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The Progeny of Santa Fe v. Green: An Analysis of the Elements of a Fiduciary Duty Claim under Rule 10b-5 and a Case for a Federal Corporation Law

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THE PROGENY OF *SANTA FE V. GREEN*: AN ANALYSIS OF THE ELEMENTS OF A FIDUCIARY DUTY CLAIM UNDER RULE 10b-5 AND A CASE FOR A FEDERAL CORPORATION LAW

CATHY S. KRENDL†

Because of the procedural advantages available in federal court, many litigants have chosen to bring suits in that forum under rule 10b-5 for breach of the fiduciary duty of officers and directors of a corporation rather than sue in state court. In Santa Fe Industries v. Green the United States Supreme Court attempted to check this trend. The Court in Santa Fe held that claims alleging simply a breach of fiduciary duty should be brought in state courts and that only those claims alleging deception or manipulation in connection with a breach of fiduciary duty could be brought in federal court. In this Article, Professor Krendl first analyzes the Santa Fe decision and then, based on the decisions of lower courts since Santa Fe, sets out what is required to bring a fiduciary claim under rule 10b-5 in federal court. Professor Krendl, focusing on the confusion and inconsistency in the lower courts, argues that the territorial rule of Santa Fe is not a workable one and that Congress, therefore, should enact express federal fiduciary standards. She concludes that in that legislation, Congress should give the federal courts subject-matter jurisdiction over all claims alleging a breach of the fiduciary duty of directors to the corporation and its shareholders.

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The board of directors of a corporation authorizes a loan from corporate funds to one of its members on terms unfavorable to the corporation; a parent company loots its most profitable subsidiary through its control of the subsidiary's board; a board fights a tender offer for the corporation's stock to preserve its control of the corporation. These transactions illustrate typical conflict of interest situations in which a corporate director has a personal interest in taking a position favorable to himself or the party responsible for his election in conflict with his fiduciary duty to the corporation. Corporate statutes and the common law traditionally have viewed these transactions with strict scrutiny and usually have required a director who seeks to enforce a corporate obligation incurred through one of these transactions to prove that the transaction is fair to the corporation. Litigants, however, often have preferred to challenge these transactions in federal court through the federal securities laws because procedural advantages are available in a federal forum,¹ federal judges are often more sophisticated and experienced in analyzing complex corporate transactions, applicable precedent is more likely to be found in federal cases, and the federal docket often affords faster consideration. This determination by litigants to pursue traditional state claims in federal forums² has raised a

1. There are several procedural advantages. First, the security for expenses statute, applicable in state court actions, is inapplicable to actions under the securities laws in federal courts. See *McClure v. Borne Chem. Co.*, 292 F.2d 824 (3d Cir.), cert. denied, 368 U.S. 939 (1961). (This statute typically requires that a plaintiff shareholder in a derivative action post a bond to cover the expenses of the defendant director or corporation, including attorney's fees). Second, a demand on shareholders is required in some states as a condition precedent to derivative actions but is unnecessary in federal courts as shareholders cannot ratify a violation of the federal securities laws. See *Dopp v. American Elec. Laboratories, Inc.*, 55 F.R.D. 151 (S.D.N.Y. 1972). Third, nationwide service of process and flexible venue provisions are available under federal laws. See Securities Exchange Act of 1934, § 27, 15 U.S.C. § 78aa (1976). Finally, the plaintiffs may demand a jury in a federal court if the corporation would have been entitled to a jury. See *Ross v. Bernhard*, 396 U.S. 531 (1970).

2. The basic securities law vehicle for bringing these suits in federal courts is rule 10b-5, which reads:

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,

- (1) To employ any device, scheme, or artifice to defraud
- (2) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
- (3) To engage in any act, practice, or course of business which operates or would oper-

territorial question—should self-dealing transactions be the turf of state or federal courts? Neither court system has been very enthusiastic about taking adverse possession of these claims. The Supreme Court, in *Santa Fe Industries, Inc. v. Green*,³ attempted to draw a property line that would return the self-dealing turf to state courts. Subsequent interpretations of *Santa Fe*, however, have revealed that this line is not a workable one. The purposes of this Article are to analyze the essential elements of a fiduciary duty claim under rule 10b-5 and to demonstrate the desirability of an express federal statute that would give the federal courts exclusive jurisdiction over self-dealing cases. First, it is helpful to review briefly the *Santa Fe Industries, Inc. v. Green* decision and particularly the reasons used to support the decision.

I. DISCUSSION OF *SANTA FE INDUSTRIES, INC. v. GREEN*

Through a series of purchases beginning in 1936, Santa Fe Industries, Inc. (Santa Fe) acquired ninety-five percent of the stock of Kirby Lumber Corporation (Kirby). In 1974 Santa Fe effected a short-form merger with Kirby to eliminate the owners of the remaining five percent of Kirby stock. The Delaware short-form merger statute permitted a parent that owned at least ninety percent of a subsidiary to merge with the subsidiary upon the approval of the parent's board of directors and to cash out the minority shareholders, provided that notice of the merger was given to the shareholders within ten days after the effective date of the merger. Under the statute minority shareholders had the right to petition the Delaware courts for appraisal, that is, to request that the court appoint an appraiser to determine the fair value of their stock and, if that price differed from the price offered by the corporation, to require the corporation to pay the appraised value.⁴

Santa Fe complied with the statutory short-form merger procedure in all technical respects and also hired Morgan Stanley and Company to appraise

ate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1980).

3. 430 U.S. 462 (1977). The subsequent history of the *Santa Fe* plaintiffs is interesting to the reader, if frustrating for the plaintiffs. In *Green v. Santa Fe Indus.*, 82 F.R.D. 688 (S.D.N.Y. 1979), the district court denied plaintiffs' motion for class certification when they sought to continue their action based on diversity jurisdiction for breach of fiduciary duty under Delaware law. Plaintiffs were to represent a class consisting of all minority shareholders with 17 or more Kirby shares at the time of the merger (each shareholder with more than 17 shares would satisfy the \$10,000 requirement). They asked either to be restored as minority shareholders of Kirby or to receive an appraisal. At the time an appraisal proceeding brought by other minority shareholders of Kirby was pending in the Delaware state courts. The New York court denied their motion for class certification on two grounds: (1) since almost all the former stockholders had either accepted the \$150 offer of Santa Fe or sought appraisal, restoration of the minority to full shareholders of Kirby would be in conflict with the relief many of the shareholders of the proposed class would want; and (2) since the question of money damages was being fully litigated in Delaware, a class action in federal court would result in duplicative litigation and run the risk of inconsistent determinations. In *Bell v. Kirby Lumber Corp.*, 413 A.2d 137 (Del. 1980), upon challenge by minority shareholders the Delaware Supreme court upheld a chancery court's acceptance of an appraiser's determination of the fair market value of Kirby stock.

4. *Green v. Santa Fe Indus., Inc.*, 391 F. Supp. 849, 851-52 (S.D.N.Y. 1975), *aff'd*, 430 U.S. 462 (1977).

the stock based on other independent appraisals of Kirby's fiscal assets and financial information. Morgan Stanley valued the stock at \$125 per share, and Santa Fe offered the minority shareholders \$150 per share. Rather than seek an appraisal remedy in the Delaware courts, minority shareholders brought a federal derivative and class action requesting rescission of the merger and fair value for their shares, allegedly \$772 per share, based on an appraisal of the assets included in the information statement sent by Santa Fe to the minority shareholders.⁵

The complaint alleged that the defendants had violated rule 10b-5 because the merger took place without prior notice to minority shareholders and because its purpose was to freeze out the minority shareholders at a wholly inadequate price. The district court dismissed the complaint for failure to state a claim⁶ but was reversed by a divided Court of Appeals for the Second Circuit.⁷ The United States Supreme Court reversed the court of appeals and held that the complaint did not state a cause of action.⁸

Using the method of analysis adopted in *Ernst & Ernst v. Hochfelder*,⁹ the Supreme Court relied upon the express statutory language of section 10(b).¹⁰ First, the Court read section 10(b) to require that the alleged conduct, to be actionable under section 10(b) and rule 10b-5, be "fairly viewed as 'manipulative or deceptive' within the meaning of the statute."¹¹ Second, the Court concluded that the conduct in *Santa Fe* was neither deceptive nor manipulative under the language of either section 10(b) or rule 10b-5.¹² There was no deception because the complaint alleged only that a fiduciary duty had been breached and not that any misrepresentation or deception or nondisclosure had occurred in connection with the alleged breach. Defining "manipulative" in its most technical and limited sense,¹³ the Court also concluded that no manipulative conduct was alleged since a breach of fiduciary duty per se is not manipulation. Consequently, there being neither deception nor manipulation, no cause of action was stated under the language of section 10(b) or rule 10b-5.

5. *Id.*

6. *Id.* at 856.

7. 533 F.2d 1283 (2d Cir. 1976).

8. 430 U.S. at 477.

9. 425 U.S. 185 (1976).

10. Securities Exchange Act of 1934, § 10(b), 15 U.S.C. § 78j (1976). Section 10(b) 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— . . .

(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.

11. 430 U.S. at 474.

12. *Id.*

13. *Id.* at 476. " 'Manipulation' is 'virtually a term of art when used in connection with securities markets.' " *Id.* (citing *Ernst & Ernst v. Hochfelder*, 425 U.S. at 199). "The term refers generally to practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity." 430 U.S. at 476.

The Court cited additional considerations that "weigh heavily against permitting a cause of action under Rule 10b-5"¹⁴ for breach of fiduciary duty in the absence of deception or manipulation. First, the Court emphasized that the fundamental purpose of the 1934 Act is to encourage full disclosure, not fairness of transactions, which is "'at best a subsidiary purpose'"¹⁵ of the federal legislation. A breach of fiduciary duty absent material omissions or misrepresentations is in effect a fairness question, and so long as the transaction is subject to full disclosure, the Court held that unfairness should not in and of itself be subject to redress under the federal securities laws.

Second, the Court argued that because self-dealing is the kind of action traditionally governed by state law, the federal courts should be reluctant to find that Congress intended to create a federal cause of action.¹⁶ Third, the Court, referring to *Blue Chip Stamps v. Manor Drug Stores*,¹⁷ said that to permit fiduciary duty causes of action in federal courts would pose a "'danger of vexatious litigation which could result from a widely expanded class of plaintiffs under Rule 10b-5.'"¹⁸ Finally, the Court expressed its concern that giving federal redress would "quite possibly interfere with state corporate law" because federal courts "could be expected to depart from state fiduciary standards at least to the extent necessary to ensure uniformity within the federal system."¹⁹ The Court cited *Cort v. Ash*²⁰ to emphasize this point. "'Corporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law expressly requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation.'"²¹

The *Santa Fe* Court found that the essence of the complaint was that the shareholders were treated unfairly by a fiduciary and that this allegation, standing alone, relegated plaintiffs' complaint to state court. In so doing, the Court defined state and federal turf as follows: claims that in essence allege breach of fiduciary duty are the turf of state courts; claims alleging deception (material omissions or misrepresentations) or manipulation in connection with a breach of fiduciary duty are the shared turf of the federal and state courts. The Court, acknowledging that this line of demarcation may not be correct,

14. 430 U.S. at 477.

15. *Id.* at 478 (quoting *Cort v. Ash*, 422 U.S. 66, 80 (1975)).

16. 430 U.S. at 478.

17. 421 U.S. 723, 740 (1975).

18. 430 U.S. at 479. This litigation would result because:

It is difficult to imagine how a court could distinguish, for purposes of Rule 10b-5 fraud, between a majority stockholder's use of a short-form merger to eliminate the minority at an unfair price and the use of some other device, such as long-form merger, tender offer, or liquidation, to achieve the same result; or indeed how a court could distinguish the alleged abuses in these going private transactions from other types of fiduciary self-dealing involving transactions in securities. The result would be to bring within the Rule a wide variety of corporate conduct traditionally left to state regulation.

Id. at 478.

19. *Id.* at 479.

20. 422 U.S. 66, 84 (1975).

21. 430 U.S. at 479 (emphasis added by *Santa Fe* court).

nonetheless insisted that only Congress can draw the line with boundaries more generous to the federal courts. "There may well be a need for uniform federal fiduciary standards to govern mergers such as that challenged in this complaint. But those standards should not be supplied by judicial extension of § 10(b) and Rule 10b-5 to 'cover the corporate universe.'"²²

Santa Fe has been interpreted by various district and appellate courts, and the discussions in those decisions are quite revealing. Those interpretations will first be discussed to determine the elements that now appear necessary to bring a fiduciary duty claim under rule 10b-5. Then a more careful analysis will be made to ascertain whether the lower courts have kept within the property lines drawn in *Santa Fe*.

II. THE REQUIRED ELEMENTS FOR A FIDUCIARY DUTY CLAIM UNDER RULE 10b-5

A. General Overview

A breach of fiduciary duty cause of action is stated under rule 10b-5 if the plaintiff alleges the following elements:

1. The jurisdictional means is satisfied; that is, the fraud involved the use of interstate commerce or the mails or a facility of a national securities exchange;
2. A security was bought or sold;
3. The plaintiff was the purchaser or seller of securities;
4. There was a material deception (a misrepresentation or omission) or manipulation;
5. The defendant acted with scienter—fault greater than negligence;
6. In the case of misrepresentation, the plaintiff relied;
7. Under some circumstances, there must be privity between the plaintiff and defendant;
8. The plaintiff sustained damages and brought the claim within the statute of limitations.

Persons liable for a violation of rule 10b-5 can include the issuer, any controlling person of the issuer,²³ and any person who aids and abets²⁴ the violation.

22. *Id.* at 479-80 (quoting Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 700 (1974) (footnote omitted). The Court defended this position citing Cary, *supra*, at 700 (1974).

Professor Cary argues vigorously for comprehensive federal fiduciary standards, but urges a "frontal" attack by a new federal statute rather than an extension of Rule 10b-5. He writes: "It seems anomalous to jig-saw every kind of corporate dispute into the federal courts through the securities acts as they are presently written."

430 U.S. at 480 n.17.

23. Section 20(a) of the Securities Act of 1934 provides that

Every person who . . . controls any person liable under any provision of this chapter . . . shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the control-

B. Jurisdictional Means

The jurisdictional requirement of section 10(b) is met if, in connection

ling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

15 U.S.C. § 78t(a) (1976). The controlling person's defense is that he acted in good faith. For determination of good faith, see *Edwards & Hanly v. Wells Fargo Sec. Clearance Corp.*, 602 F.2d 478 (2d Cir. 1979), *cert. denied*, 100 S.Ct. 734 (1980) (inadequate precautionary mechanisms); *Zweig v. Hearst Corp.*, 521 F.2d 1129 (9th Cir.), *cert. denied*, 423 U.S. 1025 (1975) (no affirmative acts required on facts; controlling person was simply required to maintain a reasonable and proper system of supervision and internal control); *Walsh v. Butcher & Sherrerd*, 452 F. Supp. 80 (E.D. Pa. 1978) (dictum; failure to supervise adequately is bad faith). For good faith determination as applied to an outside director, see *Mader v. Armel*, 461 F.2d 1123 (6th Cir.), *cert. denied*, 409 U.S. 1023 (1972). For a more complete discussion of § 20, see generally Annot., "Controlling Person" Liability Under § 20(a) of Securities Act of 1934, 38 A.L.R. FED. 725 (1978).

24. Liability for aiding and abetting is justified upon two theories. Persons may be liable under rule 10b-5 based upon a tort theory or a criminal theory. The tort theory, which makes persons liable in civil causes of actions for violations of the 1933 and 1934 Acts, is based on RESTATEMENT (SECOND) OF TORTS § 876 (1977), which states:

Persons Acting in Concert

For harm resulting to a third person from the tortious conduct of another, one is subject to liability if he . . . (b) knows that the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other so to conduct himself . . .

The theory that makes aiders and abettors liable for criminal violations is based on 18 U.S.C. § 2 (1976), which provides:

Principals

- (a) Whoever commits an offense against the United States or aids, abets, counsels, commands, induces or procures its commission, is punishable as a principal.
- (b) Whoever willfully causes an act to be done which if directly performed by him or another would be an offense against the United States, is punishable as a principal.

To establish aiding and abetting liability, it is necessary to show:

- (1) Existence of an independent wrong, that is, a securities law violation. See, e.g., *Morgan v. Prudential Funds, Inc.*, 446 F. Supp. 628 (S.D.N.Y. 1978);
- (2) Knowledge of the wrong's existence. Some courts require *actual knowledge*. See, e.g., *Stern v. American Bankshares Corp.*, 429 F. Supp. 818 (E.D. Wis. 1977) (requires actual or imputed knowledge of fraud and positive assistance to wrongdoers or breach of duty to disclose fraud to plaintiff); *Brennan v. Midwestern United Life Ins. Co.*, 259 F. Supp. 673 (N.D. Ind. 1966) (motion to dismiss), 286 F. Supp. 702 (1968) (on merits), *aff'd*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970). Other courts require only the existence of a *general awareness*. See *SEC v. Coffey*, 493 F.2d 1304 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975) ("[G]eneral awareness that his role was part of an overall activity that is improper, and if . . . [he] knowingly and substantially assisted the violation." *Id.* at 1316. "Inaction may be a form of assistance in certain cases, but only where it is shown that the silence of the accused aider and abettor was consciously intended to aid the securities law violation." *Id.* at 1317.) Still other courts suggest that a showing of recklessness is sufficient. See *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1979) (if a fiduciary duty is owed to the defrauded party, recklessness satisfies the scienter requirement. *Id.* at 44); *but see* *Edwards & Hanley v. Wells Fargo Sec. Clearance Corp.*, 602 F.2d 478 (2d Cir. 1979), *cert. denied*, 100 S. Ct. 734 (1980); *Cumis Ins. Soc'y, Inc. v. E.F. Hutton & Co.*, 457 F. Supp. 1380 (S.D.N.Y. 1978). For recent applications, see *Hirsch v. du Pont*, 553 F.2d 750 (2d Cir. 1977); *SEC v. Universal Major Indus. Corp.*, 546 F.2d 1044 (2d Cir. 1976), *cert. denied*, 434 U.S. 834 (1977) (aiding and abetting still viable claim in injunctive action after *Hochfelder*); *Katz v. Realty Equities Corp.*, 406 F. Supp. 802 (S.D.N.Y. 1976) (negligence not enough, actual knowledge required);
- (3) Substantial assistance of the violation. This requirement can be established by demonstrating *knowing participation*. See *Zabriskie v. Lewis*, 507 F.2d 546 (10th Cir. 1974). It is more clearly defined in *Landy v. FDIC*, which cites the Restatement definition of substantial assistance. "If the encouragement or assistance is a

with the purchase or sale of securities, there is a use of the mails *or* of a means or instrumentality of interstate commerce *or* of a facility of a national securities exchange.²⁵ The securities need not be traded on a national securities exchange, nor must the issuer have one million dollars in assets and five hundred holders of one class of equity securities. It is not necessary that the misstatement or omission be transmitted by the use of interstate commerce; any use of the jurisdictional means in connection with the transaction is sufficient.²⁶ Interstate commerce is defined by the statute to include an intrastate telephone call.²⁷

C. Defining "Security"

The term "security" is defined broadly in section 3a(10) of the Securities Exchange Act of 1934:

The term "security" means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but

substantial factor in causing the resulting tort, the one giving it is himself a tortfeasor and is responsible for the consequences of the other's act.'" 486 F.2d 139, 163 (3d Cir. 1973), *cert. denied*, 416 U.S. 960 (1974) (quoting RESTATEMENT (SECOND) OF TORTS § 346 (1967)). Facts relevant in determining substantial assistance in the Restatement view include: (1) the amount of assistance given by the defendant; (2) his presence or absence at the time of the tort; (3) his relation to the other person; and (4) his state of mind. RESTATEMENT (SECOND) OF TORTS § 876, Comment b (1977). The most difficult question is whether mere silence or inaction is substantial assistance. For cases that suggest that it is, see *Monsen v. Consolidated Dressed Beef Co.*, 579 F.2d 793 (3d Cir.), *cert. denied*, 439 U.S. 930 (1978) (inaction may result in liability where there is a conscious intent to assist in the perpetration of a wrongful act); *Kerbs v. Fall River Indus., Inc.*, 502 F.2d 731 (10th Cir. 1974) (mere silence is enough if it amounts to knowing assistance of, or participation in, a fraudulent scheme); *Brennan v. Midwestern United Life Ins. Co.*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970) (when there is a special relationship, silence amounts to a tacit agreement with the fraudulent party); *In re Gap Stores Sec. Litigation*, 457 F. Supp. 1135 (N.D. Cal. 1978) (director found not to aid and abet). *But see* *Woodward v. Metro Bank*, 522 F.2d 84 (5th Cir. 1975) (whether mere silence is sufficient depends upon facts).

For a discussion of all of these elements, see generally Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification and Contribution*, 120 U. PA. L. REV. 597 (1972). See also *SEC v. Coffey*, 493 F.2d 1304 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975); *Landy v. FDIC*, 486 F.2d 139 (3d Cir. 1973), *cert. denied*, 416 U.S. 960 (1974); *Epprecht v. Delaware Valley Mach. Inc.*, 407 F. Supp. 315 (E.D. Pa. 1976). Some question remains whether aiding and abetting is an appropriate theory. The Supreme Court left the question open in *Ernst & Ernst v. Hochfelder*, 425 U.S. at 191 n.7 and denied certiorari in *SEC v. Universal Major Indus. Corp.*, 546 F.2d 1044 (2d Cir.), *cert. denied*, 434 U.S. 834 (1977), which raised the question with respect to lawyers and accountants.

25. Securities Exchange Act of 1934, § 10(b), 15 U.S.C. § 78j (1976).

26. See, e.g., *Stevens v. Vowell*, 343 F.2d 374 (10th Cir. 1965).

27. Securities Exchange Act of 1934, § 3(a)(17), 15 U.S.C. § 78c(a)(17) (1976).

shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.²⁸

The courts, in interpreting "investment contract," have broadened the definition further by using a combination of a modified *Howey* test,²⁹ which classifies as an investment contract a device through which an investment of money is made in a common enterprise with an expectation of profits to be derived substantially from the managerial efforts of third parties, and the *Joiner* test, which looks to the "character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect."³⁰ In the typical conflict of interest case, the sale of stock is usually involved;³¹ therefore, a security is clearly present.

D. A Purchaser or Seller of Securities—the Birnbaum Requirement

The *Birnbaum* requirement, a standing test first adopted by the court in *Birnbaum v. Newport Steel Corp.*³² and reaffirmed in *Blue Chip Stamps v. Manor Drug Stores*,³³ requires that the plaintiff himself be a purchaser or seller of securities. A shareholder who is suing derivatively, as in a fiduciary duty case, meets the *Birnbaum* requirement if the corporation is the purchaser or seller of securities.³⁴ Although some exceptions to *Birnbaum* have not survived *Blue Chip*,³⁵ others have been relied on by some courts to give relief

28. *Id.* § 78c(a)(10).

29. *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946); *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473 (5th Cir. 1974).

30. *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 352-53 (1943). For the most recent applications of the *Howey-Joiner* test by the Supreme Court, see *International Bhd. of Teamsters v. Daniel*, 439 U.S. 551 (1979) (a noncontributing compulsory pension plan is not a security) and *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975) (stock issued in consideration for an apartment in a cooperative nonprofit housing project is not a security).

31. See, e.g., *Kidwell v. Meikle*, 597 F.2d 1273 (9th Cir. 1979); *Wright v. Heizer Corp.*, 560 F.2d 236 (7th Cir. 1977), *cert. denied*, 434 U.S. 1066 (1978); *Goldberg v. Meridor*, 567 F.2d 209 (2d Cir. 1977), *cert. denied*, 434 U.S. 1069 (1978); *Goldberger v. Baker*, 442 F. Supp. 659 (S.D.N.Y. 1977).

32. 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952).

33. 421 U.S. 723 (hereinafter cited as *Blue Chip*). The Court held that the offerees of a stock offering made pursuant to an antitrust consent decree could not maintain a private cause of action for many damages under rule 10b-5 because they neither purchased nor sold the offered shares and because their "right" to obtain the shares was not a contractual right sufficient to qualify under the exception to *Birnbaum*. *Id.* at 754-55.

34. See, e.g., *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 10 (1971); *Goldberger v. Baker*, 442 F. Supp. 659, 663 (S.D.N.Y. 1977).

35. Exceptions that have been determined not to survive *Blue Chip* are the aborted seller, would-be seller, and frustrated seller exceptions. The aborted seller exception was not recognized in *Superintendent of Ins. v. Freedman*, 443 F. Supp. 628 (S.D.N.Y. 1977), in which a corporation that had transferred funds for securities when there was no intention to convey the securities was deemed not to be a purchaser. The would-be seller exception (a shareholder who would have sold but for defendant's omission) was eliminated by the express language of *Blue Chip*. See *Blue Chip*, 421 U.S. at 737-38; *Sacks v. Reynolds Sec., Inc.*, 593 F.2d 1234, 1241 (D.C. Cir. 1978). But see *Herm v. Stafford*, 455 F. Supp. 650 (W.D. Ky. 1978) (dictum), in which a shareholder who refrained from selling stock in reliance on misleading statements in a proxy solicitation seeking approval of merger had standing to sue. The frustrated seller exception (shareholder fraudulently induced to retain his securities) also was expressly eliminated by *Blue Chip*. See *Blue Chip*, 421

to shareholders who sue either on their own behalf or on behalf of the corporation. For example, a "forced" seller has been permitted to sue under rule 10b-5 if the nature of his interest in the corporation has been fundamentally changed, that is, there has been a change in his status with the issuer or in his relative investment. "Forced" sellers have been found to include shareholders of an acquired corporation in an ordinary merger or sale of assets,³⁶ minority shareholders cashed out by short-form mergers,³⁷ and shareholders forced out in certain liquidations.³⁸ The forced seller doctrine was used to support standing in a fiduciary duty claim in *Canadian Javelin Ltd. v. Brooks*.³⁹ Javelin was suing its former directors, who also constituted a majority of the boards of directors of "Bison" and "Jubilee," for violating rule 10b-5 in eliminating Javelin's controlling interest in Bison and Jubilee through an exchange of stock between Bison and Jubilee. Javelin argued that it met the *Birnbaum* requirement as a "forced" seller because the exchange of securities between Bison and Jubilee deprived it of its controlling interest in both companies and, therefore, constituted a fundamental change in the nature of its investment and expectations.⁴⁰ The court found that the degree of change was not sufficient to make Javelin a "forced" seller because, although Javelin's proportional ownership of Bison and Jubilee had been reduced, Javelin still retained a 34.5% interest in Bison and a 23.9% interest in Jubilee. The court said: "To argue, as Javelin does, that such a reduction in interest is tantamount to a sale, is to carry the doctrine of 'forced seller' to an extreme."⁴¹

The *Birnbaum* doctrine, including the "forced" seller exception, was discussed by the District Court for Delaware in a fiduciary duty claim in *Valente v. Pepsico*.⁴² In the context of a tender offer, the court applied *Birnbaum* as

U.S. at 737-38; *Marsh v. Armada Corp.*, 533 F.2d 978, 981 (6th Cir. 1976), *cert. denied*, 430 U.S. 954 (1977).

36. *See, e.g.*, *Mader v. Armel*, 402 F.2d 158 (6th Cir. 1968), *cert. denied*, 394 U.S. 930 (1969), *appeal after remand*, 461 F.2d 1123, *cert. denied*, 409 U.S. 1023 (1972); *Dasho v. Susquehanna Corp.*, 380 F.2d 262 (7th Cir.), *cert. denied*, 389 U.S. 977 (1967); *Wulc v. Gulf & W. Indus., Inc.*, 400 F. Supp. 99 (E.D. Pa. 1975).

37. *See Vine v. Beneficial Fin. Co.*, 374 F.2d 627 (2d Cir.), *cert. denied*, 389 U.S. 970 (1967).

38. *See Alley v. Miramon*, 614 F.2d 1372 (5th Cir. 1980) (minority shareholder deemed a forced seller when the controlling shareholder fraudulently obtained possession of former's securities, liquidated the corporation, and denied the minority shareholder access to proceeds); *Broad v. Rockwell Int'l Corp.*, 614 F.2d 418 (5th Cir. 1980) (forced seller doctrine deemed inapplicable when a surviving corporation in a merger exchanged its predecessor's debt securities, which had stock conversion rights, for debentures having only a cash conversion right because the fundamental nature of the security holder's interest was not substantially changed); *Coffee v. Permian Corp.*, 434 F.2d 383 (5th Cir. 1970), *appeal after remand*, 474 F.2d 1040 (5th Cir.), *cert. denied*, 412 U.S. 920 (1973); *Weisman v. Darneille*, 78 F.R.D. 669 (S.D.N.Y. 1978); *Rich v. Touche Ross & Co.*, 415 F. Supp. 95 (S.D.N.Y. 1976). The forced seller exception is not met if there is a wind-down rather than a liquidation. *See In re Penn Cent. Sec. Litigation*, 494 F.2d 528, 534 (3d Cir. 1974); *Alpex Computer Corp. v. Pitney-Bowes, Inc.*, 417 F. Supp. 328 (S.D.N.Y. 1976); *Goodall v. Columbia Ventures, Inc.*, 374 F. Supp. 1324 (S.D.N.Y. 1974).

39. 462 F. Supp. 190 (S.D.N.Y. 1978).

40. *Id.* at 195.

41. *Id.* at 196. *See Parness v. Liebllich*, [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,392 (S.D.N.Y. 1980) (minority shareholder is not a forced seller when other court has blocked proposed merger that would cause sale). The court noted in dictum that a reduction in proportionate ownership does not constitute a forced sale.

42. 454 F. Supp. 1228, 1236 (D. Del. 1978).

follows: (1) a shareholder whose tender was accepted by the offeror was a seller within *Birnbaum*; (2) a shareholder who retained his shares at the time of the tender offer but was required at the time of a subsequent short-form merger either to surrender the shares in exchange for cash or to request appraisal was a "forced seller;" (3) the nontendering warrant holders were "forced sellers" because they were "left with either the right to purchase shares in a nonexistent corporation or the right to receive cash;"⁴³ and (4) the nontendering debenture holders were not "forced" sellers because debentures are debt securities with repayment and redemption terms that can be met by any solvent obligor (as opposed to equity securities, which represent a share in a particular enterprise) and because the nontendering debenture holders were not required to accept a new form of consideration.⁴⁴

A plaintiff seeking an injunction need not meet the *Birnbaum* requirement in most jurisdictions⁴⁵ unless the plaintiff is seeking declaratory relief⁴⁶ or the purpose of the injunction is to undo past activities.⁴⁷

Finally, a person may meet the *Birnbaum* requirement if he has contractual rights to purchase securities but does not exercise those rights. However, a substantial question may exist as to whether the person in fact has contractual rights. Present shareholders with conversion rights, if they are induced not to convert, are deemed to have the required contractual rights.⁴⁸ Persons deemed not to have contractual rights for the purpose of this exception include offerees of a stock offering made pursuant to an antitrust consent decree,⁴⁹ shareholders who are denied a right of first refusal for an offering of an issuer's treasury stock,⁵⁰ individuals whose contract is made expressly subject to approval by the corporation's board and no such approval is given,⁵¹ and target shareholders whose approval is necessary for a takeover to be effected by a

43. *Id.* at 1237 n.10.

44. *Id.* The change of the identity of the obligor was not a "fundamental change" in the investment.

45. See, e.g., *Davis v. Davis*, 526 F.2d 1286 (5th Cir. 1976); *Landy v. FDIC*, 486 F.2d 139 (3d Cir. 1973), *cert. denied*, 416 U.S. 960 (1974); *Britt v. Cyril Bath Co.*, 417 F.2d 433 (6th Cir. 1969); *Mutual Shares Corp. v. Genesco, Inc.*, 384 F.2d 540 (2d Cir. 1967); *Hundahl v. United Benefit Life Ins. Co.*, 465 F. Supp. 1349 (N.D. Tex. 1979); *Bertozzi v. King Louie Int'l, Inc.*, 420 F. Supp. 1166 (D.R.I. 1976); *Heyman v. Heyman*, 356 F. Supp. 958 (S.D.N.Y. 1973). But see *Wright v. Heizer Corp.*, 411 F. Supp. 23 (N.D. Ill. 1975), *modified*, 560 F.2d 236 (7th Cir. 1977), *cert. denied*, 434 U.S. 1066 (1978); *Initio, Inc. v. Hesse*, 474 F. Supp. 312 (D. Del. 1979) (questioned); *Fuchs v. Swanton Corp.*, 482 F. Supp. 83 (S.D.N.Y. 1979) (in looting case, minority shareholder permitted to seek to enjoin a proposed merger of his company and its acquiring company even though not permitted to sue for damages in an alleged bootstrap acquisition of a controlling block of his company's shares).

46. See *Lutgert v. Vanderbilt Bank*, 508 F.2d 1035 (5th Cir. 1975).

47. See *Tully v. Mott Supermarkets, Inc.*, 540 F.2d 187 (3d Cir. 1976).

48. See *Pittsburgh Terminal Corp. v. Baltimore & Ohio R.R.*, 446 F. Supp. 656 (W.D. Pa. 1977), *rev'd*, 578 F.2d 1375 (3d Cir. 1978); *Green v. Hamilton Int'l Corp.*, 437 F. Supp. 723 (S.D.N.Y. 1977) (dictum); *Camp v. Genesco, Inc.*, [1975-1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,473 (S.D.N.Y. 1976).

49. *Blue Chip*, 421 U.S. at 751.

50. *Tully v. Mott Supermarket, Inc.*, 540 F.2d 187, 193 (3d Cir. 1976).

51. *Ashton v. Thornley Realty Co.*, 346 F. Supp. 1294, 1299 (S.D.N.Y. 1972), *aff'd in open court*, 471 F.2d 647 (2d Cir. 1973).

merger.⁵²

Courts, however, generally have not been eager to define *Birnbaum* in a broad sense. For example, the Fifth Circuit, in *Reid v. Hughes*,⁵³ dismissed a complaint because the plaintiff did not meet the *Birnbaum* requirement. The plaintiff had alleged in a derivative action that the defendants had caused the corporation, without consideration or for insufficient consideration, to issue promissory notes, transfer cash, and pledge certificates of deposit to enable another corporation to purchase the stock of a third corporation. The court found that the corporation did not meet the *Birnbaum* requirement because (1) under the circumstances neither the certificates of deposit nor the notes were securities and (2) the first corporation's financing of another corporation's purchase of a third corporation did not make the first corporation a purchaser for purposes of *Birnbaum*.⁵⁴ Likewise, in *Superintendent of Insurance v. Freedman*,⁵⁵ the Southern District of New York dismissed a fiduciary claim under rule 10b-5 because the plaintiff-corporation's status as a purchaser was in doubt. The defendants had transferred money from a wholly-owned subsidiary to the parent company and covered the transfer by representing that the subsidiary was purchasing stock of another company. The court found that the purchase did not take place and was never intended to take place and refused to stretch the *Birnbaum* requirement to apply to the facts of the case.

In summary, in absence of the "forced sale," "injunction," or "contractual rights" exceptions, the fiduciary duty claim must be in connection with the purchase or sale of securities actually made by the corporation; otherwise the complaint will not withstand a motion for summary judgment because the plaintiff, suing derivatively on behalf of the corporation, cannot meet the standing requirement of *Birnbaum*.

E. *Scienter*

Another element of a 10b-5 claim is "scienter." *Scienter* requires the showing of something more than mere negligence. The Supreme Court defined *scienter* in *Ernst & Ernst v. Hochfelder*⁵⁶ as "intent to deceive, manipulate or defraud"⁵⁷ and "a mental state embracing intent to deceive, manipulate or defraud."⁵⁸ Although the *Hochfelder* Court expressly did not determine whether its definition of *scienter* includes reckless behavior,⁵⁹ the majority of courts in subsequent decisions have found reckless conduct sufficient.⁶⁰ Reck-

52. *Rediker v. Geon Indus., Inc.*, 464 F. Supp. 73 (S.D.N.Y. 1978).

53. 578 F.2d 634 (5th Cir. 1978).

54. *Id.* at 638-39.

55. 443 F. Supp. 628 (S.D.N.Y. 1977), *aff'd mem.*, 594 F.2d 852 (1978).

56. 425 U.S. 185.

57. *Id.* at 193.

58. *Id.* at 194 n.12.

59. *Id.* See *Aaron v. SEC*, 100 S. Ct. 1945, 1950 n.5 (1980).

