The Expanding Uses of Rule 10b-5

Joseph C. Tanski

Follow this and additional works at: http://lawdigitalcommons.bc.edu/bclr
Part of the Securities Law Commons

Recommended Citation
CURRENT PROBLEMS UNDER THE SECURITIES ACTS
THE EXPANDING USES OF RULE 10b-5

The existence of an implied private right of action under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated by the Securities and Exchange Commission (SEC) is no longer questioned. The issue is not raised in litigation. The question, however, of what parties have standing to sue under 10(b) is at present in "a state of flux." Further, the elements necessary to state a right of action are not at present clearly defined. The purpose of this comment is to examine the case law in this area with a view to determining the classes of plaintiffs having standing to sue and the elements necessary to state a claim under 10b-5.

The language of 10b-5, making unlawful various practices "in connection with the purchase or sale of any security" can be construed as permitting an extremely broad range of parties to sue. The SEC has argued that all that is necessary for a plaintiff to have standing to sue under 10b-5 is a violation of the Rule resulting in a loss in the value of the stock owned by that plaintiff. The courts have, to this point, avoided this broad construction and, in

---

1 15 U.S.C. § 78j (1964) provides in part:
   It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
   (a) . . .
   (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

2 17 C.F.R. § 240.10b-5 (1968) [hereinafter referred to as the Rule] provides:
   It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
   (a) To employ any device, scheme, or artifice to defraud, 
   (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
   (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

3 In Jordan Bldg. Corp. v. Doyle, O'Conner & Co., 282 F. Supp. 87 (N.D. Ill. 1967), the district court refused to grant a defrauded purchaser of securities a 10b-5 right of action because it believed that Section 12(2) of the Securities Act of 1933 was the provision intended to afford a right of action in the factual situation before the court. This decision was reversed on appeal, Jordan Bldg. Corp. v. Doyle, O'Conner & Co., 401 F.2d 47 (7th Cir. 1968), the court stating that 10(b) extended protection to both buyers and sellers. The court of appeals noted that the lower court's decision was contrary to the rulings of seven federal courts of appeals.


6 This argument was advanced by the SEC as amicus curiae in Vine v. Beneficial Fin. Co., 374 F.2d 627 (2d Cir. 1967).
response to the usual Federal Rules 12(b)(1) and 12(b)(6) motions,7 have in a variety of ways limited liability under 10b-5. This judicial response to 10b-5 has been characterized as "the search for limiting doctrine."8 It is probably more accurately described as the determination of the various rights of action which the rule implies.

A court in dealing with a 10b-5 claim is not setting limits to an existing right of action. It is, in each case, asking whether from the language of the Rule and from the legislative history9 a right of action may fairly be implied. It therefore becomes important to consider the legal theories upon which implied statutory rights of action are founded. The main theory supporting the implied 10b-5 right of action is the statutory-tort theory.10 This, indeed, was the theory advanced by the court in \textit{Kardon v. National Gypsum Co.},11 the case which first recognized a private 10b-5 right of action. A second theory advanced in \textit{Kardon} is based on Section 29(b) of the Act of 1934 and the 1938 amendment to that section.12 The court argued that when Congress provided in section 29(b) that a contract shall be void if made in violation of the Act or the rules made under the Act, it "almost necessarily implies a remedy."13 Also, the 1938 amendment, which sets a statute of limitations, clearly indicates that Congress intended that the original statute implied private rights of action. This reasoning has been called the most compelling argument for the implied 10b-5 right of action.14 It has been pointed out, however, that under this theory, since the basis of the action is in contract, the right of action would be limited to parties to the contract, or at most to third party

7 Fed. R. Civ. P. 12(b)(1)—lack of jurisdiction over the subject matter; 12(b)(6)—failure to state a claim upon which relief can be granted.
8 Mutual Shares Corp. v. Genesco, Inc., 384 F.2d 540, 544 (2d Cir. 1967).
10 A. Bromberg, Securities Law: Fraud—SEC Rule 10b-5 § 24(1)(a), at 30 (1968) [hereinafter cited as A. Bromberg].
11 69 F. Supp. 512 (E.D. Pa. 1946). The court, in explaining the statutory-tort theory, quoted Restatement of Torts § 286 (1934) which provides:
The violation of a legislative enactment by doing a prohibited act, or by failing to do a required act, makes the actor liable for an invasion of an interest of another if:
(а) the intent of the enactment is exclusively or in part to protect an interest of the other as an individual; and,
(b) the interest invaded is one which the enactment is intended to protect; and,
(c) where the enactment is intended to protect an interest from a particular hazard, the invasion of the interest results from that hazard; and,
(d) the violation is a legal cause of the invasion, and the other has not so conducted himself as to disable himself from maintaining an action.
12 15 U.S.C. § 78cc(b) (1964) provides in part:
Every contract made in violation of any provision of this chapter or of any rule of regulation thereunder . . . shall be void . . . Provided, (A) . . . (B) that no contract shall be deemed to be void by reason of this subsection in any action maintained in reliance upon this subsection, by any person to or for whom any broker or dealer sells, or from or for whom any broker or dealer purchases a security in violation of any rule or regulation prescribed pursuant to paragraph (1) of subsection (c) of section 78o of this title, unless such action is brought within one year after the discovery that such sale or purchase involves such violation and within three years after such violation.
The proviso clause was added in 1938. 52 Stat. 1076 (1938).
13 69 F. Supp. at 514.
14 59 Yale L. J. 1120 (1950).
EXPANDING USES OF RULE 10b-5

beneficiaries. The third rationale advanced to support an implied right of action is based upon the congressional policy in enacting the Act of 1934. As has been pointed out, all of these theories relate to congressional intent and are somewhat intertwined. It would seem that the first two are the primary theories while the last can be termed only supportive.

I. THE BIRNBAUM DOCTRINE

Possessed of these theories, the courts, faced with a galaxy of factual patterns, have been asked in each case to determine whether Rule 10b-5 implies a right of action which may afford relief to the particular plaintiff. Where the answer is negative it is often said that plaintiff lacks standing to sue. A variety of distinct reasons underlie the holdings that deny particular plaintiffs a right of action under the Rule. Most are related to the theories under which statutory liability is implied. However, there is one requirement limiting standing to sue which, it can be argued, has been advanced by the courts for reasons other than a desire to conform to the wording of 10b-5 or to legislative intent. This requirement, which permeates the case law in the 10b-5 area, is that plaintiff be a purchaser or a seller of securities.

The purchaser-seller requirement, which has acquired such stature that it is termed a “doctrine,” was first articulated in Birnbaum v. Newport Steel Corp. In that case minority shareholders in Newport brought suit derivatively on behalf of the corporation, and as representatives of all other similarly situated shareholders, against Newport, Wilport Corporation and Feldman, the former president and chairman of the board of Newport. Feldman had held 40 percent of the common stock of Newport and had been negotiating what allegedly would have been a profitable merger of Newport with a third corporation. However, Feldman ended the merger negotiations and promptly sold his holdings in Newport to Wilport at a price per share which was approximately twice the then market value. Wilport intended to use Newport as a “captive” source of steel.

Plaintiffs, basing their claim on 10b-5, alleged fraud in Feldman’s letter to Newport’s shareholders in that he misrepresented the reason for the suspension of the proposed merger with the third corporation, and further that the new president of Newport, in a letter sent subsequent to Feldman’s sale of stock, failed to state the price Feldman received or the fact that Newport was to be used as a “captive” source.

