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Securities Regulation -- The Reincarnation of the Deception Requirement

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its inclusion under the interpretation of *Typographers Local 38 v. NLRB*.[57] Management negotiators will be able to condition agreement to the benign clause only upon receipt of a valuable concession by the union.

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Securities Regulation—The Reincarnation of the Deception Requirement

Rule 10b-5[1] has been used to develop a corpus of federal law relating to fiduciary obligations of directors, officers, and majority shareholders[2] in an area that has traditionally been a subject for state rather than federal regulation.[3] Due to its broad language, the rule creates an almost undefined liability. Absent definitive legislative action, courts have assumed primary responsibility for defining the extent of liability. In the recent case of *Popkin v. Bishop*,[4] the Second Circuit clearly rejected imposition of rule 10b-5 liability in the absence of an allegation of nondisclosure or deception in connection with the purchase or sale of securities. This holding, reiterating nondisclosure as a fundamental element in such an action, represents a significant restriction on the expansion of rule 10b-5 into the area of corporate fiduciary obligations.

[57]*See* notes 23-26 and accompanying text *supra*. Attention should be called to the fact that *Typographers Local 38* was affirmed by an equally divided Supreme Court. However, an opposite decision in the near future seems unlikely.

[1]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.

[2]*See* Pappas v. Moss, 393 F.2d 865 (3d Cir. 1968); Vine v. Beneficial Fin. Co., 374 F.2d 627 (2d Cir.), *cert. denied*, 389 U.S. 970 (1967); O'Neill v. Maytag, 339 F.2d 764 (2d Cir. 1964); Entel v. Allen, 270 F. Supp. 766 (S.D.N.Y. 1965).

[3]Some commentators have expressed concern about this intrusion. *Compare* Fleischer, *"Federal Corporation Law": An Assessment*, 78 HARV. L. REV. 1146 (1965), *with* Lohf, *The Corporation Law of the Securities Acts: Federal Rights of Corporations*, 36 U. COLO. L. REV. 76 (1963).

For a discussion of the fiduciary responsibilities of corporate management, see H. HENN, CORPORATIONS §§ 235-41 (2d ed. 1970).

[4]464 F.2d 714 (2d Cir. 1972).

Popkin, a shareholder of Bell Intercontinental Corporation, brought a derivative action[5] to enjoin the proposed corporate merger of Bell and its two subsidiaries into the Equity Corporation, the majority shareholder of Bell.[6] Injunctive relief was sought on the ground that the exchange ratios in the proposed merger agreement were unfair to the minority shareholders of Bell and its subsidiaries as well as to the companies themselves. Popkin alleged that by proposing those exchange ratios, Equity and various officers and directors of Bell breached a variety of fiduciary duties and that such breaches entitled him to relief despite a complete disclosure of the merger terms. In affirming dismissal of the complaint, the Second Circuit held that in view of the adequate disclosure, which is the principal federal interest served by rule 10b-5,[7] the appropriate remedy of minority shareholders to test the fairness of the merger terms is a suit for injunction in the state courts.[8] Furthermore, the court reiterated that "non-disclosure [is] a key issue in rule 10b-5 cases" and noted that plaintiff's "complaint contains no allegation or hint of any misrepresentation . . . or of a failure . . . to disclose any material fact in connection with the merger proposal."[9] The basic problem thus presented in the case was whether rule 10b-5 is violated when a breach of fiduciary duty is at issue in the sale or purchase of stock[10] even though there has been full and fair disclosure of the terms of the proposed merger.

[5]Although neither § 10(b) of the Securities Exchange Act of 1934 nor the implementing rule 10b-5 provides explicitly for a private remedy, such a right was implied early in the history of the section. Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946). The Supreme Court recently noted that "[i]t is now established that a private right of action is implied under § 10(b)." Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 n.9 (1971).

[6]Bell owned 66% of the common stock of one of its subsidiaries and 81% of the other. Equity Corporation controlled Bell and through Bell the two subsidiaries. 464 F.2d at 716.

