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Securities Regulation -- A Little Light and More Obfuscation on Rule 10b-5

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Two other courts recently presented with cases quite similar to *Gore* ruled that the limitation-of-damages clause was against public policy.[47] These decisions did not go nearly as far as *Gore*, however, because in each case the defendant was found to have been culpable in some degree. In one instance the seed grower was actually negligent,[48] and in the other, he fraudulently misrepresented the kind and quality of the seeds.[49] In contrast, the defendant in *Gore* was free of fault. The result of the court's decision in *Gore* is that seed growers and retailers are strictly liable for selling mislabeled products in North Carolina. Under the *Uniform Commercial Code*, now in force in this state, the seller by labeling his seeds to be a specific variety has given an express warranty of description[50] that may not be disclaimed by any inconsistent terms in the sales contract.[51] While the *Code* permits contractual limitation of damages, the *Gore* opinion would forbid such a modification, at least if the damages were limited to the return of purchase price. Thus, under the *Code*, a seed seller may not disclaim his liability for breach of an express warranty and under *Gore* he may not limit his damages.

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Securities Regulation—A Little Light and More Obfuscation on Rule 10b-5

For a decade or more there has been a prolific development of federal case law involving private actions based on violations of section 10(b) of the Securities Exchange Act of 1934[1] and of the implementing

[47]Klein v. Asgrow Seed Co., 246 Cal. App. 2d 87, 54 Cal. Rptr. 609 (1966); Dessert Seed Co. v. Drew Farmers Supply, Inc., 248 Ark. 858, 454 S.W.2d 307 (1970). In *Dessert Seed* the court stated that the limitation-of-damages clause was "unreasonable, *unconscionable*, and against sound public policy." *Id.* at 865, 454 S.W.2d at 311 (emphasis added).

[48]Dessert Seed Co. v. Drew Farmers Supply, Inc., 248 Ark. 858, 865, 454 S.W.2d 307, 311 (1970).

[49]Klein v. Asgrow Seed Co., 246 Cal. App. 2d 87, ____, 54 Cal. Rptr. 609, 618 (1966).

[50]UCC § 2-313(1)(b).

[51]*See* UCC § 2-316(1); UCC § 316, Comment 1; UCC § 2-313, Comments 1, 4.

[1]15 U.S.C. § 78j(b) (1970). The portion of the statute relevant to this discussion reads as follows:

> 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—

Rule 10b-5.[2] The result has been a broadly based federal anti-fraud law which is tending to replace state remedies of common law fraud in securities transactions.[3] As this new body of law developed, the United States Supreme Court remained relatively silent on section 10(b) and Rule 10b-5.[4] This silence has been broken with *Superintendent of Insurance v. Bankers Life & Casualty Co.*[5] Unfortunately, the nature of the facts alleged in the complaint in *Bankers Life* and the questions of law presented are outside the ambit of common corporate experience. Thus, those who had hoped for much illumination of Rule 10b-5 when the Court chose to review a case will probably be more disappointed than enlightened.

Section 10(b) and Rule 10b-5 directly affect the activities of most corporations and their directors, officers, and controlling shareholders. Decisions must be made on a recurrent basis with respect to transactions in securities and in particular with respect to disclosure of information on corporate activities. The holdings of the lower federal courts have left varying degrees of uncertainty in the law governing such decisions. What is the extent of the duty to disclose material information? What information is material? Who is liable to be treated as an insider and thus be required to surrender trading profits?[6] And, finally, how are

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(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.

[2]17 C.F.R. § 240.10b-5 (1971):

It shall be unlawful . . .

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

(b) to make any untrue statement of a material fact or to [make a misleading omission] . . . 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.

[3]For sympathetic discussions of this trend *see* Bloomenthal, *From Birnbaum to Schoenbaum: The Exchange Act and Self-Aggrandizement*, 15 N.Y.L.F. 332 (1969); Ruder, *Current Developments in the Federal Law of Corporate Fiduciary Relations—Standing to Sue under Rule 10b-5*, 26 BUS. LAW. 1289 (1971).

