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FRAUD WITHOUT DECEIT: MARSHEL v. AFW FABRIC CORP. AND GREEN v. SANTA FE INDUSTRIES, INC.

Barbara Ann Banoff*

The Supreme Court has characterized private litigation under rule 10b-51 as a "judicial oak which has grown from little more than an acorn." That oak, with a few quickly cut back exceptions, has been rooted in deception.3 Recently, however,

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1. Rule 10b-5, 17 C.F.R. 240.10b-5 (1976), was promulgated in 1942 by the Securities and Exchange Commission pursuant to the authority granted it by section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b) (1970). Section 10(b) outlaws the employment of "manipulative or deceptive devices or contrivances" in contravention of Commission rules. Rule 10b-5 makes it unlawful, in connection with the purchase or sale of any security,
   (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 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 operate as a fraud or deceit upon any person.

For the last 30 years, since Kardon v. National Gypsum Co., 73 F. Supp. 798 (E.D. Pa. 1947), a judicially implied private right of action has furnished the courts with an increasing number of occasions to explore the contours of the rule.


3. The exceptions have arisen in the context of derivative actions alleging that a corporation trading in securities (either its own or those of another company) has been deceived by its own directors and officers. Ordinarily, a corporation acts through its agents and "knows" what the agents know, unless, for some reason, their knowledge is not imputed. An allegation that a corporation has been defrauded by its own officers thus raises squarely the knotty, quasi-theological question of how a fictional person is deceived. One line of cases has answered that question in terms of "disclosure": a corporation is deceived if the interested corporate agents fail to disclose the material facts surrounding the transaction to disinterested members of the board of directors or, if none exists, to the shareholders. This duty to disclose arises even if neither the minority directors nor the shareholders have the voting power to stop the challenged transaction. Dasho v. Susquehanna Corp., 461 F.2d 11 (7th Cir. 1972); Ruckle v. Roto Corp., 339 F.2d 24 (2d Cir. 1964). But see O'Neill v. Maytag, 339 F.2d 764 (2d Cir. 1964) (a corporation is not deceived when the entire board knew the facts, even if all the directors were interested).

A second line of cases however, has followed a "fairness" standard established in Schoebaum v. Firstbrook, 405 F.2d 215 (2d Cir. 1968) (en banc), c ens. denied, 395 U.S. 906 (1969). Schoenbaum held that if a corporation's board of directors is controlled by another corporation or individual, and that controlling person induces an unfair securities transaction between it and the controlled corporation, a derivative claim for relief exists on behalf of the controlled corporation. This "fairness" standard was

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the Court of Appeals for the Second Circuit created a new branch which (if the metaphor will stand the strain) looks like another tree entirely.

In two decisions handed down five days apart, the Second Circuit created a new branch which (if the metaphor will stand the strain) looks like another tree entirely. In two decisions handed down five days apart, the Second Circuit followed in Shell v. Hensley, 430 F.2d 819, 827 (5th Cir. 1970). That court described the standard as functionally equivalent to deception: the purpose of disclosure is to permit unimpaired investment judgment, but a controlled corporation's investment judgment is impaired by virtue of the control. The result of unfair self-dealing is, therefore, the same as if the corporation were "deceived" by a stranger. See also Herpich v. Wallace, 430 F.2d 792 (5th Cir. 1970).


However, Schoenbaum's fairness doctrine was accompanied by an alternative holding which had been urged by the SEC, as amicus, and which was framed in disclosure terms: the controlling shareholder had deceived the minority shareholders by failing to disclose the facts of the transaction to them. This alternative holding was seized by a subsequent panel in Popkin v. Bishop, 464 F.2d 714, 719 (2d Cir. 1972) as the "conclusion" of Schoenbaum.

In Popkin, a minority shareholder brought a derivative action challenging a merger between his company and its controlling shareholder, alleging that the merger ratios were grossly unfair and amounted to a breach of fiduciary duty by the controller. The plaintiff stipulated that the proxy statement made full and fair disclosure of all material facts, but argued that rule 10b-5 affords minority shareholders protection against overreaching whether or not the facts are disclosed. The Popkin court disagreed, stating that Schoenbaum's emphasis on self-dealing had not eliminated nondisclosure as a key issue in rule 10b-5 cases, and holding that full disclosure defeated the plaintiff's claim for injunctive relief. Id. at 720. Popkin's restriction of Schoenbaum has been criticized, see Jacobs, The Role of Securities Exchange Act Rule 10b-5 in the Regulation of Corporate Management, 59 CORNELL L. REV. 27 (1973); Note, The Controlling Influence Standard in Rule 10b-5 Corporate Mismanagement Cases, 86 HARV. L. REV. 1007 (1973), and language in a subsequent opinion appeared to revive the "fairness" doctrine. See Schlick v. Penn-Dixie Cement Corp. 507 F.2d 374 (2d Cir. 1974), cert. denied, 421 U.S. 976 (1975); 63 CALIF. L. REV. 563 (1975). Nevertheless, Popkin continued to be followed in the Second Circuit. See Note 20 infra.

4. Marshall v. AFW Fabric Corp., 533 F.2d 1277 (2d Cir. 1976), and Green v. Santa Fe Indus., Inc., 533 F.2d 1283 (2d Cir. 1976). On October 12, 1976, the Supreme Court granted the petition for certiorari in Marshall, vacated the decision and remanded for consideration of mootness. Marshall v. AFW Fabric Corp., 97 S. Ct. 229 (1976). The merger enjoined in Marshall was actually called off on February 10, 1976, three days before the Second Circuit decision was handed down. The court of appeals was notified by letter of the merger's abortion, but did not consider its effect on the motion for a preliminary injunction. Because Marshall has been followed in subsequent cases, and was relied on in Green, the opinion continues to be important whether or not the question of injunctive relief has been mooted. The Supreme Court granted the Green petition for certiorari on October 4, 1976. Santa Fe Indus., Inc. v. Green, Inc., 97 S. Ct. 54 (1976).
Circuit Court of Appeals eliminated deception as a necessary ingredient in a rule 10b-5 action. The conduct assailed in both opinions was "going private"—cashing out minority public shareholders. In both cases the facts surrounding the challenged transactions were fully disclosed. Nevertheless, both panels held that deception was not necessary to a 10b-5 claim; a breach of fiduciary duty was sufficient.

As might be expected, the opinions have not passed unnoticed. Petitions for rehearing en banc were denied because the cases were of "such extraordinary importance" that the Supreme Court was certain to grant petitions for certiorari. The Sixth Circuit Court of Appeals, asked to apply the Second Circuit's opinions to an exchange-of-shares merger, stated that "these two decisions cannot be read apart from the milieu of 'going private' merger transactions," and declined to "equate a breach of fiduciary duty with fraud." Other courts, however, have either followed or felt it necessary to distinguish Green and Marshel in cases not involving "going private."* 

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6. 533 F.2d 1309, 1310 (2d Cir. 1976).


8. Bailey v. Meister Brau, Inc., 535 F.2d 982 (7th Cir. 1976) (exchange-of-shares merger unfair to corporation gives derivative 10b-5 claim against executor of controlling shareholder's estate, when executor grossly negligent in failing to recognize the unfairness of the transfer; decision also rested on duty to disclose to minority shareholder); Applied Digital Data Systems, Inc. v. Milgo Elec. Corp., [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,824 (S.D.N.Y. Jan. 3, 1977) (target management's sales of shares to friendly purchaser, solely to defeat a proposed tender offer with no proper corporate purpose, violates section 14(e)); Del Noce v. Delyard Corp., [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,670 (S.D.N.Y. July 30, 1976) (Green distinguished in exchange of shares merger because there was "no breach of the fiduciary duty to deal fairly" with shareholders); Nash v. Farmers New World Life, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,519 (S.D. Ohio March 30, 1976) (exchange-of-shares merger did not violate 10b-5 because the exchange ratio was fair and the merger was not designed to serve solely the interests of majority shareholders); St. Louis Union Trust Co. v. Merrill Lynch, Pierce, Fenner &
The phenomenon of “going private” has been amply discussed elsewhere. This article does not reargue the question whether “going private” ought to be prohibited, encouraged, or substantively regulated. Rather, it examines Green and Marshel to determine, first, whether the opinions are consistent with their own premises and, second, whether section 10(b) and rule 10b-5 can be properly interpreted to proscribe “fraud” without deceit. The article concludes that the cases have internal contradictions and that neither the statute nor the rule applies to fully-disclosed breaches of fiduciary duty.

Smith, Inc., 412 F. Supp. 45 (E.D. Mo. 1976) (exercise of option to repurchase restricted shares without disclosing plans to go public; Green cited for proposition that, even if restrictions on shares were legal, they would be invalid if exercised for a fraudulent purpose); Seigel v. Merrick, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,467 (S.D.N.Y. March 11, 1976) (corporate repurchase of shares at a premium to protect management control violates 10b-5).


Nor has the discussion been confined to the law reviews. Former SEC Commissioner Sommer has forcefully expressed his view that “going private” transactions are “serious, unfair, and sometimes disgraceful, a perversion of the whole process of public financing,” and urged imaginative application of rule 10b-5 to prevent breaches of fiduciary duty. Address by Commissioner A.A. Sommer, Jr., “Going Private”: A Lesson in Corporate Responsibility, Notre Dame Law School (Nov. 1974), reported in [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶¶ 80,010, 84,695 (1974) [hereinafter cited as Commissioner Sommer]. The Commission has announced a fact-finding investigation into “going private” and has promulgated two proposed alternative rules under section 13(e) of the Securities Exchange Act which would provide for substantive regulation of such transactions as well as disclosure. Proposed rule 13e-3A would require that the consideration offered to the minority shareholders constitute “fair value . . . as determined in good faith by the issuer or its affiliate, and shall be no lower than that . . . recommended jointly by two qualified independent persons.” Proposed rule 13e-3B would require that the issuer have a “valid business purpose” for the transaction, and that the terms be fair. SEC Securities Act Release No. 5567 (Feb. 6, 1975); SEC, Proposed Rules 13e-3A, 13e-3B reprinted in [Current Binder] Fed. Sec. L. Rep. (CCH) ¶¶ 23,704-05.

Shareholders have also had their say. Letters from aggrieved shareholders who have been unwilling participants in “going private” transactions form the bulk of the investigative file in the Commission’s factfinding investigation.
THE CASES

Marshel v. AFW Fabric Corp.

The Marshel case presents the “going private” transaction in the most unappealing form. In the bull market of 1968, Concord Fabrics, Inc., a New York corporation, made its first public offering of 300,000 shares at $15 per share. Eleven months later, Concord’s controlling shareholders, the Weinstein brothers, publicly offered 200,000 shares of their own stock at $20 per share. The Weinstiens retained ownership of 68% of Concord’s outstanding stock.

