

## SECURITIES REGULATION: SHAREHOLDER DERIVATIVE ACTIONS AGAINST INSIDERS UNDER RULE 10b-5

*After a general examination of Rule 10b-5 in the context of its traditional application, this comment focuses on the recent developments concerning the rule's function as a weapon for the enforcement of controlling insiders' duties to their corporation.*

THE GENERAL anti-fraud provision of the Securities Exchange Act of 1934, section 10 (b),<sup>1</sup> (and rule 10b-5,<sup>2</sup> promulgated thereunder), has been focal to an extensive commentary respecting the "securities acts [which] may be said to have generated a wholly new and far reaching body of federal corporation law."<sup>3</sup> The area engendering most emphasis by scholars has been the civil liability imposed under rule 10b-5 upon corporate insiders *in favor of minority shareholders or outside investors* whom the insider has deceived in buying or selling his corporation's securities.<sup>4</sup> An emerging new area, however, is the expansion of "federal corporation law" to prescribe liability of insiders *to their corporation* under rule 10b-5.

It has become increasingly apparent in the last five years that

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<sup>1</sup> "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." 48 Stat. 891 (1934), as amended, 15 U.S.C. § 78j (b) (1964).

<sup>2</sup> "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." 17 C.F.R. § 240.10b-5 (1964).

<sup>3</sup> Cady, Roberts & Co., 40 S.E.C. 907, 910 (1961).

<sup>4</sup> See generally, e.g., 3 LOSS, SECURITIES REGULATION 1421-74, 1763-97 (2d ed. 1961) [hereinafter cited as Loss]; Fleischer, "Federal Corporation Law": An Assessment, 78 HARV. L. REV. 1146 (1965); Latty, *The Aggrieved Buyer or Seller or Holder of Shares in a Close Corporation Under the S.E.C. Statutes*, 18 LAW & CONTEMP. PROB. 505 (1953); Ruder, *Civil Liability Under Rule 10b-5: Judicial Revision of Legislative Intent?*, 57

successful shareholders' derivative actions might be prosecuted under rule 10b-5 against insiders who seek personal benefit by causing the corporation to buy or sell securities on unfavorable terms. If this implementation of rule 10b-5 continues to expand, it could effect a virtual federal preemption of much of the heretofore exclusively state law concerning the fiduciary responsibility of corporate management.<sup>5</sup> Because this aspect of rule 10b-5 has only recently acquired practical significance, its discussion must be prefaced by a general examination of the rule's twenty-four year history.

### *The Promulgation of Rule 10b-5*

The general prohibitions which constitute the antifraud provisions in the federal securities acts are reflections of the essential objective of the whole regulatory scheme. They are designed "to protect those who do not know market conditions from the overreachings of those who do."<sup>6</sup> The antifraud provisions of the federal acts diverged from the common law over which they had been super-

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Nw. U.L. REV. 627 (1963); Ruder, *Pitfalls in the Development of a Federal Law of Corporations By Implication Through Rule 10b-5*, 59 Nw. U.L. REV. 185 (1964); Comment, 30 U. CHI. L. REV. 121 (1963); Comment, 59 YALE L.J. 1120 (1950).

<sup>5</sup> There can of course be no absolute preemption of state fiduciary legislation because the 1934 act specifically allows additional rights and remedies to be conferred under state law. Securities Exchange Act § 28, 48 Stat. 903 (1934), 15 U.S.C. § 78bb (1964). To a substantial degree, however, federal law could become dominant because of the procedural advantages inherent in basing a shareholder derivative action on rule 10b-5 instead of a claim under state law. Exclusive jurisdiction is accorded federal court actions founded on the Exchange Act, and is accompanied by both broad venue provisions and extraterritorial service of process. Securities Exchange Act § 27, 63 Stat. 107 (1949), 15 U.S.C. § 78aa (1964).

In addition, plaintiffs in a derivative action under rule 10b-5 are not subject to obstacles such as state law requirements of posting security for expenses. *McClure v. Borne Chem. Co.*, 292 F.2d 824 (3d Cir.), *cert. denied*, 368 U.S. 939 (1961); *Kane v. Central Am. Mining & Oil, Inc.*, 235 F. Supp. 559, 569 (S.D.N.Y. 1964). Highly significant in this respect is the recent and sweeping Supreme Court approval of derivative actions against management for alleged misrepresentation in the solicitation of proxies under § 14(a) of the Exchange Act. The Court emphasized that derivative actions under the federal securities acts may not be impeded by state security-for-expenses provisions or any other state law requirements, and that it is the duty of the courts to provide an effective remedy in accordance with the broad policies of the securities acts. See *J. I. Case Co. v. Borak*, 377 U.S. 426, 430-34 (1964).

Moreover, if a claim under rule 10b-5 survives defendant's motion to dismiss, plaintiff's state law claims would be properly before the court under the doctrine of pendent jurisdiction, and most courts apparently regard the federal extraterritorial service of process as sufficient to give personal jurisdiction with respect to the state claims. *Kane v. Central Am. Mining & Oil, Inc.*, *supra* at 568. Plaintiffs may, however, be required to post security as to the state claims. *Id.* at 569.

<sup>6</sup> *Charles Hughes & Co. v. SEC*, 139 F.2d 434, 437 (2d Cir. 1943), *cert. denied*, 321 U.S. 786 (1944).

imposed in that they were specifically designed to preserve the integrity of the securities trading process and were given sufficient breadth and flexibility to proscribe any conduct which would menace that integrity.<sup>7</sup> Thus section 17 (a) of the 1933 Act made unlawful any fraudulent practice in the *selling* of any securities<sup>8</sup> and section 15 (c) (1) of the 1934 Act proscribed fraud by over-the-counter broker-dealers in either selling or purchasing.<sup>9</sup>

Until 1942, however, there was a serious loophole in the anti-fraud scheme, for there was nothing in the acts which operated to prohibit fraud in the *purchasing* of securities by persons other than broker-dealers. Thus corporate insiders could buy the securities of their corporations by using fraudulent practices, with virtual immunity from federal authority. To close this and any other loopholes not previously perceived the Securities Exchange Commission in 1942 promulgated rule 10b-5, acting under the theretofore dormant section 10b of the 1934 act.<sup>10</sup> This rule, the broadest of all the antifraud provisions, prohibited all fraudulent practices by any person in connection with the *sale or purchase* of any securities.

### *The Judicial Inference and Development of Civil Liability Under Rule 10b-5*

Despite the equality of protection for buyers and sellers which the promulgation of rule 10b-5 effected by rendering fraud against either a criminal offense, the buyer remained the favorite son of the securities acts. The defrauded buyer was given *express* civil remedies against the wrongdoer in sections 11,<sup>11</sup> 12 (1),<sup>12</sup> and 12 (2)<sup>13</sup>

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<sup>7</sup> See 3 Loss 1430-44. On the operation of the common law with respect to securities transactions see generally Shulman, *Civil Liability and the Securities Act*, 43 YALE L.J. 227 (1933).

<sup>8</sup> Securities Act of 1933, § 17 (a), 48 Stat. 84, 15 U.S.C. § 77q (a) (1964).

<sup>9</sup> Securities Exchange Act of 1934 § 15 (c) (1), 48 Stat. 895, 15 U.S.C. § 78o (c) (1) (1964).

<sup>10</sup> 3 Loss 1426-27.

<sup>11</sup> Securities Act of 1933, § 11, 48 Stat. 82, as amended, 15 U.S.C. § 77k (1964). Under § 11, if the registration statement for a registered security contains material misstatements or omissions, the purchaser has a cause of action against all persons who were instrumental in the initial sale of the stock to the general public. See generally 3 Loss 1721-42.

<sup>12</sup> Securities Act of 1933, § 12 (1), 48 Stat. 84, as amended, 15 U.S.C. 77l (1) (1964). The buyer of a security which should have been but was not registered has a cause of action against his immediate seller under § 12 (1). See generally 3 Loss 1692-98.