The court of appeals, in upholding the district court’s dismissal of plaintiffs’ claim for failure to state a cause of action, held that 10b-5 protects only the defrauded purchaser or seller. The court reasoned that 10b-5 was adopted to extend to sellers the protection against fraud or deception which

15 A. Bromberg, supra note 10, § 2.4(1)(b), at 32, citing Brouk v. Managed Funds, Inc., 286 F.2d 901, 908 (8th Cir. 1961).
16 Ellis v. Carter, 291 F.2d 270, 274 (9th Cir. 1961). The court indicated that to allow buyers a right of action under 10(b) and 10b-5 would effectuate Congress’ policy of providing complete and effective public and private sanctions with respect to the duties imposed by the securities acts. Cf. Fratt v. Robinson, 203 F.2d 627 (9th Cir. 1953).
17 A. Bromberg, supra note 10, § 2.4(1), at 29.
18 193 F.2d 461 (2d Cir.), cert. denied, 343 U.S. 956 (1952).
19 Id. at 464.
Section 17(a) of the 1933 Act explicitly gave to purchasers. It supported this contention with an SEC release concerning 10b-5, and by noting that 10b-5 is merely the language of Section 17(a) of the Securities Act of 1933 with the words "any person" substituted for the words "the purchaser" and the clause "in connection with the purchase or sale of any security" substituted for the clause "upon the purchaser." The court added that Section 16(b) of the Act of 1934, which gives the corporate issuer or its shareholders derivatively a right of action against insiders using their position to profit from the purchase or sale of any equity securities of the issuer, strengthens the conclusion that Congress did not create section 10(b) to protect shareholders against corporate mismanagement. Thus, rather than stressing the language of 10b-5, the court relied upon a release containing a statement of the purpose of the Rule, and upon other sections of the securities laws.

The doctrine that plaintiff must be a purchaser or a seller has been criticized as being too narrow and rigid. Such arguments stress the broad language of the Rule itself, and argue that the complexity and variety of securities fraud demand that the Rule be flexible in order that wrongs will be remedied. A rigid doctrine such as the purchaser-seller requirement, the argument continues, will allow ingenious wrongdoers to devise means of evading the law. This argument assumes that 10b-5 is a law which affords relief to all parties defrauded in connection with the purchase or sale of securities, and then contends that the purchaser-seller requirement allows the wrongdoer to avoid legal sanctions against his wrong. The relevant inquiry, however, is whether the requirement is a defect in the reasoning of , or whether it arises from section 10(b) and Rule 10b-5 themselves.

Under the statutory-tort theory, in order for the defendant to be liable to the party seeking relief for an invaded interest, the interest invaded must be one which the statute intended to protect. If the statute was intended to protect only a limited class the plaintiff must bring himself within that class. This was the principle with which the court in was concerned when it held that plaintiff must be a purchaser or seller. It is difficult to deter-

---

20 The court stated:

Prior to [the Rule's] adoption the only prohibitions against fraud in the sale or purchase of securities were contained in Section 17(a) of the 1933 Act... and § 15(c) of the 1934 Act... Section 17(a) of the 1933 Act only made it unlawful to defraud or deceive purchasers of securities, and Section 15(c) of the 1934 Act dealt only with fraudulent practices by security brokers or dealers in over-the-counter markets. No prohibition existed against fraud on a seller of securities by the purchaser if the latter was not a broker or a dealer. Consequently, on May 21, 1942 the SEC adopted Rule X-10B-5 to close this "* * * loophole in the protections against fraud administered by the Commission by prohibiting individuals or companies from buying securities if they engage in fraud in their purchase." SEC Release No. 3230, May 21, 1942.

Id. at 463.


23 193 F.2d at 464.


25 Id.


27 Restatement of Torts § 286(b), supra note 11.
EXPANDING USES OF RULE 10b-5

mine solely from the language of the statute and Rule whether protection should extend only to purchasers or sellers. It has been pointed out that there are two methods of construing the words "in connection with the purchase or sale of any security":

The question is presented whether those words limit the operation of the section and rule to those 'devices and contrivances' (as defined in the rule) which operate upon purchasers or sellers of securities, or whether the section and rule proscribe practices which are injurious to other persons, not purchasers or sellers, so long as a purchase or sale of a security is one of the steps in the effectuation of those practices.28

The court in Birnbaum accepted the former interpretation. The broad connotation of the words "in connection with" militates against this interpretation. However, the court's analysis of the Rule's relation to other securities provisions and the press release is very convincing that only purchasers or sellers are within the class intended to be protected, or put another way, that the interests intended to be protected were the interest which a purchaser has in acquiring securities and that which a seller has in disposing of them. If the second of the above mentioned interpretations is accepted there would be an extremely broad class of plaintiffs with standing to sue and the types of actions spawned under 10b-5 would be numerous and varied. Though this result might be desirable it is doubtful whether Congress in enacting 10(b) or the SEC in promulgating 10b-5 intended to provide such sweeping relief to injured securities investors.

The purchaser-seller requirement has often been utilized by the courts to deny a 10b-5 right of action. However, there has been a trend away from the strict application of the requirement and toward an expanding definition of a purchaser and a seller.29 Not only the writers but also one district court is of the opinion that the doctrine will be abandoned.30 The decline of the doctrine has been happily traced by some and the possibility of new federal rights emerging has been explored.31 If the Birnbaum analysis is correct these would indeed be new federal rights and their origin would be the judiciary and not the legislature.

Apart from the propriety of the creation of such rights by the courts,32 there has already been some expansion of the possible implied rights of action under 10b-5. Three patterns emerge from the case law: derivative actions for alleged injury to the corporation; derivative or corporate actions brought to halt a control shift or a scheme to perpetuate control; actions by shareholders on their own behalf. Different considerations are involved in each of the three areas and the requirements for standing to sue under 10b-5 vary in

28 Leech, supra note 24, at 832.
31 Lowenfels, supra note 26, at 275-77.
32 If the new rights are needed, it is perhaps preferable that they be supplied by the Congress. However, doubt has been expressed as to the probability of any such action absent great public clamor. A. Bromberg, supra note 10, § 12.9, at 286.
II. DERIVATIVE ACTIONS

As the courts expressly recognize, the gist of the complaints in this area is some form of corporate mismanagement or breach of fiduciary duty. In Birnbaum the court stated that 10b-5 was not directed at "fraudulent mismanagement of corporate affairs."\(^{33}\) The court in Pettit v. American Stock Exch\(^{34}\) rejected the defendant's argument as based on that holding. In that case the corporate reorganization trustees of Swan-Finch Oil Corporation (Swan) brought a derivative action in which it was alleged that various banks, stock brokers and dealers, a corporate insider, Birrell, who owned a controlling interest in Swan, and others had conspired to defraud Swan by causing it to issue a large number of shares for valueless consideration. These shares, under the control of Birrell, were then sold to the public and Birrell and his co-conspirators pocketed the proceeds of these sales. In denying defendants' motions to dismiss, the court rejected defendants' "effort to characterize the trustees’ claim as one of ‘corporate mismanagement',"\(^{35}\) stressing that both the corporation and the various investors were injured. The court thus felt that to deny the claim would be to ignore what Congress intended: “the protection of the integrity of stock transactions."\(^{36}\) Moreover, the scheme defrauded the corporation of a substantial asset, a large number of its shares, by causing it to issue its stock. Citing Hooper v. Mountain States Sec. Corp.,\(^{37}\) the court indicated that when a corporation issues shares there is a sale and a corporation injured by fraud in connection with that sale clearly has a valid 10b-5 claim. It can be argued that the court was willing to grant a right of action in Pettit because of the massive proportions of the Birrell conspiracy and the practical difficulties which would accompany any effort to prosecute a lawsuit on behalf of the scattered class of injured investors, each of whose potential recovery is limited. Similarly, the corporation has other ways to seek relief but, as the court noted, the procedural and jurisdictional difficulties might well have frustrated effective recovery.\(^{38}\) Although the court indicated that these considerations were not essential to its decision, it is likely that they played an important role therein.

In Pettit the motive behind the fraud was purely monetary. In O'Neill v. Maytag,\(^{39}\) the motive of the defendant directors, although in the last analysis it may have been monetary, was primarily a desire to eliminate a threat to

---


\(^{34}\) 217 F. Supp. 21 (S.D.N.Y. 1963).

\(^{35}\) Id. at 26.

\(^{36}\) Id. at 28.

\(^{37}\) 282 F.2d 195 (5th Cir. 1960), cert. denied, 365 U.S. 814 (1961). In Hooper, the corporation was fraudulently caused to issue its stock for “spurious assets.” The court granted a 10(b) right of action on the ground that the issuance was a sale and that damage was caused by this sale since the corporation parted with stock which it could have used to acquire valuable property.