Soon after the Weinsteins’ offer, the price of the stock began to decline along with the fortunes of the company and the stock market in general. In January, 1975, with the stock trading at under $2, the controlling shareholders decided to eliminate the public shareholders and return the company to their sole ownership. They formed AFW Fabric Corporation, transferring to it their 68% of the outstanding Concord stock in return for 100% of AFW’s stock. AFW first made a tender offer for Concord’s publicly-held shares, but withdrew it when Marshel, a minority shareholder, sued. As the controlling shareholder of Concord, AFW then proceeded with its plan to merge into Concord; the public shareholders were to receive $3 a share.

Although AFW’s announced intention to vote its shares in favor of the merger guaranteed shareholder approval, it did not have enough shares to dispense with a formal meeting and vote. A proxy statement was therefore mailed to the public shareholders which stated that the purpose of the merger was to “return the company to the status of a privately-held corporation owned by the Weinstein family” so that they could “determine all policies of the Company, such as salaries for themselves and others, dividends and business activities, without public scrutiny and solely with regard to their own interests.” The proxy statement further informed Concord’s public shareholders...

11. New York’s “short-form” merger statute provides that a corporation which owns 95% of the shares of another corporation may merge the two without advance notice and without a vote of the subsidiary’s shareholders. N.Y. Bus. Corp. Law § 905 (McKinney 1963) as amended, (Supp. 1976-77). In other cases, the “long form” merger must be used which requires the approval of two-thirds of the outstanding voting stock.
12. Appeal from Order of United States District Court for the Southern District of New York, app. at 68, Marshel v. AFW Fabric Corp., 533 F.2d 1277 (2d Cir. 1976) [hereinafter cited as Marshel Appendix].
shareholders that the money to pay for their shares was to come from short-term bank loans advanced to Concord immediately following the merger.

Marshel quickly amended his complaint to challenge the merger, asserting two 10b-5 claims. The first claim was a derivative count on behalf of Concord against the Weinsteins and AFW, alleging that the merger would constitute a breach of the defendants' fiduciary duty to Concord by forcing it to spend "millions of dollars for no legitimate business purpose," thereby wasting Concord's assets "for the sole benefit of AFW and the individual defendants."14

The second claim was a "class claim" against all the defendants, including Concord, on behalf of the public shareholders.15 It alleged that the $3 per share price was "unreasonably low," enabling the defendants to "acquire for themselves an interest in over $2,000,000 of Concord's assets which rightfully belongs to the class."16

Marshel then moved for a preliminary injunction to prohibit the merger during the pendency of the litigation. The motion was denied by the trial judge.17 Seeing the essence of the plaintiffs' complaints as the "class claim" charge that defendants were defrauding them into selling their shares at an unfair price, he concluded that, under the authority of Popkin v. Bishop,18 injunctive relief is not available under the securi-

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13. Id. at 44-45.
14. Id. at 18. Although the defendants aborted the merger, the derivative claim will probably survive, both because Concord had already expended some funds and because Marshel will probably claim the merger was called off because of his efforts, entitling him to attorneys' fees for the resulting corporate benefit.
15. Although the complaint contains class allegations, no class determination pursuant to FED. R. Civ. P. 23 has been made. Nor does it appear likely that such a determination will be made, since the abortion of the merger has removed the class claimants from the category of "forced sellers." See generally text accompanying note 61 infra. Nevertheless, for convenience, this count will be referred to as the class claim.
16. Marshel Appendix, supra note 12, at 19. Two additional pendent state law claims track the language of the federal claims, adding that the $3 price is "grossly unfair."
18. Marshel was joined by three other plaintiffs. One of them, suing in diversity and alleging only violations of state law, joined in the appeal.
19. 398 F. Supp. at 737. This argument was indeed the core of the class claim, but the judge's characterization ignored the derivative claim. Although the defendants conceded, for the purpose of the motion, that there was no business purpose for the merger other than to return Concord to private ownership (Marshel Appendix, supra note 12, at 48), they too characterized the complaint as basically amounting to a claim that the plaintiffs were being frozen out at "unreasonably low prices" (id. at 51) and did not address the derivative claim.
20. 464 F.2d 714 (2d Cir. 1972), discussed in note 3 supra. Popkin had been
ties laws when there has been full disclosure, even if the merger terms are unfair. 21

Marshel appealed to the Second Circuit. His brief on appeal stressed the derivative claim, although "class claim" arguments were freely intermingled. 22 The Court of Appeals reversed. 23 The court's opinion did not focus on the difference between the class and derivative claims. Nevertheless it seems clear that the court's holding applies only to the derivative federal claim:

We hold that when controlling stockholders and directors of a publicly-held corporation cause it to expend corporate funds to force elimination of minority stockholders' equity


21. The court, having thus disposed of the merits of the plaintiff's federal claims, noted that the "damage to be suffered by plaintiffs, should the merger be consummated and ultimately adjudicated illegal, will not be irreparable, since plaintiffs have a sufficiently adequate remedy at law' in the way of monetary damages." 398 F. Supp. at 739, quoting Tanzer Economic Assoc. v. Haynie, 388 F. Supp. 365, 369 (S.D.N.Y. 1974).

The court went on to conclude that the plaintiffs' state law claims were equally without merit, because the merger was permitted by statute and under New York law appraisal was their exclusive remedy. 398 F. Supp. at 739. On appeal, plaintiffs contested the merger's legality under New York law. Their arguments were buttressed by a decision of the New York Supreme Court, in a proceeding brought by the State Attorney General under New York's Martin Act, granting a motion for a preliminary injunction of the Concord-AFW merger. People v. Concord Fabrics, Inc., 83 Misc. 2d 120, 371 N.Y.S.2d 550 (Sup. Ct.), aff'd, 377 N.Y.S.2d 84 (App. Div., 1st Dept. 1975).

This article does not explore further the question whether the merger is legal under New York law, since that question is irrelevant to a determination of the federal claims. See text accompanying note 78 infra.

22. Brief for Plaintiff, Marshel v. AFW Fabric Corp., 533 F.2d 1277 (2d Cir. 1976) [hereinafter cited as Marshel Plaintiff's Brief]. While much was made of the difference between the book value of the stock and the $3 merger price, a "class claim" argument (id. at 8, 18), the plaintiffs stated at another point:

This case . . . does not require an analysis of the fairness of merger terms.
We are not here arguing that it is the obvious inadequacy of the $3 per share price which invalidates the transaction. We are arguing, however, that without a business purpose, the merger and the resolutions with respect thereto are void as a matter of law whatever the price offered may be.

Id. at 32-33 (emphasis in the original).

23. 533 F.2d at 1282.
participation for reasons not benefiting the corporation but rather serving only the interests of the controlling stockholders such conduct will be enjoined pursuant to Section 10(b) and Rule 10b-5 which prohibits "any act, practice, or course of business which operates or would operate as a fraud . . . in connection with the purchase or sale of any security." 24

The fairness or unfairness of the $3 merger price to the minority shareholders was nowhere mentioned.

In short, the court held that a corporation has a claim for relief under rule 10b-5 when its controlling shareholders cause it to purchase securities for no business purpose, even though the transaction was fully disclosed to all interested parties, including the minority shareholders:

Under these circumstances it would surely be anomalous to hold that a cause of action is stated under §10(b) and Rule 10b-5 when the fraudulent conduct in connection with a purchase or sale of securities includes deception but that similarly fraudulent practices carried out with prior disclosure to the helpless victim do not give rise to a Rule 10b-5 claim. Neither the statutory language nor the broadly remedial purposes of the Act . . . allow such a distinction. 25

24. Id. at 1281. The Court also described the merger as a "fraudulent scheme" because "it represents an attempt by the majority stockholder to utilize corporate funds for strictly personal benefit" (id. at 1282), and "a scheme by the appellants . . . to appropriate for their personal benefit the entire stock ownership of Concord at a price determined by them and paid out of the corporate treasury at a cost of over $1,600,000." Id. at 1280. In support of its holding, the court cited Schoenbaum v. Firstbrook, 405 F.2d 215 (2d Cir. 1968) (en banc) and Drachman v. Harvey, 453 F.2d 736 (2d Cir. 1976) (en banc), both derivative cases, and stressed their application to "fraud against the corporation." Id. at 1281.

25. 533 F.2d at 1282. In reaching its conclusion, the court had to distinguish or overrule Popkin, which held that if the terms of an "unfair" merger were fully disclosed, no derivative action would lie. See note 3 supra. The court chose to distinguish Popkin on the ground that the plaintiff in that case had merely challenged the fairness of the merger, rather than the merger itself.

The distinction is dubious, to say the least. In both cases, the controlling shareholders were charged with a breach of fiduciary duty to the controlled corporation. In both cases, this breach allegedly resulted in damage to the corporation. In Popkin, the damage was in the unfair merger terms; in Marshel, the damage was supposedly the use of corporate funds. Nor does the lack of business purpose alleged in Marshel make a crucial difference, since the business purpose in Popkin—an earlier state court settlement requiring the merger—was attacked by the plaintiff as a sham.

Judge Hays, the author of the Marshel decision, also wrote the en banc opinion in Schoenbaum, whose fairness doctrine was limited by Popkin to cases of nondisclosure. Judge Smith, who was on the Popkin panel, concurred in the Marshel result, although he found it "difficult" to reconcile the 10(b) basis of the holding with the
Putting aside for the moment the question whether a holding that prior disclosure to a "helpless victim" forecloses a 10b-5 claim is really an anomaly, it is worthwhile to examine the decision on its own terms. It is essential to understand clearly the *Marshel* holding. The court did not hold that "going private" without a business purpose violates rule 10b-5. The court held that using corporate funds to "go private," without a corporate business purpose, is a fraud on the corporation within the meaning of the rule.

That holding makes no sense at all under the facts of the case. First, in return for its $1.6 million, Concord would have received shares which, according to the plaintiffs, were worth more than $4.5 million. How, then, would the corporation be damaged?

Second, even assuming, for the sake of argument, that the shares would not have been worth $1.6 million to Concord, a derivative action would still be inappropriate. The shareholders were suing on behalf of the "old," pre-merger Concord, but "old" Concord was not buying any shares. Further, apart from some incidental pre-merger expenses, "old" Concord's funds

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26. See text accompanying notes 59-65 infra.

