



2-1-1964

# Corporations -- Unlawful Proxy Solicitation Under Securities Exchange Act -- Rights of Shareholders -- Jurisdiction of Federal Courts to Grant Retrospective Relief

Robert B. Long Jr.

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## Recommended Citation

Robert B. Long Jr., *Corporations -- Unlawful Proxy Solicitation Under Securities Exchange Act -- Rights of Shareholders -- Jurisdiction of Federal Courts to Grant Retrospective Relief*, 42 N.C. L. REV. 442 (1964).

Available at: <http://scholarship.law.unc.edu/nclr/vol42/iss2/15>

appraisal rights for transactions not specifically mentioned by statute. The case-law emphasis in other jurisdictions has been concerned with broad interpretations of legislative intent; however, the real problem is that the form of the transaction has been made the controlling factor while the pertinent question of whether there should be appraisal rights at all has been overlooked. The granting of this remedy compels a loss of mobility to the corporation<sup>46</sup> and reduces the speed and effectiveness with which the corporation can make decisions. It is expensive<sup>47</sup> and uncertain, as the corporation never knows how many dissenters to expect. The resulting flow of cash away from the corporation may frighten creditors and cause reorganization plans to be cancelled.<sup>48</sup> These may well be adequate reasons for refusing appraisal rights in all situations, but deciding whether or not they are to be granted on the basis of the form of the transaction alone does not meet the problem squarely. Certainly such a rule enables a corporation to avoid granting appraisal rights simply by adopting a certain form for the transaction, but even the severest critics of appraisal rights admit their utility in "no market" situations<sup>49</sup> which are often found when dealing with closely held corporations. To grant relief in such situations and still preserve a maximum of corporate freedom, granting the remedy should depend on the effect of the transactions, rather than their form, and this would involve a thorough revamping of the appraisal statutes.

WALTER RAND, III

**Corporations—Unlawful Proxy Solicitation Under Securities Exchange Act—Rights of Shareholders—Jurisdiction of Federal Courts to Grant Retrospective Relief**

Under section 14(a) of the Securities Exchange Act of 1934,<sup>1</sup> it is unlawful to solicit proxies in violation of the Securities Ex-

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<sup>46</sup> See Note, 59 COL. L. REV. 366, 368 (1959).

<sup>47</sup> In *Farris v. Glen Alden Corp.*, 393 Pa. 427, 431 n.5, 143 A.2d 25, 28 n.5 (1958), it was conceded that the reorganization plan would fail if appraisal rights were given, due to the expense involved.

<sup>48</sup> For a good discussion of "the company's perspective" see Manning, *supra* note 7, at 233-39.

<sup>49</sup> *Id.* at 260-62.

<sup>1</sup> "It shall be unlawful for any person, by the use of the mails or by any means or instrumentality of interstate commerce... or otherwise to solicit or permit the use of his name to solicit any proxy... in respect of any se-

change Commission's rules promulgated thereunder.<sup>2</sup> The proxy rules apply to securities listed and registered on a national exchange.<sup>3</sup> The Commission is empowered to enforce the provisions of the act by seeking a federal district court injunction against further violations.<sup>4</sup> Recently the courts have been faced with deciding whether a right enforceable in the courts is created in private parties (as opposed to the Commission) by section 14(a). Broadly speaking, there are two questions to be considered in connection with this problem: (1) Does a private right of action exist for injuries suffered or threatened from a violation of section 14(a), and if so, who may assert it, and (2) who has the power to grant relief to a party injured by such a violation?

In three recent decisions, it has been expressly held that a right of action is created in an individual stockholder by a violation of section 14(a) and the Commission's proxy rules, notwithstanding the fact that the act does not expressly provide for such.<sup>5</sup> Such a right of action is based on "the general rule that a breach of statutory duty normally gives rise to a right of action on behalf of the in-

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curity (other than an exempted security) registered on any national securities exchange 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." 48 Stat. 895 (1934), 15 U.S.C. § 78n(a) (1958).

<sup>2</sup> 17 C.F.R. §§ 240.14a-1 to -11 (Supp. 1963).

<sup>3</sup> 17 C.F.R. § 240.14a-2 (Supp. 1963).