60. See *Healey v. Catalyst Recovery, Inc.*, 616 F.2d 641 (3d Cir. 1980); *Spectrum Financial Cos. v. Marconsult, Inc.*, 608 F.2d 377 (9th Cir. 1979), *petition for cert. filed sub nom. Harris, Kerr, Forster & Co. v. Spectrum Financial Cos.*, No. 79-1251, (U.S. Feb. 21, 1980); *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017 (6th Cir. 1979); *Berdahl v. SEC*, 572 F.2d 643 (8th Cir. 1978).

less conduct most frequently has been defined as "a highly unreasonable omission, involving not merely simple, or even inexcusable, negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it."⁶¹ In *Aaron v. SEC*,⁶² the Supreme Court recently held that *Hochfelder* scienter must be established by the Securities and Exchange Commission in an injunctive action.⁶³

(implication); *Cook v. Avien, Inc.*, 573 F.2d 685, 692 (1st Cir. 1978) (dictum); *Nelson v. Serwold*, 576 F.2d 1332 (9th Cir.), *cert. denied*, 439 U.S. 970 (1978); *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978) (aiding and abetting); *Coleco Indus., Inc. v. Berman*, 567 F.2d 569 (3d Cir. 1977), *cert. denied*, 439 U.S. 830; *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977); *Bartels v. Algonquin Properties, Ltd.*, 471 F. Supp. 1132 (D. Vt. 1979); *Kaufman v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 464 F. Supp. 528 (D. Md. 1978); *Continental Assurance Co. v. American Bankshares Corp.*, 439 F. Supp. 804 (E.D. Wis. 1977); *SEC v. Cenco Inc.*, 436 F. Supp. 193 (N.D. Ill. 1977). A sound application of facts to law in the fiduciary duty context—the court found sufficient recklessness to meet the scienter requirement—was made in *Wright v. Heizer Corp.*, 560 F.2d 236 (7th Cir. 1977), *cert. denied*, 434 U.S. 1066 (1978). See also *Healey v. Catalyst Recovery, Inc.*, 616 F.2d 641 (3d Cir. 1980) (court found sufficient evidence to create jury question of scienter). The Delaware district court, in *Valente v. PepsiCo, Inc.*, 454 F. Supp. at 1249, presents a helpful general discussion of the scienter requirement in a fiduciary duty case. Recklessness was found to meet the scienter requirement even in an omission case and in a transaction not carried out face-to-face. *Id.* at 1250 n.40. The Delaware court cited *Nelson v. Serwold*, 576 F.2d 1332 (9th Cir. 1978); *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38 (2d Cir. 1978); and *Coleco Indus., Inc. v. Berman*, 567 F.2d 569 (3d Cir. 1977). The court used the *Sundstrand* definition of recklessness, see note 61 and accompanying text *infra*, and also cited *Sundstrand's* further elaboration of that definition. "[N]ot only must the danger of misleading buyers be actually known or so obvious that any man would be legally bound as knowing, but the omission must derive from something more egregious than even 'white heart/empty head' good faith." *Valente v. PepsiCo, Inc.*, 454 F. Supp. at 1250-51. The court said that this standard was applied in *Nelson v. Serwold* and *Cook v. Avien, Inc.*. The court, in leaving to the trier of fact the question whether the defendants' behavior was reckless, cautioned that the determination of materiality would not demonstrate recklessness. *Id.* at 1251 n.42. The court held that the scienter requirement was also met if the defendants had actual knowledge of the omitted facts even though they had no knowledge that the information would mislead investors, *id.* at 1252 n.45, and then specifically found that the scienter requirement was met in this case because the defendants had actual knowledge of the existence of the appraisal and did not put this information in the tender offer materials. This knowledge of the officers and directors was attributed to the company to find it liable. *Id.* at 1252-53. *But see* *Utah State Univ. of Agriculture & Applied Science v. Bear, Stearns & Co.*, 549 F.2d 164 (10th Cir.), *cert. denied*, 434 U.S. 890 (1977) (willful or intentional misconduct, or the equivalent thereof, is essential to recovery under § 10(b)); *Greene v. Emersons, Ltd.*, 86 F.R.D. 66 (S.D.N.Y. 1980) (Outside directors' failure to discover actions by officers that artificially inflated price of company's stock did not constitute 10b-5 scienter even though the outside directors allegedly held no regularly scheduled meetings, met infrequently, did not receive or insist on receiving an agenda prior to the meetings or internal financial information on a regular basis, and had no audit committee. The court did not decide whether recklessness would satisfy the scienter requirement when no duty is owed to the plaintiff because the facts alleged in the complaint were found insufficient to constitute recklessness); *Schulman v. Weil*, 466 F. Supp. 432 (S.D.N.Y. 1979) (court noted in dictum that it was not clear whether recklessness is sufficient if no duty is owed to the plaintiff); *Competitive Assoc., Inc. v. Laventhol Krekstin Horwath & Horwath*, 478 F. Supp. 1328 (S.D.N.Y. 1979) (dictum) (recklessness may not be sufficient if no duty is owed to plaintiff).

61. *Franke v. Midwestern Okla. Dev. Auth.*, 428 F. Supp. 719, 725 (W.D. Okla. 1976). This definition was adopted by the Seventh Circuit in *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1045 (7th Cir. 1977); by the First Circuit in *Cook v. Avien, Inc.*, 573 F.2d 685, 692 (1st Cir. 1978); by the Sixth Circuit in *Mansbach v. Prescott, Bell & Turben*, 598 F.2d 1017, 1024 (6th Cir. 1979) (by implication); by the Third Circuit in *Healey v. Catalyst Recovery, Inc.*, 616 F.2d 641, 649 (3d Cir. 1980) and in *McLean v. Alexander*, 599 F.2d 1190, 1197 (3d Cir. 1979).

62. 100 S. Ct. 1945 (1980).

63. *Id.* at 1958.

The definition of scienter in *Hochfelder* has required changes in other elements of rule 10b-5: the plaintiff is deemed to be duly diligent even if he is negligent because his diligence need be no higher than that of the defendant;⁶⁴ a 10b-5 claim must be pleaded with greater particularity because it is now more akin to fraud;⁶⁵ and the applicable statute of limitations may need to be more related to an action that requires a higher degree of intent, such as fraud.⁶⁶

F. Statute of Limitations

Because there is no express federal statute of limitations for 10b-5 actions, state statutes of limitations are applied. The third, sixth, ninth, and tenth circuits have applied the state fraud statute of limitations,⁶⁷ while the fourth, fifth, and eighth circuits have applied the statute of limitations applicable to blue sky actions.⁶⁸ The Supreme Court has declined to resolve the controversy.⁶⁹ The question of the tolling of the statute of limitations is governed by federal law, which provides that the statute will not begin to run until the plaintiff, exercising reasonable care and diligence, discovers the fraud.⁷⁰ Discovery may occur "from the time when a clue to the facts, if pursued diligently, would lead to an uncovering of the general fraudulent scheme"⁷¹ or when the plaintiff has "either actual knowledge or notice of facts which, in the exercise of due diligence would have led to actual knowledge of the violation."⁷² For example, knowledge of a suit raising similar claims has been im-

64. *Holdsworth v. Strong*, 545 F.2d 687, 693 (10th Cir. 1976), *cert. denied*, 430 U.S. 955 (1977); *Straub v. Vaisman & Co.*, 540 F.2d 591, 598 (3d Cir. 1976) (due diligence obligation depends upon facts of each case).

65. See note 435 *infra*.

66. See text accompanying note 67 *infra*.

67. *McNeal v. Paine, Webber, Jackson & Curtis, Inc.*, 598 F.2d 888 (5th Cir. 1979) (fraud statute); *Roberts v. Magnetic Metals Co.*, 611 F.2d 450 (3d Cir. 1979); *Nickels v. Koehler Management Corp.*, 541 F.2d 611 (6th Cir. 1976), *cert. denied*, 429 U.S. 1074 (1977); *Robuck v. Dean Witter & Co.*, No. 77-1841 (9th Cir., filed Aug. 31, 1979) (not for routine publication) (general statute of limitations, not fraud statute, applied in fiduciary claim); *Pollution Control & Eng'r Corp. v. Lange*, No. 76-1338 (10th Cir. April 22, 1976) (not for routine publication); *Clegg v. Conk*, 507 F.2d 1351 (10th Cir. 1974), *cert. denied*, 422 U.S. 1007 (1975).

68. *Morris v. Stifel, Nicolaus & Co.*, 600 F.2d 139 (8th Cir. 1979); *In re Alodex Corp. Sec. Litigation*, 533 F.2d 372 (8th Cir. 1976) (court applied blue sky statute because, like 10b-5, it did not require a showing of scienter); *Nortek, Inc. v. Alexander Grant & Co.*, 532 F.2d 1013 (5th Cir. 1976), *cert. denied*, 429 U.S. 1042 (1977) (blue sky statute); *Dirksen v. Hynes & Howes Ins. Counselors, Inc.*, 423 F. Supp. 1290 (S.D. Iowa 1976) (Iowa changed its blue sky statute to require scienter after *Hochfelder*); *Fox v. Kane-Miller Corp.*, 398 F. Supp. 609 (D. Md. 1975), *aff'd*, 542 F.2d 915 (4th Cir. 1976).

69. In 1977 the Supreme Court declined to review the Fifth Circuit decision in *Nortek, Inc. v. Alexander Grant & Co.*, 532 F.2d 1013 (5th Cir. 1976), *cert. denied*, 429 U.S. 1042 (1977), that applied the blue sky statute of limitations rather than the fraud statute. Likewise, the Court denied certiorari in *Nickels v. Koehler Management Corp.*, 541 F.2d 611 (6th Cir. 1976), *cert. denied*, 429 U.S. 1074 (1977), in which the Sixth Circuit applied the fraud statute.

70. *Hupp v. Gray*, 500 F.2d 993, 996 (7th Cir. 1974). See *Smith v. Equity Nat'l Indus., Inc.*, 609 F.2d 1007 (5th Cir. 1980) (mem.), *cert. denied*, 100 S. Ct. 2941 (1980).

71. *Wachovia Bank & Trust Co. v. National Student Marketing Corp.*, 461 F. Supp. 999, 1009 (D.D.C. 1978).

72. *Osterneck v. E.T. Barwick Indus., Inc.*, 79 F.R.D., 47, 51 (N.D. Ga. 1978). See *Jones v. Ford Motor Co.*, 599 F.2d 394 (10th Cir. 1979); *Biggans v. Bache Halsey Stuart Shields, Inc.*, 487 F. Supp. 829 (E.D. Pa. 1980) (plaintiff deemed to be on notice when advised by accountant that

puted to the plaintiff for the purpose of determining when the statute of limitations begins to run.⁷³

G. *The Presence of Deception or Manipulation*

The crux of any 10b-5 cause of action is a fraudulent act, and this requirement is best discussed specifically in the context of fiduciary duty cases. In *Santa Fe* the Supreme Court held that a mere breach of fiduciary duty absent "other" deception or manipulation was not the kind of fraudulent activity actionable under rule 10b-5.⁷⁴ Courts since *Santa Fe* have struggled to determine whether that "other" undefined deception or manipulation is present to a degree sufficient to fall within the parameters set in *Santa Fe*. In that struggle questions peculiar to the fiduciary duty setting have emerged: (1) Who acts as the corporate persona capable of being deceived, or, to whom must disclosure be made? (2) Was the disclosure adequate? (3) Did the misrepresentation or omission cause the harm? These questions first will be analyzed within the broad overview of a paradigm fiduciary duty case brought under rule 10b-5. Then each question will be examined in depth in the context of other fiduciary duty cases.⁷⁵

III. ELEMENTS OF 10b-5 AS ADAPTED TO A FIDUCIARY DUTY CLAIM

A. *A Broad Overview in a Paradigm Fiduciary Duty Case*

In *Wright v. Heizer Corp.*⁷⁶ the Seventh Circuit held that rule 10b-5 was properly pleaded in a case that raised the typical questions in a fiduciary duty claim under 10b-5.⁷⁷ In *Wright* plaintiff minority shareholders brought a derivative action alleging that the majority shareholder had defrauded the corporation in a series of five transactions. The allegedly defrauded corporation, International Digisonics Corporation (IDC), was formed to develop and use electronic monitoring equipment to police television commercials to ascertain whether the commercials were shown in accordance with agreements between advertising agencies and television stations. At the outset Jordan Ross, the company's founder, and Beneficial Standard Corporation, the first investor in IDC, owned approximately two-thirds of the IDC stock; the remaining one-third of the stock was owned by friends and business associates of Ross. The

irregularities existed in brokerage account and that he should see counsel); *Koke v. Stifel, Nicolaus & Co.*, 480 F. Supp. 747 (E.D. Mo. 1979), *aff'd*, 620 F.2d 1340 (8th Cir. 1980) (confirmation slips and account statements gave constructive knowledge of misrepresentation); *Roberts v. Magnetic Metals Co.*, 463 F. Supp. 934 (D. N.J. 1978), *reversed on other grounds*, 611 F.2d 450 (3d Cir. 1979) (SEC letter stating that there appeared to be adequate disclosure does not toll statute).

73. *Braunstein v. Laventhol & Horwath*, 433 F. Supp. 1077 (S.D.N.Y.), *aff'd in open court*, 573 F.2d 1288 (2d Cir. 1977).

74. See text accompanying notes 3-22 *supra*.

75. Of course, also included in the list of required elements for a fiduciary duty claim under rule 10b-5 are the elements of materiality, reliance, and causation. These elements are discussed in Part III of this article.

76. 560 F.2d 236 (7th Cir. 1977), *cert. denied*, 434 U.S. 1066 (1978).

77. *Id.* at 249.

defendant, Heizer Corporation (Heizer), a venture capitalist that specialized in investing in high-risk companies, first became acquainted with IDC in the fall of 1969 when IDC was seeking a one million dollar capital contribution as a preliminary step to going public. At that time Heizer, in a transaction receiving unanimous approval of the IDC board of directors and shareholders, purchased, in consideration for one million dollars, 100,000 shares of a new class A common stock for ten dollars per share and warrants to purchase 155,000 shares of common stock at \$8.50 per share. The exercise price of the warrants was hotly contested. Ross insisted on ten dollars per share and Heizer offered five dollars per share. In 1970, when the public offering had not yet taken place and IDC needed additional capital, Heizer agreed to loan two million dollars to IDC on the same basis as the earlier transaction.⁷⁸ This transaction also received the unanimous approval of the IDC board and shareholders. Heizer received 200,000 shares of new preferred stock for ten dollars per share and warrants to purchase 400,000 shares of common stock at an exercise price of six dollars per share. The subscription agreement further provided that if certain conditions were not met, the warrants could be exercised for four dollars per share. About a year later IDC needed more money and, with unanimous approval of the IDC board and shareholders, Heizer invested \$1.7 million in consideration for a twenty-year note and warrants to purchase an additional 472,222 shares of common stock at \$3.60 a share. This third agreement, which obligated the corporation to issue additional common stock, triggered the antidilution clauses negotiated in the first two agreements and entitled Heizer to purchase 1,304,000 shares of IDC stock for \$3.60 per share, which amounted to sixty-one percent of the company's equity. IDC's articles of incorporation were then amended to give the Heizer preferred stock 4.4 votes per share and the right to appoint two of Heizer's officers to the IDC board. In the next six months IDC once again needed capital and after the underwriter it retained could not find other private investors interested in buying IDC stock, Heizer agreed to lend IDC \$600,000 in consideration for a demand note, which, if not paid, would be convertible into common stock at one dollar per share. This fourth transaction triggered the antidilution clauses in the previous three transactions, thereby giving Heizer the right to purchase 4,694,400 shares of IDC common stock for one dollar per share. If these rights were fully exercised, Heizer would have eighty-five percent of the equity of IDC. The board of directors that met to consider this transaction consisted of four persons—two of the other three directors had resigned and one was absent from the country.⁷⁹ Of these four directors, two were Heizer nominees. The Heizer nominees, admitting their conflict-of-interest positions, permitted the two independent directors to vote first, assuring them that there would be no transaction if either of them disapproved. The two independent directors voted for the proposal, and the transaction then was submitted for a shareholder vote because it was necessary to amend the articles of incorporation to

78. *Id.* at 241-43.

79. *Id.* at 241-44.

increase the number of authorized shares. Written consent of the shareholders, permitted by Delaware law, was secured by Ross through solicitations from himself and his friends and business associates.⁸⁰ Beneficial, a large shareholder, refused to give its consent. In December 1971, when the public financing fell through, IDC, unable to develop the technology necessary to monitor the commercials as previously hoped, changed the company's focus and, at the behest of Hezier, sought new management. About three months later the IDC board, with the Beneficial director dissenting, amended the agreement in the fourth transaction to provide that Heizer would lend IDC another \$250,000, which would be convertible into common stock at an exercise price of one dollar per share if not paid in eighteen days. When the loan was not paid in the specified period, Heizer gained the right to purchase eighty-seven percent of the company's equity at one dollar per share. Following a change of management in the next year, Heizer extended approximately two million dollars in nonconvertible demand loans to IDC to keep it afloat.⁸¹

In October 1972 a derivative action was filed by Beneficial and another shareholder against Heizer for violating rule 10b-5. While the case was pending, a fifth loan was made by Heizer to IDC, apparently because there was no other financing available except through recapitalization of the corporation, a measure that was impossible because of the pending law suit. In that fifth transaction Heizer demanded a pledge of all the stock of T & R, the only profitable IDC subsidiary, in consideration for which Heizer agreed to postpone demand on previous loans and lend the corporation between \$460,000 and \$1,181,700 during the remainder of the year. This loan would be secured by the pledge and payable in January of the next year. The new president of the company, elected by Heizer directors, testified that one purpose of the pledge was "to smoke [the plaintiffs] out of the woodwork" by threatening to foreclose on IDC's most profitable asset, T & R.⁸²

The complaint, which ultimately was amended twice, alleged that Heizer had violated rule 10b-5 by failing to disclose its controlling position to the IDC shareholders and by setting an unfair exercise price for IDC's stock in the second, third, and fourth transactions. The complaint further alleged that Heizer, even if not in control of IDC, had aided and abetted IDC's management in its failure to disclose material facts about the fourth transaction and was liable as a controlling person for the actions of its nominees on the board who voted for the allegedly unfair and improperly disclosed fourth transaction.⁸³

The district court found for plaintiffs on the fourth and fifth transaction only and (1) ordered that the notes from the fourth transaction be declared nonconvertible; (2) cancelled any warrants issued in connection with the fourth transaction; (3) declared void the triggering of the prior warrants; and

80. This represented 52.4% of the IDC common stock. *Id.* at 244.

81. *Id.* at 241-44.

82. *Id.* at 245.

83. *Id.*

(4) cancelled the pledge of T & R stock.⁸⁴ On appeal to the Seventh Circuit, the defendants challenged the lower court's ruling on liability for the fourth and fifth transactions and argued that the court had granted overly broad prospective relief. The plaintiffs did not challenge the district court's ruling that there was no deception in the first three transactions. The district court also ruled, however, that the unfair price and Heizer's violation of its fiduciary duty were sufficient to establish liability under 10b-5 *without* proof of deception or nondisclosure. The Seventh Circuit, stating that this reasoning was no longer valid in light of the Supreme Court's decision in *Santa Fe*, nevertheless affirmed the district court's decision, but on different grounds.⁸⁵

In reviewing the fourth and fifth transactions, the Seventh Circuit first asked whether shareholder approval was required for the transactions.⁸⁶ This question was raised at the outset because, after *Santa Fe*, an essential requirement of a 10b-5 claim is that there be deception, and there can be no deception unless there is a person who is deceived. If shareholder approval is required, the shareholders are the actors who are susceptible to deception;⁸⁷ and to avoid deception of the shareholders there must be disclosure to them of all material facts.

In the fourth Heizer-IDC transaction, a charter amendment was necessary to increase the number of authorized shares, and under Delaware law the amendment requires approval by a majority of the common shareholders voting as a class. At the time of the fourth transaction, Heizer had the right to acquire, through the exercise of warrants, a majority of the common stock but had not yet exercised this right. Consequently, the other IDC shareholders still had the power to defeat the amendment to the articles and thereby block the fourth transaction. Since shareholder approval was required to effect this transaction, the court concluded that the shareholders, as the principal actors in the transaction, were entitled to full disclosure of all the material facts concerning the transaction.⁸⁸

Once it decided *who* was entitled to disclosure, the court had to determine whether full disclosure had been made. The court found that: (1) the only written disclosure in the written consent and notice to shareholders was that the number of common shares would be increased from three to seven million by shareholder action; (2) the only oral disclosure was a representation that the amendment was necessary for financing and the amount of the financing; and (3) when Ross obtained the consents he did not reveal the source of the financing or give any other information that would indicate that the financing involved anything more than a simple purchase of stock.⁸⁹ Heizer argued that the shareholders should have inferred from the proposed increase in the

84. *Id.*

85. *Id.* at 246.

86. *Id.* at 247.

87. If shareholder approval is not required, the question of who is deceived is more complex. See text accompanying notes 108-21 *infra*.

88. 560 F.2d at 247.

89. *Id.*

number of shares of common stock that their equity position would be eroded and that this inference should have put them on notice to ask Ross more questions.⁹⁰ The court refused to impose this duty of inquiry on the shareholders. Using the *TSC Industries, Inc. v. Northway, Inc.*⁹¹ standard of materiality, the court held that the following material facts were not disclosed to the shareholders: (1) the terms of the transaction; (2) the method by which Heizer arrived at the dollar per share exercise price; (3) the alternatives that would be available to the corporation if the transaction could not be consummated; and (4) that a majority vote of the shareholders (excluding Heizer) was necessary for passage of the amendment.⁹² The court also suggested that the affirmative statement located at the bottom of the consent form—that Heizer had 300,000 votes—may have given the shareholders the misleading impression that their votes were not important. This impression would be incorrect because, even though Heizer had a large number of voting shares, it did not have a majority of the common stock, and since the Delaware statute required the affirmative vote of a majority of each class,⁹³ Heizer could not by its vote alone assure passage of the amendment.

The third step in the court's analysis of whether this fiduciary duty claim was proper under 10b-5 was an examination of the reliance requirement (or the causation question). The court cited *Affiliated Ute Citizens v. United States*⁹⁴ for the general proposition that "in the ordinary 10b-5 case involving a failure to disclose, proof of materiality is sufficient to establish reliance."⁹⁵ The court, applying this materiality concept to a fiduciary duty case, suggested that if the minority shareholders would have been powerless to prevent the proposed self-dealing by the controlling shareholder, even if they had possessed knowledge of all the facts, the failure to disclose presumably would be immaterial and reliance would not be shown.⁹⁶ In this case, however, the court reasoned that the shareholders would have had the power under state law to veto the transaction entirely and thus, if all the information had been disclosed, could have prevented the self-dealing simply by voting against the transaction. The required reliance, therefore, was clearly present.

Next the court, with more rigor and much greater difficulty, reviewed the fifth transaction, using the framework of the same three questions: (1) Who is

90. *Id.* at 247.

91. 426 U.S. 438 (1976). See text accompanying notes 307-22 *infra*.

92. 560 F.2d at 247-48.

93. *Id.* Once it found that the disclosure was inadequate, the next question addressed by the court was whether Heizer, as majority shareholder, should be liable for the failure of IDC to disclose. The court found that even though Heizer did not control the board at the time of the fourth transaction, three factors made it liable for the inadequate disclosure: (1) Heizer had voting control of the company at the crucial time; (2) Heizer had placed two of its officers on the IDC board; and (3) Heizer had assumed responsibility for the disclosure by undertaking to control and supervise the communication to the shareholders and even had its counsel draft the closing documents for all four transactions, including the infamous shareholder consents used in the fourth transaction. *Id.* at 248.

94. 406 U.S. 128 (1972).

95. 560 F.2d at 249.

96. *Id.* at 250.

capable of being deceived, or, to whom must disclosure be made? (2) Was the disclosure to this group adequate? (3) Did the failure to disclose cause the harm? Because the corporation was the real party plaintiff in the fifth transaction, the court first grappled with the problem of who could act for the corporation and, therefore, could be subject to deception. The fifth transaction involved a pledge of the assets of the corporation's subsidiary, a transaction that under Delaware law does not require shareholder approval. It would appear, therefore, that the board of directors would have authority to act for the corporation and that disclosure to the board would be sufficient. The problem with this analysis was that a majority of the board of directors allegedly were "interested" and, therefore, had full knowledge of all the material facts and were not "deceived." If the directors' knowledge were attributed to the corporation, the corporation also would not be deceived for purposes of rule 10b-5. Wrestling with this dilemma, the court reasoned that if the entire board had been controlled by a self-dealing director or shareholder, the corporation would be deceived absent disclosure to the shareholders because the knowledge of a self-dealing director should not be attributed to the corporation.⁹⁷ In other words, disclosure to an interested director would not constitute disclosure to the corporation. Disclosure to the corporation could only be made through disclosure to the shareholders who, under those circumstances, would be the only group available to act for the corporation. On the other hand, if disinterested directors constituted a majority of the board, disclosure to those directors would be sufficient because the directors would be qualified to act for the corporation.⁹⁸

The key to this analysis is how many of the directors are interested, if any. In this case there were only four directors participating at the time the fifth transaction was approved. One of those directors, Jordan Ross, was presumably disinterested. Two of the directors were Heizer nominees and, therefore, clearly were interested. The fourth director was Paul Roth, the President of IDC, who was hired by the Heizer directors over the objection of Jordan Ross, the only other disinterested director.⁹⁹ The court, after some difficulty, concluded that Roth was an interested director. In support of this conclusion the court cited the testimony of Heizer and Roth, particularly the statement by Roth that "I was pretty much convinced that Heizer, you know, would insist on the pledging of the stock, and that I didn't have a hell of a lot of alternative short of resigning if it came to a matter of the pledge agreement."¹⁰⁰ In finding that Roth was an interested director, the court also cited Heizer's acknowledgement that it had assumed control of IDC when Jordan Ross refused to hire Roth. The court finally concluded that three of the directors were interested and that disclosure to Ross, the sole disinterested director, would not constitute disclosure to the corporation, at least when Ross did not represent the

97. *Id.* at 249.

98. *Id.*

99. The other directors had resigned or were absent from the country at the time of the fifth transaction.

100. 560 F.2d at 248.

interest of the second largest shareholder and was completely excluded from the negotiation of the transaction.¹⁰¹ Under these circumstances the shareholders, and not the board of directors, would be the persons acting for the corporation for purposes of applying the deception test. Accordingly, Heizer, the majority shareholder, should have disclosed the material facts to the independent shareholders prior to the consummation of the transaction. There was little reason for the court to deal seriously with the question of whether there was sufficient disclosure to the shareholders in this case since evidence indicated they were told of the pledge only in general terms two months *after* it had been made. There being no meaningful disclosure to the shareholders, who in this case were considered "the corporation," there was also no disclosure to the corporation. The corporation, therefore, was "deceived" within the *Santa Fe* interpretation of rule 10b-5.

Finally, the *Wright* court considered the third and most troublesome question: was there 10b-5 reliance (or causation) with respect to the pledge transaction? The minority shareholders could not have vetoed the fifth transaction by their vote since shareholder approval was not required. The court found the requisite degree of reliance, however, because if there had been full disclosure the shareholders could have brought a derivative action on behalf of the corporation in state court to enjoin a breach of Heizer's fiduciary duty to deal fairly with the corporation.¹⁰² The court reached this conclusion by an elaborate process necessitating an inquiry into the fairness of the transaction. First, the court reasoned that reliance would be presumed if the omission were material and that materiality would be present if the minority shareholders could have *successfully* brought a derivative action in state court to enjoin the transaction as a breach of fiduciary duty. To defeat the injunction in state court, the controlling shareholder would have had the burden of demonstrating that the transaction was fair. If the controlling shareholder could not sustain this burden, the minority shareholders would have established a breach of fiduciary duty by the controlling shareholder, and the derivative action would have been successful. If the minority shareholders would have been able to block the transaction in state court because it was unfair, the requisite materiality and, in an omission case, reliance would be established in federal court for an action under rule 10b-5.¹⁰³

As the court noted, the existence of "the causal link" between the violation of 10b-5 and the confirmation of the pledge depended upon the fairness of the transaction.¹⁰⁴ Since fairness was the key to its analysis of causation, the court felt compelled to examine the fairness of this transaction as it would presumably have been analyzed by a state court. After reviewing Heizer's jus-

101. *Id.* at 249.

102. *Id.* at 250.

103. *Id.* at 250-51. Although the court did not articulate the alternative proposition, it seems clear that if the controlling shareholder could have shown the transaction to be fair, the requisite materiality would not be shown and the requisite reliance would not be presumed. Consequently, a derivative action in federal court would also have been unsuccessful.

104. *Id.* at 250.

tifications for the pledge, the court found that Heizer could not meet the burden of proving that the transaction was fair under Delaware law.¹⁰⁵ The court then concluded that the "freezeout" of the minority could be enjoined as a breach of fiduciary duty under Delaware law and, therefore, the requisite 10b-5 reliance was established in the fifth transaction.¹⁰⁶

Finding that the fourth and fifth transactions violated rule 10b-5, the Seventh Circuit fashioned the kind of relief it believed the Delaware state court would have given. The court cancelled the conversion feature and price adjustment effected through the fourth transaction, removed the charter amendment permitting an increase in the number of authorized shares, voided the pledge in the fifth transaction, and required that the maturity dates of the loans be adjusted to make them commensurate with IDC's ability to pay. Further, the court enjoined Heizer from entering into any security transaction with IDC absent approval by a majority of the shareholders, other than Heizer, upon disclosure of all the facts bearing on the fairness of the transaction, including Heizer's own evaluation of the company and its future prospects; or failing such approval, the transaction is found to be fair and equitable by the district court or another court having jurisdiction to make that finding. Thus, not only did the federal court find a federal claim in the fifth transaction to the extent that the claim would have been actionable in the state court, but it also designed the kind of remedy it believed would be appropriate under state law for both the fourth and fifth transactions.¹⁰⁷

The *Wright* case illustrates the factual context in which a typical fiduciary duty claim arises and is resolved under rule 10b-5. The three questions discussed by the *Wright* court are somewhat peculiar to a fiduciary duty claim: (1) Who is capable of being deceived, or to whom must full and fair disclosure be made? (2) Is there adequate disclosure? (3) Did the inadequate disclosure cause the harm (or was there reliance)? Each of these questions will now be discussed in greater depth and detail.

B. Who is Deceived or To Whom Must Disclosure Be Made?

1. The General Rule When All Directors Are Interested or All or a Majority are Disinterested

For there to be a violation of rule 10b-5 after *Santa Fe v. Green* in a fiduciary duty case, there first must be deceptive or manipulative conduct. To determine whether deception exists, a court first must ascertain to whom disclosure must be made. If shareholder approval is required, as was the situation in *Wright v. Heizer* where an amendment to the articles of incorporation was necessary to increase the number of authorized shares, the court must examine the disclosure made to the shareholders to see if there were any omis-

105. *Id.* at 251.

106. *Id.*

107. See text accompanying notes 75-105 *supra*.

sions or misrepresentations in the disclosure.¹⁰⁸ If no shareholder action is required the inquiry becomes more complicated, because then the relevant issue is whether the corporation's board of directors is sufficiently disinterested to act as the "corporate persona" capable of being deceived. If all or a majority of the board members are disinterested, and if the transaction is one that does not require shareholder approval, the board is deemed the corporate persona, and the court therefore must examine the disclosure to the board to determine if any omissions or misrepresentations were made.¹⁰⁹ On the other hand, if all of the directors are interested, the directors are not deemed to be qualified to act as the corporate persona, and disclosure must be made to the shareholders.¹¹⁰ If a majority of the board is interested, it is unclear whether disclosure must be made to the disinterested members who constitute a minority of the board or to the shareholders.¹¹¹

This issue is a modern version of the age-old question of who can act for the corporation in a self-dealing transaction.¹¹² The inanimate corporate entity cannot be deceived. Therefore, the corporation must be represented by natural persons who can be deceived. Obviously, if all of the directors are interested, they have knowledge of the material facts and therefore cannot be deceived by themselves. If this knowledge is attributed to the corporation, the corporation is likewise not deceived. This is hardly fair to the corporation or to its shareholders because the more self-dealing directors on the board, the more attributed knowledge and the less likely the corporation can be found to be deceived under rule 10b-5. Therefore, when all of the board are clearly interested, the courts should and do find that only the shareholders can act as the corporate persona. However, courts have justified this conclusion on a number of different grounds. For example, the court in *Goldberg v. Meridor*¹¹³ used an attribution theory. In *Goldberg* a derivative action was brought by a shareholder of a subsidiary, Universal Gas & Oil Co., Inc. (UGO), a Panama corporation having its principal place of business in New York City, against the controlling parent, Maritimcor, and several other persons. The complaint alleged a violation of rule 10b-5 in a transaction between the subsidiary and the parent in which the subsidiary, UGO, issued to the parent 4,200,000 shares of its stock and also assumed all of the parent's liabilities, including a \$7,000,000 debt owed to the subsidiary, in consideration for the transfer of all the parent's assets, except 2.8 million of the subsidiary's shares held by the parent. Since all of the directors of the subsidiary apparently were interested, the crucial question in the case was whether, after *Sante Fe*, 10b-5 deception could lie when all the corporate decision makers knew of

108. 560 F.2d at 247-48.

109. *Id.* at 249. See also *Maldonado v. Flynn*, 448 F. Supp. 1032, 1037-38 (S.D.N.Y. 1978); *Goldberger v. Baker*, 442 F. Supp. 659, 663 (S.D.N.Y. 1977).

110. See *Goldberg v. Meridor*, 567 F.2d 209, 215-16 (2d Cir. 1977), *cert. denied*, 434 U.S. 1069 (1978); *Goldberger v. Baker*, 442 F. Supp. 659, 663-64 (S.D.N.Y. 1977).

111. See *Goldberg v. Meridor*, 567 F.2d 209, 215-16 (2d Cir. 1977), *cert. denied*, 434 U.S. 1069 (1978); *Wright v. Heizer Corp.*, 560 F.2d at 249. See also text accompanying notes 122-70 *infra*.

112. See, e.g., *Frick v. Howard*, 23 Wis. 2d 86, 126 N.W.2d 619 (1964).

113. 567 F.2d 209 (2d Cir. 1977), *cert. denied*, 434 U.S. 1069 (1978).

the fraud. The court said that, "[t]he problem with the application of § 10(b) and Rule 10b-5 to derivative actions has lain in the degree to which the knowledge of officers and directors must be attributed to the corporation, thereby negating the element of deception."¹¹⁴ The court rejected automatic attribution even in those cases in which all of the directors know of the fraud.

We come then to the question whether it is possible within the meaning of section 10(b) and Rule 10b-5 for a corporation to be defrauded by a majority of its directors. We note at the outset that in other contexts, such as embezzlement and conflict of interest, a majority or even the entire board of directors may be held to have defrauded their corporation. When it is practical as well as just to do so, courts have experienced no difficulty in rejecting such clichés as the directors constitute the corporation and a corporation, like any other person, cannot defraud itself.¹¹⁵

The court then concluded that a corporation can be deceived if a majority or even if *all* of the directors have knowledge of the fraud. There is no requirement for "one virtuous or ignorant lamb among the directors in order for liability to arise under § 10(b) or Rule 10b-5 on a deception theory."¹¹⁶

The Southern District of New York in *Klamberg v. Roth*¹¹⁷ reached the same conclusion in a slightly different context by using an agency law theory. A class action was brought by an employee-beneficiary of a retirement trust on the ground that the employer-settlor had failed to disclose its conflict of interest to the beneficiaries in violation of rule 10b-5. The A. Sandler Company's noncontributory pension plan gave the corporation the right to appoint and remove members of the committee that administered the plan and gave to the committee the right to make investment decisions, including investment in Sandler stock. In the event of a merger any successor corporation was to be given the right to terminate the plan or to continue it with all of the powers and rights of Sandler. In 1969 Kayser-Roth acquired Sandler and replaced the committee members. The new committee invested seventy percent of the trust assets in Kayser-Roth stock. The plaintiffs brought this action, alleging that Kayser-Roth violated both 10b-5 and state law fiduciary duties¹¹⁸ because it did not disclose to the beneficiaries (1) that Kayser-Roth insiders had replaced former committee members; (2) that seventy percent of the trust's assets had been invested in Kayser-Roth stock; and (3) other information that was in their possession about Kayser-Roth stock.

In the court's view, the threshold question was determining the appropriate persona who could be deceived on behalf of the retirement trust:

In 10b-5 cases, whether conduct may 'fairly be viewed as deceptive' will generally depend upon the circumstances of the particular

114. *Id.* at 215.

115. *Id.* (citing *Ruckle v. Roto Am. Corp.*, 339 F.2d 24, 29 (2d Cir. 1964)).

116. *Id.* at 216.

117. 473 F. Supp. 544 (S.D.N.Y. 1979).

118. The court had jurisdiction over the state law claims on the basis of diversity of citizenship and pendent jurisdiction. See text accompanying note 490 *infra*.

person or class allegedly deceived, their knowledge and perceptive faculties. In other words, before the court can ask 'Was the conduct deceptive?', it must first ascertain 'To whom?' Since a 10b-5 action requires a causal connection between the defendant's violation and the plaintiff's loss, the allegedly deceived observers will have to be persons who were in a position to make a decision that led to that loss. Such a decision will often be whether to purchase or sell securities, but may also include a proxy vote, a decision to seek an injunction, or even whether to retire from active employment.¹¹⁹

The court recognized that if the above principle were applied to this case, the committee members who had the power to purchase and sell stock on behalf of the trust not only would be the "person" to be defrauded but also would be the persons alleged to have committed the fraud. This analysis would require the plaintiffs to prove that the defendants deceived themselves. Therefore, the court was forced to use another approach; however, finding one that worked was difficult. After rejecting the analogy of trust committee member to corporate director as one "not likely to bear lasting fruit,"¹²⁰ the court returned with conviction to principles of agency law:

In general, if the corporation's agents have not been deceived, neither has the corporation. However, as in other situations governed by agency principles, knowledge of the corporation's officers and agents is not imputed to it when there is a conflict between the interests of the officers and agents and the interests of the corporate principal. Therefore, a corporation may be defrauded in a stock transaction even when all of its directors know all of the material facts, if the conflict between the interests of one or more of the directors and the interests of the corporation prevents effective transmission of material information to the corporation, in violation of Rule 10b-5(2).¹²¹

However, while the *Klamberg* court articulated this principle, it did not apply it to find deception because the conflicts were "built into the trust relationship by the terms of the Agreement."¹²² This agreement gave Kayser-Roth as the successor corporation the right to appoint the committee members, who in turn were given the right to invest in Kayser-Roth stock.