<sup>13</sup> "Any person who . . . (2) offers or sells a security . . . [except, among others, securities issued or guaranteed by the United States or a state or political subdivision], by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which

of the 1933 act. These civil remedies were embodied in a closely drawn statutory scheme and were subject to a number of significant restrictions. For example, under section 12(2) the buyer's action for rescission or damages against a seller who had made materially false or misleading statements was (1) available only against the seller, not others who may have deceitfully induced the purchase;<sup>14</sup> (2) ineffectual even against the seller if he could prove his lack of scienter;<sup>15</sup> and (3) subject to a short period of limitations.<sup>16</sup> Despite the restricted nature of the buyer's express civil remedies, in general he continued to occupy a more favorable position than the seller. Having no civil remedies under the securities acts, the seller was relegated to the common law actions of deceit and rescission.<sup>17</sup> This disparity was, however, short-lived, for in 1946 the leading case of *Kardon v. National Gypsum Co.*<sup>18</sup> held that civil liability could be inferred from a violation of rule 10b-5.<sup>19</sup>

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includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security." Securities Act of 1933, § 12(2), 48 Stat. 84, as amended, 15 U.S.C. § 771(2) (1964). See generally 3 Loss 1699-1712.

<sup>14</sup> The action may be brought only against the actual seller or one who is a "controlling person" of the seller under § 15 of the Securities Act of 1933, 48 Stat. 84, as amended, 15 U.S.C. § 770 (1964).

<sup>15</sup> 3 Loss 1704-05.

<sup>16</sup> The action must be brought within one year after discovery of the untrue statement or omission and not more than three years after the date of the sale. Securities Act of 1933, § 13, 48 Stat. 84, as amended, 15 U.S.C. § 77m (1964). Other significant restrictions on the buyer's action under § 12(2) include exemption of sales of state and municipal securities and limiting the plaintiff to an action for rescission (as opposed to damages) if he still owns the stock at the time of suit. Securities Act of 1933, § 12(2), 48 Stat. 84, as amended, 15 U.S.C. § 771 (1964).

<sup>17</sup> With respect to the buyer's advantages and disadvantages under § 12(2) as compared with his state law actions relating to deceit and rescission, see 3 Loss 1702-05; Latty, *supra* note 4, at 523-24.

<sup>18</sup> 69 F. Supp. 512 (E.D. Pa. 1946).

<sup>19</sup> The *Kardon* court based its finding of an implied private right of action on two theories: (1) the common law tort doctrine, embodied in 2 RESTATEMENT, TORTS § 286 (1934), that a private tort action exists in favor of those whose interests are intended to be protected by a statute even though the statute expresses only a criminal sanction; and (2) the fact that § 29(b) of the Exchange Act was specifically amended to impose a short period of limitation for *private* actions against brokers under § 15(c)(1), a section which is also silent about civil liability. 69 F. Supp. at 513-14. For an extensive critical analysis of these theories see Ruder, *Civil Liability Under*

The entrance of rule 10b-5 into the area of civil liability has been described by one commentator as follows: "Into this neat statutory scheme bursts X-10b-5 purporting to redress all grievances in the securities field, giving causes of action to everybody, buyer and seller alike, and for all bad deeds—and by implication at that."<sup>20</sup> This depiction contains no overstatement of the expansive applicability which the literal terms of rule 10b-5 could generate. Rule 10b-5 expressly prohibits, and by implication prescribes civil liability for the commission of, the following practices by any person: (1) employing any scheme or device to defraud; or (2) misrepresenting a material fact or omitting a material fact which causes any statement made to be misleading; or (3) doing anything that operates or would operate to deceive anyone.<sup>21</sup> The only qualifications on the face of the rule are that the proscribed conduct must be "in connection with the *sale or purchase* of any security"<sup>22</sup> and must involve the use of the mails, interstate commerce, or the facilities of a national securities exchange.<sup>23</sup>

No clear-cut elements of a civil cause of action have yet been judicially extrapolated from the generalities of rule 10b-5. The

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*Rule 10b-5: Judicial Revision of Legislative Intent?*, 57 Nw. U.L. Rev. 627, 629-60 (1963).

Since *Kardon*, civil liability under rule 10b-5 has been upheld by courts of appeals in most of the circuits. *E.g.*, *Texas Continental Life Ins. Co. v. Dunne*, 307 F.2d 242 (6th Cir. 1962); *Estate Counseling Serv., Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 303 F.2d 527 (10th Cir. 1962); *Hooper v. Mountain States Sec. Corp.*, 282 F.2d 195 (5th Cir. 1960), *cert. denied*, 365 U.S. 814 (1961); *Errion v. Connell*, 236 F.2d 447 (9th Cir. 1956); *Speed v. Transamerica Corp.*, 235 F.2d 369 (3d Cir. 1956); *Fischman v. Raytheon Mfg. Co.* 188 F.2d 783 (2d Cir. 1951). The existence of civil liability is implicit in the opinion of a number of other decisions. See, *e.g.*, *James Blackstone Memorial Library Ass'n v. Gulf, M. & O.R.R.*, 264 F.2d 445 (7th Cir. 1959); *Beury v. Beury*, 222 F.2d 464 (4th Cir. 1955); *Kohler v. Kohler Co.*, 208 F. Supp. 808 (E.D. Wis. 1962), *aff'd*, 319 F.2d 634 (7th Cir. 1963); *Nash v. J. Arthur Waruer & Co.*, 137 F. Supp. 615 (D. Mass. 1955).

<sup>20</sup> Latty, *supra* note 4, at 514.

<sup>21</sup> 17 C.F.R. § 240.10b-5 (1964). See note 2 *supra*.

<sup>22</sup> This has been interpreted to mean that only an actually defrauded purchaser or seller of securities may bring an action under the rule. *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952).

<sup>23</sup> This requirement has been so liberally construed that it rarely constitutes a significant obstacle to a rule 10b-5 plaintiff. See *Hooper v. Mountain States Sec. Corp.*, 282 F.2d 195, 204-05 (5th Cir. 1960), *cert. denied*, 365 U.S. 814 (1961); *Fratt v. Robinson*, 203 F.2d 627, 633-34 (9th Cir. 1953); 3 Loss 1519-28. Civil liability under rule 10b-5 can arise from transactions in which no national stock exchange, stock broker or organized market is involved. *Matheson v. Armbrust*, 284 F.2d 670 (9th Cir. 1960), *cert. denied*, 365 U.S. 870 (1961); *Fratt v. Robinson*, *supra*; *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1964). See generally Latty, *supra* note 4, at 509-12 (1953).

courts have on the whole accorded an expansive ambit to the rule's literal scope.<sup>24</sup> Thus it appears that the buyer as well as the seller has a cause of action under rule 10b-5, in addition to the carefully limited express remedies given the buyer by the 1933 act.<sup>25</sup> Apparently, neither the seller's nor the buyer's action under rule 10b-5 is limited by the 1933 act restrictions.<sup>26</sup> It has been established that only buyers or sellers of securities may sue under the rule,<sup>27</sup> but there is no strict requirement of "privity" between plaintiff and defendant.<sup>28</sup> Moreover, the deception which gives rise to liability may relate to the value of the consideration given as well as that of the securities bought or sold.<sup>29</sup> Finally, the courts have repeatedly stated that the liability imposed by rule 10b-5 extends well beyond the restrictive common law notions of fraud and deceit.<sup>30</sup> Actionable "fraud" under the rule is said to be "the infinite variety of devices by which undue advantage may be taken of investors and others."<sup>31</sup>

It would seem that the sweeping proscription of fraud contained in the rule's first and third clauses would alone be adequate to encompass all actionable misconduct. However, most of the judicially accepted rule 10b-5 claims have been sustained on the basis of the rule's second clause, which applies to misstatements or misleading omissions of material facts.<sup>32</sup> A fact is said to be "material" if a reasonable investor's awareness of it would affect his judgment.<sup>33</sup> Once a misstatement or half-truth is shown to have been uttered with respect to a material fact, the aggrieved plaintiff's claim is virtually complete. The "reliance," "causation," and "scienter" elements of the common law action for deceit are applied, if at all,

<sup>24</sup> See, e.g., *Hooper v. Mountain States Sec. Corp.*, *supra* note 23.

<sup>25</sup> *Ellis v. Carter*, 291 F.2d 270, 273 (9th Cir. 1961); *Matheson v. Armbrust*, 284 F.2d 670, 674 (9th Cir. 1960), *cert. denied*, 365 U.S. 870 (1961).

