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the patent rights in the form of a patent application. He will receive capital gains treatment on the proceeds and his controlled corporation will be allowed a depreciation allowance once the patent is approved.

The Commissioner could rectify this situation by simply revoking Revenue Ruling 69-482 and acquiescing to the *Poole* decision. This action would make § 1235 the exclusive means by which the holder of a patent could receive capital gains benefits on its sale. Perhaps the results reached in *Stahl*, *Chu*, and *Davis* will convince the Commissioner to reconsider his position and prompt him to accept the interpretation of § 1235 that is consistent with Congressional intent.

JEFFREY LYNN WILLIS

A NEGLIGENCE STANDARD FOR MATERIAL MISSTATEMENTS AND OMISSIONS IN TENDER OFFERS UNDER § 14(e) OF THE SECURITIES EXCHANGE ACT OF 1934

Prompted by the increased use of cash tender offers¹ as a means of gaining control of publicly held corporations,² Congress in 1968 enacted the Williams Act amendment to the Securities Exchange Act of 1934.³ Included in the Williams Act is § 14(e),⁴ a special antifraud

¹A cash tender offer is a technique whereby the offeror, who seeks to obtain control of a target corporation, publicly offers to purchase a specified amount of the target's outstanding stock. The offeror thus requests the present stockholders of the target corporation to "tender" their shares, at a fixed price customarily in excess of the current market value. An exchange offer, or share tender offer, is similar, except that in return for their tendered shares target shareholders receive stock in the acquiring corporation, rather than cash. See generally Fleischer & Mundheim, *Corporate Acquisition by Tender Offer*, 115 U. PA. L. REV. 317 (1967).

²H.R. REP. No. 1711, 90th Cong., 2d Sess., U.S. CODE CONG. & AD. NEWS 2811, 2812 (1968). See Hayes & Taussig, *Tactics of Cash Takeover Bids*, 45 HARV. BUS. REV. 135 (1967).

³Act of July 29, 1968, Pub. L. No. 90-49, 82 Stat. 454, amending 15 U.S.C. § 78, codified at 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (1968), as amended, 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (1970). The Williams Act was a legislative response to a "gap" in the federal securities laws concerning disclosure with respect to shifts in corporate control. Although exchange offers were subject to the requirement of the Securities Act of 1933 and proxy contests were regulated under the Securities Exchange Act of 1934, tender offers for cash were exempt from disclosure requirements. See H.R. REP. No. 1711, 90th Cong., 2d Sess., U.S. CODE CONG. & AD. NEWS 2811, 2812-13 (1968); 1 A. BROMBERG, *SECURITIES LAW: FRAUD—SEC RULE 10B-5 § 6.3* (111) (1969) [hereinafter cited as BROMBERG]; Sowards & Mofsky, *Corporate Take-Over Bids: Gap*

provision designed to insure disclosure to investors of all material facts in connection with tender offers.⁵ In the first appellate case considering § 14(e),⁶ Judge Friendly of the Second Circuit observed that the provision "largely tracks the substantive provisions of Rule 10b-5"⁷ and suggested that § 14(e) was "very likely, except perhaps for any bearing it may have on the issue of standing, only a codification of existing case law."⁸ This conclusion was probably prompted both by the similarity in language of § 14(e) and Rule 10b-5, and by the fact that, prior to the Williams Act, Rule 10b-5 was the provision invoked by persons seeking damages or injunctive relief for alleged

in *Federal Securities Regulation*, 41 ST. JOHN'S L. REV. 499 (1967). Extensive commentary accompanied the proposal and eventual passage of the Williams Act. Numerous sources are cited in 1 A. BROMBERG § 6.3 (111) at 116 n.21.

⁵Securities Exchange Act of 1934 § 14(e), 15 U.S.C. § 78n(e) (1970).

⁶Securities Exchange Act of 1934 § 14(e), 15 U.S.C. § 78n(e) (1970) provides:

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

As it initially appeared in the Williams Act, § 14(e) consisted of only the first sentence quoted above. The second and last sentence, granting the SEC rulemaking authority, was added to § 14(e) as part of a series of amendments to the Williams Act in 1970, see notes 21-27 and accompanying text *infra*, but did not affect the operation of the antifraud provision. Throughout this article reference to § 14(e) will be to the first sentence of that provision, unless otherwise provided.

⁷*Electronic Specialty Co. v. International Controls Corp.*, 409 F.2d 937 (2d Cir. 1969).

⁸*Id.* at 945 (footnote omitted). Promulgated by the SEC pursuant to statutory authority granted in Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78(b) (1970), Rule 10b-5 provides in pertinent part:

It shall be unlawful for any person . . .

(a)[1] To employ any device, scheme, or artifice to defraud,

(b)[2] 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)[3] 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.

17 C.F.R. § 240.10b-5 (1973).

⁹409 F.2d at 940-41.

misrepresentations and other fraudulent activities in tender offer situations.⁹ Federal courts applying § 14(e) have thus far echoed Judge Friendly's comments and, beyond determinations of standing, have treated claims under the new antifraud provision as they would claims under the similarly worded Rule 10b-5.¹⁰

However, while district and appellate courts¹¹ have unanimously incorporated the elements of a Rule 10b-5 cause of action into claims asserted under § 14(e), those courts also have been unanimous in their failure to consider whether such wholesale extraction is proper. In light of the specialized nature of § 14(e), which is applicable only to tender offers, as opposed to the broad proscriptions of Rule 10b-5, this apparent oversight by the courts has led to the questionable practice of equating Rule 10b-5 with § 14(e). Particularly suspect is the proposition, as yet uncontroverted, that the standard of culpability for liability in a private action for damages under § 14(e)¹² should mirror the standard applicable to claims asserted under Rule 10b-5.

⁹The prohibitions of Rule 10b-5 encompass a broad range of activities involving transactions in securities. Plaintiffs asserting fraud in tender offer transactions had to overcome a substantial impediment under 10b-5 in the purchaser-seller limitation on standing originally enunciated in *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952). The *Birnbaum* doctrine, premised upon the language "in connection with the purchase or sale of any security" in 10b-5, generally limits that antifraud remedy to those who have either bought or sold securities. Thus, defeated tender offerors and non-tendering shareholders often encountered difficulty qualifying as proper parties to invoke the rule. *See, e.g., Iroquois Indus., Inc. v. Syracuse China Corp.*, 417 F.2d 963 (2d Cir. 1969), *cert. denied*, 399 U.S. 909 (1970). *But cf. Crane Co. v. Westinghouse Air Brake Co.*, 419 F.2d 787 (2d Cir. 1969). This obstacle was removed by the enactment of § 14(e) which, as Judge Friendly noted in *Electronic Specialty*, 409 F.2d at 945 n.6, omits the purchaser-seller language of Rule 10b-5 in favor of the words "in connection with any tender offer . . . or any solicitation . . . in opposition to or in favor of any such offer."

¹⁰*See, e.g., Smallwood v. Pearl Brewing Co.*, 489 F.2d 579 (5th Cir. 1974), *petition for cert. filed*, 42 U.S.L.W. 3633 (U.S. May 8, 1974) (No. 73,671); *Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 480 F.2d 341 (2d Cir.), *cert. denied*, 414 U.S. 910 (1973); *Cauble v. White*, 360 F. Supp. 1021 (E.D. La. 1973). The courts have thus interpreted the relaxation of the standing requirement to be the *only* change from Rule 10b-5 incorporated in the new provision.

¹¹The Supreme Court has not yet heard any cases involving § 14(e), having so far refused to grant petitions for certiorari. *E.g., Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 480 F.2d 341 (2d Cir.), *cert. denied*, 414 U.S. 910 (1973).

¹²Section 14(e) does not provide explicitly for a private right of action. However, by analogy from cases granting private remedies under § 10(b) and Rule 10b-5, *e.g., Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946), and under § 14(a) and Rule 14a-9, *e.g., J.I. Case Co. v. Borak*, 377 U.S. 426 (1964), courts have inferred such a right. *See, e.g., H.K. Porter v. Nicholson File Co.*, 482 F.2d 421, 424 (1st Cir. 1973); *Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 480 F.2d 341, 361 (2d Cir.), *cert. denied*, 414 U.S. 910 (1973). In *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579 (5th Cir.

Given the lack of consensus among the circuits on whether a negligence or scienter¹³ standard should be invoked under Rule 10b-5,¹⁴ a more logical analysis would base determination of the proper standard for § 14(e) upon an independent interpretation of that provision. Such an examination of the language of § 14(e), the purpose for which it was enacted, and its relation to other antifraud provisions under the securities laws indicates not only that § 14(e) is distinguishable from Rule 10b-5,¹⁵ but also that the two main clauses of § 14(e) are functionally distinct, and that the standard for liability under these clauses should vary accordingly.

That the clauses of § 14(e) are separable on a functional basis is evidenced by their linguistic dissimilarity. The first clause of § 14(e),¹⁶ which prohibits misstatements and omissions of material facts, appears to require the affirmative disclosure of material facts of the nature enumerated in the specific tender offer disclosure provisions of the Williams Act.¹⁷ The clause contains no language connot-

1974), *petition for cert. filed*, 42 U.S.L.W. 3633 (U.S. May 8, 1974) (No. 73,671), the court explained:

We take this opportunity to make explicit what has been implicit . . . ; a private right of action may be inferred from Section 14(e). Not only do we thereby follow the overwhelming weight of authority, but we reaffirm the importance of private litigation to the effective enforcement of the securities laws.

Id. at 596 n.20.

¹³For a discussion of the distinction between negligence and scienter, see note 33 *infra*.

¹⁴See notes 30-49 and accompanying text *infra*.

¹⁵See generally 2 A. BROMBERG § 8.4 (440-49). Cf. Note, *Defensive Tactics Employed by Incumbent Managements in Contesting Tender Offers*, 21 STAN. L. REV. 1104 (1969) (recommending that § 14(e) be interpreted independently of Rule 10b-5, fearing that courts would overlook legislative intent not to tip the balance of power away from target management in contested tender offers).

¹⁶See note 5 *supra*.

¹⁷The principal disclosure requirement in the Williams Act dealing specifically with tender offers was § 14(d)(1) of the 1934 Act, 15 U.S.C. § 78n(d)(1) (1970). Under § 14(d)(1), a tender offeror who, if successful, will become the beneficial owner of more than 5% of any class of equity securities registered under the Securities Exchange Act must, by the time of the offer, have filed with the SEC a statement containing information specified in § 13(d)(1), 15 U.S.C. § 78m(d)(1) (1970). This latter provision, which requires disclosure of information up to 10 days after a person has acquired more than 5% of any class of registered securities by *whatever* method, requires such information as the background and identity of the offeror, the source of funds used to purchase the securities, any plans or proposals the offeror may have to change significantly the structure of the target if the purpose of the offer is to acquire control, and the number of target corporation shares already owned by the offeror. See Rule 14d-1, 17 C.F.R. § 240.14d-1 (1972), and Schedule 13D, 17 C.F.R. § 240.13d-101 (1972). In addition, the offeror must include similar but less extensive information with a tender offer pub-

ing a requirement of scienter, and is seemingly directed toward instances of inadequate disclosure, whether in the form of affirmative misrepresentations, half-truths, or total nondisclosure.¹⁸ On the other hand, the language of the second clause, which proscribes "fraudulent, deceptive, or manipulative" acts and practices, does seem to introduce a scienter requirement. The apparent objects of this clause are the various manipulative practices employed during some tender offers, and not the failures to disclose covered in the first clause. Admittedly, material misrepresentations or omissions under the first clause of § 14(e) could be interpreted to constitute deceptive acts or practices under the second clause, thereby refuting the proposition that the clauses are separable. However, unless the first clause is read to encompass activity other than deceptive or manipulative practices, it is rendered mere surplusage.¹⁹ Congress surely did not intend the detailed language of the first clause of § 14(e) to be subsumed within the second clause;²⁰ a more logical conclusion is that the two clauses were designed to proscribe different types of conduct.

Although there is little in the legislative history of the Williams Act itself to either support or weaken the proposition that Congress

lished or sent to the target shareholders. Rule 14d-1, 17 C.F.R. § 240.14d-1 (1972). Furthermore, persons advising target shareholders to accept or reject a tender offer for registered securities are required under Rule 14d-4 to file with the SEC information specified in Schedule 14D.

For a more complete discussion of the operation of § 14(d) and the remainder of the Williams Act provisions, see 1 A. BROMBERG § 6.3; Brown, *The Scope of the Williams Act and Its 1970 Amendments*, 26 BUS. LAW. 1637 (1971).

¹⁸Similar contentions have been made by some commentators concerning the coverage of the clauses of Rule 10b-5. See note 45 *infra*.

¹⁹*Cf.* Comment, *Negligent Misrepresentations under Rule 10b-5*, 32 U. CHI. L. REV. 824, 826 (1965).

²⁰The contention that the first and second clauses of § 14(e) should operate independently is supported by a comparison of § 14(e) with Rule 10b-5 which, because of the similarity in language, some apparently believe was the model for the later provision. The similarity and overlap between Rule 10b-5 clauses (1) and (3) have been well acknowledged, and distinctions between the two clauses are drawn with difficulty. 1 A. BROMBERG § 2.6(1). If Congress fashioned § 14(e) from Rule 10b-5, apparently it must have recognized this duplicity, and thus consolidated in the second clause of § 14(e) clauses (1) and (3) of Rule 10b-5. This possibility, and the similarity between clauses (1) and (3), is illustrated by the fact that while many commentators have asserted that the second clause of § 14(e) reproduces Rule 10b-5(3), *e.g.*, 1 A. BROMBERG § 6.3 (211), some describe it as resembling Rule 10b-5(1). *E.g.*, Folk, *Civil Liabilities Under The Federal Securities Acts: The BarChris Case*, 55 VA. L. REV. 199, 250 (1969). This consolidation and elimination of repetitive language indicates that Congress desired to exclude whatever language was not necessary for the intended functioning of § 14(e). Assuming that Congress thus omitted all extraneous language, the fact that Rule 10b-5(2) was "preserved" in the first clause of § 14(e) is evidence that it was designed to maintain independent vitality.

intended the two clauses of § 14(e) to be functionally distinct, an amendment to § 14(e) and its history indicate that the separate operation of the clauses was congressionally contemplated. In 1970, § 14(e) was amended by the addition of the last sentence, giving the SEC rulemaking power to "define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative."²¹ The language of the amendment essentially reproduces that of the second clause of § 14(e), while avoiding any mention of material misstatements and omissions.

