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Securities Regulation—Deception and the “in connection with” Clause of Rule 10b-5

Section 10(b) of the Securities Exchange Act of 1934¹ and rule 10b-5² are designed to prevent fraud and deceit “in connection with the purchase and sale of any security.”³ In *Superintendent of Insurance v. Bankers Life & Casualty Co.*,⁴ the Supreme Court reiterated a liberal construction of rule 10b-5 and issued rare policy guidance⁵ as to who must be deceived, what transactions are “in connection with” a sale of securities, and who has standing to bring a rule 10b-5 cause of action.

The New York State Superintendent of Insurance, as liquidator of Manhattan Casualty Co. (Manhattan), brought an action for damages to Manhattan alleged to have resulted from a fraudulent scheme “in connection with” a sale of United States Treasury bonds owned by it. Bankers Life, the sole stockholder of Manhattan, sold all its stock to James F. Begole for five million dollars. A conspiracy of Begole and Standish T. Bourne, and possibly others, arranged for a check for five million dollars to be issued by the Irving Trust Company for the purchase price. Because the conspirators had no funds on deposit with Irving Trust, as soon as the sale of the Manhattan stock was consummated Manhattan’s entire investment portfolio consisting of Treasury bonds was transferred to Irving Trust to cover the five-million-dollar check.⁶ In order to disguise the fraud, the conspirators initiated a second series of transactions that resulted in superficially valid corporate books but an actual loss to Manhattan of five million dollars.⁷ The net effect

¹Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (1970). The relevant portion of § 10(b) is set out in Note, *Securities Regulation—A Little Light and More Obfuscation on Rule 10b-5*, 50 N.C.L. REV. 706, 707 n. 1 (1972).

²17 C.F.R. § 240.10b-5 (1971). For the text of rule 10b-5 see Note, 50 N.C.L. REV., *supra* note 1, at 707 n. 2.

³Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j (b) (1970); 17 C.F.R. § 240.10b-5 (1971).

⁴92 S. Ct. 165 (1971).

⁵Despite the fact that § 10(b) and rule 10b-5 “may well be the most frequently litigated provisions in the federal securities laws,” SEC v. National Sec., Inc., 393 U.S. 453, 465 (1969), *Bankers Life* is only the second United States Supreme Court interpretation of them. The first was SEC v. National Sec. Inc., 393 U.S. 453 (1969).

⁶92 S. Ct. at 167.

⁷Certificates of deposit were obtained in Manhattan’s name in the second series of transactions. However, “the certificates of deposit were never assets of Manhattan” because they had been pledged upon creation as collateral for a \$5,000,000 loan in favor of an unrelated corporation. *People v. Sweeny*, 27 N.Y.2d 138, 148, 261 N.E.2d 655, 659-60, 313 N.Y.S.2d 744, 750-51 (1970) (a criminal trial resulting from these transactions). As a result Manhattan’s corporate books

of these transactions was that Begole and his fellow conspirators obtained control of Manhattan by misappropriating Manhattan's own assets to buy all of its outstanding stock.⁸

It was understood that a general state tort law cause of action existed against the conspirators for the fraudulent transactions which resulted in the depletion of Manhattan's assets without a corresponding benefit. However, the issue litigated in *Bankers Life* was whether a federal cause of action existed under section 10(b) and rule 10b-5.⁹ The district court, in dismissing the complaint in *Bankers Life*, concluded that "the purity of the security transaction and the purity of the trading process are the sole objectives"¹⁰ of 10b-5 jurisdiction. The court of appeals, affirming, enunciated the congressional purpose as "limited to preserving the integrity of the securities markets."¹¹ However, the United States Supreme Court reversed, stating that these interpretations of 10b-5 were too narrow and that "[s]ection 10(b) must be read flexibly, not technically and restrictively."¹² All three courts based their decisions to some extent on the purposes of the Securities Exchange Act of 1934, and yet they reached obviously different results—possibly because there is a dearth of evidence as to the congressional intent in enacting section 10(b).¹³

The Supreme Court in *Bankers Life* did not directly address the unsettled issue of whether the plaintiff in a 10b-5 cause of action must

reflected only the sale of its Treasury bonds and the purchase of a certificate of deposit for a like amount. They did not reflect the misappropriation. 92 S. Ct. at 167.