A few of the early cases had denied buyers an implied right of action under rule 10b-5, reasoning that the express right of action accorded by the 1933 act was exclusive. See, e.g., *Rosenburg v. Globe Aircraft Corp.*, 80 F. Supp. 123, 124-25 (E.D. Pa. 1948); *Montague v. Electronic Corp. of America*, 76 F. Supp. 933, 936 (S.D.N.Y. 1948).

<sup>26</sup> *Ellis v. Carter*, *supra* note 25, at 273. See generally 3 *Loss* 1778-92.

<sup>27</sup> See note 22 *supra*.

<sup>28</sup> See *Cochran v. Channing Corp.*, 211 F. Supp. 239, 243-44 (S.D.N.Y. 1962). See generally Comment, 74 *YALE L.J.* 658 (1965).

<sup>29</sup> *Errion v. Connell*, 236 F.2d 447 (9th Cir. 1956).

<sup>30</sup> See, e.g., *Ellis v. Carter*, 291 F.2d 270, 274 (9th Cir. 1961); *Hooper v. Mountain States Sec. Corp.*, 282 F.2d 195, 201 (5th Cir. 1960), *cert. denied*, 365 U.S. 814 (1961).

<sup>31</sup> *Cady, Roberts & Co.*, 40 S.E.C. 907, 911 (1961).

<sup>32</sup> See cases cited note 19 *supra*.

<sup>33</sup> *List v. Fashion Park, Inc.*, 340 F.2d 457, 462 (2d Cir. 1965).

in such watered-down form that they constitute only minor obstacles to a rule 10b-5 plaintiff.<sup>34</sup>

Moreover, the liability of defendants who are corporate insiders or professionals in the securities business may be imposed by broadening the concept of materiality to embrace non-disclosure, as distinct from misstatement or half-truth.<sup>35</sup> This imposition of an affirmative duty of disclosure on the insider has been based on two rationales, taken either severably or together. First, his conduct may be considered as a scheme or course of business which operates as a fraud on investors.<sup>36</sup> Second, silence may be deemed an implied representation that the insider has not withheld any material information which his quasi-fiduciary position requires him to reveal.<sup>37</sup>

<sup>34</sup> See 3 Loss 1763-66.

"Reliance" and "causation" appear to be integral to the requirement that the fact misrepresented or omitted be "material." In *List v. Fashion Park, Inc.*, *supra* note 33, at 463, the court reasoned that satisfying the tort law "principle of causation in fact," was a necessary element of a rule 10b-5 claim. The court states that "the proper test [of reliance] is whether the plaintiff would have been influenced to act differently than he did act if the defendant had disclosed to him the undisclosed. . . . This test preserves the common law parallel between 'reliance' and 'materiality,' differing as it does from the definition of 'materiality' under Rule 10b-5 solely by substituting the individual plaintiff for the reasonable man." *Ibid.*

Whether defendant's scienter (*i.e.*, that defendant knew or reasonably should have known of the untruth or incompleteness of his statement) must necessarily be alleged is still in doubt. See, *e.g.*, *Trussell v. United Underwriters, Ltd.*, 228 F. Supp. 757, 773 (D. Colo. 1964) (plaintiff must allege and prove defendant's scienter); *Kohler v. Kohler Co.*, 208 F. Supp. 808, 823 (E.D. Wis. 1962) (dictum that scienter is not a necessary element of the claim), *aff'd*, 319 F.2d 634 (7th Cir. 1963).

<sup>35</sup> "It is unlawful for an insider, such as a majority stockholder, to purchase the stock of minority stockholders without disclosing material facts affecting the value of the stock, known to the majority stockholder by virtue of his inside position but not known to the selling minority stockholders, which information would have affected the judgment of the sellers. The duty of disclosure stems from the necessity of preventing a corporate insider from utilizing his position to take unfair advantage of the uninformed minority stockholders." *Speed v. Transamerica Corp.*, 99 F. Supp. 808, 828-29 (D. Del. 1951), *aff'd*, 235 F.2d 369 (3d Cir. 1956).

The "fraud" concepts developed under § 10b with respect to insiders apply to broker-dealers as well. See *Cady, Roberts & Co.*, 40 S.E.C. 907 (1961). In addition, special broker-dealer fraud concepts have been formulated. For example, a broker-dealer always impliedly represents that his prices are reasonably related to the current market unless he discloses to the contrary, *Charles Hughes & Co., Inc. v. SEC*, 139 F.2d 434 (2d Cir. 1943), *cert. denied*, 321 U.S. 786 (1944), and any person is entitled to rely on the implied representation regardless of his access to market information. *United Securities Corp.*, 15 S.E.C. 719, 727 (1944). See 3 Loss 1482-93. A broker-dealer who is held to have placed himself in a fiduciary relationship to his customer must scrupulously make full disclosure of every element of his adverse interest in the particular transaction. See 3 Loss 1500-08.

<sup>36</sup> *E.g.*, *Kardon v. National Gypsum Co.*, 83 F. Supp. 613, 614 (E.D. Pa. 1947); *Speed v. Transamerica Corp.*, 99 F. Supp. 808, 829 (D. Del. 1951), *aff'd*, 235 F.2d 369 (3d Cir. 1956).

<sup>37</sup> *E.g.*, *Speed v. Transamerica Corp.*, *supra* note 36, at 829. In that case, the court

To summarize, it has been judicially determined that the policy of protecting uninformed investors, which underlies the prohibitory antifraud scheme of the securities acts, cannot be effectuated without a correlative system of general civil liability. To this end the courts have applied rule 10b-5 in a free-wheeling fashion to encompass almost all misconduct in the purchase or sale of securities, particularly where the transaction occurs in the context of a fiduciary relationship. It has never been possible to delimit precisely the elements of a rule 10b-5 claim. The primary judicial consideration has been whether the alleged misconduct would subvert the broad policy of investor protection prescribed by the securities acts. Should such subversion appear, the elements of a rule 10b-5 claim are likely to be found present.<sup>38</sup>

What result, then, could be expected when the federal courts extended rule 10b-5 to actions brought on behalf of corporations against controlling insiders? The strict fiduciary duty which directors, officers, and controlling shareholders owe the corporation would seem to require the very highest standards of conduct in connection with *any* corporate securities transaction. Moreover, virtually none of the usual procedural obstacles to shareholder derivative actions under state law would be encountered if the action were based on rule 10b-5.<sup>39</sup> The Third Circuit in 1961 characterized the then seldom-utilized application of rule 10b-5 in this context as follows:

Section 10 (b) imposes broad fiduciary duties on management vis-a-vis the corporation and its individual stockholders. As implemented by Rule 10b-5 . . . Section 10 (b) provides stockholders with a potent weapon for enforcement of many fiduciary duties. It can be said fairly that the Exchange Act . . . constitutes far reaching federal substantive corporation law.<sup>40</sup>

This enthusiastic generalization, made without precedential support, has not been borne out by the development of subsequent case

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emphasized that the three clauses of rule 10b-5 "are mutually supporting and not mutually exclusive," and that an insider's breach of his disclosure obligations "can be viewed as a violation of all three subparagraphs." *Ibid.* The court stated that "in making an offer of 33 $\frac{1}{4}$ % above the current market price, defendant impliedly represented that the price offered was a fair price at that time." *Id.* at 843. See generally 3 Loss 1450-66.

<sup>38</sup> See notes 25-37 *supra* and accompanying text.

<sup>39</sup> See note 5 *supra*.