<sup>4</sup> SECURITIES EXCHANGE ACT § 21(e), 48 Stat. 899 (1934), as amended, 15 U.S.C. § 78u(e) (1958). Although the Commission is merely empowered to seek an injunction against further violations of the act, the courts will go beyond this and enjoin the use of the proxies illegally solicited as equity will not allow the wrongdoer to profit by his wrongdoing. *SEC v. May*, 134 F. Supp. 247 (S.D.N.Y. 1955), *aff'd*, 229 F.2d 123 (2d Cir. 1956); *Central Foundry Co. v. Gondelman*, 166 F. Supp. 429 (S.D.N.Y.), *modified sub nom.*, *SEC v. Central Foundry Co.*, 167 F. Supp. 821 (S.D.N.Y. 1958).

<sup>5</sup> *Borak v. J. I. Case Co.*, 317 F.2d 838 (7th Cir. 1963), *cert. granted*, 32 U.S.L. WEEK 3173 (U.S. Nov. 12, 1963) (No. 402); *Dann v. Studebaker-Packard Corp.*, 288 F.2d 201 (6th Cir. 1961); *Walsh & Levine v. Peoria & E. Ry.*, 222 F. Supp. 516 (S.D.N.Y. 1963) (dismissed for failure to join indispensable parties). Before these decisions, there had been dicta both to the effect that there was a right of action and to the effect there was not. Assuming its existence, *Mack v. Mishkin*, 172 F. Supp. 885 (S.D.N.Y. 1959). *Contra*, *Howard v. Furst*, 140 F. Supp. 507 (S.D.N.Y.), *aff'd*, 238 F.2d 790 (2d Cir. 1956), *cert. denied*, 353 U.S. 937 (1957).

It does not seem that all of the Commission's proxy rules would support a private action, especially after the vote had been taken. Some of the rules are of administrative importance only. See SEC Reg. 14a-6(a), 17 C.F.R. § 240.14a-6(a) (Supp. 1963), which requires that copies of any proxy material be furnished to the Commission ten days in advance of solicitation.

jured persons for whose benefit the statute was enacted."<sup>6</sup> Specifically, section 14(a) has been interpreted to give the stockholder the "right to a full and fair disclosure of all material facts which affect corporate elections by proxy,"<sup>7</sup> and to place the proxy solicitor under a duty to provide such disclosure by obeying the proxy rules.<sup>8</sup> This duty is owed the stockholder because the purpose of section 14(a) is to protect the voting rights of stockholders.<sup>9</sup> To enforce this right, the stockholder has a personal right of action.<sup>10</sup>

The second problem, the one confronting the courts today, is whether the federal courts possess the power to give relief to a stockholder injured by a violation of section 14(a) who subsequently brings a suit on the theory outlined above. There seems to be no doubt that an adverse party is entitled to "prospective relief," *i.e.*, injunction against the use of proxies obtained in violation of section 14(a).<sup>11</sup> However, whether corporate elections or action authorized

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<sup>6</sup> *Dann v. Studebaker-Packard Corp.*, *supra* note 5, at 208-09. *Accord*, *Walsh & Levine v. Peoria & E. Ry.*, *supra* note 5, at 519. See RESTATEMENT, TORTS, § 286 (1934). In so holding, the courts reject the maxim of statutory construction, *expressio unius est exclusio alterius* (the expression of one thing is the exclusion of another), which might have been applicable because Congress expressly provided for civil remedies under three sections of the act: § 9(e), 48 Stat. 889 (1934), 15 U.S.C. § 78i(e) (1958) (manipulation of prices); § 16(b), 48 Stat. 896 (1934), 15 U.S.C. § 78p(b) (1958) (recovery of "insider" profits); § 18, 48 Stat. 897 (1934), as amended, 15 U.S.C. 78r (1958) (reliance on misleading statements in material filed pursuant to the act when buying or selling). This is in accord with the upholding of private rights of action under other sections of the act where not expressly provided for. *E.g.*, *Hooper v. Mountain States Securities Corp.*, 282 F.2d 195 (5th Cir. 1960), *cert. denied*, 365 U.S. 814 (1961) (implying a right of action for violation of § 10(b), 48 Stat. 891 (1934), 15 U.S.C. 78j(b) (1958), and SEC Reg. 10b-5, 17 C.F.R. § 240.10b-5 [1949]).