[7]*Id.* at 720. The Supreme Court recently remarked that "the 1934 Act and its companion legislative enactments embrace a 'fundamental purpose ... to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* . . . .'" Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972) (footnote omitted).

[8]The court noted that the merger terms had been included in a judicially approved settlement to other litigation and as a result a question of estoppel exists. However, serious doubt was expressed that estoppel applies under the circumstances presented. 464 F.2d at 720-21.

[9]*Id.* at 718-19. Indeed, plaintiff conceded that a full and fair disclosure had been made. *Id.* at 718.

[10]The SEC originally took the position that an exchange of stock as a result of a merger did not constitute a "sale." Since 1951, however, this position has been reversed. Mader v. Armel, 402 F.2d 158, 161 (6th Cir. 1968). Under the theory of Dasho v. Susquehanna Corp., 380 F.2d 262 (7th Cir. 1967), a merger involving an exchange of stock is a "sale", thus allowing a 10b-5 action either by the corporation or by its shareholders in a derivative capacity.

A logical starting point in analyzing the relevance of rule 10b-5 to an alleged breach of fiduciary obligation is the landmark decision of *Birnbaum v. Newport Steel Corp.*[11] In that case the president and controlling stockholder of Newport passed up a merger which would have been beneficial to the minority stockholders and instead sold his stock at a premium to another company. Plaintiffs' theory of injury was that this sale of control stock at a premium, together with certain misrepresentations made to them to facilitate the sale, constituted fraudulent practices in connection with the purchase and sale of securities. The court, in denying relief to the plaintiffs[12] concluded:

> (1) that Section 10(b) was directed solely at that type of misrepresentation or fraudulent practice usually associated with the purchase or sale of securities,
> (2) that it extended protection only to the defrauded purchaser or seller, and
> (3) that it was not intended to provide a remedy for fraudulent mismanagement of corporate affairs.[13]

While both the "usually associated with"[14] and the purchaser-seller[15] requirements enunciated in *Birnbaum* are significant isues in the area of securities regulation, the third aspect of the opinion will be the focus of this discussion.[16]

Although it is apparent that the *Birnbaum* court excluded fraudulent mismanagement of corporate affairs from the scope of rule 10b-5, it is by no means certain that other courts would likewise construe the section. In *McClure v. Borne Chemical Co.*[17] the Third Circuit observed by way of dictum that rule 10b-5 "imposes broad fiduciary duties on

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[11] 193 F.2d 461 (2d Cir.), *cert. denied,* 343 U.S. 956 (1952).

[12] The Birnbaum defendants were subsequently held liable to the shareholders under state law in Perlman v. Feldmann, 219 F.2d 173 (2d Cir.), *cert. denied,* 349 U.S. 952 (1955).

[13] 193 F.2d at 464.

[14] A significant erosion occurred in the case of A.T. Brod & Co. v. Perlow, 375 F.2d 393 (2d Cir. 1967). In that case the court held that rule 10b-5 prohibits *all* fraudulent schemes in connection with the purchase or sale of securities whether involving a unique form of deception or a "garden variety" type. *Id.* at 397.

[15] For discussion of the standing problem, *see generally* Lowenfels, *The Demise of The Birnbaum Doctrine: A New Era for Rule 10b-5,* 54 VA. L. REV. 268 (1968); Ruder, *Current Developments in the Federal Law of Corporate Fiduciary Relations—Standing to Sue Under Rule 10b-5,* 26 BUS. LAWYER 1289 (1971).

[16] *See generally* Lowenfels, *Rule 10b-5 and the Stockholder's Derivative Action,* 18 VAND. L. REV. 893 (1965).