<sup>40</sup> *McClure v. Borne Chem. Co.*, 292 F.2d 824, 834 (3d Cir.), *cert. denied*, 368 U.S. 939 (1961) (appeal from order refusing to require plaintiff to post security).

law, most of which has evolved from decisions in the Second Circuit.<sup>41</sup>

*The Cautious Beginning—Birnbaum and Pettit*

In *Birnbaum v. Newport Steel Corp.*,<sup>42</sup> minority stockholders of Newport brought a derivative action claiming that Feldman, Newport's president and controlling stockholder, had rejected an offer of merger which would have appreciably benefited the stockholders. Instead, he sold his controlling stock interest at a high premium to another corporation. Plaintiffs alleged that in the course of this transaction Feldman and the directors, whom he controlled, had breached their fiduciary duties to Newport and its other stockholders and had made misrepresentations to the latter. Plaintiffs sought federal jurisdiction under rule 10b-5 by claiming that "these misrepresentations operated as a fraud upon the stockholders of Newport in connection with the sale of Feldman's stock."<sup>43</sup> The Second Circuit affirmed the dismissal of the complaint because neither Newport nor the complaining stockholders had bought or sold securities within the meaning of the rule.<sup>44</sup> The court also asserted that rule 10b-5 applied only to "that type of misrepresentation or fraudulent practice usually associated with the sale or purchase of securities rather than . . . [the] fraudulent mismanagement of corporate affairs . . ."<sup>45</sup> This language has been relied on by defendant-insiders in subsequent cases where, in contradistinction to *Birnbaum*, they were alleged to have defrauded the corporation by causing it to buy or sell securities at an unfavorable price.<sup>46</sup> If deemed applicable in the latter context, the *Birnbaum* distinction between rule 10b-5 fraud and "fraudulent mismanagement" can be taken as shorthand for the argument that no rule 10b-5 claims

<sup>41</sup> Cases in which courts in other circuits have taken cognizance of rule 10b-5 derivative actions on behalf of corporations against insiders include *Surowitz v. Hilton Hotels Corp.*, 342 F.2d 596 (7th Cir. 1965) (action dismissed because of insufficient verification of complaint); *Voegel v. American Sumatra Tobacco Corp.*, 241 F. Supp. 369, 376 (D. Del. 1965) (denied motion to dismiss complaint); *Dauphin Corp. v. Redwall Corp.*, 201 F. Supp. 466 (D. Del. 1962) (denied motion to dismiss complaint); Annot., 37 A.L.R.2d 649 (1954).

<sup>42</sup> 193 F.2d 461 (2d Cir.), cert. denied, 343 U.S. 956 (1952).

<sup>43</sup> 193 F.2d at 462.

<sup>44</sup> Plaintiffs later brought an action under state law for breach of fiduciary duty and succeeded in obtaining relief in the celebrated case of *Perlman v. Feldman*, 219 F.2d 173 (2d Cir. 1955), cert. denied, 349 U.S. 952 (1955).

<sup>45</sup> 193 F.2d at 464.

<sup>46</sup> See text accompanying notes 59, 65 *infra*.

on behalf of corporations against management should be recognized.<sup>47</sup>

If *Birnbaum* in fact embraced the argument that fraudulent mismanagement is *never* a 10b-5 concern, the impact of the case was modified in 1963 when the massive Birrell frauds came to light in *Pettit v. American Stock Exchange*,<sup>48</sup> a derivative action.<sup>49</sup> It was claimed that Birrell, the controlling stockholder, had induced the corporation to issue him shares<sup>50</sup> for worthless consideration and that by conspiring with the Exchange and several of its members Birrell had sold these overvalued shares to the public. Since procedural difficulties would have hampered recovery by the large and scattered number of defrauded individual investors, and because of the incredible proportions of the whole fraudulent scheme, the court felt that the case demanded a private corporate remedy under the federal securities acts. The court applied rule 10b-5, but warned that the rule should not be used as a basis for federal inquiry into internal corporate affairs where a purchase or sale of securities is only "incidental to a major mismanagement issue."<sup>51</sup> However, the court continued, if the transaction involves an "abuse of the securities trading process" and recourse to the federal securities laws is necessary for an adequate remedy, the fact that the action is against insiders does not in itself render rule 10b-5 inapplicable.<sup>52</sup> This restrained approach seemed to indicate

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<sup>47</sup> The argument may be summarized as follows: The Exchange Act was obviously a broad assertion by Congress of its power to regulate securities transactions, but it is equally clear that Congress did not intend to create a body of federal law for regulation of the internal affairs of ordinary business corporations. Congress has repeatedly rejected proposed legislation which would have this effect. Instead, corporate mismanagement and breach of fiduciary duty have deliberately been left to state law, and it has adequately coped with these problems whether or not they occur in connection with a corporate securities transaction. It may be true that desirable procedural and perhaps substantive changes would be effected by permitting shareholder derivative actions to be based on rule 10b-5 rather than state law, but such changes should be accomplished, if at all, by a comprehensive legislative approach, not by piecemeal judicial lawmaking. See 63 COLUM. L. REV. 934, 934-44 (1963); Comment, 74 YALE L.J. 658, 681-82. See generally Ruder, *supra* note 4.

<sup>48</sup> 217 F. Supp. 21 (S.D.N.Y. 1963).

<sup>49</sup> The action was brought on behalf of the corporation by its trustees in reorganization and was not a *shareholder* derivative action. *Id.* at 21.

<sup>50</sup> Notwithstanding any accounting concepts to the contrary, the issuance of stock by a corporation is a "sale" within the meaning of rule 10b-5. *Hooper v. Mountain States Sec. Corp.*, 282 F.2d 195, 203 (5th Cir. 1960), *cert. denied*, 365 U.S. 814 (1961).

<sup>51</sup> 217 F. Supp. at 25.

<sup>52</sup> *Ibid.*

The court noted that the case consisted of two fraudulent securities transactions: (1) Birrell's inducing the corporation to issue him stock for virtually worthless

that *Pettit* would be construed as representing the outer limit of derivative actions against insiders under rule 10b-5.

*Extension of Pettit—The Search for the “Elements”*

Shortly after *Pettit* was decided, a corporate action was brought in the District Court for the Southern District of New York against three former directors and officers in *New Park Mining Co. v. Cranmer*.<sup>53</sup> One of the allegations was that defendants had caused plaintiff New Park to purchase stock at an inflated price in companies in which the defendants had recently acquired a stock interest for negligible consideration. Plaintiffs claimed that by concealing this course of conduct from New Park, defendants had rendered themselves liable to that corporation under rule 10b-5. Without attempting to define the substantive “elements” of a rule 10b-5 claim, the court held New Park’s allegations legally sufficient. The court also cited *Pettit*, with no mention of its exceptional facts, for the general proposition that “it is immaterial whether the purchase or sale was part of a larger scheme of corporate mismanagement if the *elements* of a claim under . . . Rule 10b-5 are otherwise present.”<sup>54</sup> This extension of *Pettit* has continued to be the general

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consideration and (2) Birrell’s conspiring with members of the American Stock Exchange to sell the overvalued stock to the public. The court observed that the first these transactions would suffice to justify the invocation of rule 10b-5 on behalf of the corporation, but emphasized that “both transactions being one overall scheme in which the channels of interstate commerce, the mail, and the Exchange were used for fraudulent manipulation, and in which people trading in corporate securities through the Exchange facilities were damaged, defendants’ effort to characterize the trustees’ claim as one of ‘corporate mismanagement’ to which Section 10(b) would not apply is invalid and must be denied effect.” *Id.* at 26.

The court also rejected defendant Exchange’s contention that since it had not conspired with Birrell until after he had fraudulently induced the corporation to issue the stock, the fraud practiced by the Exchange could not be said to have caused damage to the corporation but rather only to the individual investors who had bought the stock. Emphasizing the broad effect of the overall fraudulent scheme and the difficulties which the individual investors would face in pursuing a remedy, the court simply swept aside defendant’s technically appealing causation argument and permitted the corporate action in order to achieve an adequate remedy and prevent a subversion of the policies of the securities acts. *Id.* at 26-28. For a criticism of the court’s reasoning in this respect see Comment, 74 YALE L.J. 658, 679 n.86 (1965).

<sup>53</sup> 225 F. Supp. 261 (S.D.N.Y. 1963).

<sup>54</sup> *Id.* at 266. The court reasoned that to bar corporate actions against insiders under rule 10b-5 would create the anomaly that “corporate officers and directors would possess an immunity from the consequences of their fraud under Section 10-b and Rule 10b-5 which outsiders who may have collaborated with them in defrauding the corporation would not possess . . .” *Ibid.* This “anomaly,” however, would hardly seem to rebut the arguments against complementing insider liability for abuse of corporate position under state law with additional liability to the corporation under rule 10b-5. See note 47 *supra* and accompanying text. The court’s reasoning

position to which the courts ostensibly adhere. Subsequent decisions, however, underscore the difficulty the courts have encountered in determining when the "elements" of a rule 10b-5 derivative claim are present.