In describing the rulemaking provision, the House Report stated: "The section would amend Section 14(c) [*sic*, 14(e)] of the Securities Exchange Act, which prohibits false *statements and* fraudulent or deceptive *practices* It would grant to the Commission rulemaking power to . . . prevent fraudulent, deceptive and manipulative *practices*"²² A distinction is clearly drawn between mere false statements, which should be covered by the first clause of § 14(e), and the deceptive or manipulative practices prohibited by the second clause. The operation of the amendment, which includes language strongly connoting a requirement of scienter, is restricted to that part of § 14(e) which proscribes such practices. The likely purpose of the addition, as indicated in the House Report, was "to allow the Commission to deal more effectively with the devices sometimes employed on both sides in contested tender offers."²³ The contemplated objects of the addition to § 14(e), and therefore the objects of § 14(e)'s second clause, include such tactics as phony mergers, unwarranted dividend declarations, and manipulations of market price during the offering period,²⁴ but not the affirmative duty of management and offerors to disclose material information to shareholders.²⁵ The type of affirmative disclosure required by the first clause of

²¹See note 5 *supra*.

²²H.R. REP. No. 1655, 91st Cong., 2d Sess., U.S. CODE CONG. & AD. NEWS 5025, 5030 (1970) (emphasis added).

²³*Id.* at 5028.

²⁴For discussion of some of these tactics, see Schmults & Kelly, *Cash Takeover Bids—Defensive Tactics*, 23 BUS. LAW. 115 (1967).

²⁵The desire of the SEC to regulate these tactics is shown by a memorandum it filed urging passage of the 1970 Amendment:

As it now exists, section 14(e) prohibits false *statements and* fraudulent or deceptive *practices* in connection with tender offers, but does not specifically grant the Commission any rulemaking authority to deal with such *practices*.

H.R. REP. No. 1655, 91st Cong., 2d Sess., U.S. CODE CONG. & AD. NEWS 5025, 5034 (1970) (emphasis added). The distinction drawn between the operation of the clauses of § 14(e) is again apparent.

§ 14(e) had already been more specifically effectuated to some extent by the particular tender offer provisions such as § 14(d).²⁶ With the amendment to § 14(e), Congress gave the Commission power to implement the second clause's proscription of deceptive acts and practices. Congress seemingly acknowledged this difference in the scope of the first and second clauses of § 14(e), as did the SEC,²⁷ and, consistent with a theory of separability for the purpose of determining standards of liability, left the prohibition of misstatements and omissions of material facts unaffected by the scienter language in the amendment. Nevertheless, courts have not distinguished between the clauses when considering alleged violations of § 14(e) but have chosen rather to incorporate the substantive elements of a Rule 10b-5 violation into § 14(e) as a whole.

This incorporation by the courts has been due largely to the substantially similar language of Rule 10b-5 and § 14(e), both of which are devoid of any express mention of a scienter requirement. The first clause of § 14(e), dealing with material misstatements and omissions, duplicates the wording of Rule 10b-5(2).²⁸ The second clause approximates Rule 10b-5(3), with the exception of the addition of the word "manipulative."²⁹ Thus, courts construing § 14(e) have understandably concluded that actions under the new provision should be based on the same elements required under its presumed precursor, Rule 10b-5. The judicial reliance placed upon Rule 10b-5 cases for determining whether scienter or negligence is required in private damage actions under § 14(e) necessitates an examination of the culpability standard for that Rule.

The controversy surrounding the scienter requirement under Rule 10b-5 has been variously and appropriately labeled the "great debate,"³⁰ "this thicket,"³¹ and "the still clouded cauldron in which the oracles continue to stew."³² The federal courts agree that the specific

²⁶See note 17 *supra*.

²⁷See note 25 *supra*.

²⁸See notes 5 and 7 *supra*.

²⁹See notes 5 and 7 *supra*.

³⁰*Globus v. Law Research Serv., Inc.*, 418 F.2d 1276, 1291 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970).

³¹*Heit v. Weitzen*, 402 F.2d 909, 914 (2d Cir. 1968), *cert. denied*, 395 U.S. 903 (1969).

³²*Lanza v. Drexel & Co.*, [1970-71 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,826 at 90,103 (S.D.N.Y. 1970), *aff'd*, 479 F.2d 1277 (2d Cir. 1973). On the dispute whether scienter is required under Rule 10b-5, see generally Bucklo, *Scienter and Rule 10b-5*, 67 Nw. U.L. REV. 562 (1972); Epstein, *The Scienter Requirement in Actions Under Rule 10b-5*, 48 N.C.L. REV. 482 (1970); Mann, *Rule 10b-5: Evolution of a Continuum of Conduct to Replace the Catch Phrases of Negligence and Scienter*, 45

intent to defraud required in common law deceit actions is unnecessary for recovery under Rule 10b-5.³³ Nevertheless, the circuits are divided over the nature of conduct sufficiently objectionable to warrant liability. The First,³⁴ Second,³⁵ Third,³⁶ Fifth,³⁷ and Sixth³⁸ Cir-

N.Y.U.L. REV. 1206 (1970); Note, *Scienter and Rule 10b-5*, 69 COLUM. L. REV. 1057 (1969); Comment, *Scienter in Private Damage Actions Under Rule 10b-5*, 57 GEO. L.J. 1108 (1969); Note, *Proof of Scienter Necessary in Private Suits Under SEC Anti-Fraud Rule 10b-5*, 63 MICH. L. REV. 1070 (1965); Note, *Rule 10b-5: Elements of a Private Right of Action*, 43 N.Y.U.L. REV. 541 (1968); Comment, *Negligent Misrepresentation Under Rule 10b-5*, 32 U. CHI. L. REV. 824 (1965). See also Kohn v. American Metal Climax, Inc., 458 F.2d 255, 276-91 (2d Cir. 1972) (Adams, J., concurring and dissenting).

³³E.g., *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579 (5th Cir. 1974), *petition for cert. filed*, 42 U.S.L.W. 3633 (U.S. May 8, 1974) (No. 73,671). "There is no question of requiring plaintiffs to prove scienter in its strict common law sense The trend in the federal courts has been toward a more relaxed test." *Id.* at 606. See also *Globus v. Law Research Serv., Inc.*, 418 F.2d 1276, 1290-91 (2d Cir.), *cert. denied*, 397 U.S. 913 (1970). Inconsistent use of language to describe various degrees of culpability has probably contributed to the confusion surrounding the scienter requirement and Rule 10b-5. Thus, when courts state that proof of intent to defraud is not required under Rule 10b-5, they refer apparently to a conscious, bad faith misrepresentation with an intent to mislead, excluding modern concepts of scienter. See Bucklo, *Scienter and Rule 10b-5*, 67 NW. U.L. REV. 562 (1972). Cf. *Derry v. Peek*, House of Lords 1889, 14 App. Cas. 337; W. PROSSER, *LAW OF TORTS* § 107 (4th ed. 1971). Courts today normally interpret scienter to mean some degree of awareness, either knowing misrepresentation or reckless disregard for the truth or falsity of a representation. See, e.g., *Lanza v. Drexel & Co.*, 479 F.2d 1277, 1306 (2d Cir. 1973). Professor Bromberg suggests that the same conduct may be more accurately described through knowledge criteria, that is, as either actual or constructive knowledge of the falsity of a representation. 2 A. BROMBERG § 8.4 (504). *Accord*, *Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 480 F.2d 341, 396-98 (2d Cir.), *cert. denied*, 414 U.S. 910 (1973) (Mansfield, J., concurring and dissenting) (actual knowledge or notice of misrepresentation).

A negligent misrepresentation, on the other hand, is one which presumably could have been prevented through diligent investigation. Such a misrepresentation is not entirely innocent but is not so careless as to warrant constructive knowledge, as in cases of recklessness. See Bucklo, *Scienter and Rule 10b-5*, 67 NW. U.L. REV. 562 (1972).

³⁴E.g., *Rogen v. Ilikon Corp.*, 361 F.2d 260 (1st Cir. 1966); *Carr v. Warner*, 137 F. Supp. 611 (D. Mass. 1955).

³⁵E.g., *Cohen v. Franchard Corp.*, 478 F.2d 115 (2d Cir.), *cert. denied*, 414 U.S. 857 (1973); *Shemtob v. Shearson, Hammill & Co.*, 448 F.2d 442 (2d Cir. 1971). *Globus v. Law Research Serv., Inc.*, 418 F.2d 1276 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970); *Heit v. Weitzen*, 402 F.2d 909 (2d Cir. 1968), *cert. denied*, 395 U.S. 903 (1969). The Second Circuit's most recent judicial pronouncement of the correct standard for liability under Rule 10b-5 appears in *Lanza v. Drexel & Co.*, 479 F.2d 1277 (1973), an en banc proceeding in which the negligence standard was specifically rejected. The court described the culpability necessary to establish liability under Rule 10b-5 as "willful or reckless disregard for the truth." *Id.* at 1306. Nevertheless, three of the ten judges hearing the case joined with Judge Hays in his partial concurrence and dissent, calling for imposition of liability upon an exonerated outside director on the basis of negligence. *Id.* at 1311-20.

cuits apparently require a showing of scienter prior to awarding damages under Rule 10b-5. On the other hand, decisions in the Seventh,³⁹ Eighth,⁴⁰ Ninth,⁴¹ and Tenth⁴² Circuits indicate that liability may be grounded upon proof of mere negligence, and that actual or imputed knowledge of falsity is unnecessary.⁴³

³⁹*E.g.*, *Kohn v. American Metal Climax, Inc.*, 458 F.2d 255 (3d Cir.), *cert. denied*, 409 U.S. 874 (1972).

⁴⁰The Fifth Circuit recently declined to elaborate on the exact degree of wrongdoing required, but stated that "some culpability, beyond mere negligence" was necessary. *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579, 606 (5th Cir. 1974), *petition for cert. filed*, 42 U.S.L.W. 3633 (U.S. May 8, 1974) (No. 73,671). *See also* *Clement A. Evans & Co. v. McAlpine*, 434 F.2d 100 (5th Cir. 1970), *cert. denied*, 402 U.S. 988 (1971); *Herpich v. Wallace*, 430 F.2d 792 (5th Cir. 1970).

⁴¹*E.g.*, *Golob v. Nauman, Vandervoort, Inc.*, CCH FED. SEC. L. REP. ¶ 93,979 (N.D. Ohio 1972). *Cf. Mader v. Armel*, [1970-71 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,027 (S.D. Ohio 1971), *aff'd*, 461 F.2d 1123 (6th Cir.), *cert. denied*, 409 U.S. 1023 (1972).

⁴²*E.g.*, *Dasho v. Susquehanna Corp.*, 461 F.2d 11, 29 n.45 (7th Cir.), *cert. denied*, 408 U.S. 925 (1972); *Kohler v. Kohler Co.*, 319 F.2d 634 (7th Cir. 1963).

⁴³*E.g.*, *Vanderboom v. Sexton*, 422 F.2d 1233 (8th Cir.), *cert. denied*, 400 U.S. 852 (1970); *Myzel v. Fields*, 386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968).

⁴⁴*E.g.*, *Douglass v. Glenn E. Hinton Invs., Inc.*, 440 F.2d 912, 915 (9th Cir. 1971); *Royal Air Properties, Inc. v. Smith*, 312 F.2d 210 (9th Cir. 1962); *Ellis v. Carter*, 291 F.2d 270 (9th Cir. 1961). In a most novel and potentially significant decision, the Ninth Circuit recently reinterpreted *Royal Air* and *Ellis*, maintaining that the proper approach in determining liability in Rule 10b-5 requires a case-by-case determination of whether a defendant has satisfied his particular duty of disclosure under the Rule, the extent of which is to be determined from the particular facts and circumstances. *White v. Abrams*, 495 F.2d 724 (9th Cir. 1974). Noting the difficulties inherent in attempting to apply a blanket standard to all Rule 10b-5 situations, the court rejected the traditional negligence or scienter concepts, and chose rather to adopt a "flexible duty standard" approach. Significantly, the Ninth Circuit also rejected the contention that negligence would never be sufficient for imposition of liability under Rule 10b-5. Although the reason for the latter rejection was that negligence or non-negligence was no longer a factor in the Ninth Circuit's Rule 10b-5 liability analysis, at the same time the possibility of liability for negligence was clearly admitted, since in some circumstances a defendant's negligent nondisclosure will breach his duty to disclose. In particular, the court stated:

Where the defendant derives great benefit from a relationship of extreme trust and confidence with the plaintiff, the defendant knowing that plaintiff completely relies upon him for information to which he has ready access, but to which plaintiff has no access, the law imposes a duty upon the defendant to use extreme care in assuring that all material information is accurate and disclosed.

Id. at 736.

⁴⁵*E.g.*, *Mitchell v. Texas Gulf Sulphur*, 466 F.2d 90 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971); *Stevens v. Vowell*, 343 F.2d 374 (10th Cir. 1965).

⁴⁶The status of a scienter standard in the Fourth Circuit is unclear. *Compare* *Batchelor v. Legg & Co.*, 52 F.R.D. 545 (D. Md. 1971), *with* *Johns Hopkins Univ. v. Hutton*, 326 F. Supp. 250 (D. Md. 1971).