Whether the attribution model or the agency model is used, the conclusion that the board of directors should not be the "corporate persona" when *all* of its members are interested is correct, primarily because it is simply unfair to attribute the knowledge of self-dealing directors to the corporation under those circumstances. When a majority, but not all, of the directors are interested, however, the equities are not so clear.

119. 473 F. Supp. at 550 (footnotes omitted).

120. *Id.* at 551.

121. *Id.* at 554-55 (quoting *Schoenbaum v. Firstbrook*, 405 F.2d 200, 211 (2d Cir.), *rev'd*, 405 F.2d 215 (2d Cir. 1968) (en banc), *cert. denied*, 395 U.S. 906 (1969)).

122. 473 F. Supp. at 556.

2. The Corporate Persona When a Minority of the Board is Disinterested

Can or should the disinterested members who constitute a minority of the board of directors be the corporate persona for purposes of 10b-5 disclosure? The *Wright* court held that disclosure to a sole disinterested director was not sufficient when the director did not represent the interest of the second largest shareholder and was completely left out of the negotiations regarding the disputed transaction.¹²³ In *Maldonado v. Flynn*, however, the four disinterested directors of an eight-member board were deemed to be the corporate persona because the four represented a majority of a quorum and thus could legally act for the corporation under Delaware law.¹²⁴

When at least some of the board members are disinterested, the courts are properly reluctant to require disclosure to the shareholders, even though a majority of the board members are interested. There are at least two justifications for this position. First, taking the matter to the shareholders is expensive and time-consuming. Second, state legislatures deliberately have chosen to leave the running of the corporation to a small group of well-informed persons who presumably can make better and quicker decisions than a widely scattered group of shareholders.

Court decisions on a related question—whether a decision not to sue by a disinterested board bars a derivative action—indicate a tendency to defer to the judgment of disinterested directors even when they constitute a minority of the board. In the landmark case of *Burks v. Lasker*,¹²⁵ shareholders of a registered investment company sued several members of the company's board of directors and its registered investment adviser. The derivative complaint alleged that the defendants had violated their duties under the Investment Company Act, the Investment Advisers Act, and the common law in connection with the 1969 purchase by the corporation of \$20 million in Penn Central Transportation Company commercial paper. Five members of the eleven-member board, who were neither affiliated with the investment adviser nor defendants in the action, and who were acting as a quorum under the company's bylaws, concluded, on the basis of outside counsel's recommendation and their own investigation, that continuation of the litigation was contrary to the best interests of the company and its shareholders and moved the district court to dismiss the action. The district court, applying the business judgment rule, dismissed the action, but the Second Circuit reversed.¹²⁶ The Supreme Court reversed the Second Circuit and stated that "corporations are creatures of state law. . . ."¹²⁷ The ICA and IAA, therefore, do not require that federal law displace state laws governing the powers of directors unless the state laws

123. See text accompanying notes 98-100 *supra*.

124. *Maldonado v. Flynn*, 448 F. Supp. 1032, 1038 (S.D.N.Y. 1978). See text accompanying notes 173-84 *infra*.

125. 441 U.S. 471 (1979).

126. 567 F.2d 1208 (2d Cir. 1978).

127. 441 U.S. at 478 (citing *Cort v. Ash*, 422 U.S. 66, 84 (1975)).

permit action prohibited by the Acts, or unless 'their application would be inconsistent with the federal policy underlying the cause of action. . . .'¹²⁸ The Court deferred to the business judgment of the directors not to pursue the action even though (1) complaints were raised under two federal acts, (2) the situation was inherently fraught with potential conflicts of interest, and (3) Congress had taken affirmative steps to minimize the conflicts by imposing strict standards for director independence.¹²⁹ The Court set forth a two-prong test to determine whether a court should defer to the directors' business judgment: (1) would state law permit disinterested directors to terminate a derivative suit and (2) would the state rule be inconsistent with the policy of the federal securities laws.¹³⁰ In formulating the test, the Court used strong language to defend the value of the judgment of disinterested directors even in situations fraught with conflicts of interests:

Yet, while these potential conflicts may justify some restraints upon the unfettered discretion of even disinterested mutual fund directors, particularly in their transactions with the investment adviser, they hardly justify a flat rule that directors may never terminate nonfrivolous derivative actions involving co-directors.¹³¹

There may well be situations in which the independent directors could reasonably believe that the best interests of the shareholders call for a decision not to sue—as, for example, where the costs of litigation to the corporation outweigh any potential recovery. . . . In such cases, it would certainly be consistent with the Act to allow the independent directors to terminate a suit, even though not frivolous. Indeed, it would have been paradoxical for Congress to have been willing to rely largely upon "watchdogs" to protect shareholder interests and yet, where the "watchdogs" have done precisely that, require that they be totally muzzled.¹³²

This deference to the decisions of disinterested directors not to sue has relevance in the area of 10b-5 disclosure as well, because if disinterested directors, even though they represent a minority of the board, can decide *not* to sue, surely they can act as the corporate persona for purposes of 10b-5 disclosure. In *Burks* the Court justified deference to the five-member minority because that number constituted a quorum under the company's bylaws whereas, as previously noted, the court in *Maldonado* emphasized that the four minority directors were a sufficient number because they could legally act for the corporation under the state statute.

The *Burks* trend has been followed with enthusiasm by the circuits. For example, the Eighth Circuit in *Abbey v. Control Data Corp.*¹³³ affirmed the district court's entry of summary judgment for the defendants on the basis of *Burks*. A class action was brought in *Abbey* to compel seven senior officers

128. *Id.* at 479 (citing *Johnson v. Railway Express Agency*, 421 U.S. 454, 465 (1975)).

129. *Id.* at 481-82.

130. *Id.* at 480.

131. *Id.* at 481-82 (citation omitted).

132. *Id.* at 485.

133. 603 F.2d 724 (8th Cir. 1979), *cert. denied*, 100 S. Ct. 670 (1980).

and directors of Control Data to repay over one million dollars in civil and criminal penalties levied on the corporation as a result of its guilty plea to criminal charges stemming from illegal payments admittedly made by the corporation to certain foreign entities.¹³⁴ The complaint alleged that Control Data and its officers and directors had violated the federal securities laws by failing to give its shareholders notice of the illegal foreign payments in the proxy and registration materials released during the payment period and had violated various common law corporate duties through waste and mismanagement. The board had created a "Special Litigation Committee," composed of seven "outside" directors, none of whom had been named as a defendant in the class action or had been involved in or had contemporaneous knowledge of the foreign payments. After retaining independent counsel and pursuing an investigation, the committee directed its legal counsel to move for summary judgment on behalf of Control Data.¹³⁵

The Eighth Circuit applied the two-prong test suggested by the Supreme Court in *Burks v. Lasker*. First, the court found that under Delaware law a committee of outside directors can terminate a derivative action. The court quoted Justice Brandeis in *United Copper Securities Co. v. Amalgamated Copper Co.*¹³⁶ for this "long-standing rule . . . found in the common law of many states."¹³⁷

Whether or not a corporation shall seek to enforce in the courts a cause of action for damages is, like other business questions, ordinarily a matter of internal management and is left to the discretion of the directors, in the absence of instruction by vote of the stockholders. Courts interfere seldom to control such discretion *inter vires* the corporation, except where the directors are guilty of misconduct equivalent to a breach of trust, or where they stand in a dual relation which prevents an unprejudiced exercise of judgment.¹³⁸

The court was not persuaded by the argument that the rule does not apply when the directors are charged with criminal misconduct because the decision not to pursue the claims is tantamount to a ratification of the criminal acts. In

134. The action also sought cancellation of several executive stock options approved by the shareholders during the period in which the payments were made. *Id.* at 726.

135. *Id.* at 727.

The committee determined that legal action by CDC against the defendants was not in the best interest of the corporation because: (1) the defendants had not been directly involved in the payments, nor had they personally profited from them; (2) the defendants had fully cooperated with the Justice Department and the committee; (3) legal action against the defendants could significantly impair their ability to manage corporate affairs; (4) the foreign payments were a customary business practice at the time they were made and were intended to serve the business interests of CDC; and (5) disclosure of the details of the payments might endanger certain CDC employees and would nullify the Justice Department's agreement with CDC to treat the results of its criminal investigation as confidential

Id.

136. 244 U.S. 261 (1917).

137. 603 F.2d at 729.

138. *Id.* (citing *United Copper Sec. Co. v. Amalgamated Copper Co.*, 244 U.S. at 263-64).

support of its reasoning the court quoted *Gall v. Exxon*:¹³⁹

The decision not to bring suit with regard to past conduct which may have been illegal is not itself a violation of law and does not result in the continuation of the alleged violation of law. Rather, it is a decision by the directors of the corporation that pursuit of a cause of action based on acts already consummated is not in the best interest of the corporation. Such a determination, like any other business decision, must be made by the corporate directors in the exercise of their sound business judgment. The conclusive effect of such a judgment cannot be affected by the allegedly illegal nature of the initial action which purportedly gives rise to the cause of action.¹⁴⁰

The court then applied the second prong of the test—does termination of the litigation undermine the policies of the federal securities laws? Termination of this case was found not to undermine section 13 of the Exchange Act because the section 13 claim was weak and the cause of action was of the kind traditionally relegated to state law.¹⁴¹ Likewise, section 14(a) was not undermined by dismissal of the case because the section 14 claim was “at best marginally related to the federal policies underlying that section”¹⁴² and because any injury to the shareholders from the corporation’s illegal foreign payments stemmed directly from the corporate waste and mismanagement in authorizing the payments and not from allegedly misleading proxy solicitations dealing with other corporate matters.¹⁴³

Abbey, however, is not especially helpful to our analysis of the type of minority that can constitute a 10b-5 corporate persona. The court did not consider whether the number of directors must be sufficient to constitute a quorum under the company’s bylaws or whether they must represent the minimum number of directors required for legal action under the corporate statute. The court simply stated that before it would defer to their judgment, the directors must: (1) be outside directors; (2) not be named as defendants or not claimed to be involved in or have contemporaneous knowledge of the illegal act; (3) constitute a “Special Litigation Committee” created by the board; and (4) act with independent legal counsel.¹⁴⁴

Perhaps providing more guidance is *Lewis v. Anderson*,¹⁴⁵ in which the Ninth Circuit relied on *Burks* to defer to the business judgment of a special litigation committee of the corporation’s directors. One year after Walt Disney Productions had adopted a stock option plan for key employees, the board-appointed “stock option committee” granted new, and allegedly more

139. 418 F. Supp. 508, 518 (S.D.N.Y. 1976).

140. 603 F.2d at 730 (quoting *Gall v. Exxon*, 418 F. Supp. at 518).

141. *Id.* at 731.

142. *Id.* at 732.

143. *Id.*

144. *Id.* at 727.

145. 615 F.2d 778 (9th Cir. 1979). The Ninth Circuit denied rehearing on April 8, 1980 even though the Delaware Chancery court held that courts are not obligated to defer to the business judgment of directors in dismissing derivative actions. *See Maldonado v. Flynn*, 413 A.2d 1251 (Del. Ch. 1980).

favorable, options to defendant directors. The plaintiffs contended that the issuance of the new options and management's behavior in seeking shareholder approval of the new option plan violated federal securities laws. The litigation committee, which determined that maintaining the action was not in the corporation's best interest, consisted of two outside directors, appointed to the board after the challenged transaction, and one other director who, although a named defendant, did not benefit from the transaction.¹⁴⁶ The court applied the *Burks* test and held that the committee's good faith determination not to sue barred any further action by a shareholder on behalf of the corporation.¹⁴⁷ First, the court, "sitting as a state court," examined decisions of intermediate California appellate courts and courts in other jurisdictions and concluded that California would extend the business judgment rule to dismiss a derivative action if a duly delegated committee had determined that the action was not in the corporation's best interest. That the committee was appointed by the interested directors, though troublesome, was not deemed to be conclusive. Citing *Auerbach v. Bennett*,¹⁴⁸ the court said:

To assign responsibility of the dimension here involved to individuals wholly separate and apart from the board of directors would, except in the most extraordinary circumstances, itself be an act of default and breach of the nondelegable fiduciary duty owed by the members of the board to the corporation and to its shareholders, employees and creditors. For the courts to preside over such determinations would similarly work an ouster of the board's fundamental responsibility and authority for corporate management.¹⁴⁹

The court justified its deference to directors with the argument that directors are better equipped to make the decision to sue than one minority shareholder.

To allow one shareholder to incapacitate an entire board of directors merely by leveling charges against them gives too much leverage to dissident shareholders. There is no reason to believe that a minority shareholder is more likely to act in the best interest of the corporation than are directors who are elected by a majority of the stockholders.¹⁵⁰

In applying the second-prong of the *Burks* test the court found, with much greater difficulty, that deference to the director's judgment in the case was not inconsistent with rule 10b-5. The court gave two reasons for this conclusion: (1) "It [the business judgment rule] operates only to insulate the committee's good faith decision to dismiss an action, even if that decision is negligent. In that sense the business judgment rule is closely analogous to

146. 615 F.2d at 780. Whether the committee exercised good faith is a determination for the trier of fact. *Id.*

147. *Id.* at 783.

148. 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979).

149. 615 F.2d at 783 (quoting *Auerbach v. Bennett*, 47 N.Y.2d at 633, 393 N.E.2d at 1002, 419 N.Y.S.2d at 928).

150. *Id.*

Rule 10b-5 itself, which affords no cause of action for negligence,"¹⁵¹ and (2)

"Section 10(b) and Rule 10b-5 were not intended to bring within their ambit simple corporate mismanagement or every imaginable breach of fiduciary duty in connection with a securities transaction". . . . That description of Rule 10b-5 is an equally apt description of the business judgment rule. We find, in sum, that the two rules can coexist harmoniously.¹⁵²

These two reasons appear to be neither sound nor persuasive, but it is hard to see how the court could find better ones. It is difficult to apply the second-prong of *Burks* to 10b-5 because 10b-5 is so broad. Any decision that takes the case out of federal court, including deferring to the business judgment of the directors who decide not to sue, limits rule 10b-5 and arguably undermines the policies of the rule by failing to give relief for a deceptive or fraudulent cause of action.

The Ninth Circuit in *Lewis* was helpful in pinpointing the nature of the minority that can act as the corporate persona for purposes of 10b-5. The court emphasized the "disinterestedness" of the directors, not whether they constituted a quorum or could legally act for the corporation.¹⁵³ This is an equally proper focus. Of course, the fact that the minority are sufficient in number to act under the bylaws or corporate statute is the *most* persuasive case for accepting minority directors as the corporate persona, provided they are disinterested.

Deference is not accorded even to disinterested directors unless a trier of fact determines that the directors acted in good faith.¹⁵⁴ It is not clear what "good faith" adds to disinterested. A more precise standard might result if good faith is presumed when the directors are proven to be disinterested.¹⁵⁵ A

151. *Id.* at 783-84 (citing *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976)).

152. *Id.* at 784 (citing *St. Louis Union Trust Co. v. Merrill Lynch, Pierce, Fenner & Smith*, 562 F.2d 1040, 1048 (8th Cir. 1977), *cert. denied*, 435 U.S. 925 (1978)).

153. The committee retained independent legal counsel was also considered important by the court. *Id.* at 780.

154. In *Falkenberg v. Baldwin*, [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,086 (S.D.N.Y. June 13, 1977), the court's good faith inquiry was into the independence of members of a committee that decided not to sue and into the appropriateness and sufficiency of the committee's investigation procedures.

155. In *Nussbacher v. Chase Manhattan Bank*, 444 F. Supp. 973 (S.D.N.Y. 1977), the Southern District of New York seemed to imply that good faith may mean disinterestedness:

The fact that the board opposed the action does not, of course, establish their good faith in so doing. Thus, plaintiff stands on firmer ground in asserting that the business judgment rule should not apply where the directors themselves are charged with complicity in the allegedly wrongful action, as they are in the case at bar. It is inconceivable that directors who participated in and allegedly approved of the transaction under attack can be said to have exercised unbiased business judgment in declining suit based on that very transaction. In this regard it is well to note the concurrence of Judge Coffin in *In re Kauffman Mutual Fund Actions*, 479 F.2d 257, 269 (1st Cir.), *cert. denied*, 414 U.S. 857, 94 S. Ct. 161, 38 L.Ed.2d 107 (1973):

I find it hard to imagine that a director, however, unaffiliated, who had participated, or under these circumstances knowingly acquiesced, in a major transaction, albeit for a corporate purpose, would authorize a suit, effectively against himself, claiming that the transaction violated the federal antitrust laws. Even independent watchdogs cannot be thought ready to sign a confession of that magnitude.

court that directed its inquiry primarily to the disinterestedness of the directors rather than to their good faith was the Second Circuit in *Galef v. Alexander*.¹⁵⁶ The court refused to defer to the business judgment of directors who were named as defendants in a derivative action for alleged violations of Section 14 of the Exchange Act. Even if Ohio courts would defer to the business judgment of these directors (and the court did not decide that they would), the policy of Section 14(a) was found to be undermined by that state policy:

Obviously the goal of § 14(a) that communications from management be accurate and complete as to all material facts is a vital one. Its achievement would quite clearly be frustrated if a director who was made a defendant in a derivative action for providing inadequate information in connection with a proxy solicitation were permitted to cause the dismissal of that action simply on the basis of his judgment that its pursuit was not in the best interests of the corporation. The very premises which give life to a derivative right of action to enforce § 14(a) must save it from a premature death.¹⁵⁷

The Southern District of New York in *Maldonado v. Flynn*,¹⁵⁸ in deference to the business judgment of only two directors, dismissed a shareholders' derivative action against the other directors for an alleged violation of Section 14. The court examined the independence (a synonym for disinterested in this case) and the good faith of the directors:

The cornerstone of the business judgment rule is the independence and disinterestedness of the directors charged with responsibility for decisions. It requires a group of directors who are genuinely independent of the disqualified board and disinterested in the action; it requires them to exercise their business judgment in fact and to do so in good faith. No court is required to take for granted that these conditions have been met and the shareholder is free to challenge the committee's bona fides.¹⁵⁹

The court found that the two directors were independent even though appointed by the wrongdoers¹⁶⁰ because they: (1) were not defendants in the action; (2) were designated long after the suit was filed; (3) had no involvement in matters that were the subject of the action; and (4) had no substantial

Id. at 977.

156. 615 F.2d 51 (2d Cir. 1980).

157. *Id.* at 63, 64.

158. 485 F. Supp. 274 (S.D.N.Y. 1980).

159. *Id.* at 282.

160. The court, in response to plaintiffs' argument that "the business judgment rule in effect empowers the 'wrongdoers' by their very designation of the independent committee to obtain exoneration," stated:

This cynical attitude would require a per se disqualification of any committee appointed by a board exercising its statutory authority no matter how far the independent committee may be removed from the transactions that are at the core of the litigation. Moreover, this concept would sterilize the corporation, for "to disqualify the entire board would be to render the corporation powerless to make an effective business judgment with respect to prosecution of the derivative action."

Id. at 282 (quoting *Auerbach v. Bennett*, 47 N.Y.2d at 633, 393 N.E.2d at 1002, 419 N.Y.S.2d at 928 (1979)).

previous involvement with either the corporation or its directors. The committee also was found to have acted in good faith.¹⁶¹ The business judgment rule, said the court, would permit disinterested directors to decide not to pursue an action even though it is legally sound if other considerations (for example, ethical, commercial, promotional, public relations, employee relations, fiscal) would make dismissal in the best interest of the corporation.¹⁶²

The Chancery Court of Delaware in *Maldonado v. Flynn*¹⁶³ held that the directors' decision not to sue does not bar the derivative action under Delaware law. The court reasoned that a derivative action has two phases—one that is the equivalent of a suit to compel the corporation to sue, which belongs to the complaining shareholders, and the other a suit by the corporation against those liable to it, which belongs to the corporation. The court said:

Under settled Delaware law the directors do not have the right to compel the dismissal of a derivative suit brought by a stockholder to rectify an apparent breach of fiduciary duty by the directors to the corporation and its stockholders after the directors have refused to institute legal proceedings, because the stockholder then possesses an independent right to redress the wrong.¹⁶⁴

Under our system of law, courts and not litigants should decide the merits of litigation. Aggrieved stockholders of Delaware corporations ought to be able to expect that an impartial tribunal, and not a committee appointed by the alleged wrongdoers, will decide whether a stockholder's derivative suit alleging breach of fiduciary duty has any merit.¹⁶⁵

This decision would have changed the result of *Abbey v. Control Data*,¹⁶⁶ *Lewis v. Adams*,¹⁶⁷ and *Siegal v. Merrick*,¹⁶⁸ all of which based their decisions upon a contrary interpretation of Delaware law.

The Chancery Court later reconsidered its ruling, dismissed the suit on the grounds of res judicata, and stayed the dismissal pending the decision of the Second Circuit.¹⁶⁹ The Appellate Division of the New York Supreme

161. As evidence of the committee's good faith the court noted that the committee had spent three months reviewing the matter and preparing its report, retained its own counsel, reviewed the pleadings and thousands of related documents, considered the depositions of parties and witnesses taken in the actions, and conducted numerous interviews—including interviews with the defendant directors, the corporation's president and former officers and employees, its auditors and tax advisers. *Id.* at 284.

162. *Id.* at 285.

163. 413 A.2d 1251 (Del. Ch. 1980).

164. *Id.* at 1262.

165. *Id.* at 1263.

166. 603 F.2d 724 (8th Cir. 1979), *cert. denied*, 100 S. Ct. 670 (1980).

167. No. 77-266C (N.D. Okla., filed Nov. 15, 1979).

168. 84 F.R.D. 106 (S.D.N.Y. 1979). Applying the reasoning of the Delaware Court of Chancery in *Maldonado v. Flynn*, the District Court for Southern Texas in *Maher v. Zapata Corp.*, 490 F. Supp. 348 (S.D. Tex. 1980), refused to dismiss a derivative action charging breach of fiduciary duty and violations of §§ 14(a), 13(a) and 13(b)(2) (the latter of which embodies the Foreign Corrupt Practices Act), despite a recommendation to do so by an ostensibly independent committee of shareholders.

169. *Maldonado v. Flynn*, 413 A.2d 1251 (Del. Ch. 1980). The history of this suit is complex. During the pendency of the Delaware action, the shareholder filed suit in the U.S. District Court

Court took a contrary position in *Parkoff v. General Telephone & Electronics Corp.*,¹⁷⁰ holding that the decision whether to prosecute claims alleging waste of corporate property in connection with questionable foreign payments lies within the business judgment of the corporation's board of directors. Regardless of the way in which this controversy is finally resolved, it can be argued with authority that even if a minority of disinterested directors cannot act to bind the courts by requiring the dismissal of a derivative action, they can serve in the much more innocuous role of the corporate persona for purposes of disclosure under rule 10b-5.

In conclusion, the best view is that disclosure to a disinterested board, regardless of size, should be deemed disclosure to the corporation.¹⁷¹ These directors, even if in the minority, are elected by the shareholders to act for the corporation. They have greater knowledge and expertise and can therefore digest the disclosure better than the shareholders—and certainly at less expense to the corporation. They are also better able to evaluate the transaction than even a learned judge who must review the transaction long after the events and who may find it difficult to ignore the knowledge of hindsight. A few directors can act with the speed and precision necessary in most corporate transactions. Disclosure can be oral and new information can be easily and quickly communicated to the directors. To require disclosure to the shareholders not only delays the process but exposes the corporation to liability for possible omissions or misrepresentations in the voluminous written material that must be mailed to the shareholders and updated. Corporate statutes, for all these reasons, wisely require a shareholder vote only on rare occasions.

3. Defining "Interested"

Whether a director is interested is a factual determination. Analysis of the cases reveals some relevant facts that may indicate when a director is inter-

for Southern New York against the company and its officers and directors under §§ 7, 10(b), and 14(a) of the 1934 Act. The shareholder also asserted in the federal action, as pendent to his securities law violation claims, the common-law claims asserted in Delaware. The district court dismissed the securities law claims, and because there were no federal claims to which the common law claims were pendent, also dismissed the common law claims. *Maldonado v. Flynn* 448 F. Supp. 1032 (S.D.N.Y. 1978). On appeal, the U.S. Court of Appeals for the Second Circuit affirmed the dismissal of the § 10(b) claim but reversed the dismissal of a § 14(a) claim. *Maldonado v. Flynn*, 597 F.2d 789 (2d Cir. 1979). The case was remanded to the district court with specific instructions to determine whether to exercise its discretionary pendent jurisdiction over the common-law claims. Prior to any determination by the district court whether to exercise pendent jurisdiction, the shareholder filed an amended complaint alleging only a single cause of action for violation of § 14(a).

Applying the Supreme Court's analysis in *Burks v. Lasker*, the U.S. District Court on January 24, 1980, held that Delaware's business judgment rule requires the dismissal of a shareholder's derivative action once a duly delegated committee of disinterested directors determines that the action is not in the corporation's best interests. *Maldonado v. Flynn*, [Current Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,260 (S.D.N.Y. Jan. 24, 1980).

170. 425 N.Y.S.2d 599 (App. Div. N.Y. 1980).

171. An example of the court's unwillingness to extend the disclosure obligation is *Superintendent of Ins. v. Freedman*, 443 F. Supp. 628 (S.D.N.Y. 1977), *aff'd mem.*, 594 F.2d 852 (2d Cir. 1978), in which the court found that there was no duty under rule 10b-5 to disclose to policy holders and creditors. Disclosure had been made to the directors, who were controlled by the defendant parent, and there were no minority shareholders.

ested but, perhaps more important, circumstances that do *not* automatically make a director interested. The court in *Wright v. Heizer*¹⁷² found that the president of the company was controlled by the majority shareholder and was, therefore, an interested director in a transaction between the majority shareholder and the corporation because: (1) he was hired by the directors chosen by the majority shareholder over the objection of the only other director and (2) he testified that he felt he had no alternative to approving the transaction short of resignation.¹⁷³ The Second Circuit discussed "interestedness" at length in *Maldonado v. Flynn*¹⁷⁴ in which it upheld the district court's dismissal of the 10b-5 claim but reversed the dismissal of the claim under section 14 and rule 14a-9. The directors in that case allegedly had modified a stock option plan to accelerate the exercise date of the options and had loaned certain officers corporate money to exercise the options, knowing that the corporation was about to make a tender offer for its stock that would increase the "bargain spread."¹⁷⁵ The modifications allegedly were made to permit the officers to exercise their options prior to the price rise so as to lower their bargain spread and thereby reduce their tax liability. An early exercise of the options, although in the best interest of the officers, had the concurrent effect of decreasing the corresponding tax deduction for the corporation. Five directors of the eight-member board were present at the special meeting when the modifications were made. The president, a beneficiary of the option plan, abstained and the other four directors voted unanimously to approve the changes in the option plan. One of those four directors was a partner in a large law firm that received substantial fees from the corporation, and another had traded on the inside information that the tender offer was pending.¹⁷⁶

The court dismissed the 10b-5 claim because the corporation was not deceived, disclosure having been made to a "disinterested" board, which under Delaware law could act for the corporation.¹⁷⁷ In reaching this conclusion, the court stated:

Even if some directors have an interest in the transaction, absent domination or control of a corporation or of its board by the officer-beneficiaries, approval of the transaction by a disinterested majority of the board possessing authority to act and fully informed of all relevant facts will suffice to bar a Rule 10b-5 claim that the corporation or its stockholders were deceived. [Citations omitted] The

172. 560 F.2d at 236.

173. *Id.* at 248.

174. 597 F.2d 789 (2d Cir. 1979).

175. The bargain spread is "the difference between the fair market price of the stock at the time the option is exercised and the option price paid for the stock." *Id.* at 792.

176. *Id.* at 792-94. Even though shareholder approval was not necessary, the directors decided at the meeting to refer the proposal to the shareholders, and the option agreement provided that it would be cancelled if the shareholders did not approve. The proposal was never submitted to the shareholders, however. *Id.* at 792.

177. *Id.* at 795. Under Delaware law a majority of the eight-member board (five) constituted a quorum, and a majority of a quorum (at least three) could approve the transaction. In this case, five directors were present, and the transaction was approved by four of those directors (the president abstaining).

knowledge of the disinterested majority must in such event be attributed to the corporation and its stockholders, precluding deception.¹⁷⁸

The key to the court's conclusion was that the four directors who approved the transaction were "disinterested." The court found that the four directors who approved this transaction were "disinterested" because none had "a financial stake in the transaction."¹⁷⁹ The process used to reach that conclusion was arduous. First, the court rejected the argument that the nonoptionee directors were "interested" because they aided and abetted the optionees in violating rule 10b-5, noting that "[t]his bootstrapping theory would convert every alleged act of mismanagement in connection with the purchase or sale of a security into a 10b-5 claim, unless the act were ratified by the shareholders after full disclosure."¹⁸⁰ Nor, in the court's view, was the lawyer-director shown to be interested. The mere fact that the attorney's continued employment, from which he received substantial legal fees, depended upon the directors' favor did not make the attorney an interested director absent a specific claim that he voted in favor of this particular transaction in exchange for the continued retention of his firm as counsel. The court said: "Unless and until board membership on the part of a corporation's outside counsel, or of anyone with a commercial relationship with the corporation, is outlawed, we cannot assume that a counsel-director acts for reasons that are against the corporation's interest, as distinguished from the private interests of its officers."¹⁸¹ The court also mentioned that the shareholders had elected the attorney a director knowing of his relationship to the corporation.

The court then determined whether Woolcott, who through a corporation wholly owned by his mother had traded on the inside information of the imminent tender offer, was interested. The court acknowledged that Woolcott may have voted in favor of the transaction to remain in the good graces of the other directors with the hope that his vote would induce them to cover up his private profiteering at the expense of the public shareholders. However, because his vote was not necessary to approve the transaction, the court was able to evade the question of whether his desire to conceal separate wrongdoing was sufficient to label him an interested director for purposes of this transaction.¹⁸²

Finally, the court examined whether the four directors who approved the transaction lost their disinterestedness because of the controlling influence of the six officers, who were the beneficiaries of the transaction. The court said domination by interested directors in some cases could make otherwise disinterested directors interested.

Domination or control of a corporation or of its board by those bene-

178. *Id.* at 793.

179. *Id.*

180. *Id.* at 794 n.6.

181. *Id.* at 794. The court might have strengthened its argument by a reference to the Code of Professional Responsibility, which requires the attorney to act in the best interests of the corporation. ABA CODE OF PROFESSIONAL RESPONSIBILITY Canon 5, EC 5-18.

182. 597 F.2d at 794-95.

fitting from the board's action may under some circumstances preclude its directors from being disinterested. In such a case, since they would be acting as mere pawns of the controlling wrongdoer, their knowledge could hardly be imputed to the corporation or its stockholders. We have so held, for instance, where the "corporation is influenced by its controlling shareholder to engage in a transaction adverse to the corporation's interests . . . and there is a nondisclosure or misleading disclosures."¹⁸³

The court did not apply this doctrine to the facts of *Maldonado*, however, because the plaintiffs did not claim that the officers who were the beneficiaries of the transaction were controlling shareholders or that they controlled the decision-making by the "disinterested" directors who voted in favor of the transaction.¹⁸⁴ The court then modified its definition of disinterested by adding a requirement of materiality and substituting personal interest for financial stake—the director is disinterested if he "has no material personal interest in the transaction or matter under consideration."¹⁸⁵

"A material personal" interest in the outcome is a much broader and more ambiguous definition of interested than "financial stake" in the transaction.¹⁸⁶ Since the presence of disinterested directors is the key to determining to whom disclosure must be made, the test of interestedness should be clear and precise so that corporate planners can decide whether there should be disclosure to the shareholders. "Financial stake" is the more precise of the two tests and would be even more precise if defined as "material financial stake" in the outcome. An indirect financial stake should not be sufficient, as wisely held by the *Maldonado* court. It is arguable that an attorney, in a transaction in which controlling persons of the corporation are the interested directors, does have an indirect financial stake in voting for the transaction to assure that his firm will remain in favor with those directors, who will be directly responsible for its continued employment. Likewise, a person like Woolcott could have an indirect financial stake in a transaction in which his vote would benefit other directors, whose future cooperation might minimize the chances that he would be sued for damages resulting from his insider trading. However, the addition of "indirect" makes the test of interestedness much less precise and therefore of less value to corporate planners who should be able to structure transactions upon which the decision makers can rely. Furthermore, directors are elected by shareholders to use their expertise and knowledge to make decisions for the corporation. That mandate should not be ignored by the courts because of possibilities of "indirect" financial rewards, for then the corporation loses (for what may be no good reason) any expert contribution

183. *Id.* at 795 (quoting *Goldberg v. Meridor*, 567 F.2d at 217).

184. *Id.* The complaint alleged that the directors "may have been controlled" but not that they were in fact controlled.

185. *Id.*

186. State legislators have not succeeded in defining "interested director" with any greater precision. See DEL. CODE ANN. tit. 8, § 144 (1974); N.Y. BUS. CORP. LAW § 713 (McKinney) (1963).

the directors can make to the decision. Accordingly, only a director with a direct financial stake in the transaction should be presumed interested.

There are some situations in which directors would be clearly disinterested, regardless of the test used by the court. For example, directors are deemed to be disinterested if there is no conflict of interest *alleged* between any of the directors of the corporation. In *Kaplan v. Bennett*¹⁸⁷ the Southern District of New York held that plaintiffs had failed to state a claim under rule 10b-5 since they had not alleged that the corporation was deceived.¹⁸⁸ Plaintiffs brought a derivative action alleging that defendants had violated 10b-5 because they had caused the corporation to sell its interest in a foreign subsidiary for "virtually nothing."¹⁸⁹ The court found that the corporation had not been deceived because the knowledge of the directors would be attributed to the corporation absent an allegation of conflict of interest. The court, after analyzing and citing several cases,¹⁹⁰ acknowledged that "a corporation can be held to have been deceived within the meaning of section 10(b) and rule 10b-5 when the board has a conflict of interest or is under the improper influence of a controlling person or when some members of the board have been deceived."¹⁹¹ However, the knowledge that defendants argued was possessed by all members of the board was attributed to the corporation because there was no allegation that "some members of the board misled others [or] a conflict of interest on the part of the board or a controlling influence exerted over it by a dominant shareholder, parent corporation or board faction."¹⁹² Thus, this case turned upon a failure to plead a conflict of interest.

Despite better pleading, the Eastern District of Pennsylvania in *Tyco Laboratories, Inc. v. Kimball*¹⁹³ also found that directors' knowledge was attributed to the corporation absent a "classic" conflict of interest.¹⁹⁴ The plaintiffs brought a derivative action alleging that two defendant directors failed to disclose to the other defendant directors, the corporation, and the stockholders or, in the alternative, all the defendant directors failed to disclose to the corporation and the stockholders the known willingness of plaintiffs to purchase a substantial amount of the corporation's preferred stock at a price materially

187. 465 F. Supp. 555 (S.D.N.Y. 1979).

188. *Id.* at 566.

189. *Id.* at 562. Other claims were made for failure to disclose kickbacks and bribes to officials of foreign governments, the details of which had been disclosed in a proxy statement after the investigation of an audit committee. A special litigation committee had decided it would not be in the corporation's best interest to sue. *Id.* at 558.

190. *Santa Fe Indus., Inc. v. Green*, 430 U.S. at 462; *Goldberg v. Meridor*, 567 F.2d at 209; *Maldonado v. Flynn*, 448 F. Supp. at 1032; *Falkenberg v. Baldwin*, [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,086 (S.D.N.Y. 1977); *Tyco Laboratories, Inc. v. Kimball*, 444 F. Supp. 292 (E.D. Pa. 1977); *Goldberger v. Baker*, 442 F. Supp. 659 (S.D.N.Y. 1977).

191. *Kaplan v. Bennett*, 465 F. Supp. at 565.

192. *Id.* at 565-66. The court in passing noted that "[a]lthough plaintiffs' claim would not necessarily be precluded by the fact that the Audit and Special Litigation Committees found no evidence of personal profit, plaintiffs have not even alleged pecuniary interest or other conflict on the part of the board." *Id.* at 566.

193. 444 F. Supp. 292 (E.D. Pa. 1977).