In *Ruckle v. Roto Am. Corp.*,<sup>55</sup> a minority director of Roto successfully asserted a claim for injunctive relief under rule 10b-5 against defendants, who constituted a controlling majority of the board of directors. The facts alleged were that plaintiff, the largest single shareholder of Roto, had amassed enough support to eliminate control of the board by the defendants at the next annual shareholders meeting. With the date set for the meeting approaching, the defendants launched an effort to retain control which, according to the plaintiffs, was at all times "glaringly apparent."<sup>56</sup> They announced a postponement of the shareholders meeting, falsely claiming that the latest financial statements had not yet been prepared. Then they convened the board to approve the issuance and sale of a large block of treasury stock at a low price to persons who had agreed either to vote as directed or resell to the defendants. Denying plaintiff's demands for production of the latest financial data and for discussion of all aspects of these transactions the defendants quickly stamped the imprimatur of the board upon the proposed sale.<sup>57</sup> The plaintiff then sought injunctive relief under rule 10b-5, characterizing the alleged conduct as "a series of acts and practices which operate as a fraud or deceit not only upon the stockholders . . . but on the corporation itself."<sup>58</sup>

Relying on *Birnbaum*, the defendants argued that the plaintiff had at most alleged the effectuation of corporate mismanagement by a majority of the board in the fact of his protest, not "that type of misrepresentation or fraudulent practice usually associated with the sale or purchase of securities."<sup>59</sup> It was further suggested that a corporation could not possibly be "defrauded" within the meaning of rule 10b-5 by the controlling majority of its board of directors.<sup>60</sup>

The court of appeals, however, rejected these defenses and held

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could logically be extended to embrace the proposition that the outsider should have the same fiduciary responsibility to the corporation under state law as the insider, a radical departure from concepts of fiduciary duty.

<sup>55</sup> 339 F.2d 24 (2d Cir. 1964).

<sup>56</sup> Reply Brief for Plaintiff, p. 7.

<sup>57</sup> 339 F.2d at 26.

<sup>58</sup> Statement of Points and Authorities for Plaintiff, p. 5.

<sup>59</sup> Memorandum in Support of Motion to Dismiss, p. 5.

<sup>60</sup> 339 F.2d at 29.

that a valid claim under rule 10b-5 had been stated.<sup>61</sup> *Birnbaum* was distinguished as applicable only when the allegedly defrauded corporation was not a buyer or seller of securities.<sup>62</sup> The conceptual difficulty arising from the fact that the defendants constituted a majority of the board was disposed of by the court as follows:

[A] majority or even *the entire board of directors* may be held to have defrauded their corporation. When it is practical as well as just to do so, courts have experienced no difficulty in rejecting such cliches as the directors constitute the corporation and a corporation, like any other person, cannot defraud itself.<sup>63</sup>

The court did not attempt to categorize defendants' conduct as violative of a particular clause of rule 10b-5; all three provisions were apparently deemed applicable to the "failure or refusal" to disclose pertinent facts to the minority directors. It was clearly considered immaterial that the allegedly unlawful scheme was, as the plaintiff stated, so "glaringly apparent" that he was not actually deceived. The corporation, not the plaintiff, was the "defrauded" seller of securities.<sup>64</sup> The court reasoned that to deny a corporate rule 10b-5 claim in the circumstances of *Ruckle* would, as a practical matter, destroy any remedy against the defrauding directors under the securities acts, undercutting the basic policies behind them by leaving the minority shareholders unprotected and facilitating the public distribution of worthless securities.<sup>65</sup>

Shortly after its decision in *Ruckle*, the Second Circuit was confronted with another 10b-5 derivative action in *O'Neill v. Maytag*.<sup>66</sup> As in *Ruckle*, the controversy arose out of a control maneuver by the directors, but the court in *O'Neill* affirmed the district court's dismissal<sup>67</sup> of the claim. The *O'Neill* case arose from director action which resulted in a barter of a block of the corporation's outstanding securities on terms which were clearly disadvantageous to the corporation. In 1958 National and Pan American World Airways had each issued 400,000 shares of its own common stock to a trustee

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<sup>61</sup> *Id.* at 27-28.

<sup>62</sup> *Ibid.* The district court in an unreported decision had dismissed plaintiff's complaint, relying primarily on *Birnbaum* and *O'Neill v. Maytag*, 230 F. Supp. 235 (1964). Appeal in the latter case was pending at the time the court of appeals rendered its decision in *Ruckle*.

<sup>63</sup> 339 F.2d at 29. (Emphasis added.)

<sup>64</sup> *Id.* at 28.

<sup>65</sup> *Id.* at 28-29.

<sup>66</sup> 339 F.2d 764 (2d Cir. 1964).

<sup>67</sup> *O'Neill v. Maytag*, 230 F. Supp. 235 (S.D.N.Y. 1964).

for the benefit of the other. Finding this cross ownership detrimental to the public interest, the Civil Aeronautics Board ordered the companies either to sell or to re-exchange the stock.<sup>68</sup> Two of National's substantial shareholders and directors, Maytag and Swim, were in complete control of its board of directors, but the block of National shares held by the trustee for Pan American constituted a threat to their control.<sup>69</sup> For the alleged sole purpose of eliminating this threat, National's board of directors unanimously approved an exchange of 390,000 of the National shares held by Pan American for 353,000 of the Pan American shares held by National. This exchange ratio was extremely unfavorable to National because the shares of its own stock which were acquired were valued on the New York Stock Exchange at about \$1,800,000 less than the Pan American shares released.<sup>70</sup>

The plaintiff proceeded on a tack similar to that taken by his counterpart in *Ruckle*. The alleged conduct was characterized as a scheme and course of conduct which operated as a fraud upon National and its stockholders.<sup>71</sup> Further, the defendant again relied on *Birnbaum*, contending that plaintiff had at best alleged a claim under state law for corporate waste and breach of fiduciary duty since no fraud or *deception* of any kind had been alleged, much less fraud of the type usually associated with securities trading.<sup>72</sup>

The court of appeals essentially accepted the defenses interposed, stating that:

There can be no serious claim of deceit, withheld information or misstatement of material fact in this case. . . .

. . . . The question posed by this case is whether it is sufficient for an action under Rule 10b-5 to allege a breach of . . . fiduciary duties where the breach does not involve deception.<sup>73</sup>

The court reasoned that a negative answer to this question followed from its acceptance of the *Birnbaum* view that rule 10b-5 applied

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<sup>68</sup> 339 F.2d at 766.

<sup>69</sup> Brief for Plaintiff, pp. 6-7.

<sup>70</sup> 339 F.2d at 767.

<sup>71</sup> Brief for Plaintiff, p. 8.

<sup>72</sup> Brief for Defendants, p. 8.

The defendant further asserted that "deception under rule 10b-5 contemplates the creation by one person of a false appearance, whether by deed, word, or silence, which is transmitted to another person inducing him to buy or sell . . . . But here the charge is that all persons involved in the share exchange . . . were all guilty of breaching their fiduciary duties. Deception was thus impossible." *Id.* at 19.

<sup>73</sup> 339 F.2d at 767.

solely to the usual type of fraud in securities transactions and not to the state law matter of "fraudulent mismanagement."<sup>74</sup> No rule 10b-5 claim is stated in the absence of "an allegation of facts amounting to *deception*," although "it need not be deception in any restricted common law sense . . ."<sup>75</sup> The *O'Neill* court did note that the occurrence of the alleged deception within the corporate structure would not in itself prevent the application of rule 10b-5.<sup>76</sup> In this respect the court distinguished *Ruckle* as involving "a clear allegation of deception."<sup>77</sup>

Within the matrix of these rationales, the District Court for the Southern District of New York in *Barnett v. Anaconda Co.*,<sup>78</sup> purported not only to follow *Ruckle* and *O'Neill* simultaneously but also to add a new "element" which it found to be consistent with both. In *Anaconda* a rule 10b-5 derivative action was brought on behalf of a subsidiary corporation against both its directors and the parent corporation. It was alleged that the parent and the directors of the subsidiary had collaborated to enable the parent to acquire all the assets of the subsidiary in exchange for stock of an inadequate value. This transaction required approval by the owners of two-thirds of the subsidiary's stock.<sup>79</sup> However, because the parent owned seventy-three per cent of the subsidiary's stock, the approval was assured. Nevertheless, the parent chose to camouflage the questionable aspects of the transaction by causing the directors of the subsidiary to distribute a false and misleading proxy statement for its upcoming special shareholders meeting. At the meeting the parent utilized its dominant stock interest to dictate approval of the sale of the subsidiary's assets. A minority shareholder of the sub-

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<sup>74</sup> *Id.* at 768.