⁸Superintendent of Ins. v. Bankers Life & Cas. Co., 300 F. Supp. 1083, 1092 (S.D.N.Y. 1969).

⁹Superintendent of Ins. v. Bankers Life & Cas. Co., 430 F.2d 355, 361 (2d Cir. 1970). A federal cause of action is generally sought by the plaintiff because state substantive law may be more restrictive and state procedural rules may create obstacles to the plaintiff's recovery. See generally Comment, *The Prospects for Rule X-10B-5: An Emerging Remedy for Defrauded Investors*, 59 YALE L.J. 1120, 1123-36 (1950).

¹⁰300 F. Supp. at 1101.

¹¹430 F.2d at 361.

¹²92 S. Ct. at 169. This is a reaffirmance of the Court's holding in *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963), that securities legislation "enacted for the purpose of avoiding frauds, [should be construed] not technically and restrictively, but flexibly to effectuate its remedial purposes." (Footnote omitted.) Since Congress could not catalog all the kinds of fraudulent and illegitimate schemes, it gave broad discretionary powers to the Securities Commission. H.R. REP. NO. 1383, 73d Cong., 2d Sess. 6-7 (1934). See also *Rekant v. Desser*, 425 F.2d 872, 880 n.15 (5th Cir. 1970).

¹³2A BROMBERG, *SECURITIES LAW: FRAUD—SEC RULE 10B-5* § 2.2(331) (Supp. 1970-71). The purpose of § 10(b) is to serve as a "catch-all" provision and assure fair dealings in securities transactions. *Hearings on H.R. 7852 and H.R. 8720 Before the House Comm. on Interstate and Foreign Commerce*, 73d Cong., 2d Sess. 115 (1934).

be a purchaser or seller of securities. The purchaser-or-seller requirement was initially expressed in *Birnbaum v. Newport Steel Corp.*,¹⁴ but subsequent decisions have left its validity uncertain.¹⁵ Instead of settling this controversy, the Supreme Court chose to base its reversal on the only transaction in which Manhattan was clearly a seller of securities.¹⁶ However, an analysis of the facts indicates at least a practical expansion of the concept of purchasers or sellers. The Superintendent of Insurance, the liquidator of Manhattan,¹⁷ was allowed to maintain the action. Because Manhattan was bankrupt the Superintendent was not protecting the interests of Manhattan but was actually representing the interests of Manhattan's creditors and policyholders.

Creditors and policyholders are not members of the corporate decision-making process and have no proprietary interest in the corporation's assets.¹⁸ However, the *Bankers Life* Court gave creditors the power to represent the corporation in a 10b-5 action because the legislative history of section 10(b) indicates congressional concern for the impact fraudulent transactions have on creditors and because the officers, directors, and controlling shareholders are under a fiduciary obligation to protect creditors as well as stockholders.¹⁹

The unusual facts of *Bankers Life* created further problems that the

¹⁴193 F.2d 461 (2d Cir. 1952).

¹⁵At least one court has concluded that the Second Circuit Court of Appeals in *A.T. Brod & Co. v. Perlow*, 375 F.2d 393 (2d Cir. 1967), "seriously challenged, if not overruled" the *Birnbaum* doctrine. *Weitzen v. Kearns*, 271 F. Supp. 616, 622 (S.D.N.Y. 1967). The district court in the principal case, however, applied the doctrine based on the Second Circuit's post-*Brod* reaffirmance of the doctrine in *Greenstein v. Paul*, 400 F.2d 580 (2d Cir. 1968). *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 300 F. Supp. 1083 (S.D.N.Y. 1969). The *Birnbaum* doctrine has precipitated commentaries both pro and con. Compare Patton, *The "Purchase or Sale" Restriction of SEC Rule 10b-5—Judicial Extension of a Federal Remedy*, 18 CATHOLIC U. L. REV. 463 (1969), with Lowenfels, *The Demise of the Birnbaum Doctrine: A New Era for Rule 10b-5*, 54 VA. L. REV. 268 (1968).