194. *Id.* at 297-98. *Accord*, *Falkenberg v. Baldwin*, [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,086 (S.D.N.Y. June 13, 1977).

higher than that actually paid by a lower bidder. Plaintiffs alleged that defendant directors concealed the higher bid because selling to the lower bidder would allow the two directors to remain as incumbent management of the corporation.¹⁹⁵ The court found that the complaint stated a 10b-5 cause of action against the two directors, Kimball and Loidl, on the theory that they deceived the other directors.¹⁹⁶ It also found, however, that the allegation that all of the directors had deceived the corporation did not state a cause of action because no conflict of interest was alleged.¹⁹⁷

Whether the directors are interested then is crucial to ascertaining the persons who must be informed to avoid deception under 10b-5. If all of the directors are interested, disclosure must be made to the shareholders even though the decision normally would be made by the board. If all or a majority of the directors are disinterested, disclosure should be to the board. If a minority of the board is disinterested, the law is unclear but the better view is that disclosure should be made to the board.

C. Was There Adequate Disclosure?

After the court determines the person to whom disclosure should be made, it must examine whether disclosure is adequate under the standards of rule 10b-5.

1. Disclosure Deemed Adequate if No Allegation of Misrepresentation or Omission

If there is no allegation in the complaint of a material misrepresentation or omission, a claim that the defendants breached their fiduciary duty clearly is not actionable after *Sante Fe*. For example, the Southern District of New York in *In re Sunshine Mining Co. Securities Litigation*¹⁹⁸ dismissed a claim by the stockholders of Sunshine Mining Company that its directors, motivated solely by selfish interests, violated section 14(e) by resisting the tender offer of Great Western United Corporation. Throughout the period of its resistance to the tender offer, management made no public statements except to announce the various activities it was undertaking and never recommended that the shareholders refrain from tendering their shares. The court, applying *Santa Fe* to section 14(e),¹⁹⁹ held that the complaint was "no more than a charge that Sunshine management acted unfairly and in breach of its fiduciary duties"²⁰⁰ and thus did not state a claim under section 14(e).

195. 444 F. Supp. at 295.

196. *Id.* at 296.

197. *Id.* at 298. The court distinguished *Goldberg v. Meridor*, 567 F.2d at 209, on the ground that the directors here, unlike in *Goldberg*, had no pecuniary involvement with the transaction. 444 F. Supp. at 297.

198. [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,217 (S.D.N.Y. 1979).

199. *Id.* at ¶ 96,635. The court rejected the argument that a breach of fiduciary duty came within the broader language of § 14(e), which prohibits "fraudulent" as well as deceptive or manipulative conduct. *Id.* at ¶ 96,636.

200. *Id.* at ¶ 96,636.

2. Disclosure Deemed Inadequate to Meet 10b-5 Standards

At one extreme of the disclosure continuum is the case in which virtually no disclosure is made. This most often occurs when there is a duty to disclose to the shareholders but disclosure has been made, if at all, to directors, some of whom are interested. A recent illustration is *Kidwell v. Meikle*.²⁰¹ In *Kidwell*, the defendant corporation was Targhee, an Idaho nonprofit cooperative membership corporation formed to operate for its members a ski resort on lands leased from the United States Forest Service. When a consulting firm hired by Targhee recommended that additional housing be built to improve the operation of its resort, the executive vice president of Targhee suggested to the fifteen-member board a housing plan that led to the formation of Sioux Corporation (Sioux), a profit corporation. Certain Targhee shareholders were permitted to become members of Sioux. Targhee borrowed money from the Small Business Association to build the housing units and leased them to Sioux for twenty-five years in consideration for which Sioux agreed to pay off the mortgage. Targhee signed a management contract, which was alleged to be highly unfavorable because it forced Targhee to remain in operation the year round to manage and maintain the units.

After the units were operational William Robinson approached the Targhee board with the proposal to purchase Targhee's assets through a stock-for-assets exchange between a newly-formed corporation, Big Valley, and Targhee. Big Valley, in consideration for Targhee's assets and assumption of its liabilities, including its contract with Sioux, would give to Targhee and its members a minority stock interest in Big Valley. The fifteen-member Targhee board voted two to one to approve the sale and called for an advisory membership vote, even though the vote was not required under Idaho law.²⁰² The directors voting for this first proposal included three directors who were shareholders of Sioux and two persons who had guaranteed Targhee's liabilities to the Valley Bank. The chairman of the board of directors, who was not a shareholder of Sioux, opposed the sale. The notice sent to the shareholders prior to the advisory vote contained a brief outline of the proposal and stated that full disclosure of the details of the Robinson proposal would be made at the meeting. The evidence was in conflict on whether the Targhee members were informed at the meeting that: (1) certain Targhee directors owned shares in Sioux; (2) the counsel for Targhee had been and may still have been the counsel for Sioux; and (3) two of Targhee's directors had become personally liable for the corporation's debts to the Valley Bank. Less than one-third of the total voting stock of the corporation voted for the sale. (Sixty-five percent of those present approved the sale but fewer than half of the members were present.)

Some directors and various members of Targhee sued the other directors,

201. 597 F.2d 1273 (9th Cir. 1979).

202. *Id.* at 1280-81. Section 30-145(2) of the Idaho Code provided that if a corporation were unable to meet its liabilities then matured, shareholder approval of the sale of all its assets was not required. *Id.* at 1280 n.1.

the bank, and various other individuals for violations of 10b-5 and state fiduciary duties. The court ultimately dismissed all causes of action except a derivative cause of action by a member of the corporation under 10b-5 against the directors, the attorney, Sioux, Valley Bank, Big Valley, Robinson, and others.

In refusing to dismiss the 10b-5 claim, the court first found that disclosure should have been made to the shareholders. "Even where shareholder approval is not required for a corporate act under state law, failure by directors and others to disclose conflicts of interest or unfairness to shareholders regarding the transaction constitutes a violation of the rule."²⁰³ The court then examined the adequacy of the disclosure to the shareholders, which consisted of a brief outline of the proposal and a statement that full details would be given at the meeting. Since there was virtually no disclosure in the notice sent to the shareholders, the court found that there were material omissions in the disclosure, which gave rise to a cause of action under rule 10b-5.²⁰⁴ Whether there had been full disclosure at the meeting was, in the court's opinion, irrelevant, because an incomplete notice and poor attendance made *any* disclosure at the meeting irrelevant. "The only disclosure . . . came in an ambiguous notice followed by a disorderly meeting which fewer than half of Targhee's members attended."²⁰⁵

There was also virtually no attempt at disclosure in *Wright v. Heizer Corp.*²⁰⁶ In *Wright*, a derivative action, the only written disclosure made to the shareholders, whose written consent to an amendment to the articles was sought, was that the number of common shares would be increased from three to seven million, and the only oral disclosure was a statement that the amendment was necessary for financing and the amount of the financing. Testimony indicated that the shareholders were not told the source of the financing or given any other information that would suggest that the financing was more than a simple purchase of stock.²⁰⁷ The court found that this disclosure did not meet the standards of rule 10b-5.

3. Disclosure Deemed Adequate Under 10b-5

When there is some disclosure by the defendants *and* an allegation in the complaint that the disclosure was inadequate under rule 10b-5, the courts are faced with less of a clear-cut resolution than in *Kidwell* and *Wright*. There are some categories that are used by the courts in analyzing the adequacy of disclosure. If the alleged omission falls into one of these categories, it is usually deemed to be immaterial and thus does not constitute inadequate disclosure: (1) a characterization of the transaction; (2) readily available information; (3)

203. *Id.* at 1291.

204. *Id.* at 1293.

205. *Id.* at 1292.

206. 560 F.2d 236 (7th Cir. 1977), *cert. denied*, 434 U.S. 1066 (1978). *See* text accompanying notes 75-105 *supra*.

207. 560 F.2d at 247.

an expert opinion; (4) prediction and speculation; and (5) alternative courses of action.

a. Characterizing the Transaction

By far the most common basis for finding that the disclosure is adequate under 10b-5 is that the underlying terms of the transaction have been disclosed and the alleged omission is simply a failure to characterize the transaction in pejorative terms. In *Goldberger v. Baker*,²⁰⁸ a derivative action, shareholders of Health-Chem Corporation alleged that Health-Chem's officers and directors and corporate parents violated rules 14a-9 and 10b-5 by looting Health-Chem through several fraudulent transactions. After examining the transactions and the allegations made in the complaint, the court concluded that plaintiffs' claims were nothing more than that Health-Chem had been badly managed²⁰⁹ and thus did not state a claim under rule 10b-5. Specifically, plaintiffs alleged that Health-Chem failed to disclose to its shareholders and the public that \$900,000 in loans to its corporate parents were in violation of a representation in an earlier prospectus that it would not loan funds to any of its parents. Plaintiffs also alleged that Health-Chem received less than fair and adequate consideration for the loans.²¹⁰ The court held that since the complaint failed to allege that the terms of the loans were either not disclosed or disclosed in a misleading manner, allegations that the company did not disclose that the terms were unfair or that the loans were inconsistent with company policy did not give rise to a cause of action under rule 10b-5. The court refused to require that the transaction be described in pejorative terms.

To hold that such an allegation was sufficient would be tantamount to asking defendants to 'characterize' the transactions with 'pejorative' words, and the failure to use such descriptions is not a 10b-5 violation. *Meridor, supra*. If the *Green* case means anything, it is that such an allegation is not a sufficient claim of deception. Similarly, the mere fact that the loans were inconsistent with previously stated policy and defendants did not disclose the inconsistency also does not rise to the level of an actionable deception. So long as the minority shareholders are not misled about the actual terms of the transactions, this Court sees no reason why every transaction in which a corporation wishes to engage should have to be measured against all statements of company policy previously made, in order to search for any possible inconsistencies. Plaintiffs do not allege that they were deceived as to the terms or conditions of the loans, and, based on their carefully inexplicit pleading, one would have to conclude that they were not. Accordingly, under *Green* and *Meridor*, the complaint does not presently state a claim under Rule 10b-5.²¹¹

Plaintiffs also had alleged that the defendants forced Health-Chem to

208. 442 F. Supp. 659 (S.D.N.Y. 1977).

209. *Id.* at 665.

210. *Id.* at 662.

211. *Id.* at 665.

enter into an agreement with Funding Systems Leasing Corporation under which Health-Chem purchased equipment from Funding Systems and then leased back the equipment at a loss of approximately \$300,000. The complaint alleged that defendants violated rule 10b-5 because they failed to disclose that the deal would result in Health-Chem's committing more funds to the purchase than its net worth and would depress the market price of Health-Chem common stock. In finding that this was not an adequate allegation of deception under rule 10b-5, the court said: "Plaintiffs do not allege that any terms of the transaction were withheld, only that certain conclusions and derogatory predictions were not made. Defendants cannot be liable for a mere failure to say that their deal was a bad one."²¹²

Similarly, in *Biesenbach v. Guenther*²¹³ the Third Circuit not only upheld the district court's dismissal of plaintiffs' complaint for failure to state a claim but also denied them an opportunity to amend their complaint a second time. The basic justification for finding defendant's disclosure adequate under rule 10b-5 was the court's unwillingness to hold that defendants had a duty to characterize the transaction or to state their motives. Plaintiffs, minority shareholders of Heidelberg, Inc., brought derivative and class actions against the individual members who constituted a majority of the Heidelberg board of directors, challenging two loans defendants had made to the corporation. The loans were repugnant to plaintiffs because the corporate directors had the option of receiving the interest and principal in stock of the corporation, thereby increasing their control. The complaint further alleged that, in pursuit of their goal of taking over the corporation and eliminating opposition, defendants had reduced the number of the board of directors from nineteen to seven and had issued a million new shares after representing to the shareholders that they intended to issue only 500,000.

The court read the complaint to allege that the deception consisted of (1) defendants' statements that the transactions were in the best interests of the shareholders and (2) defendants' failure to disclose the true purpose behind the various transactions. In the court's view, "appellants are stating that the failure to disclose the breach of fiduciary duty is a misrepresentation sufficient to constitute a violation of the Act."²¹⁴ Quoting an oft-cited passage from Judge Higginbotham in *Stedman v. Storer*,²¹⁵ the court found that failure to disclose faithless motives or an unclean heart is not actionable under 10b-5.

[I]t is bemusing, and ultimately pointless, to charge that directors perpetrated a 'material omission' when they failed to (a) discover and adjudged [sic] faithless motives for their actions and (b) announce such a discovery in reporting the products of their managerial efforts and judgment. The securities laws, while their central insistence is upon disclosure, were never intended to attempt any such measures of psychoanalysis or reported self-analysis. The unclean heart of a

212. *Id.*

213. 588 F.2d 400 (3d Cir. 1978).

214. *Id.* at 402.

215. 308 F. Supp. 881 (S.D.N.Y. 1969).

director is not actionable, whether or not it is 'disclosed,' unless the impurities are translated into actionable deeds or omissions both objective and external.²¹⁶

Another example is *Lavin v. Data Systems Analysts, Inc.*,²¹⁷ in which the Eastern District of Pennsylvania dismissed a derivative action brought against the corporate executives and directors (also alleged to be majority shareholders) because they violated rule 10b-5 by enacting an employee bonus plan in which forty percent of the corporation's pretax profits would be distributed as bonuses to key personnel selected by the board of directors. The plaintiffs alleged that the corporation had failed to disclose in various corporate documents, including proxy statements and annual reports, that the plan "involved self-dealing, conflict of interest, and utilization of corporate funds for strictly personal benefit" and that the plan was "devoid of a legitimate or justifiable corporate purpose."²¹⁸ Noting that the shareholders had been informed of the plan's purpose, the maximum percentage of pretax profits available for the plan, that the board would select the recipients, and that officers and directors

216. 588 F.2d at 402 (quoting *Stedman v. Storer*, 308 F. Supp. at 887).

217. 443 F. Supp. 104 (E.D. Pa. 1977), *aff'd mem.*, 578 F.2d 1374 (3d Cir. 1978). See also *Lewis v. Oppenheimer & Co.*, 481 F. Supp. 1199 (S.D.N.Y. 1979). But see *Maldonado v. Flynn*, 597 F.2d 789 (2d Cir. 1979). The proxy statement contained a table showing the number and monetary value of the stock options granted to or exercised by the officers over a certain period and discussed the loans made to cover the cost of purchasing the stock and the tax liability of the officers. This was insufficient because:

the statement significantly failed to advise the stockholders that on July 2, 1974, members of the board, possessed of inside information to the effect that an imminent tender offer would sharply increase the market value of Zapata's shares, had amended the plan by accelerating the option exercise date, thus enabling Zapata's six senior officers to enlarge their profit substantially and reducing by several hundred thousand dollars the benefit which Zapata would otherwise have derived from the exercise of the options under the plan as it stood before amendment. In addition, the statement did not point out that under the original terms of the stock option plan Zapata shares could be purchased by the officers only for cash, so that amendment of the plan was necessary to obtain authorization for the loans. The statement also neglected to mention that the board had directed that the resolution be submitted for shareholders' approval, which had neither been sought nor obtained.

What the 1975 proxy statement did represent was that

The purpose of the . . . loan arrangements was to enable [the] officers to exercise their options at a time when, because of the generally depressed state of the securities markets, the differential between the market value of the Common Stock and the exercise price of their options, and therefore the Federal income tax liability resulting from exercise, would be minimized.

At best this statement was a half-truth and quite misleading. It was true that the loans were made and the options exercised in order to minimize the optionees' resulting tax liability. What was not true was the implication that prompt exercise of the options had been encouraged merely to anticipate a turnaround in a generally depressed state of a market that would reduce the attractiveness of the options.

Id. at 797. In short, the court said that the "proxy statement, however, left the misleading impression that the authorization of the loans was a routine corporate action undertaken to serve the interests of the Corporation, whereas in fact the authorization facilitated transactions costing it more than \$400,000 in tax savings." *Id.* at 798.

218. 443 F. Supp. at 107. The complaint also alleged that the corporation had failed to disclose that the bonuses would be given primarily to officers and directors and that they, as majority shareholders, could approve the plan without the votes of the other shareholders. The court did not specifically discuss these allegations.

were eligible for the bonuses, the court held that the failure to disclose improper motives was not deceptive under 10b-5.

On distinguishable facts in *SEC v. Parklane Hosiery Co.*,²¹⁹ the Second Circuit held that a failure to disclose improper motives was actionable deception under 10b-5 but denied injunctive relief. Management sought shareholder approval of a merger to effect a going private transaction in which public shares that sold for nine dollars per share six years prior to the merger were being repurchased for two dollars per share. The SEC claimed *inter alia* that the proxy statement inadequately disclosed²²⁰ that the president and principal shareholder's true intention and underlying purpose in proposing the merger was to discharge his personal debts from the corporation's treasury. After the merger the president's salary was increased from \$90,000 to \$150,000 retroactively, and some of his properties were purchased by the corporation for \$2 million. The Second Circuit found that there was substantial evidence for the district judge to find "that the overriding purpose for the merger was to enable Somekh [the president] to repay his personal indebtedness. Had his finances been otherwise, the merger may never have occurred. There is not so much as a hint of Somekh's huge debts in the proxy statement. The non-disclosure is clearly established."²²¹ It is unclear from this language whether there was deception because of the failure to disclose the existence of the debts or failure to disclose Somekh's motive in affecting the merger. *Parklane Hosiery* may be distinguished from the cases described above because it is an SEC enforcement action and, more significantly, because one of the underlying facts—the existence of the debt—was not disclosed.

The Fifth Circuit in *Alabama Farm Bureau Mutual Casualty Co. v. American Fidelity Life Insurance Co.*,²²² despite several statements that a failure to characterize the transaction was not actionable under 10b-5,²²³ nonetheless held that deception was properly alleged in a complaint apparently based on a failure to disclose motives. Specifically, the court upheld the claim because defendants failed to disclose that a corporate repurchase plan would be carried out in a manner that would artificially inflate the price of the company's stock to benefit defendants and in fact misrepresented in a press release that the purchases would be made in a manner that would not unduly affect the mar-

219. 558 F.2d 1083 (2d Cir. 1977).

220. The proxy statement disclosed the following facts:

If the proposed merger is consummated, the shareholders of Newco will be entitled to the benefit of all of the assets, earnings, earning capacity and cash flow of the Company. The merger will make possible a combination of the resources of the Company with those of Mr. Somekh (who with his wife and trusts for the benefit of his children, owns approximately 86% of the stock of Newco) for the conduct of real estate activities of the type that Mr. Somekh has to date conducted individually (primarily development of garden apartments). Such a combination is presently being contemplated.

Id. at 1086 n.2.

221. *Id.* at 1086.

222. 606 F.2d 602 (5th Cir. 1979).

223. *Id.* at 609-11.

ket.²²⁴

The cases discussed above, except *Parklane Hosiery Co.* and *Alabama Farm Bureau*, were based firmly on the premise that the underlying terms of the transactions were disclosed and that the only omission was a failure to characterize the transaction as unfair or as a breach of fiduciary duty or to reveal the underlying motives of the defendants. Going even further, the Southern District of New York, in *Rodman v. Grant Foundation*,²²⁵ expressed some doubt as to the necessity of disclosing even the underlying facts of the conflict. In *Rodman*, the court dismissed an action brought by the trustee of a bankrupt corporation against various directors and shareholders for making misleading statements in a proxy statement used by the corporation to purchase its own stock. Noting that the proxy statements did disclose facts from which the alleged conflicts of interest could be inferred—the stock holdings of the individual defendants, the Foundation and the various trusts, and the affiliation of the individual defendants with the foundation and trusts²²⁶—the court held “that the two proxy statements [which] failed to disclose that Staley’s [chairman of the bankrupt corporation and trustee of the Foundation] and Mayer’s [president and chief executive officer of the corporation] true purposes in the proposed purchases of stock were to prevent the Foundation and trust from selling Grant shares to the public, (which would have diluted Staley’s and Mayer’s control of Grant) and to enable the foundation and the trust to receive more for their shares than they would have received in an arm’s length sale”²²⁷ were not misleading.²²⁸ The court carefully analyzed previous cases²²⁹ and concluded that although it is not yet settled whether there is a duty to disclose the facts giving rise to a conflict of interest, it is clear that “failure to disclose on top of such facts one’s actual subjective purpose does not violate the securities laws.”²³⁰

224. *Id.* at 613. The court seemed to be influenced by the lack of discovery and that the case had been decided by the lower court on summary judgment.

225. 460 F. Supp. 1028 (S.D.N.Y. 1978), *aff’d*, 608 F.2d 64 (2d Cir. 1979). The Second Circuit, although agreeing that there was no requirement to disclose a subjective purpose, did not decide whether the underlying conflict need be disclosed. 608 F.2d at 71. However, the court found that the conflict in this case was fully disclosed, at least to the directors. *Id.* at 73.

226. 460 F. Supp. at 1037.

227. *Id.*

228. *Id.* at 1038.

229. *Id.* at 1037-38. The court cited *Joyce v. Joyce Beverages, Inc.*, 571 F.2d 703 (2d Cir.), *cert. denied*, 437 U.S. 905 (1978); *SEC v. Parklane Hosiery Co.*, 558 F.2d at 1083; *Browning Debenture Holders’ Comm. v. DASA Corp.*, 560 F.2d 1078 (2d Cir. 1977); and *Goldberg v. Meridor*, 567 F.2d at 209.

230. 460 F. Supp. at 1037-38. The court cited *Golub v. PPD Corp.*, 576 F.2d 759 (8th Cir. 1978), *Altman v. Knight*, 431 F. Supp. 309 (S.D.N.Y. 1977), and *Tyco Laboratories, Inc. v. Kimball*, 444 F. Supp. 292 (E.D. Pa. 1977), to support its position.

The court also found that disclosure of a conflict to the corporation’s board of directors on another occasion prior to the transaction in question was adequate disclosure. The disclosed facts were that the directors were affiliated with the foundation and that the foundation was remainderman of trusts that held over 3,000,000 shares of Grant stock of which CBT was either trustee or co-trustee. “The disclosure that the Foundation was remainderman of the trusts was sufficient to put the directors on notice that the shares purchased were from a trust of which the Foundation was remainderman.” 460 F. Supp. at 1037.

Courts have acknowledged quite frankly that distinguishing between an underlying fact and a characterization of that fact or the motive behind the transaction is often quite difficult. For example, in *Hundahl v. United Benefit Life Insurance Co.*,²³¹ the court found that the omissions alleged in the complaint were not actionable under rule 10b-5 because they concerned disclosures of motives, which would require management to label its decisions.²³² In *Hundahl*, class, derivative, and individual actions were brought against a parent corporation that had allegedly depressed the price of a subsidiary it sought to acquire through a tender offer. The allegations of deception included claims that the parent failed to disclose: (1) the extent to which certain changes in expense allocation concealed the subsidiary's profitability; (2) the degree to which the parent's "very conservative" book value conversions understated the subsidiary's worth and earnings; (3) the reason that the Company frequently changed the accountants' decisions with regard to the subsidiary's accounting without first informing the subsidiary of the accountants' position; (4) the explanation for the fact that the market price of the subsidiary's stock was artificially low and not indicative of its true intrinsic value; and (5) that the subsidiary's assets had appreciated to an amount substantially in excess of their book value.²³³ With two exceptions, the court did not discuss each allegation separately or with any specificity but rather concluded that none of them were actionable because they were omissions of purpose or motive, not of underlying fact. The court was concerned that this distinction between fact and motive—the crucial distinction in determining the adequacy of disclosure under 10b-5—is not easy to draw.

Rule 10b-5 was designed to impose a duty to disclose and inform, not a duty to become enmeshed in labeling disclosed information. . . . The line between informing and labeling, however, is often not easy to draw. Courts have made clear that a party cannot bootstrap its way into federal court by alleging violations of state law and then claiming that the defendant failed to so label these violations. . . .

Viewed separately, none of the alleged acts amounts to an affirmative misstatement; rather, the bare facts disclosed are true, and the claim is that there was not *enough* information given by Mutual to make the facts disclosed meaningful and, hence, not deceptive. But the omissions are not facts. They are instead nondisclosures of purpose and motive; for example, not disclosing that the true worth of the company stock was depressed by the accounting methods used. In a narrow sense, then, the essence of the plaintiff's complaint is that Mutual did not adequately explain, or label, the elemental facts that it disclosed.²³⁴

With this in mind the court did analyze two of the allegations of decep-

231. 465 F. Supp. 1349 (N.D. Tex. 1979). See text accompanying notes 324-31 *infra*.

232. 465 F. Supp. at 1365.

233. *Id.* at 1364-65.

234. *Id.* at 1364 (citing *Golub v. PPD*, 576 F.2d 759 (8th Cir. 1978) and *Popkin v. Bishop*, 464 F.2d 714 (2d Cir. 1972)).

tion with specificity to determine whether they were omissions of fact or simply were failures to characterize the facts that were disclosed. The parent's failure to disclose that its changes in expense allocation "concealed" the subsidiary's profitability and adversely affected the price of the subsidiary's stock was viewed by the court as a self-evident failure to characterize an action as a breach of fiduciary duty and consequently not deception under 10b-5.²³⁵ The court had more difficulty in deciding whether fact or characterization of fact best described plaintiff's allegation that the parent failed to accompany its statement of a dividend restriction with a representation that management did not regard the restriction as a serious bar to declaring dividends. Recognizing that this was a close question, the court said: "it is arguable that the gist of the claim is that management failed to request a lifting of the dividend restriction and in that sense, it is more a matter of mismanagement than of nondisclosure."²³⁶ The court left it to the trier of fact to draw the fact/characterization line.

At least one court, in *Klamberg v. Roth*,²³⁷ held that the existence of a conflict can be inferred by the shareholder from other facts and therefore need not expressly be disclosed because the conclusion would require a characterization. The court explained its position:

The principle underlying these cases appears to be that, once the facts are disclosed, a failure to articulate adverse inferences from or pejorative descriptions of those facts is not materially deceptive: a reasonable person would not be deceived by their nondisclosure, since he would be able to draw whatever inferences and append whatever characterizations he believed appropriate. Of course, the distinction between facts and characterizations may not be a nice one. See, e.g., *Hundahl v. United Benefit Life Insurance Co.*, *supra*.²³⁸

The *Klamberg* court then concluded that plaintiffs, employee-beneficiaries of a trust, should have known from available information that defendant corporation, Kayser-Roth, successor to the original employer-settlor, could replace the trustees who made the investment decisions with its own insiders. Furthermore, given the information available, they should have realized that the insiders could and very well might invest the trust assets in Kayser-Roth stock. Plaintiffs had alleged that the trustees would have conflicting loyalties to the trust and to Kayser-Roth and therefore might be unwilling to sell Kayser-Roth stock when sale would be in the best interest of the trust but deleterious to Kayser-Roth. The court characterized the allegations as "attendant conflicts of interests [that] are readily inferable [from these facts]."²³⁹

235. 465 F. Supp. at 1365.

236. *Id.*

237. 473 F. Supp. 544 (S.D.N.Y. 1979); see text accompanying notes 116-211, *supra*; text accompanying notes 245-49 *infra*.

238. 473 F. Supp. at 552.

239. *Id.* at 553.

b. Readily Available Information

Failure to disclose information readily available from other sources generally is not deemed a violation of rule 10b-5. The problem of course is deciding whether the information is readily available. *Valente v. PepsiCo*²⁴⁰ includes several examples of information that may or may not be reasonably expected to be available and known to shareholders. In *Valente*, a 10b-5 action, the Delaware District Court considered various omissions allegedly made in connection with a PepsiCo tender offer for a controlling share of Wilson and the ensuing short-form merger of Wilson into PepsiCo. The court focused on whether the omitted information was known or reasonably should have been known to the shareholders. The tender offer materials disclosed the subsequent merger and stated that the minority would be cashed out in the merger for \$17.50 a share, the price of the tender offer. The court found material as a matter of law failure to disclose the availability of an appraisal remedy in the subsequent merger. The court characterized the disclosed alternatives available to the shareholders as "\$17.50 now or \$17.50 later."²⁴¹ The alternative of seeking an appraisal should have been disclosed because the merger giving rise to an appraisal remedy was "probable,"²⁴² and the appraisal remedy was the only alternative whereby a shareholder could receive more than the \$17.50 per share offered by PepsiCo. The court was unconvinced by the defendant's argument that the shareholders should have been on notice of their statutory appraisal rights.

The Court concludes that statutory appraisal rights are not so frequently invoked nor so familiar that a reasonable shareholder could be deemed to be conscious of their existence, at least in the circumstances of this case. Even among those who knew about appraisal rights, the wording of the tender materials may have created the impression that the rights would be unavailable in this case.²⁴³

The court left the trier of fact to decide whether disclosure that PepsiCo owned 88.2% of Wilson stock and intended to acquire 100% was sufficient to reveal the extent of PepsiCo's control over Wilson. PepsiCo did not disclose (1) the interlocking directorates between the two companies, (2) the fact that PepsiCo's attorneys provided all legal advice to Wilson, and (3) PepsiCo's control over Wilson borrowing, capital expenditures, financial planning, and marketing decisions.²⁴⁴ The court cautioned the trier of fact to keep in mind that "[f]acts which indicate control and conflict of interest may be material, since such facts cause shareholders to scrutinize a proposal more carefully than usual."²⁴⁵ It is improbable that a reasonable investor could not infer the extent of PepsiCo's control from the disclosure that PepsiCo owned 88.2% of Wilson stock. The court's unwillingness to find this as a matter of law suggests

240. 454 F. Supp. 1228 (D. Del. 1978).

241. *Id.* at 1240.

242. *Id.* at 1240 n.16.

243. *Id.* at 1240 n.17.

244. *Id.* at 1241.

245. *Id.*

its special sensitivity to conflict of interest disclosure. The trier of fact also was left to decide whether a reasonable shareholder might have known the extent of PepsiCo's control over Wilson from prior annual reports even though the reports allegedly were received months or years before the tender offer, many of the details of control were never disclosed in the annual reports, and the disclosed facts were not always displayed prominently.²⁴⁶

After examining the Company's previous proxy statements and annual reports, the court refused to impute to the shareholders knowledge of premiums paid to the company's employees—allegedly to improve morale by compensating employees for loss of otherwise available tax benefits²⁴⁷—because the disclosure of the provisions was neither adequate nor prominently displayed, and the documents were issued several months before the tender offer.²⁴⁸ However, the court found as a matter of law no obligation to disclose readily available financial information, such as earnings per share, when the improvements in the company's earnings were highlighted in its annual and quarterly reports and appeared on the financial pages of major newspapers. "Common sense suggests that the minority shareholders would have known about the improved EPS figures, or at least would have checked them before making a decision whether or not to tender."²⁴⁹

The court found immaterial as a matter of law the allegation that Wilson, when it made a tender offer of \$920 for each of its own debentures should have disclosed its obligation to pay \$1,054.50 per debenture should it redeem the debentures at that time, because, *inter alia*, the schedule of redemption prices was contained in the indenture agreement.²⁵⁰ In addition, information contained in other documents would be reasonably imputed to the shareholder since the disclosure in those documents was adequate, prominent, and of a recent date. The court also considered whether to impute to the shareholders knowledge of the tax benefits to be received by the controlling shareholder as a result of the timing of the tender offer and the merger; the answer was deemed to depend upon whether the benefits were unusual in nature.²⁵¹

The court was reluctant to find that certain market information would be readily available. For example, the court found that "[i]n light of the uncertainty as to the nature of the effect on the market price of Wilson, it might have been misleading for defendants to make any statement about that effect in the tender materials."²⁵² Nonetheless, it left for the trier of fact a decision on the materiality of the failure to disclose that PepsiCo's announcement of

246. *Id.* at 1242.

247. *Id.* at 1244-45.

248. *Id.* at 1245 n.26.

249. *Id.* at 1243.

250. *Id.* at 1242 n.22. Other relevant facts were: (1) since a debenture holder could not force the corporation to redeem, redemption was not a practical alternative to acceptance of the tender offer; (2) there was no indication that Wilson had any intention of redeeming; and (3) the market value of the debenture was determined by a variety of factors, including the prevailing interest rate, and would be affected only slightly by redemption price. *Id.* at 1242-43.

251. *Id.* at 1245.

252. *Id.* at 1246 n.28.

the Wilson acquisition might place a ceiling on the market price of Wilson stock.

The *Valente* case typifies judicial reluctance to find omissions immaterial as a matter of law on the ground that knowledge of the omissions is readily available from other sources and therefore imputable to the shareholders. Courts are much more willing to dismiss a complaint when the information can be deemed readily available *and* the significant omission is a failure to characterize the disclosed facts. For example, the Second Circuit in *Rodman v. Grant Foundation*,²⁵³ upholding a dismissal, discussed whether the defendant's motives should have been reasonably inferred by the shareholders. The trustees of the bankrupt corporation, Grant, had alleged that various directors, and shareholders controlled by the directors, had violated proxy rules. When the corporation purchased its own stock, the directors (Staley and Mayer) failed to disclose in proxy materials that they designed the transaction to maintain their control of Grant by preventing the foundation and the trust, substantial holders of Grant stock, from selling Grant shares to the public. The court said that this purpose clearly could be inferred from the corporation's purchase of an unusually large bloc of stock.²⁵⁴ The court also rejected the argument that the proxy statement failed to disclose adequately that the purchase price offered by Grant was twenty dollars higher per share than the price its employees were required to pay for the same stock under Grant's Employee Stock Purchase Plan. Because the proxy statements had disclosed both the price to be paid by the employees and the formula for calculating the price Grant was to pay for the shares it purchased from the foundation and trust, shareholders were found to have enough information to compute the difference in prices for themselves.²⁵⁵ The failure to disclose in the proxy statement that Grant had a sufficient number of authorized but unissued shares to meet its obligations under the Employee Stock Purchase Plan without having to purchase its outstanding stock was likewise held not misleading since the numbers of authorized and issued shares were disclosed in the company's annual statement.²⁵⁶ The Second Circuit also upheld without discussion two findings of the District Court.²⁵⁷ First, since the financial statements disclosed the amount of assets and liabilities, the number of shares issued, and the number of treasury shares, the lower court did not find misleading the failure to disclose that the price to be paid for the shares was in excess of their book value, would decrease the company's net worth, and would have an adverse effect on its profit and loss statement. The court reasoned that a share-

253. 608 F.2d 64 (2d Cir. 1979); see text accompanying notes 227-28 *infra*.

254. 608 F.2d at 71. The court found little support in the record for the argument that the desire to entrench management control was the sole reason for the stock purchase program. *Id.* at 70.

255. *Id.* at 72. See 460 F. Supp. 1028, 1036 (S.D.N.Y. 1978) (district court decision); text accompanying notes 224-29 *supra*.

256. 608 F.2d at 70. The court said that this contention misstated the facts. "Purchase of Foundation stock was said to be 'desirable,' not necessary, and there is not the slightest intimation that unissued shares were unavailable for use." *Id.*

257. *Id.* at 72.

holder could compute book value from the information disclosed and could infer (since treasury stock was carried on the books as an asset valued at cost) that a purchase of stock at more than book value would leave net worth unchanged and increase book value.²⁵⁸ Second, the lower court held not misleading the failure to disclose that the prices to be paid under the stock purchase agreement could exceed the market price on the date of closing. The court said "[t]his risk could be inferred easily from the fact that the price was to be the average of the daily closing market prices during a certain month," a fact which was disclosed.²⁵⁹ Although a careful reader might uncover the so-called omissions in the proxy statement, the court seems to have unrealistically high expectations of the average shareholder, who, to infer these facts, would have to piece together information revealed in several different parts of the proxy statement.²⁶⁰ No doubt the court was unsympathetic because what plaintiffs claimed to be significant omissions were in fact failures to characterize the transaction in pejorative terms.

An example of a more reasonable expectation of the shareholder is found in *Klamberg v. Roth*.²⁶¹ Plaintiffs, employee beneficiaries of defendant Kayser-Roth's trust, alleged that certain material information about the investment quality of Kayser-Roth's stock had not been disclosed: (1) its financial condition depended upon developments in the volatile clothing industry; (2) its continued growth depended upon acquisitions, many of which were made in the late 1960's at unrealistic prices; (3) its most profitable division was under pressure because of current fashion trends; and (4) it was subject to foreign competition and had higher proportionate costs for raw material and labor than its competitors.²⁶² The court found that these alleged omissions consisted of "factual" information readily available to the plaintiff because Kayser-Roth stock was at all material times traded on the New York Stock Exchange and therefore was subject to the SEC's and the Exchange's reporting requirements. In addition, the court found that to the extent the omissions concerned nonfactual information, the information "comprises pejorative characterizations and adverse inferences, which, it appears, the plaintiff has drawn without the defendant's help."²⁶³

The court then characterized as "merely inferences about the legal effects

258. 460 F. Supp. 1028, 1037 (S.D.N.Y. 1978).

259. *Id.*

260. In 1979 the Ninth Circuit found that an information statement announcing a proposed merger of a publicly held corporation into a company wholly-owned by one of its debtors adequately revealed the conflict of the company's directors who were also trustees in bankruptcy for the debtors. In rejecting plaintiff's claim that the information was buried in the information statement and therefore did not give adequate notice of potential conflicts, the court found the disclosures were in three different places well toward the front of the statement, preceded by a boldface headline that would have alerted the reasonable reader and was in type of the same size and prominence as that used throughout the information statement. *Valley Nat'l Bank v. Trustee for Westgate-California Corp.*, 609 F.2d 1274, 1282 (9th Cir. 1979).

