FRAUD IS IN THE EYES OF THE BEHOLDER: 
RULE 10b-5'S APPLICATION TO ACTS OF 
CORPORATE MISHANAGEMENT

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Much has been written in the last few years concerning Section 10(b) of the Securities Exchange Act and the Securities and Exchange Commission's Rule 10b-5. Despite the breadth of this discussion, an unusual amount of confusion over the application of these provisions remains. In this article, Professor Cox posits an artificial framework for clarifying one of the most troublesome issues—namely, the establishment of a standard to determine which kinds of corporate mismanagement are considered fraudulent under the Act. After examining the Supreme Court's recent holding that an alleged fraud need only touch the purchase or sale of securities, and after focusing on the purposes of the Act, Professor Cox proposes that the standard for applying Rule 10b-5 to acts of corporate mismanagement should depend on the participants in the corporate decision-making process. When only the board of directors is involved, the search for deceit and the use of agency fictions should be rejected in favor of a standard requiring a lack of independence in the board of directors' investment judgment coupled with either an economic loss or want of a corporate purpose. However, when both the board and the shareholders participate in the decision-making process, although this same standard should apply to the directors, Rule 10b-5 should require only the traditional full disclosure at the shareholder level.

In their traditional applications, Section 10(b)¹ and Rule 10b-5² function as safeguards insuring that both buyers and sellers of securities have equal access to information that will enable them

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¹ Securities Exchange Act of 1934, § 10(b), 15 U.S.C. § 78j(b) (1970), provides as follows:
   It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
   . . . .
   (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.
² 17 C.F.R. § 240.10b-5 (1972) provides as follows:
   It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
   (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

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to make sound investment decisions. In the wake of litigation seeking to regulate the affairs of corporate management under the antifraud prohibitions of the Securities Exchange Act of 1934 (Exchange Act), the initial objective of assuring parity of information now appears to have become an inappropriate and misleading standard for determining the application of these prohibitions; when those authorized under state law to undertake a securities transaction on behalf of their corporation are in full possession of all the facts material to that decision, the quest under section 10(b) for information necessary to make an informed decision is satisfied. That the result may be unfair to the corporation and motivated by self-interest are arguments all too easily characterized as supporting a charge of corporate mismanagement or waste to be remonstrated under state law and, accordingly, not a matter of federal concern. To be sure, the concepts of corporate mismanagement and waste are broad enough to include conduct acknowledged to be in violation of section 10(b); therefore, the mere classification of conduct as such does not satisfy the plaintiff's burden. Yet, doubt still remains as to a meaningful standard which can be applied to distinguish corporate mismanagement actionable under section 10(b) from that which is not. Thus, when the Supreme Court agreed to decide the first private claim it has heard under rule 10b-5, in Superintendent of Insurance v. Bankers Life & Casualty Co., which involved the clearest

(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 Section 10(b) was certainly enacted as a "catchall," so its provisions logically extend to much more than compelling the disclosure of material facts. See 1 A. Bromberg, Securities Law: Fraud: SEC Rule 10b-5, § 2.2 (332) (1971). Unfortunately, the legislative and administrative history of § 10(b) and rule 10b-5 provide little illumination and have had even less influence upon their scope and meaning in view of emerging judicially articulated objectives. See generally Rudor, Civil Liability Under Rule 10b-5: Judicial Revision of Legislative Intent?, 57 Nw. U.L. Rev. 627, 642-60 (1963).

4 See, e.g., Schenck v. Firstbrook, 405 F.2d 200, 211-12 (2d Cir.), rev'd on rehearing en banc, 405 F.2d 215 (2d Cir. 1968), cert. denied, 395 U.S. 906 (1969); O'Neill v. Maytag, 339 F.2d 764, 767-68 (2d Cir. 1964). This reasoning is not new to corporate law: see Justice Holmes' classic opinion in Old Dominion Copper Mining & Smelting Co. v. Lewisohn, 210 U.S. 205 (1908).


6 404 U.S. 6 (1971). The Supreme Court upheld the implied private right of action with little insight into its reasons for doing so and even less fanfare. See id. at 13 n.9. However, in view of its actions in analogous areas, and after 26 years of private litigation under § 10(b) and rule 10b-5, the result was hardly unanticipated. See Bahnem, Rule 10b-5: The Case for Its Full Acceptance as Federal Corporation Law, 37 Cin. L. Rev. 727, 747-49 (1968).
form of corporate mismanagement and waste, *viz.*, embezzlement, there was hope that the Court would provide some much-needed guidance in this area now deemed "federal corporation law."

I

THE IMPLICATIONS OF Bankers Life

A. Introduction

Bankers Life & Casualty Company agreed to sell its wholly owned subsidiary, Manhattan Casualty Company, to Begole for $5 million cash. Begole acquired this amount of cash through a scheme by which the purchase price was in fact supplied out of Manhattan’s assets. Under this plan, Begole exchanged a check drawn on the Irving Trust Company for the Manhattan stock held by Bankers Life. Upon closing the transaction, Begole installed Sweeny as Manhattan’s president, who on the same day as the sale, delivered to Irving Trust Government bonds which were among the securities held in Manhattan’s portfolio. Irving Trust thereupon sold the bonds and credited Manhattan’s account against which the check issued to Bankers Life was drawn. As a result, Manhattan’s assets had been diminished by $5 million—the amount of the purchase price.

To conceal the effect of these transactions, Begole arranged for a certificate of deposit to be issued to Manhattan in the amount of $5 million. While the certificate of deposit was valid, Manhattan’s balance sheet failed to reflect that the certificate was fully pledged to secure a loan the proceeds of which were used to acquire the certificate of deposit. Manhattan’s financial position then began to deteriorate until it became insolvent, whereupon the Superintendent of Insurance of New York assumed his powers under state law and proceeded with the liquidation of Manhattan.

Unlike the sale of the Manhattan stock to Begole or the various allegations of fraud arising out of certificates of deposit issued in Manhattan’s name, Manhattan’s standing to sue for the

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7 This phrase was coined by Chairman Cary in *In re Cady*, Roberts & Co., 40 S.E.C. 907, 910 (1961). While a desired goal is to maintain flexibility by avoiding a rigid definition of the elements which comprise a cause of action under rule 10b-5, in an analogous area the Supreme Court has nevertheless demonstrated that it is possible to provide a meaningful standard and still retain flexibility. See *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375 (1970) (discussing the elements of a private cause of action under § 14(a) of the Exchange Act, 15 U.S.C. § 78n(a) (1970)).

sale and misappropriation of the proceeds of the Government
bonds was clear. However, both the district court and the court of
appeals concluded that since Manhattan was not misled as to the value of the bonds it sold, nothing more than an act of corpo-
rate mismanagement redressable only under state law had been
stated. Both courts believed section 10(b) was violated only
by conduct which posed a threat to the trading process generally,
such as by the issuance of watered stock.

B. Abandonment of the Requirement that an Invasion of
the Trading Process Be Threatened

The Supreme Court settled the argument that the gravamen
of the plaintiff's complaint was a charge of mere embezzlement,
and not a violation of the securities laws, by refusing to bifurcate
the sale and misappropriation, as had the Second Circuit. Utili-
zation of the vehicle of deception, the Court decided the case on the
grounds that Sweeny's failure to disclose to the board that the
proceeds of the sale would be misappropriated was deceit under
section 10(b). In so doing, the Court clearly embraced the thought that materiality includes more than matters going to the value
of the security and includes, as well, the motive for the

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9 In the district court, the plaintiff alleged fraud was practiced upon the
corporation in three transactions: (1) Bankers Life's sale of the Manhattan stock
to Begole; (2) the sale of the Government bonds and subsequent misappropriation
of the proceeds thereof; and (3) the transactions involving the various certificates
of deposit used to conceal the earlier misappropriations. 300 F. Supp. 1033, 1037-92
(S.D.N.Y. 1969). However, in the court of appeals, the plaintiff only pressed the
charge of fraud in the latter two areas. 430 F.2d 355, 357 (2d Cir. 1970).