[17] 292 F.2d 824 (3d Cir. 1961).

management vis-a-vis the corporation and its individual stockholders."[18] Subsequently, other courts have emphasized that the fact that a securities transaction was part of a broader scheme involving corporate mismanagement does not bar a rule 10b-5 action. As stated by the court in *Pettit v. American Stock Exchange*,[19] the mere fact "that the fraud was perpetrated by insiders does not render Section 10(b) inapplicable, if the transaction represents an abuse of the securities trading process, and should be properly subject to SEC regulation for an adequate remedy."[20] A contrary interpretation would import its own demise: "[C]orporate officers and directors would possess an immunity from the consequences of their fraud under . . . Rule 10b-5 which outsiders who may have collaborated with them in defrauding the corporation would not possess . . . ."[21] Such an expansive reading of rule 10b-5 as enunciated by the *Pettit* court encouraged further development in the application of rule 10b-5 to management misconduct.

In 1964 the Second Circuit had before it the similar cases of *Ruckle v. Roto American Corp.*[22] and *O'Neill v. Maytag*[23] but reached different results. In *Ruckle* plaintiff's derivative claim alleged that the majority directors, in authorizing issuance of shares to insiders at an inadequate price, withheld from the minority directors the latest financial information relating to a proposed stock issue. In upholding plaintiff's claim, the Second Circuit held that the majority directors' failure to disclose material information to the minority directors constituted deception upon the corporation.[24] In dictum *Ruckle* went further and suggested that even full disclosure to all the directors does not necessarily preclude rule 10b-5 liability.[25]

In *O'Neill* the same court affirmed the dismissal of the complaint by the lower court. After observing that there was "[n]o serious claim of deceit, withheld information or misstatement of material fact in this

[18] *Id.* at 834.

[19] 217 F. Supp. 21 (S.D.N.Y. 1963) (stock issued for inadequate consideration and subsequently distributed publicly).

[20] *Id.* at 25.

[21] New Park Mining Co. v. Cranmer, 225 F. Supp. 261, 266 (S.D.N.Y. 1963) (corporate officers acquired stock interests in properties in which their corporations were interested and caused the corporation to purchase and sell its own and other stock at unfair prices).

[22] 339 F.2d 24 (2d Cir. 1964).

[23] 339 F.2d 764 (2d Cir. 1964).

[24] 339 F.2d at 27.

[25] *Id.* at 29.

case,"[26] the court held that "where the duty allegedly breached is only the general duty existing among corporate officers, directors, and shareholders, no cause of action is stated under rule 10b-5 unless there is an allegation of facts amounting to deception."[27] In *O'Neill* plaintiff had charged that the directors set an exchange ratio that was detrimental to the minority for the purpose of retaining control. It was alleged that all board members were participants. Although seemingly falling within the dictum of *Ruckle*, the *O'Neill* court distinguished *Ruckle* as involving "a clear allegation of deception"[28] whereas no such allegation existed in *O'Neill*.[29] The *Ruckle* dictum was later followed, however, by the Third Circuit in a rule 10b-5 derivative suit in which the directors were unanimous in defrauding the corporation.[30] By viewing the minority shareholders as the defrauded corporate entity, the Third Circuit had no difficulty in finding "deception."[31]

In 1968 the "deception" requirement was further analzyed by the Second Circuit in *Schoenbaum v. Firstbrook*.[32] Plaintiff sued derivatively, alleging that his corporation (Banff Oil, Ltd.) issued securities to Aquitaine, a controlling corporation, and to an outsider at prices that, because of undisclosed material information, did not represent the true value of the shares. This issuance was allegedly part of a conspiracy to defraud the remaining Banff stockholders. On these facts the Second Circuit dismissed the complaint as to the outsider, but held that the issuance of securities to Aquitaine presented a triable issue under rule

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[26]339 F.2d at 767.

[27]*Id.* at 767-68.

[28]*Id.* at 768.

[29]One judge offered this explanation:

> The only possible material difference I can perceive between *Ruckle* and *O'Neill* is that in *Ruckle* there were directors who were not participants in the transaction and thus could be deceived in the ordinary sense. In either case, however, the failure of the defendant directors to perform their duty presumably injured the corporation, and I do not believe it is sound to differentiate between situations where the directors were unanimous in wrongdoing and those where less than all were involved.