261. 473 F. Supp. 544 (S.D.N.Y. 1978), discussed in text accompanying notes 116-21, 236-38 *supra*.

262. *Id.* at 552.

263. *Id.* at 552-53.

of the 1971 amendment, about which the beneficiaries knew or could readily have learned,"²⁶⁴ the allegation that Kayser-Roth had improperly amended the trust to justify discontinuance of Kayser-Roth contributions and that such purported amendment should have, by the terms of the trust, effected its automatic termination. The court also found that Kayser-Roth's replacement of the trustees and the committee's subsequent investment in Kayser-Roth stock need not have been disclosed to the beneficiaries because they knew or could readily have learned by reading the agreement that these actions were expressly permitted by its terms.²⁶⁵

Imputing this information to the beneficiaries is more easily justified in *Klamberg* than in *Rodman* because in *Klamberg* inferences either were not required or could have been made from facts generally available. The piecing-together of facts disclosed in different places of a multiple page document was not necessary in *Klamberg*.

Requiring a shareholder to draw an inference makes more sense, however, if the shareholder is sophisticated and knowledgeable. For example, *Bridgen v. Scott*²⁶⁶ involved a speculative real estate partnership, formed largely to provide "dramatic" tax savings for the participants with a possibility for profit upon resale. The question was whether the investors should have known that the promoter only sold forty-five percent of the interests and retained fifty-five percent for himself and that the partnership property was sold twice on the same day. The court, influenced also by the fact that the plaintiffs sought rescission *after* realizing the tax savings, found that the alleged omissions were "details" that could either have been determined by the "highly sophisticated and knowledgeable investors"²⁶⁷ or could have been obtained from the promoter because of the supposed "position" of the plaintiffs.²⁶⁸ Had a public offering or less sophisticated investors been involved, a different result likely would have followed.

c. *Expert Opinions*

Courts are much more tolerant of omissions relating to expert opinions and often are unwilling to find that those omissions constitute inadequate disclosure for purposes of 10b-5. In *Helfant v. Louisiana & Southern Life Insurance Co.*,²⁶⁹ for example, the Eastern District of New York dismissed a class action brought on behalf of minority shareholders who were to be cashed out of the merged corporation while two insiders were to receive debentures in the surviving corporation. The plaintiff had alleged that the opinion letter of Alex. Brown & Sons (Alex. Brown), which accompanied the proxy statement and contained Brown's evaluation of the fairness of the transaction and the

264. *Id.* at 553.

265. *Id.*

266. 456 F. Supp. 1048 (S.D. Tex. 1978).

267. *Id.* at 1064.

268. *Id.* at 1065.

269. 459 F. Supp. 720 (E.D.N.Y. 1978).

value of the debentures given to the insiders, was a misrepresentation under federal laws. The court said that the sweeping "characterization of a statement as a 'misrepresentation' is not sufficient to state a claim under Rule 10b-5" when there was no allegation that the financial data upon which Brown based its opinion was false or undisclosed, or that the firm was unqualified to make its assessment, had acted in a manner unacceptable in its field, or had intentionally caused a false statement to be issued.²⁷⁰ The court granted leave to amend, and the amended complaint was found to state a claim under sections 10(b) and 14(a) because the plaintiff's "broad and vague complaint has been reduced to the simple theory that Alex. Brown knowingly issued a false opinion."²⁷¹

A similar reluctance to find that an alleged misrepresentation in an expert opinion is actionable under 10b-5 was shown in *Volge v. Magnavox Co.*²⁷² In *Volge* the court denied plaintiff's motion for summary judgment in a class action brought under section 10(b) and section 14(a) for alleged misrepresentations in connection with a freeze-out merger. The court, after discussing *Santa Fe* in great detail, concluded that the only difference between this case and *Santa Fe* was that the complaint in *Volge* alleged misrepresentations and omissions.²⁷³ Plaintiffs claimed misrepresentation in defendant's statements that the merger was authorized by Delaware corporation law and that shareholders had no choice but to surrender their shares for nine dollars per share or seek appraisal. The issue was whether the asserted validity and effect of the merger, even if untrue in point of law, was a misrepresentation actionable under 10b-5. The court said "[f]or plaintiff to characterize the statements in the Proxy Statement as 'misrepresentations' and 'concealments' does not make them so."²⁷⁴ Since the validity of the merger was based on an opinion of counsel, which was disclosed, and since plaintiffs did not allege that counsel was incompetent, had failed to follow Delaware decisions at variance with its opinion, or was disqualified to give the opinion because of interest, "[t]he only reason that plaintiff alleges the statements are untrue is because plaintiff entertains a [different] view of the law,"²⁷⁵ and this was not actionable under 10b-5.

d. Prediction and Speculation

Failure to disclose speculative information or what amounts to a prediction is not usually deemed a violation of rule 10b-5. Illustrative is *Goldberger v. Baker*²⁷⁶ in which plaintiffs, shareholders of Health-Chem, alleged that defendants caused three subsidiaries of Health-Chem to enter into sale lease-back transactions and failed to disclose that these transactions would substan-

270. *Id.* at 725.

271. *Helfant v. Louisiana & S. Life Ins. Co.*, 82 F.R.D. 53, 56 (E.D.N.Y. 1979). The court also granted defendant's motion to change the venue to the Middle District of Florida. *Id.* at 55.

272. 439 F. Supp. 935 (D. Del. 1977).

273. *Id.* at 941.

274. *Id.*

275. *Id.* at 941-42. See also *Lewis v. Oppenheimer & Co.*, 481 F. Supp. 1199 (S.D.N.Y. 1979).

276. 442 F. Supp. 659 (S.D.N.Y. 1977). See text accompanying notes 207-12 *supra*.

tially damage the parent. The Southern District of New York held that as long as plaintiffs did not allege that they were deceived about the terms or facts of these transactions, failure to predict their unfavorable result did not violate 10b-5.²⁷⁷

Similarly, in *Rodman v. Grant Foundation*,²⁷⁸ a proxy misrepresentation action, the plaintiff alleged unlawful failure to disclose that corporate borrowing to finance stock purchases would be necessary unless corporate expansion and dividend policies were discontinued. The court noted that the plaintiff had failed to prove that the borrowing took place and had only offered the opinion of one director that it might. "Full factual disclosure need not be embellished with speculative financial predictions."²⁷⁹ As illustrated by these cases, rule 10b-5 has long required only the disclosure of a material fact. Therefore, to the extent that speculation or prediction is not fact, disclosure should not be required under 10b-5.

e. Alternative Courses of Action

Under some circumstances a corporation has been found to have no obligation to disclose possible alternative courses of action. For example, in *Umbriac v. Kaiser*²⁸⁰ the District Court for Nevada granted defendant's motion for summary judgment, no doubt influenced by the fact that the liquidation plan challenged by the plaintiffs doubled the value of their holdings²⁸¹ and was approved by 98.8% of the shares present in person or proxy at the meeting.²⁸² In their second amended complaint, plaintiffs charged that the liquidation plan selected by the directors sacrificed a "control premium" that could have been realized without adverse tax consequences by the use of another device—the liquidating trust. The specific omissions alleged by plaintiffs were that: (1) a control premium might have been realized had the corporation sold its portfolio rather than distribute it; (2) even though all of the corporation's assets might not have been disposed of within twelve months, the nonrecognition treatment provided by section 337 of the Internal Revenue Code could have been secured by transfer of all unsold assets to a liquidating trust; (3) the plan selected well served the special interests of the corporation's principal stockholders not only by solving the divestiture problems created by the Tax Reform Act of 1969 but also by perpetuating control of their corporate empire; and (4) the endorsement given the plan by First Boston Corporation was not

277. 442 F. Supp. at 665.

278. 608 F.2d 64 (2d Cir. 1979), discussed in text accompanying notes 252-59 *supra*.

279. *Id.* at 72. The court cited as support for this conclusion *Seibert v. Sperry Rand Corp.*, 586 F.2d 951, and *Goldberger v. Baker*, 442 F. Supp. at 665. See, e.g., *Dower v. Mosser Indus., Inc.*, [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,509 (E.D. Pa. 1980) (failure to disclose financial projections not material to average minority stockholder in a merger of a company into a newly created subsidiary).

280. 467 F. Supp. 548 (D. Nev. 1979).

281. *Id.* at 550.

282. *Id.* at 551. 73.2% of the total number of shares were present in person or proxy at the meeting. *Id.*

the product of independent, rigorous review.²⁸³ The court set some general guidelines for analyzing whether these omissions were material. Management is not required (1) to disclose to the shareholders information only suggestive of mere possibility;²⁸⁴ (2) to go beyond revelation of facts and debate issues of law;²⁸⁵ or (3) "to discuss the panoply of possible alternatives to the course of action it is proposing, absent perhaps some suggestion that the route not chosen was so well recognized and legally sound that the failure to pursue it demands consideration."²⁸⁶ The justifications for these guidelines were that "too much information can be as misleading as too little,"²⁸⁷ and state corporation law gives "shareholders a right of veto or approval over organic corporate changes but entrusts management with the task of devising the means by which the end will be reached."²⁸⁸ Measured against these standards the court found that failure to disclose that the corporation might have obtained a control premium or might have accomplished the liquidation in a tax-free fashion was immaterial as a matter of law. These facts, in the court's view, were both practically and legally speculative²⁸⁹ since there was no evidence, other than a theoretical argument in a professor's deposition, that a premium was available.²⁹⁰ Second, the possibility that section 337 could be used to avoid tax was legally remote and would require management to discuss a "novel and uncharted" area of law and, therefore, was not required to be disclosed.²⁹¹ Finally, even though the allegations regarding First Boston and the Kaiser Foundation were found to raise the "spectre of materiality,"²⁹² the court nonetheless granted defendants' motion to dismiss because plaintiffs could not establish actual damages.²⁹³

4. Measuring the Adequacy of Disclosure: Essential Facts

If certain basic facts are disclosed, courts seem more tolerant of other alleged omissions. For example, in *Cole v. Schenley Industries Inc.*,²⁹⁴ the Second Circuit upheld the dismissal of a complaint challenging the merger of Schenley, a subsidiary of Glen Alden, with another wholly owned Glen Alden subsidiary because the shareholders were told the basic fact—the value of their shares.²⁹⁵ In 1968 Glen Alden had acquired eighty-six percent of Schenley's common stock through a tender offer for Schenley stock at \$58.66 2/3 per

283. *Id.* at 551-52.

284. *Id.* at 553.

285. *Id.*

286. *Id.*

287. *Id.*

288. *Id.*

289. *Id.* at 554.

290. *Id.* at 554 n.5.

291. *Id.* at 554.

292. *Id.* at 555.

293. *Id.* at 556.

294. 563 F.2d 35 (2d Cir. 1977).

295. *Id.* at 43. The case was remanded for further consideration under state law in light of a recent state court decision. *Id.* at 45.

share. Three years later Glen Alden announced a proposed merger in which the minority shareholders would receive \$29 per share for common stock and \$26.10 per share for preferred stock. The action, filed against Schenley, its board of directors, and Glen Alden, alleged violations of section 14(a) and rules 14a-9 and 10b-5. The court found that none of the alleged omissions was misleading and, therefore, there was no actionable deception under federal securities laws.²⁹⁶

First, plaintiffs had alleged that the proxy statement did not adequately reveal as part of the corporation's cash and marketable securities the money the corporation had received from the sale of Guild Wine Company and six percent Glen Alden debentures. The court said that the proxy statement specifically stated that the financials excluded the proceeds of the Guild Wine sale. The court further noted that appellants did not contest appellees' claim that the debentures were not readily marketable, and then found that "the proxy statement adequately set forth Schenley's cash position as of December 31, 1970."²⁹⁷ Second, plaintiff-appellants argued that the proxy statement did not specifically state that Schenley would transfer \$81.6 million to Glen Alden immediately and another \$36 million by the end of 1973. Upon a careful examination of the proxy statement, the court found, in bold print, a statement in the second paragraph that "Schenley will transfer to Glen Alden substantial funds of Schenley, including a substantial part of the proceeds received by Schenley from the recent sale of its subsidiary."²⁹⁸ That statement, and the proxy statement, which apparently made clear that at least \$47 million would be transferred, was found to constitute sufficient disclosure. The court found that the corporation had no obligation to clarify the meaning of a 'substantial' transfer.²⁹⁹ Third, plaintiff-appellants claimed that the proxy statement failed to state that Schenley had approximately \$140 million of surplus cash, liquid assets not needed for the operation of Schenley's business. Plaintiffs alleged that, if this fact had been disclosed, they would have sought appraisal. Perhaps influenced by the fact that 250 Schenley shareholders did seek appraisal, the court, in an interesting analysis, stated:

Page 3 of the proxy statement says that at least \$47 million of Schenley's funds would be transferred (provide a source of payment) immediately to Glen Alden. The financial tables at pages 12 and 26 of the proxy statement indicate that Glen Alden planned to issue about \$102 million of debentures as part of the merger. Section 1.3(b) of the Plan and Agreement of Reorganization, Exhibit A of the proxy statement, says that one possibility is for Schenley to purchase for cash these Glen Alden debentures. A shareholder could have reasonably concluded from this information that as of May 21, 1971 management had decided that Schenley had 'surplus cash' of be-

296. *Id.* at 37-38.

297. *Id.* at 41.

298. *Id.*

299. *Id.* at 42.

tween \$47 million and \$102 million.³⁰⁰

The court obviously was willing to permit some omissions and require the shareholders to read the proxy statement carefully, possibly because the shareholders were told the *most* important fact—the value of the shares:

While the proxy statement did not allow the shareholder to make a precise estimate of the value of a share of Schenley stock, it did give the shareholder enough information to decide whether to accept the Glen Alden offer, to seek appraisal, or to try to enjoin the merger. Page 15 of the proxy statement shows that the book value of Schenley's common stock (assuming full conversion of the preference stock and adjusting for the sale of Buckingham) was \$40.44 . . . the fair market value of the Glen Alden offer was \$29 per share of common stock and \$26.10 per share of preferred stock.³⁰¹

This information was sufficient to permit the shareholder to make his only real decision—whether to accept the offer, seek appraisal, or enjoin the merger.³⁰²

5. Measuring the Adequacy of Disclosure: Action and Sophistication of Shareholders

Courts also may be less willing to find actionable deception under 10b-5 if a significant number of disinterested shareholders approve the transaction. For example, in *Golub v. PPD Corp.*³⁰³ the Eighth Circuit affirmed summary judgment to the defendants and denial of plaintiffs' leave to amend on the ground that there was no actionable deception for purposes of either 10b-5 or the proxy rules. In that case Old PPD was to be sold and continued as New PPD, with the top management of Old PPD, who owned directly or indirectly about eighty-two percent of Old PPD stock, to be paid substantial bonuses if they remained in the employ of New PPD *and* if the operations of New PPD exceeded certain profitability targets. A proxy statement, which described the terms of the sale, including the bonus arrangement, was submitted to the shareholders for a vote, and the sale was approved by 99.4% of the voting stock. The complaint alleged that the proxy statement failed to state the "true purpose and nature of the sale transaction" and that it failed to state "that the bonuses were a reward or premium for the sale of the business."³⁰⁴ Applying *Santa Fe* to the proxy rules, the Eighth Circuit found that failure to characterize a transaction was not deception under 10b-5 and that absent deception, a mere breach of fiduciary duty was not actionable under 10b-5, section 14a, or rule 14a-9.³⁰⁵ The large shareholder vote approving the

300. *Id.*

301. *Id.* at 43.

302. Not only did 250 Schenley shareholders obtain appraisal, *id.* at 40 n.7, but minority shareholders brought three separate suits to enjoin the merger, *id.* at 40 n.8. See also *Nash v. Farmers New World Life Ins. Co.*, 570 F.2d 558 (6th Cir.), *cert. denied*, 439 U.S. 822 (1978), in which several minority shareholders, despite claimed omissions, gleaned enough from the disclosure document to decide to dissent under Ohio law.

303. 576 F.2d 759 (8th Cir. 1978).

304. *Id.* at 763.

305. *Id.* at 764.

transaction was no doubt a significant, but unmentioned, factor in the court's decision. If, however, there had been a misrepresentation or omission of greater significance to the shareholders, their vote in support of a transaction would be of less relevance.

A court may also be reluctant to find deception if the investors are sophisticated and have profited from the investment. In *Bridgen v. Scott*,³⁰⁶ for example, participants in a partnership formed to obtain "dramatic" tax savings for its participants by investing in speculative real estate sued the promoter under 10b-5 for "premature" termination of the partnership. The court, largely influenced by the sophistication of the investors in the private offering, concluded that there was no material deception and that, citing *Santa Fe*, "it is not the function of the 1933 or 1934 Securities Acts to remedy or provide a cause of action for managerial mis-management."³⁰⁷

6. The Crux of Deception: Materiality

Inextricably linked with the concept of 10b-5 deception is materiality, because no misstatement or omission is actionable under 10b-5 unless it is proved to be material. Materiality has been described as "one of the most unpredictable and elusive concepts of the federal securities laws."³⁰⁸ The test for materiality used in most 10b-5 cases is that set forth in *TSC Industries, Inc. v. Northway, Inc.*:

An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. This standard is fully consistent with *Mills*' general description of materiality as a requirement that "the defect have a significant *propensity* to affect the voting process." It does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote. What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.³⁰⁹

Applying the *Northway* test of materiality to a fiduciary duty cause of action under 10b-5, the Second Circuit in *Goldberg v. Meridor*³¹⁰ adopted a director-focused standard: a fact is material if it would have assumed actual significance in the deliberations of reasonable and disinterested directors and if those directors would have considered the fact to have "significantly altered"

306. 456 F. Supp. 1048 (S.D. Tex. 1978).

307. *Id.* at 1057.

308. SEC v. Bausch & Lomb Inc., 565 F.2d 8, 10 (2d Cir. 1977).

309. TSC Indus., Inc. v. Northway, Inc., 426 U.S. at 438, 449 (1976).

310. 567 F.2d 209 (2d Cir. 1977).

the "total mix" of information available.³¹¹ On the other hand, the Ninth Circuit, in *Kidwell v. Meikle*,³¹² adopted a shareholder-focused test of materiality in a similar fiduciary duty case. The *Kidwell* test of materiality was whether a "reasonable minority shareholder probably would have considered this information important in any decision whether or not to sue to block the sale."³¹³ The court did not hesitate to state its disagreement with the Second Circuit's director-focused test:

In cases such as this, where the deception is found in nondisclosure affecting shareholders' decisions whether or not to sue to block a corporate transaction, we believe that the proper inquiry on the materiality question is what a reasonable shareholder would have considered significant. To the extent that it differs (by focusing on the expectations of a reasonable director), the Second Circuit's analysis in *Goldberg v. Meridor* . . . is disapproved.³¹⁴

In *Kidwell* the only undisclosed fact held material under the shareholder-focused test was the directors' share ownership in a sister corporation that would profit from the transaction. The shareholder-focused *Kidwell* test is more sensible when the court is deciding whether disclosure to the shareholders is adequate, as was the case in both *Goldberg* and *Kidwell*. However, the *Goldberg* test is more proper if the question is the adequacy of disclosure to directors.

Materiality usually depends upon the circumstances of each case. For example, whether a particular fact is material, according to the *Kidwell* court, must depend upon the theories under which the transaction in question could have been enjoined under state law. If, for example, state causes of action other than the directors' conflicts of interest were available to enjoin the sale, such as *ultra vires* or the *de facto* merger theory, completely different facts may be material.³¹⁵ Also, materiality may vary in relation to the sophistication and knowledge of the investors. In *Brigden v. Scott*,³¹⁶ for example, the court emphasized that the "highly sophisticated and knowledgeable" investors could have determined the crucial facts from the confidential memorandum distributed to each participant.³¹⁷

A detailed application of the *Northway* materiality standard was made in *Valente v. PepsiCo, Inc.*³¹⁸ First, the court, using a shareholder-focused test, stated that summary judgment for the plaintiff on the issue of materiality is appropriate only "if the established omissions are so obviously important to an

311. *Id.* at 219.

312. 597 F.2d 1273 (9th Cir. 1979), discussed in text accompanying notes 100-04 *supra*, 346-53, 364-65 *infra*.

313. *Id.* at 1293.

314. *Id.* at 1293 n.10. The court observed, however, that the result in *Goldberg* could have been the same under a shareholder-focused materiality analysis.

315. *Id.* at 1293.

316. 456 F. Supp. 1048 (S.D. Tex. 1978).

317. *Id.* at 1064-65. The court added that "a reasonable juror (in this Court's opinion) could not conclude, that a reasonable investor might have considered additional details important in making his [investment] decision." *Id.* at 1065.

318. 454 F. Supp. 1228 (D. Del. 1978), discussed in text accompanying notes 42-44, 239-51 *supra*, 376-79 *infra*.

investor that reasonable minds cannot differ.”³¹⁹ From that perspective the failure to disclose in tender offer materials the availability of an appraisal remedy in a subsequent merger was material as a matter of law because the tender offer materials did disclose that the minority would be cashed out for the tender offer price in the planned merger. The appraisal remedy would be the only alternative for a shareholder who wanted a higher price for his shares. The *Valente* court also found as a matter of law that the failure to disclose readily available financial information, such as earnings per share, was not material when the improvements in the corporation’s earnings were highlighted in its annual and quarterly reports and appeared on the financial pages of major newspapers from time to time.³²⁰

Materiality was also key to the District Court of Nevada’s findings in *Umbriac v. Kaiser*.³²¹ The failure to disclose the possibility that the corporation could have effected a liquidation to obtain a “control premium” was found to be immaterial because there was no evidence that the premium was actually available. The failure to disclose that the liquidation might have been accomplished in a tax-free fashion through the use of a liquidating trust was also immaterial because such a possibility was “legally remote” and would require discussion of a “novel and uncharted” area of law.³²² Omission of alternative procedures was likewise immaterial because the shareholders had the authority under state corporation law to decide whether the corporation should liquidate but not the authority “to pick and choose among the various routes that could be taken to that end.”³²³

Therefore, as discussed earlier,³²⁴ certain kinds of omissions are not material because of their nature and thus are not deception under 10b-5. To that extent the usual factual discussion of materiality can be made a matter of law. If the omitted fact falls within one of the categories—characterization of a fact, readily available information, expert opinions, prediction, speculation, or alternative course of action—it is not material as a matter of law, and the 10b-5 claim can be disposed of on summary judgment or a motion to dismiss.

D. Manipulation

Absent deception, a claim can nonetheless be actionable under 10b-5 if manipulation is demonstrated. Courts, however, usually have defined manipulation in its technical sense and consequently have concluded that a breach of fiduciary duty is not manipulation under 10b-5. Perhaps the best, and cer-

319. *Id.* at 1238 (quoting *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 450 (1976)).

320. *Id.* at 1243. For further discussion of the *Valente* analysis of materiality see text accompanying notes 239-51 *supra*.

321. 467 F. Supp. 548 (D. Nev. 1979), discussed in text accompanying notes 279-92 *supra*.

322. *Id.* at 553, 554.

323. *Id.* at 553. When the question of materiality cannot be determined as a matter of law, which is most frequently the case, courts review materiality as a question of fact under the clearly erroneous standard. See, e.g., *Nash v. Farmers New World Life Ins. Co.*, 570 F.2d 558 (6th Cir.), cert. denied, 439 U.S. 822 (1978).

324. See notes 207-90 and accompanying text *supra*.

tainly most extensive, discussion of whether a breach of fiduciary duty might be manipulation within 10b-5 is found in *Hundahl v. United Benefit Life Insurance Co.*³²⁵ Class, derivative, and individual actions were brought against a parent who had allegedly taken various actions for the purpose of depressing the price of the stock of the partially owned subsidiary it sought to take over through a tender offer. The plaintiffs alleged that the defendants, in violation of rule 10b-5, engaged in a manipulative scheme that consisted of the following acts: (1) improper allocation to the subsidiary of certain expenses that should have been borne by the parent; (2) improper restriction of dividends to the subsidiary's shareholders; (3) creation of unnecessarily large reserves for policy reevaluation and contingencies; (4) use of grossly conservative accounting principles in the preparation of the subsidiary's financial reports; and (5) failure to disclose the true value of the subsidiary's assets in its financial reports.³²⁶ The court, concluding that the "heart of plaintiffs' 10b-5 claim is manipulation," said: "The issue which this court must resolve is whether the Supreme Court's definition of manipulation in *Santa Fe* encompasses acts occurring outside the marketplace which, absent an intent to manipulate, would constitute only a breach of fiduciary duty. We find that it does not."³²⁷

In language that may provide guidance in other cases, the court defined manipulation and its relationship to a free market:

To state a claim for manipulation under § 10(b), the plaintiff must at the very least complain of conduct that interferes with the proper functioning of the free market. A free market is one in which investors are provided with sufficient information to enable them to assess accurately the value of a security. But conduct that interferes with the free market only by depriving it of complete information is not necessarily manipulative. When a corporation files a false report, or its director issues a misleading press release or its officer sells stock based on inside information, the price of the security may have been changed and the securities laws may have been violated—but the conduct alone is not manipulative. The Supreme Court in *Santa Fe* explained that manipulative conduct consists of "practices . . . intended to mislead investors by artificially affecting market activity." 430 U.S. at 476. . . . In determining what the Supreme Court meant by this definition, this court has viewed the free market concept against the common law of manipulation, the language and legislative history of the Securities Exchange Act, and the Supreme Court's recent emphasis in securities cases on federalism. From this study, the following definition emerges: practices in the marketplace which have the effect of either creating the false impression that certain market activity is occurring when in fact such activity is unrelated to actual supply and demand or tampering with the price itself are manipulative.³²⁸

325. 465 F. Supp. 1349 (N.D. Tex. 1979), discussed in text accompanying notes 230-35 *supra*.

326. *Id.* at 1354.

327. *Id.* at 1359.

328. *Id.* at 1360.

The court, applying its definition to the facts of *Hundahl*, concluded that a market reaction to defendants' actions was not by itself sufficient evidence of 10b-5 manipulation.

[P]laintiffs here to [*sic*] not complain that defendants conducted transactions in the marketplace which had the effect artificially of lowering the stock's price. Rather, they complain of acts which resulted in the market forming a judgment about the value of United stock based on its perception of the wisdom of decisions made by United's management. Such a judgment considered whatever was disclosed about the dividend policy, the allocation method[,] the expenses, and the surplus. The mere fact that the market reacted to them by price changes does not make the acts manipulative. Indeed, a rise or fall in a stock price as a result of such acts is indicative of a free market process. Thus the acts of which plaintiff complain are properly the subject of suits "traditionally relegated to state law," for if proved they are classic breaches of fiduciary duty. A failure to disclose them is arguably deception, but it does not constitute manipulation.³²⁹

Apparently somewhat uncomfortable with this result, the court quite frankly stated that it felt compelled to limit manipulation to its narrow technical definition because of the mandate of the Supreme Court in *Santa Fe*.

To draw manipulation more expansively pulls pure breaches of fiduciary duty such as a restrictive dividend policy into the federal stream. It does so although that breach is traditionally redressable under state law. Thus this court's definition is an *a fortiori* result of *Santa Fe*. . . . The decision to disallow such a claim is at its root one of policy grounded in federalism; such a choice ultimately ought to be made by the Supreme Court. The Supreme Court made the choice in *Santa Fe*. Any quarrel of this court with that decision is irrelevant. Nor would it be intellectually honest to attempt to steer in a direction opposite that in which the Supreme Court has pointed.³³⁰

Finally, the *Hundahl* court distinguished *Schlick v. Penn-Dixie Cement Corp.*³³¹ In *Schlick* a parent caused its subsidiary's pension fund to buy the parent's share on the market with the purpose of increasing the price of the shares. The *Hundahl* court said the *Schlick* scheme "falls squarely within this court's definition of manipulation" because the "actions occurred in the marketplace and constituted artificial acts of stimulative trading designed to mislead investors into believing that there was a heavy demand for Penn-Dixie stock."³³²

In *Nash v. Farmers New World Life Insurance Co.*³³³ plaintiffs argued that defendants' acquisition of ninety-five percent of their company had destroyed the market for the company's stock and was therefore manipulation.

329. *Id.* at 1362.

330. *Id.* at 1362, 1363.

331. 507 F.2d 374 (2d Cir. 1974), *cert. denied*, 421 U.S. 976 (1975).

332. 465 F. Supp. at 1363.

333. 570 F.2d 558 (6th Cir.), *cert. denied*, 439 U.S. 822 (1978).

Citing the *Santa Fe* definition of manipulation,³³⁴ the Sixth Circuit found that even though the acquisition of ninety-five percent of the stock may have destroyed the market for the company's shares, it "hardly amounts to 'manipulation' of prices."³³⁵ In *Blackmar v. Lichtenstein*,³³⁶ the trustee of a profit-sharing trust, created for the benefit of Liberty Loan Corporation employees, sued the successor trustees for violating rule 10b-5. The trustees were alleged to have purchased Liberty Loan stock on behalf of the trust for the primary purpose of increasing their control of Liberty Loan and maintaining the price of the Liberty Loan stock for their benefit. The court dismissed the complaint because the allegations constituted neither deception nor manipulation. There was no deception because plaintiffs failed to allege any omissions or misstatements of information.³³⁷ Further, there was no manipulation "since the knowing purchase of high risk securities by a fiduciary to protect its own interests in the issuer of the securities is not that type of device which artificially affects market activity."³³⁸ It is clear from these cases that manipulation is not a useful theory to convince a court that a breach of fiduciary duty is actionable under rule 10b-5. However, the Fifth Circuit, in *Alabama Farm Bureau Mutual Casualty Co. v. American Fidelity Life Insurance Co.*,³³⁹ suggested a broader definition of manipulation. The directors of the corporation were accused of violating rule 10b-5 by causing the corporation to repurchase its own stock for the purpose of maintaining their control. The repurchase was said to inflate artificially the market price of the corporation's shares, thereby discouraging other persons from buying shares or attempting to gain control of the company. The court suggested that manipulation could be more than "a term of art."

Conduct designed to deter investment is within the scope of Rule 10b-5 when it acts as a deceit or works as a fraud on a corporation or those who have invested in its stock [citations omitted]. Such conduct falls within the scope of the literal language of § 10(b) and Rule 10b-5 and is consistent with the congressional intent to proscribe intentional or wilful conduct designed to deceive or defraud investors. As the Supreme Court has noted, § 10(b) is "described rightly as a 'catchall' clause to enable the Commission 'to deal with new manipulative [or cunning] devices'. . . ."³⁴⁰

Then, in a footnote, the court said:

The Senate indicated in its report that § 10(b) was directed "at those manipulative and deceptive practices which have been demonstrated

334. *Id.* at 562.

335. *Id.* at 562 n.9.

336. 438 F. Supp. 803 (E.D. Mo. 1977), *rev'd on other grounds*, 578 F.2d 1273 (8th Cir. 1978).

337. *Id.* at 807.

338. *Id.* (quoting *O'Brien v. Continental Ill. Nat'l Bank & Trust*, 431 F. Supp. 292, 297 (N.D. Ill.), *appeal dismissed*, 566 F.2d 1175 (1977)).

339. 606 F.2d 602 (5th Cir. 1979).

340. *Id.* at 612 (quoting *Ernst & Ernst*, 425 U.S. 185, 203, which was quoting *Hearings on H.R. 7852 and H.R. 8720 Before the House Comm. on Interstate and Foreign Commerce*, 73d Cong., 2d Sess. 115 (1934) (remarks of Thomas G. Corcoran)).

to fulfill no useful function." A corporation's purchase of its shares at artificially inflated prices would not appear to serve a useful purpose.³⁴¹

Despite the broader language used by the Fifth Circuit, a plaintiff is well advised to use deception and not manipulation as a vehicle for bringing a fiduciary duty cause of action under 10b-5.

E. The Third Question in a 10b-5 Fiduciary Duty Case: Did the Deception Cause the Harm?

1. Three Tests of Causation

After the court has determined to whom disclosure should be made and the adequacy of disclosure, the third question is whether the omitted or misrepresented fact caused the injury to the shareholder. In an omission case,³⁴² if the shareholders would have been powerless to prevent the proposed self-dealing even if all material facts had been disclosed, the omission would not have caused the harm, and there would be no causation or reliance for the purpose of 10b-5. The relationships among the concepts of materiality, reliance, and causation are often indistinct. In the usual 10b-5 case, reliance is presumed in a case of an omission if there is a showing of materiality.³⁴³ Therefore, in situations in which a shareholder vote is required to approve the transaction, the questions of materiality, reliance, and causation are related and demonstrable, because the shareholders could have taken direct action by their vote if the information had been properly disclosed. When a shareholder vote is not required, these questions are resolved less easily. Most courts have found that causation is shown if it is demonstrated that the shareholders, if possessed of all the material facts, could have brought a successful suit in state court to enjoin the transaction. Thus, the ironic result is that the federal courts—in order to find a violation of 10b-5—must examine state law as it would be interpreted by the appropriate state court and determine whether that law would, or with reasonable probability of success might, have afforded plaintiffs relief. In all cases that have been discussed in this article, the basis of an injunction under state law would most likely have been that the directors breached their fiduciary duty by engaging in the self-dealing transaction. If an action for breach of fiduciary duty is brought in a state court, the self-dealing director must bear the burden of proving that the transaction is fair. In most cases, if he can demonstrate fairness, no breach of fiduciary duty is found. The plaintiff under these circumstances cannot successfully challenge the transaction in state court and, as a result, also cannot show the causation necessary to bring a successful 10b-5 action in federal court.

On the other hand, if the self-dealing director cannot meet the burden of proving that the transaction is fair, the state court will likely conclude that he

341. *Id.* at 612 n.8 (quoting S. REP. NO. 792, 73d Cong., 2d Sess. 6 (1934)).

342. The discussion in this section concentrates on the causation issue in an omission case. In an affirmative misrepresentation case, the question becomes one of actual reliance.

343. *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972).

has breached his fiduciary duty. The plaintiff will then have proven that he can successfully challenge the transaction in state court and also will have demonstrated causation under 10b-5. The crux of both the state and federal actions is whether a state court will determine that the director has proven that the transaction is fair. Thus, in *Wright v. Heizer Corp.*,³⁴⁴ the Second Circuit determined that the questionable pledge transaction would be unfair and consequently a breach of fiduciary duty under Delaware law. The court found, therefore, that the requisite causation existed to justify a 10b-5 action. Likewise, in *Goldberg v. Meridor*,³⁴⁵ the court carefully examined New York law and concluded that under existing case law and a newly passed statute, "where an appraisal remedy is not available, the courts of New York have displayed no hesitancy in granting injunctive relief" and that the omission and misrepresentations in the press release were therefore material even though the shareholders had no right to vote to approve the transaction.³⁴⁶

The Ninth Circuit, like the Seventh Circuit in *Wright* and the Second Circuit in *Goldberg*, adopted in *Kidwell v. Meikle*³⁴⁷ the "actual success" test for causation. After stating that "the record before us sheds little light on the question whether, in state court, an action could have been brought to block the sale of . . . assets,"³⁴⁸ the Ninth Circuit concluded that "[u]nder Idaho law, in these circumstances minority members reasonably could have brought a well-pleaded derivative suit to block the sale of . . . assets."³⁴⁹ The court then examined an Idaho statute and three cases dealing with duties owed by fiduciaries to the corporation. It concluded that "[g]iven this line of cases, the Idaho courts almost certainly would have entertained a suit by the shareholders charging a breach of the fiduciary duties by the . . . directors who voted for the sale of assets," and that "given the mandate of Idaho Code § 30-142 and the Idaho case law of directors' fiduciary duties, we believe the defendants are correct in admitting that a suit could have been brought in state court to enjoin sale on grounds of conflict of interest and unfairness."³⁵⁰

The *Kidwell* court did not find that the state suit would have been successful but rather required the district court to decide the state question on remand before reaching the causation question under 10b-5. The court simply found that a suit could have been brought under state law for breach of fiduciary duty and possibly on other grounds such as *ultra vires* or *de facto* merger theory.³⁵¹ The Ninth Circuit then articulated its test: to prove causation the

344. 560 F.2d 236 (7th Cir. 1977), discussed in text accompanying notes 75-105, 171-72, 205-06 *supra*.

345. 567 F.2d 209 (2d Cir. 1977), discussed in text accompanying notes 112-15, 309-10 *supra*.

346. *Id.* at 219.

347. 597 F.2d 1273 (9th Cir. 1979), discussed in text accompanying notes 200-04, 311-14 *supra*, 364-65 *infra*. The court in *Kidwell* made a reasonable attempt to distinguish between materiality and causation in a fiduciary duty setting. An omitted fact would be material if its disclosure would have caused the shareholder to bring suit in state court, but there would be no causation unless the shareholder would have been successful in bringing the action. *Id.* at 1293-94.

348. *Id.* at 1292.

349. *Id.*

350. *Id.* at 1292-93.