The conflict over the scienter requirement of Rule 10b-5 arises first from contrary interpretations of the relation between the language of § 10(b) and that of the second clause of Rule 10b-5. Proponents of a negligence standard note that the broad language of Rule 10b-5(2), which prohibits material misstatements and omissions, alone implies no scienter requirement.⁴⁴ These courts and commentators stress the separability of Rule 10b-5(2) from the scienter-connoting subsections of the rule,⁴⁵ and they contend that by prohibiting in § 10(b) "any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe,"⁴⁶ Congress granted the SEC broad authority to define and proscribe unacceptable conduct.⁴⁷ Scienter adherents, on the other hand, focus on the scienter language in § 10(b), which prohibits "manipulative and deceptive" devices, and conclude that the empowering legislation is an effective limitation on the operation of the rule. Under this view, imposition of liability for mere negligent omissions or misrepresentations would transgress the congressional grant of authority to the SEC.⁴⁸

In further support of a scienter requirement under Rule 10b-5, reference is often made to older provisions of the securities laws which prohibit conduct similar to that proscribed by Rule 10b-5.⁴⁹ Since § 11 and § 12(2) of the Securities Act of 1933⁵⁰ in effect prohibit

⁴⁴See, e.g., *Ellis v. Carter*, 291 F.2d 270 (9th Cir. 1961).

⁴⁵Rule 10b-5(1) prohibits "devices" and schemes to defraud, and Rule 10b-5(3) similarly prohibits acts which operate as a "fraud or deceit." For commentary in favor of treating Rule 10b-5(2) separately, see, e.g., Comment, *Rule 10b-5: Elements of a Private Right of Action*, 43 N.Y.U.L. Rev. 541 (1968); Comment, *Negligent Misrepresentation Under Rule 10b-5*, 32 U. CHI. L. REV. 824 (1965). *Contra*, 2 A. BROMBERG § 8.4 (505); Epstein, *The Scienter Requirement in Actions Under Rule 10b-5*, 48 N.C.L. Rev. 482 (1970) (noting that most courts do not distinguish between the subsections of 10b-5, and asserting that the three clauses should be treated alike).

⁴⁶Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78(b) (1970).

⁴⁷See, e.g., *Ellis v. Carter*, 291 F.2d 270, 274 (9th Cir. 1961).

⁴⁸See, e.g., *Lanza v. Drexel & Co.*, 479 F.2d 1277, 1305 (2d Cir. 1973). Cf. 6 L. Loss, SECURITIES REGULATION 3883-88 (Supp. 1969).

⁴⁹See generally 2 A. BROMBERG § 8.4 (506). Securities Act of 1933 § 11 and § 12(2) proscribe material misstatements and omissions in registration statements and in offers or sales of securities, respectively. Liability is "strict" in each provision, in the sense that a defendant has available only the "due diligence" defense. He bears the burden of proving a "reasonable ground to believe" and actual belief in the truthfulness of statements made, to avoid liability under § 11. See generally *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968). Similarly, he must prove that he "did not know, and in the exercise of reasonable care could not have known" of any misstatement or omission, to escape liability under § 12(2). See Securities Act of 1933 §§ 11, 12(2), 15 U.S.C. § 77k,1 (1970).

⁵⁰15 U.S.C. § 77k,1 (1970).

negligent misstatements,⁵¹ implementation of a negligence standard under Rule 10b-5 would purportedly emasculate these earlier express liability provisions⁵² which are accompanied by various procedural limitations.⁵³ A negligence standard for actions brought under § 10(b) and Rule 10b-5 would permit plaintiffs to circumvent those procedural restrictions, thereby providing a remedy Congress did not intend.⁵⁴ To avoid this result, many courts require that a greater showing, that of scienter, must be made by plaintiffs under Rule 10b-5.⁵⁵

The scienter-negligence dispute under Rule 10b-5 is further exacerbated by conflicting policy considerations. Basically, negligence standard proponents⁵⁶ stress the goals, often ascribed to the securities laws, of fair dealing and free access to information for the investing public.⁵⁷ Presumably, the higher degree of care occasioned by a negligence standard will more surely guarantee greater disclosure and thus the achievement of those objectives.⁵⁸ Scienter adherents, on the other hand, assert that imposition of the higher duty of care necessitated by a negligence standard will discourage individuals from seeking or accepting directorships and may produce inflated damage recoveries.

Finally, recent support for a scienter standard has been discerned from the fact that, despite the broad negligence language employed in some opinions, courts have never imposed liability in a Rule 10b-5 private damage action for mere negligent conduct.⁵⁹ Interesting

⁵¹*Globus v. Law Research Serv., Inc.*, 287 F. Supp. 188, 198 (S.D.N.Y. 1968), *rev'd in part on other grounds*, 418 F.2d 1276 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970).

⁵²*See, e.g., Weber v. C.M.P. Corp.*, 242 F. Supp. 321, 323-25 (S.D.N.Y. 1965). *Cf. Lanza v. Drexel & Co.*, 479 F.2d 1277, 1298-99, 1309 (2d Cir. 1973).

⁵³Under both § 11 and § 12(2), plaintiffs are subject to a limitation statute of one year after discovery of a misrepresentation has been or should have been made and may also be required to post a security bond.

⁵⁴*See cases cited note 42 supra.*

⁵⁵*See, e.g., Fischman v. Raytheon Mfg. Co.*, 188 F.2d 783 (2d Cir. 1951), in which the court states "[W]hen, to conduct actionable under § 11 of the 1933 Act, there is added the ingredient of fraud, then that conduct becomes actionable under § 10(b) of the 1934 Act and the Rule" *Id.* at 787.

⁵⁶*E.g., Comment, Negligent Misrepresentation Under Rule 10b-5*, 32 U. CHI. L. REV. 824 (1965).

⁵⁷*See, e.g., Affiliated Ute Citizens v. United States*, 406 U.S. 128, 151 (1972); *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963) (reiterating the securities law's philosophy of full disclosure).

⁵⁸The theory that imposition of liability for negligent material misstatements and omissions will encourage full disclosure is not universally accepted. *See, e.g., Bucklo, Scienter and Rule 10b-5*, 67 NW. U.L. REV. 562 (1972).

⁵⁹*Kohn v. American Metal Climax, Inc.* 458 F.2d 255 (3d Cir. 1972) (Adams, J., concurring and dissenting); *Bucklo, Scienter and Rule 10b-5*, 67 NW. U.L. REV. 562 (1972).

though this observation may be, the clear language of those cases applying a negligence standard should not be dismissed. The inevitable conclusion is that the scienter question under Rule 10b-5 remains unresolved. For this reason alone, the wisdom of interpreting § 14(e) in exactly the same manner as Rule 10b-5 is debatable, and a decision to read the new provision in such a way should be prefaced by at least a thorough judicial analysis of the section.

However, only two courts have specifically addressed the scienter-negligence conflict with regard to § 14(e),⁶⁰ and neither court questioned whether considerations relevant in determining a standard for liability under Rule 10b-5 were equally applicable to both clauses of § 14(e). In *Chris-Craft Industries, Inc. v. Piper Aircraft Corp.*,⁶¹ the Second Circuit noted the "virtually identical" proscriptions of § 14(e) and Rule 10b-5 and stated: "[i]n determining whether § 14(e) violations were committed in the instant case, we shall follow the principles developed under Rule 10b-5 regarding the elements of such violations."⁶² In this suit by a defeated tender offeror, Chris-Craft, against the target management, a competing offeror, and the underwriter for

⁶⁰*Smallwood v. Pearl Brewing Co.*, 489 F.2d 579 (5th Cir. 1974), *petition for cert. filed*, 42 U.S.L.W. 3633 (U.S. May 8, 1974) (No. 73,671); *Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 480 F.2d 341 (2d Cir.), *cert. denied*, 414 U.S. 910 (1973). Most of the cases arising under § 14(e) have involved requests for injunctive relief. *E.g.*, *Sonesta Int'l Hotels Corp. v. Wellington Associates*, 483 F.2d 247 (2d Cir. 1973); *Gulf & W. Indus., Inc. v. Great Atl. & Pac. Tea Co.*, 476 F.2d 687 (2d Cir. 1973); *Susquehanna Corp. v. Pan Am. Sulphur Co.*, 423 F.2d 1075 (5th Cir. 1970); *Electronic Specialty Co. v. International Controls Corp.*, 409 F.2d 937 (2d Cir. 1969); *Butler Aviation Int'l, Inc. v. Comprehensive Designers, Inc.*, 307 F. Supp. 910 (S.D.N.Y. 1969), *aff'd*, 425 F.2d 842 (2d Cir. 1970).

⁶¹480 F.2d 341 (2d Cir.), *cert. denied*, 414 U.S. 910 (1973) (noted at 51 TEXAS L. REV. 1444 (1973)). A consolidation of three district court actions, the case stemmed from the following facts. In an attempt to gain control of Piper Aircraft, Chris-Craft in January, 1969, announced a cash tender offer for the purchase of Piper shares. In resisting the takeover attempt, Piper management, comprised primarily of the Piper family, in correspondence with its shareholders, described the offer as "inadequate"; announced an agreement to sell to Grumman Aircraft a large block of unissued shares, omitting mention of an accompanying "put" agreement under which Grumman could reverse the sale; and entered agreement with Bangor Punta Corp. whereby Piper management would transfer its one-third holdings in Piper for Bangor Punta shares, and Bangor Punta would attempt to gain control of Piper through a subsequent exchange offer. Piper management recommended acceptance of the latter offer, but it did not mention that a monetary reward to the Piper family would accompany successful takeover by Bangor Punta. Furthermore, in conjunction with the exchange offer, Bangor Punta failed to disclose a substantial impending financial loss. Eight months after the initial tender offer, Bangor Punta had achieved a majority stockholder position in Piper with 51% of the Piper shares, thus repulsing the Chris-Craft takeover attempt.

⁶²480 F.2d at 362.

the competing offer, Chris-Craft alleged as the basis for its cause of action material misstatements and omissions to Piper shareholders. The court categorized materiality⁶³ and culpability as the key concepts in determining whether violations of § 14(e) had occurred. Judge Timbers explained that the necessary culpability would be shown under Rule 10b-5 or § 14(e) if a defendant knowingly or recklessly failed to discharge his duty to disclose material facts in representations to investors.⁶⁴ By application of this scienter standard, each of the defendants was found guilty of more than mere negligence in failing to apprise Piper shareholders of material information, and Chris-Craft was awarded monetary and injunctive relief.

In a concurring opinion in *Chris-Craft*, Judge Mansfield treated similarly the issue of scienter under § 14(e). After noting that the Second Circuit requires some form of scienter in a private damage action under Rule 10b-5, Judge Mansfield observed that "[n]o reason has been advanced for a different standard in the enforcement of § 14(e), the language of which is substantially the same as that found in § 10(b) and Rule 10b-5."⁶⁵ He concluded that in § 14(e) and § 10(b) Congress intended not to reach "merely negligent" misrepresentations or omissions, but only those accompanied by some degree of awareness, or scienter, of the party responsible.⁶⁶ Had Congress intended to impose liability subject only to a "due diligence" defense⁶⁷ or to confine liability to willful and intentional misrepresentations, language such as that in § 11 of the 1933 Act⁶⁸ or § 9(e) of the 1934 Act,⁶⁹ respectively, could have been employed in § 14(e) and § 10(b).

⁶³*Id.* at 362-63. The court applied the materiality test adopted for Rule 10b-5 in *List v. Fashion Park, Inc.*, 340 F.2d 457, 462 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965): "whether 'a reasonable man would attach importance [to the fact misrepresented] in determining his choice of action in the transaction in question,'" and in *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

⁶⁴480 F.2d at 363. Judge Timbers described the culpability standard as follows: "In sum . . . the standard for determining liability under § 14(e) . . . is whether plaintiff has established that defendant either (1) knew the material facts that were misstated or omitted, or (2) failed or refused to ascertain such facts when they were available to him or could have been discovered by him with reasonable effort." *Id.* at 364.

⁶⁵*Id.* at 397.

⁶⁶Support for this conclusion was based on use of the words "fraudulent," "deceptive," and "manipulative" in § 14(e), together with the somewhat similar language and the legislative history of § 10(b). *Id.*

⁶⁷See note 49 *supra*.

⁶⁸See note 49 *supra*.

⁶⁹Securities Exchange Act of 1934 § 9(e), 15 U.S.C. § 78i(e) (1970), declares liable any person who "willfully participates" in any of a number of prohibited activities, including the sale of securities, by means of materially false or misleading statements.

Finally, Judge Mansfield argued that a scienter test⁷⁰ under § 10(b), Rule 10b-5, and § 14(e) of the 1934 Act, and § 17(a) of the 1933 Act,⁷¹ would effectively distinguish those provisions from § 11 and § 12 of the Securities Act, which place on defendants the burden of establishing "due diligence."⁷²

Recently in *Smallwood v. Pearl Brewing Co.*,⁷³ the Fifth Circuit expressed its agreement with the Second Circuit's evaluation of the culpability standard for § 14(e) violations. After determining that an uncontested offer to purchase shares in connection with a merger agreement constituted a "tender offer,"⁷⁴ and that a non-tendering shareholder had standing to assert a damage claim for a § 14(e) violation, the court asserted:

Congress adopted in Section 14(e) the substantive language of the second paragraph of Rule 10b-5 and in so doing accepted the precedential baggage those words have carried over the years Once standing is established, therefore, the analysis under Section 14(e) and Rule 10b-5 is identical.⁷⁵

With respect to culpability as an element of proof, the court repeated that "the elements to be proved to establish a violation of Section 14(e) are identical to those under the Rule."⁷⁶ The court acknowledged the uncertain status of scienter requirements among the circuits and, preferring not to delineate precisely the scienter standard for the Fifth Circuit, noted only that some culpability beyond mere negligence was necessary.⁷⁷

⁷⁰Under Judge Mansfield's formulation, the scienter requirement would be satisfied if a defendant "(1) knew the essential facts and failed to disclose them, or (2) failed or refused, after being put on notice of a possible material failure in disclosure, to apprise himself of the facts under circumstances where he could reasonably have ascertained and disclosed them without any extraordinary effort." 480 F.2d at 398.