¹⁶The Supreme Court accepted the reasoning of the SEC as amicus curiae that *Bankers Life* could maintain a 10b-5 cause of action based on the sale of the Treasury bonds and that a decision based on that transaction would afford all the necessary relief. Brief for SEC as Amicus Curiae at 7 n.6. The SEC's reluctance to press its pronounced disagreement with the *Birnbaum* doctrine is attributable to its belief that even if the purchaser-or-seller limitation were rejected in *Bankers Life*, the other two transactions might have precluded the plaintiff's recovery. Brief for SEC as Amicus Curiae for Certiorari at 5.

¹⁷The New York Superintendent of Insurance is vested with all the rights of action that the insurer possessed. N.Y. INS. LAW § 514(2) (McKinney 1966).

¹⁸300 F. Supp. at 1101 n.16.

¹⁹2 S. Ct. at 169.

Court dismissed with little discussion. Whether deceit²⁰ was practiced upon Manhattan was decided by the Court in four words, "the seller[corporation] was duped"²¹ However, the question of whether a corporation can be "duped" when all the persons involved in its decision-making process are involved in the fraudulent scheme had given the district court considerably more difficulty.²²

The Supreme Court justified its conclusion that Manhattan, as a seller of securities, was deceived by quoting from a Fifth Circuit case to the effect that when a person dealing with a corporation denies its directors access to material information, a 10b-5 action is recognized because the board is disabled from making an informed judgment.²³ The Supreme Court's decision that Manhattan's directors had been denied access to material information was based on the court of appeals' finding that the board had been deceived.²⁴ However, the Supreme Court's conclusion contradicts the district court's factual determination that the injury was not incurred by anyone who was the subject of federal concern because it was not practiced on the officers, directors, or shareholders of the corporation.²⁵

When deception is committed by the directors²⁶ or the shareholders,²⁷ "the corporation is . . . 'deceived,' in the only sense in which a fictional legal person can be deceived, i.e., through deception practiced upon those real persons through whom it acts."²⁸ Moreover, courts have

²⁰Previous Second Circuit decisions have held deception an essential element of a 10b-5 cause of action. *See, e.g., O'Neill v. Maytag*, 339 F.2d 764, 768 (2d Cir. 1964).

²¹92 S. Ct. at 167.

²²"[I]t is dubious whether plaintiff corporation was ever defrauded or deceived." 300 F. Supp. at 1101 n.16.

²³*Shell v. Hensley*, 430 F.2d 819, 827 (5th Cir. 1970).

²⁴"No doubt the deception was successful, for had the board known that [those in control of Manhattan] intended to misappropriate the proceeds for their own use it undoubtedly would not have authorized their sale." 430 F.2d at 360.

²⁵300 F. Supp. at 1101 n.16.

²⁶*Ruckle v. Roto Am. Corp.*, 339 F.2d 24 (2d Cir. 1964). The allegation in *Ruckle* was that a majority of the board fraudulently obtained the board's approval of an issue of securities by withholding a financial statement.

²⁷*Globus, Inc. v. Jaroff*, 266 F. Supp. 524 (S.D.N.Y. 1967).

²⁸*Id.* at 529 (footnote omitted). "All information reasonably relevant to a rational investment must be disclosed to the decision-making body, whether that body be composed of directors, officers, or shareholders of the corporation." *Simon v. New Haven Bd. & Carton Co.*, 250 F. Supp. 297, 299 (D. Conn. 1966). The issue of deception has met with diverse interpretations. *See, e.g., O'Neill v. Maytag*, 230 F. Supp. 235 (S.D.N.Y. 1964), *aff'd*, 339 F.2d 764 (2d Cir. 1964) (allegations of deception required); *Dasho v. Susquehanna Corp.*, 380 F.2d 262 (7th Cir. 1967) (failure to disclose material facts to disinterested minority directors constitutes deception); *Weitzen v.*

allowed 10b-5 actions for failure to disclose information to a minority of the directors even though the knowing directors have sufficient votes to perpetrate the scheme, presumably because the "corporation" was deceived.²⁹ However, the vitality of the deception requirement is suspect if courts recognize deception of the corporation by treating the "corporation" separately from its directors and shareholders.³⁰