<sup>75</sup> *Ibid.*

The court observed that the particular breach of fiduciary duties commonly occasioned through the purchase or sale of securities, such as breaches by brokers and investment advisors, "may well be the kind of 'fraudulent practice usually associated with the sale or purchase of securities'" and thus violative of rule 10b-5 even in the absence of "deception." *Id.* at 769.

<sup>76</sup> *Id.* at 768. The court intimated that deception within the corporate structure would be grounds for a 10b-5 claim even where *all* the directors participated in the alleged fraud. However, the court cautioned that rule 10b-5 should not serve as the federal court's "mandate to inquire into every allegation of breach of fiduciary duty respecting the issuance or sale of corporate securities." *Ibid.*

<sup>77</sup> *Id.* at 768.

<sup>78</sup> 238 F. Supp. 766 (S.D.N.Y. 1965).

<sup>79</sup> DEL. CODE ANN. tit. 8, §§ 271, 275 (c) (1953).

subsidiary then brought a derivative action under rule 10b-5 against its directors and the parent.<sup>80</sup>

The court stated that the rule to be derived from *Ruckle* and *O'Neill* was that allegations of deception "by way of affirmative misrepresentation or omission of material facts" were indispensable.<sup>81</sup> However, the court reasoned that even though the plaintiff in *Anaconda* had alleged deception his claim was defective because there was no "causal relationship" between the deception and plaintiff's damage. The minority shareholders of the subsidiary could not possibly have blocked the parent's course of action by any "internal corporate procedures." Therefore, the parent did not have to indulge in any deception which would give rise to a rule 10b-5 claim, and the fact that it had chosen to do so was immaterial. Plaintiff's damage was "caused" not by the alleged violation of rule 10b-5 but solely by breach of corporate fiduciary duty for which redress should be sought under state law.<sup>82</sup>

*Ruckle*, *O'Neill*, and *Anaconda* raise the following basic questions: (1) If *Ruckle* and *O'Neill* can be reconciled on the basis of "deception," what is the effect of making such "deception" requisite to a rule 10b-5 derivative claim against insiders? (2) Is the *Anaconda* "causation" requirement consistent with the *Ruckle-O'Neill* "deception" concept?

#### 1. Deception

In both *Ruckle* and *O'Neill* it was alleged that the corporation had been or would be damaged by selling securities at an unfavorably low price. In both cases it was claimed that the defendants had utilized their control to insure approval of the sale by the board of the directors. The essence of the rule 10b-5 claims in these cases, then, was that defendants had not allowed the board of directors to function as the decision making body of the corporation, but rather as the defendants' personal agent. Although both complaints obvi-

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<sup>80</sup> 238 F. Supp. at 768-69.

<sup>81</sup> *Id.* at 775.

<sup>82</sup> *Id.* at 776. Because the misrepresentations were allegedly made in proxy statements, the plaintiffs in *Anaconda* also claimed violation of and a private remedy under the federal proxy rules enumerated in Securities Exchange Act of 1934, § 14(a), 48 Stat. 895, 15 U.S.C. § 78n(a) (1964). Plaintiffs relied on the Supreme Court's broad approval of shareholder derivative actions under § 14(a) in *J. I. Case Co. v. Borak*, 377 U.S. 426 (1964). The district court also denied this claim, finding no causal relation between the director-parent action and the securities transaction being challenged. *Borak* was distinguished by reasoning that the corporate transaction in that case could not have been approved without the plaintiffs' votes. 238 F. Supp. at 771.

ously stated a corporate claim for breach of fiduciary responsibility, only in *Ruckle* was the breach held to have been accompanied by "deception." Since the claim asserted in each case was that of the corporation, the decisions are reconcilable only if interpreted as holding that in *Ruckle* deception against *the corporation* was alleged but was not in *O'Neill*. However, a definition of "the corporation" is not entirely clear in these cases. Obviously, defendants who constitute the body controlling the corporate entity cannot be said to have deceived themselves. They can only have deceived the minority segment<sup>83</sup> which appears to be, therefore, "the corporation" on behalf of which the rule 10b-5 claim is really asserted.<sup>84</sup> Clearly, as the court in *Ruckle* indicates, the primary justification for recognizing derivative actions against insiders under rule 10b-5 is to provide an adequate remedy under the securities acts for uninformed minority shareholders.<sup>85</sup> If "deception," therefore, is to be a necessary element of rule 10b-5 claims in the instant cases, it can only be meaningful in terms of its operation against the corporation's minority segment.

Certain factual differences between *Ruckle* and *O'Neill* may render the two decisions distinguishable. In *Ruckle* there was allegedly a direct confrontation of the defendants, who were a controlling majority of the board of directors, with the minority directors. Defendants, after futile attempts to deceive the minority, simply engineered the board's approval of the transaction over the minority's protest and refused to reveal facts on which the propriety of the action from the corporation's standpoint should have been judged.<sup>86</sup> In *O'Neill*, however, there was no direct communication between defendants and the complaining minority shareholders because all of the directors participated in the allegedly fraudulent conduct. The defendants merely voted the board's approval of the exchange at a grossly unfavorable ratio, motivated solely by the enhancement of their control. Since nothing more was allegedly attempted by defendants, the court concluded that the *O'Neill*

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<sup>83</sup> By "minority segment" is meant the non-controlling element of the corporate entity which can, as in *O'Neill*, consist of shareholders holding a majority of the corporation's stock but who are nevertheless not in control.

<sup>84</sup> The derivative action, however, may inure as much to the benefit of the corporation's creditors as the minority shareholders. This is demonstrably true where, as in *Pettit v. American Stock Exch.*, the action is brought by the corporation's trustees in reorganization. See Comment, 74 YALE L.J. 658, 679 n.86 (1965).

<sup>85</sup> 339 F.2d at 29; cf. *J. I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964).

<sup>86</sup> See text accompanying note 57 *supra*.

complaint, unlike that of *Ruckle*, was completely devoid of any "deception," which the court defined as "that type of fraudulent practice usually associated with the sale or purchase of securities . . . ." <sup>87</sup> Apparently the court's "deception" requirement can be met only by allegations that the defendants *actively* attempted to deceive the minority segment, generally by withholding or misrepresenting material facts.<sup>88</sup> If no such active deception is alleged, nothing more than a claim of "fraudulent mismanagement" is stated, for which state law and not rule 10b-5 is the traditional and only source of redress.

Despite this ostensible reconciliation of *Ruckle* and *O'Neill*, the Second Circuit appears to have made an abrupt change in its basic approach. In *O'Neill* the court attached crucial importance to the distinction it had drawn in *Birnbaum* between "fraudulent mismanagement" and the type of "fraudulent practice usually associated with the purchase or sale of securities."<sup>89</sup> In *Ruckle* this same distinction was ignored entirely,<sup>90</sup> and it is hard to divine the reason for according it more weight in *O'Neill*. Although *Birnbaum* was an attempted derivative action under rule 10b-5 against a controlling insider, it involved no sale or purchase of securities by the corporation. Instead, there had merely been a sale by the defendant insider of his own stock to another company. There was no occasion in *Birnbaum* to determine the presence or absence of "deception"; rather, it was conceded that direct misrepresentations to the minority shareholders had been alleged.<sup>91</sup> The pivotal holding in *Birnbaum* was that for a plaintiff to have been defrauded "in connection with" a purchase or sale of securities within the meaning of rule 10b-5, he must have actually purchased or sold some securities. It was understandably easy for the court in *Birnbaum* to find the transaction essentially one involving "fraudulent mismanagement" rather than fraud inhering in the buying or selling of securities. The particular misrepresentations were not directed to an injured party who had either bought or sold securities. Thus, the transaction lent itself to classification as something other than the type of fraudulent practice usually directed at buyers and sellers. As the

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<sup>87</sup> 339 F.2d at 768, quoting from *Birnbaum*.

