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Remedies—Fair Labor Standards Act—Private Damage Suit Uuavailable to Redress Violations of Cbild Labor Provisions of the Fair Labor Standards Act

After their sixteen-year old son was killed when the fork lift truck he was driving overturned, plaintiffs brought an action for damages under the child labor provisions of the Fair Labor Standards Act.[1] Alleging that the fatal accident had occurred within the scope of their son's employment,[2] plaintiffs argued that defendant, their son's employer, had violated an FLSA regulation declaring that the operation of fork lift trucks is an occupation "particularly hazardous" to employees under the age of eighteen.[3] Plaintiffs further contended that, although the FLSA does not specifically provide a damages remedy for the sort of violation alleged, the court should imply a private compensatory remedy. Defendant, however, moved to dismiss on the ground that the FLSA establishes civil remedies for certain violations,[4] but prescribes only criminal sanctions for child labor violations.[5] Adopting defendant's assertion that Congress did not intend to authorize a private damages remedy for violations of the FLSA's child labor provisions, the district court dismissed the action. On appeal to the United States Court of Appeals for the Fifth Circuit, *held*, affirmed. The child labor provisions of the Fair Labor Standards Act and the regulations promulgated thereunder do not contemplate a private cause of action for damages for wrongful death. *Breitwieser v. KMS Industries, Inc., 467 F.2d 1391 (5th Cir. 1972).*

When Congress either has been silent on the matter of private remedies or created some remedies but failed to mention others, the general rules of statutory construction conflict with judicial arguments favoring implication of a private remedy. The maxim *expressio unius*

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1. 29 U.S.C. §§ 203(l)(2), 212 (1970).
2. Plaintiffs received a workmen's compensation award of $750, the maximum permitted under Georgia law to beneficiaries of a deceased worker without dependents. GA. CODE ANN. § 114-413(a) (Supp. 1972). Plaintiffs also argued that they had a right to damages based on a state wrongful death claim. However, the court held on a motion for summary judgment that this claim was barred by Georgia's workmen's compensation law. GA. CODE ANN. § 114-103 (1956).
3. 29 C.F.R. § 570.58(a)(1) (1972).
4. 29 U.S.C. § 216(b) (1970).
5. 29 U.S.C. §§ 215(a)(4), 216(a) (1970).

exclusio alterius suggests that when the legislature has conferred some private rights the courts should not fashion others.[6] Pre-emption or supersession is another principle of construction that militates against the implication of unmentioned remedies. The pre-emption principle provides that, by establishing a comprehensive regulatory scheme, Congress intends to foreclose use of pre-existing remedial law. The argument, which has found little favor among the courts,[7] emphasizes the desirability of uniform standards for federal laws operative within a particular regulated sector and seeks to preclude the possibility that uniformity might be jeopardized by numerous private lawsuits in different courts.[8] In light of these arguments against creating private causes of action under federal legislation, courts have required the presence of three factors before a private civil remedy will be implied: the act or regulations in question establish a new standard of protection; the act or regulations do not provide adequate administrative remedies; and no adequate state remedies exist to redress violations of the new standard.[9] In the presence of these factors, courts have been quick to infer or recognize private remedies to aid those whom the statute was designed to protect.[10] When the statute does not mention a private remedy, the courts' justification for inferring one has been that the legislation would provide incomplete protection if it could be enforced only by criminal

6. Note, *Implying Civil Remedies from Federal Regulatory Statutes*, 77 HARV. L. REV. 285, 290 (1963). There are varying applications of the maxim: where there is an express authorization of a particular remedy in one section of a statute, an omission of that remedy from other sections was intended by the legislature; alternatively, any remedy provided to enforce a provision excludes by implication other remedies; more narrowly, the existence of a civil remedy precludes additional civil remedies. *Id.*

7. O'Neil, *Public Regulation and Private Rights of Action*, 52 CALIF. L. REV. 231, 259 (1964).

8. *Id.*

9. Note, *Labor Relations—Wagner-Peyser Act—Migrant Farm Laborers—Gomez v. Florida State Employment Service, 417 F.2d 569 (5th Cir. 1969)*, 19 AM. U.L. REV. 551, 556 (1970). Other criteria for establishing a private remedy include: congressional intent, the existence of an alternate remedy, the desirability of uniform enforcement, and analogous precedent in a particular area. Armstrong, *Expressio Unius, Inclusio Alterius: The Fagot-Gomez Private Remedy Doctrine*, 5 GA. L. REV. 97, 102-03 (1970).

10. *See, e.g.*, Tunstall v. Brotherhood of Locomotive Firemen & Enginemen, 323 U.S. 210 (1944) (employee recovered against his bargaining representative for violation of the Railway Labor Act's standard prohibiting racial discrimination); Fitzgerald v. Pan Am. World Airways, 229 F.2d 499 (2d Cir. 1956) (private civil remedy implied for violation of FAA provision prohibiting discrimination aboard commercial airliners); Reitmeister v. Reitmeister, 162 F.2d 691 (2d Cir. 1947) (implication of private cause of action when telephone conversation had been intercepted in violation of the FCA); Neiswonger v. Goodyear Tire & Rubber Co., 35 F.2d 761 (N.D. Ohio 1929) (private cause of action upheld for farmer who suffered personal and property damage when a dirigible violated federal minimum altitude regulations).

sanctions or by an injunction obtained to protect state interests.[11] Congressional failure to create or preserve private remedies often has prompted courts to create or preserve their own remedies when the only alternative is to leave aggrieved parties unprotected.[12] The tendency in such instances to find private rights of action and to fashion private remedies that do not contradict manifest congressional intent has increased.[13] The practice of implying causes of action to justify recovery of damages originated in the 1854 English case, *Couch v. Steel*,[14] and was first recognized by the Supreme Court in *Texas & Pacific Ry. v. Rigsby*,[15] a 1916 case in which the Court declared that "disregard of the command of the [Federal Safety Appliance Act] is a wrongful act, and where it results in damage to one of the class for whose especial benefit the statute was enacted, the right to recover the damages from the party in default is implied . . . ."[16] Recognition of civil liability claims under federal regulatory statutes—especially when the defendant's conduct is criminal—has expanded considerably in recent years.[17] Implied private rights of action for damages have been allowed, for example, under the Securities Exchange Act,[18] the Federal Communications Act,[19] the Rivers and Harbors Appropriation Act,[20] and the Railway Labor Act.[21]

11. Fagot v. Flintkote Co., 305 F. Supp. 407, 410 (E.D. La. 1969).

12. *See, e.g.*, United Constr. Workers v. Laburnum Constr. Corp., 347 U.S. 656, 663-65 (1954) (Labor Management Relations Act's delegation of jurisdiction to NLRB does not preclude an appropriate state court from adjudicating a common-law tort action for damages); Steele v. Louisville & Nashville R.R., 323 U.S. 192, 207 (1944) (in the absence of administrative remedy under the Railway Labor Act remedy implied for breach of bargaining representative's statutory duty to represent and act for the members of a craft).

13. Armstrong, *supra* note 9, at 101-02. *See also* cases cited note 10 *supra*.

14. 118 Eng. Rep. 1193 (Q.B. 1854). The court found that defendant shipowner was under a duty by virtue of 7 & 8 Vict. c. 112, § 18, to have a proper supply of medicines on board. Plaintiff, a seaman serving on defendant's vessel, alleged that his health had suffered because defendant had neglected this duty. The court held that although the Act imposed a criminal penalty for the breach of the duty, sailors sustaining a private injury also were entitled to maintain an action to recover damages. The court stated that "[t]here is, however, beyond the public wrong, a special and particular damage sustained by the plaintiff by reason of the breach of duty by the defendant, for which he has no remedy unless an action on the case at his suit be maintainable . . . ." *Id.* at 1197. Today, however, this doctrine has been largely repudiated by English courts. *See* Williams, *The Effect of Penal Legislation in the Law of Tort*, 23 MODERN L. REV. 233 (1960).