<sup>7</sup> *Borak v. J. I. Case Co.*, 317 F.2d 838, 848 (7th Cir. 1963), *cert. granted*, 32 U.S.L. WEEK 3173 (U.S. Nov. 12, 1963) (No. 402).

<sup>8</sup> See *Dann v. Studebaker-Packard Corp.*, 288 F.2d 201, 208 (6th Cir. 1961).

<sup>9</sup> *Dann v. Studebaker-Packard Corp.*, *supra* note 8 at 207-08.

<sup>10</sup> It has been held that there is no right of action when the damage to the stockholder is of a derivative nature. *Howard v. Furst*, 140 F. Supp. 507 (S.D.N.Y.), *aff'd*, 238 F.2d 790 (2d Cir. 1956), *cert. denied*, 353 U.S. 937 (1957). This decision has been criticized heavily. See 2 LOSS, SECURITIES REGULATION 950-51 (2d ed. 1961); 70 HARV. L. REV. 1493 (1957). While this limits the right of action, it is in accordance with the statute which is aimed at the protection of the personal right of the stockholder to cast his vote knowing all the facts. *Dann v. Studebaker-Packard Corp.*, 288 F.2d 201, 207-08 (6th Cir. 1961).

<sup>11</sup> See note 4 *supra*, regarding courts enjoining the use of illegally solicited proxies even though not expressly authorized to do so when the Commission is plaintiff. In *Central Foundry Co. v. Gondelman*, 166 F. Supp. 429

by illegally solicited proxies may be set aside or damages awarded if rescission should prove inequitable is less clear. The cases have split on the question of the jurisdiction of the federal courts to grant "retrospective relief" for such violations.<sup>12</sup>

In *Borak v. J. I. Case Co.*,<sup>13</sup> the plaintiff stockholder brought a class action on behalf of himself and all other stockholders similarly situated against the defendant corporation, its officers, and directors in a federal district court. Plaintiff alleged that a merger and a stock option plan were approved at a special stockholder's meeting by the use of proxies solicited in violation of section 14(a). Plaintiff also alleged that the agreements were void contracts under the provisions of section 29(b) of the act<sup>14</sup> because they were made pursuant to a violation of sec. 14(a). He asked that the merger be declared void and that damages and such other relief as equity might

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(S.D.N.Y.), *modified sub nom.*, *SEC v. Central Foundry Co.*, 167 F. Supp. 821 (S.D.N.Y. 1958), both director-stockholders and the Commission were plaintiffs. The court declared the proxies void and adjourned the meeting until another solicitation with adequate facts could be held. *Dann v. Studebaker-Packard Corp.* also recognized jurisdiction to grant this "prospective" relief. 288 F.2d at 214.

<sup>12</sup> Holding there is jurisdiction to grant "retrospective" relief: *Borak v. J. I. Case Co.*, 317 F.2d 838 (7th Cir. 1963), *cert. granted*, 32 U.S.L. WEEK 3173 (U.S. Nov. 12, 1963) (No. 402); *Walsh & Levine v. Peoria & E. Ry.*, 222 F. Supp. 516 (S.D.N.Y. 1963). Holding that federal jurisdiction is limited to "prospective" relief: *Dann v. Studebaker-Packard Corp.*, 288 F.2d 201 (6th Cir. 1961).

<sup>13</sup> *Supra* note 12.

<sup>14</sup> "Every contract made in violation of any provision of this chapter . . . and every contract . . . the performance of which involves the violation of, or the continuance of any relationship or practice in violation of, any provision of this chapter . . . shall be void (1) as regards the rights of any person who, in violation of any such provision . . . shall have made or engaged in the performance of any such contract, and (2) as regards the rights of any person who, not being a party to such contract, shall have acquired any right thereunder with actual knowledge of the facts by reason of which the making or performance of such contract was in violation of any such provision . . . ." 48 Stat. 903 (1934), as amended, 15 U.S.C. § 78cc(b) (1958).