27. Neither the plaintiffs nor the defendants addressed this issue in their briefs. It was not contended that the shares would have a different value in the hands of Concord than in the hands of the public shareholders. That argument is, however, worth a closer look. If Concord's ability to resell the shares in a future public offering were to be hampered by its past conduct in "going private"—which seems likely—the shares could nevertheless be used for acquisitions and employee compensation. See Note, *Going Private*, 84 Yale L.J. 903, 908 (1975). While the shares might, therefore, be valued differently in a face-to-face transaction between Concord and a third party than by the stock market, the shares would still have had some value to Concord. The plaintiffs might have argued that Concord was paying too much for the shares, because it was offering a premium over market, but, perhaps understandably, they did not. Such an argument would have been an admission that $3 a share was too generous. See *Raffa v. Mechanics Bldg. Material Co.*, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,535 (E.D.N.Y. April 28, 1976): "Initially it is interesting to note that plaintiffs in their representative capacity are claiming that the $1 per share offer is inadequate and in their derivative capacity maintain, in effect, that it will harm the corporation." See also *Rochelle v. Marine Midland Grace Trust Co. v. Arthur Young & Co.*, 535 F.2d 523 (9th Cir. 1976) (a corporation cannot base a 10b-5 action on its repurchase of its debentures at a discount because the corporation suffered no losses upon the repurchase); *Hoover v. Allen*, 241 F. Supp. 213 (S.D.N.Y. 1965) (no damage to a corporation in buying its own shares at a depressed price).

were not being used. The corporate funds which were to be expended would have come from loans to the "new," post-
merger Concord—an entity which would have no public share-
holders. The controlling shareholders, therefore, would not be using someone else's money. At least for the purposes of a
derivative suit, they would have been spending their own funds. As the Supreme Court recently noted: "The sole share-
holder who defrauds or mismanages his corporation hurts only himself. For the corporation to sue him for his wrongs is simply
to take money out of his right pocket and put it in his left." 29

The significance of the court's failure to distinguish be-
tween "new" and "old" Concord is best demonstrated by hy-
pothesizing, for a moment, that AFW, rather than Concord,
had been designated the "surviving" corporation. AFW, not
Concord, would be the "purchaser"; AFW's money, not Con-
cord's, would finance the merger (although the assets pledged
would remain exactly the same); and Concord's public share-
holders would probably have no derivative standing to sue. 30

One must question the utility of any ground for decision so easy
to avoid. 31

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(1975) (dissenting opinion). The dissent agreed with the majority on the inappropria-
teness of a derivative recovery for a sole shareholder's defalcations, but differed on
whether a subsequent shareholder could sue for the prior acts. The majority held that
the subsequent shareholder could not maintain a derivative action.

30. Fed. R. Civ. P. 23.1 requires that the derivative action be one which the
corporation could properly assert. As noted earlier, since Concord is not a purchaser
or seller of shares, it cannot assert a 10b-5 claim. Additionally, the capacity of corpora-
tion to sue or be sued is determined by the law of the state in which it was organized.
Fed. R. Civ. P. 17(b); Smallwood v. Pearl Brewing Co., 489 F.2d 579, 591 n.12 (5th
Cir. 1974). Under New York law, even if "old" Concord had a valid 10b-5 claim, its
rights would pass to the survivor, AFW, and could not be asserted by Concord or its
shareholders. N.Y. Bus. Corp. LAW § 906(b)(3) (McKinney 1963); Beloff v. Conso-
diated Edison Co., 300 N.Y. 11, 87 N.E.2d 561 (1949); accord, Vine v. Beneficial Fin.
Co., 374 F.2d 627, 637 (2d Cir.), cert. denied, 389 U.S. 970 (1967); Voge v. Ackerman,
364 F. Supp. 72 (S.D.N.Y. 1973). Finally, while federal rather than state law deter-
mines a shareholder's standing under Rule 23.1 when a federal claim is asserted,
(Drachman v. Harvey, 453 F.2d 736 (2d Cir. 1972) (en banc)), the contemporaneous
ownership requirement of the Rule would apparently block a claim by former share-
holders who have "sold" their shares for cash in a merger, although it does not prevent
a claim when shares have been exchanged. Abrams v. Occidental Petroleum Corp., 20
F.R. Serv. 2d 170 (S.D.N.Y. 1975); Orenstein v. Compusamp, Inc., 19 F.R. Serv. 2d
466 (S.D.N.Y. 1974). See generally 3B MOORE'S FEDERAL PRACTICE ¶ 23.1.17, 23.1.18
(2d ed. 1976).

31. One must also question the appropriateness of a preliminary injunction in
this case, even before the merger was called off. The court of appeals never discussed
the showing necessary for injunctive relief. This silence led a subsequent panel to state
that "[o]nce we assumed, in Marshel, that such conduct was in violation of the federal
Even on its own terms, therefore, *Marshel* was incorrectly decided. Derivative claims are sensible only in the case of an ongoing public corporation. In a “going private” transaction, if rule 10b-5 permits a claim for a fully-disclosed breach of fiduciary duty, it is the duty of the controlling shareholders and directors to the minority shareholders, rather than to the corporation, which should be examined.

**Green v. Santa Fe Industries, Inc.**

Five days after the *Marshel* decision, a different panel of the Second Circuit considered a “going private” merger. This time, the court focused directly on the class claims of the minority shareholders.

The *Green* plaintiffs were shareholders in Kirby Lumber Company. They were frozen out in a merger between Kirby and Forest Products, Inc., a corporation formed for that purpose by Kirby’s majority shareholder, Santa Fe Natural Resources, Inc., which owned 95% of Kirby’s stock. Resources is itself a wholly-owned subsidiary of Santa Fe Industries, Inc.

Although the merger cashed out Kirby’s minority shareholders, and may therefore be termed a “going private” transaction, Kirby was not really “public” before the merger. Kirby’s shares, which had been outstanding since the securities laws, the ultimate result was a foregone conclusion and, hence, a preliminary injunction was in order.” Merrit v. Libby, McNeill & Libby, 533 F.2d 1310, 1312 (2d Cir. 1976).

The *Merrit* court fairly assessed *Marshel*, but that assessment is not the law. The mere fact that a plaintiff has a clear claim for relief does not entitle him or her to equitable relief; “questions of liability and relief are separate in private actions under the securities law, and . . . the latter is to be determined according to traditional equitable principles,” Rondeau v. Mosinee Paper Corp., 422 U.S. 49, 64 (1975). Under these principles, any damage caused Concord by the expenditure of its funds could have been recompensed in money damages, although that would have led to the absurdity of the sole shareholders repaying themselves.


33. As in *Marshel*, no class determination had been made by the district court, although the complaint contained class allegations. The complaint also asserted a derivative cause of action, which the district court rejected because the “old” company was no longer in existence, and a derivative recovery would benefit the sole shareholder. 391 F. Supp. at 856. The court of appeals did not address the derivative claim and the trial judge later cited his *Green* opinion on the derivative point, noting that it had been “rev’d on other grounds.” Del Noce v. Delyar Corp., [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,670 (S.D.N.Y. July 30, 1976).

34. When Resources organized Forest Products, it contributed enough cash to pay Kirby’s shareholders in the planned merger. This cash contribution immediately distinguishes *Green* from *Marshel*, since Kirby’s assets were not used to finance the merger.
pany's reorganization in 1936, were not listed on a national securities exchange, and Kirby was not subject to the reporting requirements of the Securities Exchange Act of 1934.\textsuperscript{35}

Thus, Kirby—unlike Concord Fabrics—did not go public on a bull market and private on a bear market.\textsuperscript{36} Nevertheless, for reasons which do not appear in the record, Kirby's parent decided to remove Kirby's minority shareholders, utilizing Delaware's short-form merger statute.\textsuperscript{37} Kirby's shareholders were notified after the merger of their right to accept $150 a share or seek appraisal.

The notification contained a thirty-three-page information statement setting forth Kirby's financial position. Attached to the statement were asset appraisals showing that the liquidation value of Kirby's assets was $320 million (which amounts to $640 per share). Also attached was a letter from Morgan Stanley & Co., an investment banker, giving its opinion that the fair market value of the shares, apparently valued as a going concern (taking into account the asset appraisals and the publicly traded stock of similar companies) was $125 per share.\textsuperscript{38}

The \textit{Green} plaintiffs, having received the information statement, filed an action in federal court alleging that the

\textsuperscript{35} Letter from Ronald A. Lane to Barbara Banoff (Dec. 2, 1976) [copy on file at \textit{SANTA CLARA L. REV.}].

\textsuperscript{36} The Second Circuit opinion treats the facts in \textit{Green} as if they were the same as those in \textit{Marshel}. The differences in the facts should have produced a different analysis, even from a court inclined to condemn "going private" transactions generally. See Greene, \textit{Corporate Freeze-out Mergers: A Proposed Analysis}, 28 STAN. L. REV. 487 (1976).

\textsuperscript{37} Delaware permits a parent corporation owning at least 90% of the capital stock of a subsidiary to cause a merger of the parent into the subsidiary by adopting a resolution of merger. Approval by the shareholders or board of directors of the subsidiary is not required. \textit{Del. Code Ann. tit. 8, § 253} (1974). Section 253 permits the shares held by anyone other than the parent to be exchanged for other property. Shareholders dissatisfied with the offering price may seek appraisal. The Delaware courts have noted the purpose of section 253 is to permit freeze-out mergers. Accordingly, in cases where the only dispute is how much the shares are worth, appraisal is the exclusive state remedy, even if it is alleged that the price is grossly inadequate. \textit{Stauffer v. Standard Brands, Inc.}, 40 Del. Ch. 202, 178 A.2d 311 (Ch.), \textit{aff'd d}, 41 Del. Ch. 7, 187 A.2d 78 (Sup. Ct. 1962).

\textsuperscript{38} Appeal from Order of United States District Court for the Southern District of New York, app. at 14A, \textit{Green v. Santa Fe Indus., Inc.}, 533 F.2d 1283 (2d Cir. 1976).

Morgan Stanley was named as a defendant in the subsequent complaint which alleged that it "knowingly assisted and facilitated" the "fraud" by submitting an appraisal it knew was too low. \textit{Id.} at 76A. The district court's dismissal of the complaint was upheld on appeal as to Morgan Stanley, and the plaintiffs' petition for certiorari on that issue has not been granted by the Supreme Court.
merger violated rule 10b-5 by freezing out shareholders, without prior notice, at a “wholly inadequate price.”

The defendants moved to dismiss the complaint for failure to state a claim and lack of subject matter jurisdiction. The district court granted their motion. The court stated that the plaintiffs’ allegations had two distinct aspects: first, that the method used to freeze out the minority shareholders operated as a fraud, since the merger benefited the majority shareholders, without any justifiable business purpose, and without prior notice; and second, that the low valuation placed on their shares was in itself actionable.

The court then held that the first theory, which attacked the Delaware short-form merger procedure, was “without merit”:

The primary objective of Rule 10b-5 is to impose a duty of disclosure upon a corporation and its controlling persons. Popkin v. Bishop, 464 F.2d 714 (2d Cir. 1972). That objective is to be achieved in conjunction with the state corporate law. This Court does not regard Rule 10b-5 as an omnibus federal corporation law having such broad reach as to modify the notice requirements of the Delaware merger statute, or prevent Delaware in its legislative wisdom from providing a means by which a majority can exclude a minority from the corporation’s future affairs, so long as due process is satisfied, as it is here, by the appraisal procedures.