Dasho v. Susquehanna Corp., 380 F.2d 262, 270 (7th Cir.) (Fairchild, J., concurring), *cert. denied*, 389 U.S. 977 (1967).

[30]Pappas v. Moss, 393 F.2d 865 (3d Cir. 1968) (defendant insiders sold shares to themselves at an unfair price).

[31]*Id.* at 869.

[32]405 F.2d 215 (2d Cir. 1968) (en banc), *cert. denied*, 395 U.S. 906 (1969). For a detailed analysis, *see* Comment, *Schoenbaum v. Firstbrook: The "New Fraud" Expands Federal Corporation Law*, 55 VA. L. REV. 1103 (1969).

10b-5.[33] The allegedly improper exercise of a "controlling influence" by Aquitaine over the Banff board of directors was itself within the proscription of rule 10b-5:

> If it is established that the transaction took place as alleged it constituted a violation of Rule 10b-5, subdivision (3) because Aquitaine engaged in an "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." Moreover, Aquitaine and the directors of Banff were guilty of deceiving the stockholders of Banff (other than Aquitaine).[34]

If indeed *Schoenbaum* stands for the proposition that a violation of rule 10b-5 is established upon the showing of an improper exercise of control, as suggested by at least one commentator,[35] then by eliminating the traditional "fraud" or "deception" requirement, the *Schoenbaum* decision gives impetus to the further broadening of federal law relating to fiduciary duties of directors, officers, and majority shareholders.[36]

Thus the stage was set for clarification of the role of deception in rule 10b-5 cases involving breaches of fiduciary duties. The Second Circuit responded with the decision in *Popkin v. Bishop*.[37] After observing that it had focused on improper self-dealing in *Schoenbaum*, the Second Circuit nonetheless concluded that such emphasis "did not eliminate nondisclosure as a key issue in Rule 10b-5 cases."[38] The justification for the emphasis was that since state law does not demand prior shareholder approval in most situations involving self-dealing in securities transactions, full and fair disclsoure will rarely occur. Thus, "it makes sense to concentrate on the impropriety of the conduct itself rather than on the 'failure to disclose' . . . ."[39] However, where merger transactions are involved that require shareholder approval under state law, the principal design of rule 10b-5 (imposing a duty of disclosure) has special relevance. Indeed, it is apparent that this renewed emphasis

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[33]The critical difference appeared to be that Aquitaine could exercise controlling influence over the board of directors.

[34]405 F.2d at 219-20.

[35]Ruder, *"Challenging Corporate Action Under Rule 10b-5"*, 25 BUS. LAWYER 75, 86 (1969).

[36]Subsequently, the Fifth Circuit held that deception is not a necessary element of a 10b-5 claim. Shell v. Hensley, 430 F.2d 819, 827 (5th Cir. 1970).

[37]464 F.2d 714 (2d Cir. 1972).

[38]*Id.* at 719. The decision is careful to point out that the court in *Schoenbaum* "suggested" that self-dealing itself constituted a rule 10b-5 violation.

[39]*Id.*

on disclosure only applies in those rare situations of self-dealing where the law mandates prior shareholder approval. This, plus full and fair disclosure (or concession thereof by plaintiff) will arise infrequently due to the nature of corporate self-dealing. Accordingly, the court reasoned that since Popkin "admitted that defendants fully and fairly disclosed all material facts surrounding the merger to all interested parties, including the minority shareholders,"[40] the federal interest under rule 10b-5 had been satisfied.[41] The court rejected plaintiff's argument that where the minority shareholders are powerless to prevent the merger, additional protection should be afforded them. The court noted that such disclosed information placed them in a position to sue under state law to enjoin the merger as unfair.[42] Even should such action fail, the disclosed information would enable shareholders intelligently to exercise their appraisal rights. One should note, however, that although appraisal rights mitigate against the unfairness of such a merger by permitting a minority shareholder to sell his shares for cash at a fair price, an unfair merger forecloses a choice of retention of ownership in the surviving corporation.