An alternative theory for upholding the plaintiff's right of action may be found here. The proxy is treated as a contract and its solicitation in violation of § 14(a) makes it void. See Brief for the SEC as Amicus Curiae, pp. 15-16, *Borak v. J. I. Case Co.*, 317 F.2d 838 (7th Cir. 1963); Comment, *Private Rights and Remedies under the S.E.C. Proxy Rules*, 3 B.C. IND. & COM. L. REV. 58, 59 (1961). It has been held that under the general rule implying a right of action from the statute, the plaintiff does not have to show that he was even solicited. *Dann v. Studebaker-Packard Corp.*, 288 F.2d 201, 209 (6th Cir. 1961). Here however, plaintiff might have to show that he was solicited and gave his proxy in order to have standing to sue as a party to the contract.

see fit be granted. The district court held that the federal court's jurisdiction to grant relief is limited to a declaratory judgment as to the validity or invalidity of the proxies once they had been voted.<sup>15</sup> The Seventh Circuit Court of Appeals reversed the district court, and held that section 27 of the act<sup>16</sup> confers jurisdiction upon the federal courts to award damages or to grant discretionary equitable relief, although retrospective, as the merits of the case require.<sup>17</sup>

In so holding, the court analyzed *Dann v. Studebaker-Packard Corp.*,<sup>18</sup> on which the district court relied, and concluded that the *Dann* court had taken a mistaken view of the jurisdictional grant of section 27.<sup>19</sup> In *Dann*, plaintiff stockholder asked that Studebaker-Packard be returned to the economic position it held prior to the consummation of certain "arrangements" between Studebaker-Packard and another corporation, if the court, discounting void proxies solicited in violation of section 14(a), found that the two-thirds majority vote necessary under Michigan law for approval of the transaction was wanting. Plaintiff alleged that jurisdiction was conferred upon the federal courts to grant such relief by section 27 of the act<sup>20</sup> and section 1331 of the Judicial Code.<sup>21</sup> The *Dann* court adopted the view that the ultimate decisions involved in the case, *i.e.*, what were the consequent effects of the validity or invalidity of the proxies, were so strictly questions of state corporation law that, in the absence of a clear mandate to do so by Congress, the federal courts should not assume jurisdiction to decide them.<sup>22</sup> *Gully v.*

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<sup>15</sup> 317 F.2d at 841.

<sup>16</sup> "The district courts of the United States . . . shall have exclusive jurisdiction of violations of this chapter . . . and of all suits in equity and actions at law brought to enforce any liability or duty created by this chapter or the rules and regulations thereunder. . . . Any suit or action to enforce any liability or duty created by this chapter . . . or to enjoin any violation of such chapter . . . may be brought in any such district or in the district wherein the defendant is found or is an inhabitant or transacts business, and process . . . may be served in any other district of which the defendant is an inhabitant or wherever the defendant may be found." 48 Stat. 902 (1934), as amended, 15 U.S.C. § 78aa (1958).

<sup>17</sup> 317 F.2d at 849.

<sup>18</sup> 288 F.2d 201 (6th Cir. 1961).

<sup>19</sup> 317 F.2d at 848-49.

<sup>20</sup> See note 16 *supra*.

<sup>21</sup> "The district courts shall have original jurisdiction of all civil actions wherein the matter in controversy . . . arises under the . . . laws . . . of the United States." 28 U.S.C. 1331 (1958).

<sup>22</sup> 288 F.2d at 214.

*First Nat'l Bank*<sup>23</sup> was cited as the basis for the court's decision to end federal jurisdiction with the voting of the proxies. *Gully* stands for the proposition that "to arise under the laws of the United States" so as to give the federal courts jurisdiction, the federal right must be the primary right asserted and not merely a collateral one. The federal right which plaintiff sought to assert in *Dann* was found to be "really negligible in comparison" to the state questions which would have to be decided.<sup>24</sup> Thus, even though the federal right asserted by the plaintiff "would probably be material to the ultimate outcome"<sup>25</sup> it was merely collateral to the primary question, the validity of a corporate vote, which arose under state law.<sup>26</sup>

*Borak*, in disagreeing, pointed out that the "jurisdictional facts" in these cases were totally different from those in *Gully*.<sup>27</sup> In *Gully*, it was held that there was no case "arising under the laws of the United States," and consequently, no federal jurisdiction, where the right plaintiff sought to assert (collection of a tax) was actually given by a state statute and the only connection that could be shown with federal law was that a federal statute allowed the states to pass such statutes.<sup>28</sup> However, in the principal case and *Dann*, a right given by the federal statute was directly violated and it was the violation of his federal right that the plaintiff asserted as the basis for redress. For this reason, the *Gully* decision is not applicable to *Borak*.<sup>29</sup> Rather, the court viewed the doctrine set forth in *Bell v. Hood*<sup>30</sup> as the better reasoning. As the court somewhat loosely stated that doctrine: "[F]ederal courts have the power, under a general grant of jurisdiction to enforce a federal statute, to grant all of the relief . . . commensurate with the effective enforcement of the statute, and the protection of rights created thereby . . ."<sup>31</sup> As section 14(a) created a right to "full and fair disclosure," the jurisdiction given the courts by section 27 is large enough in scope under this doctrine to encompass damages or other retrospective relief as might be

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<sup>23</sup> 299 U.S. 109 (1936).