As to the plaintiff's attack on Bankers Life's sale to Begole, the district court
had little difficulty in concluding that the plaintiff lacked standing: the Superin-
tendent of Insurance was neither a purchaser nor a seller, even though he argued
Manhattan must be so deemed since its funds were employed by Begole to acquire
the Manhattan stock. 300 F. Supp. at 1098. Nor did the district court believe that
Manhattan was a purchaser or seller of the certificates of deposit issued in its name,
arguing it was only nominally the payee since each certificate was immediately
endorsed to another upon issuance. Id. at 1098-99.

Both lower courts upheld Manhattan's standing to sue on the sale of the Gov-
ernment bonds, but ultimately held for the defendant for the reasons stated in
the text following this note. The court of appeals also upheld the right of Man-
hattan to sue on the certificates of deposit, but affirmed the dismissal of the plain-
tiff's complaint on the same reasoning it had employed in dismissing the charge of
fraud regarding the misappropriation of the bond proceeds. 430 F.2d at 361.

10 430 F.2d at 350-51; 300 F. Supp. at 1102-03.

11 430 F.2d at 361; 300 F. Supp. at 1101-03.

12 404 U.S. at 8 n.1.

13 Materiality refers to rule 10b-5's requirement that "material" facts be dis-
closed. For the text of rule 10b-5, see note 2 supra. See generally SEC v. Texas
Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969); List v. Fashion Park, Inc., 340 F.2d 457 (2d Cir.), cert. denied, 382

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transaction.\textsuperscript{14} Furthermore, the Court stated that there was no additional requirement that the transaction threaten the integrity of securities markets, such as by the distribution of watered stock, for rule 10b-5 protects all securities transactions, including those not undertaken in organized securities markets.\textsuperscript{15}

The lower court's reliance upon an invasion of the trading process was not particularly extraordinary. Enacted in the aftermath of the stock market crash of 1929, provisions of the Securities Act of 1933 (Securities Act)\textsuperscript{10} and the Exchange Act\textsuperscript{17} sought to correct the abuses in the trading process which were at the heart of that financial catastrophe.\textsuperscript{16} It is not surprising then that rule 10b-5 has often been interpreted and applied against the background of maintaining the integrity of the securities markets. Actions have been successfully maintained to remedy the danger posed to investors by management's dissemination of misleading press releases\textsuperscript{19} or other manipulative conduct.\textsuperscript{20} Similarly, the requirement that there be a threat to the integrity of the securities markets has been deemed satisfied in situations in which management has caused its corporation to enter into an unfavorable security transaction quite apart from any trading or potential trading over organized securities markets.\textsuperscript{21}

\textit{Petitit v. American Stock Exchange}\textsuperscript{22} remains the classic exam-

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\item[\textsuperscript{14}] 404 U.S. at 9-10.
\item[\textsuperscript{15}] Id. at 10.
\item[\textsuperscript{17}] Id. §§ 78a-78hh.
\item[\textsuperscript{19}] See, e.g., Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90 (10th Cir. 1971), cert. denied, 404 U.S. 1004 (1972); Helt v. Welten, 402 F.2d 909 (2d Cir. 1968), cert. denied, 395 U.S. 603 (1969).
\item[\textsuperscript{20}] See, e.g., Briti v. Cyril Bath Co., 417 F.2d 433 (6th Cir. 1969); Mutual Shares Corp. v. Genesco, 384 F.2d 540 (2d Cir. 1967). But see Christofides v. Porco, 289 F. Supp. 403, 407 (S.D.N.Y. 1968) (withholding dividends so as to use money retained to acquire the corporation's stock and thereby maintain unquestioned control of the corporation deemed not to be within rule 10b-5).
\item[\textsuperscript{22}] 217 F. Supp. 21 (S.D.N.Y. 1963). An analogous case is Hooper v. Mountain States Sec. Corp., 282 F.2d 195 (5th Cir. 1960), cert. denied, 365 U.S. 814 (1961), in which a corporation was caused to issue its stock for greatly overvalued consideration through the fraudulent representations of authority made by its former management to its stock transfer agent. Since the corporation's decision-
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ple of this approach. There, the defendant allegedly conspired with the controlling stockholder to defraud the corporation by causing it to issue stock with an established market value in exchange for worthless assets. In what was the first serious erosion of the pronouncement in *Birnbaum v. Newport Steel Corp.* that section 10(b) did not apply to acts of corporate mismanagement, the court stated that the mere fact "the fraud was perpetrated by insiders does not render Section 10(b) inapplicable, if the transaction represents an abuse of the securities trading process." The court found such an abuse in the threat that the watered stock would be distributed to the public. While under this approach the court acknowledged that the corporation would not have suffered a federally compensable injury (the harm being to the potential distributees of the stock), the corporation was nevertheless deemed an appropriate party to make recovery because of the difficulties investors would have in asserting their own causes of action.

It is far from clear whether *Pettit*'s reasoning was intended as a statement that section 10(b) operates only to protect the integrity of organized securities markets or as merely an acknowledgment of the conceptual paradox inherent in situations in which the inanimate corporation is alleged to have been deceived by its full board of directors, thereby causing the court to require the additional showing of harm to others. Both concepts,

making body was not misled, a violation could not be premised on a fraud upon the corporation. The court proceeded to view the transaction in the abstract as a scheme to "dupe" the corporation into issuing its stock for less than its true value. Unlike the *Pettit* decision, there was no discussion of the possible threat to the trading process caused by the distribution of watered stock.


*25* Id. at 26.

*26* Id. at 27-28.


*28* See Searburg-Commonwealth United Litigation, [1971-72 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 93,277 (S.D.N.Y. Nov. 12, 1971), in which the court felt compelled to find a threat to the securities trading market when the full board of directors acted to defraud their corporation by causing it to issue its stock for grossly inadequate consideration and also to acquire another corporation's stock at an excessive price. The court reasoned that this caused a diminution in stock-
of course, serve to limit section 10(b)'s application. Thus, while the Supreme Court's opinion in Bankers Life unquestionably refutes the reasoning of the first concept, there is a decided lack of consistency among the circuits in the grounds for concluding that a corporation may be deceived by its directors. To be sure, the possible threat to investors because of the directors' acts is a most appropriate basis for invoking the protection of section 10(b), but it remains to be decided whether it is the only ground.

C. Broadening the "In Connection With" Requirement

The most notable effect of the decision in Bankers Life is that it puts to rest a line of argument recently developed in the lower courts with the objective of setting forth a workable standard which would serve to limit rule 10b-5's application to the managerial affairs of corporations. The argument first enunciated in Judge Herland's district court decision in Bankers Life, and quickly adopted in subsequent cases, is essentially a test of remoteness of the fraud from the security transaction. It provides that the consummation of a security transaction as a mere incident of a fraudulent scheme fails to bring that conduct, however reprehensible, within the scope of federal concern. As such, a violation of rule 10b-5 arises only in cases in which the security transaction was the essence of the fraud, such as occurs when the fraud deprives the corporation of full value from the sale of its stock.

Thus, in a later Second Circuit panel decision, Drachman v. Harvey, subsequently modified en banc, the plaintiff failed to

holds' equity, which in turn resulted in a decline in the market value of the defrauded corporation's stock. Id. at 91,958.

20 See, e.g., Dasho v. Susquehanna Corp., 461 F.2d 11 (7th Cir.), cert. denied, 408 U.S. 925 (1972); Shell v. Hentley, 430 F.2d 819 (5th Cir. 1970); Schoenbaum v. Firstbrook, 405 F.2d 215 (2d Cir. 1968) (en banc), cert. denied, 395 U.S. 906 (1969); Pappas v. Moss, 393 F.2d 865 (3d Cir. 1968).

21 Judge Herland's argument was as follows:

Manifestly, the sale of Manhattan's portfolio and the purchase of the Manhattan shares were necessary steps toward the ultimate looting of Manhattan's assets. But rule 10b-5 requires the employment of fraud in connection with a security transaction, which is essentially different from the effectuation of a security transaction in connection with a fraudulent activity.