⁷¹Securities Act of 1933 § 17(a), 15 U.S.C. § 77q(a) (1970). Section 17(a) is considered to be the statutory precursor of Rule 10b-5, and their language is remarkably similar.

⁷²See note 49 *supra*.

⁷³489 F.2d 579 (5th Cir. 1974), *petition for cert. filed*, 42 U.S.L.W. 3633 (U.S. May 8, 1974) (No. 73,671).

⁷⁴*Id.* at 596-99. The term "tender offer" is not defined in the securities laws, and commentators have not reached a consensus on its precise meaning. *Id.* at 596. See Note, *The Developing Meaning of "Tender Offer" Under the Securities Exchange Act of 1934*, 86 HARV. L. REV. 1250 (1973).

⁷⁵489 F.2d at 605. As authority for this proposition the court cited only *Chris-Craft and Electronic Specialty Co. v. International Controls Corp.*, 409 F.2d 937 (2d Cir. 1969).

⁷⁶489 F.2d at 606.

⁷⁷*Id.* Since plaintiff *Smallwood* had not requested that a special issue on culpability be submitted to the jury, that issue was deemed decided in defendant's favor, as was the lower court judgment. The appellate court did not view the evidence as sufficient to warrant an overriding finding of culpability as a matter of law. *Id.* at 606-07.

An examination of *Chris-Craft*, *Smallwood*, and other cases⁷⁸ which have considered private damage actions under § 14(e) reveals that a number of factors arguing against the blanket grafting of Rule 10b-5 standards to § 14(e) have apparently been overlooked. One potentially distinguishing factor concerns the varying scope of operation of the respective provisions. Unlike Rule 10b-5, which regulates an extremely broad spectrum of activities involving the purchase or sale of securities, § 14(e) is directed toward one specific set of events: the use of the tender offer to secure a portion of a corporation's stock.⁷⁹ This specificity of purpose and scope of § 14(e) should render the provision sufficiently distinct from Rule 10b-5 to warrant an independent interpretation on the issue of the existence of a scienter requirement. Possibly the myriad unrelated purchase and sale situations subject to the proscriptions of Rule 10b-5 have contributed to the uncertainty surrounding the standard of fault under that provision. In contrast, the restricted scope of § 14(e) presents the courts with an opportunity to establish uniform standards far more amenable to consistent application. Furthermore, this unique nature of § 14(e) should obviate the need to impute a scienter requirement to the first clause of § 14(e) for the purpose of avoiding alternative remedies under the securities laws,⁸⁰ as some courts have deemed necessary under Rule 10b-5.⁸¹

Another significant distinguishing aspect of § 14(e) is that unlike the superficially similar Rule 10b-5, which is ultimately circumscribed by the provisions of its authorizing legislation § 10(b), the new tender offer antifraud provision is itself congressionally promulgated and is thus subject to no such limitation. For this reason, the contention that a scienter standard must be read into Rule 10b-5(2)

⁷⁸E.g., *H.K. Porter, Inc. v. Nicholson File Co.*, 482 F.2d 421 (1st Cir. 1973); *Dyer v. Eastern Trust & Banking Co.*, 336 F. Supp. 890 (D. Me. 1971); *Emmi v. First-Manufacturer's Nat'l Bank*, 336 F. Supp. 629 (D. Me. 1971); *Fabrikant v. Jacobellis*, [1969-70 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,686 (E.D.N.Y. 1970); *Neuman v. Electronic Specialty Co.*, [1969-70 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,591 (N.D. Ill. 1969).

⁷⁹Section 14(e) applies to all tender offers, both those for cash and those for securities, regardless of whether the offers are subject to the requirements of § 14(d). See *Henry Heide, Inc.*, [1972-73 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,838, at 81,836 (SEC Staff Letter, May 1, 1972). Prior to the 1970 amendments to the Williams Act, exchange offers were exempt from the disclosure requirements of § 14(d). The amendments eliminated the exemption from § 14(d), though § 14(e) had already been applied to an exchange offer in *Butler Aviation Int'l, Inc. v. Comprehensive Designers, Inc.*, 307 F. Supp. 910 (S.D.N.Y. 1969), *aff'd*, 425 F.2d 842 (2d Cir. 1970). See H.R. REP. NO. 1655, 91st Cong., 2d Sess., U.S. CODE CONG. & AD. NEWS 5025, 5028 (1970).

⁸⁰2 A. BROMBERG § 8.4 (440).

⁸¹See notes 49-55 and accompanying text *supra*.

because of the wording of § 10(b)⁸² is clearly inapplicable to § 14(e). Likewise inapposite is the "precedential baggage" which imposes a scienter standard for Rule 10b-5 in its entirety, at least to the extent that such precedent is founded upon the purportedly overriding language of § 10(b).⁸³

Arguably, Congress may have intended to impute to § 14(e) the pre-existing substantive elements of violations under Rule 10b-5, including a requirement of scienter. However, since the law concerning scienter under Rule 10b-5 in 1968 was ambiguous at best, arguments that a negligence standard was intended are equally persuasive. An emphasis on extending to § 14(e) the existing liability standard for Rule 10b-5 is thus inconclusive, since reliance on Rule 10b-5 case law will produce the rather anomalous result of different law for different federal circuits. Surely Congress did not mean to subject the new antifraud provision to the conflicting judicial treatment formerly accorded Rule 10b-5 with respect to scienter.⁸⁴ A more logical and sensible conclusion is that Congress intended the plain language of § 14(e) to be given full effect, apart from the confines of reasoning peculiar to § 10(b) and Rule 10b-5, thereby avoiding an otherwise inevitable

⁸²See text at note 48 *supra*.

⁸³Courts construing § 14(e) have often equated its language with that of Rule 10b-5 and § 10(b). See, e.g., text accompanying note 65 *supra*. In fact only clause (2) of § 14(e) resembles § 10(b). Thus, case law under § 10(b) and Rule 10b-5(1) and (3) may be suitable precedent for "fraudulent, deceptive or manipulative" acts under § 14(e) but not for the material misstatements or omissions proscribed in the first clause of § 14(e). In the district court opinion prior to the Second Circuit's oft-quoted decision, *Electronic Specialty Co. v. International Controls Corp.*, 409 F.2d 937 (2d Cir. 1969), the lower court found that ICC had violated Rule 10b-5(3) and also § 14(e) "which . . . 'in substance makes the provisions of Section 10(b) and Rule 10b-5 applicable to tender offers,' and particularly that portion of Section 14(e) which proscribes engaging 'in any fraudulent, deceptive or manipulative acts or practices . . .'" 295 F. Supp. 1063, 1077 (S.D.N.Y. 1968) (emphasis added). The court further noted that "the similarities of language and purpose between Sections 10(b) and 14(e) are such as to suggest that the standards of Rule 10b-5 are appropriate standards for the interpretation of the portion of Section 14(e) relevant in this case." *Id.* (emphasis added). Here, where a series of statements were found to be *deliberately* misleading, thus qualifying them as "fraudulent, deceptive, or manipulative acts or practices," the district court apparently recognized a basis for possible distinction between the first and second clauses of § 14(e). Unfortunately, the Second Circuit did not make this distinction, and that opinion has been cited ever since as authority for viewing § 14(e) in its entirety through § 10(b) and Rule 10b-5.

⁸⁴This is not, of course, to say that Congress did not intend other substantive elements of Rule 10b-5 actions, such as causation, which were more uniformly interpreted to be extended to § 14(e). Unlike these other elements, when courts look to Rule 10b-5 precedent for scienter guidance, factors other than the Rule's plain meaning are necessarily included.

conflict among the federal circuits.⁸⁵ Giving this more appropriate effect to the language of § 14(e) results in the independent vitality of its clauses⁸⁶ and indicates that a negligence standard is appropriate for the first clause of the provision.⁸⁷

Although nowhere in the scant legislative history of § 14(e) is there specific mention of scienter or negligence, some general considerations of the legislative history and purpose of the Williams Act support the conclusion that liability under § 14(e) may be incurred through the negligent misstatement or omission of material facts. One illuminating aspect of § 14(e) and the accompanying disclosure provisions of the Williams Act pertaining to tender offers is their similarity to the proxy rules and regulations.⁸⁸ Particularly noteworthy is the proxy antifraud provision, Rule 14a-9,⁸⁹ the language of

⁸⁵The only appellate courts which have considered private actions for damages under § 14(e) are the First, Second, and Fifth Circuits, none of which are "negligence" circuits under Rule 10b-5. See *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579 (5th Cir. 1974), petition for cert. filed, 42 U.S.L.W. 3633 (U.S. May 8, 1974) (No. 73,671); *H.K. Porter, Inc. v. Nicholson File Co.*, 482 F.2d 421 (1st Cir. 1973); *Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 480 F.2d 341 (2d Cir.), cert. denied, 414 U.S. 910 (1973).

⁸⁶See text accompanying notes 16-27 *supra*.

⁸⁷This result should follow, despite an argument raised by Judge Mansfield in *Chris-Craft*. In Rule 15c1-2(b) under the 1934 Act, the Commission restrictively defined language similar to that contained in both Rule 10b-5(2) and the first clause of § 14(e) to be limited to any material misstatement or omission which is made "with knowledge or reasonable grounds to believe that it is untrue or misleading." Since this rule was promulgated pursuant to Securities Exchange Act § 15(c)(1), which like § 10(b) prohibits "any manipulative, deceptive or other fraudulent device or contrivance," the limitation has been considered significant for purposes of determining whether liability may be imposed under Rule 10b-5(2) for merely negligent misstatements or omissions. See 6 L. LOSS, SECURITIES REGULATION 3884 (Supp. 1969). In *Chris-Craft*, Judge Mansfield cited the Rule 15c1-2(b) definition, asserting that the language of Rule 10b-5(2) and presumably that of § 14(e) should be similarly interpreted, thus negating liability for negligent misleading statements or omissions. 480 F.2d at 398. However, the analogy once again is unpersuasive with respect to § 14(e), since that provision is not subject to any authorizing legislation which connotes a scienter requirement, as are § 10(b) and § 15(c)(1). See text accompanying notes 82-83 *supra*.

⁸⁸Compare Rules 14d-1, 14d-4 and Schedules 13D and 14D, discussed at note 17 *supra*, with Rule 14a-11 and Schedule 14B. Similarities include the fact that both the tender offer and proxy provisions are binding on both sides in contest situations. See 1 A. BROMBERG § 6.3 (220); Sowards & Mofsky, *Corporate Takeover Bids: Gap in Federal Securities Regulation*, 41 ST. JOHN'S L. REV. 499, 511-14 (1967). See also Loss, *The Role of Rule 10b-5 in Tender Offers*, SEC. REG. & TRANSFER REP. (Jan. 1969) (noting that § 14(e) is closer in spirit to the proxy rules than to Rule 10b-5).

⁸⁹Rule 14a-9 reads in part:

(a) No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting or other communication, written or oral, containing any statement which, at the time and in the light of the circumstances under which it is made,

which is very similar to that of the first clause of § 14(e). Significantly, in private damage actions for violations of Rule 14a-9, liability has been premised on the negligence of the defendant.⁹⁰

Both Rule 14a-9 and the first clause of § 14(e) prohibit misstatements and omissions of material facts in their separate but related fields of operation. In this manner, each provision imposes a duty of disclosure on persons engaged in activities contemplated within the respective provisions. The proper standard for imposing liability in private damage actions under either Rule 14a-9 or § 14(e) will depend on the nature and extent of this duty of disclosure, and the degree of care necessary for its satisfaction.⁹¹ Under Rule 14a-9, courts have agreed that the duty of disclosure will not be satisfied, and liability may attach, when a defendant has made statements which he knew or should have known were materially false or misleading⁹²—in other words on a showing of negligence. The similarity of both purpose and intended effect in Rule 14a-9 and § 14(e), taken together with their similar proscriptive language, may warrant extrapolation of the case law under Rule 14a-9 as precedent for a negligence standard under the first clause of § 14(e).⁹³

The legislative history of the Williams Act evidences frequent recognition of the basic similarity between tender offers and proxy

is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading.

17 C.F.R. § 240.14a-9 (1973).

⁹⁰See *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281 (2d Cir. 1973); *Gould v. American Hawaiian S.S. Co.*, 351 F. Supp. 853 (D. Del. 1972); *Berman v. Thomson*, 312 F. Supp. 1031 (N.D. Ill. 1970); *Norte & Co. v. Huffines*, 304 F. Supp. 1096 (S.D.N.Y. 1968), *aff'd*, 416 F.2d 1189 (2d Cir. 1969), *cert. denied*, 397 U.S. 989 (1970); *Richland v. Crandall*, 262 F. Supp. 538 (S.D.N.Y. 1967).

⁹¹In determining who should be held liable under § 14(e), the court in *Chris-Craft* noted that "[t]he initial inquiry in each case is what duty of disclosure the law should impose upon the person being sued." *Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 480 F.2d 341, 363 (2d Cir.), *cert. denied*, 414 U.S. 910 (1973). In *White v. Abrams*, 495 F.2d 724 (9th Cir. 1974) (discussed at note 41 *supra*), the Ninth Circuit agreed with this statement in *Chris-Craft* but determined that a further requirement of scienter was unnecessary, stating that it was "unfortunate that the Second Circuit attempted to limit this duty by requiring some degree of scienter or culpability and holding that mere negligent conduct would not be sufficient for liability." *Id.* at 95,607.

⁹²*Richland v. Crandall*, 262 F. Supp. 538, 553 n.11 (S.D.N.Y. 1967).