15. 241 U.S. 33 (1916).

16. *Id.* at 39. The Federal Safety Appliance Act no longer is held to provide a basis for an implied cause of action. *See* Jacobson v. New York N.H. & H. R.R., 206 F.2d 153 (1st Cir. 1953), *aff'd per curiam*, 347 U.S. 909 (1954).

17. *See* Note, *supra* note 6.

18. 15 U.S.C. § 78 (1970). *See* J.I. Case Co. v. Borak, 377 U.S. 426 (1954).

19. 47 U.S.C. § 605 (1970). *See* Reitmeister v. Reitmeister, 162 F.2d 691 (2d Cir. 1947).

20. 33 U.S.C. § 403 (1970). *See* United States v. Perma Paving Co., 332 F.2d 754 (2d Cir. 1964).

21. 45 U.S.C. § 151 (1970). *See* Tunstall v. Brotherhood of Locomotive Firemen & Enginemen, 323 U.S. 210 (1944).

Securities legislation has been the most frequent and perhaps most noteworthy source of implied rights of action.[22] In *J.I. Case Co. v. Borak*,[23] a 1964 Supreme Court decision, a stockholder successfully brought suit for damages sustained as a result of proxy statements that allegedly contained false and misleading assertions in violation of section 14(a) of the Securities Exchange Act of 1934.[24] Although the 1934 Act contains no specific reference to a private right of action, the Court held that an action for damages or rescission could be maintained in federal court because, in the court's view, such an action was "necessary" to effectuate the purposes of the Act.[25] Moreover, the Court declared that the existence of other limited remedies[26] did not preclude the judicial creation of a further remedy that would effectuate congressional intent more fully. In a 1971 case, *Bivens v. Six Unknown Named Agents of Federal Bureau of Narcotics*,[27] the Supreme Court recognized a cause of action for money damages by one whose fourth amendment rights allegedly had been violated by a federal officer. The Court held that, notwithstanding the absence of legislation authorizing such a cause of action, the offending officer may be liable in a federal action based solely on the constitutional amendment.[28] Similarly, the Fifth Circuit, in *Gomez v. Florida State Employment Service*,[29] first questioned whether migrant farm workers have rights and remedies for violations of the Wagner-Peyser Act[30] when they have gained employment through the employment system established by the Act and regulations. The court declared that the Act, its regulations, and the factual setting of the case demanded an implied remedy if the purpose of the regulations—the protection of migratory farm workers—was to be achieved.[31] Considering the same legislation, the Fifth Circuit stated

22. Note, *supra* note 7, at 286. For examples of implied remedies for violations of § 10(b) see Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961); Fischman v. Raytheon Mfg. Co., 188 F.2d 783 (2d Cir. 1951). For an illustration of an implied remedy for a seller see Hooper v. Mountain States Sec. Corp., 282 F.2d 195 (5th Cir. 1960).

23. 377 U.S. 426 (1964).

24. 15 U.S.C. § 78n(a) (1970).

25. 377 U.S. at 432-33.

26. Proxy statements were examined in advance by the SEC and a state-created cause of action for damages and rescission was available. However, given the number of proxy statements submitted each month, the Commission's review was necessarily cursory. 377 U.S. at 432. To proceed under the state cause of action, plaintiffs additionally were required by state law to provide security for costs. *Id.* at 435. Thus, many investors were left without an effective remedy.

27. 403 U.S. 388 (1971).

28. *Id.* at 397.

29. 417 F.2d 569 (5th Cir. 1969).

30. 29 U.S.C. § 49 (1970).

31. Gomez v. Florida State Employment Serv., 417 F.2d 569, 576 (5th Cir. 1969).

that it would be "unthinking" that Congress intended the migrants' only protection to be the Secretary's power to withhold funds from the state in which the violations occurred.[32] Although it is a regulatory law, the Fair Labor Standards Act does not delegate broad discretionary responsibilities to a specialized administrative agency charged with governing an industry or a particular phase of commercial relations. Instead, the FLSA bestows a series of rights on a broad class of employees and arms the Secretary of Labor with extensive power to assist employees in enforcing their rights.[33] In *Fagot v. Flintkote Co.*,[34] an employee brought an action under FLSA section 15(a)(3)[35] after his employer allegedly discharged him for assisting in the prosecution of another FLSA claim against the employer. Although actions for the enforcement of and relief under this section are delegated to the Secretary of Labor by the terms of the statute,[36] the district court in *Fagot* inferred a private right to sue and upheld the employee's claim for monetary damages.[37] No cases, however, have addressed yet the implication of a civil remedy under the child labor provisions of the FLSA and the regulations promulgated thereunder.[38]

At the outset, the instant court asserted that federal courts will imply a remedy for infringement of a federal right only when the law creating that right provides no remedy at all or a grossly inadequate remedy.[39] The court then proceeded to distinguish the instant case from the three leading cases that suggest a basis for the recognition of plaintiffs' private cause of action. Addressing *Borak* initially, the instant court noted that the Securities Exchange Act of 1934 evinces a strong congressional policy against stock fraud, but, unlike the FLSA, provides no specific remedy for violations of the proscribed activity. On the basis of this difference between the Securities Exchange Act of 1934 and the FLSA, the court distinguished *Borak* from the instant decision. In dis-

32. *Id.*

33. Fagot v. Flintkote Co., 305 F. Supp. 407, 413 (E.D. La. 1969).

34. 305 F. Supp. 407 (E.D. La. 1969).

35. Fair Labor Standards Act of 1938, § 15(a)(3), 29 U.S.C. § 215(a)(3) (1970). This section makes it unlawful for any person to discharge or discriminate against an employee because the employee has filed a complaint, or caused a proceeding to be instituted under the FLSA, or has testified or was about to testify in any such proceeding.

36. 29 U.S.C. § 211(a) (1970).

37. Fagot v. Flintkote Co., 305 F. Supp. 407, 415 (E.D. La. 1969. *But see* Powell v. Washington Post Co., 267 F.2d 651 (D.C. Cir. 1959) (private cause of action under § 15 of the FLSA denied); Britton v. Grace Line Inc., 214 F. Supp. 295 (S.D.N.Y. 1962) (private cause of action denied).

38. *See* Breitwieser v. KMS Indus., Inc., 467 F.2d 1391 (5th Cir. 1972).

39. *Id.* at 1392.

tinguishing *Bivens*, the court relied on the same argument—there are no specific remedies for violation of the fourth amendment. The majority then summarily distinguished the *Gomez* case on the ground that the Wagner-Peyser Act, unlike the FLSA, provides a grossly inadequate remedy for those who suffer as the result of violations of the Act. Moreover, the instant court concluded that the comparative size of a state compensation award for job-related injuries does not justify creation of a new federal remedy to supplement the amount of relief afforded. Therefore, the court refused to imply a private remedy to redress violations of FLSA child labor provisions.

