of the plaintiff's behavior would not create a variable standard of conduct for defendants.<sup>225</sup> Under the *Dupuy* approach, whether a defendant violated his Rule 10b-5 duty of disclosure would not depend on the sophistication of the plaintiff. First the court would decide whether the defendant violated Rule 10b-5, and then the court would determine whether, because he failed to exercise due care, the plaintiff should be barred from recovery.

The *Dupuy* court then reconsidered the standard of care imposed by the plaintiff's duty of due care in light of the *Hochfelder* holding that a plaintiff must show intentional or reckless conduct on the part of the defendant.<sup>226</sup> Prior to *Hochfelder* the standard was one of reasonableness. If a plaintiff acted negligently in a securities transaction he would be barred from recovery. In *Dupuy* the Fifth Circuit rejected the negligence standard and held that the same standard of care would be imposed on both the plaintiff and the defendant in Rule 10b-5 cases.<sup>227</sup> Allowing negligent plaintiffs to recover from fraudulent defendants is in keeping with common law tort theory.<sup>228</sup> Noting that common law tort theory<sup>229</sup> recognized that the policy of deterring intentional misconduct outweighed the policy of deterring negligent behavior,<sup>230</sup> the *Dupuy* court followed the lead of other circuits which have reconsidered the plaintiff's duty of due care in light of *Hochfelder* and lowered the standard to recklessness to discourage intentional fraud.<sup>231</sup> Thus, under the Fifth Circuit's view of the plaintiff's duty of due care high standards of defendant conduct under Rule 10b-5 are promoted.<sup>232</sup>

<sup>224</sup> 551 F.2d at 1015-16; see note 196 *supra*.

<sup>225</sup> 551 F.2d at 1015-16.

<sup>226</sup> *Id.* at 1017-20.

<sup>227</sup> *Id.* at 1020.

<sup>228</sup> See W. PROSSER, HANDBOOK OF THE LAW OF TORTS § 108 at 716 (4th ed. 1971) [hereinafter cited as PROSSER]; RESTATEMENT OF TORTS § 540 (1938).

<sup>229</sup> See PROSSER, *supra* note 228, at 709 & 716.

<sup>230</sup> 551 F.2d at 1018; see PROSSER, *supra* note 228, § 65 at 426, & § 108 at 717.

<sup>231</sup> 551 F.2d at 1018-19. The *Dupuy* court cited two other reasons for lowering the plaintiff's standard of due care to recklessness. *Id.*

<sup>232</sup> The affirmative defense approach adopted by *Straub v. Vaisman*, 540 F.2d 591 (3d Cir. 1976) promotes conceptual clarity as well as the *Dupuy* approach. The *Dupuy* approach is better reasoned because, due to the standard of care imposed on plaintiffs, it is better able to deter fraudulent behavior in securities transactions. See text accompanying note 233 *infra*.



The court's decision to allow a negligent plaintiff to recover under Rule 10b-5 is also well reasoned. This holding is a strong deterrent against intentional fraud in securities transactions because it allows private plaintiffs to continue their role in enforcing the securities laws by reducing the number of situations where they will be barred from recovery.<sup>233</sup> Allowing negligent plaintiffs to recover does not encourage investor care to the same extent as does a rule barring negligent plaintiffs from recovery. The *Dupuy* rule, however, is supported by the common law policy of placing greater importance on deterrence of fraudulent behavior as opposed to negligent behavior, a policy which should be implemented in the complicated securities market.

#### D. Rule 10b-5 and Corporate Mismanagement

In *Santa Fe Industries, Inc. v. Green*,<sup>234</sup> the Supreme Court restricted the role of Rule 10b-5 in remedying corporate mismanagement by refusing to impose a substantive federal fiduciary obligation on corporate officials, insiders and controlling shareholders. After *Santa Fe*, no Rule 10b-5 action will lie unless the conduct characterized by plaintiffs as "fraud" in connection with the purchase or sale of securities involves deception or manipulation within the meaning of section 10(b) of the '34 Act.<sup>235</sup> With this decision, the Supreme Court continued to restrict the availability of the Rule 10b-5 private action<sup>236</sup> and declined to develop a body of substantive federal corporation law based on existing securities laws.<sup>237</sup>

In *Santa Fe*, the Court held that a breach of fiduciary duty by majority stockholders in a "going private" short form merger<sup>238</sup> was not actionable

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<sup>233</sup> Cf. *Perma Life Mufflers, Inc. v. International Parts Corp.*, 392 U.S. 134, 138-40 (1968) (nothing in antitrust laws indicates a congressional intent that plaintiff misconduct should constitute a defense to a private antitrust action; to bar recovery for plaintiff misconduct would undermine important function performed by private antitrust action in enforcing the antitrust laws).