300 F. Supp. at 1102.


23 The idea that the fraud must relate to the value of the securities sold was first posited in Fleisher, Federal Corporation Law: An Assessment, 78 Harv. L. Rev. 1146, 1165 (1965).

24 453 F.2d 722 (2d Cir. 1971), modified on rehearing en banc, 453 F.2d 736 (2d Cir. 1972).
state a derivative action under rule 10b-5 by alleging that the
corporation was deceived by its directors’ subservience to the
desires of its dominant stockholder, Martin Marietta Corpora-
tion. The latter wanted the corporation to undertake the re-
demption of its convertible debentures so that the prospective con-
version of those bonds would not remove control from Martin
Marietta. Ultimately, the redemption was authorized by the
board, even though that transaction later necessitated heavy bor-
rowing by the corporation at onerous interest rates. The Second
Circuit concluded on the basis of its earlier opinion in Bankers
Life that, since the redemption was pursuant to the fairly nego-
tiated contractual terms of the bond indenture, no violation of
section 10(b) was stated; the security transaction was merely
incidental to the alleged wrongful objective of retaining control.35
Under this narrow construction of the “in connection with” re-
quirement, a cause of action under rule 10b-5 could be stated only
if it could be shown that because of the fraud the security trans-
action did not result in a fair exchange of values. Any effort to
premise a charge of fraud on the ground that the security trans-
action was, for example, motivated by a desire to gain or retain
control or to eliminate dissident factions, or that it was the pre-
lude to looting of the corporate assets, would all be deemed too
remote. It is all too apparent that this broadly worded provision
necessitates a much fuller inquiry than is required for merely
determining whether the security transaction was the vehicle for
the accomplishment of fraud or the fraud itself. Certainly, the
Supreme Court, in Bankers Life, manifested its desire for a broad
reading of rule 10b-5 by setting forth that the alleged fraud need
only “touch” the purchase or sale of securities.36

II
POSSIBLE OBJECTIVES WHICH MAY BE EMPLOYED TO
DETERMINE WHETHER CONDUCT IS FRAUDULENT

A. Bankers Life’s Impact upon the Resolution of
What Is Fraud

Although the Supreme Court has defined where the situs of
the fraud may be in reference to the purchase or sale of stock, the

34 See note 36 infra.
35 453 F.2d at 732.
36 404 U.S. at 12. After the Supreme Court’s Bankers Life opinion, the Sec-
ond Circuit, en banc, decided to overrule the panel decision in Drach-
man because of the Supreme Court’s articulation of a much looser “in connection with” require-
ment. 453 F.2d at 736-38. In its en banc decision, the Second Circuit hinted it
would review its opinions in Birnbaum and Schoenbaum after the facts in Drach-
man were developed in the district court. 453 F.2d at 738.
meaning of fraud remains in doubt. While fraud clearly encompasses more than the value to be exchanged for the securities, does it nevertheless require proof of some economic harm? Or does it concern the motive behind the transaction and the climate in which it was effected? Although it did not supply an answer to these questions, Bankers Life's loose "in connection with" requirement clears the way for a fuller exploration and eventual resolution of these inquiries. This is partly because in many of the prior cases, such as Drachman, the battleground was whether the fraud was in connection with the security transaction, not whether the conduct was fraudulent. Also, the looser "in connection with" requirement is a further invitation to the disgruntled minority to bring within rule 10b-5 conduct traditionally a matter solely of state concern. These two factors—removal of an obstacle to more complete examination of the meaning of fraud and the stimulation of litigation concerning acts of corporate mismanagement—are to be the great impact of Bankers Life. And though it provided the stimulus for the eventual answer to the above inquiries, Bankers Life's great deficiency is its opaque references as to their resolution.

Necessarily, the meaning of fraud must be found in the objectives sought to be achieved under section 10(b). As stated in

37 Hopefully, further enlightenment will come from the Second Circuit in its reconsideration of the peculiar facts in Drachman, in which the alleged sin was the board's subservience to the self-interest of the corporation's dominant stockholder's desire to retain control. Unlike the board of directors in Bankers Life, however, the board in Drachman was not deceived by misrepresentations, but operated with full knowledge of all the facts. As such, the subsequent decision in that case may well foretell what the final result will be in Bankers Life, if the trial court resolves that Sweeny had the inherent authority to sell the Government bonds and, accordingly, no solicitation of the board's approval was sought or necessary. This seems to have been the interpretation Judge Herlands gave the facts, see 300 F. Supp. at 1089 & n.6, although the plaintiff hotly maintained that there was a formal resolution of the board of directors on the basis of Sweeny's representation that the sale constituted no more than switching Manhattan's Investment from Government bonds to a certificate of deposit, 450 F.2d at 357 n.3. As the case came up on a motion to dismiss, the plaintiff's allegations were, of course, accepted as being true.

It would appear that under the Supreme Court's loose requirement that the fraud merely touch the securities transaction, the subsequent concealment of the misappropriation with the certificates of deposit may satisfy the requirement, if indeed one does exist, that deceit be practiced upon the board of directors. See Seeburg-Commonwealth United Litigation, [1971-72 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 93,577 (S.D.N.Y. Nov. 12, 1971), a case in which concealment of the unfair terms of a securities transaction was deemed to have satisfied the "in connection with" requirement of rule 10b-5. An analogy to Hooper v. Mountain States Sec. Corp., 282 F.2d 195 (5th Cir. 1960), cert. denied, 365 U.S. 814 (1961), likewise would not be inappropriate. See note 22 supra.

38 404 U.S. at 9.
the *Bankers Life* opinion, an objective of Congress in enacting section 10(b) was, in part, to protect corporate creditors. Extending this objective to its logical conclusion, it may well be said that section 10(b) is violated whenever a corporation undertakes an economically disadvantageous security transaction, because such transactions erode the estate to which creditors may look for eventual payment. Under such a theory, inquiries into scienter and the motives of the defendants would be eschewed and the analysis would rest upon the effects of the transaction. However, the securities laws, and particularly the antifraud provisions of the Exchange Act, were never designed to assure profitable or desirable investment decisions. Emphasis in both the Securities Act and the Exchange Act is rather upon creating a climate conducive to achieving a free and informed investment decision. And while section 10(b) was not intended to be a mere disclosure statute, the tenor of case law has been to construe it as such. Accordingly, cases have consistently held there to be an insubstantial federal interest where the only allegation of harm is that the corporation has entered into an economically improvident transaction.

Even though it is beyond doubt that a mere allegation that a security transaction resulted in a financially unfair exchange fails to state a cause of action under section 10(b), the *Bankers Life* opinion suggests that such an allegation, buttressed with a charge that the security transaction was instigated in derogation of the controlling stockholder's fiduciary obligation to the minority, may state a cause of action under the statute. And while the argument that section 10(b) is a fiduciary duty section is not novel, the exact meaning of that statement is far from clear; as Justice Frankfurter expressed in his now classic quote, "to say that a man is a fiduciary only begins analysis."

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30 404 U.S. at 12 n.8. For a discussion of the cases which have employed rule 10b-5 for the protection of creditors, see Macey, Protection of Creditors Through the Use of Rule 10b-5, 76 Col. L.J. 133 (1971).


42 404 U.S. at 12.


In the context of section 10(b), the controlling stockholder's duty may extend to requiring that it withdraw its personal interest from the corporate decisional process, thereby providing, in some instances, a federal answer to the classic corporate question whether a stockholder may vote as he pleases. In the alternative, section 10(b) may require much less, and instead, rest upon compelling openness in the manner the controlling stockholder manifests its self-interest in the security transaction and disclosure of its reasons for voting as it did. As the remainder of this article will illustrate, both avenues of thought can be found in the opinions which have dealt with the question. Results have varied, depending upon whether the corporation's decisional process is comprised solely of the board of directors or whether it includes the stockholders as well.