\(^{39}\) 339 F.2d 764 (2d Cir. 1964).
EXPANDING USES OF RULE 10b-5

their control. In O'Neill, plaintiff, a shareholder in National Airlines, brought a derivative action on behalf of National against National's directors and Pan American World Airways. Pan Am and National had exchanged stock, but pursuant to an order of the Civil Aeronautics Board, which had found the cross ownership to be against the public interest, they re-exchanged shares. Plaintiff alleged that in this exchange the shares given up by National were worth approximately $1,800,000 more than those given by Pan Am. Plaintiff viewed this as a payment by the directors of National to eliminate a block of National shares held by Pan Am which threatened the directors' control of National. The court, in affirming the dismissal of plaintiff's claim by the district court, reasoned that where the breach of general corporate fiduciary duty does not involve deception there is no 10b-5 right of action. The court, by its insistence upon "deception," would appear to require an affirmative misrepresentation or nondisclosure as opposed to a mere branch of fiduciary duty. Viewed from a different perspective, the underlying economic basis of O'Neill is that the directors received no "direct or monetarily measurable indirect benefit" from the transaction. Different problems underlie each of these considerations. In justification of its holding that absent deception there is no federal right of action for violation of a fiduciary duty, the court maintained that such was not the purpose of 10b-5. The court admitted, however, that there is no reason why a director "may not violate both his common law duty and the duty imposed by Rule 10b-5," but concluded, quoting Birnbaum, that 10b-5 was aimed at "that type of misrepresentation or fraudulent practice usually associated with the sale or purchase of securities rather than at fraudulent mismanagement of corporate affairs."

The considerations underlying the "economic basis" of the denial of a right of action in O'Neill are of a more practical nature. These, it would seem, are related to remedial problems. The alleged harm to the corporation was the unfair exchange. This is monetary injury which could probably be remedied in the action against Pan Am. But the directors, having received no measurable monetary benefit, cannot be forced to give up a monetary profit. Their

40 Id. at 767-68.
41 A. Bromberg, supra note 10, § 2.6(1), at 50 n.135. It has been pointed out that the plaintiff in O'Neill could have argued deception by omission, i.e., that the directors deceived the stockholders by concealing the real motive for their transaction. The minority stockholders could, had they known these facts, have instituted a derivative suit to prevent the transaction. Thus it could be found that the deception caused the injury to the corporation. Comment, Shareholders' Derivative Suit to Enforce a Corporate Right of Action Under SEC Rule 10b-5, 114 U. Pa. L. Rev. 578, 583 (1966). It is arguable that even if the plaintiff had so pleaded deception the court would have denied a right of action since its analysis indicates that it was determined to avoid the area of corporate mismanagement even if the mismanagement involved the purchase or sale of securities and deception by omission. In short, the deception "present in O'Neill is not of the type that Congress intended to deal with." Id. at 584.
42 A. Bromberg, supra note 10, § 4.7(1), at 84 n.65.
43 The direct monetary benefit from the transaction was received by Pan Am. Whether plaintiffs stated a right of action against Pan Am was not in issue since Pan Am, named as a defendant, did not move for dismissal below. O'Neill v. Maytag, 339 F.2d 764, 766 n.2 (2d Cir. 1964).
44 Id. at 768. (Emphasis added.)
45 Id.
profit was retention of corporate control. Thus, if Pan Am were required to
disgorge its profit the federal court would be faced with the difficult question
of what action to take in regard to the directors of National. In Pettit and
Hooper, on the other hand, this problem did not exist since in those cases the
defendants did receive monetary benefits.

In Hoover v. Allen,46 the plaintiffs did not mention 10(b) in their com-
plaint, yet the court considered the statute on its own initiative.47 Plaintiffs,
suing derivatively, alleged that various misleading statements to shareholders,
which defendants had caused the corporation to make, reduced the price of
the stock below its true value and thereby induced shareholders to sell to the
corporation. This sale had the effect of increasing defendants' proportionate
ownership and, according to the plaintiffs, was designed to give defendants
control of the corporation. Plaintiffs alleged further that the waste of corpo-
rate assets then perpetrated by the defendants constituted damage to the
corporation. The court viewed the selling shareholders, rather than the corpo-
ration which had purchased at the depressed prices, as the victims of the
fraud,48 and denied a derivative right of action on the ground that control
acquired as part of a fraudulent scheme is not injury to the corporation.49

The court recognized four possible levels of injury caused by defendants’
scheme. First, there was injury to the selling shareholders. The court felt
that no derivative action should lie for this injury. Secondly, the power of
the minority shareholders who did not choose to sell was "diluted" as a result
of the scheme. This plainly is not injury to the corporation. The third level
of injury is acquisition of corporate control. The court recognized, correctly it
would seem, that this in itself is not injury to the corporation. The fourth
level of injury, however, which the court discussed, and which indeed had
been pleaded by plaintiffs, was the waste of corporate assets occurring after
control was acquired. Plainly this was injury to the corporation. But the court
was unwilling to ground a 10b-5 right of action on such an injury, for the
reason that it was not proximately caused by the fraudulent acquisition of
control.50 Though admitting that in a "but for" sense the waste was caused
by the acquisition of control, the court reasoned that waste is not the neces-
sary and probable result of the acquisition of control.

The importation of a proximate cause requirement into this area might
be explained by a fear on the part of the court of a large influx of federal
claims, were it to allow such an action. Without the proximate cause require-
ment the courts would be faced with a wide variety of federal claims each
time corporate control was attained by means of action or inaction in viola-
tion of 10b-5. All injuries to the corporation occurring after the acquisition of
control could conceivably give rise to a federal claim since all injuries in a
"but for" sense would have been made possible by the acquisition of control.
It is at least arguable that such a situation is not objectionable, as it would
appear to further the federal policy of exposure and prevention of fraud in

47 Id. at 226 n.7.
48 Id. at 227.
49 Id. at 228.
50 Id. at 229.
EXPANDING USES OF RULE 10b-5

the securities field. If this development is not desirable, however, it would seem that there is less reason for restraint by the courts where the fraudulent acquisition of control is part of a conspiracy. Indeed, the court, in noting that there was not such an allegation in plaintiffs' complaint, intimated that, had there been, plaintiffs might have had a right of action.\(^\text{51}\) In such a situation it is arguable that the proof to which plaintiffs would be put in order to establish the scheme or plan would insure that the injuries alleged would not be remote in time or events from the fraudulent takeover. It could be argued also that if a scheme to gain control of the corporation in order to loot it of its assets were alleged, the resulting waste would be the necessary and probable result of the acquisition of control.

That a fear of remote damages and a great influx of federal claims was behind the court's decision is also evidenced by its interpretation of \textit{O'Neill}. The court was of the view that, had a fraudulent scheme been adequately pleaded in \textit{O'Neill}, plaintiff there would have had a right of action.\(^\text{52}\) In distinguishing \textit{O'Neill} the court pointed out that there the injuries existed independent of the acquisition of control, whereas in \textit{Hoover} the corporate waste flowed from the acquisition of control. If the corporation sustains injury directly, as where it is induced to purchase its own shares at a price higher than their true value, this direct monetary injury might serve as the basis for a 10b-5 derivative action.