<sup>234</sup> 430 U.S. 462 (1977).

<sup>235</sup> 15 U.S.C. 78j(b) (1970); see note 3 *supra*.

<sup>236</sup> See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975); note 1 *supra*.

<sup>237</sup> See *1976-1977 Developments*, *supra* note 5, at 936-37 nn. 328 & 329.

<sup>238</sup> A "going private" transaction is one in which the controlling interest in a corporation eliminated public ownership while continuing control of the enterprise as a closely held corporation. See generally, Borden, *Going Private - Old Tort, New Tort or No Tort?* 49 N.Y.U.L. REV. 987 (1974); Brudney, *A Note on "Going Private,"* 61 VA. L. REV. 1019 (1975); Note, *Going Private*, 84 YALE L.J. 903 (1975). A "going private" transaction typically is accomplished by a cash tender offer or debt security exchange offer by the corporation to the public shareholders who did not voluntarily relinquish their shares pursuant to such offers. Frequently, the "freeze-out" is accomplished by executing a short form merger under state merger statutes which allow the controlling interest of a corporation to eliminate public ownership without obtaining minority shareholder approval. See generally Greene, *Corporate Freeze-Out Mergers: A Proposed Analysis*, 28 STAN. L. REV. 487 (1976).

The potential for unfairness in "going private" transactions utilizing a state short form

under Rule 10b-5 absent allegations of deception, misrepresentation or nondisclosure.<sup>239</sup> The Supreme Court's elimination of breach of fiduciary

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merger statute provided the impetus for minority public shareholders to seek relief in private actions under Rule 10b-5. See, O'Neal & Janke, *Utilizing Rule 10b-5 for Remedying Squeeze-Out or Oppression of Minority Shareholders*, 16 B.C. IND. & COM. L. REV. 327 (1975) [hereinafter cited as O'Neal & Janke]. Where the merger statute has been followed, state remedies are limited to state court appraisal of the value of the stock, see e.g., DEL. CODE ANN. tit. 8 § 262 (Cum. Supp. 1976); N.Y. BUS. CORP. LAW § 623 (McKinney) [1963 & Supp. 1976-77], and injunctive relief for breach of fiduciary duty. See Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663 (1974). The inadequacy of state law remedies for "squeezed" minority shareholders has been widely criticized by commentators. See, e.g., F. O'NEAL, "SQUEEZE OUTS" OF MINORITY SHAREHOLDERS: EXPULSION OR OPPRESSION OF BUSINESS ASSOCIATES (1976); O'Neal & Janke; *supra* at 343-45. See generally Borden, *supra*; Solomon, *Going Private: Business Practices, Legal Mechanics, Judicial Standards and Proposals for Reform*, 25 BUFFALO L. REV. 141 (1975); Vorenberg, *Exclusiveness of the Dissenting Stockholder's Appraisal Right*, 77 HARV. L. REV. 1189 (1964).

In *Santa Fe*, the defendants complied fully with the Delaware short form merger statute, DEL. CODE ANN. tit. 8 § 253 (Cum. Supp. 1976), which permits a parent company owning at least 90% of the stock of a subsidiary to buy out the minority interest without prior notice to the shareholders or a justifiable business purpose. A subsidiary of Santa Fe owned 95% of the capital stock of Kirby Lumber Corp., a public corporation, which was merged with a shell corporation created by Santa Fe Industries for the sole purpose of eliminating the 5% minority public shareholders. 430 U.S. at 465. The notification statement sent to the minority shareholders the day after consummation of the merger explained the terms of the merger and informed the shareholders that they must exchange their shares for cash and that if dissatisfied with the exchange rate, they could seek appraisal of the value of the stock in state court. *Id.* at 466.