<sup>24</sup> 288 F.2d at 214.

<sup>25</sup> *Ibid.*

<sup>26</sup> *Id.* at 215.

<sup>27</sup> 317 F.2d at 848.

<sup>28</sup> 299 U.S. at 116.

<sup>29</sup> 317 F.2d at 848.

<sup>30</sup> 327 U.S. 678 (1946).

<sup>31</sup> 317 F.2d at 848.

necessary in the individual case to fully protect the right.<sup>32</sup> Ample support for this doctrine was found in the cases.<sup>33</sup>

If the Supreme Court crosses the first hurdle and upholds the private right of action for a violation of section 14(a),<sup>34</sup> it will be faced with choosing between these views of the jurisdictional grant of section 27. Because of the fact that section 27 provides for "exclusive jurisdiction" in the federal district courts to enforce liabilities or duties created by the act,<sup>35</sup> either result would have a definite effect on the future rights of shareholders to enforce private rights of action under the Securities Exchange Act.

Clearly it seems that the *Gully* case on which *Dann* relied is inapplicable to this situation where there is a direct violation of a federal statute. However, the problem raised by *Dann*, whether the validity of the vote is a matter of state law or of federal law, is critical. It results from the fact that the federal law regulating proxy solicitation is "super-imposed" on the general body of state corporation law governing the validity of corporate votes and the consequences of invalidity.<sup>36</sup> If we disregard the discredited reliance on *Gully*,<sup>37</sup> it would seem that the basis of the *Dann* court's decision was that it could find no Congressional intent to create a right which would involve determinations of what have traditionally been matters of state law.<sup>38</sup> The court seemed to think that deciding questions in

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<sup>32</sup> *Id.* at 849.

<sup>33</sup> Although the remedy was not specifically provided for in the statutes under which the following actions were brought, the Court held that it could grant the relief necessary to accomplish full justice: *Mitchell v. Robert Demario Jewelry, Inc.*, 361 U.S. 288 (1960) (authority to order defendant to reimburse for wages lost through a violation of the Fair Labor Standards Act of 1938); *Schine Chain Theatres, Inc., v. United States*, 334 U.S. 110 (1948) (power to order a violator of the Sherman Antitrust Act to divest himself of holdings unlawfully acquired); *Porter v. Warner Holding Co.*, 328 U.S. 395 (1946) (traditional equity powers used to order restitution of rents above the maximum allowed by the Emergency Price Control Act of 1942).

<sup>34</sup> It would seem that the Court will be constrained to uphold the private right of action in view of the body of law which has grown up around SEC Reg. 10b-5. The section of the act it is promulgated under, § 10(b), like § 14(a), does not provide any private remedy for its violation. See note 6 *supra*.

<sup>35</sup> *Supra* note 16.

<sup>36</sup> See 2 Loss, *op. cit. supra* note 9, at 973.

<sup>37</sup> The *Dann* court's reliance on *Gully* is criticized in the following: Comment, *Private Rights and Remedies under the S.E.C. Proxy Rules*, 3 B.C. IND. & COM. L. REV., 58, 67 (1962); 75 HARV. L. REV. 637, 639 (1962).