351. The court cited Pennsylvania and Delaware cases, but no Idaho cases, for its *de facto*

plaintiff must prove that he "would have succeeded in getting permanent injunctive relief, or damages in excess of an appraisal remedy, in the state law action."³⁵² "The question is essentially one of fact, but the federal trial judge should decide any legal issue that would have arisen in the hypothetical state suit as a matter of law in the rule 10b-5 suit."³⁵³ The *Kidwell* court cited *Goldberg* to justify a federal grant of relief contingent on the availability of such relief in a state court. "Inadequate disclosures lull into security those shareholders who might bring a derivative action under State law to enjoin the securities transactions if all material facts were revealed."³⁵⁴ Apparently, a 10b-5 claim is an essential enforcement tool to give substance to the state law claims.

The "actual success" test was expanded by the Second Circuit in *Cole v. Schenley Industries, Inc.*³⁵⁵ In *Cole* minority shareholders sought to enjoin a merger under section 14 because of alleged misrepresentations and omissions in the proxy statement and under section 10(b) for a breach of fiduciary duty. The court found that causation was shown regardless of whether minority shareholders could have successfully enjoined the merger under Delaware law because the minority shareholders could have either sought appraisal rights under Delaware law or threatened to seek appraisal rights in an attempt to force Glen Alden to improve its offer.³⁵⁶

The Fifth Circuit, in *Alabama Farm Bureau Mutual Casualty Co. v. American Fidelity Life Insurance Co.*,³⁵⁷ used a "might" test of causation. A shareholders' derivative action was brought against directors of a company for causing the company to purchase its own shares, allegedly to maintain their own control. By artificially inflating the market price, the directors could discourage other persons from purchasing the company's shares or attempting to take control of the company. Citing *Goldberg*,³⁵⁸ the court said that 10b-5 requires "a showing that state law remedies were available and that the facts shown make out a prima facie case for relief; it is not necessary to go further and prove that the state action would have been successful."³⁵⁹ Likewise, in an enforcement case, *SEC v. Parklane Hosiery*,³⁶⁰ the Second Circuit substituted a "might enjoin" causation test for the "actual success" test. Had all the information been disclosed to the minority shareholders, reasoned the court, the shareholders "might well have been able to enjoin the merger under New

merger theory. The *ultra vires* claim arose because of plaintiff's allegation that the board was constituted in violation of the corporation's articles and bylaws. *Id.* at 1293.

352. *Id.* at 1294.

353. *Id.*

354. *Id.* at 1292.

355. 563 F.2d 35 (2d Cir. 1977), discussed in text accompanying notes 293-301 *supra*.

356. *Id.* at 39-40.

357. 606 F.2d 602 (5th Cir. 1979). See text accompanying notes 221-23, 338-40 *supra*.

358. 606 F.2d at 614. The court noted that the Second Circuit in *Goldberg* refused to dismiss a claim because a state suit would have been possible even though there was no allegation that the shareholders would have been successful. The *Goldberg* court did not inquire further into the shareholders' likelihood of success in the state action. *Id.*

359. *Id.*

360. 558 F.2d 1083 (2d Cir. 1977).

York law as having been undertaken for no valid corporate purpose.”³⁶¹ The “might” test also was used in a private action by the Delaware District Court in *Jacobs v. Hanson*.³⁶² The court denied defendant’s motion to dismiss a complaint in which the trustee in dissolution of the corporation and the minority shareholders sued certain directors, principal officers, and majority shareholders on the ground that pursuant to a plan of liquidation they caused the corporation’s assets to be sold on terms unfavorable to the corporation’s minority shareholders, terms which included lucrative consulting and anti-competitive covenants for the defendants. In reaching its decision, the court found that causation could be established if the trier of fact (1) believed the defendant majority shareholders’ allegation that he would not have voted for the sale if a majority of the minority shareholders had not approved it³⁶³ or (2) found that a minority shareholder *might have* secured an injunction barring the challenged transaction.³⁶⁴ Not only did the court fail to examine state law to determine if an injunction might have been obtained, it also found that the shareholder’s previously unsuccessful attempt to enjoin the *meeting* at which the transaction was approved did not demonstrate that, even with the benefit of the undisclosed information, he might have been unable to enjoin the *sale*.³⁶⁵

The Third Circuit, in *Healey v. Catalyst Recovery of Pennsylvania, Inc.*³⁶⁶ (CRP), took still a different approach and chose simply to analyze causation as an aspect of the materiality requirement. In *Healey* the plaintiff, a twenty percent owner of Catalyst Regeneration Services, Inc. (CRS), sought an injunction and damages under rule 10b-5 for a merger that caused CRS to merge with CRP, a subsidiary created by CRS that had previously purchased eighty percent of CRS. Plaintiff lost an appraisal petition in the Texas state court but won an approximately \$200,000 judgment after a lengthy jury trial on his 10b-5 claim in federal court. Defendants appealed to the Third Circuit, which reversed the judgment and remanded the case to the district court for further proceedings. First, the Third Circuit found that, after *Santa Fe*, the crucial fact in determining whether a fiduciary duty cause of action exists is “whether there was misrepresentation or omission in the flow of information between the majority and minority shareholders.”³⁶⁷ In the court’s view, the causation test, which it deemed most logically to be a part of the materiality analysis, should be framed as follows: If the investor had received the correct

361. *Id.* at 1088.

362. 464 F. Supp. 777 (D. Del. 1979).

363. *Id.* at 780.

364. *Id.* at 781.

365. *Id.* For a finding of no causation see *Lewis v. McGraw*, [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,195 (S.D.N.Y. 1979), in which the court found shareholders who were suing directors of the target corporation for frustrating the consummation of a tender offer did not have the benefit of a presumption of reliance when materiality was shown because no tender offer actually was made. *Id.* at 96,570.

366. 616 F.2d 641 (3d Cir. 1980). See also *Toledo Trust Co. v. Nye*, 588 F.2d 202, 207 n.21 (6th Cir. 1978), in which the court also preferred a materiality analysis to a reliance or causation analysis, because in an omission case, reliance is presumed if materiality is established.

367. 616 F.2d at 646.

information, would he have had a *reasonable probability* of securing an injunction in a state court.³⁶⁸ Focusing the analysis on the decision-making process of the reasonable investor, the Third Circuit substituted "reasonable probability" for the *Kidwell* "actual success" test because (1) absolute certainty is an impossible goal and an impracticable standard for a jury to implement, and (2) in most cases, the state remedy will be a preliminary injunction, which looks to the likelihood of ultimate success.³⁶⁹ The court was unable to determine whether the omissions were material absent an explanation of the bases on which the merger could be enjoined under state law, which might include fraud, illegality, an *ultra vires* act, or unfairness. The case was remanded to the district court with an instruction that the court consider whether there was sufficient evidence to create a jury issue on the question of the plaintiffs' reasonable probability of ultimate success under Texas law. In the Third Circuit's view, this determination would require a two-step inquiry by the district court: (1) whether the jury could reasonably believe that any information was withheld, and (2) whether this information could have been used to obtain a Texas injunction.³⁷⁰

There are then three causation tests used by the various circuits: (1) the "actual success" test, (2) the "might" test, and (3) the "reasonable probability" test. After a brief discussion of other views of causation, these tests will be analyzed.

2. Other Views of Causation

Courts wrestling with the question of causation in contexts slightly different from the traditional fiduciary duty setting often use different words and tests but generally have the same focus: could the shareholder have taken some kind of action if the information had been fully disclosed? For example, in *Bridgen v. Scott*,³⁷¹ plaintiffs purchased participation interests in a partnership formed to obtain "dramatic" tax savings as well as future speculative profits for the investors. The complaint alleged the venture was prematurely terminated in violation of rule 10b-5 because, among other things, it was not disclosed that the promoter acquired fifty-five percent of the participation when he was able to sell only forty-five percent of the interests. The investors further alleged that they were unfairly treated because the partnership was terminated when the promoter, who could not or would not raise enough cash to continue his fifty-five percent participation, backed out of the deal. Heavily influenced by the fact that most of the participants were sophisticated investors, the court found no deception and no causation under the *Piper v. Chris Craft Industries*³⁷² test of causation.

368. *Id.* at 647.

369. *Id.*

370. *Id.* at 648.

371. 456 F. Supp. 1048 (S.D. Tex. 1978), discussed in text accompanying notes 265-67, 305-06, 315-16 *supra*.

372. 430 U.S. 1 (1977).

Applying this language and reasoning to the case at bar, the ultimate injury of which the plaintiffs here complain is the premature (in their present view) termination of the partnership's interest in Dr. Thorn's property. To conclude that the ultimate result would have been different had Scott's 55% ownership of the participation interests been more widely distributed requires one to engage in totally unsupported speculation and conjecture. Thus, there is no proof that the alleged violation, i.e., the alleged omissions, in any way would have altered the ultimate result and thus plaintiffs, applying Justice Blackmun's reasoning, have totally failed to establish that the alleged omissions in any way caused or contributed to the plaintiff's "ultimate injury."³⁷³

The plaintiffs' failure to specify the action they could have taken had the information been disclosed was fatal to their claim. For the same reason, the Eighth Circuit, in *St. Louis Union Trust Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*,³⁷⁴ dismissed a complaint brought by the executors of the estate of a former employee, officer, and stockholder of Merrill Lynch whose stock was purchased at his death pursuant to a charter provision giving Merrill Lynch the right to purchase upon death of the holder. Plaintiffs alleged that the stock was purchased in furtherance of a fraudulent scheme devised by the insiders to increase the public offering price of the company's stock and to maintain and preserve the insiders' control of company management after public ownership. In addition, defendants allegedly failed to disclose to the executors at the time of exercise of the option the future public offering of Merrill Lynch stock. In dismissing the claim on the ground that causation was not shown because plaintiffs could have taken no action to stop the purchase even if the information had been disclosed, the court stated:

Whether we analyze the causation issue before us in terms of materiality, reliance or both, the result is the same: causation in fact does not exist as a matter of law under § 10(b) and Rule 10b-5. Any "loss" which was occasioned by the sale of the Bitting stock to the corporation was not caused by any material omission, fraudulent or otherwise, on the part of the defendants. The purported "loss" was caused by two events unrelated to the alleged fraud: 1) the execution of the stock restriction, which was enforceable under Delaware law, and 2) the death of the shareholder Bitting, the specified contingency which triggered the operation of the stock restriction. Whatever the Bitting executors knew or did not know about a future public offering of Merrill Lynch stock was wholly irrelevant to their decisions to sell the stock.³⁷⁵

The plaintiffs have not suggested how they might have acted differently had they been given prior notice of any company preparations to go public, aside from the observation that they would have taken every possible legal action to protect their interests. However,

373. *Bridgen v. Scott*, 456 F. Supp. at 1066.

374. 562 F.2d 1040 (8th Cir. 1977), *cert. denied*, 435 U.S. 925 (1978).

375. *Id.* at 1049.

plaintiffs could have litigated nothing more at that time than they have litigated in this case. The point we wish to emphasize is that plaintiffs could have done nothing to block the sale of the stock.³⁷⁶

The District Court for Delaware, in *Valente v. PepsiCo, Inc.*,³⁷⁷ used an unconventional and expansive test of causation that focused on action that could have been taken by the defendant even after disclosure rather than on actions that would have been taken by the plaintiff. In that case PepsiCo, an 88.2% owner of Wilson, made a tender offer for Wilson stock, which was to be followed by a short-form merger in which minority shareholders would be cashed out at the tender offer price. In response to the claim of minority shareholders that certain omissions in the tender offer materials violated rule 10b-5, defendants argued that a causal connection could not be established between the alleged violations and the asserted injuries because PepsiCo, with an 88.2% interest in Wilson, could have effected the merger without conducting the tender offer. The court, citing various cases and commentators to justify its position, found transaction causation might exist,³⁷⁸ even though the votes of the minority shareholders were unnecessary to effect the merger, because disclosure might serve other functions beyond obtaining the informed consent of a certain percentage of the shareholders.³⁷⁹ The court gave examples of these other functions by suggesting that plaintiffs might prove causation if the trier of fact found (1) full disclosure would have produced an incentive for PepsiCo to raise the price offered or (2) PepsiCo would have foregone the tender offer and merger altogether because of the failure of the tender offer, direct shareholder pressure, or the obligation to disclose.³⁸⁰

3. Difficulties Presented by the Causation Theory

The element that the causation theories have in common is the requirement that some action be possible as a result of the disclosure.³⁸¹ In the fiduciary duty context, in order to find the required 10b-5 causation, courts generally must determine that plaintiffs might, or with actual or a reasonable

376. *Id.* at 1050 n.15. See also *Blackmar v. Lichtenstein*, 438 F. Supp. 803 (E.D. Mo. 1977), *rev'd on other grounds*, 578 F.2d 1273 (8th Cir. 1978), in which a trustee was suing prior trustees on behalf of the beneficiaries of the trust for what was essentially a self-dealing claim. The court found that the complaint failed to state a claim because, among other deficiencies, the failure to disclose material information was not material to any investment decision made by the plaintiffs because the trustees were given discretionary power to purchase securities, subject only to the beneficiaries' right to ratify or disapprove the investment decision *after* it had been made.

377. 454 F. Supp. 1228 (D. Del. 1978), *discussed in text* accompanying notes 42-44, 239-51, 317-19 *supra*.

378. In the case of a tender offer, the concept of causation can be somewhat complex because a plaintiff must prove not only that a defendant's misstatements or omissions caused shareholders to accept the tender offer ("transaction causation"), but also that the violations caused the injuries of which the plaintiff complains ("loss causation"). The court found sufficient loss causation because the tendering shareholders' acceptance of the tender offer resulted in the loss of their right to obtain an appraisal at the time of the subsequent merger, which would not have occurred if the merger had been executed without a prior tender offer. *Id.* at 1247.

379. *Id.* at 1248-49.

380. *Id.* at 1249 n.36.

381. However, this is not true of the unusual and unconventional test adopted by the court in *Valente*. See text accompanying notes 376-79 *supra*.

probability of success could have, obtained an injunction under state law if the information had been properly disclosed. Problems with this approach have only begun to surface. Of course, there are the typical conflict of laws questions that arise any time a federal court is bound by state court interpretations. First, the federal court must decide which state's laws to apply when determining whether an injunction would issue,³⁸² a problem exacerbated by the fact that causation can be shown if the transaction can be enjoined on any one of several theories—ultra vires, fraud, or unfairness—each of which may be governed by a different state's law. More importantly, unlike the usual conflict of laws case, there often may be little or no applicable precedent. For example, the Ninth Circuit in *Kidwell* found no Idaho cases to support its theory that the merger might be enjoined on a de facto merger theory and had to rely on cases in other jurisdictions.³⁸³ Even in Delaware there were no cases until quite recently on whether a court should defer to the business judgment of disinterested directors if they decide not to bring an action on behalf of the corporation.³⁸⁴

Aside from the conflict of laws problems,³⁸⁵ the crucial difficulty with causation as it has been defined by the federal courts is that there is a great deal of justifiable confusion regarding the degree of probability of success in obtaining an injunction under state law that must be proved by the plaintiff. Must the plaintiff demonstrate that an injunction could actually have been obtained if the information had been properly disclosed, as required in *Meikle*, or is it sufficient to prove that there was a reasonable probability that it could have been obtained, as required in *Healey*? Or is it enough simply to show that an injunction could have been sought, without determining the likelihood that it would have been granted, as required in *Alabama Farm Bureau*?³⁸⁶ To require "actual success" would make it more difficult for plaintiffs to establish causation and therefore presumably would discourage them from bringing actions in federal courts. However, the determination of "actual success" would require a more intensive exploration of state law, a function traditionally, and under *Santa Fe* preferably, left to state courts. In addition, this test permits a *federal* cause of action only when a *federal* court determines there would also be a *state* cause of action. The "reasonable probability" requirement, on the other hand, would result in a lower standard

382. This question is raised by the Southern District of New York in dictum in *Kerrigan v. Merrill Lynch, Pierce, Fenner & Smith*, 450 F. Supp. 639, 644 n.5 (S.D.N.Y. 1978).

383. 597 F.2d at 1293.

384. *Maldonado v. Flynn*, 413 A.2d 1251 (Del. Ch. 1980).

385. The Third Circuit in *Healey v. Catalyst Recovery of Pa.*, 616 F.2d at 648, was unsure whether the court or the jury should determine the law of the relevant state. Comparing the problem to cases involving malpractice or the law of a foreign country, it permitted the district court to decide whether Texas law should be determined by judicial notice or by the jury. *Id.* at 648.

386. See *Alabama Farm Bureau Mut. Cas. Co. v. American Fidelity Life Ins. Co.*, 606 F.2d 602 (5th Cir. 1979). The Seventh Circuit in *O'Brien v. Continental Ill. Nat'l Bank & Trust Co.*, 593 F.2d 54, 60 n.9 (7th Cir. 1979), seemed genuinely uncertain. To justify its uncertainty, the court cited *Santa Fe*, 430 U.S. at 474 n.14 and Note, *Suits for Breach of Fiduciary Duty Under Rule 10b-5 After Santa Fe Industries, Inc. v. Green*, 91 HARV. L. REV. 1874, 1893-98 (1979).

of proof for causation, thereby making it easier to establish a 10b-5 cause of action in federal courts. At the same time, however, it would not require a federal court to examine and interpret state law with the same exhaustive degree of thoroughness necessitated by the "actual success" test. Moreover, as argued by the *Healey* court, the "reasonable probability" requirement has the advantage of being more familiar to the federal courts because it is the test usually applied in determining whether an injunction should issue. Like the "actual success" test, the "reasonable probability" test grants 10b-5 relief only when the chances are high that the same relief is available in state court. The inescapable difficulties that federal courts are willing to tolerate in formulating and applying a causation test illustrate their reluctance to relegate fiduciary duty cases to the state courts. The federal courts apparently are willing to use tortured definitions of causation to retain jurisdiction over fiduciary duty claims, a predilection at odds with *Santa Fe*. The requirement of causation, as now defined by the circuits, undermines the policies of *Santa Fe* by conditioning federal remedies upon the presence of state remedies and by requiring time-consuming interpretations of state law by federal courts.

It certainly would be simpler to return to the *Affiliated Ute* rationale and decide that once materiality is demonstrated, at least in an omission case, reliance and causation should be presumed. Materiality would be established if a reasonable investor could have made a more informed decision, such as selling, buying, seeking appraisal, seeking an injunction, or ousting the directors, had the information been properly disclosed.³⁸⁷ Although this test will make proof of causation less burdensome for the plaintiffs, it also will minimize the exploration of state law by federal courts and possibly will make federal remedies less dependent upon the availability of state remedies. In addition, this approach will focus the inquiry on action to be taken by investors, rather than certain litigants,³⁸⁸ and will return the focus to materiality, as urged in *Affiliated Ute*. In fact, the causation requirement might be effectively eliminated altogether. If materiality is established, it is not productive to require an additional showing of causation when that showing entangles the federal courts in discussions discouraged, with good reason, by *Santa Fe* and does not improve the disclosure relevant to informed investor decision-making.

387. The Fifth Circuit, in *Alabama Farm Bureau*, argued that the "might" test would "predicate relief on a hypothetical basis" while the "actual success" test would in effect "exact the equivalent of a trial of the state claim. The rule that appears to us to be both desirable and practicable steers between Scylla and Charybdis: the plaintiff must show that there is at least a reasonable basis for state relief, but need not prove that the state suit would in fact have been successful." 606 F.2d at 614.

388. *But see* the dissenting opinion in *Healey*:

By deeming the allegations of materiality legally sufficient merely because Healey alleges availability of injunctive relief, the majority change the emphasis of rule 10b-5 from protection of the reasonable investor to protection of a certain type of litigant. Healey does not contend that the information would have enabled him to make a more informed investment decision. Indeed, he had no investment decision to make because his votes were unnecessary to complete the merger. As in *Santa Fe*, his options, either to tender his stock or seek appraisal, were fully disclosed to him. The purpose of the federal securities laws, to promote a full and fair disclosure, was fulfilled.

616 F.2d at 654 (Aldisert, J., dissenting).

The problems the courts face in applying the present causation test are far exceeded by the problems confronted by the corporate planner who attempts to structure a transaction to avoid 10b-5 exposure. He can justify two diametrically opposed courses of actions. On the one hand, he might be inclined to disclose all information that conceivably might be material to an investor who is deciding whether to seek an injunctive remedy available under state law. Theories that have been suggested as affording injunctive relief under state law include fraud, ultra vires, de facto merger, unfairness, or illegality. Given this plethora of theories, it would be challenging at best to disclose all the information that might be deemed material by a trier of fact long after the transaction. On the other hand, it is arguable that the corporate planner might advise his client to disclose nothing.³⁸⁹ The most likely theory under which injunctive relief could be sought is breach of fiduciary duty when a state court will enjoin the transaction only if the directors cannot prove that the transaction is fair. One then could argue that if the transaction is demonstrably fair, no plaintiff can successfully sue under rule 10b-5 *even* if no material facts are disclosed, because he cannot establish causation under the "actual success" or "reasonable probability" test. Therefore, rather than disclose anything, the planner might be well-advised to assure that the transaction is demonstrably fair. But what is fair and in whose eyes? Will the courts defer to a disinterested board's determination that a transaction is fair at the time it is negotiated? Or will the court after the fact determine whether the transaction is fair? What guidelines will the court use for fairness? The Court of Chancery of Delaware gave the most extensive list of facts to be considered in determining whether a merger used to effect a going-private transaction was fair:³⁹⁰

389. In dictum the court in *Goldberger v. Baker* hinted that there was an affirmative duty to disclose:

In their brief, plaintiffs restate their allegations concerning the sale lease-back transactions to say that defendants failed to disclose any facts of the transactions prior to the time they occurred. If true, this allegation might raise a substantial issue of whether in certain self-dealing situations, the parent has a duty under federal law to disclose the fact that the transaction is to occur, notwithstanding the absence of trading and in addition to the applicable reporting requirements under the 1934 Act. See *Meridor*, 567 F.2d 209 at 221 n.10. Cf. *Wright v. Heizer Corp.*, 560 F.2d 236, 248. The instant complaint does not make such an allegation, however, and it would be unwise to explore this issue on these pleadings in their current form.

442 F. Supp. at 665 n.5. In *IIT v. Cornfeld*, 462 F. Supp. 209 (S.D.N.Y. 1978), *modified on other grounds*, 619 F.2d 909 (2d Cir. 1980), the court dismissed a complaint because 10b-5 was found not to extend to foreign corporations under the circumstances of the case. Noting that in *Goldberg* it was not faced with "the more difficult issue whether pure nondisclosure surrounding a transaction for which no shareholder approval was necessary could constitute an actionable deception under Rule 10b-5," the court mused:

Such a holding would effectively impose an independent duty on directors, in addition to the other reporting provisions of the act, to make disclosures to minority shareholders about transactions in which the directors have a conflict of interest and no shareholder approval is otherwise required. . . . It is interesting to note that such a holding was advocated by the SEC ten years ago as *amicus curiae* in the *Schoenbaum* rehearing en banc, but has never been explicitly adopted by the Second Circuit.

Id. at 222 n.27.

390. *Tanzer v. International Gen. Indus., Inc.*, 402 A.2d 382, 390-94 (Del. Ch. 1979). See also Sec. Exchange Act Release No. 16075 (8-8-79) 44 F.R. 46736 (fairness criteria in going-private release).

1. Purpose of the merger: does it have a legitimate and compelling business purpose?
2. Are there alternatives to a cash-out merger?
3. Are there independent recommendations as to fairness of price?
4. Was adequate notice given to minority shareholders?
5. Was there a possibility of public issue at a high price followed by a merger at a low price?
6. Were corporate funds used to finance the merger?
7. Were appraisal rights available to minority shareholders?
8. Did the defendants appropriate the benefits of the merger?

Even these were not taken with equal degrees of seriousness by the Delaware court. The court's consideration of those factors illustrates the difficulty inherent in a fairness review after the fact. A planner should be reluctant to rely on the transaction's fairness to avoid 10b-5 disclosure because of the uncertainty of his being able to prove fairness.

That causation ultimately becomes a test of fairness is a further irony. The federal securities laws were designed to mandate disclosure, not to determine merit. As a result of the causation test, the federal courts now are reviewing the transaction for merit as well as disclosure.

F. The "In Connection With" Requirement

A related but somewhat different element that has arisen in fiduciary duty cases, but not with the frequency of the deception and causation questions, is the "in connection with" requirement. To be actionable under 10b-5 the fraud must be in connection with the purchase or sale of a security. In *Ketchum v. Green*³⁹¹ the Third Circuit affirmed the district court's dismissal of a 10b-5 action for failure to state a claim, primarily because the "in connection with" requirement was not met. Plaintiffs, who owned the controlling bloc (their holdings plus proxies) at the shareholders' meeting, had voted to give defendants control of the corporation's board of directors, allegedly unaware of defendants' intention to remove plaintiffs as corporate officers. Immediately after their election to the board, defendants refused to re-elect plaintiffs as officers of the corporation, fired them as employees, and adopted a resolution for the corporation to purchase plaintiffs' shares as authorized by the corporation's stock retirement plan. Plaintiffs claimed that defendants' failure to reveal their intentions at the shareholders' meeting violated 10b-5 because plaintiffs were fraudulently induced to vote for their own demise. It was alleged that by deceiving the plaintiffs defendants obtained control of the board, which resulted in plaintiffs' termination as officers and then as employees of the corporation. Termination then led to the forced sale of plaintiffs' stock under the stock retirement plan.

The court, noting that the "connection" factor "of rule 10b-5 has received relatively scant consideration by the Supreme Court and other federal tribu-

391. 557 F.2d 1022 (3d Cir.), cert. denied, 434 U.S. 940 (1977).

nals,"³⁹² found that this factor was not satisfied on the facts of this case. The court cited *Superintendent of Life Insurance v. Bankers Life & Casualty Co.*,³⁹³ which found that the "connection" requirement is met if the party is defrauded "as a result of deceptive practices touching its sale . . . of securities."³⁹⁴ The *Ketchum* court, however, ignored the "touch" test because it could be interpreted to cover practically all disputes relating to intracorporate management³⁹⁵ and held that the relevant inquiry in *Banker's Life* was whether the complaint *essentially* alleged internal corporate mismanagement.³⁹⁶ Since the essence of the plaintiffs' claim in *Ketchum*, in the view of the court, was their dismissal as officers, the case was actually a dispute arising from an internal contest for control of a corporation. Thus, reasoned the court, any alleged deception was in connection with a struggle for control, not a securities transaction, and essentially involved "internal corporate mismanagement."³⁹⁷ Thus, the "connection" requirement was not met. A second basis for reaching the same conclusion was that there was not sufficient proximity between the securities transaction and the claimed fraud.³⁹⁸ In distinguishing *Bankers Life* the court said:

By contrast, the degree of proximity seems to be more attenuated in the situation before us. Instead of being merely one step away from a securities deal, the supposed deception here is somewhat removed from the ultimate transaction. Indeed, there are a substantial number of intermediate steps between the fraud and the accomplishment of the forced sale of plaintiffs' shares: the shareholders' vote subsequent to the misrepresentation; the ensuing meeting of the company directorate during which the plaintiffs were removed as officers; and the adoption of the resolution terminating the plaintiffs' status as company employees. Only the last development triggered the operation of the stock retirement program, compelling Ketchum and Bigler to tender their shares to the corporation.³⁹⁹

The court finally observed that even though "causation" and "connection" apparently were viewed as different requirements by the Supreme Court in *Bankers Life*, they are nonetheless similar because both "speak to the degree of proximity required between a misrepresentation and a securities transaction."⁴⁰⁰ In finding an absence of causation, the court reasoned:

Assuming that the supposed misrepresentations of the defendants did set into motion a chain of events which culminated in the securities transaction, we believe that the retirement agreement operates as an independent and intervening cause of such transaction – a force that

392. *Id.* at 1025.

393. 404 U.S. 6 (1971).

394. 557 F.2d at 1026 (citing *Superintendent of Life Ins. v. Bankers Life & Cas. Co.*, 404 U.S. at 12-13).

395. 557 F.2d at 1027.

396. *Id.*

397. *Id.* at 1028.

398. *Id.*

399. *Id.*

400. *Id.* at 1029.

serves to disrupt the connection between the challenged conduct on the part of the defendants and the relinquishment of plaintiffs' shares.⁴⁰¹

The District Court for Massachusetts in *Wittenberg v. Continental Real Estate Partners*⁴⁰² also dismissed claims because the alleged fraud was not "in connection with" the plaintiffs' purchases. The plaintiffs had purchased real estate limited partnership interests pursuant to a prospectus representing that the issuer would adhere to a fiduciary duty of good faith. However, the alleged fraud occurred after plaintiffs' purchase. The court stated that "[a]t best the complaint makes out a claim of postinvestment fraud or mismanagement."⁴⁰³

Similarly, in *Filor, Bullard Inc. v. Empress International, Ltd.*,⁴⁰⁴ the District Court for Delaware, relying heavily on *Ketchum*, granted summary judgment in a "going private" transaction. Violations of 10b-5 and sections 14(a) and 14(e) were alleged because the defendants had not disclosed in a proxy statement, which solicited votes for the election of directors, that the directors intended to cause the company to make a going-private tender offer. Since the tender offer was made after this challenged election, and the court could not find the necessary connection between the tender offer and the election of directors.

In this case, because the only corporate action sought to be authorized was the election of five directors and the ratification of the selection of independent auditors and no authorization was sought from the shareholders to approve a cash tender offer, there was no violation of Section 14(a) or the rules thereunder for failure to disclose a contemplated cash tender offer as a matter of law, since the injury complained of—"coercive tender offer"—was not directly traceable to the corporate action authorized by the electorate as a *result of* the proxy solicitation. . . .⁴⁰⁵

In *Jacobs v. Hanson*⁴⁰⁶ the court distinguished *Ketchum* and used a broad definition of "in connection with". In *Jacobs* plaintiffs alleged that the majority shareholders had caused the assets of the corporation to be sold, pursuant to a plan of liquidation, on terms favorable to them and unfavorable to the minority shareholders. Defendants argued that the "in connection with" requirement was not met because the alleged misrepresentations were in connection with the forced sale resulting from the dissolution, not from the sale of the corporation's assets. However, the court did not accept that argument, finding

401. *Id.*

402. 478 F. Supp. 504 (D. Mass. 1979).

403. *Id.* at 509. The court further stated that even if the defendants had breached their fiduciary duty, the representations on which plaintiffs allegedly relied were made by other owners. See also *Rodman v. Grant Foundation*, 460 F. Supp. 1028 (S.D.N.Y. 1978), *aff'd on other grounds*, 608 F.2d 64 (2d Cir. 1979), in which the court found there was no connection between purchases of securities and alleged omissions at a later board of directors meeting.

404. 442 F. Supp. 217 (D. Del. 1977).

405. *Id.* at 223.

406. 464 F. Supp. 777 (D. Del. 1979).

that the dissolution and sale of assets were part of a single scheme. The dissolution was "an essential and central element of [the] scheme"⁴⁰⁷ because the dissolution not only produced favorable tax results but was necessary to obtain the minority shareholders' support of the sale of assets. The *Jacobs* court said that in *Ketchum* "the misrepresentations were in connection with one transaction—the election of a board of directors—and the sale of plaintiffs' securities was a part of a separate transaction—the subsequent firing of the plaintiff and the purchase of his stock by the corporation pursuant to a buy-out agreement." The *Jacobs* court then found that the "misrepresentations were made to induce action on one step in a plan of dissolution."⁴⁰⁸

IV. PLANNING A CONFLICT OF INTEREST TRANSACTION TO MINIMIZE 10b-5 LIABILITY

A corporate planner who seeks to minimize 10b-5 exposure in a self-dealing transaction may find the following guidelines helpful.

A. To Whom Should Disclosure Be Made?

If shareholder approval is necessary to effect the transaction, disclosure should be made to the shareholders. If shareholder approval is not necessary and if a majority of the board are disinterested under the *Maldonado* test,⁴⁰⁹ disclosure should be made to the board. If all of the board are interested, disclosure should be made to the shareholders even though shareholder approval is otherwise unnecessary. If only a minority of the board members are disinterested under the *Maldonado* test, it is at least arguable that disclosure to the disinterested members of the board is sufficient, provided shareholder approval is unnecessary to effect the transaction under state law.⁴¹⁰ If the minority directors constitute a quorum under the company's bylaws or the state corporation statute, or if they can legally act on behalf of the corporation under the state corporation statute, an even better case is made for disclosure to the board.

B. When Should Disclosure Be Made?

Disclosure should be made prior to the consummation of the transaction so that the party to whom disclosure is owed can take effective action.⁴¹¹ In *Kidwell* the court held that disclosure at a shareholders' meeting was per se

407. *Id.* at 781.

408. *Id.* One year earlier the same court in *Valente v. PepsiCo, Inc.*, 454 F. Supp. at 1228, found that omissions in tender offer materials were "in connection with" forced sales effected by a subsequent short-form merger several months later because both the tender offer and the merger were part of a single plan. The court based its finding of a single plan on two facts: (1) the tender offer and the merger were jointly referred to in the press releases and tender materials; and (2) the short-form merger was possible only as a result of the successful tender offer, which gave the tender offeror 90% of the target company's stock. *Id.* at 1237.

409. See text accompanying notes 173-84 *supra*.

410. See text accompanying notes 122-70 *supra*.

411. *Wright v. Heizer Corp.*, 560 F.2d at 236.

inadequate when a notice containing only a brief outline of the proposed plan to be considered was sent to shareholders and there was poor attendance at the meeting—a startling conclusion when one considers that the defendant was a nonprofit corporation and that a shareholders' vote was not required by Idaho law.⁴¹²

C. *What Kind of Information Should Be Disclosed?*

1. All material facts should be disclosed, that is, all information which, if disclosed, would influence a reasonable investor to seek an injunction in state court.⁴¹³

2. Materiality may depend upon the nature of the injunction that could be sought. Although courts have alluded to various theories upon which an injunction might be granted under state law, the only injunction seriously discussed in the cases is one sought on the basis that the defendants breached their fiduciary duty. Facts material in determining whether an investor should seek such an injunction in state court would include all facts relevant to the fairness of the transaction.⁴¹⁴

3. Specifically, in fiduciary duty cases, which almost always have been based on self-dealing, courts have sometimes found certain information material as a matter of law:

- (1) The terms of the transaction;⁴¹⁵
- (2) Occasionally, the alternatives available to the corporation in the transaction;⁴¹⁶
- (3) Whether a majority vote of the shareholders is necessary to approve the transaction;⁴¹⁷
- (4) Underlying facts indicating a conflict;⁴¹⁸
- (5) "Bottom line facts," the disclosure of which is usually evidenced by other shareholders' seeking appraisal or injunctive relief, based on the disclosed facts.⁴¹⁹

412. See text accompanying notes 200-04 *supra*.

413. *Healey v. Catalyst Recovery*, 616 F.2d 641 (3d Cir. 1980); text accompanying notes 307-22 *supra* (materiality discussion). See *Kidwell v. Meikle*, 597 F.2d at 1293; *Goldberg v. Meridor*, 567 F.2d at 218-19.

414. See text accompanying note 389 *supra*.

415. See *Wright v. Heizer Corp.*, 560 F.2d at 247; *Helfant v. Louisiana & S. Life Ins. Co.*, 459 F. Supp. at 724 (E.D.N.Y. 1978); *Goldberger v. Baker*, 442 F. Supp. at 665; *Lavin v. Data Sys. Analysts, Inc.*, 443 F. Supp. 104 (E.D. Pa. 1977), *aff'd mem.*, 578 F.2d 1374 (3d Cir. 1978).

416. See, e.g., *Wright v. Heizer Corp.*, 560 F.2d at 247. But see text accompanying note 410 *supra*.

417. 560 F.2d at 247. But see *Lavin v. Data Sys. Analysts, Inc.*, 443 F. Supp. at 107.

418. See *Kidwell v. Meikle*, 597 F.2d 1273 (9th Cir. 1979) (no written disclosure to members of a non-profit corporation that directors who approved sale of corporation were shareholders of a for-profit corporation that would benefit from the sale). But see *Rodman v. Grant Foundation*, 460 F. Supp. 1028, 1038 (S.D.N.Y. 1978), *aff'd*, 608 F.2d 64 (2d Cir. 1979).

419. See *Cole v. Schenley Indus., Inc.*, 563 F.2d 35, 40 (2d Cir. 1977). "While 'corporations are not required to address their stockholders as if they were children in kindergarten,' it is not sufficient that overtones might have been picked up by the sensitive antennae of investment analysts." *Id.* (citing *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1297 (2d Cir. 1973) (court perhaps

4. Courts have been more helpful in clarifying what information need not be disclosed:

- (1) Characterization of the transaction in pejorative terms;⁴²⁰
- (2) Stating motives or the true purpose for the transaction;⁴²¹
- (3) Providing information readily available to the plaintiffs from other sources;⁴²²
- (4) Predictions and speculation;⁴²³

influenced because 250 shareholders sought appraisal and minority shareholders brought three separate suits to enjoin merger); *Kidwell v. Meikle*, 597 F.2d 1273, 1293, (9th Cir. 1979) (failure to disclose that nonprofit corporation would sustain a loss and sister corporation would enjoy a profit constituted material omission).