B. Disclosure as the Worthy Objective

In Dasho v. Susquehanna Corp., a derivative action was brought to recover for the loss that Susquehanna allegedly suffered when its board of directors caused the corporation to acquire a block of its own stock from a dissident faction. Threatened with the prospect of a suit by the dissidents to enjoin a proposed merger favorable to Susquehanna's controlling stockholders, the directors agreed to exchange investment securities held by Susquehanna in another corporation for the dissident's Susquehanna stock on terms which the plaintiff alleged seriously undervalued the worth of the securities given up in the exchange. Presented

46 For an inclusive discussion on the general topic of the dominant shareholder's freedom to vote as he pleases, see Sneed, The Stock-Holder May Vote as He Pleases: Theory and Fact, 23 U. Pitt. L. Rev. 23 (1960).

47 461 F.2d 11 (7th Cir.), cert. denied, 408 U.S. 925 (1972). The court also dealt with a matter of equal importance in deciding that the holding of Ross v. Bernhard, 396 U.S. 531 (1970), regarding the right to a jury trial in derivative actions, was retroactive and applied to cases filed and concluded before Ross was decided. 461 F.2d at 20-21.

48 Earlier the former controlling stockholders, the Lannan Group, sold control at a premium to American Gypsum Company, which was controlled by Korholz. Gypsum financed the purchase through a loan. Upon Susquehanna's merger with Gypsum, this loan was to be assumed, with the result that Susquehanna thereby provided the funds with which Korholz acquired control of Susquehanna. It was upon these facts that the dissidents threatened suit to require the Lannan Group to disgorge their profits and to enjoin the merger. This eventually culminated in the accord under which the dissidents exchanged their Susquehanna holdings for stock Susquehanna held in the Vanadium Corporation of America. 461 F.2d at 17. See generally Dasho v. Susquehanna Corp., 380 F.2d 262 (7th Cir.), cert. denied, 389 U.S. 977 (1967).

49 The plaintiff's documentation of this charge was the fact that the Vanadium stock was simultaneously resold at a price much above the prevailing market price.
for the first time with the issue of how the inanimate corporation whose investment judgment rests in the board of directors could be defrauded by that process, the Seventh Circuit stated that a corporation is deceived whenever material facts are withheld from some members of the corporation's board of directors or, in the alternative, whenever the entire board of directors is interested in the transaction and fails to disclose such material facts to the shareholders.\(^{49}\)

Unlike other situations in which disclosure of material facts in itself and without more accomplishes the objective of protecting the investor from the unscrupulous,\(^{60}\) disclosure in the factual setting of Dasho does not. Even with disclosure of all material facts, the directors remain in control of the corporation's investment judgment and may proceed to effect the transaction. To be sure, the imposition of a duty upon the directors to disclose the unfairness of the transaction presents three alternative courses of action upon which such reasoning plays.

The least desirable from the directors' viewpoint is to make full disclosure of their wrongful conduct, proceed with the transaction and face the consequences, which could include a loss of business reputation, removal from corporate office and civil liabil-

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49 Id. at 26. The question of the directors' interest in the transaction can be deemed as an essential aspect of the plaintiff's burden of establishing scienter coupled with a showing that the directors acted out of that interest. This is a much more realistic approach than to rely upon the agency fictions that because of the directors' interest in the transaction their knowledge will not be imputed to the corporation, so that the corporation remains uninformed and, therefore, is deceived. See Bailey v. Meister Brau, Inc., 250 F. Supp. 539, 543-44 (N.D. Ill. 1965), and Cohen v. Colvin, 266 F. Supp. 677, 681 (S.D.N.Y. 1967), which employed this reasoning. This analysis would seem to be overcome by another equally applicable principle of agency law that whenever the agent (i.e., the directors) is the "sole actor" in the transaction—which is certainly the case when only the directors act on behalf of the corporation—the agent's knowledge will be imputed to his principal (i.e., the corporation), regardless of the impropriety of his actions. See Monroe v. Harriman, 85 F.2d 493, 495 (2d Cir. 1936); Note, Fiduciary Suits Under Rule 10b-5, 1968 Duke L.J. 791, 795, 799. For criticism of the application of agency doctrines to these cases, see Babcock, Rule 10b-5: The Case for Its Full Acceptance as Federal Corporation Law, 37 Cin. L. Rev. 727, 734-37 (1958). Obviously, the disinterest of the board has an influence upon a court's reaction to judging the fairness of the transaction. See Lauranzano v. Einbender, 448 F.2d 1, 5 (2d Cir. 1971).

60 See, e.g., Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90, 97 (10th Cir. 1971), cert. denied, 404 U.S. 1004 (1972) (plaintiff recovering upon an allegation that she would not have sold stock had she been fully informed of the extremely rich mineral strike the company had made); Speed v. Transamerica Corp., 59 F. Supp. 835, 829 (D. Del. 1951).
ity under state law for breach of their fiduciary duty. At the other extreme, the directors could forego the transaction entirely. But more than likely they would forego the disclosure and proceed with the transaction.\textsuperscript{51}

It must be observed that the immediate objective of compelling such disclosure is to protect the corporation's investment judgment, for the directors retain the ability to effect the transaction regardless of disclosure; rather it is to provide notice to the minority directors or stockholders so they may take action under state law to prevent the consummation of the transaction.\textsuperscript{52}

The validity of this explanation seems in great doubt in view of the paramount objective of section 10(b) to provide relief otherwise not available under state law\textsuperscript{53} in a forum not fettered by the narrower procedural rules and jurisdictional limitations of the state.\textsuperscript{64} Furthermore, the focus of state law has remained upon

\textsuperscript{51} Under such an appraisal of the directors' conduct, no shortcomings in the Dasko analysis exist, save perhaps in those instances in which management has made a forthright presentation of all material information to the stockholders or minority directors. No cases on this point have been found, perhaps for the reasons discussed earlier in the text. The author's primary criticism of the disclosure line of analysis is that adequate standards for determining liability have not yet been developed; instead, courts which employ the disclosure concept continue to rely on the ineffectual rubric of deception guided by agency fiction. See note 49 supra. However, it would appear that if all interests of the corporation are to be afforded the protection of rule 10b-5, the concept of fraud must include more than want of disclosure.

\textsuperscript{52} In Seeberg-Commonwealth United Litigation, [1971-72 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 93,277, at 91,598 (S.D.N.Y. Nov. 12, 1971), the court, relying upon this argument to find that the subsequent concealment of the unfair terms of a securities transaction violated rule 10b-5, stated:

The allegedly fraudulent, self-serving securities transactions engineered by the Commonwealth management with the participation of defendant Arthur Young may provide a basis for a derivative claim against Arthur Young inasmuch as vital information concerning them was withheld from or misrepresented to the Commonwealth stockholders and inasmuch as the stockholders might at some point have put a stop to the Rozel-Kleiner Bell Group's scheme, either by removing the self-serving management . . . or by instituting appropriate derivative court action . . . .

Contra, Laureano v. Einbender, 264 F. Supp. 356 (E.D.N.Y. 1966), aff'd, 448 F.2d 1 (2d Cir. 1971) (where the court refused to conclude that a proxy violation must be found for want of full disclosure merely because it would have facilitated private action under state law to enjoin the transaction).


\textsuperscript{54} Section 27 of the Exchange Act, 15 U.S.C. § 78aa (1970), affords not only broad venue but also nationwide service of process coupled with the freedom from the procedural restraint of posting security for the defendant's expenses in derivative actions. See Borak v. J.I. Case Co., 317 F.2d 838, 849 (7th Cir. 1963), aff'd on other grounds, 377 U.S. 426 (1964); McClure v. Borne Chem. Co., 292 F.2d 824 (3d Cir.), cert. denied, 368 U.S. 919 (1961). These amenities involving matters previously of concern only under state law are discussed in Dykstra, The Revival
the relative fairness of the financial terms of the transaction; but given an informed and independent investment judgment, fairness of the financial terms of the proposed transaction does not assure its approval. If section 10(b)’s thrust only went to the financial terms of a transaction, then facts deemed material and required to be disclosed would only include such financial matters, which, of course, is not the case. An acknowledged goal of the securities laws is to assure the inviolability of the corporate right to reject or accept a security transaction regardless of the financial merit of the transaction. As such, the courts’ immediate focal point should be upon the climate in which that investment judgment is exercised, not the mere incidental exposure of that climate coupled with the erstwhile hope that it may be regulated under state law in such a way as to be responsive to the over-all objectives of the federal securities laws.