If the *Popkin* situation were held to be within the ambit of rule 10b-5 without the "disclosure" requirement, federal courts would in effect be called upon to regulate many areas of internal management traditionally in the state realm. Such an intrusion would present the danger of disruption of state policies on corporate management as well as a possible conflict in standards of conduct. This factor becomes especially acute when, as presently, state court decisions are redefining the fiduciary duties of corporate directors and officers[43] and the responsibility of majority shareholders to the minority shareholders.[44] Seen in this

[40] *Id.* at 720.

[41] Injury to the corporation as a result of nondisclosure takes several forms: (1) it may permit the defendants to position themselves so as to commit further mismanagement, Vine v. Beneficial Fin. Co., 374 F.2d 627, 637 (2d Cir.) (by implication), *cert. denied*, 389 U.S. 970 (1967); (2) it may encourage mismanagement, Globus, Inc. v. Jaroff, 271 F. Supp. 378, 381 (S.D.N.Y. 1967); (3) it may preclude others from seeking derivative relief, Barnett v. Anaconda Co., 238 F. Supp. 766, 766 n.7 (S.D.N.Y. 1965) (dictum).

[42] 464 F.2d at 720. Equity Corporation's ability, as majority shareholder, to accomplish the merger with or without any other shareholder's approval could not by itself defeat a 10b-5 claim. *See* Vine v. Beneficial Fin. Co., 374 F.2d 627 (2d Cir.), *cert. denied*, 389 U.S. 970 (1967).

One writer has suggested that many 10b-5 merger cases pose essentially a question of fairness. Ruder, *supra* note 35, at 77-78.

[43] *See, e.g.*, Diamond v. Oreamuno, 24 N.Y.2d 494, 248 N.E.2d 910, 301 N.Y.S.2d 78 (1969).

[44] *See, e.g.*, Jones v. H.F. Ahmanson & Co., 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969).

perspective, *Popkin's* reincarnation of the "disclosure" limitation in rule 10b-5 actions involving alleged breaches of fiduciary obligations seems a salutary conclusion. On the other hand, a merger often involves self-dealing and, because of the complexity of the transaction, "enhances the opportunities for fraud and thus increases the need for antifraud protection."[45]

In view of the special provisions under rule 10b-5 for venue,[46] choice of forum,[47] and nationwide service of process[48] and the opportunity it provides for escape from the state security-for-costs statutes in derivative suits[49] and a more restrictive state substantive law,[50] it is apparent why the scope of rule 10b-5 has been continuously tested in private actions. But before expansion beyond the current precariously defined limits, comprehensive congressional policy seems preferable to the present *ad hoc* decisional approach supported by administrative rules.[51]

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[45]Argument of Commissioner's Counsel quoted in Dasho v. Susquehanna Corp., 380 F.2d 262, 267 (7th Cir.), *cert. denied*, 389 U.S. 977 (1967). Due to inability to agree upon a position, the SEC declined to file an amicus brief in *Popkin*. 464 F.2d at 719 n.15.

[46]15 U.S.C. § 78aa (1970).

[47]*See* Zorn v. Anderson, 263 F. Supp. 745, 747-48 (S.D.N.Y. 1968).

[48]15 U.S.C. § 78aa (1970).

[49]*See* McClure v. Borne Chemical Co., 292 F.2d 824 (3d Cir.), *cert. denied*, 368 U.S. 939 (1961).

[50]*See generally* Comment, *The Prospects for Rule X-10B-5: An Emerging Remedy for Defrauded Investors*, 59 YALE L.J. 1120, 1123-33 (1950).

[51]For discussion of a current attempt at codification of rule 10b-5, *see generally* Loss, *The American Law Institute's Federal Securities Code Project*, 25 BUS. LAWYER 27 (1969).