<sup>239</sup> The Second Circuit Court of Appeals had ruled in favor of the plaintiff, holding that consummation of a short form merger which lacked a justifiable business purpose violated Rule 10b-5 as a breach of the majority stockholder's duty of fair dealing to the minority. *Green v. Santa Fe Indus., Inc.*, 533 F.2d 1283, 1291 (2d Cir. 1976), *rev'g* 391 F. Supp. 849 (S.D.N.Y. 1975). The absence of misrepresentation or nondisclosure was held not fatal to the Rule 10b-5 claim where the controlling shareholder paid an unfairly low price for outstanding shares, failed to give the minority shareholders prior notice of the merger, and had no valid business justification for the elimination of minority public shareholders. 533 F.2d at 1291. For pre-*Santa Fe* discussions on whether Rule 10b-5 should be interpreted to require fair dealing between majority and minority shareholders, compare Note, *The Second Circuit Adopts a Business Purpose Test for Going Private: Marshel v. AFW Fabric Corp. and Green v. Santa Fe Industries, Inc.*, 64 CAL. L. REV. 1184 (1976) (favoring adoption of business purpose test under Rule 10b-5) with Note, *Securities Acts - Securities Exchange Act of 1934 - Majority Stockholders' Elimination of Minority Through Merger Without Legitimate Business Purpose Violates Rule 10b-5 Notwithstanding Full Disclosure*, 89 HARV. L. REV. 1917 (1976) (business purpose test is inappropriate and confusing under 10b-5).

In reversing the circuit court, the Supreme Court relied upon the congressional intent behind the language of section 10(b) of the '34 Act and considerations of policy against extending Rule 10b-5 into an area traditionally regulated by state corporation law. The majority opinion emphasized that the meaning of the statutory provision must be derived primarily from the statutory language itself. 430 U.S. at 472. The Court reasoned that the "fraud" covered by § 10(b) is stated clearly in terms of deception and manipulation. *Id.* at 473. In the absence of legislative history revealing an expansive congressional intent, the plain meaning of the statutory language controlled the Court's interpretation. *Id.* Thus, the Court declined to infer that Congress meant to include breach of fiduciary duty within the fraud covered by Rule 10b-5.

The *Santa Fe* Court held that there was no deception since the information statement

duty as a basis for Rule 10b-5 liability has shifted the focus of mismanagement suits to the element of deception. Reaffirmation of the deception requirement raises two issues the resolution of which will determine the impact of *Santa Fe* on corporate mismanagement suits pursued under Rule 10b-5. First, can a corporation be "deceived" by its self-dealing directors, and second, does nondisclosure of an unfair securities transaction by a self-dealing board of directors constitute "deception" sufficient to invoke Rule 10b-5. During the past year lower courts have considered these issues.

With the affirmation of the deception requirement, courts faced with shareholder derivative actions<sup>240</sup> must determine the "degree to which the knowledge of officers and directors must be attributed to the corporation,

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accompanying the merger contained no "omission" or "misstatement." *Id.* at 474. Thus, the Court found inapposite the array of cases relied upon by the respondent and the Second Circuit in which breaches of fiduciary duty in violation of Rule 10b-5 included some element of deception. *Id.* at 474-75 n.15. Furthermore, the Court found no manipulation. The Court recognized that the term "manipulation" as used in § 10(b) is a term of art which refers to practices intended to mislead investors by artificially affecting market activity. *Id.* at 476. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 (1975). See generally A. JACOBS, *supra* note 11, at §§ 138-41; BROMBERG, *supra* note 107, at § 7.3. Since the conduct alleged in *Santa Fe* was essentially corporate mismanagement, the unfair treatment of the minority shareholders by the fiduciary was not manipulation. 430 U.S. at 477. Finding that the conduct complained of in *Santa Fe* was neither deceptive nor manipulative, the Supreme Court held that the plaintiff failed to properly state a Rule 10b-5 cause of action.

In addition to the statutory analysis based on the language of section 10(b), the *Santa Fe* Court supported its strict interpretation of the meaning of fraud with several policy justifications. First, the Court noted that the central purpose of the federal securities laws is to fulfill the philosophy of full disclosure in connection with securities transactions and that the reach of the implied private action under Rule 10b-5 should be limited to the implementation of this philosophy. 430 U.S. at 477-78. Thus, where there has been full and fair disclosure, the ultimate fairness of a securities transaction is beyond the principal congressional purpose of the antifraud provisions. *Id.* at 478. Second, the potential for broad overlap and interference with traditional state regulation of corporations militated against expanding an implied federal right of action. The Court found that the conduct alleged in *Santa Fe* was indistinguishable from a wide variety of corporate self-dealing and unfairness traditionally regulated by state corporation law. *Id.* Affirmation of the circuit court decision would have brought within the purview of federal securities laws a substantial portion of state corporation law. In the absence of a clear congressional intent to accomplish this result, the Supreme Court refused to expand the jurisdiction of federal courts in the area of substantive corporation law.