⁹³See 2 A. BROMBERG § 8.4 (441-42).

contests. Indeed, language in both the House Report⁹⁴ and a statement by then-SEC Chairman Cohen⁹⁵ indicates that the nature and extent of disclosure contemplated in the tender offer disclosure requirements was similar to that accomplished in the existing legislation and Commission regulation covering proxies.⁹⁶ This conclusion is supported by the nature of the particular disclosure provisions themselves,⁹⁷ and the similarity of the underlying shareholder activity protected. As Chairman Cohen observed,⁹⁸ both tender offers and proxy contests involve a decision by shareholders on the future composition of management. The specific tender offer disclosure provisions of the Williams Act are designed to insure that target shareholders receive enough information to make such choices intelligently⁹⁹ and, in this respect, are similar in philosophy to the proxy rules. In each situation the effect of a potential change in management and

⁹⁴The House Report accompanying the Williams Act included the following language:

The cash tender offer is similar to a proxy contest, and the committee could find no reason to continue the present gap in the Federal securities laws which leaves the cash tender offer exempt from disclosure provisions This bill is designed to make the relevant facts known so that shareholders have a fair opportunity to make their decision.

H.R. REP. NO. 1711, 90th Cong., 2d Sess., U.S. CODE CONG. & AD. NEWS 2811, 2813 (1968). The tender offer antifraud provision § 14(e) appears in Securities Exchange Act § 14, which is labelled "Proxies."

⁹⁵At the House Hearings on the Williams Bill, Chairman Cohen Noted:

The procedures provided by the bills in the case of contested tender offers are analogous to those now followed when contending factions solicit proxies under the Commission's proxy rules. These rules . . . are generally accepted as having been successful in providing adequate and accurate information to shareholders in contests for control of their companies. While there are obvious differences between tender offers and proxy contests, there is in both situations the common element of concern with the future management and control of the company. Adequate material information is equally important to a shareholder who is faced with a decision whether to sell his securities or retain his investment in the company.

Hearings on H.R. 14475, S. 510 Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce, 90th Cong., 2d Sess. 13 (1968) [hereinafter cited as House Hearings].

⁹⁶An effective closing of the "gap" would require no less. See note 94 *supra*.

⁹⁷See note 88 *supra*.

⁹⁸See note 95 *supra*.

⁹⁹The House Report reflects this concern with ensuring that shareholders are able to make informed decisions:

The persons seeking control, however, have information about themselves and about their plans which, if known to investors, might sub-

control is crucial to the investor's decision,¹⁰⁰ and in both instances the shareholder is in a position to hasten or impede such a change.¹⁰¹

The analogy between the proxy and tender offer situations is not exact, however. Admittedly, a shareholder who disposes of all his shares in response to a tender offer has not decided meaningfully in favor of incumbent management or the outside challengers, since he no longer has an interest in the corporation.¹⁰² Nevertheless, a share-

stantially change the assumptions on which the market price is based. This bill is designed to make the relevant facts known so that shareholders have a fair opportunity to make their decision.

H.R. REP. NO. 1711, 90th Cong., 2d Sess., U.S. CODE CONG. & AD. NEWS 2811, 2813 (1968).

¹⁰⁰In the House Hearings, SEC Chairman Cohen further noted:

It is argued by some that the basic factor which influences shareholders to accept a tender offer is the adequacy of the price. But . . . how can an investor evaluate the adequacy of the price if he cannot assess the possible impact of a change in control? Certainly without such information he cannot judge its adequacy by the current or recent market price. That price presumably reflects the assumption that the company's present business control and management will continue.

House Hearings at 13. The identity and future plans of management are considerations which all rational investors presumably evaluate in making investment decisions. The shareholder in a proxy contest makes such an investment decision when he casts his vote for or against incumbent management. The target shareholder in a tender offer makes a similar investment decision when he determines whether he will tender or retain his shares. Equal protection should be afforded shareholders making these analogous investment decisions, under the corresponding antifraud provisions, Rule 14a-9 and § 14(e).

¹⁰¹The decision of a shareholder in a proxy situation is definitive, either in favor of incumbent management or the outside challenger. The decisions of shareholders in tender offer situations may be somewhat ambiguous, however, because of the conflicting interests which may lead shareholders to adopt similar courses of action. For example, a shareholder who favors current management may retain his shares in the hope of contributing to the defeat of a takeover attempt, or he may tender part or all of his shares because he fears that the tender offer will succeed and that incumbent management will be supplanted. On the other hand, a shareholder who dislikes present management may keep his shares as an investment in what he trusts will be a company under new management, or he may tender part of his holdings to assist the takeover.

¹⁰²The facts of *Smallwood* present another situation in which shareholders could not make a meaningful management choice pursuant to a tender offer. In that case, a merger of *Smallwood* and *Southdown* was planned, with *Smallwood* shareholders to receive *Southdown* stock. Under the terms of the merger agreement, *Smallwood* shareholders were then given an opportunity to tender a maximum of 45% of the *Southdown* stock so distributed. The Fifth Circuit defined *Southdown's* unopposed offer to purchase—which offer was a necessary element of the merger agreement, and was conditioned upon successful completion of the merger—as a tender offer subject to § 14(e). 489 F.2d at 596-99 (5th Cir. 1974), *petition for cert. filed*, 42 U.S.L.W. 3633 (U.S. May 8, 1974) (No. 73,671). The only alternatives presented to *Smallwood* shareholders were to remain under the future management of the survivor *Southdown*, or to bail out by

holder who declines to tender his shares, or who tenders only a part of his shares, retains an investment in the corporation and in effect has made a choice in management.¹⁰³ The fact that shareholders in tender offer situations are given the opportunity to relinquish all their shares, thereby separating themselves from the corporation, should not eliminate the concurrent opportunity to make the same management choice that shareholders make in proxy situations. Unless he is apprised of material information to the same extent as a shareholder in a proxy contest, the target shareholder cannot meaningfully decide whether to retain his shares and thus maintain present management.¹⁰⁴ This is a choice which he should be afforded.

The contention that the required disclosure for tender offers should equal that for proxy solicitations is reinforced by the observation that the tender offer is an alternative to a proxy contest as a means of acquiring corporate control. An apparent contradiction arises in permitting corporate officials choosing a takeover technique to render thereby a unilateral decision on the standard of care for disclosure. To insure that shareholders may make informed decisions on management, the fair corporate suffrage principle underlying the proxy rules has thus been extended to tender offers in the form of the disclosure requirements of § 14(d).¹⁰⁵ Imposition of a negligence standard under the analogous antifraud provision, the first clause of § 14(e), should logically follow, so that the intent to establish a similar duty of disclosure and thereby guarantee equal shareholder protection under the alternative takeover techniques will not be frustrated.

On the other hand, since the significant hearing and committee comments¹⁰⁶ were not directed specifically to § 14(e), an argument may arise that the proxy analogy extends no further than the specific

tendering their shares. This option hardly presented an opportunity to make a meaningful choice in management. However, the applicability of § 14(e) in these circumstances, pursuant to the Fifth Circuit's interpretations of "tender offer," should be considered the exception rather than the rule, because in far more instances target shareholders are presented with a real management choice. Furthermore, in *Smallwood* the target shareholders had already made their management decision in approving the merger agreement via proxy vote, under the protection of Rule 14a-9. *Id.* at 586-87, 601-05.

¹⁰³Note, *The Scope of Section 14(d): What Is A Tender Offer?*, 34 OHIO ST. L.J. 375 (1973).

¹⁰⁴Nor can a shareholder meaningfully decide to tender part of his shares and keep part, in an attempt to assist the takeover effort while retaining an investment in the corporation, which he anticipates will come under new management.

¹⁰⁵See note 17 *supra*. The inclusion of these disclosure requirements in the Williams Act indicates a congressional interest in more than merely relaxing the standing requirement under Rule 10b-5. See notes 6-10 and accompanying text *supra*.

¹⁰⁶See notes 94-95 *supra*.

affirmative disclosure requirements legislatively created. Furthermore, there are some dissimilarities between the proxy and tender offer antifraud provisions.¹⁰⁷ The only comment directed specifically toward § 14(e) in the committee reports stated:

This provision would affirm the fact that persons engaged in making or opposing tender offers or otherwise seeking to influence the decisions of investors or the outcome of the tender offer are under an obligation to make full disclosure of material information to those with whom they deal.¹⁰⁸

One court has concluded from this comment that "§ 14(e) was not adopted as wholly separate and distinct from 10b-5, but rather, was intended by Congress to 'affirm' the applicability to tender offers of the standards of disclosure in Rule 10b-5."¹⁰⁹ However, since the scope of Rule 10b-5 with respect to all persons acting in connection with tender offers was uncertain at the time,¹¹⁰ a more logical interpretation of this strong disclosure language is that § 14(e) was intended to "affirm" the notion that the rationale of the disclosure requirements of § 14(d)¹¹¹ was to be accorded broad application.

By itself, the legislative history of the Williams Act does not conclusively establish a negligence standard for imposing liability in private damage actions under § 14(e) for misstatements or omissions of material facts. By the same token there is no affirmative indication that a scienter requirement should be imposed under the first clause of § 14(e). Unless the Commission promulgates rules restricting that clause,¹¹² nothing will indicate that its operation was intended to be limited by a scienter requirement. Rather, the overall legislative concern for full and fair disclosure and the frequent parallel with the proxy regulatory scheme, coupled with the similarity in language

¹⁰⁷For example, § 14(e) encompasses *all* tender offers, even those not regulated under § 14(d), while Rule 14a-9 is confined to regulated proxy solicitations. Furthermore, tender offerors need not deliver the offers to shareholders individually, whereas proxy statements must be delivered in conjunction with proxy solicitations.

¹⁰⁸H.R. REP. No. 1711, 90th Cong. 2d Sess, U.S. CODE CONG. & AD. NEWS, 2811, 2821 (1968).

¹⁰⁹*Neuman v. Electronic Specialty Co.*, [1969-70 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,591 at 98,705 (N.D. Ill. 1969) (dicta). Note, however, that this district court is located in the Seventh Circuit, traditionally a Rule 10b-5 "negligence" circuit. See note 28 *supra*.

¹¹⁰See note 9 *supra*.

¹¹¹See note 17 *supra*.

¹¹²The SEC could adopt an interpretation of the first clause of § 14(e) similar to that adopted for Rule 15c1-2(b), see note 87 *supra*, but such a possibility is seemingly remote. See Speech by SEC Commissioner Sommers, *Directors and the Federal Securities Laws*, CCH FED. SEC. L. REP. ¶ 79,669 (Feb. 21, 1974).

with Rule 14a-9, indicate that a negligence standard is appropriate.¹¹³

From examination of the language of § 14(e), its history and purpose, and its relation to the other provisions of the securities laws, a number of conclusions may be drawn which support the contention that the operative clauses of § 14(e) should be applied separately, and that liability under the provision may be incurred for negligent misstatements or omissions of material facts. First, nothing in the wording of § 14(e) establishes that scienter must be shown in a private action for damages arising from misleading statements in tender offers, or in communications to shareholders endorsing or disapproving such offers. Further, neither that part of the case history of Rule 10b-5 requiring scienter, nor any other antifraud provisions of the securities laws, necessitates inferring such a scienter requirement. Section 14(e) is not limited by any authorizing legislation connoting scienter, as Rule 10b-5 may be by § 10(b), nor is it nearly as broad in scope as Rule 10b-5. Finally, there is no indication from Congress that scienter was intended in the first clause of § 14(e). Rather, the legislative history evidences an intention on the part of Congress to extend to tender offers the same affirmative disclosure requirements embodied in previous congressional enactments and in the SEC rules for proxy contests. A logical extension of this philosophy to an analogy between the respective antifraud provisions, § 14(e) and Rule 14a-9, suggests a negligence standard for the first clause of § 14(e). When all these factors are considered, one must conclude that nothing should prevent a judicial determination that negligence is the proper standard for determining liability for damages under the first clause of § 14(e). Indeed, other considerations encourage such an interpretation. In light of the large number of shareholders who may place great reliance on the information they receive in tender offer situations, the interested parties should properly be held to a standard requiring a reasonable investigation and examination of statements contained or omitted in communications to those shareholders.¹¹⁴

¹¹³At least one state has statutorily created a negligence standard under its equivalent of the first clause of § 14(e), but only with respect to offerors. The Virginia Take-Over Bid Disclosure Act contains a provision which, although labeled "Deceptive practices," reproduces exactly the first and second clauses of § 14(e), differing from that provision only in its description of the coverage of the operative clauses. VA. CODE ANN. § 13.1-533 (Repl. Vol. 1973). The Virginia Act also contains a provision which imposes liability on any offeror who makes a take-over bid by means of misstatements or omissions of material facts and who cannot prove that he "did not know, and in the exercise of reasonable care could not have known" of the material misstatements or omissions. VA. CODE ANN. § 13.1-539(a)(2) (Repl. Vol. 1973).

¹¹⁴Inapplicable should be the argument that a high standard of care, *i.e.*, a negligence standard, placed on corporate officials will decrease the amount of information

The application of a negligence standard under the first clause of § 14(e) will depend upon whether courts look beyond the dicta of early § 14(e) cases¹¹⁵ to examine those factors distinguishing § 14(e) from Rule 10b-5 with respect to standard of fault. The courts in *Chris-Craft* and *Smallwood* failed in this respect, relying on the similarity in language with Rule 10b-5 to establish a scienter standard under § 14(e). In so doing, those courts declined to exercise the caution urged by the Supreme Court when examining the securities laws¹¹⁶ and may have initiated a conflict between the circuits similar to that surrounding Rule 10b-5.¹¹⁷ Courts subsequently applying § 14(e) should examine closely the reasons for interpreting it apart from Rule 10b-5 and give full effect to the investor-protecting language in that antifraud provision, thereby rescuing the provision from the overcrowded "cauldron in which the oracles continue to stew."¹¹⁸

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voluntarily extended to shareholders, thus defeating the congressional purpose of encouraging disclosure. The affirmative disclosure requirements of the Williams Act prevent total non-disclosure, and communications to shareholders will almost certainly be forthcoming from both management and offeror in contested tender offer situations.

Interestingly, an extrapolation of the "flexible duty standard" approach of the Ninth Circuit in *White v. Abrams*, 495 F.2d 724 (9th Cir. 1974), to § 14(e) should result in the imposition of a high duty of disclosure on defendants in most tender offer situations. As some of the factors to be considered in determining a defendant's duty of disclosure, the *White* court included:

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, the defendant's awareness of whether the plaintiff was relying upon their relationship in making his investment decisions, and the defendant's activity in initiating the securities transaction in question.