In his dissent, Judge Wisdom attacked the instant majority's decision on three grounds. He first stated that the criminal sanctions for violations of the FLSA child labor provisions were remedial with respect to society but not with respect to injured minors and their families. Secondly, he observed that, under the majority's rationale, the absence of express statutory language authorizing a private damage suit effectively precludes private compensatory relief for a violation of a federal statute. Judge Wisdom noted, however, that the courts often have recognized private damage suits for violations of statutes that are silent regarding civil liability.[40] Thirdly, the dissent contended that the majority improperly distinguished prior case law bearing on the implication of private damage suits. Judge Wisdom explained that the Securities Exchange Act of 1934, like the FLSA, establishes a comprehensive enforcement scheme, which includes criminal penalties, but does not create a private remedy for violation of section 14(a). The Court in *Borak*, however, inferred a private remedy to effectuate the congressional policy against stock fraud. Judge Wisdom explained further that criminal penalties exist for violations of the fourth amendment[41] and therefore concluded that *Bivens* offers persuasive support for recognizing the instant plaintiffs' claim. Moreover, he contended that the reason for implying a private damage remedy in *Gomez*—the gross inadequacy of the remedy under the Act in question—was applicable to the instant situation because the FLSA criminal penalties are remedial only with respect to society. To support his argument favoring recognition of plaintiffs' claim, Judge Wisdom asserted that the FLSA conferred a right upon the deceased minor to work free from hazardous conditions. Because numerous decisions[42] have held that if a right is created by a

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40. *See* cases cited notes 18-22 *supra*.

41. *See* 18 U.S.C. § 2236 (1970).

42. *See, e.g.*, Bell v. Hood, 327 U.S. 678 (1946). The Court in *Bell* stated that "where federally protected rights have been invaded, it has been the rule from the beginning that courts

federal statute, the federal courts have the power to fashion an appropriate remedy, Judge Wisdom concluded that plaintiffs' action was maintainable.

The instant court felt compelled to choose between exclusive reliance on FLSA remedies and recognition of plaintiffs' damage action, but persuasive case law suggests these "alternatives" may be coextensive. *Borak* recognized a private damage action to effectuate a strong congressional policy against stock fraud; congressional concern for improper use of child labor probably should equal that accorded defrauded stockholders. The instant majority emphasized that the FLSA contains a comprehensive scheme of enforcement, but failed to note that Congress provided an equally comprehensive enforcement scheme—a scheme including substantial criminal penalties—for violations of the Securities Exchange Act of 1934.[43] The majority distinguished *Gomez* on the ground that the Wagner-Peyser Act provides a grossly inadequate remedy. In the instant case, however, criminal sanctions against defendant likewise constitute a grossly inadequate remedy for the working minor who dies as a consequence of his employer's breach of duty. The Secretary of Labor cannot compensate the decedent's parents by criminal prosecution, and the Labor Department does not have the manpower or time to undertake complete enforcement of the statute.[44] Compensating plaintiffs in the instant case, however, would have conformed directly with the congressional policy of making whole one who by its own declaration should never have been injured.[45] Moreover, the traditional prerequisites for the implication of a private civil remedy assuredly were presented by the instant case:[46] congressional intent to establish a new standard of protection for the working minor; existence of an inadequate statutory remedy for injuries inflicted when the standard was ignored; and the remedy afforded at the state level failed to vindicate adequately the rights that had been breached under the new standard. Thus, recognizing plaintiffs' private action would have supplemented effectuation of the congressional policy favoring protection of child labor and would have compensated plaintiffs more satisfactorily. Manifest in situations like that presented in the instant case is the importance of flexibility and a willingness to consider a number of

will be alert to adjust their remedies so as to grant the necessary relief." *Id.* at 684 (footnote omitted). *See also* notes 10 & 12 *supra*.

43. *See* 15 U.S.C. § 78ff (1970).

44. Breitwieser v. KMS Indus., Inc., 467 F.2d 1391, 1396 (5th Cir. 1972) (Wisdom, J., dissenting).

45. Fagot v. Flintkote Co., 305 F. Supp. 407, 411-12 (E.D. La. 1969).

46. *See* note 9 *supra* and accompanying text.

factors before reaching a decision.[47] Courts must be cognizant of precedent in a particular area; sometimes uniform enforcement weighs more heavily than achieving ad hoc justice. When an administrative agency is granted jurisdiction over a plaintiff's complaint, however, the adequacy of the agency's remedies with respect to the injured minor or his family should be the question of foremost concern.[48] Therefore, judicial re-evaluation or legislative clarification is necessary in light of the instant decision to achieve a more equitable result in future cases and to assure a more adequate protection for working minors.

Securities Regulation—Commercial Paper—Promissory Notes with Maturity Not Exceeding Nine Months hut Offered to Puhlic as Investment Are "Securities" Within Section 3(a)(10) of the 1934 Act.

After plaintiff had purchased short-term promissory notes[1] from defendant broker-dealer, the corporate issuer of the notes became insolvent.[2] Plaintiff, on behalf of all purchasers of the notes, then brought a class action[3] alleging that defendant had sold "securities" in violation of the antifraud provisions of the Securities Exchange Act of 1934.[4] In

47. *Cf.* Lehigh Valley Coal Co. v. Yensavage, 218 F. 547 (2d Cir. 1914). Learned Hand stated that statutes "should be construed, not as theorems of Euclid, but with some imagination of the purposes behind them." *Id.* at 553.

48. *See* O'Neil, *supra* note 7, at 267-68.

1. For purposes of this Comment, the term "short-term note(s)" will he used as a general descriptive term: (1) denoting any note with a maturity of 9 months or less; (2) denoting "commercial paper" as that term is used in the market place. The term "commercial paper" will be used in those instances in which the instant court employed the term and when its omission might result in confusion about the impact of the instant decision.

2. On January 30, 1970, plaintiff bought short-term notes from defendant. Defendant had purchased the short-term notes (described by the court as "short-term commercial paper") for resale to the general public. The maker hecame insolvent on or about February 1970. The large majority of the 42 purchasers of the insolvent's notes were individuals. Sanders v. John Nuveen & Co., 463 F.2d 1075, 1079 & n.14 & 18 (7th Cir.), *cert. denied*, 409 U.S. 1009 (1972).

3. Plaintiff brought the class action under FED. R. CIV. P. 23(b), alleging that defendant had schemed to defraud plaintiff and the members of the class by selling short-term commercial paper issued by Winter & Hirsch, Inc., but owned by defendant, John Nuveen & Co.

4. Plaintiff specifically alleged a violation of the Securities Exchange Act of 1934, § 10(b), 15 U.S.C. § 78(j)(b) which provides: "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or . . . any national securities exchange . . . (b) To use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations

its answer,[5] defendant contended that any note, draft, or bill of exchange with a maturity not exceeding nine months is specifically excluded from the definition of "security" as found in section 3(a)(10) of the 1934 Act.[6] Plaintiff, however, argued that the exemption of short-term paper under the 1934 Act is limited to "prime quality negotiable commercial paper" as defined under the SEC's interpretation of section 3(a)(3) of the 1933 Act.[7] On defendant's motion, the district court certified the question whether the notes in question are "securities" within section 3(a)(10) of

as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." Rule 10b-5, 17 C.F.R. § 240.10b-5, provides: "It shall be unlawful for any person, directly or indirectly . . . (a) [t]o employ any device, scheme, or artifice to defraud, (b) [t]o 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) [t]o 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." Plaintiff also alleged violations of the Securities Act of 1933, 15 U.S.C. § 77a (1970) and the Rules of Fair Practice of the National Association of Securities Dealers.