As to the second theory, that the undervaluation itself was a fraud, the court accepted for the purposes of its decision the plaintiffs’ claimed valuation of $772, although it questioned the propriety of using liquidation value as the sole basis for determining the “true worth” of the shares. The court pointed out,

39. Id. at 74A. The plaintiffs alleged that the stock was worth $772 a share. They arrived at this figure by taking the amount by which the appraised value of the assets ($320,000,000) exceeded their book value ($9,000,000), or $311,000,000 and apportioning it on a per-share basis—which equals $622. They then simply added that $622 to the $150 going concern value they were offered in the merger. Id. at 75A. If the asset appraisals are correct, however, Kirby’s liquidation value is $640 per share.
40. 391 F. Supp. at 855.
41. Id. at 853.
42. Id. See note 39 supra. In Del Noce v. Delyar Corp., [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,670 (S.D.N.Y. July 30, 1976), the same judge noted that for certain companies engaged in extractive operations, a liquidation may realize more than a merger—the company may be “worth more dead than alive.” Id. at 90, 297 n.11. Nevertheless, for purposes of determining damages resulting from a merger, the shares exchanged would be valued at “going concern” and not liquidation value. The judge
however, that the plaintiffs’ valuation was based on information disclosed in the merger information statement, and that the complaint did not allege an omission, misstatement or fraudulent course of conduct which would have impeded a shareholder’s judgment of the value of the offer in determining whether to seek appraisal. Relying, as did the Marshel district court, on Popkin v. Bishop and its progeny, the court concluded that full disclosure removed the transaction from the purview of rule 10b-5.43

The plaintiffs appealed the dismissal to the Second Circuit, arguing that the short-form merger violated rule 10b-5 as a “flagrant self-deal” in which the majority stockholder violated its fiduciary duty to the minority by cashing them out at a grossly inadequate price, without prior notice or consent.44

The Second Circuit panel agreed. Over a vigorous dissent by Judge Moore, the court held that rule 10b-5 is violated when a majority shareholder breaches “its fiduciary duty to deal fairly with minority shareholders,”45 whether or not state law grants appraisal rights or other relief to the plaintiffs. In the context of Green’s facts, that breach of fiduciary duty consisted of three elements: (1) effecting the merger without any justifiable business purpose, (2) failing to give minority shareholders advance notice of the merger, and (3) undervaluation of the minority’s shares.

It is important to note that, like the Marshel court, the Green court did not adopt a “business purpose” test for freeze-out mergers, but rather adopted a “business purpose-plus” test. A simple “business purpose” test would prohibit freeze-outs lacking a business purpose whether or not the price was explicitly stated that “going concern” value is fair value, even if liquidation value is higher, when there is no intention to liquidate the merged company. Id. at 90,305.

Professor Dyer reaches the opposite conclusion, stating the only economically rational reason for not liquidating in such a situation must be that Kirby’s controlling shareholders place a higher value on Kirby as a going concern than would be realized from liquidation. Accordingly, he argues, their own higher assessment of going concern value should determine the price paid to the minority shareholders. Dyer, An Essay on Federalism in Private Actions Under Rule 10b-5, 1976 UTAH L. REV. 7, 23.

43. 391 F. Supp. at 854. The court went on to point out that even if the information statement were deceptive, the plaintiffs were not damaged by it, since they did not accept the $150 cash-out price. Therefore, there was no causal connection between any deception and the harm allegedly suffered by these plaintiffs. Id. at 855.

44. 533 F.2d 1283, 1285, 1288 (2d Cir. 1976).

45. Id. at 1289-1290, 1291. The majority opinion by Judge Medina undoubtedly surprised those who remembered his dissent in Schoenbaum v. Firstbrook, 405 F.2d 215, 219 (2d Cir. 1968), in which he termed the fairness doctrine an “invitation to blackmail and extortion.”
In contrast, although there is language in the *Green* opinion which appears to support a simple "business purpose" test, the opinion as a whole leaves no doubt that lack of prior notice and undervaluation are necessary, if not in themselves sufficient, allegations.\(^{47}\)

Thus, even under *Green*, a majority may cash out the minority without a business purpose if it gives prior notice of its intention to do so and if it pays a fair price, and conversely—at least so far—may behave as unconscionably as it likes in share valuation if the merger has a business purpose.\(^{48}\)

The court's holding, thus stated, does not appear to remedy the "fraud" it defined. The court has, in effect, adopted the rationale of the Delaware courts which it purported to reject: when the only dispute is how much the shares are worth, the state appraisal procedure is the exclusive remedy, even if the price is grossly inadequate.\(^{49}\)

If, however, the federal securities laws impose on majority shareholders a duty to "deal fairly" with the minority, but do not forbid freeze-outs, the essence of that duty is surely the obligation to offer a fair price. A valid business purpose for the transaction, and prior notice to the shareholders, are not adequate substitutes for the aggrieved minority whose dissatisfaction with their state remedy drove them to federal court in the first place.

For example, the defendants in *Green*, unlike those in *Marshel*, never conceded that the Kirby merger did not have a business purpose. On remand, if the case is not reversed, that purpose will have to be litigated, and the extensive discovery and trial on that issue will be only tangentially related to the fairness of the buy-out price.\(^{50}\) The *Green* plaintiffs will hardly

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47. The Court specifically referred to lack of a business purpose and prior notification as "additional elements" to a charge of undervaluation in discussing the claim against Morgan Stanley. 533 F.2d at 1292.

48. The court carefully stated that it was not holding that "the charge of excessively low valuation by itself satisfies the requirements of Rule 10b-5 because that is not the case before us." *Id.* at 1291.

49. *See* note 37 supra.

50. Litigating the business purpose of a transaction may also be unrewarding for the plaintiffs in most cases:

[It is seldom that a valid business purpose cannot be shown or con-
be solaced by the notion that a benefit to the corporation of which they are no longer shareholders—the "business purpose" of the transaction—is a sufficient reason for their forced contribution of over $500 a share to the deal (assuming that liquidation value is "fair" value).

Nor is prior notice likely to be helpful. The plaintiffs in Green had argued that prior notice of the merger would have given them an opportunity to seek injunctive relief, but advanced no other reason for requiring prior disclosure. The court agreed, stating that "the unavailability of this additional [injunctive] remedy" was "further justification" for its holding. As both the majority and the concurring opinions noted, however, the frozen-out shareholders in a Delaware short-form merger have no right to state court equitable relief, prospective or otherwise. Nor would these plaintiffs have been entitled to federal injunctive relief, since their claims, even if assumed to be valid, are compensable in damages. It seems strange, to say the least, to hold that the defendants' failure to disclose the merger before its consummation injured the plaintiffs by depriving them of something to which they were not entitled, and stranger yet to assume that such notice will protect minority shareholders in future transactions.

The court's choice of the elements of a claim for relief in a "going private" transaction is therefore puzzling, given its view of the wrong done to minority shareholders. Whatever specific allegations are required in a "going private" case, however, Green's broader holding is that rule 10b-5 prohibits all intentional breaches of fiduciary duty, whether or not the conduct which constitutes the breach is disclosed.

\text{\footnotesize \textsuperscript{51} Structured with a little ingenuity if need be; litigation on this point is not likely to be any more restrictive of the corporation and the controlling shareholders than is the business judgment rule in determining the propriety and legality of actions by corporate directors. Kaplan, \textit{Fiduciary Responsibility in the Management of the Corporation}, 31 \textit{Bus. Law.} 883, 906 (1976). Indeed, even among the advocates of the business purpose test, there are almost as many definitions of the test as there are commentators. See articles cited note 9 supra.}

\text{\footnotesize \textsuperscript{52} Brief for Plaintiffs at 39-42, \textit{Green v. Santa Fe Indus., Inc.}, 533 F.2d 1283 (2d Cir. 1976).}

\text{\footnotesize \textsuperscript{53} 533 F.2d at 1291.}

\text{\footnotesize \textsuperscript{54} Id. at 1289, 1297 n.4.}

\text{\footnotesize \textsuperscript{55} \textit{See} Merrit v. Libby, McNeill & Libby, 533 F.2d 1310, 1311 (2d Cir. 1976): "We affirm the denial of a preliminary injunction by the District Court primarily on the ground that there is an adequate remedy at law." \textit{Merrit} was a post-\textit{Green} challenge to a short-form "going private" merger.}

\text{\footnotesize \textsuperscript{55} As noted earlier, the Sixth Circuit has refused to read Green that broadly.}
The court relied on clauses (1) and (3) of the rule, noting that, of the three clauses in rule 10b-5, only clause (2) explicitly deals with nondisclosure and misrepresentation. Clause (2) makes it unlawful for any person "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" in connection with the purchase or sale of any security. Clauses (1) and (3), on the other hand, make it unlawful "to employ any device, scheme, or artifice to defraud," or to "engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person" in connection with the purchase or sale of any security.\(^{56}\)

These provisions, according to Judge Medina, "state explicitly that fraud other than and in addition to a failure to disclose or truthfully represent is also actionable."\(^{57}\) For purposes of those "broader" clauses of the rule, therefore, allegations "of breaches of fiduciary duty by a majority against minority shareholders" are sufficient; "in such cases, including the one now before us, no allegation or proof of misrepresentation or nondisclosure is necessary."\(^{58}\)

See Marsh v. Armada Corp., 533 F.2d 978 (6th Cir. 1976). Other courts however, have applied Green to a variety of corporate transactions in which a breach of fiduciary duty has been alleged. See cases cited note 8 supra.

57. 533 F.2d at 1287.
58. Id. Although the court tried valiantly to make its holding look like just another 10b-5 case, saying that it did not "write on a clean slate," (id. at 1286) the cases relied on simply do not support that assertion. Only the Marshel decision, five days earlier, prevented Green's tabula rasa.

In support of its conclusion, the court quoted language defining equitable fraud as encompassing breaches of fiduciary duty and overreaching in SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 194 (1963) (which in fact held merely that an investment advisor must disclose to his clients his own trading in recommended stocks), and the famous dicta in Pepper v. Litton, 305 U.S. 295, 306-07 (1939) (involving a bankruptcy court's powers of equitable subordination), on a corporate fiduciary's obligation to show the inherent fairness of transactions with the corporation.

The court also relied on Schoenbaum v. Firstbrook, discussed in note 3 supra, which it said held that "improper self-dealing and a breach of fiduciary duty, without more, constituted a violation of Rule 10b-5," 533 F.2d at 1290. The court thus applied, without further explanation, a derivative holding, which addressed the problem of the deceived fiction, to class claims brought by human beings who were not deceived.

Not surprisingly, the Green opinion noted with approval the decision in Marshel; quite surprisingly, it also contended that Popkin v. Bishop, discussed in notes 3 and 25 supra, supports its opinion, because the Popkin merger had a "compelling" business purpose—the prior settlement agreement attacked by Popkin as a sham—and because in Popkin, disclosure occurred prior to the merger. Of course, in Marshel, which Green cited with approval, the facts surrounding the merger were also disclosed prior to the
The underlying philosophy of the court’s holding is that disclosure is irrelevant when minority shareholders do not have the power to alter the result. Thus, the court adopts, without attribution, the Marshel rationale that full disclosure to a “helpless victim” is as much a fraud as nondisclosure is to someone making a choice.