<sup>240</sup> Although only defrauded purchasers or sellers of securities have standing to sue under Rule 10b-5, *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), the rule protects corporations as well as individuals who purchase or sell securities. See *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 10 (1971). Thus a shareholder may sue derivatively to assert the rights of a corporation that has been defrauded in connection with the purchase or sale of securities. See generally, H. BLOOMENTHAL, 3B SECURITIES AND FEDERAL CORPORATE LAW § 11.20 (1974). The issue of what constitutes deception of the corporation arises in shareholder derivative actions rather than in damage actions against the corporation. In derivative actions, the plaintiff asserts only the rights of the corporation and, therefore, must show that the corporation was defrauded. After *Santa Fe*, this burden is met only by proving deception or manipulation. In damages actions against a corporation, such as in *Santa Fe* where the plaintiff shareholders had been forced out under a short form merger statute, see note 238 *supra*, the plaintiffs must demonstrate that they were deceived. See note 239 *supra*. The issue of deception of the corporation does not arise in this situation.

thereby negating the element of deception."<sup>241</sup> In *Goldberg v. Meridor*,<sup>242</sup> the Second Circuit considered whether a corporation was deceived within the meaning of Rule 10b-5 when the controlling shareholder influenced the corporation to enter into a transaction that was grossly unfair to the corporation and the material facts of the transaction were either not disclosed or misrepresented to minority shareholders. In *Meridor*, a minority shareholder of Universal Gas & Oil, Inc. (UGO) brought a derivative action against the controlling parent corporation and several directors of UGO and the parent.<sup>243</sup> The plaintiff alleged that a contract executed between the two corporations providing for the issuance of UGO stock to the parent and the assumption of all the parent's liabilities by UGO in exchange for the transfer of the assets of the parent to UGO was adverse to the interests of UGO.<sup>244</sup> The transaction allegedly caused the dissipation of UGO's assets since the liabilities assumed by UGO exceeded the value of the assets received from the parent.<sup>245</sup> The plaintiff argued that such self-dealing in connection with nondisclosure and misrepresentation of the material facts of the transaction violated Rule 10b-5.<sup>246</sup>

The Second Circuit held that UGO had been "deceived" within the meaning of Rule 10b-5 even though the terms of the stock-for-assets transaction were fully disclosed to UGO's board of directors and prior shareholder approval of the transaction was not required by state law.<sup>247</sup> The court held that nondisclosure of the terms of the transaction to minority shareholders operated as a deception of the subsidiary under Rule 10b-5.<sup>248</sup> The court relied on pre-*Santa Fe* decisions finding Rule 10b-5 liability where dominant directors or shareholders exercising a controlling influence

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<sup>241</sup> *Goldberg v. Meridor*, 567 F.2d 209, 215 (2d Cir. 1977), *cert. denied*, 98 S.Ct. 1249 (1978).

<sup>242</sup> *Id.*

<sup>243</sup> *Id.* at 211. Universal Gas & Oil Co., Inc. is a Panama corporation having its principal place of business in New York City. *Id.* The defendants in the action were Maritimecor, S.A., also a Panama corporation and UGO's controlling parent, Maritime Fruit Carriers Co. Ltd., an Israel corporation and Maritimecor's controlling parent, a number of individuals who were directors of one or more of these companies, and an investment firm and an accounting firm. *Id.*

<sup>244</sup> Under the agreement, UGO issued to its parent corporation up to 4.2 million shares of UGO stock and assumed 42.5 million dollars in liabilities. In addition, a 7 million dollar debt owing from the parent to UGO was apparently forgiven. *Id.* UGO received, in consideration, all of the parent's assets except UGO shares already held by the parent. *Id.* Net shareholder equity in the parent corporation was 40.4 million dollars. *Id.* at 212 n.1.