5. Plaintiff filed his complaint on March 12, 1970. On May 18, 1970, defendant challenged the jurisdiction of the court under the 1934 Act, arguing that the short-term notes in question were exempted from the Act. Defendant also brought a challenge to the class action aspects of the complaint. Initially the district court dismissed both challenges. Two banks sought leave to intervene as creditors of the insolvent. Intervention was allowed on behalf of all creditors, including the members of the class that plaintiff sought to represent. Plaintiff then filed a motion to vacate the intervention order but the motion was denied. Thereafter, the district court, on its own motion, ordered the action to proceed as an individual complaint. The district judge then certified 3 questions: (1) whether it was error to permit the intervention; (2) whether it was error to find that plaintiff did not represent the class; and (3) whether it was error to strike the class aspects of the complaint. On defendant's motion, the district court also certified the question: whether the commercial paper in question is a "security" as defined in section 3(a)(10) of the Securities Exchange Act of 1934.

6. Securities Exchange Act of 1934, § 3(a)(10), 15 U.S.C. § 78c (a)(10) (1970), provides: "The term 'security' means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or . . . investment contract . . . or in general, any instrument commonly known as a 'security' . . . *but shall not include* currency or *any note,* draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of *not exceeding nine months,* exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited." (emphasis added).

7. Section 3(a)(3) of the Securities Act of 1933, 15 U.S.C. § 77c(a) (3) (1970), provides: "(a) Except as hereinafter expressly provided, the provisions of this subchapter shall not apply to any of the following classes of securities: . . . (3) Any note, draft, bill of exchange, or banker's acceptance which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions, and which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace or any renewal thereof the maturity of which is likewise limited . . . ." In response to inquiries concerning the scope of § 3(a)(3), the SEC issued Securities Act Release No. 4412 (Sept. 20, 1961). Emphasizing the legislative history of the 1933 Act and the prime quality of the short-term notes intended to be exempted from the registration requirements, the release set out 4 criteria for exemption from the 1933 Act. *See* note 25 *infra*. A type of security usually exempted by the terms of § 3(a)(3) is the short-term note that is issued by a finance company to carry its installment loans.

the 1934 Act.[8] By decision of the Seventh Circuit Court of Appeals, *held,* promissory notes with a maturity not exceeding nine months but offered to the public as an investment are "securities" within section 3(a)(10) of the Securities Exchange Act of 1934. *Sanders v. John Nuveen & Co.,* 463 F.2d 1075 (7th Cir.), *cert. denied,* 409 U.S. 1009 (1972).

The Securities Act of 1933, the Trust Indenture Act of 1939, the Investment Company Act of 1940, and the Investment Advisors Act of 1940 all define a security as "any note, . . . evidence of indebtedness, . . . investment contract, . . . or, in general, any interest or instrument commonly known as a 'security' . . . ."[9] The definition found in the Public Utility Holding Company Act of 1935 differs slightly by omitting the term "evidence of indebtedness," but retains the term "any note."[10] Therefore, *any* note, regardless of the nature of its terms, is subject to the general provisions of these five acts. Only the Securities Exchange Act of 1934 limits these otherwise broad definitions of a "security." Section 3(a)(10) of the 1934 Act provides that "the term security means any note, . . . investment contract, . . . or in general, any instrument commonly known as a security, . . . but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months . . . ."[11] Although the legislative history of the 1934 Act provides no explanation of the exclusionary provision of section 3(a)(10),[12] recent opinions[13] have analyzed its scope under the "plain meaning" principle of statutory interpretation.[14] After applying this principle, several district courts

8. The question was certified pursuant to 28 U.S.C. § 1292(b) (1970).

9. Securities Act of 1933, § 2(1), 15 U.S.C. § 77b(1) (1970); Trust Indenture Act of 1939, § 303(1), 15 U.S.C. § 77ccc (1) (1970); Investment Company Act of 1940, § 2(a)(36), 15 U.S.C. § 80a-2(36) (1970); Investment Advisors Act of 1940, § 202(a)(18), 15 U.S.C. § 80b-2(a)(18) (1970).

10. Public Utility Holding Company Act of 1935, § 2(a)(16), 15 U.S.C. § 79b(a)(16) (1970).

11. Securities Exchange Act of 1934, § 3(a)(10), 15 U.S.C. § 78c (a)(10) (1970).

12. Comment, *Commercial Paper and the Securities Acts,* 39 U. CHI. L. REV. 362, 398 (1972). The original draft of the 1934 Act provided no exclusion for short-term notes. S. 2693, 73d Cong., 2d Sess. (1934); H.R. 7852, 73d Cong., 2d Sess. § 3.10 (1934). As the bill progressed, an exception using language identical to the § 3(a)(3) exemption of the 1933 Act was introduced. H.R. 8720, 73d Cong., 2d Sess. § 3(a)(10) (1934). Subsequent changes, however, omitted the provision that excluded short-term notes must arise out of a current transaction—language used in the 1933 exemption. *See* H.R. 9323, 73d Cong., 2d Sess. § 3(a)(10) (1934).

13. Superintendent of Ins. v. Bankers Life & Cas. Co., 300 F. Supp. 1083, 1100 (S.D.N.Y. 1969) (dictum), *aff'd,* 430 F.2d 355 (2d Cir. 1970), *rev'd,* 404 U.S. 6 (1971); SEC v. Fifth Ave. Coach Lines, Inc., 289 F. Supp. 338 (S.D.N.Y. 1968), *aff'd,* 435 F.2d 510 (2d Cir. 1970).

14. This rule provides that only the meaning derived from a literal reading of a statute shall be considered if the statute is clear and unambiguous on its face and such a reading does not give rise to obscure or mischievous consequences or thwart a manifest purpose. *See* Frankfurter, *Some Reflections on the Reading of Statutes,* 47 COLUM. L. REV. 527 (1947); Note, *The Plain Meaning Rule in the Reflection of Current Trends and Proclivities,* 26 TEMP. L.Q. 174 (1952).

have stated in dictum that short-term notes fall within the exclusionary provision of section 3(a)(10).[15] These decisions considered the notes in question merely as evidences of individual loans and not the type of instruments that Congress intended to include within the definition of "security" under the 1934 Act.[16] One case, *Anderson v. Francis I. duPont & Co.*,[17] however, has held a short-term note to be a security within the 1934 Act. In *Anderson,* the purchasers of defendant's short-term notes sought damages under the 1934 Act for defendant's allegedly fraudulent scheme involving dealings in the commodities market.[18] In examining the status of the notes as "securities" within the 1934 Act, the court first observed that the exclusionary language in section 3(a)(10) of the 1934 Act is substantially identical to language in section 3(a)(3) of the 1933 Act, which exempts short-term notes from registration requirements.[19] The court then interpreted section 3(a)(10) in light of the legislative history of the 1933 Act and administrative interpretations of the section 3(a)(3) registration exemption.[20] Although no exemption for short-term notes was found in the original draft of the 1933 Act,[21] one was included subsequently on prompting by the Federal Reserve Board.[22] The Board had urged the exemption under section 3(a)(3) because it believed that the proposed act was "intended to apply only to stocks, bonds, debentures, and other similar securities of the kind commonly known as investment securities, which are issued for the purpose of obtaining capital funds for business enterprises and are pur-

15. Cases cited note 13 *supra.*

16. In *Superintendent of Ins. v. Bankers Life & Cas. Co.*, the district court stated that it need not answer the difficult question of whether certificates of deposit fall with the definition of "security." Nevertheless, the court did indicate that the exclusionary provision of the 1934 Act would appear applicable to a 6-month certificate of deposit which was issued for cash by a bank. 300 F. Supp. 1083, 1099-1100 (S.D.N.Y. 1969). The same court had found earlier that a 90-day note was excluded specifically from the definition of a security in the 1934 Act. The court did not rely solely on the exclusionary provision, however, but held that the transaction was merely an individual loan and that the note, therefore, did not constitute a security within the fair meaning of the securities acts. SEC v. Fifth Ave. Coach Lines, Inc., 289 F. Supp. 338 (S.D.N.Y. 1968).