If the “helpless victim” argument sounds familiar, it is because we have heard it before—not in defining fraud, but in deciding whether a merger transaction comes within the rule at all. Ironically, the “forced seller” doctrine, which holds that participants in a merger are sellers under the rule, was developed because defendants in 10b-5 litigation argued that an exchange of shares or property in a merger did not involve a volitional act on the part of individual shareholders, and was not therefore a “sale” of their shares. In other words, they argued that disclosure was irrelevant because the plaintiffs were helpless victims.

After initially adopting this “no sale” position for purposes of registration under the Securities Act of 1933, the Securities and Exchange Commission decided that shareholders were not helpless after all; the act of voting and the decision whether to dissent and exercise appraisal rights are both investment deci-
sions requiring the protections of the Act.  

This change was prompted in part by judicial decisions holding that a merger is a "sale" for purposes of rule 10b-5 precisely because the shareholders are required to make an investment decision affected by a misrepresentation or omission.  

If disclosure is indeed irrelevant when the minority shareholders' decision cannot change the result, and if the existence of appraisal rights is also irrelevant to the coverage of rule 10b-5, the argument may prove too much. The anomaly produced by full disclosure to helpless victims which is decried by the Green and Marshel courts may as logically be resolved by excluding "forced sellers" in that situation from the coverage of the rule as by extending it beyond disclosure.  

Judge Moore's impassioned dissent in Green did not discuss the self-contradictory bootstrapping involved in the "forced seller/helpless victim" dichotomy, but it covered considerable ground nevertheless. Castigating the majority opinion as "legal legerdemain" and "judicial legislation," he reviewed prior 10b-5 cases to "dispel at once any rumors that 10b-5 no longer concerns itself with fraud," meaning deception, and then proceeded to his main concern—the majority's invasion of the traditional province of the states:  

There is no question that it is within the proper power of the State to enact statutes regulating corporation mergers. Corporations are creatures of the State. They are created  

64. See SEC v. National Sec., Inc., 393 U.S. 453 (1969); Swanson v. American Consumers Indus., Inc., 415 F.2d 1326 (7th Cir. 1969), modified, 475 F.2d 516 (7th Cir. 1973); Dasho v. Susquehanna Corp., 380 F.2d 262 (7th Cir. 1967), cert. denied, 389 U.S. 977 (1967). In Swanson, faced with an argument that deception was irrelevant because the minority shareholders did not have the power to alter the result, the court noted that appraisal rights would be affected and said, "We are not prepared to sanction a rule of causation which would presume that full disclosure could have no transactional function in corporate affairs." 415 F.2d at 1332.  
In Vine v. Beneficial Fin. Co., 374 F.2d 627 (2d Cir.), cert. denied, 389 U.S. 970 (1967), a short-form merger was held to be a "purchase and sale" simply because the shares were converted into cash, whether directly or through exercise of the appraisal remedy. The court noted, however, that the plaintiff would still have to prove that the defendants deceived other shareholders into tendering enough shares to make the short-form merger possible in order to satisfy the "in connection with" requirement. Thus, someone must have been in a position to make an investment decision, which affected the defendant's ability to turn the plaintiffs into "forced sellers," in order for plaintiffs to sue.  
66. 533 F.2d at 1304 (Moore, J., dissenting).  
67. Id. at 1303.
under State law; they are empowered by State statute; and they are regulated by the legislative mandates of the State which has sanctioned their existence. Every State in the Union has comprehensive general business or corporation codes which attest to the exercise of the States' proper responsibilities over the formation of corporate entities and the regulation of corporate activities. 68

Judge Moore then went on to demonstrate that the short-form merger in Green complied with state law, and that the defendants had not breached any fiduciary duty recognized by Delaware. 69 He also stressed the availability of appraisal rights, pointing out that the federal remedy would do no more than "determine a fair buy-out price," 70 and thus require the same battle of experts which would have existed in the state court. 71

68. Id. at 1302. As stated earlier, the majority's attempt to wrap itself in precedent cannot disguise the novelty of its holding.

69. Judge Moore's characterization of the conflict between Delaware law and the majority holding is not quite correct. While Delaware's statute does not require advance notice of a short-form merger (see note 37 supra), and Delaware's courts have not required a business purpose for "going private" (see, e.g., Singer v. Magnavox Co., ___ A.2d ___ (Del. Ch. Oct. 26, 1976)), Delaware does not grant majority stockholders the right to undervalue the minority's shares. Delaware may not characterize the obligation to give fair value as a "fiduciary duty," but it has provided a method for enforcing it—the appraisal proceeding. However, there is no doubt that Delaware itself agrees with Judge Moore. It urged the Second Circuit to re-hear Green en banc, and requested permission to file an amicus brief. Letter of Richard Weir, Jr., Attorney General, to court clerk, March 1, 1976.

The conflict between state law and the Green holding was the subject of Professor Dyer's interesting article, An Essay on Federalism in Private Actions Under Rule 10b-5, 1976 UTAH L. REV. 7. Stating that the creation of a federal claim for conduct permitted under state law raises "significant policy questions," Professor Dyer suggests a resolution: a federal fiduciary standard may be proper if it reflects a principle of equivalent treatment, but possible conflicts with state standards should be resolved by requiring a plaintiff to exhaust any state remedies before resorting to federal court.

Dyer does not convincingly explain why two proceedings are better than one in this area of 10b-5 litigation, but not in any other. More significantly, he does not examine the federalism concepts inherent in the division of subject matter jurisdiction between federal and state courts. Indeed, he views the question whether deception is essential to fraud as "trivial," since it raises "only" a question of choice of forum when the violation of a state fiduciary standard is asserted. Id. at 15. Where federal diversity jurisdiction exists, the choice of forum to enforce a state claim may well be "trivial," although those concerned with lessening the burdens on federal court calendars undoubtedly see it differently. Absent diversity jurisdiction, however, the determination of the scope of rule 10b-5 is central to a federal court's power to decide the state claim.

70. 533 F.2d at 1309. Judge Mansfield's concurrence had condemned the procedural inadequacies of the Delaware appraisal remedy and noted that a federal court might use a different measure of valuation. 533 F.2d at 1297 & n.4 (Mansfield, J., concurring).

71. Id. at 1309 (Moore, J., dissenting). Had the Kirby shares been listed on a stock exchange, the Delaware appraisal statute would not have provided an arena for
He concluded that the majority had extended rule 10b-5 to afford to plaintiffs a substantive right "in complete derogation of a valid state rule regulating corporate activity,"72 thus "putting a torch to the teachings of Erie"73 which "put an end to federal common law and forbade the federal courts from formulating their own 'better rule.'"74

Judge Moore's wrath is misdirected. It is simply not true to say that the federal securities laws violate the teachings of Erie if they impose duties on corporate insiders not imposed by state law (or, to put it concisely, that conduct lawful under state law may not be unlawful under federal laws).75 For example, rule 10b-5 has long been interpreted as requiring insiders to disclose material information before they trade in their company's securities, whether or not state law permits inside trading on undisclosed information.76

The issue, therefore, is not state power versus federal power. When federal power is granted, it is "paramount,"77 and whether state law also prohibits the conduct involved is irrelevant.78 A plaintiff damaged by conduct which violates both

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74. 533 F.2d at 1307 (Moore, J., dissenting). Judge Moore also disagreed with the notion that the majority's holding is a better rule, believing "going private" transactions to be "corporate actions of the utmost simplicity and patent reasonableness in today's economy and securities market." Id. at 1300. As noted earlier, commentators have differed on the merits of "going private," and this article does not attempt to reargue the question.
78. Any doubts about the validity of this statement with regard to corporate mismanagement should have been set to rest by Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6 (1971). That decision's interpretation of the "in connection with" clause of rule 10b-5 may be criticized, see, e.g., IIT v. Vencap, Ltd., 519 F.2d
state and federal law has his or her choice of forum; a plaintiff damaged by conduct which violates federal law, but not state law, may proceed in federal court.\footnote{1001, 1014 n.26 (2d Cir. 1975) ("the Supreme Court, as we read its opinion, has pushed the petimeters rather far"), but the Court's treatment of the role of state law is clearly correct: "Since there was a 'sale' of a security and since fraud was used 'in connection with' it, there is redress under Section 10(b), whatever might be available as a remedy under state law." 404 U.S. at 12. To hold otherwise would provide an affirmative defense against a federal charge for every defendant whose conduct also violated a state's blue sky laws or corporate fiduciary requirements.}

The question is not one of deference to state legislation and the \textit{Erie} doctrine, but whether the federal law, properly construed, reaches the questioned conduct. It is thus necessary to consider whether the language of section 10(b) and rule 10b-5 may be construed to include substantive federal standards of conduct (whether stated as "fiduciary duty," "fairness" or "business purpose") which go beyond disclosure.

\textbf{The Statute}

It is perhaps significant that in both \textit{Green} and \textit{Marshel} the text of the statute to be construed was mentioned briefly and then forgotten.\footnote{79. The other possible permutations are, of course, that state law will provide a remedy but federal law will not, or that neither forum will be available. That state law may reach conduct morally objectionable but not federally illegal may comfort those displeased by the denial of a federal right (see Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 738 n.9 (1975)), but unless one adopts a "jurisdiction by moral necessity" approach, the lack of a state remedy is no more relevant to the existence of the federal right than is the presence of a state remedy. A fortiori, the procedural difficulties of obtaining the state remedy, and the procedural advantages of the federal rules, cannot justify the extension of a federal right.}


Nevertheless, the procedural advantages of the Federal Rules of Civil Procedure, and the nationwide service of process and liberal venue provisions of the Securities Acts, are incidents of a federal right under those statutes. Procedural rights are not intended to alter a preexisting substantive right, let alone confer one which would not otherwise exist.
Court’s decision in *Ernst & Ernst v. Hochfelder*, however, to remind courts that the scope of rule 10b-5 cannot exceed that of the statute. If section 10(b) does not reach fraud without deceit, it does not matter how far the language of the rule might be stretched.

Section 10(b) is the “catch-all” provision of the Securities Exchange Act. It makes it unlawful “to use or employ, in connection with the purchase or sale of any security . . . 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.” The key words are “manipulative or deceptive device or contrivance.” Although this section is often referred to as an “anti-fraud” statute, the word “fraud”—equitable or otherwise—nowhere appears. If conduct is neither manipulative nor deceptive, it is not prohibited under the language of the section.

The conduct in *Green* and *Marshel* was admittedly not deceptive. Was it, then, manipulative? Judge Mansfield, in the *Green* dissent paid little attention to the statute, relying instead on the language of the rule. See *id.* at 1300 n.2.

If *Ernst & Ernst* was merely a scienter case, then the requisite allegation in *Marshel* would presumably have been a “knowing” or “intentional” breach of the majority shareholders’ duty not to use corporate funds for their own benefit without a corporate business purpose. In *Green*, however, where the gravamen of the “fraud” is a breach of the duty to “deal fairly” with the minority shareholders, it is difficult to reconcile an allegation of “knowing” or “intentional” unfairness with the controlling shareholders’ reliance on an independent appraisal of the value of the minority’s shares, particularly since the court of appeals affirmed the dismissal of the complaint as to the appraiser. See note 38 *supra*.