Strong doubt has been cast upon the validity of \textit{O'Neill}'s requirement that the corporation must be deceived. In \textit{Entel v. Allen}\(^\text{53}\) the essence of the complaint was that insiders had violated a duty to the corporation and its shareholders. The directors of Atlas, which had owned Northeast Airlines, were allegedly strong-armed by Hughes, who owned "Toolco" and 10 percent of Atlas, into selling Northeast to "Toolco" for inadequate consideration. Plaintiffs alleged further that the sale was not at arm's length. Suing on their own behalf and on behalf of Atlas, shareholders in Atlas alleged that Hughes, acting in his own interest, breached his fiduciary duty to Atlas in causing the sale for inadequate consideration.\(^\text{54}\) The 10(b) action was rejected in two sentences.\(^\text{55}\) The court held that plaintiffs probably could not allege in support of the derivative action that the corporation was deceived in negotiating the sale, and thus could not meet the requirement of \textit{O'Neill}. Furthermore, plaintiffs did not purchase or sell their stock in reliance on misrepresentations made in connection with Atlas' sale of Northeast. This, however, was not the end of plaintiffs' case. On re-argument the court reversed itself\(^\text{56}\) because it was of the view that two recent cases had undermined \textit{Birnbaum},\(^\text{57}\) and that the purchaser-seller requirement would probably not be followed when that issue was next presented to the court of appeals. The court interpreted \textit{Brod}

\(^{51}\) Id. at 228.
\(^{52}\) Id. at 227-28.
\(^{53}\) 270 F. Supp. 60 (S.D.N.Y. 1967).
\(^{54}\) Id. at 68.
\(^{55}\) Id. at 64-65.
\(^{56}\) Id. at 70-71.
\(^{57}\) The cases were \textit{Brod v. Perlow}, 375 F.2d 393 (2d Cir. 1967), and \textit{Vine v. Beneficial Fin. Co.}, 374 F.2d 627 (2d Cir.), cert. denied, 389 U.S. 970 (1967). See p. 326 infra.
v. Perlow,\textsuperscript{58} in which a broker had alleged that defendants ordered securities intending to pay for them only if their market value increased, as holding that "an undisclosed scheme to breach state contract law is encompassed by section 10(b) and Rule 10b-5."\textsuperscript{60} From this proposition the court reasoned that it must follow that an undisclosed scheme to breach state fiduciary law must be covered by 10(b) and 10b-5.\textsuperscript{80} The court in \textit{Entel} has thus, on the basis of its interpretation of \textit{Brod}, dispensed with the requirement that the corporation be deceived.\textsuperscript{61}

It is questionable whether the \textit{Brod} reasoning should be applied in the derivative area. The \textit{Brod} rationale, if confined to the factual situation presented in that case, would have little impact on state law or on the number of federal 10(b) and 10b-5 claims. In addition, the considerations in the broker-client area are not nearly as complex as decisions in the corporate mismanagement area. Thus, merely to import the \textit{Brod} reasoning into the derivative area is to make possible a wide range of federal claims in the corporate mismanagement area, without a consideration of the problems involved.

\textit{Pappas v. Moss,}\textsuperscript{62} decided recently by the Court of Appeals for the Third Circuit, represents another probe into the area of corporate mismanagement. The injured party was the corporation and a 10b-5 action was brought by shareholders suing derivatively for the corporation against its directors. The directors, by a unanimous resolution of the board, had authorized the issuance of 100,000 shares to themselves and a few outsiders, not named in the action, for a price allegedly far below the true value of the stock. The resolution contained two misrepresentations.\textsuperscript{63} The court was of the opinion that where, as in this case, it is alleged that directors cause the corporation to sell its stock at a fraudulently low price, a 10b-5 violation is validly stated. More importantly, however, the court answered defendants' argument that there had been no deception by "viewing this fraud as though the 'independent' stockholders were standing in the place of the defrauded corporate entity at the time the original resolution authorizing the stock sales was passed."\textsuperscript{64}

As concepts of standing to sue under 10b-5 are expanded, it should be

\textsuperscript{58} 375 F.2d 393 (2d Cir. 1967).
\textsuperscript{59} 270 F. Supp. at 70.
\textsuperscript{60} Id.
\textsuperscript{61} The court in \textit{Entel} found that the corporation had not been deceived. Id. at 69. Yet it granted a derivative right of action, seemingly in express contradiction of \textit{O'Neill}'s deception requirement. As has been noted, when the board of a corporation engages in misconduct, "a shareholder is permitted to bring a suit on behalf of the corporation. The board then is no longer the focus of the corporate entity for these purposes; the shareholder represents the effective decision making power of the corporation." Comment, supra note 41, at 582-83. Therefore, when the decision making power shifts, deception of the shareholders is arguably causative of the alleged injury. Id. at 583. Thus, a scheme to breach state fiduciary law, undisclosed to the shareholders, is causative of the corporate injury. Despite the soundness of such arguments, however, and despite the broad language of the Rule, it can still be convincingly argued that the interest invaded in cases such as \textit{Entel} is simply not an interest which Congress intended to protect.
\textsuperscript{62} 393 F.2d 865 (3d Cir. 1968).
\textsuperscript{63} Id. at 869.
\textsuperscript{64} Id.
noted that possible conflicts with state law may arise. Apart from advantages related to proving the substantive elements of a 10b-5 claim, there are distinct procedural advantages offered to plaintiffs in derivative actions in the federal courts. The jurisdiction and venue provisions of Section 27 of the Act of 1934 are very broad and alleviate many problems arising in this regard where suit is brought pursuant to state law. There are other state procedural matters which may hamper a derivative action brought under state law, such as the requirement that plaintiff must have exhausted his remedies within the corporation. Plaintiff must, in a federal action, comply with Federal Rule 23.1, but its requirements are not as demanding as certain state requirements.

Several state statutes also require the posting of a security bond for the corporation's expenses of defending the action. In addition, a plaintiff in a state action may be faced with a short statute of limitations. Rule 10b-5, on the other hand, does not require the posting of a security bond, and does not provide for a statute of limitations. Although under 10b-5 the applicable statute of limitations is that of the state in which the federal court sits, since a federal right is being asserted the federal court will look to the more liberal federal law to determine the date of the accrual of the action, and will then apply the time period of the state statute of limitations.

It has been urged in support of a limiting interpretation of 10b-5 that the purpose of Congress in enacting the securities laws was not to create a separate body of federal law controlling the internal management of corporations. Even if such federal law were desirable, it is felt that it would be

---

65 It has been pointed out that plaintiffs in securities actions under state law have found it difficult to prove such elements as scienter, causation and justifiable reliance, and that "non disclosure cases have rarely been actionable." A. Bromberg, supra note 10, § 2.7(1), at 55 (1968). It has been stated further that the Blue Sky laws "rarely have the punch of 10b-5," id. § 2.7(2), at 57, and that in enacting securities legislation Congress plainly intended that "injured investors have an easier time." Id. § 2.7(1), at 55.

66 U.S.C. § 78aa (1964) provides in part:

Any suit or action to enforce any liability or duty created by this chapter or rules and regulations thereunder, or to enjoin any violation of such chapter or rules and regulations, may be brought in any such district [wherein any act or transaction constituting a violation has occurred] or in the district wherein the defendant is found or is an inhabitant or transacts business, and process in such cases may be served in any other district of which the defendant is an inhabitant or wherever the defendant may be found.

67 Lowenfels, Rule 10b-5 and the Stockholder's Derivative Action, 18 Vand. L. Rev. 893, 902 (1965). The Federal Rule in question, 23(b), was amended in 1966 and is now Federal Rule 23.1, under which the federal requirements remain substantially the same.


70 McClure v. Borne Chem. Co., 292 F.2d 824 (3d Cir. 1961), cert. denied, 368 U.S. 939 (1961), makes it clear that state limitations on derivative actions will not hinder federal derivative actions under 10b-5. The question before the court was whether plaintiff need post security for expenses as required by state law. The court held in the negative. Regarding state claims before a federal court under pendant jurisdiction, a state's requirement of security for expenses must be followed. Kane v. Central Am. Mining & Oil, Inc., 335 F. Supp. 559 (S.D.N.Y. 1964).

71 Hooper v. Mountain States Sec. Corp., 282 F.2d 195, 205 (5th Cir. 1960).

72 Janigan v. Taylor, 344 F.2d 781, 783-84 (1st Cir.), cert. denied, 382 U.S. 879 (1965). The advantages under federal procedure are outlined and discussed in Lowenfels, supra note 67.
better accomplished by a well planned legislative scheme rather than by “piecemeal judicial lawmaking.” Be that as it may, the clear judicial trend is toward regulation of internal corporate affairs if they involve transactions in securities. If plaintiffs are suing in a derivative capacity it is, of course, not necessary that they have purchased or sold securities, but rather it is sufficient that the corporation was involved in a securities transaction. The issuance of its own shares, a re-exchanging of shares with another corporation, or a direct sale of securities will each satisfy the requirement of Birnbaum. It would seem, further, that O'Neill's requirement of deception will not stand as a bar to actions in this area. If the alleged injury arises in direct connection with a sale, as where, for example, the corporation receives inadequate consideration for shares sold by it, the courts will probably grant a right of action. If the injury is more remote, as where it is only made possible by control fraudulently attained, no right of action will be granted unless the plaintiff can allege a plan or scheme to bring about the alleged injury. Although regulation of internal corporate affairs by the federal courts was probably not foreseen by Congress in enacting section 10(b) or by the SEC in promulgating Rule 10b-5, the effect will be to further the broad purposes embodied in the Acts and rules protecting the investing public.