17. 291 F. Supp. 705 (D. Minn. 1968). *See* note 18 *infra.*

18. Defendant had issued 2 notes to each plaintiff—one for the legal rate and a second for a usurious rate of from 20% to 60%. The notes (all except one) were to mature in less than 9 months.

19. The court cited 2 L. Loss, SECURITIES REGULATION 796 (2d ed. 1966), in which Professor Loss states: "Short-term notes of the type which are *exempted from registration* under the Securities Act by § 3(a)(3) are *excluded from the definition of 'security'* in the Exchange Act [section 3(a)(10) of the 1934 Act]."

20. For a brief description of the legislative and interpretative history of § 3(a)(3) see note 7 *supra.*

21. *See* H.R. 4314, 73d Cong., 1st Sess. (1933); S. 875, 73d Cong., 1st Sess. (1933).

22. *Hearings on H.R. 4314 Before the House Comm. on Interstate and Foreign Commerce,* 73d Cong., 1st Sess. 179-83 (1933); *Hearings on S. 875 Before the Senate Comm. on Banking and Currency,* 73d Cong., 1st Sess. 94-95, 120 (1933).

chased by persons for investment . . . . [The Act] was not intended to apply . . . to short-term paper issued for the purpose of obtaining funds for current transactions in commerce, industry, or agriculture and purchased by banks and corporations as a means of employing temporarily idle funds."[23] The scope of the section 3(a)(3) exemption was further defined by SEC Release No. 4412,[24] which sets out four criteria for determining whether short-term notes are exempted from the registration provisions of the 1933 Act. To qualify for exemption under the release, the notes must be: (1) prime quality negotiable commercial paper; (2) issued to facilitate well-recognized types of current operational business requirements; (3) discountable by Federal Reserve banks; and (4) of a type not ordinarily purchased by the general public.[25] Applying these criteria, and relying on the 1933 Act legislative history, the *Anderson* court found that the short-term notes at issue were "securities" under section 3(a)(10) of the 1934 Act.[26] Subsequent cases, however, have cast some doubt upon both the *Anderson* court's interpretation of the 1933 Act exemption, and its application of that interpretation to the 1934 Act. First, although *Anderson's* reliance on the SEC Release exemption criteria finds support in the House and Senate Reports,[27] the recent case of *SEC v. Perera Co.*[28] brings into question the criterion that short-term notes not be offered to the general public by holding that a sale of unregistered short-term paper to the general public did not violate the 1933 Act's registration requirements. The legislative history is not conclusive on this point; an initial draft of section 3(a)(3) required that exempt short-term notes not be sold to the public[29] but this requirement was later dropped as unnecessary since, at that time, such notes circulated only among banks.[30] Secondly, since its decision in 1968,

23. Letter from Chester Morrill, Secretary, Federal Reserve Board, to Sen. Duncan U. Fletcher, Apr. 3, 1933, in *Hearings on S. 875 Before the Senate Comm. on Banking and Currency*, 73d Cong., 1st Sess. 120 (1933).

24. Securities Act Release No. 4412 (Sept. 20, 1961).

25. *Id.* The Release states: "The legislative history of the Act makes clear that section 3(a)(3) applies only to prime quality negotiable commercial paper of a type not ordinarily purchased by the general public, that is, paper issued to facilitate well recognized types of current operational business requirements and of a type eligible for discounting by Federal Reserve banks. . . .

Notes, drafts, bills of exchange, and banker's acceptances which are commercial paper and arise out of current commercial, agricultural, or industrial transactions, and which are not intended to be marketed to the public, are exempted . . . ."

26. 291 F. Supp. 705, 708-09 (D. Minn. 1968).

27. In formulating Securities Act Release No. 4412 the SEC relied primarily on S. REP. No. 47, 73d Cong., 1st Sess. 3-4 (1933), and H.R. REP. No. 85, 73d Cong., 1st Sess. 15 (1933).

28. 47 F.R.D. 535 (S.D.N.Y. 1969).

29. S. 875, § 2(a), 73d Cong., 1st Sess. (1933), *as amended*, 77 CONG. REC. 2987 (1933).

30. 77 CONG. REC. 2987 (1933): "Mr. Adams, 'I move to strike out the words "when such

Anderson has not been cited for the proposition that short-term notes are "securities" under the Securities Exchange Act of 1934. On the contrary, several cases more recent than *Anderson* have commented in dicta that short-term notes are not securities within the 1934 Act.[31]

In the instant case the court followed *Anderson* and adopted plaintiff's contention that the definition of short-term notes in other securities legislation, particularly in section 3(a)(3) of the 1933 Act, should be applied to the 1934 Act. Consequently, the court applied the four-element test of SEC Release No. 4412 to determine whether the short-term notes in question were excmpted commercial paper under the 1934 Act. The notes in the instant case were found to meet none of the SEC criteria. The court reasoned that, because the issuer had become insolvent, it was highly unlikely that the commercial paper was prime quality, issued to facilitate current transactions, or eligible for discounting by Federal Reserve banks. Furthermore, the court found that the notes had been offered to the general public because they had been placed with defendant for sale and had been bought by 42 purchasers, most of whom were private individuals. The court additionally noted that the issuer had characterized the notes in its financial statements as "short-term open market" paper. Acknowledging the Supreme Court's directive that "form should be disregarded for substance"[32] and that economic reality should be emphasized,[33] the court found that it was Congress's intent in the 1934 Act to protect investors against fraudulent manipulations of instruments like the instant ones. Moreover, the court noted Congress's characterization of "commercial paper" in the Public Utility Holding Company Act of 1935 and the Investment Company Act of 1940 as (1) notes not part of a public offering and (2) paper of a commercial rather than an investment nature.[34] Drawing a distinction between "true" commercial paper, which is exempt, and short-term notes of an investment nature, which are not exempt, the court concluded that

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paper is not offered or intended to be offered for sale to the public." The matter has been discussed . . . and [the exemption] is intended to protect from the operation of the act certain paper which should not be included along with commercial paper, since it merely circulates among banks, instead of the general public.' " The amendment to the amendment was agreed upon.

31. Movielab, Inc. v. Berkey Photo, Inc., 321 F. Supp. 806, 809 (S.D.N.Y. 1970), *aff'd per curiam*, 452 F. 2d 662 (2d Cir. 1971); Superintendent of Ins. v. Bankers Life & Cas. Co., 300 F. Supp. 1083, 1100 (S.D.N.Y. 1969) (dictum), *aff'd*, 430 F.2d 355 (2d Cir. 1970), *rev'd*, 404 U.S. 6 (1971); SEC v. Fifth Ave. Coach Lines, Inc., 289 F. Supp. 3, 38 (S.D.N.Y. 1968), *aff'd*, 435 F.2d 510 (2d Cir. 1970).

32. SEC v. W.J. Howey Co., 328 U.S. 293, 298 (1946).

33. Tcherepnin v. Knight, 389 U.S. 332, 336 (1967).

34. *See* Public Utility Holding Company Act of 1935, § 6(b), 15 U.S.C. § 79f(b) (1970); Investment Company Act of 1940, § 2(a) (38), 15 U.S.C. § 80a-2(a) (38) (1970).

promissory notes with a maturity not exceeding nine months but offered to the public as an investment are "securities" within the definition of the Securities Exchange Act of 1934.