The Second Circuit Court of Appeals took a more practical approach to this conceptual problem in *Schoenbaum v. Firstbrook*.³¹ There the panel acknowledged the general rule that a corporation can be deceived only if its agents are deceived, since a corporation can act only through its agents and can know only what its agents know.³² The *Schoenbaum* panel recognized that a corporation may be defrauded even if *all* the directors know the material facts, if the transmission of information to the corporation is prevented by a conflict between the interests of the directors and those of the corporation.³³ In other words, the *Schoenbaum* panel utilized fictional attributes of a corporation in order to analyze a specific transaction, but Judge Hays, who later authored the en banc reversal of the panel decision, dissented and was quick to point out that the corporate fictionalization could "constitute a trap for the unwary when they ascribe reality to the fictions."³⁴ The treatment of a corporation as possessing the attributes of a person cannot be used as a universal solvent for corporate problems. The an-

Kearns, 271 F. Supp. 616 (S.D.N.Y. 1967) (failure to disclose material facts to all stockholders constitutes deception); *Simon v. New Haven Bd. & Carton Co.*, *supra* (no deception unless majority of the decision-making body is misled).

²⁹*Ruckle v. Roto Am. Corp.*, 339 F.2d 24 (2d Cir. 1964). Nondisclosure is said to injure the corporation for several reasons: (1) failure to disclose may preclude others from seeking derivative relief, *Barnett v. Anaconda Co.*, 238 F. Supp. 766, 776 n.7 (S.D.N.Y. 1965) (dictum); (2) nondisclosure may encourage mismanagement that the knowing director would not otherwise have had the courage to commit, *Globus, Inc. v. Jaroff*, 271 F. Supp. 378 (S.D.N.Y. 1967); (3) nondisclosure may permit the defendants to put themselves in positions to commit further mismanagement, *Vine v. Beneficial Fin. Co.*, 374 F.2d 627 (2d Cir. 1967).

³⁰One writer, criticizing the finding of deception by treating shareholders as standing in the place of the corporation, characterized it as "legal slight-of-hand." Comment, *Rule 10b-5 Corporate Mismanagement Cases: Who Must Deceive Whom?*, 63 NW. U.L. REV. 477, 492 (1968).

³¹405 F.2d 200, *rev'd en banc*, 405 F.2d 215 (2d Cir. 1968), *cert. denied*, 395 U.S. 906 (1969).

³²*Id.* at 211. *See also* *Shell v. Hensley*, 430 F.2d 819, 826 (5th Cir. 1970); 3 W. FLETCHER, PRIVATE CORPORATIONS § 790 (perm. ed. 1965); RESTATEMENT (SECOND) OF AGENCY §§ 9(3), 282(1) (1958).

³³405 F.2d at 211.

³⁴*Id.* at 215 (Hays, J., dissenting). Judge Hays warned against the conclusion that the directors *are* the corporation and that therefore the corporation has knowledge if the directors have knowledge. *Id.*

thropomorphism must yield to the predominant concern of effectuating the remedial purposes of 10b-5,³⁵ and the corporate fiction should not be interposed between the directors and the injured shareholders. It must be "the shareholders, the real owners of the property"³⁶ whom the directors deceive before there is "deceit" in the 10b-5 sense. Unless the creditors and policyholders of Manhattan are considered to be "the real owners" of the corporation, the analysis of deceit in *Schoenbaum* is not applicable to the *Bankers Life* situation. This is true because in *Bankers Life* all directors and shareholders were aware of the facts.³⁷ "When it is practical as well as just to do so, courts have experienced no difficulty in rejecting such cliches as the directors constitute the corporation and a corporation, like any other person, cannot defraud itself."³⁸ The *Bankers Life* Court extended this analysis one step further by allowing a 10b-5 action to be brought to protect creditors from fraud perpetrated by all the officers, directors, and shareholders of the corporation. Just as the *Schoenbaum* Court solved the corporate fiction problem by substituting shareholders for the corporation in order to protect the shareholders, the *Bankers Life* Court substituted creditors for the corporation to allow a 10b-5 action for the protection of creditors.

Bankers Life indicated that Congress in enacting the 1934 Act was concerned with the protection of corporate creditors. The controlling stockholder owes his corporation a fiduciary obligation to protect creditors as well as stockholders, and consequently all transactions between the stockholders and the corporation that may injuriously affect the rights of creditors will be carefully examined.³⁹ Presumably, this creditor-protection cause of action will be available in the future only in fact situations in which the interests of the defrauders are adverse to

³⁵Shell v. Hensley, 430 F.2d 819 (5th Cir. 1970).