C. Focus upon the Independence of the Investment Judgment

A different approach was taken in Schoenbaum v. Firstbrook, the central holding of which reflects the belief that section 10(b) seeks to assure the independence of the corporation’s investment decision. Schoenbaum brought an action on behalf of Banff Oil, Ltd. seeking to recover the full value of 770,000 shares of Banff treasury stock which were issued to Aquitaine Company and Paribas. Aquitaine controlled Banff, placing three of its own nominees on Banff’s eight-member board. After Banff’s exploration of a Canadian oil field had proven highly successful, but before notice of its discovery had been made public, Banff’s directors voted to issue 500,000 shares of Banff’s treasury stock at the current market price to Aquitaine. Subsequent to the sale, Banff’s board issued a press release announcing that the oil had been discovered. However, the details of the discovery were not


made public until a year later.\textsuperscript{58} In the meantime, the board voted to sell 270,000 shares of its treasury stock to Paribas.\textsuperscript{60} The plaintiff attacked the transactions as a scheme, knowingly participated in by all of Banff's directors, to enrich Aquitaine and its business associates at the expense of Banff and its shareholders by issuing the stock at an inadequate price—\textit{i.e.}, all of Banff's directors must have known that the market price, which pegged the selling price of Banff stock to both Aquitaine and Paribas, did not represent the true value of the stock since the market price did not fully reflect the impact of the discovery, if at all.\textsuperscript{60}

The Second Circuit, on rehearing en banc,\textsuperscript{61} concluded that the improper exercise of "controlling influence" by Aquitaine over Banff's board of directors, causing the board to issue Banff's stock for an inadequate consideration, constituted a violation of section 10(b).\textsuperscript{62} In essence, the court concluded that Aquitaine, by preventing the directors from exercising an independent judgment because of the control it held over them, had impaired the investment judgment of the corporation as effectively as a misrepresentation prevents the exercise of an informed, independent investment decision.\textsuperscript{63}

\textsuperscript{58} Id. at 205.
\textsuperscript{60} Paribas was an investment bankers' company which was not affiliated with Aquitaine or Banff.
\textsuperscript{60} The movement in the market price of Banff's stock documents this conclusion. On December 11, 1964, when Aquitaine acquired its 500,000 shares, the market price was $1.35 per share. After the succinct announcement of the discovery, the price rose to $7.30. After the full details of the discovery were made public, Banff's stock traded at a price as high as $18.00 per share. 405 F.2d at 217-18.
\textsuperscript{61} In the Second Circuit's original decision, Judge Lumbard concluded that since all of Banff's directors were fully informed, and only noninterested directors participated in the vote, there was no deception. 405 F.2d at 212. Judge Lumbard stated the court could not "refuse to impute the directors' knowledge to the corporation on the ground that the directors participating in the corporate decision had a conflicting personal interest in the transaction." Id.
\textsuperscript{62} Id. at 218-19.
\textsuperscript{63} The court in Shell v. Hensley, 430 F.2d 819, 827 (5th Cir. 1970), arrived at the same conclusion by reasoning that a corporation would be defrauded under rule 10b-5 by all of its directors:

When the other party to the securities transaction controls the judgment of all the corporation's board members or conspires with them to profit mutually at the expense of the corporation, the corporation is no less disabled from availing itself of an informed judgment than if the outsider had simply lied to the board.

See similar reasoning in Reliant v. Desser, 425 F.2d 873, 882 (5th Cir. 1970). Schoenbaum has been similarly interpreted as abandoning the deceit analysis and as promising the result upon the exercise of control over the corporation's investment judgment. See Carpenter v. Hall, 311 F. Supp. 1095, 1103 (S.D. Tex. 1970); Bloomenthal, From \textit{Birnbaum} to \textit{Schoenbaum}: The Exchange Act and Self-Aggrandizement, 15 N.Y.L.F. 332, 346-49 (1969).

The SEC interprets \textit{Schoenbaum} as protecting the corporation from secu-
While an investment decision arrived at by the board of directors without the exercise of due care or with pure recklessness is hardly unimpaired and informed, cases subsequent to Schoenbaum have refused to impose federal liability in such instances, even though the error is of such a magnitude as to amount to a waste of the corporate assets.\textsuperscript{64} Furthermore, the mere fact that the securities transaction is unfair to the corporation does not itself give rise to an action under section 10(b). This was established in Schoenbaum, by the court's dismissing the plaintiff's complaint against Paribas to whom Banff had also sold its treasury stock for an inadequate price since it was not alleged that Paribas exercised any control over Banff's directors.\textsuperscript{65} Therefore, transactions conducted at arm's length appear to be beyond the pale of section 10(b) both under Schoenbaum and under Dasho.

Neither Dasho nor Schoenbaum precludes the directors from engaging in a security transaction with their corporation, if it is otherwise fair on its face.\textsuperscript{66} The question, nevertheless, remains whether the mere exercise of controlling influence, without more, violates rule 10b-5. While a good deal of judicial lip service is paid to the desirability of maintaining the board's independence, it is a corporate fact of life that the dominant stockholder's voice is more than heard in the boardroom.\textsuperscript{67} Schoenbaum need not be read as requiring the complete independence of the board, for Aquilaine's exercise of controlling influence was coupled with a substantial economic loss to the corporation flowing from the transaction.\textsuperscript{68} Yet, the concept of fraud is broad enough to include

\footnotesize{\begin{itemize}
  \item 405 F.2d at 219.
  \item See, e.g., Review 71 v. Alloys Unlimited, Inc., 450 F.2d 482 (10th Cir. 1971).
  \item Corporate law permits the exercise of influence over the corporation's affairs by its controlling stockholder, provided the transaction complies with the court's concept of fairness. See Note, The Fiduciary Duty of Parent to Subsidiary Corporation, 57 Va. L. Rev. 1223 (1971); Note, Corporate Fiduciary Doctrine in the Context of Parent-Subsidiary Relations, 74 Yale L.J. 338 (1964).
  \item It remains to be decided whether the Bankers Life opinion will become a license to the disgruntled minority to premise injury to the corporation upon a transaction separate from the one being sued upon. This, of course, was in part the harm alleged in Drachman, where the corporate loss resulted from heavy borrowing at onerous interest rates due to the redemption of the debentures. Bankers Life's statement that the alleged fraud need not involve the value of the security traded, read with the broader "in connection with" requirement, certainly is to be viewed as an open invitation to include any harm proximately caused by
\end{itemize}
conduct not giving rise to an immediate economic loss to the corporation or its stockholders, and could be deemed to circumcribe the manipulation of the corporation's investment judgment to effect a security transaction which serves no valid corporate purpose. 69 Certainly, rule 10b-5 should be flexible enough to distinguish between instances in which the dominant stockholder's influence is an exercise of business acumen, such that it is compatible with prevailing business ethics and mores, and those in which it is motivated purely out of narrow personal considerations which pose a threat to the minority.

The fact that state law may also provide an adequate and efficacious remedy should not prevent the application of rule 10b-5 to if the corporation's investment judgment is impaired by the directors' subservience to the influence of the dominant stockholder's objective of purely personal gain. To be sure, this will involve substantial and serious factual disputes; but the standard of want of independence in the directors' investment judgment, coupled with economic loss or the want of a corporate purpose for the transaction, can be expected to be a much more workable and comprehensible standard than the inquiry into how the directors have deceived themselves, coupled with agency fictions 71 and unarticulated considerations hidden under the rubric of undisclosed material facts. 72

the transaction sued upon, even though it did not arise immediately out of that transaction.