[4]Rule 10b-5 was construed in SEC v. National Sec. Inc., 393 U.S. 453 (1968), but in the Court's own language "[t]he questions presented [were] narrow ones." *Id.* at 465. The case was not a private action, and the more significant question resolved was that the McCarran-Ferguson Act, 15 U.S.C. § 1012(b) (1970), reserves to the states the regulation of insurance companies with respect to their relations with policyholders but does not preempt federal regulation where securities transactions are concerned.

[5]92 S. Ct. 165 (1971).

[6]The leading case which posed these questions and which is responsible for the proliferation

remedies to be determined?[7] Cases that pose these questions are not infrequent, and the answers to these questions are of much concern to corporate managers. Fortunately, it is the rare corporate manager who must decide—like the defendants in *Bankers Life*—whether he will be vulnerable under federal law if he siphons five million dollars of assets from an insurance company. It is, then, an unhappy accident that the principal case deals with such an unusual fact situation rather than the recurrent problems exemplified by the classic case of *SEC v. Texas Gulf Sulphur Co.*[8]

In *Bankers Life*, the Superintendent of Insurance as plaintiff stood in a role analogous to that of a trustee in bankruptcy of the defrauded and insolvent Manhattan Casualty Company.[9] The complaint alleged that certain of the defendants devised and executed a scheme whereby they bought all of the common stock of Manhattan through the use of its own assets to meet the purchase price. As a result, the company's assets were depleted by five million dollars, it was apparently rendered insolvent thereby, and creditors and policyholders were allegedly left vulnerable.[10] The fact that the complaint was evidently unclear and incomplete[11] together with the circumstance that the case arose on a motion to dismiss makes for some unfortunate speculation on the facts. Despite this, it is at least relatively clear that there were three distinct sets of transactions which made up the composite fraudulent scheme.[12] First, one of the individual defendants purchased all of the common stock of Manhattan from Bankers Life and Casualty Co. with a five-

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of Rule 10b-5 cases is SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969). In that case officers, directors, and management personnel of the company who had knowledge of a significant mineral discovery were held to have violated Rule 10b-5 by trading in the securities of the company in advance of public disclosure. In addition, the company itself was found to have committed a violation by releasing an equivocal news item underplaying the discovery.

[7]*See* Weiskopf, *Remedies under Rule 10b-5*, 45 ST. JOHN'S L. REV. 733 (1971).

[8]401 F.2d 833 (2d Cir. 1968).

[9]Superintendent of Ins. v. Bankers Life & Cas. Co., 300 F. Supp. 1083, 1086 n.1 (S.D.N.Y. 1969).

[10]There is an issue of fact as to whether any person was indeed damaged by the defendants' acts. The Supreme Court opinion alludes to damage to creditors. 92 S. Ct. at 169. The Securities Exchange Commission speaks of damage to policyholders and creditors. Brief for SEC as Amicus Curiae at 27. Contrariwise, the defendant Irving Trust Co. points out that the policyholders were reinsured and that the Superintendent of Insurance is not asserting any creditor claims. Brief for Respondent Irving Trust Co. at 23.

[11]300 F. Supp. at 1086 n.2. The confusion centers on two issues: was anyone actually damaged? *See* note 10 *supra*. And was the board of directors in fact misled? *See* text accompanying note 25 *infra*.

[12]300 F. Supp. at 1087-92 provides a comprehensive treatment of the facts.

million-dollar check drawn on the Irving Trust Co., there being no funds on deposit with Irving to cover this check. Second, the new owner caused the sale of Manhattan's portfolio of United States Treasury obligations to cover this check. Third, there ensued an elaborate "shell game" of purchasing and pledging certificates of deposit for the purpose of showing Manhattan as payee for five million dollars to replace the sold Treasury notes. In fact, the certificates were assigned to another company controlled by the individual defendants and had no asset value to Manhattan despite their appearance on the Manhattan balance sheet.