³⁶405 F.2d at 215 (Hays, J., dissenting).

³⁷In *Field v. Lew*, 184 F. Supp. 23 (E.D.N.Y. 1960), *aff'd*, 296 F.2d 109 (2d Cir. 1961), *cert. denied*, 369 U.S. 859 (1962), the court held that a corporation could not be injured as a seller when the sole shareholder authorized a fraudulent misappropriation by corporate insiders. The unauthorized acts of the conspirators become the authorized acts of the corporation upon shareholder ratification. The *Bankers Life* court rejected this reasoning in order to protect creditors of the corporation.

³⁸*Ruckle v. Roto Am. Corp.*, 339 F.2d 24, 29 (2d Cir. 1964). One court phrased the issue as whether "the corporation's choice of action . . . [was] made as a reasonable man would make it if possessed of all the material information . . ." *Shell v. Hensley*, 430 F.2d 819, 827 (5th Cir. 1970). The imputed knowledge rationale is not followed, presumably because its logical conclusion would mean the corporation could never be deceived by its directors since their knowledge would automatically be imputed to the corporation.

³⁹92 S. Ct. at 169.

the corporation, a requirement which would limit the extent of such actions.⁴⁰

In *Bankers Life* the Supreme Court broadened the scope of transactions that are considered to be "in connection with the purchase or sale of any security." The defendants in *Bankers Life* did not fraudulently induce an unfair purchase price or fail to pay a fair price for the stock they purchased.⁴¹ They transacted a sale and paid for the securities with a check cashed later by Manhattan for the full and fair value. However, the proceeds of the sale were misappropriated to cover the check used by Begole and others to purchase the Manhattan stock. The "in connection with" language of 10b-5 could be construed to include a fraudulent scheme entailing a promise that value will be received for a sale of securities and a subsequent misappropriation. However, the lower courts held that such a construction was unwarranted in this case. The Supreme Court, on the other hand, felt that a 10b-5 action was justified under a liberal construction of section 10b-5.⁴² As one commentator has concluded, the "in connection with" clause "is plainly and—one must assume—intentionally the loosest linkage, in any of the federal antifraud provisions, between a proscribed act and a security transaction."⁴³ The *Bankers Life* Court pointed out that Congress did not intend to regulate transactions amounting to no more than internal corporate mismanagement,⁴⁴ but the Court concluded that the misappropriation of funds was sufficiently "in connection with" the transaction to warrant proscription. The importance of this conclusion is overshadowed by the approach taken to determine the standards to be applied to the "in connection with" clause. Although the Supreme Court summarily declared that the fraud was used "in connection with" the transaction, a comparison of its decision with that of the lower courts

⁴⁰See note 33 & accompanying text *supra*.

⁴¹The court of appeals based its denial of a 10b-5 cause of action on the fact that the misrepresentation did not involve the value of securities. 430 F.2d at 360-61. Although this was not a widespread interpretation, *see, e.g., United States v. Peltz*, 433 F.2d 48 (2d Cir. 1970); *Allico Nat'l Corp. v. Amalgamated Meat Cutters & Butcher Workmen of North America*, 397 F.2d 727 (7th Cir. 1968), the Supreme Court's reversal made it clear that such a test is too narrow. In fact, the court of appeals decision in *Bankers Life* conflicts with its earlier decision that "[n]either § 10(b) nor Rule 10b-5 contains any language which would indicate that those provisions were intended to deal only with fraud as to the 'investment value' of securities, and, indeed, it is established that a 10b-5 action will survive even though the fraudulent scheme or device is unrelated to 'investment value.'" *A.T. Brod & Co. v. Perlow*, 375 F.2d 393, 396-97 (2d Cir. 1967).

⁴²See note 12 & accompanying text *supra*.

⁴³1 A. BROMBERG, *supra* note 13, § 7.6(1), at 190.21 (Supp. 1969-1).