<sup>38</sup> 288 F.2d at 212, 214.

these areas would be a judicial "federalizing" of state law, and this it was not willing to do. So it ended federal jurisdiction with the declaratory judgment even though realizing that such a decision meant "eating away at the vital principle that for every federal right, there should be a complete federal remedy."<sup>39</sup>

*Borak*, on the other hand, took the position that the "federalizing" was done by Congress when it chose to enter the field with such a strong program of requiring "full and fair disclosure" to investors in securities. The jurisdictional grant of section 27, extending as it does to all suits brought to enforce any liability or duty created by the act, thereby encompasses the traditional power to give a full federal remedy for the violation of a federal right.<sup>40</sup> One theory justifying this approach is that there is no question of "state law" involved. Such a conclusion finds support in *Textile Workers Union v. Lincoln Mills*.<sup>41</sup> In that case it was held that a mere grant of jurisdiction to entertain suits arising out of violations of contracts in the labor field gave rise to substantive law which was to be fashioned by the courts out of the legislative policy embodied in the national labor statutes.<sup>42</sup> The Securities Exchange Act of 1934 expresses a policy no less broad than that of the Taft-Hartley Act,<sup>43</sup> and the fact that jurisdiction to hear suits arising out of violations of the act is exclusively reposed in the federal courts is favorable evidence of Congressional intent that the rights vindicated by suit would be decided as federal law under the protective eye of its own courts. Such a view is bolstered by holdings to the effect that in areas where there is federal jurisdiction, but no federal law on a specific question, state law may be adopted if compatible with the federal aims.<sup>44</sup> The adoption of state law surrounding the corporate vote in determining whether plaintiff has been injured would be

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<sup>39</sup> *Id.* at 214.

<sup>40</sup> 317 F.2d at 849.

<sup>41</sup> 353 U.S. 448 (1957).

<sup>42</sup> *Id.* at 456.

<sup>43</sup> A former Chairman of the Commission expressed the function of the proxy rules and the policy behind them in this manner: "The proxy rules are a vital part of the shareholders' 'Bundle of rights.' They afford a means by which shareholders can exercise an informed judgment. . . . They implement the fundamental concern of the Congress expressed in the federal securities laws for the public investor." Armstrong, *Introduction to ARANOW & EINHORN, PROXY CONTESTS FOR CORPORATE CONTROL* at xxiii (1957).

<sup>44</sup> *E.g.*, *Textile Workers Union v. Lincoln Mills*, 353 U.S. 448 (1957); *Board of Comm'rs, v. United States*, 308 U.S. 343 (1939).

highly desirable solution as it would favor various local policies while redressing the violations of the federally created right.

From a practical standpoint, *Borak* seems to be the more desirable of the two decisions. If *Dann* is followed, the state courts could still refuse to take jurisdiction by holding that in determining the consequent effects of invalid proxies, they would be enforcing a liability created by the federal law, in contravention of the exclusive jurisdiction provision of section 27.<sup>45</sup> Furthermore, even if the state courts did take jurisdiction to decide the "state law" aspects of the action, two actions would be necessary before relief could be granted. Besides the time and money lost in this litigation, plaintiff would also lose the benefits of liberal venue and nationwide service of process available under section 27.<sup>46</sup>

Moreover, *Borak* carries out the purpose of section 14(a), protecting investors in securities, to a much greater degree than *Dann*. The very fact that the private action exists in addition to the enforcement by the Commission adds to the protection afforded by the act.<sup>47</sup> The decision also serves as a warning that any advantage obtained through illegal solicitation may be taken away in a private action after the vote. As such, it is a psychological weapon against those who would make use of such methods.

ROBERT B. LONG, JR.

### Liability of Continuing Shareholder for Constructive Dividend

When a closely held corporation redeems the shares of one stockholder, the threat of a constructive dividend may present tax problems for the continuing shareholder. The problem arises when one major shareholder has decided to leave the corporation and another wishes to remain. Basically, there are two ways for the continuing shareholder to acquire complete ownership of the corporation: (1) the continuing shareholder may use his personal funds to

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<sup>45</sup> State courts have so far refused to hear any claim or defense based upon § 14(a) because of § 27. *E.g.*, *Investments Associates, Inc. v. Standard Power & Light Corp.*, 29 Del. Ch. 225, 48 A.2d 501 (Ch. 1946), *aff'd*, 29 Del. Ch. 593, 51 A.2d 572 (Sup. Ct. 1947); *Eliasberg v. Standard Oil Co.*, 23 N.J. Super. 431, 92 A.2d 862 (Ch. 1952), *aff'd per curiam*, 12 N.J. 467, 97 A.2d 437 (1953).

<sup>46</sup> See these provisions of § 27 in note 16 *supra*.

<sup>47</sup> Brief for the SEC as Amicus Curiae, p. 21, *Borak v. J. I. Case Co.*, 317 F.2d 838 (7th Cir. 1963).