In any event, the significance of *Ernst & Ernst*, for purposes of this article, is not its holding on scienter, but on the proper method of statutory construction. See Note, *Judicial Retrenchment Under Rule 10b-5: An End to the Rule as Law?*, 1976 DUKE L.J. 789.

“Of course subsection (c) [§ 9(c) of H.R. 7852, which became § 10(b)] is a catch-all clause to prevent manipulative devices.” *Hearings on H.R. 7852 and H.R. 8720 Before the House Comm. on Interstate and Foreign Commerce, 73d Cong., 2d Sess.*, 115 (1934) (testimony of Thomas G. Corcoran).

While the complaints in both *Green* and *Marshel* contained allegations of deception, the complaint in *Green* was dismissed, and the preliminary injunction in *Marshel* was denied, by the trial courts, which rejected the sufficiency of the allegations. See text accompanying notes 17, 40 *supra*. The court of appeals assumed in both
his Green concurrence, repeatedly characterized the merger as "manipulative," presumably using "manipulate" in its common dictionary meaning—"to manage artfully or shrewdly, especially in an unfair way." As the Supreme Court noted in Ernst & Ernst, however, the word manipulative "is and was virtually a term of art when used in connection with the securities market. It connotes intentional and willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities." In that sense, manipu-

It should be noted that there was no claim in Marshel that the Weinstein brothers had an undisclosed intention to "go private" at the time of the public offerings. An intent to freeze out public shareholders if the market declined would undoubtedly be considered material by purchasers in the initial offerings, and would therefore have met the traditional 10b-5 test.


[With a little ingenuity and receptiveness, [manipulative] might have an elastic definition which would permit its application to other situations either (a) where the form of the transaction is artificially constructed (as for example in de facto mergers) or (b) the transaction is essentially a sham or where there is no valid business purpose or (c) by virtue of coercive actions the minority shareholders could be said to be acting at the will of another, in the sense that the puppet is manipulated by his master.

87. 425 U.S. at 199. The Court's conclusion as to the meaning of "manipulative" in section 10(b) is buttressed by the specific types of manipulation enumerated in sections 9 and 10(a). 15 U.S.C. §§ 78i-78j(a) (1970). Section 9, titled "Manipulation of Securities Prices," prohibits certain actions taken "for the purpose of creating a false and misleading appearance of active trading," and other actions which actually create active trading for the purpose of inducing trades by others. Significantly, all of the prohibitions of section 9 apply only to securities registered on a national securities exchange or to transactions involving the use of the facilities of a national securities exchange. This further supports the conclusion that "manipulation" means market manipulation.

Section 10(a) also applies only to registered securities; it prohibits the use of short sales and stop-loss orders in contravention of Commission rules. While section 10(b) specifically applies to unregistered, as well as registered securities, the word "manipulative" as used there cannot fairly be read outside the context in which it appears. In other words, "manipulative" in section 10(b) means activities which deliberately and artificially affect the price of securities in whatever market exists for them. Mr. Rosenfeld, in his Essay in Support of the Second Circuit's Decisions in Marshel v. AFW Fabric Corp. and Green v. Santa Fe Industries, 5 HOFSTRA L. REV. 111, 131 (1976), suggests that it is "arguably" a market manipulation to freeze stock at a price that is historically low and force all shareholders to sell their stock at the frozen price level. His argument would have considerable force if the "historic low" were created for that purpose by the majority shareholders who seek to take advantage of it. See note 89 infra. There is a vast difference, however, between transactions aimed directly at raising or depressing the price of a stock, and purchases or sales—forced or voluntary—based on the price produced by an unmanipulated market. It should also be
lation is a form of nonverbal deceit, and cases dealing with charges of market manipulation under rule 10b-5 have consistently viewed it that way.\textsuperscript{88}

Neither \textit{Green} nor \textit{Marshel} presents a case of market manipulation.\textsuperscript{89} Without deceit, therefore, there was no fraud cognizable under section 10(b), at least if the words of the statute are taken to mean what they say.

\textit{Green} and \textit{Marshel} ignore the language of section 10(b), adding to the prohibition against manipulation and deception a third category of forbidden conduct: “breaches of fiduciary duty.” The statute is construed as though it forbade “inequitable” devices or contrivances. This construction, according to the Second Circuit, was required by the Supreme Court’s command to read the statute “flexibly, not technically or restrictively.”\textsuperscript{90}

A flexible reading is warranted to carry out the purposes of the Act, but not to rewrite the statute for purposes supplied by the judiciary and not by the legislature.\textsuperscript{91} An examination of the legislative history of the 1934 Act, and that of the other securities regulation statutes which must be read \textit{in pari materia},\textsuperscript{92} demonstrates no legislative intent to outlaw fully


\textsuperscript{89} The complaint in \textit{Marshel} alleged, on information and belief, that Concord issued improper financial statements and ceased paying dividends in 1970 in order to depress the price of the stock. \textit{Marshel} Appendix, \textit{supra} note 12, at 13. However, on the motion for preliminary injunction, plaintiffs did not contradict defendants’ affidavits denying manipulation and setting forth the business reasons for failing to pay dividends. \textit{Id.} at 52-55, 104-09. The court of appeals decision, ignoring as it did the class claim “fairness” issue, did not address the allegations of manipulation. Presumably, if the case proceeds on the damages issue, plaintiffs will have an opportunity to prove manipulation, if it existed. No charge of market manipulation was made in \textit{Green}; the shares traded only sporadically over-the-counter.


\textsuperscript{91} It is a basic premise of this article that the courts, in interpreting a claim of statutory right, should feel themselves constrained by the language of the statute and the intent of the legislature to the extent that it can be determined. I do not wish to be understood as an opponent of judicial creativity generally; when the legislature has failed to consider issues which later arise, or when both statute and legislative history are ambiguous or silent, there is more room for play. When, however, competing policy considerations have been weighed by the legislature, and its choice is reasonably clear—which I believe to be the case in the issue under discussion—then the legislative determination should stand.

\textsuperscript{92} Ernst & Ernst v. Hochfelder, 425 U.S. at 206, \textit{quoting SEC v. National Sec.,
disclosed but "unfair" practices.

The preamble to the 1934 Act states that its purpose is "to prevent inequitable and unfair practices on such [securities] exchanges and [over-the-counter] markets," and section 2 adds a purpose "to insure the maintenance of fair and honest markets." It is quite clear, however, that fairness and equity in this context refer to market manipulation, not to intracorporate relationships. The House Report on the Act states: "to insure to the multitude of investors the maintenance of fair and honest markets, manipulative practices of all kinds on national exchanges are banned." The Senate investigative report agrees: "The purpose of the act is . . . to purge the securities exchanges of those practices which have prevented them from fulfilling their primary function of furnishing open markets for securities where supply and demand may freely meet at prices uninfluenced by manipulation or control."

Thus, the legislative purpose to prevent "unfair and inequitable practices" is entirely compatible with the limitation of section 10(b) to manipulative and deceptive devices, and cannot support—let alone compel—the implication of an additional prohibition against all intentional breaches of fiduciary duty.

In his Green concurrence, Judge Mansfield points to another legislative purpose—that of "protecting . . . the securities market from devices serving to discredit it," which "make the individual shareholder even more hostile to . . . the securities markets than he already is." Thus, he argued, section 10(b) applies to transactions which undercut investor confidence in the fairness of securities transactions.

Inc., 393 U.S. 453, 466 (1969): "the interdependence of the various sections of the securities laws is certainly a relevant factor in any interpretation of the language Congress has chosen."

97. 533 F.2d at 1295.
98. Id. at 1296, quoting Commissioner Sommer, supra note 9, at 84,695.
99. Accord, Comment, The Second Circuit Adopts a Business Purpose Test For Going Private: Marshel v. AFW Fabric Corp. and Green v. Santa Fe Industries, Inc., 64 CALIF. L. REV. 1184, 1186 (1976). The author states that the legislative purpose to promote investor confidence justifies a general interpretation of the rule which would empower federal courts to correct "patterns of abuse, such as the going private phenomenon, because of their deleterious effect on public confidence." Mr. Rosenfeld's article makes a similar point, stating that the economic purpose of the securities laws was to promote investor confidence in the capital markets, and that permitting some com-
Judge Mansfield’s argument finds some initial support in the House Committee report. There is, indeed, broad language in that report which, taken out of context, might be taken to mean that the Commission may promulgate any rule of corporate fiduciary duty which will promote investor confidence in corporate ethics:

If investors’ confidence is to come back to the benefit of exchanges and companies alike, the law must advance. . . . Unless constant extension of the legal conception of a fiduciary relationship—a guarantee of “straight shooting”—supports the constant extension of mutual confidence which is the foundation of a maturing and complicated economic system, easy liquidity of the resources in which wealth is invested is a danger rather than a prop to the stability of the system.100

The rest of the Committee report, however, makes it clear that the codified “fiduciary relationship” required to support investor confidence is a fiduciary duty to disclose.101 There is no indication of any intent to legislate fiduciary obligations beyond disclosure.

Further, if the “investor protection” purpose of the Act itself confers upon the Commission the power to promulgate any rule it likes which would promote investor confidence generally, then the language of section 10(b) is meaningless. The section provides that the Commission may prescribe rules “as necessary or appropriate in the public interest or for the protection of investors,” but that “necessary and appropriate” clause is a limitation of the Commission’s power to prohibit “manipulative or deceptive devices or contrivances,” not an independent grant of power.102

100. H.R. REP. No. 1383, 73d Cong., 2d Sess. 5 (1934).
101. Id. at 13-14. The section dealing with “control of unfair practices by corporate insiders” gives two examples of the conduct to be regulated: trading on undisclosed inside information, and management misrepresentations in corporate proxies.
102. In fact, as originally drafted, the section would have made unlawful “any device or contrivance which, or any device or contrivance in a way or manner which the Commission may by its rules and regulations find detrimental to the public interest or to the proper protection of investors.” S. 2693, 73d Cong., 2d Sess. § 9(c) (1934); H.R. 7852, 73d Cong., 2d Sess. § 9(c) (1934). Through a series of changes, the present narrower wording was enacted. While the legislative history is silent on the reasons for the changes, it is useful to compare a similar narrowing process in the language and history of section 13(e) of the 1934 Act, which was enacted in 1969, and pursuant to
Proponents of a broad reading of the section are forced to fall back on such “purpose” arguments because the legislative history of section 10(b) itself is sparse. This Congressional silence, however, would seem to support a narrow reading of the section. It is particularly unlikely that the 1934 Act would have so completely altered the basic disclosure philosophy of the Securities Act of 1933 without calling some attention to Congressional intent to do so. Any intent to impose broader fidu-

which the Commission’s proposed “going private” rules have been promulgated.