The district court characterized the case as one of common law fraud under state law.[13] The court of appeals affirmed.[14] The Supreme Court, reversed, holding that a cause of action was stated under Rule 10b-5.[15]

The first and most obvious rule that can be extracted from *Bankers Life* is that a private cause of action may be maintained on the basis of a violation of Rule 10b-5.[16] This conclusion is certainly anti-climactic in that it was clearly foretold by the holding of the Supreme Court in *J. I. Case Co. v. Borak*[17] (wherein a private cause of action was upheld for violation of other sections of the Securities Exchange Act) and had already formed the basis of decisions in substantially all of the courts of appeals.[18]

It is also clear from *Bankers Life* that the Court will place a liberal interpretation on the requirement that the Rule be confined to an "act . . . in connection with the purchase or sale of any security."[19] There were three separate transactions in *Bankers Life*. The first was the sale of the common stock of Manhattan by the defendant Bankers Life to the defendant Begole. There were two obstacles to finding a violation of section 10(b) and Rule 10b-5 solely on the basis of this transaction. First, there was no allegation that the sale was for less than the full value

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[13]*Id.* at 1102. In addition to a cause of action under state common law, it would appear that the Superintendent of Insurance could attack the transaction by statute. *See* N.Y. INS. LAW § 536 (McKinney 1966).

[14]Superintendent of Ins. v. Bankers Life & Cas. Co., 430 F.2d 355 (2d Cir. 1970).

[15]92 S. Ct. at 169-70.

[16]*Id.* at 169 n.9.

[17]377 U.S. 426 (1964). Earlier still, the apparent progenitor of private action cases under Rule 10b-5 was Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946).

[18]For a tally of cases and jurisdictions see 6 L. LOSS, SECURITIES REGULATION 3871-73 (Supp. 1969) (hereinafter cited as LOSS).

[19]*See* the text of Rule 10b-5 in note 2 *supra*. There had been little prior judicial interpretation of the significance of the "in connection with" phrase. There is a limited discussion in 6 LOSS 3616-17.

of the stock. Second, Manhattan was not a party to the sale of its own stock. To have allowed the plaintiff standing on the basis of this initial transaction would have meant repudiation of the so-called "*Birnbaum* rule"[20] that the plaintiff must be either a buyer or a seller to bring the action. As for the second transaction, Manhattan was a party to the sale of its portfolio of Treasury bonds but it was not alleged that Manhattan received less than full consideration for the bonds.[21] There was no fraud in connection with the sale of the bonds viewed as an independent transaction.

It is difficult to avoid the conclusion that the actual fraud occurred in the third transaction—when the certificate of deposit payable to Manhattan was assigned without consideration and thus became valueless as an asset of Manhattan. The fraud was consummated when the proceeds of the prior transaction were thus diverted. Certificates of deposit, however, are presumably not "securities" within the definition of Rule 10b-5.[22] Hence, the Rule would not have reached the fraudulent act if the Court had interpreted "in connection with" as limited to the immediate transaction which constituted the fraud. It was necessary to treat the three separate transactions as one for the purpose of finding an "act . . . in connection with the . . . sale of any security."

The second principle to be derived from *Bankers Life* would therefore seem to be that there is a violation of Rule 10b-5 such as to support a cause of action when there is a sale of securities for full consideration, followed by a fraudulent diversion of the proceeds, if the successive transactions are planned and executed contemporaneously as part of one integral fraudulent scheme. Such a broad interpretation of the "in connection with" requirement presents two problems. From a policy

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[20]Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952). It is possible that *Bankers Life* will be regarded by some as diluting the *Birnbaum* rule, but it should be noted that the Court was careful to avoid doing so by interpreting the transaction so as to find that the plaintiff was a "seller." The only allusion to the rule is in an ambiguous footnote. 92 S. Ct. at 169 n.10.

[21]The Treasury bonds were treated as within the definition of "securities" in 15 U.S.C. § 78c(a)(10) (1970). *Cf.* Tcherepnin v. Knight, 389 U.S. 332 (1967) (savings and loan shares included).

[22]The district court declined to rule specifically on the question of whether certificates of deposit are "securities" under Rule 10b-5, but the inference in the opinion is that they are not. 300 F. Supp. at 1099 & n.14a. In the definition of securities in the Securities Act of 1933, 15 U.S.C. § 77b(1) (1970), an "evidence of indebtedness" was covered and would presumably include certificates of deposit. The 1934 Act, however, excludes the phrase "evidence of indebtedness" and further expressly excludes "any note, draft, bill of exchange, or banker's acceptance which has a maturity . . . not exceeding nine months." 15 U.S.C. § 78c(a)(10) (1970). In the principal case, the certificates had a six month maturity. 300 F. Supp. at 1100.

perspective, it reinforces a trend toward a general federal common law governing corporate fraud based on Rule 10b-5. It also poses the practical problem of how closely related the individual transactions need be to fit into the *Bankers Life* pattern. Would the Court have found a cause of action if the diversion of the proceeds had followed the sale of the notes by one day? By one week? By one month? The opinion leaves these questions unanswered.

