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Securities—Sale of Stock by Minority Shareholders—Effect of SEC Rule 10b-5 on Insider Activities.—Cochran v. Channing Corp

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being exclusively determined by "what appears on the face of the instrument alone."[14] If the instrument thus explicitly states that it is subject to or governed by separate writings, it is not negotiable.[15] In this manner the Code maintains a separation between the problem of collateral instruments qualifying the terms of negotiable instruments and the problem of collateral instruments destroying the negotiability of the negotiable instruments.

In the principal case the court was not required to interpret the Code,[16] but it attempted to utilize section 3-119(2) and comment 5 thereto to augment its position against inclusion of the mortgage clause. The use of this subsection and comment was a misapplication of the Code to the facts of the case. Since the Code, as previously shown, establishes a separation between the problems of negotiability and inclusion of simultaneous instruments, the rationale that a note would lose its negotiability by incorporating other instruments within itself cannot be maintained under the Code. Nevertheless, in transactions involving immediate parties, there is still one basis by which the courts can sustain a holding that the terms of simultaneous instruments may not be included within the terms of the note—the intention of the parties. The courts in interpreting this intention may conclude that by not placing the provisions in the note itself, the parties did not intend the note to be governed by the clauses of the mortgage.[17]

In conclusion, the Code provisions demand that the jurisdictions decide anew whether or not, between the original parties and persons holding with notice, the acceleration clause in an accompanying mortgage will affect the terms of the note. The decision reached by these courts is also required to be based upon a fact determination of the intent of the parties and can no longer be founded upon the destruction of negotiability theory.

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Securities—Sale of Stock by Minority Shareholders—Effect of SEC Rule 10b-5 on Insider Activities.—***Cochran v. Channing Corp.***[1]—Action by minority shareholders against the dominant corporate stockholder and the directors of Agricultural Insurance Company for a violation of SEC Rule 10b-5 and New York tort law. Plaintiff alleged that the defendant, Channing Corp., engaged in a scheme aimed at obtaining the shares and control of

[14] Comment 5 to section 3-119 states that the key is the formality of the note.

[15] Ibid. The comment adds that "if it merely refers to a separate agreement or states that it arises out of such an agreement, it is negotiable." See UCC § 3-105 and comments thereto. The Permanent Editorial Board has recommended an addition to § 3-105(1)(c). A promise or order will not be made conditional by the fact that the instrument "refers to a separate agreement for rights as to . . . acceleration." Rep. No. 1, Permanent Editorial Board for the UCC (1962).

[16] The UCC became effective in New Jersey on January 1, 1963.

[17] This interpretation of the intent of the parties may be weak if the mortgage makes any reference at all to the note's inclusion of the mortgage terms. Since all the instruments are viewed as one contract, and the parties are deemed to intend the usual meaning of words used in contracts which they sign, the conclusion would appear to be that the parties' intent was to incorporate the acceleration clause within the note.

[1] 211 F. Supp. 239 (S.D.N.Y. 1962).

Agricultural at the lowest possible price, withholding from the public any disclosure of its identity or of its program until it became the dominant stockholder. Plaintiff further contended that Agricultural's directors, having become dominated by defendant, artificially reduced its quarterly dividend which successfully facilitated Channing's purchase of further shares at depressed prices. Because of this dividend reduction and lack of information plaintiff sold 500 shares of Agricultural stock at a price reflecting these factors. Motion to dismiss was denied by the district court. HELD: The fact that defendants did not make any statements to plaintiff does not in and of itself deprive plaintiff of relief because one who causes a reduction in dividends in order to buy securities at a lower cost is employing a device to defraud and is engaging in a course of business which operates as a fraud upon the seller. The fact that there is no privity of contract will not be a fatal defect, but in so far as plaintiff falls short in his proof, the lack of privity of contract will be one factor to be taken into account.

In accordance with one purpose of the Securities Exchange Act to insure fair and honest markets,[2] section 10b[3] and Rule 10b-5[4] are designed to prevent fraud and deception in securities transactions and provide broad remedies, irrespective of whether the fraud charged would be sufficient to sustain a remedy at common law.[5] To achieve these purposes more fully, the courts have consistently provided a civil remedy for investors who suffer a loss from violation of Rule 10b-5, even though it does not expressly provide for such remedy.[6] It has been interpreted by the courts as creating a duty of disclosure by insiders of information coming to their knowledge and not

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[2] Section 2, 48 Stat. 881 (1934), 15 U.S.C. § 78b (1958). See 1 Loss, Securities Regulation 130 (2d ed. 1961).

[3] 48 Stat. 891 (1934), 15 U.S.C. § 78j(b) (Supp. 1963). Section 10b 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 security exchange . . . . (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

[4] 17 C.F.R. § 240.10b-5 (Supp. 1963) 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.

[5] Cady, Roberts & Co., SEC Securities Act Release No. 6668 (November 8, 1961).