By identifying the characteristics that short-term notes must possess to qualify for an exemption under section 3(a)(10) of the 1934 Act, the instant decision indicates that some "commercial paper" will not fit the definition of exempted short-term notes under the 1934 Act. The principal ramification of this decision is the applicability of Rule 10b-5[35] to the purchase and sale of nonqualifying short-term notes. This appears desirable from the standpoint of protecting investors in short-term notes because Rule 10b-5, with its broad coverage of persons and transactions, absence of express defenses, and procedural advantages,[36] offers the most effective antifraud remedy in the federal securities acts. The court's interpretation of the section 3(a)(10) exclusionary provision in terms of the legislative history of the section 3(a)(3) exemption appears reasonable, given the joint scope and aims of the two federal securities acts[37] and the absence of a legislative explanation for the exclusionary language of section 3(a)(10). Only the court's analytical distinction between short-term notes as commercial paper and as investment securities may be questioned, because the instant notes appear to have all the qualities of commercial paper as presently defined in the market place.[38] Reliance on a distinction between commercial paper and investment securities may create confusion because the court's definition of commercial paper is of 1933 vintage and does not comport with the commonly understood meaning of that term today. A more direct statement that not all commercial paper is exempt from regulation under the 1934 Act would have indicated clearly that commercial paper failing to meet the SEC Release No. 4412 criteria is subject to the 1934 Act. The instant case, however, brings into question the viability of the four-element criteria. This standard has already been challenged with uncertain results in *Perera,* and, given the possibility of Rule 10b-5 liability, a strong challenge appears certain. The legislative history of the four-point test provides an adequate basis for each requirement set out by the SEC, yet particular pressure can be expected concerning the requirement that exempt short-term paper not be offered to the general

35. *See* note 4 *supra.*

36. 1 A. BROMBERG, SECURITIES LAW: FRAUD—SEC RULE 10b-5 §§ 2.3 (800), 2.5 (1971 ed.); W. CARY, CASES AND MATERIALS ON CORPORATIONS 794-98 (4th ed. unabr. 1969).

37. 1 L. LOSS, SECURITIES REGULATION 130-31 (2d ed. 1961, Supp. 1962). *See also* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 858 (2d Cir. 1968), *cert. denied,* 394 U.S. 976 (1968); H.R. REP. No. 1383, 73d Cong., 2d sess. 11 (1933).

38. *See* Wall Street J., Nov. 14, 1972, at 2, col. 1; note 1 *supra.*

public. Current market practices allow the offering of commercial paper to the general public, and the imposition of full registration and disclosure requirements on commercial paper placed for public sale would severely disrupt the present commercial paper market.[39] Nevertheless, if the securities acts' goal of investor protection is to be implemented fully, it is both reasonable and practical to require that publicly offered commercial paper come, at least to some extent, within the protective ambit of the 1933 and 1934 Acts.[40]

Securities Regulation—Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5—A Reorganization in the Form of a Tripartite Merger in Which There Is No Change in the Total Assets Represented by a Share of Stock Does Not Involve a "Purchase or Sale" Within the Meaning of Section 10(b) of The Securities Exchange Act of 1934 and Rule 10b-5

Plaintiffs, individuals who purchased or sold Penn Central Company stock in the open market during the period of defendants' alleged illegal activity and individuals who has acquired their stock before and held it throughout this period, brought suit[1] against defendants, Penn Central Companies, their officers, and directors, alleging materially false and misleading statements[2] by defendants in violation of section

39. Cloas, *A Larger Role for Commercial Paper*, J. COM. BANK LENDING, Apr. 1969, at 2, 13; BUSINESS WEEK, July 11, 1970, at 90-94.

40. There has been considerable discussion concerning the most appropriate means of (1) preserving the commercial paper market and (2) providing disclosure as required under the registration provisions of the 1933 Act. One suggestion is to exempt from registration short-term notes of large denominations, i.e., $100,000 or more, on the theory that large investors are sophisticated investors and do not need the protection of the registraiton provisions. *See* Cohen, *"Truth in Securities" Revisited*, 79 HARV. L. REV. 1340 (1966). Another alternative would be to allow "shelf registration"—permitting the registration of a security even though there is no intent to market it immediately. The registration statement would be amended to update information, and securities "on the shelf" could be sold over a reasonable period of time (for example, one year). Hodes, *Shelf Registration: The Dilemma of the Securities and Exchange Commission*, 49 VA. L. REV. 1106 (1963).

1. A total of 18 separate actions were consolidated into this class action pursuant to FED. R. CIV. P. 23, because the complaint alleged that defendants were engaged in a common course of fraudulent conduct that was directed at all investors and that raised substantive legal questions common to all the investors involved.

2. Plaintiffs alleged that defendants prepared reports containing materially misleading information and filed them with the Securities Exchange Commission and the New York Stock Ex-

10(b) of the Securities Exchange Act of 1934[3] and Rule 10b-5[4] promulgated thereunder. The statements allegedly were made to procure stockholder approval for a proposed merger and reorganization plan of defendant corporation,[5] whereby the Penn Central Railroad Company became the wholly owned subsidiary of the newly formed Holding Company.[6] Following the reorganization and merger, only the subsidiary

change. Plaintiffs also alleged that defendants released information concerning the financial condition of the Penn Central Companies to stockholders and the public at large through various reports, official statements, documents, and press releases that were false and misleading and tended to inflate the market price of the Penn Central Company stock. Plaintiffs further asserted that certain defendants, who had knowledge of material inside information, sold substantial amounts of Penn Central Company stock without disclosing the inside information to the public. Finally, plaintiffs maintained that defendants issued false and misleading proxy statements to induce plaintiff shareholders to vote in favor of certain management proposals.

3. Section 10(b), 15 U.S.C. § 78j (1970), provides: "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

. . . .

"(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." (emphasis added).

4. Rule 10b-5, 17 C.F.R. § 240.10b-5 (1972), provides: "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

"(a) To employ any device, scheme, or artifice to defaud,

"(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 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*." (emphasis added).

5. Plaintiffs asserted causes of action under various other sections of the federal securities laws. Plaintiffs alleged a private cause of action under § 13(a) of Securities Exchange Act (1934 Act) for filing misleading annual reports with the SEC and a cause of action under § 14(a) of the Exchange Act for use of misleading proxy statements. In addition, plaintiffs alleged a cause of action under § 9(a) of the Exchange Act and §§ 11(a) and 17(a) of the Securities Act of 1933 for various fraudulent acts.

6. The Penn Central Railroad Company was formed in 1968 through the merger of the Pennsylvania Railroad Company and the New York Central Railroad Company. The court dismissed complaints relating to this 1968 merger on the ground that plaintiffs failed to allege that any exchange of stock by them was caused by the fraudulent conduct of defendants. In the course of the merger and reorganization activities in question, defendant Penn Central and its subsidiaries changed their names several times. The surviving corporation of the 1968 merger is referred to as the Railroad Company and the Penn Central Holding Company is referred to as the Holding Company. As a part of the reorganization in question, the directors of the Railroad Company formed the Penn Central Holding Company and the PCT Company, which was a wholly owned subsidiary of the Holding Company. The reorganization plan, as approved by the shareholders of the Railroad Company, provided for the merger of the PCT Company into the Railroad Company

Railroad Company was subject to regulation by the Interstate Commerce Commission, thus enabling the parent Holding Company to diversify beyond the transportation industry. Plaintiffs contended that the stockholders of the Railroad Company had been required to make the type of investment decision incident to the reorganization transaction that section 10(b) and Rule 10b-5 were intended to protect, because the rights represented by the original Railroad Company stock differed significantly from the rights represented by the Holding Company stock for which it was exchanged. Plaintiffs emphasized that the reorganization plan provided for the abolition of pre-emptive rights in the common stock, creation of a class of preferred stock, and establishment of cumulative voting rights.[7] Defendants maintained that plaintiffs who were not open market purchasers or sellers during the period of defendants' alleged illegal activity failed to state a cause of action under section 10(b) or Rule 10b-5, because the reorganization in question did not involve a "purchase or sale" of securities, and therefore did not come within the scope of the antifraud provisions. On defendants' motion before the United States District Court for the Eastern District of Pennsylvania for summary judgment against plaintiffs who were not open market purchasers during the period of defendants' alleged illegal activity, *held*, judgment for defendant.[8] Because the stockholders' interests in the corporation were not changed materially by the reorganization in terms of the total assets represented by each share of stock, their approval of the reorganization plan did not involve the type of significant investment decision that would qualify as a purchase or sale under section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 and, therefore, plaintiffs who were not open market purchasers or sellers during the period of defendants' alleged illegal activity have not stated a cause of

through the conversion of the capital stock of the Railroad Company into the common stock of the Holding Company on a one-to-one basis. The stock of the PCT Company was cancelled and the Company ceased to exist as a distinct corporate entity.