Another question that had not been clarified by prior case law under Rule 10b-5 was whether it was necessary that at least some of the directors or shareholders of the corporation be deceived by the alleged act or practice. Unfortunately, confusion of the facts in *Bankers Life* deprives us of a clear answer to this question. This confusion centers on the authorization of the sale of Manhattan's Treasury bonds. The Supreme Court seems to have assumed that the defendants induced the directors of Manhattan to authorize the sale and in so doing misrepresented or concealed the plan for diversion of the proceeds.[23] The district court assumed with much practical logic that the defendants installed themselves or others who were presumably privy to the scheme as officers and directors immediately upon their acquisition of the Manhattan common stock.[24] The brief for the defendant Irving Trust Company so states.[25] If the latter view is correct, there was no deception or misrepresentation. It is unlikely, however, that the outcome of the case would have differed whatever view is closer to the facts. The Court had determined that the interests of the creditors and policyholders were to be protected, and it was not likely to be deterred by the distinction as to whether any of the directors had been deceived.[26] It is thus probable that an action may be brought by the "defrauded" corporation for the purpose of protecting creditors even when the directors, the officers, and the shareholder(s) of the corporation are the perpetrators of the fraud or are privy to it. It is also apparent that it is not necessary that investors be damaged by the deceptive act or practice. Thus, a third general rule

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[23]92 S. Ct. at 167 n.1.

[24]300 F. Supp. at 1089 n.6.

[25]Brief for Respondent Irving Trust Co. at 5, Superintendent of Ins. v. Bankers Life & Cas. Co., 92 S. Ct. 165 (1971).

[26]This conclusion is not totally clear from the principal case because of the apparent assumption that some or all of the directors were deceived. Some case law supports the conclusion. *See* Shell v. Hensley, 430 F.2d 819 (5th Cir. 1970); Schoenbaum v. Firstbrook, 405 F.2d 215 (2d Cir. 1968), *cert. denied*, 395 U.S. 906 (1969); Ruckle v. Roto American Corp., 339 F.2d 24 (2d Cir. 1964) (dictum); *cf.* A.T. Brod & Co. v. Perlow, 375 F.2d 393 (2d Cir. 1967). *But see* O'Neill v. Maytag, 339 F.2d 764 (2d Cir. 1964).

may be drawn from the principal case: there is no longer any doubt that the protection of section 10(b) and Rule 10b-5 extends beyond "the integrity of the securities markets"[27] to reach the corporate entity and thereby its creditors.[28]

The Court in *Bankers Life* states that it finds support for this broad view of the class of persons to be protected in the legislative history of section 10(b) of the Securities Exchange Act.[29] Illustrative, perhaps, of the dubious value of that legislative history is the fact that the court of appeals reached the opposite conclusion,[30] while at least one eminent authority finds the legislative history cursory and inconclusive.[31]

There is a basic policy question as to the need for a general body of federal law dealing with fraudulent breaches of the fiduciary duties of directors, officers, and controlling shareholders of corporations.[32] If the answer is "yes," there is a second question as to whether such a body of law should be judge-made rather than the product of legislative codification.[33] It is certainly true that those who would answer "yes" to both of these questions will be cheered by the holding of *Bankers Life.*

Two divergent lines of case law had developed under the Rule 10b-5 umbrella. The first involved securities fraud in the pattern typified by *Texas Gulf Sulphur.* The second involved general corporate mismanagement through breaches of fiduciary duties. Conspicuous examples of the

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[27]Superintendent of Ins. v. Bankers Life & Cas. Co., 430 F.2d 355, 361 (2d Cir. 1970).