69 See Drachman v. Harvey, 453 F.2d 722, 732 (2d Cir. 1971), modified on rehearing en banc, 453 F.2d 736 (2d Cir. 1972) (tenor of the complaint was that the redemption of convertible debentures was a blatant effort to retain control); Tully v. Mott Supermarkets, Inc., 337 F. Supp. 834 (D.N.J. 1972) (fraud premised on the basis that the directors issued treasury stock to themselves as a raw grasp for control).


71 See note 49 supra. An equally difficult factual dispute which must be resolved by the court in any case in which damages are sought is the issue of whether the corporation was in fact harmed by the transaction, i.e., would more favorable terms have been forthcoming had there been the fullest disclosure, or would the corporation have been better off without the transaction? See Dasho v. Susquehanna Corp., 461 F.2d 11, 29-31 (7th Cir.), cert. denied, 408 U.S. 925 (1972).

72 See, e.g., Bryan v. Brock & Blevins Co., Inc., 343 F. Supp. 1062, 1070 (N.D. Ga. 1972) (effectuation of a merger with the objective of "squeezing" minority shareholder out of the corporation deemed to be a device, scheme and artifice to defraud); Tully v. Mott Supermarkets, Inc., 337 F. Supp. 834, 835 (D.N.J. 1972) (premising fraud upon a failure to disclose that the objective of reissuance of stock was to acquire control).
III

ANALYSIS OF SHAREHOLDER PROXY VOTING AS AN EXERCISE OF INVESTMENT DECISION—THE CONTINUING VALIDITY OF Barnett v. Anaconda Co.\textsuperscript{73}

Inherent in the above theories is the belief of the courts that a violation of section 10(b) exists regardless of whether the security transaction could have been blocked by intracorporate measures.\textsuperscript{74} Inquiry necessarily should be made as to the influence of such reasoning and the validity of its application to instances in which the corporation’s decisional process is comprised not only of the board of directors, but also of the shareholders as a group.\textsuperscript{75} While the proxy provisions of section 14(a)\textsuperscript{70} and rule 14a-9\textsuperscript{77} are of special application in this setting,\textsuperscript{78} technically

\textsuperscript{73} 238 F. Supp. 766 (S.D.N.Y. 1965).
\textsuperscript{74} See Seiberg-Commonwealth United Litigation, [1971-72 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 93,277 (S.D.N.Y. Nov. 12, 1971). The determination of a rule 10b-5 violation on the basis of whether the security transaction could have been blocked by intracorporate measures was a product of a comparison of the conflicting results achieved earlier by the Second Circuit in Ruckel v. Roto American Corp., 339 F.2d 24 (2d Cir. 1964) (violation of rule 10b-5 found even though the minority directors were not party to the fraud), and O’Neill v. Maytag, 339 F.2d 764 (2d Cir. 1964) (no fraud where all directors have full knowledge of the unfair aspects of the security transaction). In Barnett v. Anaconda Co., 238 F. Supp. 766, 774-75 (S.D.N.Y. 1965), the court distinguished the result reached in Ruckel from that in O’Neill not on the basis that some part of Roto American’s board was deceived but rather on the basis that the plaintiff in Ruckel, unlike the plaintiff in O’Neill, possessed sufficient voting power as a majority shareholder to block the transaction “by appropriate corporate action” but was prevented from doing so by deception. 238 F. Supp. at 776 n.7.

\textsuperscript{75} Typical of such transactions would be a merger, a sale of the corporation’s assets for stock, or the authorization of more corporate stock, or changes in the rights and preferences of outstanding stock, all of which are required by state corporate statutes to be submitted to the stockholders for approval. See, e.g., Del. Code Ann. tit. 8, § 251 (Supp. 1970); N.Y. Bus. Corp. Law § 903 (McKinney Supp. 1972); ABA-ALI Model Bus. Corp. Act §§ 71-73 (1969). Even where the governing corporate statute does not require the security transaction to be approved by the shareholders, a corporate bylaw or stock exchange listing provision may compel approval. See, e.g., NYSE Company Manual A-284 (1968). That a shareholder vote is in fact an exercise of the corporation’s investment judgment, and not solely a shareholder decision, finds support in the conclusion of the Supreme Court that a derivative action can be maintained whenever the proxy solicitation is tainted by a material misstatement or omission. J.I. Case Co. v. Borak, 377 U.S. 426, 432 (1964). If purely a shareholder decision, the corporation would lack standing to sue since its right to an informed exercise of corporate suffrage would not have been interfered with by the misstatement or omission.

\textsuperscript{77} 17 C.F.R. § 240.14a-9 (1972).
\textsuperscript{78} Obviously, this holds true only for those securities which are registered under § 12 of the Exchange Act, 15 U.S.C. § 78l (1970). See, e.g., Popkin v. Bishop, 464 F.2d 714 (2d Cir. 1972); Kohn v. American Metal Climax, Inc.,
section 10(b) also applies whenever a security transaction is an integral part of the proposed transaction submitted to the shareholders for approval. \(^{79}\)

In its uncomplicated form, management lacking the necessary voting power to assure approval of the proposal will, by human nature and necessity, fail to disclose in the proxy statement the facts underpinning the fraudulent character of the proposal. If, as can be anticipated, the information suppressed is of such a character that it "might have been considered important by a reasonable shareholder who was in the process of deciding how to vote," it will be deemed a misstatement or omission of a material fact, giving rise to a cause of action. \(^{80}\)

The Supreme Court has intimated that this same reasoning may not apply where management controls enough voters to assure approval of the transaction. \(^{81}\) Historically, where the corporation's investment judgment is lodged solely in the board of directors, the focal point of analysis has been whether some portion of that decisionmaking body has been impaired, regardless of whether the outcome would have been different had there been full disclosure. \(^{82}\) Yet, when the decisional process is extended to include the stockholders, the result rests upon simple voting power.

The leading case for this proposition is *Barnett v. Anaconda Co.*, \(^{83}\) in which an action was brought under sections 10(b) and 438 F.2d 255, 265 (3d Cir. 1972), cert. denied, 41 U.S.L.W. 3179 (U.S. Oct. 10, 1972) (No. 72-5); Laurenzano v. Einbender, 448 F.2d 1 (2d Cir. 1971); Voge v. Smith, 319 F. Supp. 180 (S.D.N.Y. 1971).


\(^{80}\) Id. at 385 n.7. In its opinion, the Supreme Court stated the causation test as follows:

Where there has been a finding of materiality, a shareholder has made a sufficient showing of causal relationship between the violation and the injury for which he seeks redress if, as here, he proves that the proxy solicitation itself, rather than the particular defect in the solicitation materials, was an essential link in the accomplishment of the transaction. . . .

Id. at 385 (emphasis added).

\(^{81}\) See text accompanying note 67 supra.

\(^{82}\) 238 F. Supp. 766 (S.D.N.Y. 1965)
14(a) to enjoin a proposed sale of Anaconda Wire & Cable to Wireco, Inc. on the grounds the proxy materials were misleading in their failure to disclose that the sale was being made for an inadequate consideration. Since the defendants owned 73% of Anaconda and only a two-thirds vote was required for approval of the sale, the court granted the defendant's motion for dismissal, stating:

Here there is no question of fact as to causal relationship between the proxy material and the transactions under attack. The "but for" element—the element of causation—does not and, indeed, could not exist. The transactions under attack did not result from the issuance of the allegedly misleading proxy material which, in view of the affirmative and concededly true allegation as to Anaconda's 73% stock holdings, could not have had anything to do with the approval and consummation of such transactions.84

Barnett's conclusions would appear to apply with equal force where a majority of a board's directors have caused their corporation to effect an unfair securities transaction. All such attempts to so apply Barnett, however, have been unsuccessful.85 Perhaps this apparent inconsistency may be explained by the fact that section 14(a)'s proscriptions against fraud are designed specifically to assure the informed, knowledgeable exercise of corporate sufrage—an objective which is obviated when the stockholders owning the requisite number of shares to assure approval of the transaction have full knowledge of all the facts.86 However ap-

84 Id. at 771. Barnett's reasoning has been controlling in the following cases: Adair v. Schnieder, 293 F. Supp. 393, 396 (S.D.N.Y. 1968) (action under § 10(b) challenging an amendment to the corporation's charter increasing the number of authorized shares which the plaintiff alleged were at the center of a scheme to transfer control to the defendants); Robbins v. Banner Indus., Inc., 285 F. Supp. 758, 762 (S.D.N.Y. 1966) (finding a proxy solicitation which sought stockholder approval of an undisclosed fraudulent transaction to be without legal effect and, therefore, without causation); cf. Krafsin v. LaSalle Madison Hotel Co., [Current] CCH Fed. Sec. L. Rep. ¶ 83,586 (N.D. Ill. June 19, 1972) (discussed in note 103 infra); Weiss v. Sunasco, 295 F. Supp. 824, 828 (S.D.N.Y. 1969) (holding no violation when the misstatement or omission in the proxy solicitation relates to a move which could be accomplished without stockholder approval).