Section 13(e), as enacted, makes it unlawful for an issuer subject to its provisions to

purchase any security issued by it if such purchase is in contravention of such rules and regulations as the Commission, in the public interest or for the protection of investors, may adopt (A) to define acts and practices which are fraudulent, deceptive or manipulative, and (B) to prescribe means reasonably designed to prevent such practices.

As originally introduced, the section would have simply prohibited repurchases “in contravention of such rules and regulations as the Commission may prescribe as necessary and appropriate in the public interest or for the protection of investors or in order to prevent such acts and practices as are fraudulent, deceptive or manipulative.” H.R. 14475, 90th Cong., 1st Sess. (1967); S. 510, 90th Cong., 1st Sess. (1967) (emphasis added).

The chairman of the SEC at that time interpreted the original provision as conferring upon the Commission the power to adopt rules in the public interest, or to protect investors, “irrespective of the question whether, or our ability to prove that, such activity is or may be fraudulent, deceptive or manipulative. The language, for this reason, is broader in its scope than presently applicable provisions of the Exchange Act.” Hearings on S. 510 Before the Subcomm. on Securities of the Senate Comm. on Banking and Currency, 90th Cong., 1st Sess. 38 (1967) (testimony of Manuel F. Cohen); Hearings on H.R. 14475 Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce, 90th Cong., 2d Sess. 15 (1968).

The House subcommittee then amended the provision because the statutory language:

was in the disjunctive and lent itself to the possible although improbable interpretation that the Commission had authority to issue rules and regulations regarding the corporate purchase of its own securities in the public interest, or for the protection of investors, quite apart from whether designed solely to prevent acts and practices that are fraudulent, deceptive, of [sic] manipulative. The revised language makes it clear that such rules and regulations may be adopted only for these purposes.


This legislative history was noted by those who questioned the Commission’s power to enact proposed Rules 13(e)-3A and B. See, e.g., Letter from Sullivan & Cromwell to George Fitzsimmons, Secretary, Securities and Exchange Commission, March 14, 1975 [on file at SANTA CLARA L. REV.].

103. The second session of the 73d Congress would not have been unaware of the great debate in the first session over the proper role of the national government in securities regulation. Congress had considered, and rejected, comprehensive “blue sky” regulation which would have required decisions as to the merits of a securities offering or the honesty of an issuer. Instead, the 1933 Act adopted the disclosure philosophy which is its primary characteristic.

This is not to say that the 1933 Act does not create federal fiduciary duties. Like that of the 1934 Act which followed it, the legislative history of the 1933 Act emphasizes
ciary obligations would surely have been clearly expressed.\textsuperscript{104}

Another persuasive indication that Congress did not intend to mandate broad intracorporate fiduciary responsibilities in the 1934 Act is the existence of the Investment Company Act of 1940.\textsuperscript{105} That act specifically legislated federal fiduciary duties which go far beyond disclosure with regard to investment companies and their affiliates, underwriters and advisors. The 1940 Act concerned itself, among other things, with self-dealing and with unfair mergers\textsuperscript{106}—the subjects of the Green and Marshel opinions.

Significantly, the legislative history of the 1940 Act contains a statement by the SEC’s witness on the difference be-

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\textsuperscript{104} Congress would certainly have been aware that it was treading new ground. The idea that corporate fiduciary standards were generally within the province of the states was no less accepted in 1934 than in 1975, when the Supreme Court stated: “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.” Cort v. Ash, 422 U.S. 66, 84 (1975). In Cort, the Court refused to imply a private federal right of action under the federal campaign laws in favor of a derivative plaintiff for allegedly illegal corporate contributions in the form of an ideological advertisement. Although the Court recognized that the securities laws do “expressly require” certain management-shareholder responsibilities, it seems unlikely that a different result would have been reached with a 10b-5 claim for breach of fiduciary duty if the money to pay for the advertisement had been obtained from the sale of securities, thus furnishing the requisite nexus with a securities transaction.

\textsuperscript{105} 15 U.S.C. §§ 80a-1 to 80a-52 (1970). Although the views of a subsequent Congress may form “a hazardous basis for inferring the intent of an earlier one,” (United States v. Philadelphia Nat’l Bank, 374 U.S. 321, 349 (1963)), when statutes are to be read in pari materia that hazard is slight. The opinion of Congress in 1940 as to the scope of the 1933 and 1934 Acts is therefore valuable.

\textsuperscript{106} 15 U.S.C. § 80a-17(a) (1970), prohibits securities transactions, including mergers, between investment companies and their affiliated persons unless the SEC grants an exemption under section 17(b). An exemption may be granted if the transaction is fair to all persons concerned, free from overreaching, and consistent with the Act’s purposes. For an illustration of the difficulty encountered by courts in determining “fairness” even under an act which specifically requires it, see the text accompanying note 132 infra.
tween the 1933 and 1934 Acts and the Investment Company Act:

The Securities Act and the Securities and Exchange Act provide no regulation whatever of these investment trusts. They are simply required to make disclosure. The pending measure is a regulatory measure. It undertakes to regulate certain practices and to stop certain things. And, the Securities Act undertakes no such results. Under the Securities Act, if a man makes complete disclosure, he can do anything, almost, that he pleases; but there are certain practices that have happened in connection with investment companies that I think everybody agrees ... ought to be stopped, and they cannot be stopped by mere disclosure.107

If that statement was in error, and section 10(b) goes beyond "mere disclosure" to reach self-dealing, unfair mergers, and other management abuses of shareholder trust, much of the legislation establishing federal fiduciary standards for investment company managers was either unnecessary, or merely gave a specific—and sometimes more narrow—structure to the broad and amorphous fiduciary standards of section 10(b).

The notion that the Securities Exchange Act of 1934 is broader than the Investment Company Act of 1940 is novel, to say the least.108 Yet that is the inescapable conclusion of a


108. In this connection, see Brown v. Bullock, 194 F. Supp. 207 (S.D.N.Y.), aff'd en banc, 294 F.2d 415 (2d Cir. 1961):

The [Investment Company] Act regulates the entire investment company industry. Congress sought to regulate that industry as comprehensively as the banking and insurance businesses are regulated. The Act is pervasive in scope and detail. In addition, the Commission is given broad power to promulgate rules, regulations and orders.

The Act is to be sharply contrasted with the much narrower Securities Act of 1933 and Securities and Exchange Act of 1934. The 1933 and 1934 Acts articulated only a policy of disclosure and securities registration and the regulation of certain securities practices. On the other hand, the 1940 Act placed the investment company business under close but workable regulation.

194 F. Supp. at 217. The opinion continues:

In certain major respects, the 1940 Act operates as a corporation law for investment companies. In sharp contrast, the 1934 Act (like the 1933 Act) regulated one phase,—the purchase and sale of corporate securities. The distinction is between commodity regulation and industry regulation. The protective reach of the latter extends to the corporation as well as
holding that rule 10b-5 covers breaches of fiduciary duty. The contrast between the two acts in this regard is particularly striking if one examines the two “catch-all” clauses—section 10(b) of the Exchange Act and section 36 of the Investment Company Act.

Section 10(b) makes conduct in violation of Commission rules “unlawful.” Section 36, as originally drafted, would also have made “unlawful” any “gross misconduct or gross abuse of trust in respect of a registered investment company.” Representatives of the investment company industry objected to making such an “indefinite standard which was impossible of determination” the basis of a criminal offense. Accordingly, while larceny and embezzlement remain crimes under the 1940 Act, section 36 as enacted merely authorized the Commission to bring an action to remove from office any officer or director engaged in a serious breach of fiduciary duty.

It seems unlikely that Congress refused to make unenumerated breaches of fiduciary duty within a narrow class of companies criminal in 1940, but did intend to make them criminal in 1934 in legislation affecting every corporation in the country.

...
THE RULE

Although the rule cannot be broader than the statute, and the statute, as shown above, does not extend to breaches of fiduciary duty beyond those related to disclosure and manipulation, it is still useful to examine the rule and the Commission's consistent administrative construction of its meaning.

Since everyone seems to be agreed that clause (2) of the rule is limited to material misstatements and omissions, the issue is the proper construction of the first and third clauses, making it unlawful, in connection with the purchase or sale of any security: "(1) to employ any device, scheme, or artifice to defraud" or "(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person."115

If the language of the rule is considered without regard to the statute under which it was promulgated, "fraud" might indeed include "equitable fraud"—breach of trust or overreaching. On the other hand, it is not necessary to interpret the language that way in order to give the two clauses meaning. It is fully consistent with the language of the rule to say that clause (2) deals with verbal deceit, while clauses (1) and (3) are aimed at deceptive conduct, including market manipulation and, perhaps, total silence in the face of a duty to speak.116

Which interpretation is correct? Rule 10b-5 was lifted almost whole from section 17(a) of the Securities Act of 1933;117 it was intended to afford to defrauded sellers the same protections granted by section 17(a) to buyers.118 It is therefore proper to assume that the word "fraud" means the same in the rule as it does in section 17(a).

Unfortunately, neither the House nor the Senate report on

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116. Thus, in Cochran v. Channing Corp., 211 F. Supp. 239 (S.D.N.Y. 1962), an undisclosed scheme to reduce dividends in order to depress the market price of a company's shares was held actionable, because although clause (b) "seems to require a statement of some sort," clauses (a) and (c) do not. Id. at 243. See also O'Neill v. Maytag, 339 F.2d 764, 769 (2d Cir. 1964) (deception may take the form of non-verbal acts); cf. United States v. Charnay, 537 F.2d 341, 350 (9th Cir.), cert. denied, 45 U.S.L.W. 3409 (U.S. Dec. 7, 1976) ("clauses (a) and (c) of Rule 10b-5 are not aimed at failures to disclose. Rather they are flat prohibitions of deceitful practices and market manipulations.").
the 1933 Act explains the meaning of that section. The House Committee hearings on section 13, an earlier version of section 17(a), do provide some guidance, however. Section 13 made it unlawful

for any person, firm, corporation, or other entity in any interstate sale, promotion, negotiation, advertisement, or distribution of any securities . . . willfully to employ any device, scheme, or artifice to defraud or to obtain money by means of any false pretense, representation or promise, or to engage in any transaction, practice or course of business which operates or would operate as a fraud upon the purchaser.

Huston Thompson, one of the drafters of the bill, called this “fraud clause” a “combination of, I would say, the Denison bill and the Sabath bill.”

[Section 13] incorporated the main feature of the Denison bill so far as the committing of an act of fraud by way of misrepresentation through the mails if the distribution or sale of securities is concerned. . . . Then we had the Sabath bill . . . That was a fraud bill. We cover the subject of fraud in this bill of ours. It had to do with the communication of false information with reference to securities, and was somewhat like the Denison bill, although I do not believe it was limited to the question of the mails.