<sup>245</sup> Since the shareholders' net equity in the parent was 40.4 million dollars, UGO assumed liabilities several million dollars in excess of the value of the assets transferred to it. *Id.* at 212 n.1.

<sup>246</sup> The parent publicly issued two press releases which described the agreement and consummation of the transaction, but allegedly failed to disclose the facts of the transaction and the conflict of interest of the principals. *Id.* at 212. Further, the press releases allegedly misrepresented the actual effect of the transaction, which was the dissipation of UGO's assets, by describing UGO as replacing the parent as the principal operating subsidiary of Maritime Fruit Company. *Id.*

<sup>247</sup> 567 F.2d at 211-12.

<sup>248</sup> *Id.* at 218.

over a corporation caused the corporation to engage in a securities transaction adverse to its interest.<sup>249</sup> The Second Circuit had previously applied this "controlling influence plus unfairness" doctrine as a means of establishing fraud in Rule 10b-5 derivative actions without having to conclude that corporations were actually deceived in some way.<sup>250</sup> The *Meridor* court

<sup>249</sup> See *id.* at 214-18.

<sup>250</sup> The "controlling influence plus unfairness" standard was first announced in *Schoenbaum v. Firstbrook*, 405 F.2d 215 (2d Cir. 1968) (en banc), *cert. denied*, 395 U.S. 906 (1969). See generally Note, *The Controlling Influence Standard in Rule 10b-5 Corporate Mismanagement Cases*, 86 HARV. L. REV. 1007 (1973) [hereinafter cited as *Controlling Influence Standard*]; Comment, *Schoenbaum v. Firstbrook: The "New Fraud" Expands Federal Corporation Law*, 55 VA. L. REV. 1103 (1969) [hereinafter cited as *New Fraud*]. The *Schoenbaum* court rejected the traditional deception requirement and established "controlling influence plus unfairness" as fraud under Rule 10b-5 apart from deception or manipulation. See generally BROMBERG, *supra* note 107, at § 4.7 (623) (Supp. 1974); Jacobs, *The Role of Securities Exchange Act Rule 10b-5 in the Regulation of Corporate Management*, 59 CORNELL L. REV. 27, 57-61 (1973). Prior to *Schoenbaum*, in the area of corporate transactions involving conflict situations, see BROMBERG, *supra* note 107, at § 4.7 (542), common law concepts of actual deception and reliance had proved to be obstacles to establishing Rule 10b-5 liability. When the board of directors of a defrauded corporation were implicated in the fraud, deception of the corporation was impossible since traditional theory holds that the board of directors is the corporation, see BROMBERG, *supra* note 107, at § 4.7 (623), and a corporation cannot deceive itself. See, *New Fraud*, *supra* this note, at 1104 n.10; see, e.g., *O'Neill v. Maytag*, 339 F.2d 764 (2d Cir. 1964) (Rule 10b-5 inapplicable; no deception where entire board of directors approved repurchase of corporation's own stock for excessive consideration and improper purposes). Prior to *Santa Fe*, however, several courts devised legal fictions to circumvent the deception limitation. In *Ruckle v. Roto Corp.*, 339 F.2d 24 (2d Cir. 1964), the Second Circuit held that the deception of a minority of the board of directors in the issuance of stock to several directors for inadequate consideration "deceived" the corporation. The court rejected the notion that the directors constituted the corporation, and thus was incapable of defrauding itself. *Id.* at 29. Relying on *Ruckle*, the Seventh Circuit refused "to differentiate between situations where the directors were unanimous in wrongdoing and those where less than all were involved." *Dasho v. Susquehanna Corp.*, 380 F.2d 262 (7th Cir. 1967). In *Pappas v. Moss*, 393 F.2d 865 (3d Cir. 1968), the court stated that if deception of the corporation is a requisite element of a 10b-5 private action, such deception may be found by viewing the fraud as occurring against the independent shareholders standing in place of the defrauded entity. *Id.* at 869.