⁴⁴92 S. Ct. at 169.

will shed insight on the Court's analysis. The Court was satisfied that "Manhattan suffered an injury as a result of deceptive practices touching its sale of securities . . ." ⁴⁵ The lower courts' requirements that the purchase or sale of securities be at the crux of a fraudulent scheme ⁴⁶ or be the "sole object" of the fraud ⁴⁷ were rejected. Instead, the Court emphasized the fact that 10b-5 encompasses schemes that involve fraud even if the fraud is not of a type "usually associated with the sale or purchase of securities." ⁴⁸

The district court would not allow 10b-5 actions based on transactions that were mere steps toward accomplishing the ultimate goal of looting Manhattan's assets. ⁴⁹ In contrast, several courts had previously held that misappropriation of the funds from a securities transaction was sufficient for a 10b-5 cause of action. ⁵⁰ The theory of those cases was that violators of 10b-5 should not be immunized from liability merely because their violation is part of a broader scheme of misappropriation, even if corporate looting is the object or result of the fraud. ⁵¹ A 10b-5 action has been upheld as long as the "purchase or sale" is the subject or the purpose of the scheme. ⁵² The court of appeals in *Bankers Life* erred in separating the transaction into a securities sale and a subsequent misappropriation ⁵³ because the entire series of events was one unified scheme with the sale of securities an indispensable part. ⁵⁴

⁴⁵*Id.* (emphasis added). The Court rejected defendant's contention that 10b-5 liability would result in federal preemption of state law governing corporate mismanagement.

⁴⁶300 F. Supp. at 1101.

⁴⁷430 F.2d at 360.

⁴⁸92 S. Ct. at 168 n.7, quoting *A.T. Brod & Co. v. Perlow*, 375 F.2d 393, 396 (2d Cir. 1967).

⁴⁹The district court said that "Rule 10b-5 requires the employment of fraud in connection with a security transaction, which is essentially different from the effectuation of a security transaction in connection with a fraudulent activity." 300 F. Supp. at 1102. The sale of Treasury bonds was for the purpose of effecting the object of the conspiracy (looting Manhattan's assets), but a sale not independently unlawful (lack of fraud) is not actionable under 10b-5. *Id.*

⁵⁰*E.g.*, *Allico Nat'l Corp. v. Amalgamated Meat Cutters & Butcher Workmen of North America*, 397 F.2d 727, 730 (7th Cir. 1968); *Hooper v. Mountain States Sec. Corp.*, 282 F.2d 195 (5th Cir. 1960), *cert. denied*, 365 U.S. 814 (1961).

⁵¹*Rekant v. Desser*, 425 F.2d 872 (5th Cir. 1970).

⁵²*Herprich v. Wallace*, 430 F.2d 792, 807-08 (5th Cir. 1970).

⁵³430 F.2d at 360. However, because both series of transactions (sale of securities and cover-up) were accomplished in a single day, it would have been more logical to conclude that the sale transaction was at least an integral part of the scheme than to attempt to separate the sale from the misappropriation.

⁵⁴A similar analysis appeared in *Allico Nat'l Corp. v. Amalgamated Meat Cutters & Butcher Workmen of North America*, 397 F.2d 727 (7th Cir. 1968), in which the court sustained a 10b-5 cause of action. Defendant breached a contract to sell stock to plaintiff when a better deal was offered by a third party. In the process defendant misappropriated 25,000 shares of plaintiff's

The Supreme Court's broad interpretation of the "in connection with" clause must be read in view of the unusual facts of the *Bankers Life* case. The defendants had manipulated a highly complex series of transactions to gain control of a corporation without expending *any* of their own funds. The Court characterized the crux of the *Bankers Life* case as being the injury suffered as a result of deceptive practices "touching" its sale of securities. Thus characterized, the case may not seem to support a conclusion that the requirements of the "in connection with" clause were liberalized. It could also be said that "but for"⁵⁵ the securities transactions there would have been neither an injury nor a workable scheme. The Court, based on the strong facts presented, could have concluded that the fraudulent misappropriation was the proximate cause or, at least, at the crux of the securities transaction or could merely have differed from the lower courts' assessment of the facts to hold that the misappropriation was not separable from the securities transaction.⁵⁶ The fact that the Court re-evaluated the "connection" necessary for 10b-5 and held that fraud "touching" the transaction is sufficient indicates the liberality of the Court's interpretation of 10b-5 and the increased scope of its use in the future.