<sup>88</sup> This was the interpretation of the *O'Neill* "deception" requirement tendered by the court in *Anaconda*. See text accompanying note 81 *supra*.

<sup>89</sup> 339 F.2d at 768-69.

<sup>90</sup> 339 F.2d at 28.

<sup>91</sup> See text accompanying note 43 *supra*.

court stated in *Ruckle*, the *Birnbaum* distinction seems wholly inapplicable to allegations that controlling insiders have defrauded the corporation in its capacity as a buyer or seller of securities.<sup>92</sup> Moreover, the alleged misconduct in *Ruckle*, which the court in *O'Neill* characterized as a "clear allegation of deception," can hardly be called the type of fraud usually associated with securities transactions consummated in a context of corporate control by in-

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<sup>92</sup> 339 F.2d at 28. See 3 Loss 1770-71; Latty, *The Aggrieved Buyer or Seller or Holder of Shares in a Close Corporation Under the S.E.C. Statutes*, 18 LAW & CONTEMP. PROB. 505, 521 (1953).

This of course assumes that the defendant insiders have effected either a sale at too low or a purchase at too high a price by the corporation. Otherwise, whatever damage the corporation may allegedly have suffered will presumably be regarded as resulting from mere "fraudulent mismanagement" as distinguished from rule 10b-5 "fraud." In the recent case of *Hoover v. Allen*, 241 F. Supp. 213 (S.D.N.Y. 1965), the defendant insiders allegedly caused the corporation to issue misleading statements which had the effect of depressing the value of its stock. Defendants then caused the corporation to purchase a large part of its outstanding stock at the depressed price. The minority shareholders who had not sold their stock brought a derivative action under rule 10b-5 on behalf of the corporation to recover damages for corporate waste allegedly committed by defendants in the process of their control maneuver. The court held that the corporation had no rule 10b-5 claim against the defendants: "[T]he Company *purchased*, rather than sold, at the fraudulently depressed price, [and] the sellers and not the Company were the 'victims' of the alleged fraud. . . . Indeed, the immediate effect of the Company's purchasing at a price below value was to benefit, rather than injure, the Company." *Id.* at 227. (Emphasis supplied by the court.) The court stated that neither the fraudulent acquisition of control nor damages resulting from acts of waste committed by those in control as a result of the fraud constituted an injury to the corporation within the meaning of rule 10b-5. *Id.* at 228-29. The court, however, left open the possibility of a corporate rule 10b-5 claim on similar facts where there were allegations of "a conspiracy to loot the Company or to waste its assets." *Id.* at 228. See 3 Loss 1469. Moreover, the court noted that since the plaintiff shareholders had neither bought nor sold any securities, the *Birnbaum* rule would prevent their suing defendants under rule 10b-5 directly. 241 F. Supp. at 228.

But see *Voegel v. American Sumatra Tobacco Corp.*, 241 F. Supp. 369 (D. Del. 1965), where the controlling stockholders of *A* corporation allegedly caused it to merge with another company which they controlled. Under state law the minority shareholders of *A* were required to surrender their stock for the amount designated in the merger agreement or, in lieu thereof, its value as determined in an appraisal proceeding. Defendants allegedly made false statements in order to set the surrender value specified in the agreement at an inordinately low figure. The court held that the plaintiff, a minority shareholder of *A* who was ignorant of the false nature of defendant's statement but had requested an appraisal, was a seller within the meaning of rule 10b-5 and could assert a claim thereunder against defendants despite any remedy which might be pursued in an appraisal proceeding under state law. 241 F. Supp. at 373-75. The court also left open the possibility that the plaintiff shareholder could assert a rule 10b-5 claim derivatively on behalf of *A* corporation although under state law no derivative action was permitted because of the merger. The court stated: "Where federally secured rights have been invaded and a federal statute provides for a general right to sue for that invasion, a federal court may use any available remedy to make good the wrong done." *Id.* at 376, citing *J. I. Case Co. v. Borak*, 377 U.S. 426, 433 (1964). See note 5 *supra*.

siders. The *Ruckle* defendants in their face-to-face dealings with the minority directors did withhold material facts, and for this reason the *O'Neill* requirement of "deception" was said to be satisfied. However, the *O'Neill* description of *Ruckle* is somewhat misleading in this respect:

[A] majority of the board of directors . . . secured the board's approval of issuance of securities at an arbitrary value by withholding the most recent financial statements . . . .<sup>93</sup>

If the court means that the *Ruckle* defendants secured the minority directors' approval of the transaction, then the statement appears inaccurate. The minority was fully aware of the control maneuver which the defendants were attempting. The minority was equally aware that the financial statements were being withheld and demanded to see them. Defendants simply refused and forced approval of the transaction.<sup>94</sup> All that defendants could hope to accomplish by their "deception" was to hinder an injunctive suit by the minority. Outside the context of corporate control by insiders, this is surely not the usual type of rule 10b-5 fraud. But the whole tenor of the *Ruckle* decision was that rule 10b-5 should be applied within this context, and that it should be used to effectuate the usual objective of its application against insiders—to prevent their exploitation of the minority shareholders.

Of course, if the court accurately assumed that the alleged breach of fiduciary duty by the defendants in *O'Neill* was accompanied by "honest disclosure,"<sup>95</sup> then its decision appears eminently sound. Rule 10b-5 is clearly not designed to insure an adequately informed purchaser or seller against the risk of his making a bad bargain. However, the court apparently equated "honest disclosure" with the absence of its concept of "deception," and this seems contrary to the normal meaning of rule 10b-5 "fraud" by fiduciaries. A corporate insider dealing as an individual directly with a minority shareholder has an affirmative duty of disclosure, not a duty to refrain from *affirmative* deception.<sup>96</sup> The insider's failure to disclose material facts has been held to constitute a course

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<sup>93</sup> 339 F.2d at 768. (Emphasis added.)

<sup>94</sup> The *Ruckle* court held that a violation of rule 10b-5 by defendants would be accomplished by their "failure or refusal" to disclose material facts. 339 F.2d at 26. (Emphasis added.)

<sup>95</sup> 339 F.2d at 767.

<sup>96</sup> See notes 35-37 *supra* and accompanying text.

of business which operates as a fraud on the minority shareholder cognizable under rule 10b-5.<sup>97</sup> The insider's offer to purchase or sell at a certain price may be deemed an implied representation that the stated price is his judgment of the value of the security.<sup>98</sup> These standards, and arguably the more stringent ones applicable to broker-dealers,<sup>99</sup> would seem even more appropriate where, as in *O'Neill*, all the directors effect a sale or purchase by the corporation. In such a case the corporate power structure renders the shareholders of the minority segment much more vulnerable to insider exploitation than they would be in a direct confrontation. Therefore, the alleged approval of the corporation's sale of securities by the *O'Neill* directors without consideration of any material facts except their desire to use \$1,800,000 in corporate funds to cement their control, would seem to operate as a fraud on "the corporation" under rule 10b-5.<sup>100</sup>

In rejoinder to this contention, the *O'Neill* court asserted that the defendants did nothing more than exercise their corporate control positions for their own purposes. This may have been a breach of fiduciary duty, but was not deemed to be the "deception" which is requisite to support a corporate rule 10b-5 claim. In rebuttal, however, it may be argued that defendants had no need to resort to any active "deception." This fact is the anomaly of the "deception" requirement: where the control of exploiting insiders over the corporate mechanism they employ approaches the absolute, as in *O'Neill*, the necessity for the usual type of fraudulent practice decreases. Correlatively, there is an increase in the vulnerability of the minority segment whose protection is the justification for applying rule 10b-5 at all. Thus, a successful derivative action against insiders under rule 10b-5 becomes least likely where it is most needed.

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<sup>97</sup> See text accompanying note 36 *supra*.

<sup>98</sup> See note 37 *supra*.

<sup>99</sup> See text accompanying notes 25-38 *supra*.

<sup>100</sup> Such an interpretation was rendered by the court in *Ruckle*, which relied on § (3) of rule 10b-5. 339 F.2d at 28-29.

The implication which minority stockholders would fairly be expected to draw from a sale by the directors is that the price paid was reasonable and that the directors were motivated by a proper corporate purpose in approving the transaction. Achievement of quite different and culpable ends may thus be sufficient to denote such action as implied misrepresentation.