III. SHAREHOLDER ACTIONS TO REDRESS INDIVIDUAL INJURY

Shareholders have also sought to employ 10b-5 for recovery in an individual capacity. There has been greater success in such action than in the derivative actions. In Voge v. American Sumatra Tobacco Corp., plaintiff held stock in Old Company which she had purchased in 1945. Deli, a foreign corporation, owned about 50 percent of the stock of Old Co. and in 1960, as a result of a written offer to the shareholders of Old Co., increased its holdings to 90 percent. Plaintiff alleged that the offer was false and misleading in that, by omissions of material facts and misleading statements, it had failed to indicate, among other things, that the value of Old Co. shares was well in excess of the $17.00 per share offered. Having thus acquired 90 percent of the shares of Old Co., Deli incorporated New Company and transferred all of its Old Co. holdings to New Co. in exchange for all of the stock of New Co. Following this, Old Co. was merged into New Co. under the Delaware short-form merger statute. Plaintiff brought an action under 10(b) and 10b-5.

The court held, in denying defendants' (Deli, New Co. and Old Co.) Federal Rule 12(b)(1) and 12(b)(6) motions, that plaintiff was entitled to some sort of relief under 10b-5. Defendants, of course, had argued that plaintiff was neither a purchaser nor a seller and thus was not entitled to a 10b-5 right of action. In response to this argument the court stated that it need neither affirm nor reject this rule in view of its holding that plaintiff was a seller. The

73 63 Colum. L. Rev. 934 (1963).
75 Under a short-form merger statute a corporation owning 90 or 95% of the stock of another corporation may merge the latter into itself by vote of its board of directors. E.g., N.Y. Bus. Corp. Law § 905(a) (McKinney 1963); (95% ownership required).
76 Plaintiff brought suit as the owner of Old Company shares. She had not tendered pursuant to defendant's tender offer.
EXPANDING USES OF RULE 10b-5

twisting logic employed for this result progresses as follows: (1) Section 3(a) (14) of the Act of 1934\(^{77}\) indicates that "sell" or "sale" includes any contract to sell; (2) Delaware corporation law is a part of corporate charters granted by Delaware; (3) a charter is a contract between the shareholder and the corporation; (4) when plaintiff purchased her shares in Old Co. she agreed, by virtue of the Delaware corporation law, that if the company should ever merge she would surrender her stock for cash or securities which the merger agreement specified; (5) the frauds alleged here were related to the fixing of the cash to be paid per share; (6) this price is a part of the contract to sell impliedly existing between plaintiff and Old Co.; (7) thus, the fraud was "in connection with the purchase or sale [here a contract to sell] of any security."\(^{78}\) The reasoning is logically constructed. But is the logic consistent with legislative intent? If the Birnbaum analysis is correct then plaintiff was neither a purchaser nor a seller within the intended meanings of the words. In Voege, the court has inferred a right of action from the words of the securities laws, but it has ignored the SEC press release and the similarity of 10b-5 with section 17(a).

An examination of the manner in which the court satisfied the requirement that plaintiff must allege reliance on the alleged violation,\(^{79}\) which requirement the court felt obliged to follow, will illustrate the disconnected reasoning of the court. The court stated that "[i]t may fairly be inferred, however, that when plaintiff purchased her shares she did rely upon the honesty and fair dealing of New [Old?] Company and those who controlled it."\(^{80}\) Every contract, the court continued, has an implied condition of good faith and plaintiff necessarily relied on this condition. Employing like reasoning, the court satisfied the "deception" requirement of O'Neill by finding that "[p]laintiff at bar was the subject of deception for when she acquired her stock she did so upon the justifiable assumption that any merger would deal with her fairly . . ."\(^{81}\)

The court thus gave plaintiff a right of action under section 10(b) and 10b-5 not because she was deceived by or relied upon defendant's offer but rather because when she purchased her shares she relied and was deceived. The rationale of the reliance and deception requirements, furthermore, was ignored by the court. These requirements are employed to insure that the alleged misrepresentations, omissions and devices induced action and thus caused injury to plaintiff. Thus, the court should have looked to whether the alleged violations caused the shareholders of Old Co. to sell. If it so found then it could have concluded that this result caused injury to plaintiff and, on this basis, could have granted plaintiff a right of action. On the other hand, the court could have refused to take this last step and held instead that only where the prohibited activity induces action on the part of plaintiff does it

---

\(^{77}\) 15 U.S.C. 78c(a)(14) (1964) provides that "the terms 'sale' and 'sell' each include any contract to sell or otherwise dispose of."

\(^{78}\) 241 F. Supp. at 373-74.

\(^{79}\) This requirement was articulated in List v. Fashion Park, Inc., 340 F.2d 457 (2d Cir.), cert. denied, 382 U.S. 811 (1965), and, as recognized by the court, seeks to insure that the violation alleged caused injury to plaintiff.

\(^{80}\) 241 F. Supp. at 375.

\(^{81}\) Id.
impinge upon the interest in fair dealing in the purchase or sale of securities which was intended to be protected by the statute and the rule.

_Vine v. Beneficial Fin. Co._, 82 is on "all fours" with _Voege_. 83 Avoiding the involved logic of _Voege_, the court in _Vine_ held that as a result of a short-form merger plaintiff was a forced seller, since he eventually must become a party to a sale. 84 The court expressed a willingness to construe the words of the Act of 1934 liberally, emphasizing that the terms "buy" and "purchase" include "any contract to buy, purchase, or otherwise acquire" and that the terms "sell" or "sale" include "any contract to sell or otherwise dispose of" to support its argument that plaintiff was a seller. 85 Defendant argued that the deception did not relate to plaintiff but to the shareholders who sold their interest in the corporation. In this regard, the court stressed the fact that the deception was part of a single scheme and that the fraud perpetrated on the selling shareholders was "in connection with" the forced sale of plaintiff's interest. The court held that plaintiff need not show that he relied, since the injury to him occurred absent any volitional act on his part. "What must be shown," said the court, "is that there was deception which misled Class A [selling] stockholders and that this was in fact the cause of plaintiff's claimed injury." 86 This view is, at least, a proper application of the reliance and deception requirements, in that the court looked to see if the fraud alleged misled the selling shareholders. Though the court finds plaintiff to be a seller, it is arguable that the court has actually interpreted the words "in connection with the purchase or sale of any security" as indicating that the rule "proscribes practices which are injurious to other persons, not purchasers or sellers, so long as a purchase or sale of a security is one of the steps in the effectuation of those practices." 87 It should be noted that the strict causation requirement set forth in _Hoover_ is apparently abandoned, probably because here the consequences of employing a "but for," or as the court phrases it a "were it not for" test are not as far reaching as would be the case in the derivative area.

The broad definitions of purchase and sale were again stressed in _Fidelis Corp. v. Litton Indus., Inc._, 88 where it was held that the individual plaintiffs were purchasers entitled to sue under 10(b) and 10b-5. Litton had entered into an acquisition agreement with Fidelis whereby Litton was to acquire all of the assets of Fidelis and in exchange therefor was to issue initial shares of Litton stock up to $360,000 in value and an additional amount of stock, which amount would depend upon the earnings of the Fidelis assets. Shareholders of Fidelis could elect to receive a portion of the initial or additional shares. The plaintiffs chose the latter and alleged that no additional stock

---

82 374 F.2d 627 (2d Cir.), cert. denied, 389 U.S. 970 (1967).
83 Id. at 634.
84 Id. at 634-35.
85 Id. at 634. A broad interpretation of the term "sale" was also applied in _Mader v. Armel_, 402 F.2d 158, 160-61 (6th Cir. 1968), where the court held that an exchange of stock pursuant to a merger is a sale.
86 374 F.2d at 635.
had been issued. Plaintiffs alleged further that Litton made false and misleading statements to plaintiffs to induce them to agree to the acquisition agreement and to elect to take the additional stock. The court had no problem in denying defendant's contention that the plaintiffs lacked capacity to sue. If the allegations were true, reasoned the court, then plaintiffs were injured in reliance on fraudulent representations made to them. The court held, in addition, that plaintiffs "were deemed to be purchasers," since they had to elect how much stock they would receive from Litton. This conclusion rests on the determination that the broad language of the securities acts "indicates a Congressional intent not to limit 'purchase' and 'sale' to traditional face-to-face commercial transactions."