Under the "controlling influence plus unfairness" standard, disclosure of material facts of a transaction to the entire board of directors does not negate deception of the corporation for the purposes of Rule 10b-5 where there is also a duty to disclose directly to the shareholders. Thus, when an entire board of directors is controlled by a self-dealing director or shareholder, or the directors have a financial interest in the transaction, the corporation can be represented only by the independent shareholders to whom full disclosure must be made. *Wright v. Heizer Corp.*, 560 F.2d 236, 249 (7th Cir. 1977), *cert. denied* 98 S.Ct. 1243 (1978); see *Dasho v. Susquehanna Corp.*, 461 F.2d 11, 26 (7th Cir.), *cert. denied*, 408 U.S. 925 (1975); *Schoenbaum v. Firstbrook*, 405 F.2d 215, 219-20 (2d Cir. 1968); *Pappas v. Moss*, 393 F.2d 865, 869 (3d Cir. 1968); *Ruckle v. Roto Corp.*, 339 F.2d 24, 26, 29 (2d Cir. 1964). Similarly, where shareholder approval of a transaction is required by state law, the shareholders are deemed to represent the corporation and are entitled to disclosure of all material facts relating to the transaction. *Wright v. Heizer Corp.*, 560 F.2d 236, 247 (7th Cir. 1977); see *Dasho v. Susquehanna Corp.*, 461 F.2d 11, 24 (7th Cir. 1972); *Popkin v. Bishop*, 464 F.2d 714, 720 (2d Cir. 1972). See generally Sherrard, *Fiduciaries and Fairness Under Rule 10b-5*, 29 VAND. L. REV. 1385, 1427 (1976). On the other hand, where a disinterested majority of a board is fully informed of all relevant facts pertaining to a transaction, disclosure to the board of directors

recognized, however, that after *Santa Fe*, the "controlling influence plus unfairness" doctrine is, alone, insufficient to form the basis of Rule 10b-5 liability absent some showing of deception or manipulation.<sup>251</sup> The *Meridor* court ruled, however, that the deception requirement was satisfied when the controlling corporation, which caused UGO to sell its securities to the parent for inadequate consideration, failed to disclose the material facts of the transaction to the UGO stockholders.<sup>252</sup>

The court then rejected the defendant's argument that the alleged misleading disclosure was not material since the shareholders were not required to approve the transaction and the plaintiff failed to allege how he would have acted had he known the essential facts.<sup>253</sup> The *Meridor* court held that in Rule 10b-5 actions, undisclosed or misleadingly disclosed facts are material if they would have assumed actual significance in the deliberations of reasonable and disinterested directors or would have created a substantial likelihood that such directors would have considered the total mix of information available to be significantly altered.<sup>254</sup> Applying this test to the facts, the court held that a reasonable director of UGO, having knowledge of the facts alleged by the plaintiff, would not have voted for the transaction.<sup>255</sup> Moreover, the court emphasized that the minority shareholders of UGO could have sought injunctive relief under state law had they not been influenced by the defendants' misleadingly favorable disclosures.<sup>256</sup>

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constitutes disclosure to the corporation. *Maldonado v. Flynn*, 448 F. Supp. 1032 (S.D.N.Y. 1978); see *Falkenberg v. Baldwin* [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,086 (S.D.N.Y. June 13, 1977); *Goldberger v. Baker*, 442 F. Supp. 659, 665 (S.D.N.Y. 1977).

<sup>251</sup> 567 F.2d at 217.

<sup>252</sup> *Id.* at 218. The court stated that the Supreme Court in *Santa Fe* precluded only those "controlling influence plus unfairness" actions brought under Rule 10b-5 which fail to allege material misrepresentation or nondisclosure. *Id.* The Supreme Court did not overrule prior decisions in which breaches of fiduciary duty held violative of Rule 10b-5 included some element of deception, but merely distinguished them from cases involving allegations of unfairness or breach of fiduciary duty which do not satisfy the deception requirement. See 430 U.S. at 474-75, n.15.

<sup>253</sup> 567 F.2d at 218.

<sup>254</sup> The standard of materiality which the *Meridor* court applied to the Rule 10b-5 action was set forth by the Supreme Court in *TSC Indus., Inc. v. Northway, Inc.* 426 U.S. 438 (1976). Although *TCS Industries* dealt with materiality under § 14(a) of the '34 Act, 15 U.S.C. § 78n(a) (1976), and Rule 14(a)-9, 17 C.F.R. § 240.14a-9 (1977), application of this same standard under § 10(b) is correct as a matter of statutory interpretation since the statutes are *in pari materia*. See 567 F.2d at 218-19; *Joyce v. Joyce Beverages, Inc.*, [Current] FED. SEC. L. REP. (CCH) ¶ 96,327 at 93,096 n.6 (S.D.N.Y. Jan. 30, 1978).