To support a 10b-5 action, there need only be a purchase or sale of securities and fraud that "touches" any part of the transaction. Although the limits of this "touching" have not been defined, clearly a misappropriation of the corporation's assets to pay the purchase price of its stock is sufficient. The nature of the fraud, the fact that the only interests to be protected are those of creditors, and the participation in the fraud of all the corporate decision makers are irrelevant. By treating the transaction as a unified whole and not separable parts, the Court

stock, which defendant had held in escrow pending consumation of the deal. The court held that 10b-5 jurisdiction existed because defendant's motivation included the misappropriation.

⁵⁵In *Hoover v. Allen*, 241 F. Supp. 213 (S.D.N.Y. 1965), a court denied 10b-5 jurisdiction despite allegations that defendants purchased the controlling stock by deception and committed corporate waste. The court held that the deceptive acquisition of control was not the proximate cause of the later mismanagement. *See also* *Vine v. Beneficial Fin. Co.*, 374 F.2d 627 (2d Cir. 1967).

⁵⁶This interpretation was not without precedent in the lower courts. In *Cooper v. North Jersey Trust Co.*, 226 F. Supp. 972, 978 (S.D.N.Y. 1964), the court stated the issue to be whether 10b-5 covers a case in which the security purchase "is a vital aspect of a continuing scheme [when] plaintiff received his full value for the stock purchased but ultimately retained nothing as a result of the fraudulent arrangement." Answering affirmatively, the court concluded that 10b-5 is not limited to the portion of the transaction involving the exchange of consideration. *Id.*

protected a corporation's right to retain something of value from a sale of securities.⁵⁷

JOHN D. LOWERY

Truth In Lending—In Support of the Validity of the Regulation Z Four Installment Rule

In *Mourning v. Family Publications Service, Inc.*,¹ the Court of Appeals for the Fifth Circuit dealt a blow to consumer protection by holding invalid the four installment rule of Regulation Z,² a regulation promulgated by the Board of Governors of the Federal Reserve System pursuant to Title I (Truth in Lending) of the Consumer Credit Protection Act.³ Under Regulation Z the disclosure requirements⁴ of Truth in Lending are made applicable to "consumer credit," defined in the regulation as "credit offered or extended . . . for which either a finance charge is or may be imposed *or which pursuant to an agreement, is or may be payable in more than four installments.*"⁵ The court of appeals held that promulgation of the so-called "four installment rule" was beyond the authority granted the Board of Governors by Congress and that the rule created a conclusive presumption in violation of the due

⁵⁷The Fifth Circuit adopted a similarly practical approach to the scope of 10b-5 liability in *Hooper v. Mountain States Sec. Corp.*, 282 F.2d 195, 203 (5th Cir. 1960), *cert. denied*, 365 U.S. 814 (1961): "Considering the purpose of 10b-5, it would be unrealistic to say that a corporation having the capacity to acquire \$700,000 worth of assets for its 700,000 shares of stock has suffered no loss if what it gave up was \$700,000 but what it got was zero."

¹449 F.2d 235 (5th Cir. 1971), *cert. granted*, 92 S. Ct. 1248 (1972). Two student writers have noted this decision. Note, *Consumer Protection—Credit—Administrative Law—Constitutional Law—Federal Reserve Board Regulation Requiring Disclosure of Credit Terms Any Time Consumer Transaction Involves Four or More Installments Exceeds Authority Granted the Board by Truth In Lending Act and Violates Due Process Clause of the Fifth Amendment*, 40 U. CIN. L. REV. 876 (1971), strongly criticizes the decision and Note, *The Four-Installment Rule of Regulation Z Exceeds the Scope of Authority Granted by the Truth In Lending Act and Creates an Irrebuttable Presumption Prohibited by the Fifth Amendment*, 9 Hous. L. REV. 552 (1972), generally supports it.

²12 C.F.R. §§ 226.1-.1002 (1971).

³15 U.S.C. §§ 1601-81 (1970).

⁴Truth in Lending Act §§ 127-28, 15 U.S.C. §§ 1637-38 (1970). Under the Act's disclosure provisions, full disclosure of credit terms must be made to the consumer prior to the consummation of the credit transaction. The Act requires disclosure both where open-ended credit is involved (*e.g.*, credit cards and revolving credit plans) and where credit other than open-ended credit is involved.

⁵12 C.F.R. § 226.2(k) (1971) (emphasis added).