An expansive application of 10b-5 has thus resulted from a broad interpretation of the term "purchaser," as the court in *Vine* gave a broad meaning to the term "seller." It should be noted, however, that *Fidelis* can be distinguished from *Voege* and *Vine* in that, in the former, those bringing the action had themselves been misled by the defendant, whereas in the latter two actions the plaintiffs had not been misled. The decision in *Fidelis* is thus in harmony with the view that 10b-5 protects only those who have been induced to act by the proscribed practices. It does not support the view that the Rule protects those who have been injured because others were fraudulently misled, or the related view that the Rule proscribes practices injurious to non-purchasers or non-sellers as long "as a purchase or sale of a security is one of the steps in the effectuation of those practices."

In *Voege*, *Vine* and *Fidelis* the courts were willing to recognize the connection between the fraud or misrepresentation and an injury to the plaintiff. It would thus appear that if this nexus exists the courts will give an expansive view to the purchaser-seller requirement. This conclusion might indicate that the purchaser-seller requirement is in reality a device to insure that the alleged violations caused injury to the plaintiff. If such is the case, then in an action

---

89 Id. at 97,314.
90 Id. at 97,315.
91 See p. 317 supra; Leech, supra note 87.
92 As in other areas of the law, if the causal nexus becomes too attenuated, the courts may deny plaintiff the opportunity to offer his proof of causation. In *Sprayregen v. Livingston Oil Co.*, Current CCH Fed. Sec. L. Rep. ¶ 92,272 (S.D.N.Y. Sept. 25, 1968), several shareholders of Livingston brought an action against that corporation and three of its directors alleging that the directors, in a speech, greatly overestimated the future net profits and cash flow of the corporation, and that when the true figures were released about two months later the market price of the stock dropped abruptly. Plaintiffs alleged that during this period, in reliance on the speech, copies of which had been distributed by the company to its shareholders, they "purchased and/or failed to sell, the shares of the corporation's common stock." Id. at 97,310. The court indicated that in order to meet the "in connection with the purchase or sale" requirement of 10b-5 plaintiff need only be a purchaser or a seller in reliance upon defendants' misrepresentations. Though noting the "ambiguous" manner in which plaintiffs pleaded facts to meet this requirement, the court held that the pleading was sufficient because plaintiffs pleaded in the alternative that they were sellers. The court commented in this regard that the "mere retention of shares may not meet the requirements that there at least be a purchase or sale." Id. While this is not a holding that a non-seller or non-purchaser has no standing to sue, it does indicate that *Birnbaum* is probably not yet abandoned at the district court level in the Second Circuit. It is easy to see that a shareholder who retains his shares in reliance on
where injunctive relief is sought the requirement can, arguably, be discarded. Indeed, this much was made clear by the court in *Mutual Shares Corp. v. Genesco, Inc.*

In *Genesco* the essence of plaintiffs' claim was corporate mismanagement. Plaintiffs, shareholders in Kress Corporation, alleged that defendants were manipulating the market price of Kress by keeping Kress dividends to a minimum. Defendants' object was to acquire Kress stock at a reduced price. The court noted that this was also the situation in *Cochran v. Channing Corp.*, where it was held that such activity gave a 10b-5 right of action under subsections (a) and (b) thereof. Although plaintiffs in *Cochran* had sold their stock while plaintiffs here had retained theirs, the court was of the view that where injunctive relief is sought, the fact that plaintiffs retain their stock is not controlling. An injunction was granted enjoining defendants from depressing the value of Kress stock. In support of its decision, the court explained that one purpose of the Act of 1934 and 10b-5 is the prevention of market manipulation, and that present shareholders were proper parties to play a role in the enforcement of the Act. Furthermore, the court felt that, since plaintiffs would be hard pressed to prove damages, injunctive relief might cure harm suffered by Kress shareholders and prevent future violations.

The courts thus appear willing to allow shareholders to supplement the efforts of the SEC in the enforcement of the securities laws where the relief sought is injunctive. In such cases problems involved with the fashioning of damage remedies vanish. Considerations connected with the requirements necessary to establish a right to recovery under the statutory tort theory (causation, reliance and injury) also become less important. In this view Rule 10b-5 has a dual purpose. It can provide redress to those who have been injured; and it can be employed by others to insure that injuries will not be continued. Furthermore, the class of plaintiffs with standing to use the Rule in this latter capacity is broader than the class which uses the Rule as a remedial device.

**IV. Actions Brought to Halt a Control Shift or a Scheme to Perpetuate Control**

There have been numerous actions brought by plaintiffs seeking to halt a variety of plans for control changes. In each of these cases injunctive relief is sought, and in each the suit is brought either by the corporation or by a deliberately over-optimistic report of corporate affairs might very well have sold his interest and thus might, in a real sense, have been damaged. It is also easy to observe, however, that both the existence and the amount of damages in such a situation might be highly speculative. This in itself might be sufficient reason to deny a right of action, although it is arguable that a plaintiff should at least have the opportunity to attempt to prove the existence and amount of damages.

---

384 F.2d 540 (2d Cir. 1967).


384 F.2d at 546. It should be noted, however, that the court indicated that plaintiff must show that the damages were in connection with the purchase or sale of securities, and that the only purchases and sales here were those between other Kress shareholders and defendants. The court noted that the causal connection between these transactions and plaintiffs' injury was slim. Id. at 546.
shareholder suing derivatively. In *Ruckle v. Roto Am. Corp.*, the court expressly recognized that it was dealing with possible breaches of fiduciary duties by the directors of a corporation. Six of the directors, seeking to perpetuate their control, caused the board to approve the issuance of a large number of treasury shares, which were to be resold to the defendant president or voted as he directed. This behavior was alleged to be fraudulent in that the six directors withheld pertinent information from the board concerning the issuance. Plaintiffs, suing derivatively, sought an injunction to prevent the carrying out of the control device. The court granted plaintiffs standing to sue, and held that the issuance of its own shares by a corporation was a sale. Analogizing from embezzlement and conflict of interest cases, the court also concluded that a majority of the board may be held to have defrauded the corporation. The court distinguished *Birnbaum* on the ground that there the fraudulent statements and omissions were directed not at the corporation but at the shareholders, and that therefore the corporation itself had not been defrauded. It would seem that this analysis could enable a defrauded corporation or its shareholders, in a derivative action, to state successfully a right of action in a variety of situations.

Another manner in which plaintiffs have sought to employ 10b-5 is to halt an impending takeover by means of fraudulent tender offers. Such was the factual pattern in *Moore v. Greatamerica Corp.* There Greatamerica, in its published tender offer to the shareholders of Glidden Corporation, stated that no change in the management or the business operations of Glidden was planned. Plaintiff Glidden alleged that this statement was either untrue or misleading. Defendant argued that Glidden had no standing to sue since it was neither a buyer nor a seller. The court noted that the statute and the Rule were intended to protect unwary and inexperienced buyers and sellers. Commenting that it favored a broad and liberal interpretation of the Act, the court ruled that the individual shareholders and Glidden had standing to sue, and enjoined defendants from taking any action in connection with the tender offer pending a hearing on the merits.

In support of permitting the corporation standing to sue for injunctive relief it has been suggested that in such suits the matter of deception is adjudicated early, and that the corporation's greater awareness of the situation and its resources will protect the shareholders and aid in the enforcement of the securities acts. It is also true, however, that to paralyze a tender offer may cause irreparable harm to a solicitor who might later prevail on the merits.