495 F.2d at 735-36 (footnotes omitted). See note 41 *supra*.

¹¹⁵*E.g.*, *Electronic Specialty Co. v. International Controls Corp.*, 409 F.2d 937 (2d Cir. 1969) (an action for injunctive relief, not specifically concerned with the scienter-negligence issue).

¹¹⁶When interpreting § 10(b) and Rule 10b-5 for the first time, the Supreme Court prefaced its opinion as follows:

We enter this virgin territory cautiously. The questions presented are narrow ones. They arise in an area where glib generalizations and unthinking abstractions are major occupational hazards.

SEC v. National Sec., Inc., 393 U.S. 453, 465 (1969).

¹¹⁷Both *Chris-Craft* and *Smallwood* were decided by Rule 10b-5 "scienter" circuits. When given a similar opportunity to interpret § 14(e), presumably the "negligence" circuits will decide on a negligence standard, thus precipitating conflict.

¹¹⁸*Lanza v. Drexel & Co.*, [1970-71 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,826 at 90,103 (S.D.N.Y. 1970), *aff'd*, 479 F.2d 1277 (2d Cir. 1973).

THE *BIRNBAUM* RULE REJECTED: WILL
ANALYSIS OF RIGHT TO BRING PRIVATE ACTION
UNDER § 10(b) BE SIMPLIFIED?

Section 10(b)¹ of the Securities Exchange Act of 1934 and Rule 10b-5,² which was promulgated by the Securities and Exchange Commission pursuant to that section, make unlawful the use of any manipulative or deceptive device "in connection with the purchase or sale of any security."³ Originally this section was enforceable only by public action instituted by the Securities and Exchange Commission. However, the courts became aware that the purpose of the Act would largely be frustrated unless private parties were allowed to bring actions to enforce the provisions of § 10(b). Thus, in 1946, the now firmly established private right of action under that section was first recognized.⁴

¹Section 10 of the Securities Exchange Act, 15 U.S.C. § 78j (1970) provides in pertinent part:

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.

²Rule 10b-5, promulgated by the Securities and Exchange Commission pursuant to authority given by § 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,

(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.

17 C.F.R. § 240.10b-5 (1968).

³See note 2 *supra*.

⁴A private right of action under § 10(b) and Rule 10b-5 was first recognized in *Kardon v. National Gypsum*, 69 F. Supp. 512 (E.D. Pa. 1946). Although private rights of action under the Securities Exchange Act were tacitly approved by the Supreme Court in *J.I. Case Co. v. Borak*, 377 U.S. 426 (1964), a case involving § 14(a) of the Act, the Court did not specifically recognize a private right of action under § 10(b)

Having recognized a private right of action under § 10(b), the courts necessarily had to confront the additional problem of delineating the class of persons entitled to bring suit under § 10(b).⁵ The language of both § 10(b) and Rule 10b-5 is too broad effectively to identify the class protected by their provisions. Yet, without some specification of the class protected and the type of activity proscribed, the benefits of private actions under the section would be outweighed by the detrimental effect on business activity.⁶ The liberal service of process and venue provisions of the Act could allow suits brought only for their nuisance value,⁷ and legitimate security transactions could be discouraged because of uncertainty about possible liability under the section.⁸

until 1971. *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 13 n.9 (1971). See Ruder, *Civil Liability Under Rule 10b-5: Judicial Revision of Legislative Intent?*, 57 NW. U.L. REV. 627 (1963); Comment, *Securities Regulation—Civil Liability Under Rule X-10B-5 for Fraud in the Purchase or Sale of Securities*, 52 MICH. L. REV. 893 (1954).

In a private action under § 10(b) the plaintiff may sue for damages or for rescission. If the suit is for rescission, the purchase price may be recovered in the case of a purchase and the securities may be recovered in the case of a sale. In an action for damages, the defrauded buyer can recover the difference between the market value of the securities on the date of sale and the price paid plus any incidental damages. These are the so-called out-of-pocket damages. *Janigan v. Taylor*, 344 F.2d 781, 786 (1st Cir.), cert. denied, 382 U.S. 879 (1965). See also *Baumel v. Rosen*, 412 F.2d 571 (4th Cir. 1969), cert. denied, 396 U.S. 1037 (1970). In a damage action, a defrauded seller can avail himself of the constructive trust to recover any profits the buyer may have gained. See, e.g., *Janigan v. Taylor*, 344 F.2d 781, 786 (1st Cir.), cert. denied, 382 U.S. 879 (1965); *Speed v. Transamerica Corp.*, 135 F. Supp. 176 (D. Del. 1955), modified, 235 F.2d 369 (3d Cir. 1956); *Kardon v. National Gypsum Co.*, 73 F. Supp. 789 (E.D. Pa. 1947).

Section 28(a) of the Act limits recovery in damage actions to actual damages, thus precluding punitive damages. *De Hass v. Empire Petroleum Co.*, 435 F.2d 1223 (10th Cir. 1970); *Baumel v. Rosen*, 412 F.2d 571 (4th Cir. 1969), cert. denied, 396 U.S. 1037 (1970). See Hirsch and Lewis, *Punitive Damage Awards Under the Federal Securities Acts*, 47 NOTRE DAME LAW. 72 (1971).

See 3 A. BROMBERG, *SECURITIES LAW: FRAUD, SEC RULE 10b-5* §§ 9.1-9.2 (1973); JENNINGS and MARSH, *SECURITIES REGULATION* 1185-87 (1972); Weiskopf, *Remedies Under Rule 10b-5*, 45 ST. J.L. REV. 733 (1971); Comment, *Private Remedies Available Under Rule 10b-5*, 20 SW. L.J. 620 (1966).

⁵Otherwise stated, the issue is one of how far the protection of § 10(b) should be extended. *Herpich v. Wallace*, 430 F.2d 792, 804-05 (5th Cir. 1970).

⁶The determination of the right to bring suit under § 10(b) involves a balancing of factors, including the protection of investors and the national interest in a strong business community. *Id.* at 804.

⁷Securities Exchange Act § 27, 15 U.S.C. § 78aa (1970).

⁸The Supreme Court has noted that "§ 10(b) and Rule 10b-5 may well be the most litigated provisions in the federal securities laws . . ." *SEC v. National Securities, Inc.*, 393 U.S. 453, 465 (1969).

The courts have therefore developed limitations on the private right of action under § 10(b).⁹ One such limitation is the rule first announced in *Birnbaum v. Newport Steel Co.*,¹⁰ known as the purchaser-seller requirement or the *Birnbaum* rule. In *Birnbaum* the Second Circuit actually announced two limitations.¹¹ After considering the language of § 10(b) and Rule 10b-5, the court stated that:

[Section 10(b)] was directed solely at that type of misrepresentation or fraudulent practice usually associated with the sale or purchase of securities rather than at fraudulent mismanagement of corporate affairs, and that Rule X-10b-5 extended only to the defrauded purchaser or seller.¹²

The first part of the holding limits the type of activity proscribed to that involving the purchase or sale of securities and excludes suits based on corporate mismanagement or breach of fiduciary duty. These matters were deemed the proper subject of state corporate law.¹³ The second part limits the class of persons entitled to sue under § 10(b) to those who have been defrauded in their own purchase or sale of securities. While this limitation has generally been considered a standing requirement, there is question whether it can be equated

⁹For a discussion of these limiting doctrines, see Boone and McGowan, *Standing to Sue Under SEC Rule 10b-5*, 49 TEX. L. REV. 617, 619 (1971), and Bromberg, *Are There Limits to Rule 10b-5?*, 29 BUS. LAW. 167 (1974).

¹⁰193 F.2d 461 (2d Cir.), cert. denied, 343 U.S. 956 (1952).

¹¹The facts of *Birnbaum* showed that Feldmann, the president and chairman of the board of Newport, owned 40 percent of the stock in Newport Steel Co. This ownership gave him working control. Newport was negotiating a merger with another steel manufacturer which would have been highly profitable to Newport's stockholders. Feldmann, acting in his official capacity rejected the merger offer and instead sold his stock for twice the current market price to a syndicate made up of Newport's customers. The plaintiff brought suit under § 10(b) and Rule 10b-5 as a representative of the minority shareholders and derivatively on behalf of Newport. He alleged fraud in that Feldmann made certain misrepresentations to the stockholders of Newport in letters sent to them at the time of the negotiations with Follansbee Steel Corp. and again after Feldmann sold his stock.

¹²193 F.2d at 464.

¹³One commentator has observed that the broad claim that § 10(b) and Rule 10b-5 were intended to remedy situations of corporate mismanagement and breaches of fiduciary duty may have been the reason for the strict interpretation in *Birnbaum*. Leech, *Transactions in Corporate Control*, 104 U. PA. L. REV. 725, 834 (1956). For a detailed consideration of this aspect of *Birnbaum*, see Roantree, *The Continuing Development of Rule 10b-5 as a Means of Enforcing the Fiduciary Duties of Directors and Controlling Shareholders*, 34 U. PITT. L. REV. 201 (1972); Ryan, *Bankers Life: Birnbaum Reconsidered*, 4 LOYOLA U. OF CHI. L.J. 47 (1973).

Many commentators have argued that § 10(b) has resulted in a federal law of corporations. See, e.g., Bahlman, *Rule 10b-5; The Case for its Full Acceptance as*

with standing under Article III of the Constitution.¹⁴ However, the development of the purchaser-seller requirement shows that it is used as a description of both the injury which may be remedied and the persons intended to be protected by § 10(b) and Rule 10b-5.¹⁵

In spite of the apparent simplicity of the decision in *Birnbaum*, the rule announced in that case has been the subject of continuing controversy. This controversy results from indecision over whether the rule is a necessary limitation or simply judicial surplusage.¹⁶ The courts have been reluctant to apply the rule strictly, since a rigid application would often frustrate the intent of the Act, *i.e.*, protection of the investing public.¹⁷ The conflict between the need for flexibility on the one hand and the necessity of a limiting doctrine¹⁸ on the other has been partially resolved by a liberal application of the *Birnbaum* rule. This has been accomplished by an expansive reading of the words "purchase" and "sale" and of the "in connection with" language of § 10(b) and Rule 10b-5.¹⁹ A recent case, *International Controls Corp. v. Vesco*,²⁰ illustrates the expansive reading given to the

Federal Corporate Law, 37 CIN. L. REV. 727 (1968); Fleischer, "Federal Corporate Law: An Assessment," 78 HARV. L. REV. 1146 (1965); Ruder, *Current Developments in Federal Law of Corporate Fiduciary Relations—Standing to Sue Under Rule 10b-5*, 26 BUS. LAW. 1289 (1971); Ruder, *Pitfalls in the Development of a Federal Law of Corporations by Implications Through 10b-5*, 59 NW. U.L. REV. 185 (1964).

¹⁴See text accompanying notes 70-72 *infra*.

¹⁵*Herpich v. Wallace*, 430 F.2d 792, 805-07 (1970).

¹⁶Some courts and commentators are of the opinion that the rule serves a necessary purpose in defining the class of persons to be protected by § 10(b). Boone and McGowan, *supra* note 9, at 648. Others believe the rule should be abolished because it could deny standing to persons meant to be protected by the Act. Also the rule unnecessarily complicates securities law which diverts attention from substantive issues. Since the rule is inflexible, it is contrary to the rulings requiring flexible construction of securities laws. Comment, *The Purchaser-Seller Requirement of Rule 10b-5 Reevaluated*, 44 COLO. L. REV. 151 (1972).

¹⁷See *Herpich v. Wallace*, 430 F.2d 792, 800-01 (5th Cir. 1970).

¹⁸Other doctrines limiting private actions under § 10(b), such as materiality, reliance, privity and causation, have been minimized or abolished and no longer bar actions under § 10(b). For the extent to which these limitations are still of force and effect, see Bromberg, *supra* note 9.

¹⁹One court has said, "The definitions of purchase and sale have sagged under the weight of courts' attempts to prevent ingenious minds from deflecting the statutory purposes of Section 10(b)." *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579, 590 (5th Cir. 1974).

In the Act, purchase is defined as follows: "The terms 'buy' and 'purchase' each include any contract to buy, purchase, or otherwise acquire." Securities Exchange Act § 3(a)(13), 15 U.S.C. § 78c(a)(13) (1970). Sale is defined as follows: "The terms 'sale' and 'sell' each include any contract to sell or otherwise dispose of." Securities Exchange Act § 3(a)(14), 15 U.S.C. § 78c(a)(14) (1970).

²⁰490 F.2d 1334 (2d Cir. 1974).

words of § 10(b) in order to meet the purchaser-seller requirement. *International Controls* and other cases which have been decided within the framework of the *Birnbaum* rule constitute a body of law which offers guidance to the courts and insures some degree of consistency in deciding whether a plaintiff can bring a private action under § 10(b).

In another recent case, *Eason v. General Motors Acceptance Corp.*,²¹ the Seventh Circuit held that the *Birnbaum* rule "is not part of the law of this circuit."²² The court apparently objected to the strained analysis necessitated by this expansive application of the purchaser-seller requirement and considered the requirement no more than judicial surplusage. After rejecting the purchaser-seller requirement, the court predicated the right to bring a private action on three requirements: the plaintiff must have standing, the plaintiff must be protected by the Act, and there must not be overriding policy considerations which would defeat the claim.²³ The decision appears to be an attempt to simplify the process of determining whether a given plaintiff may bring a private action. However, the actual effect of the *Eason* decision cannot be assessed without considering the cases which modified the strict *Birnbaum* rule.

Under the strict *Birnbaum* rule, the plaintiff had to be either a defrauded purchaser or seller, the transaction had to be between the plaintiff and the defendant, and the defendant had to be the perpetrator of the fraud. The cases which have modified this strict purchaser-seller requirement can be divided into four categories.²⁴ In each of these categories, private plaintiffs have been allowed to bring suit under § 10(b) and Rule 10b-5, even though they would not have been considered purchasers or sellers under the *Birnbaum* rule as originally announced.