<sup>255</sup> 567 F.2d at 219.

<sup>256</sup> The *Meridor* court noted that New York state courts "display no hesitancy" in granting injunctive relief, where an appraisal remedy is not available. 567 F.2d at 219. See, e.g., *Silverman v. Lehrman*, 25 Misc. 2d 339, 203 N.Y.S.2d 171 (Sup. Ct. Kings Co. 1960) (enjoining transaction between subsidiary and parent). Typically, statutory appraisal rights are available to shareholders who object to merger or consolidation transactions. See N.Y. BUS. CORP. LAW § 623 (McKinney) (1963 & Supp. 1977); DEL. CODE ANN. tit. 8 § 262 (Cum. Supp. 1976). Since the transaction complained of in *Meridor* did not involve a merger or consolidation giving rise to a right to payment for shares, the UGO shareholders did not have any right of appraisal under state law. 567 F.2d at 219.

In applying the "controlling influence plus unfairness" doctrine to a self-dealing transaction between a parent and subsidiary, the *Meridor* court held that the deception requirement was satisfied because material facts of the unfair transaction either were not disclosed or were misleadingly disclosed to the independent shareholders, even though disclosure was not required by law.<sup>257</sup> Thus, the court brought the self-dealing transaction involved in *Meridor* within the ambit of the *Santa Fe* Court's holding that fraud does not exist under Rule 10b-5 absent "deception, misrepresentation, or nondisclosure."<sup>258</sup>

The Second Circuit's holding in *Meridor* reflects the willingness of lower courts to apply Rule 10b-5 flexibly and broadly. The court's application of Rule 10b-5 would seem to reach, however, any breach of fiduciary duty by controlling shareholders or financially interested directors who fail to inform the stockholders of their intended mismanagement.<sup>259</sup> Since those who breach their fiduciary duties rarely disclose the facts of the unfair transaction or the conflict of interest, in the controlling influence situation virtually any corporate mismanagement in connection with a securities transaction will involve some nondisclosure or misrepresentation within the meaning of Rule 10b-5. The Second Circuit's broad reading of the deception requirement<sup>260</sup> may operate to circumvent the policy of the *Santa Fe* Court to relegate corporate mismanagement suits to state courts.<sup>261</sup>

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In addition to common law injunctive relief, UGO shareholders could have sought to enjoin the transfer of corporate assets under state statute. *Id.*; see N.Y. Bus. Corp. Law § 720 (McKinney) (1963).

The dissenting judge in *Meridor* urged, however, that the nondisclosure or misleading disclosures were not material under the *TSC Industries* standard. 567 F.2d at 222 (Meskill, J., concurring in part and dissenting in part). Under Panamanian law, no shareholder action was necessary to effect the stock-for-assets transaction. Thus, the plaintiff shareholder had the burden of demonstrating a substantial likelihood that he would have acted differently had full disclosure been made. *Id.* The dissent found that the nondisclosure was not material since the plaintiff failed to allege what course of action he would have pursued. *Id.* Cf. *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 474 n.14 (1977) (failure to give advance notice of merger not material where plaintiffs failed to indicate how they might have acted with such notice).

<sup>257</sup> 567 F.2d at 218.

<sup>258</sup> 430 U.S. at 476.

<sup>259</sup> 567 F.2d at 225 (Meskill, J., concurring in part and dissenting in part).

<sup>260</sup> The *Meridor* court responded to the deception requirement announced in *Santa Fe* by modifying the purpose of the "controlling influence plus unfairness" standard. Originally, this standard developed as a means of establishing fraud under Rule 10b-5 where proof of actual deception was difficult. Under the *Meridor* decision, the controlling influence doctrine establishes deception of the corporation. See note 250 *supra*; 567 F.2d at 217-18.

<sup>261</sup> See 430 U.S. at 477-80; note 239 *supra*. One district court after *Meridor* has held that mere failure to disclose that a transaction is unfair is insufficient to establish the element of deception required by *Santa Fe*. In *Goldberger v. Baker*, 442 F. Supp. 659 (S.D.N.Y. 1977), minority shareholders brought a derivative action on behalf of a corporation on the ground that the corporate parents had looted the corporation through a series of fraudulent securities