The court’s analysis in *Moore*, however, goes little beyond saying that the

---

66 339 F.2d 24 (2d Cir. 1964).
67 Id. at 29. These analogies have been criticized as improper, since in neither the embezzlement nor the conflict of interest cases, is there a requirement that anyone be deceived. Comment, supra note 41, at 582.
69 Defendant also argued that since neither of the plaintiff shareholders made a tender that neither had standing. Plaintiffs amended the complaint to allege that one shareholder had made a tender. Id. at 492.
corporation has standing. Silently, it has given full meaning to the words "in connection with the purchase or sale of any security." The purchaser-seller requirement is totally ignored, and there is no discussion of how the corporation may be injured. The court apparently passes over these considerations and allows those in control to demand of those seeking control absolute fairness in the tender offer, possibly for the suggested reasons set out above.

Symington Wayne Corp. v. Dresser Indus., Inc., 102 decided in the Second Circuit, is more demanding of the plaintiffs than the court in Moore. In Symington, the temporary restraining order sought by the corporation and two of its shareholders was denied. Plaintiffs alleged various misrepresentations in a tender offer made by the defendant corporation for shares of the plaintiff corporation. The misrepresentations alleged by plaintiffs appeared potentially harmful only to shareholders, as opposed to the corporation. The court passed over defendant's argument that Symington was neither a purchaser nor a seller, 103 and assumed arguendo that all the plaintiffs had standing. It then denied the temporary restraining order on the grounds that plaintiffs had failed to establish that they were likely to succeed at trial in proving the materiality of the misrepresentations, or reliance on the part of tendering shareholders. Plaintiffs further failed to convince the court that they would suffer irreparable injury if the injunction were not granted. 104 They argued in this regard that if defendant corporation was successful in its tender offer it would have the power to block a merger of Symington with another corporation. The court dispensed with this argument by noting that if this power were achieved by virtue of a 10b-5 violation plaintiffs could seek relief by asking for an injunction against the voting of the shares.

The latter type of relief was sought in Allied Artists Pictures Corp. v. D. Kaltman & Co. 105 In that case, defendant brought an action in a state court seeking to compel the plaintiff corporation, Allied, to call a meeting of the preferred shareholders to elect new directors. 106 Allied sought in federal court to obtain a stay of the state court proceedings and to obtain an injunction forbidding the preferred shareholders from voting their stock. The prospective injury which Allied alleged was that Kaltman would lead Allied into a merger with Kaltman on unfair terms. Plaintiff argued that Kaltman's open market purchase of Allied's preferred stock and its tender offer constituted a scheme which would eventually bring about the alleged injury. The court denied the relief sought on the grounds that federal intervention at such an early stage would be premature, and, further, that it was doubtful that 10b-5 allows a corporation a right of action arising out of a transaction to which it is not a party. In brief, the corporation must be a party to the alleged injurious scheme. This requirement was ignored in Moore and passed over in Symington. In those cases neither corporation was a party to the scheme. In stating the "party" requirement the court cited Birnbaum and

102 383 F.2d 840 (2d Cir. 1967).
103 One of the plaintiff shareholders had tendered ten shares.
104 383 F.2d at 843.
106 Because of dividend arrearage the preferred stockholders were entitled to elect a majority of Allied's directors.
EXPANDING USES OF RULE 10b-5

Hoover, indicating that it regarded the purchaser-seller limitation applicable in this area.

In Bound Brook Water Co. v. Jaffe, the court gave expression to what several of the above decisions left unsaid. The factual pattern was not unusual. Middle Atlantic Utilities Company, some of its shareholders and a third corporation solicited tenders by shareholders of Bound Brook. The tender offer allegedly contained various material misrepresentations and omissions concerning the affairs of Bound Brook, the value of its stock and the competency of its management. Bound Brook and several of its shareholders countered with an action alleging violation of 10(b) and 10b-5, and sought to have the purchases of Bound Brook shares declared void. Defendants argued that neither the corporation nor its non-selling shareholders had standing to sue. The court interpreted Vine as holding not that a non-selling shareholder had standing but that in certain situations the normal meanings of purchaser and seller will not control. The court noted that in Genesco and Pappas the non-selling or non-purchasing shareholder was held to have standing to sue, but distinguished these cases on the ground that there the alleged fraudulent conduct was perpetrated by insiders in control of the corporation, whereas here it was perpetrated by outsiders. The relevance of this distinction is not expressly stated. Perhaps the court feared that a "flood of litigation" would result if it were to hold that "a non-selling or non-purchasing stockholder has a right to sue under Rule 10b-5 every time there was a sale of some stock of his corporation in the course of which certain facts were disclosed or omitted which he felt impinged upon a fair transfer of that stock." Neither a corporation nor its shareholders, according to the court, has any interest per se in the sale of stock by one of its shareholders to a third party. The court indicated that, although it would not be bound by a strict purchaser-seller requirement, the plaintiff still must show an interest in the alleged violative conduct. In dismissing plaintiffs' complaint for failure to state a claim, however, the court indicated how a plaintiff might show such an interest. Plaintiff must allege a violation of 10b-5 performed in connection with a transfer of a security, damage to the plaintiff and a causal connection between that damage and the violation. Plaintiffs here failed to meet the latter two requirements. Briefly, it is not every party that can have declared void a transfer of a security which violates 10b-5. Only those damaged because of such transfer have standing.

At the time of the Bound Brook decision another exploration of the question of necessary interest was occurring in the Southern District of New York. General Time Corporation brought an action against American Investors Fund (Fund) and Talley Industries, seeking injunctive relief. Time alleged that Talley and Fund, an investment company owning about 5 percent of the outstanding stock of Talley, violated 10(b) and 10b-5 in purchasing Time stock on the open market, in that they concealed from Time and its shareholders material facts. The facts concealed were "that Talley intended

108 Id. at 708.
to force a merger with Time, [and] that Talley and Fund were acting in concert.\textsuperscript{10} Time did not allege that it purchased or sold any of its own stock during the time of the alleged purchases by defendants, but attempted to assert injury to itself by arguing that the acts and omissions of defendants "created uncertainty as to the future course and conduct of plaintiff's business, impeded and complicated plaintiff's plans for future operations and adversely affected the morale of plaintiff's employees, all to the great damage of plaintiff and its stockholders."\textsuperscript{11} In granting defendants' motion to dismiss for want of standing to sue the court relied upon \textit{Allied} for the proposition that plaintiff corporation must have been a party to the transaction, and indicated that the rationale as expressed in other cases has been that unless the corporation is a party to the transaction there is no injury to the corporation. The court indicated that this requirement was especially applicable in takeover cases because the incumbent management has no protected interest in remaining in power. Control battles, according to the court, must be waged in accordance with the securities laws, but the proper parties to enforce these laws are those who bought or sold.\textsuperscript{12}

The court indicated that the alleged omissions and acts might injure shareholders who sell. It is quite possible, of course, that disclosure of Talley's plan to merge with Time would be welcome news to Time shareholders. In such a case there would be no injury to anyone except Time management, which has no protected interest. At any rate the court was of the opinion that Time had failed to show injury. Defendants' conduct affects the shareholders, and even if in the long run it did result in the merger and thus did affect the corporation, the alleged intention to merge is not a wrong, according to the court, about which Time can now complain. The court said nothing about the alleged harmful side effects, i.e., uncertainty, poor employee morale and impediment of plans. It is obvious that these are harmful to the corporation, but it is equally clear that they were not caused by the violation of which plaintiff complained. The violation which plaintiff alleged was that the defendants had concealed the plans for a merger. These injuries, it would seem, grow out of knowledge of the merger plans and were thus not caused by the alleged violation.

It would appear that Time is not a proper party to enforce the securities laws because it has not shown any prospective injury to the corporation arising out of the alleged violations which would justify injunctive relief. In neither \textit{Bound Brook} nor \textit{Allied} did the plaintiff successfully allege injury to the corporation. These cases indicate that the courts are not disposed to allow a corporation, either in a direct or derivative action, to demand that control battles be fought according to the securities laws, unless the corporation can allege irreparable injury arising out of the alleged violation.