85 See, e.g., Weber v. Battle, 272 F. Supp. 201, 204 (S.D.N.Y. 1967), which met the argument with the statement that on the ground of public policy the argument should be rejected.


87 Such a result was recently implied in In re Penn Cent. Sec. Litigation, 347 F. Supp. 1227 (E.D. Pa. 1972), in which it was held that § 14(a) sought to protect against damage caused by an infringement of the right of corporate sufrage due to misleading proxy solicitations "which affect the corporate voting process." Id. at 1342. The court stated that a cause of action would lie only when the purchase or sale of the security was "the result of a corporate transaction whose approval was obtained by a misleading proxy statement." Id.
peeling this argument may be, it has little, if any, relevance to a section 10(b) action under which the exercise of informed corporate suffrage is merely a part of a larger objective of assuring a climate of fair dealing in a security transaction.\(^8\)

Sound reasons exist for rejecting Barnett's conclusions\(^8\) aside from its inconsistency with the body of law surrounding corporate investment decisions arrived at solely by an interested board of directors. The Exchange Act was drafted primarily to protect investors against fraudulent, misleading and manipulative practices in securities transactions. Through the imposition of regular reporting requirements and proxy provisions, it sought to establish a system which would give investors greater understanding of their investments.\(^9\) As was stated earlier,\(^9\) section 10(b) has been interpreted in this light through an emphasis upon disclosure. To allow the surveying of materially misleading and fraudulent information in proxy statements to go unreduced would clearly be inconsistent with these two stated objectives.\(^9\)

Intelligent action by investors respecting their investments requires the fullest possible knowledge of the affairs of the corpo-

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9 Many cases have refused to follow Barnett. See, e.g., Popkin v. Bishop, 464 F.2d 714, 720 (2d Cir. 1972) (recognizing that "but for" causation is not required but also concluding that no material omission existed in the proxy solicitation); Laurenzano v. Emsheder, 448 F.2d 1 (2d Cir. 1971) (stating simply that the approval of the minority shareholders is always important but also finding no defect in the proxy solicitation); Swanson v. American Consumer Indus., Inc., 415 F.2d 1326 (7th Cir. 1969); Pappas v. Moss, 393 F.2d 865 (3d Cir. 1968). See also Laufer v. Stranahan, (1969-70 Transfer Binder) CCH Fed. Sec. L. Rep. ¶ 92,617 (S.D.N.Y. 1970); Eagle v. Horvath, 241 F. Supp. 341, 343-44 (S.D.N.Y. 1965). Despite the weight of these cases, there is yet some indication that Barnett's reasoning has not been rejected by the district courts in the Second Circuit. See, e.g., Lewis v. Bogin, 337 F. Supp. 331, 335 (S.D.N.Y. 1972). See also note 10 infra.


'[T]he corporate proxy [is] a tremendous force for good or evil in our economic scheme. Unregulated, it is an open invitation to self-perpetuation and irresponsibility of management. Properly circumscribed, it may well turn out to be the salvation of the modern corporate system.

See also SEC, Disclosure to Investors: A Reappraisal of Federal Administrative Policies Under the '33 and '34 Acts 376-77 (CCH ed. 1969) (The Wheat Report), where the objective of the proxy statement is likened to that of the registration statement of newly issued securities.

91 See text accompanying note 40 supra.

ration. One of the most fertile sources for information concerning a corporation's affairs is the proxy statement. A stockholder armed with the knowledge that the majority stockholders are subordinating the interests of the corporation and the minority stockholders to the narrow personal interests of the majority may proceed in a number of ways to protect his investment.

Although a strict requirement of full disclosure has meaning quite apart from fulfilling an objective of the securities laws, of importance under section 10(b) is whether the corporation should have a cause of action if it is caused to undertake a security transaction when management has sufficient voting power to assure passage of the proposal regardless of whether all material facts have been fully disclosed. When a corporation undertakes a

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92 SEC, Proposal to Safeguard Investors in Unregistered Securities, H.R. Misc. Doc. No. 677, 79th Cong., 2d Sess. 18 (1946); 2 L. Lass, Securities Regulation 1027 (2d ed. 1961) ("The proxy rules are very likely the most effective disclosure device in the SEC scheme of things.").

94 The most efficacious manner in which a stockholder may seek to protect his investment is to divorce himself from the enterprise upon disclosure of information he believes harmful to his investment. The lack of disclosure would not only prevent stockholders from taking this action, but might also stimulate and influence investments in the corporation by outsiders.

In states adhering to a corporate law that provides, or one which in a similar manner, a necessary predicate to the exercise of that right is that the stockholders vote against the proposal submitted for stockholder approval. See, e.g., Del. Code Ann. tit. 8, § 262 (Supp. 1970); N.Y. Bus. Corp. Law § 623 (McKinney Supp. 1972). Thus, a defective proxy statement may fall the unwary into foregone their appraisal remedy by causing them to vote approvingly for the proposal. In Syron v. American Consumer Indus., Inc., 415 F.2d 1326 (7th Cir. 1969), the existence of an appraisal remedy was relied upon in concluding that there was the requisite causation on the grounds that if such a remedy were exercised by enough stockholders it would cause the merger to be cancelled because of the substantial cash demand it would impose.

A final manner in which a stockholder may seek to protect his investment is to seek an injunction under state law of the fraudulent conduct alleged to be harmful to his or the corporation's interests. Needless to say, such a course would be aided by the disclosure in the proxy statement of the fraudulent character of the transaction.

The availability of these various courses of action, all of which would be aided by compelling full disclosure regardless of management's voting power, should militate against reading into both § 14(a) and § 10(b) requirements not contained in either provision. And while any concept of liability embodies a requirement of causal relationship between the right violated and the harm suffered, this is not conterminous with simple voting power. For a more extensive treatment of this subject, see Note, Causation and Liability in Private Actions for Proxy Violations, 83 Yale L.J. 107 (1973).

93 While most actions for misleading proxy solicitation have been maintained as direct class actions, they may also be maintained as derivative actions. J.I. Case Co. v. Borah, 377 U.S. 426 (1964). By focusing upon the conduct rather than the lack of deception, Schoenbaum suggests that full disclosure should not be exculpatory even in a proxy solicitation. While this could not state a cause of action under rule 14a-9, which only attacks material misstatements and omissions, the narrower requirements of one provision of the securities laws does not prohibit a
security transaction which must be submitted to the stockholders for their approval (because of applicable state law or corporate or exchange provisions), the corporation's decisional process is comprised of two independent bodies—its board of directors and the stockholders. Both elements would appear to merit the protections afforded by section 10(b), for it would be unduly artificial to eliminate the directors' decision from the reach of section 10(b) merely because it is attendant to that of the stockholders. Indeed, since it is all too well documented that the directors' recommendation to the shareholders carries great weight in the final resolution of the proposal, there seems to be good reason for providing the highest assurances that the board's decision and recommendation are at least fair. As such, what was said before regarding the dominant stockholder's exercise of controlling influence over the board's decision should apply with equal force. Emphasis upon the relative independence of the directors' decision hopefully would foster fuller disclosure in the proxy solicitation, since the board's openness should be a factor in the courts' determination whether the directors' actions have violated rule 10b-5. Certainly, the failure of the directors to disclose in the proxy solicitation the unfairness or self-interest underpinning the transaction can be interpreted as fraud in connection with their earlier decision.