420. *Golub v. PPD Corp.*, 576 F.2d at 765 (no requirement to explain that bonuses were not true bonuses but premiums paid for stock ownership or commercial bribes); *Biesenbach v. Guenther*, 588 F.2d at 401-02 (representation that transaction in best interests of shareholders not actionable); *Helfant v. Louisiana & S. Life Ins. Co.*, 459 F. Supp. at 724-25 (representation that both the price and exchange ratio in a merger were fair not deemed actionable misrepresentation); *Goldberger v. Baker*, 442 F. Supp. at 665 (need not state that loans were made for less than fair consideration); *Lavin v. Data Sys. Analysts, Inc.*, 443 F. Supp. at 107 (no need to disclose that employee bonus plan involved self-dealing and use of corporate funds for personal benefit of defendants and that plan had no legitimate business purpose; proxy provisions not aimed "at ensuring an exhaustive, dispassionate, and evenly balanced presentation of conflicting interpretations of the facts given."). See also *Rodman v. Grant Foundation*, 608 F.2d 64 (2d Cir. 1979); *Klamberg v. Roth*, 473 F. Supp. 544, 551 (S.D.N.Y. 1979); *Hundahl v. United Benefit Life Ins. Co.*, 465 F. Supp. 1349 (N.D. Tex. 1979).

421. *Golub v. PPD Corp.*, 576 F.2d at 765; *Helfant v. Louisiana & S. Life Ins. Co.*, 459 F. Supp. at 724 (need not disclose that sole purpose of merger was to freeze out minority shareholders); *SEC v. Parklane Hosiery*, 558 F.2d 1083, 1086 (2d Cir. 1977) (unclear whether the alleged deception was the failure to disclose president and principal shareholder's personal debts or that his motive for the transaction was to use corporate assets to disclose his debts). But see *Maldonado v. Flynn*, 597 F.2d 789 (2d Cir. 1979) (imposed requirement that disclosure make clearer the fact that corporation lost more than \$400,000 in tax savings.)

422. *Rodman v. Grant Foundation*, 460 F. Supp. 1028, 1036 (S.D.N.Y. 1978), *aff'd*, 608 F.2d 64, 71, 72 (2d Cir. 1979) ((1) purpose to maintain control was evident from size of purchase; (2) because the proxy statements disclosed the prices previously paid by employees for the corporation's stock and the formula by which the corporation was to calculate the price it would pay to buy its own share from its director-controlled shareholders, failure to allege that this price was \$20 higher than the price paid by employees was not a violation; (3) since the number of authorized and issued shares were disclosed in financial statements, attached to the proxy statement, failure to disclose that the company had sufficient authorized but unissued shares to meet its obligations under an employee stock purchase plan without having to purchase its presently outstanding stock was not misleading; (4) since the financial statements disclosed the amount of assets and liabilities and the number of treasury shares, failure to disclose that the prices of the shares to be purchased exceeded book value, would decrease the company's net worth, and would have an adverse effect on its profit and loss statement was not misleading because a shareholder could compute book value from the information disclosed and could infer (since treasury stock was carried on the books as an asset valued at cost) that the purchase of stock at more than book value would leave net worth unchanged and increase book value, *id.* at 1037; (5) failure to disclose that the prices to be paid under the stock purchase agreement might exceed the market price on the date of closing was not misleading because "[t]his risk could be inferred easily from the fact that the price was to be the average of the daily closing market prices during a certain month," which fact was disclosed, *id.* at 1037); *Valente v. PepsiCo, Inc.*, 454 F. Supp. 1228 (D. Del. 1978) ((1) failure to disclose the availability of an appraisal remedy in a merger which would probably follow the tender offer was material as a matter of law because it was not deemed known to shareholders, *id.* at 1240; (2) whether control was adequately disclosed in tender offer materials and prior annual reports was left up to trier of fact, *id.* at 1242; (3) there was no obligation to disclose readily available financial information, such as earnings per share, when it was highlighted in annual and quarterly reports and it appeared in financial pages of major newspapers, *id.* at 1243); *Goldberger v. Baker*, 442 F. Supp. at 667 (price listed on AMEX).

423. *Rodman v. Grant Foundation*, 608 F.2d at 72 (failure to disclose that the company would

- (5) Alternative courses of action;⁴²⁴
- (6) Inconsistency with previous policy;⁴²⁵
- (7) Expert opinions, even if wrong.⁴²⁶

5. At least one court has suggested that materiality may also depend upon the knowledge and sophistication of the investors.⁴²⁷

It is unclear how much more disclosure is required by 10b-5 than by the proxy rules. For example, the court in *Maldonado v. Flynn*⁴²⁸ suggested that rule 14a-9 simply sets forth minimum standards for disclosure and that "going beyond the Rule, it has been recognized that shareholders are entitled to truthful presentation of factual information 'impugning the honesty, loyalty, or competency of directors' in their dealings with the corporation to which they owe a fiduciary duty."⁴²⁹ However, the Eastern District of Pennsylvania in *Perelman v. Pennsylvania Real Estate Investment Trust*⁴³⁰ seemed to reach a contrary conclusion when asked to determine whether sufficient facts relating to a conflict of interest had been disclosed in a proxy statement for the election of trustees. Although certain information was disclosed, the proxy statement did not state specifically that, as a result of certain transactions, a majority shareholder's cash flow distribution would increase by twenty percent with no corresponding increase in his obligation. The court found that even though the omissions were material, rule 14a-9 was not violated because the plaintiffs failed to allege that inclusion of these facts would be necessary to make statements therein not false or misleading.⁴³¹ More important to the present dis-

have to borrow to finance the stock purchases if it continued its then-existing expansion and dividend policies was not misleading because "[f]ull factual disclosure need not be embellished with speculative financial predictions."; *Umbriac v. Kaiser*, 467 F. Supp. 548 (D. Nev. 1979) (failure to disclose certain tax treatment was immaterial because practically and legally speculative); *Goldberger v. Baker*, 442 F. Supp. at 665 (no requirement to disclose that transaction would substantially damage company).

424. *Umbriac v. Kaiser*, 467 F. Supp. at 553 (not required to discuss panoply of possible alternatives to proposed course of action absent a suggestion that the route not chosen was so well recognized and legally sound that failure to pursue it demands consideration.) But see text accompanying note 415 *supra*.

425. *Rodman v. Grant Foundation*, 608 F.2d at 72 (not required to disclose that company's management previously had rejected idea of buying outstanding shares for employee stock purchase plan); *Goldberger v. Baker*, 442 F. Supp. 659, 664-65 (S.D.N.Y. 1977).

426. *Voegel v. Magnavox Co.*, 439 F. Supp. 935, 941-42 (D. Del. 1977) (opinion of a properly qualified outside counsel, asserting that corporation had power under Delaware Law to consummate merger, even if wrong is not actionable).

427. *Bridgen v. Scott*, 456 F.Supp. 1048, 1064 (S.D. Tex. 1978) (context of a private offering).

428. *Maldonado v. Flynn*, 597 F.2d 789 (2d Cir. 1979). The court cites as authority *Cohen v. Ayers*, 449 F. Supp. 298 (N.D. Ill. 1978); *Berkman v. Rust Craft Greeting Cards, Inc.*, 454 F. Supp. 787 (S.D.N.Y. 1978); *SEC v. Kalvex, Inc.*, 425 F. Supp. 310 (S.D.N.Y. 1975); *Rafal v. Geneen*, [1972-73 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 93,505 (E.D. Pa. 1972); *Robinson v. Penn Cent. Co.*, 336 F. Supp. 655 (E.D. Pa. 1971).

429. 597 F.2d at 796 (quoting *Cohen v. Ayers*, 449 F. Supp. at 298, 317 (N.D. Ill. 1978)).

430. 432 F. Supp. 1298 (E.D. Pa. 1977).

431. For a contrary interpretation see *Valente v. PepsiCo, Inc.*, 454 F. Supp. at 1240 n.19. "In light of the spirit of the federal securities laws, the words 'necessary in order to make the statements made . . . not misleading' should be read broadly, in order to assure that investors will not be deprived of essential information." *Id.* See *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 151 (1972); *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6 (1971); *SEC v. Capital Gains Bureau*, 375 U.S. 180 (1963). "Even when all the information specifically required

cussion, the court said there is no obligation to disclose what is not specifically required by the proxy rules.

But, if Schedule 14A, promulgated by the SEC, does not require the revelation of such information, failure to provide it cannot be regarded as a violation of the Act. There is no contention that defendants failed to comply with that schedule. If such information is not required, material as it may seem, it could be that fiduciary standards and alleged violations thereof are issues more properly litigated in the state courts. Defendants argue that "Not only were the proxy rules not designed to establish fiduciary standards, but they were also not designed to provide a federal forum to litigate difficult state law questions."⁴³²

Maldonado represents the better view, particularly in the 10b-5 context. Regardless whether the proxy or tender offer rules require particular disclosures, once the decision is made to disclose, all facts material to describing the conflict of interest should be disclosed.

D. Should Any Information Be Disclosed?

Is the corporate planner well-advised to disclose nothing? It is arguable that absent causation, there is no cause of action under 10b-5 even if there is an affirmative duty to disclose.⁴³³ Causation or materiality (depending upon the approach used by the court) cannot be demonstrated unless the plaintiff can prove that if the information had been properly disclosed, he could have obtained an injunction under state law with "actual success" or a "reasonable probability" of success. The availability of an injunction has usually de-

by SEC rules and regulations is disclosed accurately in a tender offer, a document as a whole may be misleading in its effect. There is no requirement under 10b-5 that there be a one-to-one correspondence between an alleged omission and a particular affirmative statement in a document." 454 F. Supp. at 1240-41 n.19. See *Evmar Oil Corp. v. Getty Oil Co.*, [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,358, at 93,228 n.3 (C.D. Cal. 1978). "Furthermore, a facially accurate statement may suggest certain conclusions, which suggestion would be misleading without further disclosures. See, e.g., *Lyman v. Standard Brands Inc.*, 364 F. Supp. 794 (E.D. Pa. 1973). Finally, as the words of rule 10b-5 suggest, surrounding circumstances may cause certain disclosures to be necessary when they might not otherwise be required." 454 F. Supp. at 1240-41 n.19.

432. *Perelman v. Pennsylvania Real Estate Inv. Trust*, 432 F. Supp. at 1303.

433. It may be argued that under certain circumstances the corporation has no affirmative duty to disclose: (1) if the information is not material; (2) if it is not inside information; (3) if it is not available and ripe; or (4) if there is a corporate purpose served by nondisclosure. See *State Teachers Retirement Bd. v. Fluor Corp.*, [1979-80 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,340 (S.D.N.Y. 1980) (where there was no motive to deceive investors, a construction company was held not to violate rule 10b-5 when it imposed a publicity embargo required in the contract despite rumors in the marketplace and unusual market activity). Even if none of these elements would justify silence, there may be no 10b-5 liability for nondisclosure if there is no insider trading or tipping and no trading by the corporation because then there would be at least some doubt that the omission was in connection with a purchase or sale of a security. But see *SEC v. Texas Gulf Sulfur Co.*, 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969), in which there is a broad definition of "in connection with a purchase or sale" requirement if the SEC brings an action. The purchase or sale requirement may also be met if the plaintiff is a shareholder who sells or an investor who buys the corporation's stock when the information has not been disclosed. In those cases, one still might argue that a complete omission is not actionable under the language of rule 10b-5. This assumes that the corporation issues no other statements and is absolutely silent.

pended upon the fairness of the transaction. Therefore, if the directors can prove that the transaction is fair, the plaintiff cannot establish causation under rule 10b-5 because a state court would not grant an injunction for breach of fiduciary duty. However, there are few if any guidelines for determining fairness. It may be helpful if a disinterested board of directors has, with full disclosure, determined that the transaction is fair. The courts then may either defer to the board of directors' determination of fairness or to its later decision not to sue because, in its opinion, the transaction was fair.⁴³⁴ Another technique to demonstrate fairness, particularly helpful where the directors arguably are not disinterested, would be to condition approval of the transaction on the affirmative vote of a majority of the minority shareholders. In *Weinberger v. UOP, Inc.*,⁴³⁵ the complaint alleged that the majority shareholder breached the fiduciary duty of fair dealing owed the minority shareholders in a merger because the price was grossly inadequate to the minority and because the sole purpose of the merger was to benefit the majority shareholder by eliminating the minority. Not only did the minority shareholders who voted approve the plan of merger by a twelve to one margin, their approval, coupled with the shares voted by the majority shareholder, easily satisfied the condition that the plan be approved by two-thirds of all outstanding shares. The court found that while this vote did not make the merger immune from attack, it did shift the burden of proving unfairness to the complaining minority shareholders.

Although these precautions are helpful, there is never any assurance that a federal court with the clairvoyance of hindsight will find that a state court would have found the transaction to be fair. Accordingly, the planner should use the disclose-nothing approach only in those circumstances where he or she has the greatest confidence in the demonstrable fairness of the transaction.

V. CONSIDERATIONS FOR THE LITIGATOR

The attorney for a plaintiff who brings an action for a breach of fiduciary duty under rule 10b-5 may find these guidelines helpful.

1. State each allegation of deception with particularity.⁴³⁶
2. Allege that the violation occurred on an exchange, in interstate commerce, or through the mails;⁴³⁷

434. See text accompanying notes 122-70 *supra*.

435. 409 A.2d 1262 (Del. Ch. 1979). Query what this case would do to the causation question under 10b-5. The plaintiff, one assumes, would be required to prove unfairness to establish that an injunction would issue. See text accompanying notes 342-89 *supra*.

436. See *Goldberger v. Baker*, 442 F. Supp. at 664-65. See also *Helfant v. Louisiana & S. Life Ins. Co.*, 459 F. Supp. at 726: "To state a claim under Section 10(b), plaintiff must with sufficient particularity identify the misrepresentations allegedly made, the manner in which they are considered false, and the facts from which an inference of fraud by a given defendant may be drawn [citations omitted]. . . . The complaint may not rely on blanket references to acts of all named defendants, since each is entitled to be apprised of the specific circumstances surrounding the conduct for which he is charged with fraud." *Id.* There must be allegations linking controlling persons with the alleged misrepresentations or omissions. *Id.* at 727.

437. See text accompanying notes 25-27 *supra*.

3. Allege that a *security* was purchased or sold;⁴³⁸

4. Allege that the corporation (if a derivative action) or the shareholder (if a class action) was a purchaser or seller of securities;⁴³⁹

5. Allege that the defendants acted with scienter—a degree of fault greater than negligence, that is, recklessly, with knowledge or an intent to defraud.⁴⁴⁰

6. Allege that material misrepresentations or omissions were made in conjunction with the breach of fiduciary duty.⁴⁴¹

7. If a shareholders' vote is required to approve the transaction, allege that the shareholders were deceived.⁴⁴²

8. If a shareholders' vote is not required to approve the transaction, allege that all or a majority of the directors have a material, pecuniary interest in the transaction and that disclosure should have been made to the shareholders. If disclosure was made to the shareholders under these circumstances, allege that it was inadequate.⁴⁴³

9. If a majority of the directors are disinterested, allege that the directors were deceived.⁴⁴⁴

10. Allege that had the information been correctly disclosed, plaintiff "might" or "actually" or with "reasonable probability" could have succeeded in obtaining an injunction under state law. If the grounds for the injunction would be breach of fiduciary duty, allege that plaintiffs would have been successful under state law because defendants could not have met the burden of proving that the transaction was fair.⁴⁴⁵

11. If the corporation has filed a motion to dismiss the derivative action on the ground that the disinterested directors' decision not to sue should bar the action, allege that the directors did not act in good faith or were interested.⁴⁴⁶

VI. THE IMPACT OF *SANTA FE*

A. *At First Blush*

At first blush, the impact of *Santa Fe* seems to be significant. The primary goal of the Supreme Court, to reduce the number of fiduciary duty cases found actionable under rule 10b-5, appears to have been accomplished. The Second,⁴⁴⁷ Third,⁴⁴⁸ Sixth,⁴⁴⁹ and Eighth⁴⁵⁰ Circuits, expressly following the

438. See text accompanying notes 28-31 *supra*.

439. See text accompanying notes 32-55 *supra*.

440. See text accompanying notes 56-66 *supra*.

441. See text accompanying notes 75-340 *supra* (discussion of allegations of misrepresentations and omissions).

442. See text accompanying note 107 *supra*.

443. See text accompanying notes 109, 200-06 *supra*.

444. See text accompanying note 108 *supra*.

445. See text accompanying notes 342-89 *supra*.

446. See text accompanying notes 153-54 *supra*.

447. See *Rodman v. Grant Foundation*, 608 F.2d at 72, *Cole v. Schenley Indus., Inc.*, 563 F.2d

mandate of the Supreme Court in *Santa Fe*, have dismissed cases. The district courts have relegated fiduciary duty cases to the state courts with an even greater display of enthusiasm than the circuit courts.⁴⁵¹ *Santa Fe* has also had

35, 44 (2d Cir. 1977) (complaint discussed which alleged breach of fiduciary duty to minority shareholders in violation of 10b-5 but case remanded for further consideration in light of recent state court decision).

448. See *Ketchum v. Green*, 557 F.2d 1022, 1029-30 (3d Cir.), cert. denied, 434 U.S. 940 (1977), in which the Third Circuit, in affirming dismissal of a 10b-5 claim on the ground that the "in connection with" requirement was not met, stated:

Dismissal of the complaint for failure to comport with the 'in connection with' clause of § 10(b) would appear to be in order for another reason, one that is implicit in the foregoing discussion. To rule otherwise, and to reinstate the present lawsuit, might tend to promote further incursions by federal courts into areas and activities now regulated by state corporation laws. While the coverage of § 10(b) may well have been intended by Congress to overlap somewhat with that of certain state provisions, it is questionable whether the scope of the statute should be extended to all phases of corporate operations and relationships whenever they entail the incidental involvement of securities. Realistically, there are a multitude of corporate decisions and endeavors which implicate securities in some fashion.

It is apparent, in our view, that § 10(b) was not designed to preempt, in effect, a large number of state corporation provisions. Yet the plaintiffs' expansive reading of the "in connection with" clause might open the door to such a development. We are, however, unwilling to accede to the position advanced by Ketchum and Bigler, especially in the absence of a precedential or legislative mandate to do so. As noted above, the Supreme Court intimated in *Bankers Life* [Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6 (1971)] that the statute should not be construed so as to foster the federalization of corporate law. Not only is the legislative history of § 10(b) silent in this regard, but Congress repeatedly has rebuffed various proposals to preempt, in whole or part, the field of corporate regulation. Carried to its natural terminus, the plaintiffs' construction of the "connection" proviso would serve to empty it of any substantive content.

Conceivably, the plaintiff may have some compensable claim against the defendants under the Pennsylvania corporation laws. Whether they do is a matter that may not be dealt with by this Court, at least in the present case, since there is no basis for an exercise of federal diversity or other jurisdiction. Any relief that may be available to the plaintiffs is a matter to be decided in a state forum.

See also *Biesenbach v. Guenther*, 588 F.2d 400 (3d Cir. 1978), in which the court dismissed a fiduciary duty claim dressed up as a violation of 10b-5 in a two page opinion because it found that there was no deception.

449. See *Nash v. Farmers New World Life Ins. Co.*, 570 F.2d 558, 562 (6th Cir. 1978) (circuit court affirmed judgment against a minority shareholder); *Toledo Trust Co. v. Nye*, 588 F.2d 202, 209 (6th Cir. 1978) ("If we were to hold that enforcement of such options gave rise to liability under § 10(b) and Rule 10b-5, it would have far-reaching consequences beyond the intentment of the federal securities laws. Whether or not such stock options are 'fair' or wise as a policy matter is a question of state law which is beyond the power of this court to determine.") But see *Santa Fe Indus., Inc. v. Green*, 430 U.S. at 479 ("Absent a clear indication of Congressional intent, we are reluctant to federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden.")

450. *Golub v. PPD Corp.*, 576 F.2d at 764 (application of *Santa Fe* to a proxy case; upheld district court's dismissal of the original complaint and denial of plaintiff's attempt to file amended complaint). "Controversies in those areas [here corporate mismanagement or breach of fiduciary duty] have traditionally been the subject of litigation in the state courts, and federal legislation in the field of securities regulation was not designed to draw such controversies into the federal courts in the absence of diversity of citizenship and requisite amount in controversy." *Id.*

451. *In re Sunshine Mining Co. Sec. Litigation*, [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,217 (S.D.N.Y. 1979) (stockholders' claims dismissed that alleged directors violated their fiduciary duties and section 14(e) by resisting a tender offer solely for their own selfish interests); *Umbriac v. Kaiser*, 467 F. Supp. 548, 553 (D. Nev. 1979) (defendants' motion for summary judgment granted on the ground that omissions in the proxy statement were not actionable; noted concern that federal securities laws should not be interpreted to federalize state corporation

an effect on other kinds of actions brought under 10b-5. For example, the Court's concern in *Santa Fe* that state law should govern the internal affairs of corporations echoed the often-cited language of *Cort v. Ash*:

Corporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law expressly requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs

law or override state policies of corporate regulation); *Wittenberg v. Continental Real Estate Partners*, 478 F. Supp. 504, 509 (D. Mass. 1979) (10b-5 cause of action dismissed because it was not alleged that fraud was in connection with plaintiff's purchase); *Berman v. Gerber Prods. Co.*, 454 F. Supp. 1310 (W.D. Mich. 1978) (summary judgment granted to defendant directors who allegedly violated § 14 and breached fiduciary duty by seeking to enjoin a tender offer); *Bridgen v. Scott*, 456 F. Supp. 1048, 1053 (S.D. Tex. 1978) (summary judgment granted to defendant, largely because allegedly omitted facts were found to have been sufficiently disclosed to knowledgeable and sophisticated investors); *Canadian Javelin Ltd. v. Brooks*, 462 F. Supp. 190, 197 (S.D.N.Y. 1978) (10b-5 claim alleging that controlling interest was eliminated by a stock exchange dismissed in part because it was the kind of fiduciary duty claim repudiated in *Santa Fe*); *Helfant v. Louisiana & S. Life Ins. Co.*, 459 F. Supp. at 724 (E.D.N.Y. 1978) (claim dismissed that alleged misrepresentations and omissions in a proxy statement for a merger designed to freeze out minority shareholders because "plaintiff's remedies lie in the state courts," amended complaint upheld in 82 F.R.D. 53 (E.D.N.Y. 1979)); *Altman v. Knight*, 431 F. Supp. 309, 314 (S.D.N.Y. 1977) (derivative action dismissed that alleged violation of § 14 by the purchase of a subsidiary made solely to preserve directors' and officers' positions rather than for a valid purpose; the court found this was "precisely the kind of claim the Supreme Court in *Santa Fe* felt should be decided under state corporate law"); *Blackmar v. Lichtenstein*, 438 F. Supp. 803, 807 (E.D. Mo. 1977), *rev'd on other grounds*, 578 F.2d 1273 (8th Cir. 1978) (claims that 10b-5 was violated when trustees purchased stock of a corporation for the trust to increase their control of the corporation and to enhance the value of their stock in the corporation was dismissed because they "amount to no more than an alleged breach of fiduciary duties."); *Halle & Stieglitz, Filor, Bullard Inc. v. Empress Int'l*, 442 F. Supp. 217 (D. Del. 1977) (defendants' motion for summary judgment was granted in a "going-private" transaction because the action was based on substantive unfairness and impropriety of the transaction, which were deemed no longer a proper basis for a 10b-5 claim after *Santa Fe* and because there was no showing of causation. *Id.* at 222. The court concluded, "if the plaintiffs have a cause of action, it is one for breach of fiduciary duties cognizable under state law." *Id.* at 225-26.); *Lavin v. Data Sys. Analysts, Inc.*, 443 F. Supp. 104 (E.D. Pa. 1977) (defendants' motion to dismiss granted in a derivative action against officers and directors (who allegedly were also majority shareholders) for enacting an employee bonus plan that would give 40% of the pre-tax income to key personnel; failure to disclose that the program involved self-dealing, conflict of interest, and utilization of corporate funds for strictly personal benefit was found not to constitute deception within 10b-5 because all of the terms were disclosed); *Marshel v. AFW Fabric Corp.*, 441 F. Supp. 229 (S.D.N.Y. 1977) (no material misrepresentations or omissions alleged); *Perelman v. Pennsylvania Real Estate Inv. Trust*, 432 F. Supp. at 1304 (plaintiff's motion for partial summary judgment denied; court cited *Santa Fe* for position that "Congress by § 10(b) did not seek to regulate transactions which constitute no more than internal corporate mismanagement."); *Swift v. AFW Fabric Corp.*, 441 F. Supp. 300 (S.D.N.Y. 1977) (no material misrepresentations or omissions alleged); *Tyco Laboratories, Inc. v. Kimball*, 444 F. Supp. 292 (E.D. Pa. 1977) (directors' interest in maintaining their own control over corporation was held not to create a conflict of interest so that disclosure to the directors was tantamount to disclosure to the corporation and the corporation was therefore not deceived for purposes of 10b-5. This conclusion was justified by *Santa Fe*:

The Supreme Court in Part IV of the *Green* opinion indicated its disapproval of the federal courts assuming jurisdiction in securities cases based on breaches of fiduciary duties when there were ample state law remedies available. In cases where the directors, allegedly in violation of their fiduciary duties, have authorized securities transactions it can always be claimed that the directors did so to maintain their control over the corporation and failed to disclose the same thereby making a material nondisclosure of information. If such allegation stated a securities claim it would permit the federal courts to resolve those fiduciary duty cases which the Supreme Court has instructed should be left to the state courts.

Id. at 298).

of the corporation.⁴⁵²

This policy of *Santa Fe* has been partially responsible for the reluctance of courts to imply private rights of actions under the securities laws.⁴⁵³

Another example of the impact of *Santa Fe* is the Seventh Circuit's decision in *O'Brien v. Continental Illinois National Bank & Trust*,⁴⁵⁴ in which a complaint was found not to state a claim under rule 10b-5, largely because of the policy considerations enunciated in *Santa Fe*. Trustees of a pension plan had sued a bank and trust company, which had discretionary power to invest on behalf of the pension plan, for (1) purchasing securities of companies of which it was a substantial creditor without disclosing the conflict of interest arising from its role as creditor; (2) failing to disclose adverse inside information about the investment quality of the securities purchased; and (3) in some instances, delaying the sale of a company's stock to protect itself as a creditor of the company. Plaintiffs urged that had this information been disclosed, they would have exercised their right to terminate the trust.⁴⁵⁵ The court stated that plaintiffs had no claim under 10b-5 because of the court's reluctance "to superimpose federal fiduciary standards that 'would overlap and quite possibly interfere with state corporate laws.'"⁴⁵⁶ Emphasizing that the *Santa Fe* decision militates against the extension of 10b-5,⁴⁵⁷ the court stated:

It is worth noting that our holding is not out of step with the other recent decisions of the Supreme Court in this field of the law in addition to the *Santa Fe* and *Blue Chip* cases. Beginning in 1975 the Supreme Court had exercised its certiorari jurisdiction in eight private federal securities laws cases, and each time it has limited the federal remedy or its exercise. A commentator noting this development in 1977 said, "There can be little doubt about the intensity of the Court's concern over the expansion of securities liability and its determination to curb."⁴⁵⁸

The policy considerations of *Santa Fe* were also central to the grant of summary judgment by the Southern District of New York in *Reliance Insurance Company v. Barron's*.⁴⁵⁹ Barron's was charged with libel and a violation of 10b-5 for a report it published about certain securities being offered for sale by Reliance Insurance Company. The report stated, among other things, that the sale of the securities in the imminent public offering would serve the interests of the majority shareholders, not the company, and also implied that the majority shareholders were using "creative accounting" concepts and were en-

452. 422 U.S. 66, 84 (1975).

453. See, e.g., *Crane Co. v. American Standard, Inc.*, 603 F.2d 244 (2d Cir. 1979) (no implied right of action under § 10 of Exchange Act for defeated tender offeror; case is not within ambit of express civil remedy under § 9).

454. 593 F.2d 54 (7th Cir. 1979).

455. *Id.* at 57.

456. *Id.* at 59 (citing *Santa Fe*, 430 U.S. at 479).

457. *Id.* at 61.

458. *Id.* at 62 (citing 4 A. BROMBERG, SECURITIES LAW, FRAUD SEC RULE 10B-5 § 384.2 (1977)).

459. 442 F. Supp. 1341 (S.D.N.Y. 1977).

gaging in improprieties, using bad judgment, and breaching their fiduciary duties. In entering summary judgment for defendants because the requisite scienter had not been shown, the court stated:

In addition, the Court concludes that the allegation of a violation of Rule 10b-5 is being pleaded here as a method of circumventing the higher evidentiary threshold developed by the Supreme Court to limit state actions for libel. This is a misuse of the securities laws. Plaintiff's case, if it has one, is a libel action pure and simple. The securities laws, and particularly Rule 10b-5, were not developed with the intention of overlapping or reinforcing the law of libel, nor to inhibit the exercise of freedom of the press.

As we have seen recently, the heyday of the unfettered extension of the federal securities laws to recompense all those damaged has ended.⁴⁶⁰

Using a theme reminiscent of *Santa Fe* the Eighth Circuit, in *Abbey v. Control Data Corp.*,⁴⁶¹ affirmed the district court's dismissal of a derivative action on the basis that the court should defer to the determination by a special litigation committee not to pursue the litigation. The court, in deciding whether application of the business judgment rule would interfere with the policies of the federal securities laws embodied in section 13, insisted that not all instances of corporate fraud or mismanagement should fall within the protection of the federal securities laws:

We have carefully considered Abbey's § 13(a) claim and agree with the district court that it is at best weak. Illegal foreign payments cases clearly involve state law questions of breach of fiduciary duties. They should not be dealt with under the general disclosure provisions of the federal securities laws where it is apparent, as here, that the nondisclosure of such payments had little, if any, impact on the plaintiff's dealings with the corporation's stock.⁴⁶²

These cases suggest that *Santa Fe* has had an impact not only in traditional fiduciary duty cases, but also in other related areas of 10b-5 litigation.

B. A Closer Look

A more careful look, however, suggests that in some cases *Santa Fe* has been followed in name but not in substance. The first court to evade the *Santa Fe* directive—that traditional fiduciary duty claims be left to the states—was the Second Circuit in *Goldberg v. Meridor*.⁴⁶³ The complaint as initially filed alleged that a contract between a parent and subsidiary was grossly unfair to the subsidiary and violated both federal and state law.⁴⁶⁴ The district court ruled that since the complaint contained alleged violations of state law, the

460. *Id.* at 1353 (citing *Santa Fe*, 430 U.S. at 462; *Ernst & Ernst v. Hochfelder*, 425 U.S. at 185; *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. at 723).

461. 603 F.2d 724 (8th Cir. 1979), *cert. denied*, 100 S.Ct. 670 (1980).

462. *Id.* at 731.

463. 567 F.2d 209 (2d Cir. 1977), *cert. denied*, 434 U.S. 1069 (1978).

464. *Id.* at 211.

shareholder must post a bond for expenses. The shareholder then amended the complaint to remove all references to state law claims and based his action strictly on violations of section 10(b) and rule 10b-5. The essence of the amended complaint was that the deal was unfair because the consideration received by the subsidiary for its stock was inadequate. This allegation was not sufficient to state a claim after *Santa Fe* because it did not allege deception. The district court, in denying plaintiff leave to amend the complaint a third time to include examples of alleged deception, sounded much like the Supreme Court in *Santa Fe*:

There have already been two complaints. . . . Both are prime examples of an attempt to fit the square peg of a state law claim into the round hole of a 10b-5 allegation. When the original complaint was dismissed for failure to post security or obtain the requisite support from other minority shareholders, Goldberg was made exquisitely aware of the need to limit this amended pleading to a federal claim, unless he could post security under state law, which he could not. Although he now contends that he could allege that [he] was deceived by the defendants with regard to the terms of the transaction with Maritimcor, he chose to frame the amended complaint in such a way as to exclude this element altogether. There is a limit to the time and energy that a federal court should accord to marginal federal causes of action which are fully capable of being vindicated in state court. Presumably, if the element of deceit formed any significant aspect of Goldberg's claim, or was responsible for the alleged injury to UGO, Goldberg could have been expected to have plead such facts before the third go-round.⁴⁶⁵

The Second Circuit viewed the complaint as a second attempt to amend rather than a "third go-round," because at the time of the second amended complaint, the plaintiff did not realize that there was anything wrong with his federal claim and was filing the amendment simply to drop references to state law to avoid posting a bond. The court then found that the examples of deception that would have been included had the complaint been amended were sufficient to give rise to an action under 10b-5 as defined in *Santa Fe*. The press release (the only disclosure made to the minority shareholder in this transaction since shareholder approval was not required) was alleged to have omitted two material facts: (1) that the parent had current liabilities of 42.5 million dollars in addition to 7 million dollars owed to the subsidiary, which was apparently being forgiven in the transaction, compared to an equity of 40.4 million, which included 2.8 million shares of the subsidiary and (2) the conflict of interest of the principals. The Second Circuit, without discussing these omissions specifically, held that the press release was misleading under 10b-5 because it "held out an inviting picture . . . when allegedly the truth was that the subsidiary had entered into a transaction that would ensure its doom."⁴⁶⁶ The court concluded that its decision in *Schoenbaum* was applica-

465. *Id.* at 213.

466. *Id.* at 214. One of the affidavits submitted suggested that prior to the transaction the

ble and, surprisingly, that *Schoenbaum* had not been overruled by *Santa Fe Industries v. Green*.⁴⁶⁷ In defending its holding, the court first argued, relying on numerous authorities, that the corporation is deceived even if the majority or all of the directors have knowledge of all the facts of the transaction. Second, the court took the position that *Santa Fe* eliminated only those claims for breach of fiduciary duty in which no deceptions, misrepresentations, or non-disclosures are alleged or proven.⁴⁶⁸ The court stated that "[t]he nub of the matter is that the conduct attacked in *Green* did not violate the 'fundamental purpose of the Act as implementing a philosophy of full disclosure' . . . the conduct here attacked does."⁴⁶⁹ Third, the court distinguished *Santa Fe* on the ground that in *Goldberg* the omissions were material because, had there been disclosure, the minority shareholders, unlike those in *Santa Fe*, could have challenged the transaction through seeking injunctive relief in a state court. After a painstaking examination of New York law, the court found that under existing case law and a newly passed statute "New York [would] have displayed no hesitancy in granting injunctive relief" based on the facts alleged in the complaint.⁴⁷⁰

Finally, the Second Circuit was not persuaded by the policy arguments made in *Santa Fe*, particularly the Court's concern that actions traditionally relegated to state law should be left in state court and not given a federal forum:

We readily agree that if all that was here alleged was that UGO had been injured by "internal corporate mismanagement," no federal claim would have been stated. But a parent's looting of a subsidiary with securities outstanding in the hands of the public in a securities transaction is a different matter; in such cases disclosure or at least the absence of misleading disclosure is required. It would be incongruous if Rule 10b-5 created liability for a casual "tip" in the bar of a country club, as we held in *SEC v. Geon Industries, Inc.*, 531 F.2d 39 (2d Cir. 1976), but would not cover a parent's undisclosed or misleadingly disclosed sale of its overvalued assets for a stock of a controlled subsidiary with securities in the hands of the public.⁴⁷¹

subsidiary had current assets of 41 million dollars and current liabilities of 2 million dollars. However, after the transfer of the parent's liabilities to the subsidiary as a result of the transaction, the subsidiary had a deficit of 3.6 million dollars in current liabilities, which caused it to default in its obligations and resulted in its ships, which were its primary assets, being seized by creditors. *Id.* at 212.

467. *Id.* at 217-18.

468. *Id.* at 218.

469. *Id.* (citing *Santa Fe*, 430 U.S. at 478).

470. *Id.* at 219. The court also found that the directors would have acted differently had the information been disclosed. Citing *TSC Indus. Inc. v. Northway, Inc.*, 426 U.S. 438 (1976), the court claimed that the correct inquiry was whether the facts not disclosed or misleadingly disclosed would have assumed actual significance in the deliberation of reasonable and disinterested directors or created a substantial likelihood that such directors would have considered the total mix of information available to have been significantly altered. Under this test a reasonable director of the subsidiary in this case, having knowledge of the facts alleged by the plaintiff rather than the "bare bones" of the press release, would not have voted for the transaction. 567 F.2d at 218-19.

471. 567 F.2d at 221.