[28]*See* Hooper v. Mountain States Sec. Corp., 282 F.2d 195 (5th Cir. 1960), *cert. denied,* 365 U.S. 814 (1961); Macey, *Protection of Creditor's Rights Through Use of Rule 10b-5,* 76 COM. L.J. 133 (1971); *c.f.* A.T. Brod & Co. v. Perlow, 375 F.2d 393 (2d Cir. 1967).

[29]92 S. Ct. at 169 & n.8.

[30]430 F.2d at 361. The court of appeals followed the general interpretation set out in the *Birnbaum* case.

[31]6 Loss 3617 approves the *Birnbaum* version of the legislative history. For an entertaining firsthand commentary on the cursory treatment given to Rule 10b-5 at the time of its adoption by the Securities Exchange Commission *see remarks of M. Freeman in Proceedings of ABA Section of Corporation, Banking and Business Law, Conference on Codification of the Federal Securities Laws,* 22 BUS. LAW. 793, 921-23 (1967). For an appraisal which concludes that no sort of civil remedy can be supported by the legislative history *see* Ruder, *Civil Liability Under Rule 10b-5: Judicial Revision of Legislative Intent?* 57 NW. U.L. REV. 627 (1963).

[32]*See* 6 Loss 3631-45, 3875. On the subject of the growth of Rule 10b-5, Professor Loss has further said, "This is backdoor jurisprudence with a vengeance." Loss, *History of SEC Legislative Programs and Suggestions for a Code,* 22 BUS. LAW. 795, 796 (1967). *See,* in addition, the articles cited note 3 *supra.*

[33]*See Proceedings of ABA Section of Corporation, Banking and Business Law, Conference on Codification of the Federal Securities Laws,* 22 BUS. LAW. 793 (1967); Painter, *Rule 10b-5: The Recodification Thicket,* 45 ST. JOHN'S L. REV. 699 (1971); Comment, *Federal Corporation Law and 10b-5: The Case for Codification,* 45 ST. JOHN'S L. REV. 274 (1970).

latter are *Ruckle v. Roto American Corp.*,[34] where the defendant directors issued treasury stock to perpetuate their control; *Schoenbaum v. Firstbrook*,[35] in which a majority stockholder used its control to acquire additional shares for inadequate consideration; and *Hooper v. Mountain States Securities Corp.*,[36] another instance of the issuance of stock for inadequate consideration. *Bankers Life* can be seen as encouraging the use of Rule 10b-5 as it was used in these cases to allow recovery for the breach of fiduciary obligations.

Nonetheless, *Bankers Life* is an atypical case and may be more interesting for what it does not decide than for what it does. A valid argument for a federal law governing corporate fraud is that the result will be uniformity and simplified corporate decision-making. This argument for supplanting state law fails when the federal law develops helter-skelter and lacks uniformity. A major role of the Supreme Court is to help induce clarity and uniformity. Thus, if the Court decides to encourage expansion of the role of the federal courts, it can be helpful by accepting the concurrent responsibility of seeing that the expansion is orderly and consistent. *Bankers Life*, dealing as it does with a peripheral situation, may not prove to be very helpful in this respect.

In summary, *Bankers Life* foretells a broad interpretation of the requirement in Rule 10b-5 that the questioned acts must be "in connection with" the purchase or sale of securities. The case also approves the extension of the protection afforded by the Rule to creditors as well as investors. On the other hand, the Court leaves the technical "*Birnbaum* rule" undisturbed—the plaintiff must be a buyer or a seller.[37] The anomalous result is an endorsement of the letter of the *Birnbaum* case but an implied rejection of the spirit of *Birnbaum* in that the basic rationale for the *Birnbaum* rule was to confine the private cause of action to the protection of the integrity of the securities markets.

As a result, Rule 10b-5 becomes a stronger weapon for the enforcement of the general fiduciary duties of directors and controlling shareholders, apart from its narrower function of regulating securities transactions. Business lawyers and corporate managers, however, will have to wait for definitive answers to the day-to-day questions of disclosure obligations and remedies under Rule 10b-5.

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[34]339 F.2d 24 (2d Cir. 1964).

[35]405 F.2d 215 (2d Cir. 1968) (en banc), *cert. denied*, 395 U.S. 906 (1969).

[36]282 F.2d 195 (5th Cir. 1960), *cert. denied*, 365 U.S. 814 (1961).

[37]Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952).