7. Plaintiffs also noted that there was an increase in the number of authorized shares of stock, and that a different par value had been assigned to the common stock.

8. With respect to plaintiffs' claims under § 9(a) of the Securities Exchange Act and §§ 11(a) and 17(a) of the Securities Act, the court granted summary judgment in favor of defendants against all plaintiffs who were not open market purchasers or sellers during the period of defendants' alleged illegal activity. Under these sections, a plaintiff must be a purchaser or seller to recover. The court also granted summary judgment for defendants with respect to all plaintiffs claiming under § 13(a) of the Exchange Act, holding that no private right of action exists under § 13(a). The court also dismissed without prejudice one complaint under § 14(a) of the Exchange Act. Another complaint, filed by a plaintiff who purchased stock after the corporate vote, that alleged a violation of § 14(a) was dismissed. To establish a cause of action under § 14(a), there must be an allegation that the violation of the proxy rules affected a corporate transaction that injured plaintiffs. All other motions for summary judgment were denied.

action under these provisions. *In re Penn Central Securities Litigation*, 347 F. Supp. 1327 (E.D. Pa. 1972).

Section 10(b) of the Securities Exchange Act of 1934 is a broad antifraud provision that has the explicit purpose of preventing all fraudulent, manipulative devices employed "in connection with the purchase or sale" of any security.[9] Pursuant to the rulemaking powers granted by section 10(b), the Securities Exchange Commission promulgated Rule 10b-5, which defines transactions that are violations of section 10(b) when made "in connection with the purchase or sale of any security."[10] The term "purchase" is defined in section 3(a)(13) of the act to "*include* any contract to buy, purchase, *or otherwise acquire*."[11] Section 3(a)(14) similarly defines the term "sale" to "*include* any contract to sell or *otherwise dispose of*."[12] The courts have taken the position that the use of the language "include" and "or otherwise dispose of or acquire" in the definitions indicates that Congress did not intend the definitions to be exclusive.[13] Furthermore, the Supreme Court has stated that securities legislation is to be construed liberally to effectuate its remedial purposes and, to accomplish this goal, the scope of the terms "purchase or sale" should be determined by the substance and not the form of the transaction in question.[14] In *Birnbaum v. Newport Steel Corp.*,[15] however, Judge Learned Hand, speaking for the Second Circuit, interpreted the "purchase or sale" requirement to limit application of Rule 10b-5 to situations in which there is a traditional sale of securities. Dismissing the stockholders' derivative suit in *Birnbaum*, Judge Hand explained that Rule 10b-5 was "directed solely at the type of misrepresentation or fraudulent practice usually associated with the sale or purchase of securities rather than at fraudulent mismanagement of corporate affairs, and that Rule X-10b-5 extended protection only to the defrauded purchaser or seller."[16] The force of the *Birnbaum* rule as

9. *See Stock Exchange Regulation, Hearings on H.R. 7852 and H.R. 8720 before House Comm. on Interstate and Foreign Commerce*, 73d Cong., 2d Sess. 115 (1934).

10. 15 U.S.C. § 78j(b) (1970); 17 C.F.R. § 240.10b-5 (1972).

11. 15 U.S.C. § 78c(a)(13) (1970).

12. 15 U.S.C. § 78c(a)(14) (1970).

13. *See* Vine v. Beneficial Fin. Co., 374 F.2d 627, 634 (2d Cir.), *cert. denied*, 389 U.S. 970 (1967). *See also* SEC v. National Sec., Inc., 393 U.S. 453, 466-67 (1969). (merger constitutes a purchase or sale).

14. SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963) (securities legislation is to be construed liberally in order to effectuate its remedial purposes); *see* Condon v. Richardson, 275 F. Supp. 943, 948 (S.D. Ill. 1967), *rev'd on other grounds*, 411 F.2d 489 (7th Cir. 1969). It should be noted that the court in this case expanded the application of Rule 10b-5.

15. 193 F.2d 461 (2d Cir. 1952).

16. 193 F.2d at 464.

binding authority has been diminished considerably, however, by several subsequent decisions.[17] In these cases, the courts have tended to extend the coverage of Rule 10b-5 to all fraudulent schemes touching the purchase or sale of securities.[18] A Rule 10b-5 action has been held to exist, in spite of the absence of a traditional open market transaction, for example, when there is fraud in connection with a merger,[19] an assets sale transaction,[20] a short form merger in which plaintiff has not accepted defendant's tender offer or surrendered his stock,[21] or a contract to purchase or sell securities that never is consummated.[22] On the basis of these decisions, it no longer appears necessary for a plaintiff to be an open market buyer or seller to state a cause of action under section 10(b) and Rule 10b-5. Clearly, the courts now treat a traditional merger of two *active* corporations as a purchase or sale for the purposes of section 10(b) and Rule 10b-5.[23] The Seventh Circuit articulated the rationale of this position in *Dasho v. Susquehanna Corp.*, concluding that "when the merger was approved and the exchange of securities occurred, the owner of stock had in effect purchased a new security and paid for it by turning in his old one."[24] All the cases holding that a merger is a "purchase or sale" within the meaning of section 10(b) and Rule 10b-5, however, have involved the merger of two active corporations, which each own some assets.

The court in the instant case initially declared that to state a cause of action under section 10(b) and Rule 10b-5, plaintiffs must show a purchase or sale of securities and prove that the purchase or sale was caused by the fraudulent conduct of defendants. Although it recognized that the exchange of shares pursuant to a merger has been held to

17. Vine v. Beneficial Fin. Co., 374 F.2d 627 (2d Cir. 1967); A.T. Brod & Co. v. Perlow, 375 F.2d 393 (2d Cir. 1967); Symington Wayne Corp. v. Dressus Indus., Inc., 383 F.2d 840 (2d Cir. 1967) (it is sufficient that the fraud "touches" a "purchase or sale" for a cause of action to exist). *See generally* Lowenfels, *The Demise of the Birnbaum Doctrine: A New Era for Rule 10b-5*, 54 VA. L. REV. 268, 270 (1968).

18. *See* SEC v. National Sec., Inc., 393 U.S. 453 (1969); Dasho v. Susquehanna Corp., 380 F.2d 262 (7th Cir.), *cert. denied*, 389 U.S. 977 (1967).

19. SEC v. National Sec., Inc., 393 U.S. 453 (1969).

20. Dasho v. Susquehanna Corp., 380 F.2d 262 (7th Cir.), *cert. denied*, 389 U.S. 977 (1967).

21. Vine v. Beneficial Fin. Co., 374 F.2d 627 (2d Cir. 1967).

22. Commerce Reporting Co. v. Puretec, Inc., 290 F. Supp. 715 (S.D.N.Y. 1968).

23. For a discussion of cases adopting this position see 1 A. BROMBERG, SECURITIES LAW: FRAUD § 6.5(2) n.95 (1971). *See also* Mader v. Armel, 402 F.2d 158 (6th Cir. 1968), *cert. denied*, 394 U.S. 930 (1969).