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120. H.R. 4314, 73d Cong., 1st Sess. (1933).
122. Hearings on H. R. 4314 Before the House Comm. on Interstate and Foreign Commerce, 73d Cong., 1st Sess. 11 (1933) (emphasis added). Mr. Thompson’s testimony also contains a rather confusing exchange with Congressman Wolverton, who expressed concern that the statute was not as protective as the state “blue sky” laws:

Mr. Wolverton: Then the theory upon which this bill is drawn is not to prevent the issuance of worthless stock, but merely to give such facts as will enable a purchaser to recognize it as worthless stock?
Mr. Thompson: I think that is pretty near it.
Mr. Wolverton: If there is a duty on the part of our Government to give information to a purchaser that stock is worthless, why would it not be a
Ollie Butler, another draftsman, also testified that section 13 "fraud" was disclosure-related:

[Sections 3 to 12] are based on the theory that proper publicity will prevent the greater part of the fraudulent transactions that have occurred during recent years. . . .

. . . Sections 13 and 14 are auxiliary to this main body of the bill and were inserted for two reasons: First, because it has been necessary to include exemptions from the main body of the bill in order to facilitate normal and legitimate business transactions. Every time that an exemption is made to this main provision, it opens a way for evasion, and it is almost impossible to insert an exemption without the duty of the Government to stop that stock from going out just as you would stop any other fraud from being carried on?

Mr. Thompson: If you do that, you begin to get into the question of what is speculative and what is not speculative, and that is a very difficult sphere to pick up.

Mr. Wolverton: Your answer makes plain to me the theory on which the bill is drawn. Then there is no discretion, under the terms of the bill, in the Federal Trade Commission to stop the issuance of any stock when the issuer has complied with its provisions by giving the information required by the terms of the act?

Mr. Thompson: That is as I understand the act; yes.

Mr. Wolverton: Is there not any general jurisdiction or power in the Federal Trade Commission to stop unfair practices?

Mr. Thompson: Yes; there is. But you have overlooked the fact that if a fraud is committed there is a fraud section in this bill that I would like to come back to. Let us get to that, because that is very important in line with your question. Let us go back to section 13 . . . Let us see. This man has come in and complied with all the requirements of the bill, but really he is putting out what you term a worthless stock and doing it in a fraudulent way, let us say. [Mr. Thompson then read the language of the section]. You say that that operates after the horse has been taken out of the barn. Unless we are going into this question of analyzing each security that comes up in passing upon whether it is a sound security or not, that is all we can do with it.

Mr. Wolverton: Then it is your thought that we should not pass legislation that would require such action on the part of the Federal Trade Commission?

Mr. Thompson: I do not believe we should.

_id._ at 53-54 (emphasis added).

Messrs. Wolverton and Thompson appear to have been talking at cross-purposes. Thompson's testimony appears to say that section 13 and its successor, section 17(a), gave the FTC a residual discretionary power to pass upon "unfair practices" generally, including evaluating the quality of a security after its issuance. Later in his testimony, however, in response to a statement about speculative stocks by Congressman Pettengill that "if they tell the truth about it, that is as far as we intend to go, in principle," Thompson answered, "That is the understanding of this bill; that is the basis of this bill. You are speaking now about the fraud section, are you not?" Pettengill replied that he was speaking about the theory of the whole bill, but Thompson's response clarifies his own position on section 13. _Id._ at 58.
it being used by the fraudulent promoter as a vehicle for the evasion of the provision.

Therefore, Section 13, the fraud section, was added to control those who managed to evade the main provision of the law.123

On the specific question of directors' responsibilities and conflicts-of-interest under the Act, Butler added: "This bill does not attempt to regulate the internal operations of the corporation . . . it does not attempt to reform corporation law."124

Nor is the draftsmen's testimony the only indication of what was intended. The language of section 17(a) echoes that of the mail fraud statute, which outlaws the use of the mails for "any scheme or artifice to defraud."125 Just seven years before the Securities Act was passed, the Supreme Court had considered whether blackmail letters fell within the meaning of that phrase. The Court held that coercion, however morally objectionable, was not "fraud" because it did not involve trickery or deceit.126 It seems reasonable to conclude that Congress did not intend to give "fraud" a broader meaning in section 17(a) than it carries in a closely related statute.

Finally, section 17(a), like section 10(b), is a penal statute.

123. Id. at 116 (testimony of Ollie M. Butler).
124. Id. at 126.
126. Fasulo v. United States, 272 U.S. 620 (1926). The Court thus rejected an early version of the "helpless victim" argument. In reaching its conclusion, the Court relied on an earlier decision construing the statute prohibiting conspiracies to defraud the government (now 18 U.S.C. § 371). In that case, Hammerschmidt v. United States, 265 U.S. 182, 188 (1924), the Court had held that openly advocating violation of the Selective Service Act was not fraud because it did not involve "deceit, craft or trickery."

Subsequent cases under the mail fraud statute have continued to state that active, rather than constructive or equitable, fraud is necessary for a conviction under that act. See, e.g., Epstein v. United States, 174 F.2d 754, 765-66 (6th Cir. 1949):

Actual fraud has been defined as intentional fraud, consisting in deception intentionally practiced to induce another to part with property or surrender some legal right, and which accomplished the end designed. . . . Constructive fraud is a breach of legal or equitable duty which, in spite of the fact that there is no moral guilt resulting from the breach of duty, the law declares fraudulent because of its tendency to deceive others, to violate public or private confidence, or to injure public interests.

Accord, Shushan v. United States, 117 F.2d 110, 115 (5th Cir. 1941), cert. denied, 313 U.S. 574, rehearing denied 314 U.S. 706 (1941) (but concealed bribery of a public official is active fraud); Post v. United States, 407 F.2d 319, 329 (D.C. Cir. 1968), cert. denied, 393 U.S. 1092 (1969) (but "deceitful violation of . . . fiduciary obligations" is active fraud).
It is helpful, in determining its meaning, to look at the broader civil liability sections of the 1933 Act. As noted earlier, the committee reports make it clear that the explicit federal fiduciary standards created under the 1933 Act are those of "full and fair disclosure" and that the civil liabilities devised to enforce those standards "attach only when there has been an untrue statement of material fact or an omission to state a material fact in the registration statement or the prospectus." Had Congress intended to make fully disclosed, but unfair, conduct subject to criminal sanctions under section 17(a), while specifically exempting such conduct from civil liability, it would presumably have said so.

"Fraud" in section 17(a), therefore, means "deception." The rule which borrowed its language should not be read more broadly.

In this connection, the Commission's administrative construction of the rule is also entitled to some weight. I have been unable to find any case in which the Commission has challenged "unfair" but fully disclosed conduct under rule 10b-5. It is also significant, at least on the question of administrative construction, that the Commission's proposed rules on "going private," which contain "fairness" and "business purpose" tests for such transactions, were promulgated under section 13(e) of the Act, not under section 10(b).

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127. See note 103 supra.
129. In fact, in connection with Marshel, the Commission staff's letter of comment on the Concord Fabrics proxy statement pointedly drew attention to the proposed "going private" rules and noted that the furnishing of comments did not constitute a determination on the fairness of the transaction. Marshel Appendix, supra note 12, at 121. Nevertheless, the Commission took no action against the merger.

Nor has the Commission taken such a position as amicus. The Commission did not submit a brief in Green or Marshel in either the Second Circuit or the Supreme Court. The Commission's amicus brief in Schoenbaum v. Firstbrook, 405 F.2d 215 (2d Cir. 1968) (en banc), cert. denied, 395 U.S. 906 (1969), urged the narrow "deception of the shareholder" ground rather than the "controlling influence-unfairness" standard. The Commission was unable to agree on a position in Popkin v. Bishop, 464 F.2d 714 (2d Cir. 1972), and therefore did not submit a brief at all.

130. The trial judge in Green stated that "[i]mplicit in the Commission's expressed intent to enact these or similar rules is the conclusion, which this court shares, that existing rules, including Rule 10b-5, do not reach the sort of acts here complained of." Green v. Santa Fe Indus., Inc., 391 F. Supp. 849, 855 (S.D.N.Y. 1975). Another district court judge has recently noted that, when a rule is amended (or, presumably, promulgated) to require something for the first time, after several years of study and consideration, "there can be no contention that the amendment codifies a preexisting implied duty rather than creates a new one." Rothstein v. Seidman & Seidman, 410 F. Supp. 244 (S.D.N.Y. 1976) (alleged violation of a stock exchange rule).
In short, both the history of the rule and its administrative construction support the conclusion that the rule was not intended to reach claims of equitable fraud.\textsuperscript{131}

\textbf{A POSTSCRIPT ON FAIRNESS}

While Congress, unlike the \textit{Marshel} and \textit{Green} courts, has not imposed federal “fairness” standards on all corporate fiduciaries, there is no doubt that it has the power to do so. Many commentators have urged the adoption of federal fiduciary duties, either through a program of minimum federal standards\textsuperscript{132} or full federal incorporation.\textsuperscript{133}

It is not the purpose of this article to urge or combat one course or the other. If, however, Congress decides to enact general corporate fiduciary standards,\textsuperscript{134} it is to be hoped that it will do so in terms more concrete than “fairness.” Unlike motherhood and apple pie, both of which have their detractors, no one is against fairness. Whether the universally approved abstraction is a helpful guide to courts or administrators is, however, a matter of some controversy.

For example, Professor Cary has noted that the Delaware courts purport to follow a fairness standard but reach results that do not seem to him to be fair at all.\textsuperscript{135} The Investment

\textsuperscript{131} Because the language and history of the statute and rule seem to me quite clearly not to encompass fraud without deceit, this article does not discuss what the majority opinion in Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737, 762 (1975), called the “policy” (and the dissent the “pragmaticality”) of permitting such actions. Suffice it to say that if the Supreme Court is concerned with the danger of vexatious litigation which could result from a widely expanded class of plaintiffs under rule 10b-5, it will pause before deciding that the rule allows claims for any intentional breach of fiduciary duty.


\textsuperscript{134} The Senate Commerce Committee held hearings last year on various proposals for such legislation. \textit{SENATE COMM. ON COMMERCE, SEN. SER. NO. 94-95, 94TH CONG., 2D SESS.} (1976).

Company Act’s mandate of fairness in investment company mergers has produced two diametrically opposed federal opinions on the same transaction, and the Supreme Court will have to resolve the issue. Notably, a proposed requirement that a securities offering be “fair, just and equitable” was omitted from the Uniform Securities Act because it was “too vague.”

One federal judge has forcefully stated his view that “fairness, equity, and fair dealing” make a bad judicial yardstick: “this standard is too thin a reed, too much like quicksand.” “Quicksand” is, in this area, an appropriate metaphor. Congress, no less than the judiciary, should tread warily when breaking new ground in a swamp.


* While this issue was being printed, the United States Supreme Court decided Santa Fe Indus., Inc. v. Green, No. 75-1753 (U.S., filed March 23, 1977). The Court held that conduct which is neither deceptive nor manipulative does not violate section 10(b) of the Securities Exchange Act of 1934 or rule 10b-5.