If the stockholders' approval is atomized and viewed not solely as a decision of that body, but rather as a decision of a body comprised of many individual investment decisions, the overwhelming voting power of the dominant stockholder becomes


98 See note 75 supra.
97 See Pappas v. Moss, 393 F.2d 865 (3d Cir. 1968), in which the court analyzed the case in terms of the directors' decision even though the transaction had been submitted to the stockholders for their approval.
95 See text accompanying note 45 supra.
91 See, e.g., Swanson v. American Consumer Indus., Inc., 415 F.2d 1326 (7th Cir. 1969) (full disclosure will enable the stockholder to exercise his appraisal remedy); Gould v. American Hawaiian S.S. Co., 331 F. Supp. 981, 992 (D. Del. 1971) (misrepresentation in the proxy solicitation will prevent the shareholder from determining what his return should be upon the approval of the merger).
moot. This analysis is most appropriate when the proxy solicitation concerns a merger or liquidation in which the voting stockholder is presented with the choice of exchanging his stock for the value provided under the proposed plan, or of proceeding to sell the stock on the market or of seeking, where available, the value of his stock under the state appraisal statute. Having all the features of an investment decision, it should be made with the fullest knowledge of all the facts, which, of course, Barnett does not assure.

The most direct ground for rejecting Barnett, however, is that its reasons for arriving at a requirement that the plaintiff establish causation under a “but for” test were premised upon its understanding of the case law as it then existed on the question of whether a corporation could be defrauded by its entire board of directors: to wit, the directors could deceive their corporation only when sufficient voting power was reposed in the disinterested stockholders to override the board’s decision. This reasoning is not supported in recent cases such as Dasho and Schoenbaum, which have consistently held that a violation of rule 10b-5 exists even though the transaction could not have been prevented by intracorporate devices. Accordingly, Barnett should cease to have any vitality. But when, unlike Schoen-
baum, shareholder approval is an element of the decisionmaking process, rule 10b-5 should be applied to proxy solicitations by inquiring as to whether there has been disclosure sufficient to foster an intelligent investment decision. Clearly, these corporate investment decisions do not present the conceptual paradox accompanying the board's investment decision on behalf of the inanimate corporation.\(^\text{106}\) Thus, rule 10b-5 would hardly prevent the dominant stockholder from acting on the basis of his personal interests, provided this influence is exercised at the shareholder meeting and not in the boardroom. The possibility should remain, however, that an action can be maintained even though there was full disclosure in the proxy solicitation if the transaction poses a threat to the purity of the trading process.\(^\text{107}\)

IV

CONCLUSION

In view of the broad sweep of the language of section 10(b) and rule 10b-5, it is not surprising that the courts have attempted to restrain the application of these provisions through somewhat mechanical and artificial doctrines. The Second Circuit's admonition that rule 10b-5 does not apply to acts of corporate mis-

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\(^{106}\) This reasoning was recently employed in Popkin v. Bishop, 464 F.2d 714, 719-20 (2d Cir. 1972), where the court refused to view rule 10b-5 as requiring more than full disclosure in a proxy solicitation. The court rejected the argument that an overreaching transaction, approved by the shareholders after there had been full disclosure, transgressed rule 10b-5. The court stated that it is proper to focus upon the alleged impropriety of conduct surrounding the approval of a security transaction only when the corporate investment decision is made by the board of directors, a majority of whom are interested in the transaction. Id.

\(^{107}\) See text accompanying notes 15-28 supra. No cases have been so decided, and the great weight of authority continues to be that there is an insufficient federal interest in a proxy solicitation which is free of any material omissions or misstatements. See Popkin v. Bishop, 464 F.2d 714, 720 (2d Cir. 1972); Laurenzano v. Einbender, 443 F.2d 1 (2d Cir. 1971); Rosenblatt v. Northwest Airlines, Inc., 435 F.2d 1121 (2d Cir. 1970). Furthermore, it must be observed that the inquiry of whether a security transaction will eventually pose a threat to the trading process embodies a most elastic concept, as evidenced in Seeburg-Commonwealth United Litigation, [1971-72 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 93,277, at 91,598 (S.D.N.Y. Nov. 12, 1971). The court concluded that management's acquisition of property at a greatly inflated price in exchange for its stock threatened the trading process because the diminution of the stockholders' equity could deflate the stock's price.

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management, its scrutiny of the intracorporate machinery in determining whether directors may defraud their corporation, and the lower courts' requirement in Bankers Life that a security transaction be at the heart of the alleged fraud have all disappeared into the history of rule 10b-5's uncertain development. What remains are a broad statute and regulation with at best a scanty legislative history interpreted in a number of judicial opinions urging that rule 10b-5 be applied where necessary for the protection and facilitation of an investment decision. However, to continue to accomplish this all-too-apparent goal through the machinery of deception is to continue to hide the real considerations under the rubric of materiality. Furthermore, because the concepts of misrepresentation and deceit are anchored in the law of torts, which provides rigidly defined elements of those causes of action, the continued emphasis upon deception will perpetuate the requirements of reliance and causation, concepts ill-suited to a charge of fraud upon a corporation or its stockholders. Meaningful and lasting standards will only

110 430 F.2d at 360; 300 F. Supp. at 1102.
112 See, e.g., Shell v. Hensley, 430 F.2d 819 (5th Cir. 1970).
113 The requirement that the plaintiff establish his reliance upon the material misstatement first appeared in List v. Fashion Park, Inc., 340 F.2d 457 (2d Cir.), cert. denied, 382 U.S. 811 (1965). The inherent weakness of the reliance requirement is most apparent where the defendant has failed to disclose material facts, as in Shulof v. Merrill Lynch, Pierce, Fenner & Smith, Inc., [1970-71 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 93,147 (S.D.N.Y. 1971). In Shulof, the plaintiff alleged that he had acquired his stock in Douglas Aircraft Co. when the defendant was liquidating its holdings on the basis of undisclosed information that Douglas' earnings were off dramatically. The court denied any recovery to the plaintiff because of plaintiff's failure to establish his reliance upon the undisclosed material facts.

114 In a recent decision, the Supreme Court has acknowledged the infeasibility of ever establishing to a court's satisfaction reliance upon an undisclosed material fact by stating that reliance need not be established where the wrong is the failure to disclose. Allied Ute Citizens v. United States, 406 U.S. 128, 153 (1972). The Court stated the test as follows:

Under the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision. . . .

115 Id. This does not, however, read reliance out of the law, for it remains a requirement where the defendant has made a material misstatement. Even in this situation,
arise when the courts clearly articulate why the corporation, or its stockholders as a body, or the investment public have a federally protected interest which is invaded by the challenged conduct. In so doing, the judiciary must act so as to accommodate the trust modern corporate statutes repose in directors by permitting them, in most instances, to exercise alone the corporation's investment judgment. It should also bear in mind that stockholders, though they exercise a decision as a body, are exercising a judgment comprised of numerous individual decisions with alternative courses of action; that the relief available under state law is neither uniform nor as efficacious as that to be had under rule 10b-5; and finally, that any misleading information purveyed within the corporation and among the shareholders most assuredly will reach the investment community and may affect the public's investment decisions. While these factors do not demand a more expansive interpretation of rule 10b-5 than has already occurred, they do require a more forthright presentation of the courts' considerations when acts of corporate mismanagement are at the heart of an action under rule 10b-5. Otherwise, today's uncertainties will continue, and fraud will remain in the eyes of the beholder.

the proof of actual reliance appears to be ill-advised where the class harmed is as broad as the investing public or a corporation duped by its directors.