Although the courts have had little trouble in finding that tender offers, as instruments in control battles, are subject to regulation by 10(b) and 10b-5, this result was made explicit by a recent amendment to Section 14 of

\textsuperscript{10} Id. at 402.
\textsuperscript{11} Id.
\textsuperscript{12} Id. at 403 & n.5.
EXPANDING USES OF RULE 10b-5

the Act of 1934, which became effective July 29, 1968, and by Rule 14d-1(c) promulgated July 30, 1968, implementing other recent additions to the Act of 1934. It was expressly recognized in Electronic Specialty Co. v. International Controls Corp. [ELS] v. International Controls Corp. [ICC] that the amendment, section 14(e), in substance makes 10(b) and 10b-5 applicable to tender offers. Thus notions of standing and the elements required to state a 14(e) or 14d-1(c) claim will probably be adopted from the 10b-5 cases. Indeed, plaintiffs in Specialty brought the action under 10(b), 10b-5 and 14(e). Plaintiffs were ELS and two of its shareholders, one of whom had tendered his stock pursuant to the ICC solicitation. The action, as the court recognized, was an attempt by the management of ELS to halt an ICC takeover. The presidents of ELS and ICC had been carrying on considerable negotiations concerning a merger of the two companies. Although this plan was abandoned, negotiations continued concerning a sale by ICC to ELS of its holdings in ELS. After these negotiations were terminated, ICC made a tender offer to ELS shareholders. Plaintiffs brought an action seeking to enjoin defendant from carrying out its tender offer.

The court recognized, correctly it would seem, that the provisions of 10(b) and 14(e) are “intended to offer protection to the persons to whom the tender offer was addressed, i.e., the stockholders of ELS.” Despite the fact that it recognized, therefore, that the issue was whether the tender offer “misled those stockholders in order to induce them to sell their stock to ICC,” the court expressly indicated that the corporation itself has standing to sue.

Plaintiffs alleged that the tender offer was misleading in that ICC had definite plans to merge with ELS, and further that such a plan would not be advantageous to ELS shareholders. Plaintiffs argued, in this regard, and the court agreed, that a statement in the tender offer of ICC that it would consider a merger with ELS did not comply with 14d-1(c), which requires that the offer describe plans for merger.

The court found further that plaintiffs might be successful in their contention that defendant engaged in a manipulative device in contravention of 14(e). Plaintiffs, in support of this contention, argued that defendant

113 2 CCH Fed. Sec. L. Rep. ¶ 20,345. Section 14(e) provides:

It shall be unlawful for any person to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer or request or invitation for tenders, or any solicitation of security holders in opposition to or in favor of any such offer, request, or invitation.

114 Sec. Reg. 240.14d-1(c), 33 Fed. Reg. 11017 (1968), which provides that a tender offer, when the offeror's purpose is to acquire control, must “describe any plans of [or?] proposals which the purchasers may have . . . to merge it [the company being acquired] with any other persons . . . .”


116 Id. at 97,303.

117 Id. at 97,305.

118 Id.

119 Id. at 97,306.
deliberately tried to mislead the public into believing that ICC was about to dump 100,000 shares of ELS on the market, and thereby depressed the price of ELS stock. The purpose was to frighten ELS shareholders into accepting ICC’s tender offer.

Despite these findings, the court refused to grant an injunction which would end the tender offer because of the possible harm to shareholders who desired to sell, and who would lose out on the possible benefits of the tender offer if the injunction were granted. Also, in denying the injunction, the court felt that the harm to plaintiffs was not irreparable since, if they were successful on the merits, they would be able to enjoin ICC from voting the stock acquired by means of the tender offer. Furthermore, the court indicated that the possibility of harm extended to all ELS shareholders, not merely to those who sold. Perhaps the corporation was given standing because the court felt that it was in the best position to protect all ELS shareholders. In such a situation the central concern will be a balancing of prospective injury against the possible harm which might result if the injunctive relief is granted.

CONCLUSION

In the individual shareholder actions the Birnbaum requirement seems still to be viable as far as actions for damages are concerned. The courts have been very willing to expand the concepts of purchaser and seller, however, where it is clear that the plaintiff has suffered damage as a result of a violation of 10b-5. It has been suggested that the purchaser-seller requirement is needed to avoid the danger of speculative damages. In this regard, it should be noted that in the cases which have relaxed the requirement there would seem to have been no danger of speculative damages. It may be expected that where there is a plain causal connection between the alleged injury and a purchase or sale of securities induced by fraud the courts will relax the purchaser-seller requirement. It is probable, furthermore, that this readiness to afford a right of action where injury is apparent will lead to the abandonment of the requirement. The only real barrier now existing to this development is the judicial fear of a deluge of 10b-5 claims where the damages alleged are highly speculative.

Where injunctive relief is sought this fear has already been overcome. In Genesco the injunction was granted despite the fact that plaintiffs had not sold. It is not unusual that the relief sought can be an indication of the likelihood of success. As was pointed out in Genesco, the elements of a claim for prophylactic relief need not be established as clearly as when the relief sought is damages. The injunction avoids the danger of speculative damages and if viewed merely as a means of enforcing the securities rules, as the court in

1968 Utah L. Rev. 170, 178.

There is a danger of speculative damages where there has been no sale and thus no solid basis for determining the actual damages. In the cases where the purchaser-seller requirement has been expansively interpreted there is such a standard. In Vine and Voge it is the price at which plaintiffs are “forced” to sell and in Fidelis it arguably is the standard set up in the contract which provided that additional consideration was to be determined by the earnings of Fidelis’ assets.

Mutual Shares Corp. v. Genesco, Inc., 384 F.2d 540, 547 (2d Cir. 1967).
EXPANDING USES OF RULE 10b-5

*Genesco* seemed to view it, it becomes apparent why the necessity of alleging reliance, deception and causation, as well as standing as a purchaser or seller, is relaxed. There is no problem of recovery going to an undeserving plaintiff who did not in fact rely on the alleged misstatement or omissions. Further, where, as here, the injunction only forbids market manipulation, there is no danger of harm to other shareholders, as there sometimes may be where the purpose of the injunction is to halt a tender offer. Where the granting of an injunction will cause no harm to those parties whom 10b-5 was intended to protect and to other innocent parties, the policy of allowing other parties such as the corporation or a shareholder to supplement the activity of the SEC in enforcing the securities laws will further the intent of Congress to protect the investing public.

The same considerations are applicable in the area of corporate or derivative actions where plaintiffs are seeking to halt a change in corporate control or schemes to perpetuate control. The possibility of successfully meeting standing requirements in such actions is increasingly high. Where the corporation seeks to halt an impending takeover by means of a fraudulent tender offer, two problems, common where injunctive relief is sought, arise. First, the corporation must show a potential injury; second, the necessity for an injunction must be weighed against the possible injury which may occur if the injunction is granted. In all probability if the corporation can show a misleading tender offer which will allow those who would gain control thereby to perpetrate alleged plans injurious to the corporation the courts will halt such a takeover, or at least enjoin the voting of shares to effect the injurious plans. An allegation of a scheme or plan to injure may be necessary in this regard.

In the area of derivative suits brought to redress injury to the corporation the law is still in a confused state. In this area, as opposed to that of control battles, the central concern has not been a failure to allege corporate injury. In many cases the injury is clearly apparent. Nor have the courts in this area been troubled by the purchaser-seller requirement. The corporation, when it issues shares or exchanges or sells shares of another company, clearly meets this requirement. For the most part the judicial hesitancy to afford a right of action arises instead from the fact that, though the alleged violation involves securities, the essence of the complaint is a violation of a fiduciary duty, which has traditionally come within the realm of the state courts. The federal courts recognize that the internal affairs of a corporation are an area of state interest. However, in enacting the securities laws Congress has determined that in the securities field there is a wide public interest best protected by federal legislation. Yet it is arguable that Congress did not intend that section 10(b) or any rule promulgated under it regulate this entire field. Rather, the statute and the Rule may be intended only to insure fairness in the act of creating or dissolving ownership ties, and not to protect that ownership interest which exists between these two events. In the cases in this area plaintiffs, though they are enforcing a right of the corporation, are in reality seeking to employ 10b-5 to protect this interim interest. Of course this interest should be protected, but it is doubtful that 10b-5 was intended to afford this protection. Nevertheless, the judicial barrier erected in this area to deny a right of action,
the requirement of deception, has been eroded. If it is finally removed it will constitute one more example of the federal judiciary filling a void created by congressional and state inaction.

JOSEPH C. TANSKI