In applying the law to the facts of the case, the court found (1) that the corporate persona was the shareholders since all of the directors were interested and (2) that the shareholders were deceived because the press release, the only disclosure made to the shareholders, was unduly optimistic and contained at least two misrepresentations. The court did not examine the misrepresentations to see if they were misleading but instead focused upon whether they were material.⁴⁷² *Goldberg* illustrates not only a court's ability to find the necessary "deception" in what is essentially a breach of fiduciary duty case but also its extraordinary patience in permitting amended complaints. *Goldberg* ignored the mandate of the Supreme Court in *Santa Fe* and led some commentators to suggest that it had resurrected fiduciary duty claims under rule 10b-5.⁴⁷³

The Second Circuit was not the only court to find it difficult to follow *Santa Fe*. The Seventh Circuit in *Wright v. Heizer Corp.*⁴⁷⁴ held that a fiduciary duty claim was actionable under 10b-5 and awarded the relief that would have been available in a state court. One year after *Wright* the Fifth Circuit, in *SEC v. Blatt*,⁴⁷⁵ found that a lawyer's failure to disclose his beneficial interest in a shareholder of the corporation that dissented to its proposed merger was a material omission. The lawyer, in the court's view, had a duty to disclose his interest to the corporation because the corporation had a duty to disclose that interest to its minority shareholders. The court distinguished *Santa Fe* on the ground that in *Blatt* useful information was withheld from the investors.⁴⁷⁶ In 1979, relying on the *Goldberg* and *Wright* cases, the Ninth Circuit, in *Kidwell v. Meikle*,⁴⁷⁷ permitted a fiduciary claim on behalf of members of a nonprofit corporation. The court found that the 10b-5 claim was actionable because of, rather than in spite of, the presence of a remedy at state law. The court concluded that to prove the causation necessary for a 10b-5 claim, the plaintiff must show that he would have succeeded in getting permanent injunctive relief, or damages in excess of an appraisal remedy, in a state law action. In deciding whether the plaintiff had met that obligation, the federal trial judge was admonished to "decide any legal issues that would have arisen in the hypothetical state suit as a matter of law in the Rule 10b-5 suit."⁴⁷⁸ The court said:

472. Only in a footnote does the court consider whether the alleged "conflict of interest" was 10b-5 deception. *Id.* at 218 n.8. The court noted that both press releases did state that Maritimcor was UGO's "parent" and that the first release said that on consummation of the transaction Maritimcor's ownership of UGO common stock would increase from 78% to 90% and that approximately 800,000 additional shares would continue to be held by a subsidiary of Pan-maritime Ltd. S.A., a Panama corporation, which controlled Maritime Fruit, and the public, respectively. The court made no comment on these facts and did not decide whether the conflict of interest was adequately disclosed. *Id.* at 212 n.2.

473. See, e.g., Note, *Goldberg v. Meridor: The Second Circuit's Resurrection of Rule 10b-5 Liability for Breaches of Corporate Fiduciary Duties to Minority Shareholders*, 64 VA. L. REV. 765 (1978).

474. 560 F.2d at 236. See text accompanying notes 75-105 *supra*.

475. 583 F.2d 1325 (5th Cir. 1978).

476. *Id.* at 1331.

477. 597 F.2d at 1273. See text accompanying notes 200-04, 311-14, 346-53 & 364 *supra*.

478. 597 F.2d at 1294.

While clearly limiting the applicability of Rule 10b-5, *Santa Fe Industries* has not meant that every breach of fiduciary duty is necessarily immune from invocation of the rule. Indeed, two courts of appeals have held that even where shareholder approval is not required for a corporate act under state law, failure by directors and others to disclose conflicts of interest or unfairness to shareholders regarding the transaction constitutes a violation of the rule. . . .

Thus, contrary to the arguments of the defendants in this case, there is room for 10b-5 liability after *Santa Fe Industries* even when the only deceived parties are shareholders who are not entitled to vote on the transaction in question, and even though there may be a breach of fiduciary duty under state law. Indeed, under the *Goldberg* rationale, it is precisely because there are state-law remedies for the shareholders that a deception can be found. Inadequate disclosures lull into security those shareholders who might bring derivation actions under state law to enjoin the securities transactions if all material facts were revealed.⁴⁷⁹

Most recently, the Third Circuit in *Healey v. Catalyst Recovery of Pennsylvania, Inc.*,⁴⁸⁰ reversed and remanded for further proceedings the district court's entry of judgment on a jury verdict awarding damages for a 10b-5 violation. The court emphasized that the plaintiff's right to recover under 10b-5 depended upon his having a reasonable probability of obtaining an injunction in state court if the information had been correctly disclosed. The court denied it was inconsistent with *Santa Fe* to premise 10b-5 recovery upon availability of relief in a state court:

Nor do we perceive an inconsistency between this result and Part IV of *Santa Fe*. Part IV should not be read out of context. What was objectionable in *Santa Fe* was use of rule 10b-5 by the federal courts to override traditional areas of state law "[a]bsent a clear indication of congressional intent." 430 U.S. at 479, 97 S.Ct. at 1304. Thus the problem in *Santa Fe* was not merely federal judicial intrusion into areas of state law, but rather federal judicial invasion of areas of state law without explicit federal statutory authority.

Here, by contrast, the plaintiff alleges that the defendants engaged in conduct expressly forbidden by the statute and the rule: an omission of certain information claimed to be material. That the harm to the plaintiff from the omission was deprivation of a state remedy in no sense diminishes the federal interest in preventing the

479. *Id.* at 1291-92. In a related case, *Zweig v. Hearst Corp.*, 594 F.2d 1261 (9th Cir. 1979), the Ninth Circuit found a 10b-5 cause of action when there was no state cause of action. In *Zweig* a financial columnist published a column "puffing" the stock of ASI but did not disclose to his readers that he bought ASI stock at a discount and intended to sell some of it at the increased price that would result from his puffing. Plaintiffs alleged that they were damaged when they merged their company with ASI in exchange for a quantity of the temporarily inflated ASI stock. The court found that 10b-5 required a financial columnist, in recommending a security that he or she owns, to provide the public with all material information he or she has on that security, including his or her ownership, and any intent he or she may have (a) to score a quick profit on the recommendation, or (b) to allow or encourage the recommendation to be published as an advertisement in his or her own periodical. *Id.* at 1271.

480. 616 F.2d 641 (3d Cir. 1980). See text accompanying notes 365-69 *supra*.

omission and thereby ensuring full disclosure of all material information in securities transactions. Indeed, deprivation of state rights and remedies often forms the basis for federal claims. *See, e.g.*, Hart & Wechsler's *The Federal Courts and the Federal System* 500-06 (2d Ed. 1973).

Moreover, the federal courts have a duty under the supremacy clause of the Constitution to ensure that federal interests are vindicated. The Supreme Court has permitted use of the securities laws in the merger context where there has been misinformation that violates a specific federal provision. . . . Thus we do not feel that *Santa Fe* can be read to force us to stay our hand from remedying the harm that flows from the very type of conduct to which specific federal statutory and regulatory provisions are addressed.⁴⁸¹

The circuit courts not only are finding that fiduciary claims can be brought under 10b-5, they are doing it precisely *because* there is a remedy at state law. This analysis disregards the policy considerations taken into account by the Supreme Court in reaching its decision in *Santa Fe*.⁴⁸² First, the Court said that the purpose of the federal securities laws is to require full disclosure, and that the fairness of the transaction is at best a subsidiary purpose. Yet the Second, Third, Seventh, and Ninth Circuits⁴⁸³ require a federal court, in determining causation of materiality in a fiduciary duty case, to focus on the fairness of the transaction and decide whether a transaction would be found to be fair by a state court. Second, the Supreme Court in *Santa Fe* was concerned about the danger of vexatious litigation caused by permitting fiduciary claims in federal courts. Not only are the circuit courts, in their interpretations of *Santa Fe*, continuing to overburden the federal courts with state claims, they are prolonging the litigation by making state questions of fairness part of the federal inquiry. Finally, the *Santa Fe* Court emphasized that since corporations are creatures of state law, state law—presumably as interpreted by state courts—should govern the internal affairs of the corpora-

481. *Id.* at 646-47.

The district courts have been less willing than the circuit courts to distinguish *Santa Fe*. *See* text accompanying note 450 *supra*. *But see* *Valente v. PepsiCo, Inc.*, 454 F. Supp. 1228, 1253-54 (D. Del. 1978) (upheld 10b-5 claim despite argument that plaintiffs were attempting to bootstrap a claim of unfairness by framing it as a claim of nondisclosure in tender offer materials of terms of the transaction when the tender was followed by short-form merger cashing out minority shareholders); *Houlihan v. Anderson-Stokes, Inc.*, 434 F. Supp. 1330, 1336 n.4 (D.D.C. 1977) (*Santa Fe* distinguished because of allegations of widespread deceptive practices); *Jacobs v. Hanson*, 464 F. Supp. 777, 779-80 (D. Del. 1979) (The court denied defendants' motion to dismiss complaint in which a trustee, in the dissolution of a corporation, and minority shareholders sued principal officers, directors, and majority shareholders on the ground that they caused the corporation's assets to be sold, pursuant to plan of liquidation, on terms unfavorable to the corporation's minority shareholders but which included lucrative consulting and noncompetition covenants for the defendants. The court, without discussing the allegations of the complaint, found that the transcript of the shareholders' meeting and plaintiffs' affidavits provided a basis for an inference sufficient to give rise to a material dispute of fact as to whether the defendants had made misrepresentations).

482. *See* text accompanying notes 6-22 *supra*.

483. *Healey v. Catalyst Recovery of Pa., Inc.*, 616 F.2d 641 (3d Cir. 1980); *Kidwell v. Meikle*, 597 F.2d 1273 (9th Cir. 1979); *Goldberg v. Meridor*, 567 F.2d 209 (2d Cir. 1977), *cert. denied*, 434 U.S. 1069 (1978); *Wright v. Heizer Corp.*, 560 F.2d 236 (7th Cir. 1977), *cert. denied*, 434 U.S. 1066 (1978). *See* text accompanying notes 343-369 *supra*.

tion absent express federal preemption. However, as a result of the holdings of the *Santa Fe* progeny, federal courts have jurisdiction over a fiduciary claim under 10b-5 *only* if a similar claim can successfully be brought in state court. If the state court will not provide redress, neither can the federal court. For example, in *Wright v. Heizer Corp.*, the Second Circuit gave the plaintiffs relief *only* because it decided that the transaction was unfair and therefore would be found to constitute a breach of fiduciary duty under Delaware law. The *Wright* court, in granting the same kind of relief that would have been available in a state court, stated:

As is apparent from our approval of the unraveling of the fourth and fifth transactions, we do not view *Green* as requiring the federal court merely to declare the breach of the duty to disclose and send the plaintiff to the state court to remedy the unfairness. The preventive prospective relief should not be narrower in scope than the relief that could be obtained in a new federal action to remedy the future wrong.⁴⁸⁴

Dictum in other related opinions suggests the curiosity, if not the folly, of having federal relief dependent upon the availability of a state remedy. In *IIT v. Cornfeld*⁴⁸⁵ liquidators of a foreign corporation had sued the foreign directors for violating 10b-5 by investing the corporation's monies in securities of certain United States corporations for their own profit (kickbacks, increase in their management fees, and various tax avoidance schemes). Concerned that the *Goldberg* definition of materiality would require a determination that plaintiffs would have been able to enjoin the transaction under Luxembourg law, the court observed:

This places the plaintiffs in a curious position in that by establishing their right to an injunction under Luxembourg law, they could prove 10b-5 materiality; simultaneously, however, they would be offering a good reason not to apply 10b-5 to the transactions, since the availability of relief under foreign law would then be at least partially evident.⁴⁸⁶

Equal reluctance to interpret state law was expressed by the District Court of Delaware in *Voegel v. Magnavox Co.*⁴⁸⁷ The proxy statement in issue asserted that under Delaware law a corporation had the power to consummate a merger. Because the statement was based upon the opinion of properly qualified outside counsel, the court held it was not materially misleading under rule 10b-5 even if the opinion was wrong. The court explained its reluctance to consider the validity of the opinion letter:

The parties dispute whether the assertions in the Proxy Statement are in fact true or false. That issue cannot be resolved without this Court determining questions of Delaware law involving the legality of corporate transactions and affairs that have long been regulated by state

484. *Wright v. Heizer Corp.*, 560 F.2d at 255.

485. 462 F. Supp. 209 (S.D.N.Y. 1978), *modified on other grounds*, 619 F.2d 909 (2d Cir. 1980).

486. *Id.* at 224.

487. 439 F. Supp. 935 (D. Del. 1977).

corporation law and dealt with by the state courts. This Court cannot undertake to decide them in connection with a Rule 10b-5 claim without disregarding the restrictive philosophy expressed in Part IV of the *Santa Fe* decision.⁴⁸⁸

C. *The Impossibility of Avoiding State Law*

1. A Federal Forum Through Pendent and Diversity Jurisdiction

Even courts that dismiss complaints because they do not state a cause of action under 10b-5 often must hear the case because of diversity jurisdiction.⁴⁸⁹ If there is no diversity and the plaintiff's federal claims under 10b-5 are dismissed, some courts have held that state claims for breach of fiduciary duty should also be dismissed.⁴⁹⁰ However, federal courts do have jurisdiction to hear state law claims under pendent jurisdiction, even if the federal claim is dismissed before trial, provided that the federal claim is not insubstantial.⁴⁹¹ For example, the Southern District of New York decided to exercise pendent jurisdiction in *Superintendent of Insurance of New York v. Freedman*.⁴⁹² The 10b-5 claim was dismissed because plaintiff did not meet the *Birnbaum* requirement and did not demonstrate the requisite deception. Defendants had allegedly transferred money from a wholly-owned subsidiary to the parent company and had attempted to cover the transfer by representing that the subsidiary was purchasing stock in the parent. In fact, the purchase did not occur and apparently was not intended to occur. After dismissing the 10b-5 claim on the authority of *Santa Fe* and stating that 10b-5 "should not be applied automatically to every allegedly fraudulent transaction arguably involving securi-

488. *Id.* at 942.

489. If the plaintiff is a resident of a different state and has a claim of \$10,000 or more, the federal courts will hear the case on the basis of diversity of citizenship. *See, e.g.*, Consolidated Amusement Co. v. Rugoff, [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,584 (S.D.N.Y. 1978).

490. *Umbriac v. Kaiser*, 467 F. Supp. 548, 556 (D. Nev. 1979) (court particularly reluctant to exercise pendent jurisdiction since the claim was based upon "uncharted and unprecedented problems and issues under the Nevada corporation laws."); *Wittenberg, v. Continental Real Estate Partners*, 478 F. Supp. 504 (D. Mass. 1979); *Kaplan v. Bennett*, 465 F. Supp. 555 (S.D.N.Y. 1979); *Helfant v. Louisiana & S. Life Ins. Co.*, 459 F. Supp. 720 (E.D.N.Y. 1978); *Lavin v. Data Sys. Analysts, Inc.*, 443 F. Supp. 104 (E.D. Pa. 1977), *aff'd mem.*, 578 F.2d 1374 (1978).

491. *See, e.g.*, *O'Brien v. Continental Ill. Nat'l Bank & Trust*, 593 F.2d 54, 63 (7th Cir. 1979). Since pendent jurisdiction "is a doctrine of discretion, not of plaintiff's right," *UMW v. Gibbs*, 383 U.S. 715, 726 (1966), courts should decide whether to hear a claim under pendent jurisdiction only after taking into account considerations of judicial economy, convenience, and fairness. *See Valente v. PepsiCo, Inc.*, 454 F. Supp. at 1255. In addition, there should be an underlying federal claim that is substantial enough to support subject matter jurisdiction, and the state and federal claims should derive from a "common nucleus of operative facts" *Id.* (citing *UMW v. Gibbs*, 383 U.S. at 725). If state issues substantially predominate, *id.* (citing *UMW v. Gibbs*, 383 U.S. at 726-27), or if the case involves a novel and uncharted area of state law, the court may choose not to exercise pendent jurisdiction. *Valente v. PepsiCo, Inc.*, 454 F. Supp. at 1255-56. If the federal claims are dismissed early in the suit on summary judgment or a motion to dismiss, the court should exercise pendent jurisdiction only in exceptional circumstances, *Wittenberg v. Continental Real Estate Partners*, 478 F. Supp. 504 (D. Mass. 1979), because "[b]y exercising pendent jurisdiction over just such a state claim we would be permitting plaintiffs to do indirectly what they would otherwise have no standing to do directly." *Id.* at 511.

492. 443 F. Supp. 628 (S.D.N.Y. 1977), *aff'd mem.*, 594 F.2d 852 (2d Cir. 1978).

ties,"⁴⁹³ the court exercised pendent jurisdiction to hear the same case under state law. After finding the defendant liable as a co-conspirator who breached his fiduciary duty under New York law, the court, to justify its exercise of pendent jurisdiction, said:

After trial, however, with the litigation over, the Court sees no reason why in the interests of judicial economy it should not proceed to decide the pendent claims arising out of the same transaction challenged under federal law, particularly where the federal claims are neither spurious nor insubstantial.⁴⁹⁴

Ironically, the court then concluded by arguing the necessity for dismissal of the federal claim due to the *Santa Fe* mandate requiring deference to state courts:

This case displays quite well the limitations of federal securities regulation as a tool for redress of essentially state law violations. Recently, the Supreme Court has begun to exhibit a healthy skepticism of assertions that corporate mismanagement and waste should automatically come within federal proscriptions of securities fraud. . . . In trying to conform the contours of judicially implied liability under Rule 10b-5 to the purpose of the federal legislation, the Court has concluded that, in some situations, petitioners complaining of breaches of fiduciary duties should be relegated to state law remedies. This case demonstrates that such a directive is not necessarily ineffective.

Of course, this recognition that federal law is not totally inclusive does not weaken the specific proscriptions of the securities acts which mandate full and fair disclosure to securities investors. It is, however, a realization that present federal law cannot be interpreted in a principled way to usurp all of state corporation law. [citation omitted] A tortured construction of federal statutes is not a proper way to federalize the law of corporate management. Moreover, as is apparent from this case, state remedies are not necessarily inadequate to redress complaints falling outside of the scope of federal law.⁴⁹⁵

Despite the Southern District's recognition of the *Santa Fe* directive, it nonetheless interpreted state law and used it as the basis of relief through its exercise of pendent jurisdiction.

The Eighth Circuit also heard a fiduciary claim under pendent jurisdiction after dismissing it under 10b-5 in *St. Louis Union Trust Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*⁴⁹⁶ The complaint was filed by executors of the estate of a former employee, officer, and shareholder of Merrill Lynch whose stock had been purchased pursuant to a charter provision giving Merrill Lynch the right to purchase the stock upon the death of the holder. Plaintiffs alleged that the stock was purchased in furtherance of a fraudulent scheme

493. *Id.* at 636.

494. *Id.* at 637.

495. *Id.* at 639.

496. 562 F.2d 1040 (8th Cir. 1977), *cert. denied*, 435 U.S. 925 (1978).

designed by the inside group to enhance the price at which the company's stock was to be offered to the public and to maintain and preserve their control after public ownership. The court, citing *Santa Fe*, dismissed the 10b-5 claim because the requisite causation was not shown. Noting that Delaware law did not require that the corporation have a valid or justifiable corporate purpose for a stock purchase such as this, the court refused to superimpose the requirement through section 10.⁴⁹⁷ However, amid several citations that the federal courts should avoid actions traditionally relegated to state law, the court, rather than referring the plaintiffs to a state court, exercised pendent jurisdiction and found that there was no common law fraud under Missouri law and no breach of fiduciary duty under Delaware law.⁴⁹⁸

The Sixth Circuit also has considered the merits of the state law claim under pendent jurisdiction after dismissing the case under 10b-5. In *Toledo Trust Co. v. Nye*⁴⁹⁹ the court reversed a judgment entered against a corporate defendant for exercising a purchase option without disclosing that another purchaser might pay a price roughly thirty times higher than the option price. After finding that a 10b-5 cause of action was not stated because materiality was not shown, the court exercised pendent jurisdiction to dismiss plaintiff's state law claims of fraud and breach of fiduciary duty.⁵⁰⁰

Another technique used to preserve federal jurisdiction after dismissal of a 10b-5 claim is the grant of plaintiffs' motion to amend. For example, even though the Southern District of New York dismissed the complaint in *Goldberger v. Baker*⁵⁰¹ because it was "an attempt to transform what might be valid claims under state law into federal securities law claims . . . [a practice] which has recently met firm disapproval by the Supreme Court,"⁵⁰² it left the federal court door open by granting the plaintiff leave to amend.

2. The Difficulty of Drawing Exclusionary Guidelines Due to the Breadth of Section 10(b)

The good faith attempts of the federal courts to follow the *Santa Fe* mandate illustrate the impossibility of applying *Santa Fe* with any degree of certainty or predictability. First, it is difficult for any court to draw clear exclusionary guidelines for causes of action under rule 10b-5 because the con-

497. *Id.* at 1052-53.

498. *Id.* at 1054-55.

499. 588 F.2d 202 (6th Cir. 1978).

500. The court said plaintiff is in

the completely untenable position of arguing that the defendants are liable for either fraud or breach of fiduciary duty when they merely acted pursuant to a presumptively valid contractual commitment under the relevant state law. Plaintiff has cited no authority, and our research discloses none, which would support a common law claim for relief on the facts of this case.

Id. at 209. The court also observed that plaintiff ignored the conflict of laws question for both the fraud and fiduciary duty claims. *Id.* at 209 n.26.

501. 442 F. Supp. 659 (S.D.N.Y. 1977). See *Helfant v. Louisiana & S. Life Ins. Co.*, 82 F.R.D. 53 (E.D.N.Y. 1979) (court held amended complaint stated cause of action under section 10(b).) See text accompanying notes 207-11 & 275-76 *supra*.

502. 442 F. Supp. at 667-68.

cept of fraud under section 10(b) is broad and ambiguous. Second, the concepts of "fiduciary duty and fairness" are equally confusing and uncertain. Despite conscientious effort, it is challenging for even the most sophisticated court to apply consistently an inherently ambiguous concept such as fiduciary duty to a general, inclusionary rule such as 10b-5. For example, the Sixth Circuit, in *Nash v. Farmers New World Life Insurance Co.*,⁵⁰³ affirmed judgment against minority shareholders of a subsidiary who brought a class action against a parent to challenge a merger that would require the subsidiary's shareholders to either accept shares of the parent or seek appraisal. The shareholders sought relief under rule 10b-5 alleging that the exchange terms of the merger were unfair and that a proxy statement issued in connection with the merger was materially misleading. The court reviewed the record and found substantial evidence in support of the district court's finding that the exchange terms were equitable but then cited *Santa Fe* for the proposition that "an allegation of unfairness in merger terms, standing alone, does not state a claim for relief under Rule 10b-5."⁵⁰⁴ If *Santa Fe* makes fairness irrelevant to a 10b-5 cause of action, it is not immediately evident that fairness should have been central to the Sixth Circuit's opinion.⁵⁰⁵ An explanation might be that the Sixth Circuit correctly believed that fairness should be the essential element of the case despite *Santa Fe*.

Another illustration of the confusion that inevitably arises in this area is the opinion of the Western District of Michigan in *Berman v. Gerber Products Co.*⁵⁰⁶ In this strange decision, the court dismissed the action, basing its decision to some extent on *Santa Fe*. Shareholders of Gerber Products Co. (Gerber) brought an action against Gerber and its directors challenging their efforts to halt a tender offer made by Anderson, Clayton, including a suit to enjoin the offer on the ground that Anderson, Clayton violated section 14(e) by not disclosing the identities and locations of certain "sensitive payments" it had made.⁵⁰⁷ Plaintiffs claimed that the tactics used by the defendants to stop the tender offer violated section 14 and common law principles of fiduciary duty. The court found that two of plaintiffs' counts alleged nothing more than breaches of fiduciary duty and were therefore no longer actionable in federal court after *Santa Fe*. After rejecting these claims on the authority of *Santa Fe*, the court nevertheless went to great lengths to find that the board did not violate its fiduciary duty in suing to enjoin the tender offer.⁵⁰⁸ The court even

503. 570 F.2d 558 (6th Cir.), cert. denied, 439 U.S. 822 (1978).

504. *Id.* at 562 n.8.

505. Unlike the *Healey* and *Kidwell* panels, the court did not discuss fairness in relation to causation. *Id.* at 562.

506. 454 F. Supp. 1310 (W.D. Mich. 1978).

507. *Id.* at 1314-15.

508. These claims were that Gerber's litigation against Anderson, Clayton was not motivated by valid business reasons but rather by the self-serving interests of the individual board members and that the existing board was re-elected at the last annual board meeting as a result of an allegedly misleading proxy statement and therefore was able to continue its opposition to the tender offer. *Id.* at 1317. The court was heavily influenced by the fact that Anderson, Clayton violated § 14(e) by omitting material facts—the identities of the payees and locations of the sensitive payments. *Id.* at 1323.

argued that the Gerber directors had a fiduciary obligation to challenge the tender offer. "Far from violating the fiduciary duty imposed upon them, Gerber's directors were seeking protection of a statutorily established right. It has been noted, moreover, that corporate management has an affirmative duty not to refrain from bringing actions under circumstances like those present here, but to oppose offers which in its best judgment, are detrimental to the company or its stockholders."⁵⁰⁹ The court should not have inquired whether the Gerber directors violated their fiduciary duties since, as the court itself said, that is *not* the proper inquiry after *Santa Fe* (except in relation to causation). After its detour into the merits of the fiduciary duty claim, the court returned to the conventional track dictated by *Santa Fe* and examined the allegations of misrepresentation and omissions. Finding that none of the misrepresentations or omissions were material, the court entered summary judgment. This decision represents the good instincts of a court which obviously believes that the sensible focus of the decision should be fiduciary duty but which is distracted from the proper inquiry by the holding of *Santa Fe*.

Even courts that seem determined to follow *Santa Fe* and concentrate their decisions strictly on deception find doing so frustrating and difficult. Separating allegations that genuinely involve deception from those that are fiduciary duty claims faintly disguised by allegations of deception is an agonizing process. In one of the most candid, thoughtful, and revealing opinions on the subject, Judge Higginbotham, in *Hundahl v. United Benefit Life Insurance Co.*,⁵¹⁰ granted summary judgment on all but one claim in an action alleging that, through various devices, the parent company and several officers and directors had artificially depressed the price of the subsidiary's stock, which the parent corporation then sought to acquire through a tender offer. The court found that the conduct described was not manipulation in the 10b-5 sense and, after a careful examination, found only one proper allegation of deception. However, the court was concerned that "there may be a point where the facts disclosed by corporate management, though true, are so devoid of explication or other supporting data that the overall disclosure becomes deceptive, and a claim is stated under the federal securities law."⁵¹¹ The court continued with a very provocative summary:

The line between nondisclosures that amount only, at most, to mismanagement and nondisclosures so significant that they constitute deception actionable under Rule 10b-5 cannot be drawn with precision. To be sure, there is a measure of arbitrariness in drawing it, for the factors that must be considered in making the determination are not quantitatively measurable. What is clear is that the sweep of federal law has been drawn tighter by the decisions in *Santa Fe* and other recent cases. Just how tight the string has been drawn is uncer-

509. *Id.* at 1323 (quoting *Northwest Indus., Inc. v. B.F. Goodrich Co.*, 301 F. Supp. 706, 712 (N.D. Ill. 1969)).

510. 465 F. Supp. 1349 (N.D. Tex. 1979), *discussed in* text accompanying notes 230-35, 324-29 *supra*.

511. *Id.* at 1365.

tain, and, at least until the Supreme Court again addresses the question, the lower courts must attempt to fashion a useful way to approach such questions.

Whatever the boundary of the federal court's role in this area is ultimately drawn, however, this case is likely to fall either near it or directly on it. Certainly the complaint here, while it is composed essentially of acts of mismanagement, paints an overall picture that is at least very close to the type of deception contemplated by Rule 10b-5. But in these circumstances, where the language of recent Supreme Court decisions provides little specific guidance, this court is constrained to follow the tone of those decisions. From *Santa Fe* must come the notion that where as here the central thrust of a claim or series of claims arises from acts of corporate mismanagement, the claims are not cognizable under federal law. To hold otherwise would be to eviscerate the obvious purpose of the *Santa Fe* decision . . . by artful legal draftsmanship. The plaintiffs here have, with undeniable skill, woven a complex series of acts of mismanagement into a fabric that appears to reflect a scheme of corporate deception. Yet the fabric is nonetheless woven from the thread of corporate mismanagement. For that reason, this court is constrained to follow the flow of recent Supreme Court decisions in the area of securities regulation and to resolve this difficult legal question in favor of the defendants.⁵¹²

3. The Reluctance of Federal Judges to Relegate Plaintiffs to State Courts

At the heart of the reluctance of the circuit courts to leave these issues to the state courts may be a skepticism about the adequacy of state law remedies to protect investors. This skepticism was apparent in *Great Western United Corp. v. Kidwell*.⁵¹³ In *Great Western* the Fifth Circuit, in finding that the Williams Act pre-empted an Idaho takeover statute, commented on Idaho's legislative scheme for protecting investors:

Even if we accept appellant's interpretation of the legislature's purpose, it is . . . true that Idaho chose to protect investors differently from the way Congress protected investors. Instead of relying upon *investors'* decisions after full disclosure, Idaho relies upon the business judgment of corporate directors with a fiduciary duty to their shareholders. Idaho's 'fiduciary approach' to investor protection may be one way to protect shareholders, but it is an approach Congress rejected.⁵¹⁴

The court went on to point out the difficulties faced by plaintiffs seeking to recover under a scheme such as Idaho's.

In general, a state legislature may be entitled to assume that the

512. *Id.* at 1365-66.

513. 577 F.2d 1256 (5th Cir. 1978), *rev'd on other grounds, sub. nom.* Leroy v. Great W. United Corp., 443 U.S. 173 (1979) (venue improper).

514. *Id.* at 1279.

directors and officials of a target company will honor their fiduciary obligations. It would not be surprising, however, if another legislative body declined to make the same assumption. To establish a claim under state law, a shareholder usually must overcome a presumption that directors act properly and prove that they acted in self-interest. *Few plaintiffs have successfully met this burden.*⁵¹⁵

VII. THE *SANTA FE* MANDATE SHOULD NOT BE FOLLOWED: THE NEED FOR A FEDERAL STATUTORY FIDUCIARY STANDARD

The confusing and conflicting nuances of the fiduciary duty cases demonstrate the need for express federal fiduciary standards. Specific arguments based on the law of these cases may be made to support the creation of a fiduciary duty under federal law. First, the federal courts are already deciding fiduciary duty questions. To determine 10b-5 causation, the federal courts must review the fairness of the transaction. Not only is this review actually a discussion of whether the fiduciary duty has been breached, it also focuses a court's analysis on fairness,⁵¹⁶ which according to *Santa Fe* is at best a subsidiary purpose of the present federal securities laws. The federal laws should be amended to allow the courts to do directly what they are now doing indirectly. Second, the *Santa Fe* progeny, in defining causation, have made the availability of a federal remedy dependent upon the availability of injunctive relief under state law. This gives two avenues for relief to those plaintiffs who can prove that they would have been successful under state law and no remedy to those plaintiffs who cannot. Third, there can be no consistency under present law among the circuits or even within any one circuit because the circuit court, in determining causation, must look to a particular state (after solving the conflict of laws problems) to see if an injunction would be granted by that state. If State A would grant an injunction, and State B in the same circuit would not, the circuit would be obliged to reach different results *on the same facts*. The plaintiff in State A could proceed in federal court under 10b-5 because he could show causation under 10b-5; the plaintiff in State B could not. Fourth, the determination of causation requires the federal courts to become deeply involved in the formulation and interpretation of state law,⁵¹⁷ a result decried by *Santa Fe*. Under a federal standard, issues of state law could be avoided by the federal courts. Fifth, the law is *more* confusing when both federal *and* state standards are applied to the same theory. The court must apply federal

515. *Id.* at n.51 (emphasis added by *Great Western* Court).

516. See *Healey v. Catalyst Recovery of Pa., Inc.*, 616 F.2d 641, 651-61 (3d Cir. 1980) (Aldisert, J., dissenting).

517. This development of the materiality standard demonstrates the difficulty federal courts are having, and will continue to have, in expansively construing the federal securities laws while attempting to avoid conflicts with state corporate law. In each case, the federal court must immerse itself in an extensive inquiry into the existence of state remedies, the elements of the state action, the evidentiary sufficiency as perceived by the state court, and the plaintiff's perception of his case in state court. When the state law is unclear, as may often be the case, the court must speculate on each of these issues, hopelessly involving itself, and the federal securities laws, in matters of state corporate law. *Healey v. Catalyst Recovery of Pa., Inc.*, 616 F.2d at 660.

law to determine standing under *Birnbaum*, scienter, materiality, and deception. To determine causation, the court must apply inherently ambiguous state law concepts of "fraud," "fiduciary duty," and "fairness." This confusing combination of state and federal law creates an inescapable maze for the corporate planner, the litigator, and the judge. Greater clarity would result under a federal statute, interpreted exclusively by reference to federal precedent. Sixth, the federal courts' reluctance to defer to state law is based upon a genuine and well-founded skepticism regarding the adequacy of relief under state law as interpreted by state courts.⁵¹⁸ There is often little precedent under state law, and state judges may be inexperienced in handling certain corporate and securities questions. Seventh, it is a rare corporate question that does not transcend the boundaries of any one state. Corporations may be incorporated in one state, have a principal place of business in another, do business in several, and have shareholders in fifty. Questions regarding the fiduciary relationship of the corporation's directors to the entity and its shareholders are too important to be settled by state law, which may be neither well-developed nor predictable. Finally and most important, even those cases that follow *Santa Fe* in letter and spirit must now spend an inordinate amount of time and verbiage discussing real or feigned issues of deception that *should* be irrelevant.⁵¹⁹ If the case involves essentially fiduciary duty claims, the energy of the parties and courts can be spent more efficiently discussing fiduciary duty issues. As it now stands, that issue—often the real issue in the case—gets lost in elaborate and circuitous discussions of misrepresentation, omission, materiality, manipulation, and causation. This result is directly attributed to the *Santa Fe* mandate and the lack of an express cause of action for breach of fiduciary duty under federal law.

No cause of action is more central to preserving the rights of a shareholder than a suit to enforce the fiduciary duty owed to him and the corporation. It is much too important to be entangled with other issues and to depend upon the conflict of laws determination of whichever happens to be the relevant state. The progeny of *Santa Fe*, by their confusion, circuitry, and evasion, demonstrate the necessity for an express federal statute. Legislation should be passed by Congress to give federal courts subject-matter jurisdiction over the

518. State fiduciary duty laws have not effectively redressed this imbalance. These laws impose a low standard of fiduciary duty, which has been further weakened by years of near desuetude and a tradition of case law interpretation favorable to corporate management. Moreover, the shareholder's ability to institute derivative suits based on such fiduciary duty laws has been limited, in several key jurisdictions, by procedural barriers, notably a requirement to post security for costs. Although corporate controllers thus have little to fear from these state laws, self-dealing transactions are still usually concealed from shareholders. It is such failure to disclose that allows these transactions to be reached by rule 10b-5, at least in cases where the breach of fiduciary duty involves a transaction in securities.

Id. at 661 (citing Note, *Suits for Breach of Fiduciary Duty Under Rule 10b-5 After Santa Fe Industries, Inc. v. Green*, 91 HARV. L. REV. 1874, 1876-77 (1978)).

519. Federal courts are especially cautious in granting motions for dismissal, judgments on the pleadings and summary judgments in federal securities law cases because "discovery is often necessary for the shareholder to obtain the specific facts from insiders in the corporation required to fully develop its claim." *Tyco Laboratories, Inc. v. Kimball*, 444 F. Supp. at 295.

fiduciary duty of directors to the corporation and its shareholders and over derivative actions alleging breach of that duty. Then the federal courts could focus on fairness—as they should—without the artificial constraint of relating fairness to causation under 10b-5 and without the hurdle of interpreting non-existent, inexact state law.

If Congress were to pass a federal statute creating an express federal cause of action for breach of fiduciary duty, a central issue to address is whether the courts should be required to defer to the business judgment of disinterested directors who decide not to bring an action on behalf of the corporation for breach of the duty. The trend, at least in federal courts, seems to be to defer to the directors' decision not to sue, provided that they are disinterested and they act in good faith.⁵²⁰ This deference is sensible and desirable because it (1) avoids costly litigation; (2) leaves the question of fairness to persons elected by the shareholders; and (3) results in more knowledgeable decision-making because the directors presumably have an intricate knowledge of the company far superior to that of a judge.

VIII. CONCLUSION

Congress should pass a statute creating a fiduciary duty of directors and of majority shareholders to the corporation and to minority shareholders and giving the federal courts subject matter jurisdiction over breach of that duty. The statute should require the federal courts to defer to the business judgment of the company's disinterested directors who decide in good faith that the corporation should not sue. If deferral to business judgment is required, the only questions left for *any* court would be whether the directors were disinterested and acted in good faith.

This legislation would not only remove litigation from state courts, which are often ill-equipped to handle these issues, but also would limit fiduciary duty litigation in the federal courts, since the threshold questions in a derivative action would be whether the directors who decided not to sue were disinterested and whether they acted in good faith. If no significant number of the directors are deemed to be disinterested or if the directors are deemed not to act in good faith, the court, absent a vote by a majority of the minority shareholders not to bring the action, would hear the case on its merits and examine the fairness of the transaction in order to decide whether the fiduciary duty was breached. Regardless of the merits of the fiduciary duty claim, if material misrepresentations or omissions were made either to the disinterested directors or to the shareholders, an action could be still brought under 10b-5 *for deception*. Express legislation would permit fiduciary duty *and* deception actions to be heard by federal courts without the misdirected efforts of forcing the square peg of fiduciary duty into the round hole of disclosure under 10b-5.⁵²¹

520. See text accompanying notes 125-61 *supra*.

521. A more detailed description of the author's proposal for the federal legislation is beyond the scope of this article. She believes, however, that this article provides direction and guidance and plans to develop her proposal more fully in a future article.