²¹490 F.2d 654 (7th Cir. 1973), *cert. denied*, ____ U.S. ____, 94 S. Ct. 1979 (1974).

²²*Id.* at 661.

²³*Id.* at 656.

²⁴These four categories are proposed in Boone and McGowan, *supra* note 9, but other groupings have been suggested. See JENNINGS AND MARCH, SECURITIES REGULATION 1182-83 (1972), (forced seller, aborted seller, frustrated seller, would-be seller injunctive plaintiff); Ruder, *Current Developments*, *supra* note 13 (holder of shares, derivative actions, forced sellers, mergers and liquidations, injunctions); Comment, *The Decline of the Purchaser-Seller Requirement of Rule 10b-5*, 14 VILL. L. REV. 499 (1969) (corporate issues, abortive seller, constructive seller).

Some commentators have considered mergers a separate category but the cases involving mergers can be placed in one of the four categories suggested by Boone and McGowan, such as abortive transactions or derivative suits. For a discussion of cases which have dealt with mergers under § 10(b), see *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579, 590 n.10 (5th Cir. 1974).

The cases in the first of these categories, the "abortive transaction," are distinguishable from other cases under § 10(b) in that the alleged fraud prevented consummation of the transaction. *A.T. Brod & Co. v. Perlow*²⁵ was the first case based on this rationale.²⁶ In that case, the defendant ordered securities intending to pay for them only if the market price had risen by the settlement date. On one occasion the price of the ordered securities declined and the defendant refused payment, thereby forcing the broker to sell the securities at a loss of \$3,330.²⁷ The broker subsequently brought suit under § 10(b) to recover this amount. The court considered the purchase of shares for subsequent sale to the defendant a purchase of securities. However, the court did not expand the words purchase or sale but did expand the right to sue under § 10(b) by interpreting broadly the "in connection with" language of § 10(b).²⁸ The purchase and sale was between the plaintiff and a third party, while the fraud was between the plaintiff and the defendant. The court noted that the Act was intended to protect not only investors but also the public interest,²⁹ and it applied the "in connection with" language broadly to allow the broker to bring suit.

The second category of cases which relaxed the purchaser-seller requirement involves "constructive transactions" and can be illustrated by *Vine v. Beneficial Finance Co.*³⁰ In *Vine*, the plaintiff alleged that Beneficial had fraudulently gained control of Crown Fi-

²⁵375 F.2d 393 (2d Cir. 1967).

²⁶For other cases, see, e.g., *Goodman v. Hentz & Co.*, 265 F. Supp. 440 (N.D. Ill. 1967), and *Stockwell v. Reynolds & Co.*, 252 F. Supp. 215 (S.D.N.Y. 1965).

In *Goodman*, the plaintiffs' broker would represent that he was purchasing and selling securities when in fact either the purchases and sales were never made or the securities never existed. The court held that, since the plaintiffs would have been purchasers or sellers but for the fraud of the broker, they could bring suit under § 10(b).

In *Stockwell*, the plaintiffs asked the defendant broker to sell their shares in a certain corporation. The broker made misrepresentations as to the financial condition of the company and the reasons for the recent drop in the price of the company's stock, and these misrepresentations allegedly induced the plaintiffs to refrain from selling. The court allowed suit under § 10(b) because the fraud induced the plaintiffs to keep the stock and caused their loss.

²⁷375 F.2d at 395.

²⁸*Id.* at 396. The court relied on a statement made by the Supreme Court that the securities laws should not be construed "technically and restrictively, but flexibly to effectuate . . . [their] remedial purposes." *Id.*, quoting *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963).

²⁹375 F.2d at 396.

³⁰374 F.2d 627 (2d Cir. 1967).

nance Co., of which he was a stockholder.³¹ After gaining control of Crown, Beneficial effected a short-form merger³² which forced the shareholders of Crown either to sell to Beneficial at a discount or to hold worthless stock in Crown. With little discussion, the court held that the plaintiff was a seller of securities to Beneficial because Beneficial's alleged fraud had left the plaintiff with no choice of action. Thus, the court dealt with the plaintiff as if he had sold his stock to Beneficial.³³ The constructive transaction rationale has been frequently utilized to give protection to defrauded shareholders.³⁴

Derivative suits comprise the third category of cases which had eased the harshness of the strict purchaser-seller requirement. The rationale of this category is that the shareholder in a derivative suit assumes the position of the defrauded corporation for the purposes of § 10(b). Thus, the shareholder can maintain a derivative suit on behalf of the corporation without being a purchaser or seller, provided the corporation can be considered a purchaser or seller. *Ruckle v. Roto American Corp.*³⁵ was one of the earliest cases decided in this category. In *Ruckle*, the plaintiff, a shareholder of Roto American, brought suit to enjoin that corporation from reissuing 7,000 shares of treasury stock. The complaint alleged that the board of directors of Roto American had been induced to approve the issuance of the shares by the withholding of financial statements by the defendant directors. The court noted that, unless the corporation brought suit, the perpetrators of the fraud would be insulated from legal action. This result was considered improper and the shareholder was allowed therefore to bring a derivative action under § 10(b).³⁶

³¹*Id.* at 630. The plaintiff alleged fraud in that Beneficial purchased the Class A stock at a premium while offering to purchase the Class B stock at a discount. The Class B shareholders were thus unable to sell their shares for a fair price. *Id.* at 631.

³²A short-form merger provision in a state's corporation law allows the merger of a parent corporation and a subsidiary by a simple resolution of the parent's board of directors, if the parent owns a certain percentage of the subsidiary's outstanding stock. The subsidiary's remaining stockholders have no voice in the matter. Delaware requires the parent to own at least 90% of each class of the subsidiary's stock and New York requires 95% ownership. DEL. CODE ANN. tits. 8, 9 § 253 (Supp. 1968); N.Y. BUS. CORP. LAW § 905 (McKinney 1963).

³³The court cited *Ruckle v. Roto American Corp.*, 339 F.2d 24 (2d Cir. 1964), and *Hooper v. Mountain States Sec. Corp.*, 282 F.2d 195 (5th Cir. 1960), *cert. denied*, 365 U.S. 814 (1961), as supporting a broad construction of the word "sale." 374 F.2d at 634.

³⁴*See, e.g.,* *Coffee v. Permian Corp.*, 434 F.2d 383 (5th Cir. 1970); *Herpich v. Wallace*, 430 F.2d 792 (5th Cir. 1970); *Crane Co. v. Westinghouse Air Brake Co.*, 419 F.2d 787 (2d Cir. 1969), *cert. denied*, 400 U.S. 822 (1970). *Contra*, *Iroquois Indus., Inc. v. Syracuse China Corp.*, 417 F.2d 963 (2d Cir. 1969), *cert. denied*, 399 U.S. 909 (1970).

³⁵339 F.2d 24 (2d Cir. 1964).

³⁶In *Herpich v. Wallace*, 430 F.2d 792 (5th Cir. 1970), the court considered well-

The fourth category of cases involves suits for injunctive relief. In these cases the *Birnbaum* rule has been virtually eliminated, a development attributable to the Supreme Court's statement that "[i]t is not necessary in a suit for equitable or prophylactic relief to establish all the elements required in a suit for monetary damages."³⁷ In *Mutual Shares Corp. v. Genesco, Inc.*³⁸ the Second Circuit seized on this language to allow the minority shareholders to bring a suit enjoining the controlling shareholders from manipulating the market price of the stock and from keeping dividends low. The plaintiffs alleged that by these actions the majority shareholders were attempting to force the minority shareholders to sell at depressed levels. In *Mutual Shares*, the minority shareholders had not sold their stock. However, since the plaintiffs desired to continue their ownership in the company, the court considered counterproductive the requirement that the shareholders sell their stock before being allowed to bring suit.³⁹

Some commentators⁴⁰ and at least one court⁴¹ have interpreted the

established the principle that "[t]he private right of action implied under Rule 10b-5 may be invoked on behalf of a corporation in a shareholder's derivative suit." *Id.* at 803. See also *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579 (5th Cir. 1974); *Shell v. Hensley*, 430 F.2d 819 (5th Cir. 1970); *Rekant v. Desser*, 425 F.2d 872 (5th Cir. 1970); *Schoenbaum v. Firstbrook*, 405 F.2d 215 (2d Cir. 1968), *cert. denied*, 395 U.S. 906 (1969).

³⁷*SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 193 (1963). While the case involved the Investment Advisors Act of 1940, 15 U.S.C. §§ 80b-1 *et seq.* (1970), the court's language was not limited to suits under that statute.

³⁸384 F.2d 540 (2d Cir. 1967).

³⁹*Id.* at 547. Although the rationale for eliminating the purchaser-seller requirement in injunctive actions has not been explicitly stated, it would seem to be that the plaintiff in injunctive actions evidences a desire to remain a shareholder in the corporation. Under this rationale other equitable actions would still require the plaintiff to fit within the purchaser-seller requirement.

For cases reaching a result similar to *Mutual Shares*, see, e.g., *Kahan v. Rosenstiel*, 424 F.2d 161 (3d Cir. 1970); *Britt v. Cyril Bath Co.*, 417 F.2d 433 (6th Cir. 1969). See *Ruder, Current Developments, supra* note 13, at 1300; *Comment, The Purchaser-Seller Limitation to SEC Rule 10b-5*, 53 CORNELL L. REV. 684 (1968).

⁴⁰See *Lowenfels, The Demise of the Birnbaum Doctrine: A New Era for Rule 10b-5*, 54 VA. L. REV. 268 (1968); *Comment, Inroads on the Necessity for a Consummated Purchase or Sale Under Rule 10b-5*, 1969 DUKE L.J. 349; *Comment, The Purchaser-Seller Rule: An Archaic Tool for Determining Standing Under Rule 10b-5*, 56 GEO. L.J. 1177 (1968).

⁴¹*Entel v. Allen*, 270 F. Supp. 60 (S.D. N.Y. 1967). Judge Bonsal originally dismissed the complaint in *Entel* but, after his decisions in *Vine* and *Brod* were both reversed, he granted a rehearing and allowed the plaintiff to bring suit under § 10(b). The judge said in *Entel*, "Although this court feels that the extension of Section 10(b) and Rule 10b-5 to non-purchasers-or-sellers and to 'all fraudulent schemes' would be

cases relaxing the strict *Birnbaum* rule as signaling the abolition of the purchaser-seller requirement. However, cases such as *Greenstein v. Paul*⁴² demonstrated that, while the courts have been willing to expand the right to sue under § 10(b) in order to further the purpose of the Act, the purchaser-seller requirement has not been rejected. In speaking of the requirement, the *Greenstein* court noted that "[a]lthough criticized . . . it is still the rule at least insofar as actions for damages are concerned."⁴³

Even though the cases which modified the strict purchaser-seller requirement seemed to provide a framework within which to consider cases involving the *Birnbaum* rule, confusion persisted regarding the scope and viability of the requirement. For this reason, the Supreme Court's grant of certiorari in *Superintendent of Insurance v. Bankers Life and Casualty Co.*⁴⁴ was thought to evidence the Court's desire to provide a definitive ruling on the scope of the purchaser-seller requirement.⁴⁵ The alleged fraud in *Bankers Life* occurred during a complicated financial transaction.⁴⁶ Manhattan Casualty Co. was a wholly-owned subsidiary of Bankers Life. The defendants included Bankers Life, its directors, and the men who purchased the stock of Manhattan from Bankers Life. The plaintiff alleged that Manhattan was purchased with its own assets. Manhattan's board of directors approved a sale of \$5 million worth of treasury bonds held by Manhattan, based on the belief that the proceeds would be used to purchase a certificate of deposit. Instead the money was used to cover the check with which the defendants purchased all of the Manhattan stock from Bankers Life. A certificate of deposit was in fact purchased, but it was acquired with borrowed funds secured by the certificate itself. Manhattan subsequently became insolvent and the Superintendent of Insurance brought suit under § 10(b) and Rule 10b-5 in Manhattan's name to recover the \$5 million in assets of

better left to Congress than to judicial interpretation, it is bound to follow the decisions of this circuit." 270 F. Supp. at 70 (emphasis in original).

⁴²400 F.2d 580 (2d Cir. 1968). See also *Landy v. FDIC*, 486 F.2d 139, 156-57 (3d Cir. 1973), cert. denied, ___ U.S. ___, 94 S. Ct. 1979 (1974).

⁴³400 F.2d at 581 (citations omitted). In *Iroquois Indus., Inc. v. Syracuse China Corp.*, 417 F.2d 963 (2d Cir. 1969), the court stated explicitly that *Vine and Brod* "show no retreat from the proposition that a claim under Section 10(b) must relate to a purchase or sale as to which [the] plaintiff was defrauded." 417 F.2d at 968.

⁴⁴404 U.S. 6 (1971).

⁴⁵See Boone and McGowan, *supra* note 9, at 649.

⁴⁶For a schematic diagram of the transaction, see Roantree, *The Continuing Development of Rule 10b-5 as a Means of Enforcing the Fiduciary Duties of Directors and Controlling Shareholders*, 34 U. PITT. L. REV. 201, 212-13 (1972).

which Manhattan was defrauded. The Superintendent alleged that some of the directors of Bankers Life knew of the manipulations involving Manhattan and acted fraudulently in failing to disclose the dealings to the other directors.⁴⁷ The Supreme Court permitted the Superintendent to bring suit as representative of the creditors of Manhattan.