## 2. Causation

The jeopardy of the minority wrought by the artificialities of the "deception" concept would become completely entrenched if the *Anaconda* "causation" requirement were to be approved by the Second Circuit. This theory insulates controlling insiders even where the minority has been actually deceived. According to the district court in *Anaconda*, if the minority could not have prevented the alleged breach of fiduciary duty by any intracorporate procedures, the fact that the breach was accompanied by "deception" is immaterial.<sup>101</sup> The "deception" which would otherwise give rise to a rule 10b-5 derivative claim becomes meaningless because the defendants could have accomplished their breach of duty without it. The breach of fiduciary duty is therefore said to be the only cause of the corporation's damage and actionable exclusively under state law.

The district court's "causation" theory may be short-lived, however, because it appears incompatible with the holding by the Court of Appeals in *Ruckle* and its rationale in *O'Neill*. In *Ruckle* there was no intracorporate procedure by which the plaintiffs could have prevented approval of the transaction.<sup>102</sup> Plaintiff's only recourse was to threaten and/or actually pursue a legal remedy. The possibility of seeking legal relief is the reason why non-disclosure, contrary to the *Anaconda* court's reasoning, is meaningful in this type of case.<sup>103</sup> Legal proceedings also constituted the only means of stopping the *O'Neill* defendants, where the court clearly indicated

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<sup>101</sup> The court derived its "causation" requirement from *List v. Fashion Park, Inc.*, 340 F.2d 457 (2d Cir. 1965). In *List*, an individual plaintiff alleged that a defendant-director had concealed material facts in purchasing the plaintiff's stock. The court of appeals affirmed a judgment for defendant because the evidence revealed that plaintiff would not have acted differently had he known the undisclosed facts. *Id.* at 463-64. Surely it does not follow that recovery would have been denied merely because the defendant could have forced plaintiff either to sell or bring legal proceedings. See *Voegel v. American Sumatra Tobacco Corp.*, 241 F. Supp. 369 (D. Del. 1965).

<sup>102</sup> Prevention of the transaction in *Ruckle* would only have been possible if the defendants had permitted a shareholder meeting before approval of the allegedly fraudulent sale. The defendants were able to effect the approval because there was no intracorporate procedure by which the defendants could be forced to permit the shareholders meeting to be held. See text accompanying notes 57, 93-94 *supra*.

With respect to the district court's efforts subsequent to *Anaconda* to employ or limit the "causation" theory, compare *Hoover v. Allen*, 241 F. Supp. 213 (S.D.N.Y. 1965), with *Eagle v. Horvath*, 241 F. Supp. 341 (S.D.N.Y. 1965), and *Voegel v. American Sumatra Tobacco Corp.*, *supra* note 101.

<sup>103</sup> Fleischer, "Federal Corporation Law": An Assessment, 78 HARV. L. REV. 1146, 1164 (1965).

that the defendants would have been subject to liability under rule 10b-5 if they had indulged in "deception."

### Conclusion

To summarize, development in the Second Circuit of rule 10b-5 derivative actions against controlling insiders has progressed in three stages:

(1) *Birnbaum v. Newport Steel Co.* through *Pettit v. American Stock Exchange*. Rule 10b-5 has no application unless the corporation has either bought or sold securities, and even then it should rarely apply because it is directed solely at "that type of misrepresentation or fraudulent practice usually associated with the sale or purchase of securities rather than fraudulent mismanagement of corporate affairs. . . ." <sup>104</sup>

However, a rule 10b-5 claim may be recognized if a serious abuse of the securities trading process is alleged, recourse to the federal securities acts is necessary for an adequate remedy, and the corporate securities transaction is more than merely incidental to a major mismanagement issue.

(2) *New Park Mining Co. v. Cranmer* through *Ruckle v. Roto Am. Corp.* A rule 10b-5 claim is stated whenever it is alleged that the corporation has been "defrauded" by insiders in its capacity as a buyer or seller of securities, and the fact that the corporate purchase or sale is only part of a major mismanagement issue is immaterial. The presence or absence of the elements of rule 10b-5 "fraud" will be determined by considering the alleged facts in conjunction with the reason for the general application of rule 10b-5 in this context—to protect uninformed minority shareholders in accordance with the broad policies of the securities acts.

(3) *O'Neill v. Maytag* to the present. Although a rule 10b-5 claim is stated whenever it is alleged that insiders have "defrauded" the corporation in its purchase or sale of securities, the elements of rule 10b-5 "fraud" will not be present unless there is alleged something more than the mere utilization by defendants of their controlling position in the corporate power structure. It is not enough to allege that defendants intentionally breached their fiduciary duty in effectuating the corporate purchase or sale at a price unfavorable to the corporation, and that no responsible segment of the corporation was informed of its essentials. There must also be some active, affirmative attempt to deceive "the corporation" beyond any deception which may be inherent in a mere breach of fiduciary duty.

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<sup>104</sup> 193 F.2d at 464.

It is submitted that the pattern of this development is essentially circular. The same basic judicial objectives underlie the *Birnbaum-Pettit* and the *O'Neill* formulas. Rule 10b-5 is to be retained as a possible source of remedy for exploited minority segments, but its use in this respect will be limited severely enough to prevent its competing to any substantial degree with the traditionally applicable state law. In pursuit of these objectives, the *Birnbaum-Pettit* technique apparently would proceed from the premise that the rule has no general application even where insiders have allegedly defrauded the corporation in a manner which, in any other context, would constitute rule 10b-5 "fraud." The rule would be applied only when the court discerns such an "abuse of the securities trading process" to justify affording plaintiffs the advantages of a derivative action under the federal securities acts. This approach is essentially opposite to that of *New Park-Ruckle*, under which rule 10b-5 would be deemed generally applicable for the protection of "defrauded," non-controlling shareholders and the requisite "fraud" would be flexibly defined to achieve that protection. Conversely, the most recent technique, articulated in *O'Neill*, is to channel the development back toward *Birnbaum-Pettit* while purporting to adhere to the *New Park-Ruckle* formula. Rule 10b-5 is always to be available for "defrauded," non-controlling shareholders, but the traditionally flexible elements of the rule's "fraud" are to be so compressed that invocation will rarely be successful.

In this respect it appears that the *O'Neill* approach is likely to necessitate continually accelerated judicial footwork and to produce distinctions which, while they partially insulate state law from rule 10b-5, have little meaning in terms of the rationale proffered to justify the rule's general applicability. If the rule's application is to be substantially limited for the sake of preserving state law, it would seem better to accomplish that preservation by the *Birnbaum-Pettit* technique. If this approach were employed to permit the rule's application beyond the massive fraud context of *Pettit*, it would obviously call for somewhat arbitrary decisions as to when a sufficient "abuse of the securities trading process" is alleged. Moreover, even if such an "abuse" were found, a rule 10b-5 claim might be denied where it appeared that plaintiff's remedies under state law would be adequate. At least, however, such decisions could be correlated to the court's statement of the justification for permitting the rule's intrusion into the corporation-management relationship.

The other alternative, assuming that the courts will not retreat to a complete denial of the rule's application, is to employ it freely for the protection of non-controlling shareholders in accordance with the *New Park-Ruckle* reasoning. If this course were followed, the natural and seemingly inescapable result would be that which the Third Circuit suggested at the inception of the rule's expansion as a corporate weapon against overreaching insiders:

Section 10 (b) imposes broad fiduciary duties on *management vis-a-vis the corporation* and its individual stockholders. As implemented by Rule 10b-5 . . . Section 10 (b) provides stockholders with a potent weapon for enforcement of many *fiduciary duties*.<sup>105</sup>

Such an unrestrained extension of "federal corporation law" has been generally and somewhat convincingly described as undesirable,<sup>106</sup> but it could hardly be less satisfactory than current judicial efforts to inject, within tenuously defined limits, a modicum of rule 10b-5 serum into shareholder derivative actions against controlling insiders.

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<sup>105</sup> *McClure v. Borne Chem. Co.*, 292 F.2d 824, 834 (3d Cir.), *cert. denied*, 368 U.S. 939 (1961). (Emphasis added.)

<sup>106</sup> See note 47 *supra*.