[6] Fischman v. Raytheon Mfg. Co., 188 F.2d 783 (2d Cir. 1951); Northern Trust Co. v. Essaness Theatres Corp., 103 F. Supp. 954 (N.D. Ill. 1952); Speed v. Transamerica Corp., 99 F. Supp. 808 (D. Del. 1951); Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946).

known to other shareholders.[7] The protection of the Rule extends to the defrauded purchaser or seller,[8] in transactions between individual shareholders, and those carried on in stock exchanges or public markets.[9]

Thus, if the dividends were reduced by defendants with an intent to purchase outstanding shares at a price below their equity value, as plaintiff alleges, this act would be clearly a device or scheme to defraud,[10] because it would be an attempt to obtain stockholder's equity for less than its true value or part of their equity for no value whatsoever. It is not common law fraud for which plaintiff is suing but the committing of acts proscribed by the terms of 10b-5.[11]

Defendants contended that the complaint should be dismissed because there was no allegation of privity of contract between plaintiff and defendants. Specifically, plaintiffs did not allege that defendants bought the stock which plaintiffs sold because of the reduction in dividends. Defendants supported this contention chiefly with the authority of *Joseph v. Farnsworth Radio & Television Corp.*[12] In *Farnsworth* the plaintiffs bought stock of defendant corporation after individual defendant officers made public a false financial report. The court stated that a "semblance of privity between the vendor and purchaser of the security in connection with which the improper act, practice of course of business was invoked seems to be requisite and it is entirely lacking here."[13] However, in that case there was no allegation that plaintiff relied upon defendant's false report when the stock was purchased. The court expressed no opinion upon the sufficiency of a complaint alleging reliance by a plaintiff and expressly stated that reliance "coupled with the possibility that later sales by individual defendants may form the basis of privity with these plaintiffs."[14] This suggests that the privity which the court had in mind was not a strict privity of contract between the plaintiffs and defendants. Since the court in the *Farnsworth* case intimates that if reliance upon defendant's statements had been alleged, the complaint would have been sustained, the court might have been referring to an adequate causal connection between the wrongful act of defendants and the purchase or sale by the plaintiffs.[15] It is submitted that the court properly determined that the *Farnsworth* case does not lay down a strict privity of contract requirement for all cases under Rule 10b-5.[16]

The court in the *Channing* case decided the question as to the necessity of privity upon the basis of *Brown v. Bullock*.[17] This case stated that privity is not an ultimate or operative fact, but an evidentiary fact to be considered

[7] Kardon v. National Gypsum Co., 73 F. Supp. 798 (E.D. Pa. 1947); Speed v. Transamerica, supra note 6.

[8] Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir.), cert. denied, 343 U.S. 956 (1952).

[9] Northern Trust Co. v. Essaness Theatres Corp., supra note 6.

[10] 211 F. Supp. at 243.

[11] Hughes v. SEC, 174 F.2d 969, 975 (D.C. Cir. 1949).

[12] 99 F. Supp. 701 (S.D.N.Y. 1951), aff'd per curiam, 198 F.2d 883 (2d Cir. 1952).

[13] Id. at 706.

[14] Ibid.

[15] Brief for Plaintiff, p. 24.

[16] 3 Loss, Securities Regulation 1768 (2d ed. 1961).

[17] 194 F. Supp. 207 (S.D.N.Y. 1961).

with all other material facts in determining whether the relationship between the plaintiffs and the defendants and the nature of the particular acts and transaction involved the duty created by the statute.[18] The *Channing* court, in holding that to the extent that plaintiff falls short in his proof, "the lack of privity between the parties will be one factor that will have to be taken into account,"[19] follows the expression in the *Brown* case as to the proper function of a privity requirement and is in line with the most permissible inference of the *Farnsworth* case.

A strict requirement of privity between plaintiff and defendant in an action under Rule 10b-5 would seriously weaken that rule and render the act ineffectual by providing a loophole for issuers and brokers to evade liability. The court in *Texas Continental Life Ins. Co. v. Dunne*[20] observed that in the sale of bonds, a buyer had a right to rely upon the prospectus of the issuer no matter from whom the bonds were being bought since the original purchasers of securities do not always retain them as permanent investments, and public trading in such securities is not uncommon.[21] Otherwise, one, who after having caused another to sell or buy by his deceptive business practice or device, would only need to allow the interposition of a third person to insulate himself from liability.[22] This is contrary to the purpose of section 10b of the act which authorizes the rule "for the protection of investors."[23]

The court's holding in the *Channing* case, that if plaintiff is able to prove each and every allegation in the complaint, the lack of privity of contract between plaintiff and defendant will not amount to a fatal defect,[24] implies that upon the showing of reliance there will be sufficient causal connection between defendant's unlawful acts and plaintiff's loss. The nature of defendant's participation in a challenged transaction and plaintiff's reliance upon defendant's acts may vary.[25] Nevertheless, privity, as a factor in both, should be considered only to determine the requisite elements of the action under Rule 10b-5: that defendant *committed* the acts proscribed by the rule and plaintiff *relied* upon defendant's acts *causing* harm to himself. Because of these factors, the indication from the lack of a privity requirement that Rule 10b-5 will become a method by which an unsuccessful investor will be able to recover because he made a poor investment, is obviously unwarranted.

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Taxation—Corporate Liquidation—Applicability of Section 337 to Assignment of Income.—*Commissioner v. Kuckenberg*.[1]—Pursuant to a plan of complete liquidation, Kuckenberg Construction Company, an Oregon

[18] Id. at 229-30.
[19] 211 F. Supp. at 245.
[20] 307 F.2d 242 (6th Cir. 1962).
[21] Id. at 249.
[22] Brief for Plaintiff, p. 29.
[23] Supra note 3.
[24] 211 F. Supp. at 245.
[25] Brown v. Bullock, supra note 17.

[1] 309 F.2d 202 (9th Cir. 1962).