The decision in *Bankers Life* involved both limitations announced in *Birnbaum*.⁴⁸ As a preliminary matter, the Court found that Manhattan was a seller of securities by virtue of the sale of treasury bonds and was thus protected by the Act. This step arguably shows an implied endorsement of the purchaser-seller requirement.⁴⁹ The Court then altered that part of *Birnbaum* concerned with mismanagement of corporate affairs by holding that the securities laws were designed to regulate fraudulent mismanagement of corporate affairs if the mismanagement was in connection with the purchase or sale of securities.⁵⁰ The Court reasoned that the Act was intended to protect a "community of interests."⁵¹ As that term was used, it described the same class to whom the directors and majority shareholders of a corporation owed a fiduciary duty.⁵² Under the Court's formulation, a member of the community of interest could sue under § 10(b) for a breach of fiduciary duty, provided the breach occurred in connection with a purchase or sale of securities. Therefore, in *Bankers Life* the Superintendent was allowed to bring suit because he represented the creditors of Manhattan and creditors were clearly within the protected community.

The result in *Bankers Life* seems to reflect the Supreme Court's willingness to accept the modified purchaser-seller requirement. That case, considered with the decisions which explained and adapted the requirement, can be viewed as progressing toward a resolution of the controversy over the *Birnbaum* rule. The rule was based on a narrow conception of the class meant to be protected by the Securities Exchange Act. The delineation of the class protected

⁴⁷For a detailed discussion of this case, see Ryan, *Bankers Life: Birnbaum Reconsidered*, 4 LOYOLA U. OF CHI. L.J. 47 (1973); Note, *Superintendent of Insurance v. Bankers Life: Through the Looking Glass*, 67 NW. U.L. REV. 930 (1973); Comment, *Securities—Standing Under Rule 10b-5—Superintendent of Insurance v. Bankers Life & Casualty Co.*, 404 U.S. 6 (1971), 60 GEO. L.J. 1605 (1972).

⁴⁸See text accompanying notes 11-15 *supra*.

⁴⁹404 U.S. at 9. See Roantree, *supra* note 46, at 214.

⁵⁰404 U.S. at 12. See note 13 *supra*.

⁵¹*Id.* at 12, citing *Pepper v. Litton*, 308 U.S. 295, 307 (1939).

⁵²The term was first used in this context by the Court in *Pepper v. Litton*, 308 U.S. 295, 307 (1939).

seems to have reached the outer limits with the development in *Bankers Life* of the concept of a "community of interest." By utilizing this "community of interest" concept along with the liberal interpretation of the "in connection with" language of § 10(b), courts should be able to work within the purchaser-seller limitation while at the same time fully implementing the purpose of the Act.

The case of *International Controls Corp. v. Vesco*,⁵³ although not directly involving the purchaser-seller limitation, illustrates the liberal interpretation given to the words "purchase" and "sale" in order to implement the purpose of the Securities Exchange Act. *International Controls* was a suit instituted by that corporation to prevent the dissipation of its assets threatened by the securities manipulations of Robert Vesco, the controlling shareholder of ICC. The alleged fraud occurred during an intricate juggling of subsidiaries by ICC. On June 15, 1971, Skyways, a wholly-owned subsidiary of Fairfield Aviation, itself a wholly-owned subsidiary of ICC, purchased a Boeing 707 for \$1,375,000. On October 1, 1971, Skyways leased the plane to ICC for five years for a gross rental of \$3,500,000. The lease was not submitted to the board of directors of ICC for approval until December 8, 1971. Skyways was allowed to terminate the lease upon five days notice, with all improvements becoming the property of Skyways. During the period between October 1 and December 8, ICC spent between \$600,000 and \$700,000 to refurbish the plane for the personal comfort of Vesco, the primary user. Also during that period, ICC incorporated another wholly-owned subsidiary, Fairfield General. On December 8, 1971, before being informed of either the onerous lease provisions or the expenditures on the plane, ICC's directors approved a transfer of all Fairfield Aviation's stock to Fairfield General in return for all of the latter's stock. The Fairfield General stock was then distributed to the shareholders of ICC as a dividend in kind with the result that the plane was sheltered in a corporate shell controlled by Vesco's associates.⁵⁴ The corporation claimed that Vesco had planned the stock transfers because of his concern that he might lose control of ICC and thus be forced to stop his personal use of the plane. ICC contended that the spinoff had been fraudulently induced and should be rescinded.

ICC argued that the dividend of Fairfield General stock to the shareholders of ICC was a sale, thus presenting the question whether a spinoff of a subsidiary is a sale for purposes of the Securities Ex-

⁵³490 F.2d 1334 (2d Cir. 1974).

⁵⁴*Id.* at 1342.

change Act.⁵⁵ Lacking precedential guidance⁵⁶ the court turned to an analysis of both the type of behavior proscribed and the class meant to be protected by the statute.⁵⁷ *Bankers Life* was recognized as providing an umbrella of protection to the "community of interest."⁵⁸ The asset drain which would result if ICC were to lose control of the plane would detrimentally affect the shareholders and the creditors of ICC, two groups explicitly included in the Supreme Court's formulation of the community of interest. The Second Circuit concluded that the suit by ICC would protect those meant to be protected by the Act and thus construed the word "sale" broadly enough to include the spinoff of the subsidiary. This broad interpretation was presumably considered necessary to extend the protection of § 10(b) to creditors as required by *Bankers Life*.⁵⁹

Given the result in *Bankers Life*, the court in *International Controls* seems to have reached the proper result. However, the dissent extended the majority's reasoning and argued:

If a corporate spin-off of a "portfolio subsidiary" is a purchase or sale simply because it involves a stock transaction or the disposition of securities by a corporation, then a normal corporate stock dividend, a gift of shares or a distribution of securities by a fiduciary can also be found to be a purchase or sale.⁶⁰

The majority countered this argument by distinguishing a dividend of portfolio securities from an ordinary stock dividend, on the ground that only the former involves a distribution of corporate assets.⁶¹ The

⁵⁵ICC also argued that the exchange of Fairfield Aviation stock for that of Fairfield General was a "sale" under Rule 10b-5. The court rejected this contention for the reason that, both before and after the exchange, Fairfield General was a wholly owned subsidiary of ICC. Therefore, ICC had not parted with any securities but merely dealt with itself. *Id.* at 1343-44.

⁵⁶ICC urged the court to adopt the reasoning of a line of cases which held that a spinoff was a sale under the Securities Act of 1933. *Id.* at 1344, citing *SEC v. Datronics Eng'rs, Inc.*, 490 F.2d 250 (4th Cir. 1973); *SEC v. Stern-Haskell, Inc.*, CCH FED. SEC. L. REP. ¶ 94,065 (S.D.N.Y. July 11, 1973); *SEC v. Harwyn Indus. Corp.*, 326 F. Supp. 943 (S.D.N.Y. 1971). These cases were distinguished in that the definition of "sale" under the 1933 Act requires a disposition for value. Securities Act § 2(3), 15 U.S.C. § 77b(3) (1970). In each case there was a finding that the parent corporation actually received value for the spinoff. 490 F.2d at 1343-44.

⁵⁷490 F.2d at 1345-46.

⁵⁸See text accompanying notes 51-52 *supra*.

⁵⁹490 F.2d at 1345.

⁶⁰*Id.* at 1358.

⁶¹The court said, "a portfolio security dividend may have a substantially different impact on creditors than an ordinary stock dividend. Since the latter does not involve a distribution of corporate assets, corporate creditors are unlikely to be affected by a decision to issue a stock dividend." *Id.* at 1346 n.14.

majority conceded, however, that in another context the word "sale" might be given a narrower interpretation.⁶²

The dissent also argued that the broad interpretation given the word "sale" would bring about the demise of the *Birnbaum* rule because courts could easily label a party a seller of securities if no consideration were required.⁶³ However, the majority explicitly stated that the decision was not intended to weaken the purchaser-seller requirement:

[The] "fear" that our decision today signals the demise of the *Birnbaum* doctrine . . . is wholly unfounded. Having determined that ICC's dividend of its Fairfield General portfolio stock was the kind of meaningful disposition of securities which Congress sought to protect under § 10(b), it could not be more clear that ICC was the "seller" of those securities.⁶⁴

Thus, in *International Controls*, the Second Circuit reiterated the validity of the purchaser-seller requirement, while also giving an example of the analysis which allows retention of that requirement without frustration of the Act's purpose.

The Seventh Circuit, in contrast, refused to apply this type of analysis in *Eason v. General Motors Acceptance Corp.*⁶⁵ The court deemed continued adherence to the *Birnbaum* rule unjustified in view of the flexibility with which that rule has been applied to make it coextensive with the protection of § 10(b).⁶⁶ The plaintiffs in *Eason* were shareholders of Bank Service Corp. and guarantors of notes payable to GMAC. Bank Service had issued stock to defendant Waite Pontiac as partial consideration for the purchase of Waite's automo-

⁶²*Id.* at 1346.

⁶³*Id.* at 1359. The dissent considered the purchaser-seller requirement a necessary limitation in that "it serves the salutary purpose of foreclosing limitless liability under § 10(b)." *Id.*

⁶⁴*Id.* at 1346 n.16.

⁶⁵490 F.2d 654 (7th Cir. 1973), *cert. denied*, ____ U.S. ____, 94 S. Ct. 1979 (1974).

⁶⁶The court noted:

The language of Rule 10b-5 itself describes any act or practice which operates as a fraud or deceit "upon any person in connection with the purchase or sale of a security." The Supreme Court has repeatedly stated that this language should be given a broad and flexible construction. Construing the words "any person" to include a purchaser or a seller but no one else is not consistent with that admonition. Nor does the so-called rule really have integrity when the words "purchaser" and "seller" are construed as flexibly as has been necessary in order both to decide 10b-5 cases properly and also to continue to pay homage to the *Birnbaum* rule.

Id. at 659 (citations omitted).

bile leasing division. Bank Service had also assumed the liabilities of Waite, which included notes payable to GMAC. The shareholders of Bank Service then personally guaranteed both past and future notes payable to GMAC. When Bank Service became insolvent, GMAC brought suit in a state court to recover on the guarantees.

The shareholders of Bank Service brought an action under § 10(b) alleging fraud on the part of both GMAC and Waite Pontiac and seeking rescission of the loan guarantees.⁶⁷ The sole issue on appeal was whether the shareholders' claim under § 10(b) was foreclosed by the *Birnbaum* rule. The Seventh Circuit conceded that Bank Service was the seller of the securities transferred to Waite, but it refused to treat the plaintiffs as indirect sellers of that stock.⁶⁸ Under the court's interpretation of the purchaser-seller requirement, since the shareholders were not direct sellers of the securities, their suit would be precluded by the requirement. In order to avoid this result, the court provided an alternative to the *Birnbaum* rule. That alternative based the right to relief on three "aspects": the plaintiff must have standing, the plaintiff must be protected by the Act, and there must not be any overriding policy considerations which would defeat the claim.⁶⁹

In analyzing whether the plaintiffs had standing, the Seventh Circuit rejected the generally accepted view of the *Birnbaum* rule as a standing requirement. Standing, under Article III of the Constitution, was seen as requiring only that the plaintiff have "a sufficient interest in a real controversy with the defendant to entitle him to invoke the jurisdiction of a federal court."⁷⁰ Since the plaintiffs in *Eason* would be required to pay \$300,000 to satisfy the guarantees, they were thought to have a sufficient interest in the controversy. The court then relied on *Bankers Life* in determining that the shareholders were within the protection of the statute.⁷¹ Since no policy considerations were involved which would preclude the suit, the plaintiffs were allowed to bring suit under § 10(b) even though the court did not consider them either purchasers or sellers. The court summarized: "If, as plaintiffs have alleged, the transaction was consum-

⁶⁷*Id.* at 656.

⁶⁸A shareholders derivative suit was inappropriate because the prayer for rescission of the personal loan guarantees could not be asserted by the corporation. A suit by the corporation to recover its shares would have been pointless since the stock was then worthless. See *id.* at 656 n.6.

⁶⁹*Id.* at 656.

⁷⁰*Id.* at 657, citing *Frothingham v. Mellon*, 262 U.S. 447 (1923), and C. WRIGHT, *The Law of Federal Courts* § 13, at 39 (1970).

⁷¹490 F.2d at 659. See text accompanying notes 49-52 *supra*.

mated in violation of Rule 10b-5, we believe the plaintiffs, as investors and as principals in the transaction, suffered a legal injury which may be redressed by a federal court."⁷²

Thus the Seventh Circuit did away with the *Birnbaum* rule and attempted to provide in its place a simplified analysis. This analysis was designed to insure that all those meant to be protected by the Act could bring a private suit. The decision appears to be the result of the Seventh Circuit's disagreement with the strained analysis necessary to apply the modified purchaser-seller limitation in some cases.

The court arguably could have fit the plaintiff-shareholders within the modified purchaser-seller limitation without strained analysis, especially in view of the holding of *Bankers Life*. In *Bankers Life* the Superintendent was not a purchaser or seller of securities, yet he was allowed to bring suit to protect the interests of Manhattan's creditors. The creditors also were not purchasers or sellers, but they had been defrauded "in connection with" the "sale" of securities and were within the "community of interest." In *Eason* the court refused to consider the shareholders as sellers of securities even though they were referred to by the court as "principals" in the transaction with GMAC.⁷³ In spite of this determination, the Seventh Circuit could have stressed the "in connection with" language of § 10(b), as did the Supreme Court in *Bankers Life*, to allow the shareholders to sue under § 10(b). This result would seem even more logical given the fact that the plaintiffs were clearly within the "community of interest."

Whether the analysis provided by the *Eason* court will simplify decisions involving the right to bring private actions under § 10(b) is open to question. If the purchaser-seller limitation is interpreted as a description of the type of injury to be remedied and the class protected by § 10(b), then analysis under the alternative provided by the Seventh Circuit may be substantially the same as that under the modified purchaser-seller requirement. The formulation of the concept of a "community of interest" by the Supreme Court in *Bankers Life* seems to have extended the protected class to its outer limits. However, just as before the rejection of the *Birnbaum* rule, the courts must deal with the question of the type of injury which can be remedied by § 10(b). The three requirements provided by the Seventh Circuit do not seem to answer this question.

⁷²*Id.* at 659-60.

⁷³See text accompanying note 72 *supra*.