24. 380 F.2d at 267. "In such a situation the antifraud protection afforded by the Securities Act are [sic] needed no less than in a situation where one makes an outright purchase of stock for cash. We agree with counsel for the amicus curiae that the complex nature of a merger enhances the opportunities for fraud and increases the need for antifraud protection."

constitute a purchase of new securities and a sale of the surrendered securities under section 10(b), the court stated that the formal characteristics of a traditional merger will not convert an internal reorganization into a merger for section 10(b) purposes if the transaction does not involve the combination of assets of two distinct corporate structures and a resulting change in stockholders' interests. The court explained that the changes resulting from the instant reorganization were simply changes in internal corporate structure that could have been achieved through amendments to the articles of incorporation by the stockholders, that the corporation acquired no additional assets as a result of the reorganization, and that the stockholders' interests were not changed materially by the reorganization. Therefore, the court concluded that the instant reorganization did not qualify as a purchase or sale within the meaning of section 10(b) and Rule 10b-5 and thus that the plaintiffs who were not open market purchasers or sellers during the period of defendants' alleged illegal activity has not stated a cause of action under those provisions.

The decision in the instant case is the first instance in which a federal court has held that the "purchase or sale" requirement of section 10(b) and Rule 10b-5 is not satisfied by an internal reorganization of a corporation accomplished through a traditional merger, when there is no change in the amount of assets represented by each share of stock held by the shareholders of the corporation involved in the reorganization plan. This holding is of particular significance because of the frequent utilization of the reorganization procedure by corporations in heavily regulated industries to carry out diversification plans without having to comply with traditional restrictions imposed upon the activities of such corporations.[25] The instant decision was motivated by the court's desire to prevent the legitimate federal interest in protecting investors from encroaching upon the state's interest in regulating internal corporate management decisions.[26] In determining whether the present merger was the type of transaction that Congress intended to regulate, the court relied on the proposition that, for a "purchase or sale" to exist in a merger context, the stockholders must acquire something different in the exchange for their stock. In its application of this propo-

25. *Compare* J. BONBRIGHT & G. MEANS, THE HOLDING COMPANY 76-79, 90-95 (1932), *with* 2 A. DEWING, THE FINANCIAL POLICY OF CORPORATIONS 985-87, 999-1006 (5th ed. 1953). *See generally* Eisenberg, *Megasubsidiaries: The Effect of Corporate Structure on Corporate Control*, 84 HARV. L. REV. 1577 (1971).

26. *See* Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 12 (1971); Herpich v. Wallace, 430 F.2d 792, 808-09 (5th Cir. 1970).

sition, however, the court merely attempted to ascertain whether the merger resulted in a reallocation of the company's *physical* assets and whether the corporation could have achieved the same result by amending its articles of incorporation. By limiting its evaluation of the transaction almost exclusively to these two criteria, the court failed to recognize that, as a result of the merger-reorganization, the corporation acquired the ability to implement expansion activities through its holding company without subjecting them to the regulatory authority of the Interstate Commerce Commission, and this particular ability clearly is a significant new interest that the stockholders of the corporation acquired as a consequence of the merger. Moreover, by making the original stockholders of the Railroad Company stockholders of the Holding Company, the instant merger-reorganization had the effect of removing control of the corporation from the shareholders to a degree that could not have been achieved simply by amending the articles of incorporation.[27] Because of the apparent shifts in the interests of the stockholders and the declared purposes of the Securities Exchange Act of 1934, the federal government's interest in protecting investors from fraudulent practices involving transactions in securities probably should have outweighed the state's interest in regulating exclusively corporate fiduciary relationships in the instant case. Thus, the substantial restructuring of the shareholders' rights that occurred in the instant case is the sort of "significant investment decision" that the Act was designed to regulate.

Taxation—Tax-Free Incorporations—Recognition of Income for Cash Basis Taxpayer Is Not Reqnired When Accounts Payable Exceed Adjusted Basis of Assets Transferred

The Commissioner of Internal Revenue determined a deficiency on appellant-taxpayer's[1] 1965 income tax return on the ground that taxpayer, in transferring sole proprietorship assets to his newly formed

27. Eisenberg, *supra* note 25, at 1588-95. Pennsylvania, however, has a statutory provision that avoids this problem when there is a sale of all the assets of a subsidiary that possesses substantially all of the assets of the parent. This so-called "pass-through" provision allows the shareholders to vote the stock of the subsidiary in proportion to their ownership of the parent. PA. STAT. ANN. tit. 15, § 1311(B) (1967).

1. The deficiency was assessed against appellant and his wife, who had filed a joint return. Since the wife was made a party to the litigation solely for this reason, this Comment refers only to the husband as appellant.

corporation under section 351,[2] did not include as income the excess of liabilities assumed by the corporation over the adjusted basis of assets transferred[3] as required by section 357(c).[4] Since appellant had operated his masonry business on the cash receipts and disbursements basis, he had not taken accrued income or expense into account for income reporting purposes, and consequently had a zero tax basis for the substantial balance-sheet asset represented by his accounts receivable.[5] Section 357(c), however, makes no express concession to previous methods of accounting and the Commissioner, interpreting the section literally, maintained that the excess of liabilities—represented by taxpayer's accounts payable[6]—over basis must be reported as ordinary income.[7] Taxpayer was unsuccessful in convincing the Tax Court that his attempt to change from cash to accrual accounting methods immediately prior to the transfer should be allowed.[8] On appeal to the Court of Appeals for the Second Circuit, *held,* reversed. When a sole proprietor on the cash method of accounting transfers to his controlled corporation accounts payable in excess of his adjusted basis in the assets transferred, no gain is recognized under section 357(c). *Bongiovanni v. Commissioner*, 470 F.2d 921 (2d Cir. 1972).

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2. Section 351(a) of the Internal Revenue Code reads in pertinent part:
"(a) *General Rule.*—No gain or loss shall be recognized if property is transferred to a corporation . . . by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation."
In the instant case, taxpayer received a promissory note as well as stock in the exchange. The Commissioner found that the note's value should have been taken into income, and taxpayer did not contest.

3. Assets included cash, trade receivables, office equipment, work in process, raw materials, and tools and supplies, of which all but cash and office equipment had a zero basis under taxpayer's cash basis accounting method.

4. Section 357(c) of the Internal Revenue Code reads in pertinent part:
"(c) Liabilities in Excess of Basis.—
(1) *In General.*—In the case of an exchange—
(A) to which section 351 applies. . . .
. . . .
if the sum of the amount of the liabilities assumed, plus the amount of the liabilities to which the property is subject, exceeds the total of the adjusted basis of the property transferred pursuant to such exchange, then such excess shall be considered as a gain from the sale or exchange of a capital asset or of property which is not a capital asset, as the case may be."

5. Assets totaled $94,490 in value but had a basis of only $1,383; the zero-basis accounts receivable amounted to $57,741 of the total value. *See* note 3 *supra*.

6. Liabilities consisted solely of payables totalling $17,237.

7. The "ordinary income" issue was not discussed by the Tax Court since the facts clearly paralleled Peter Raich, 46 T.C. 604 (1966). *See* notes 20-26 *infra* and accompanying text.

8. John B. Bongiovanni, P-H 1971 TAX CT. REP. & MEM. DEC. ¶ 71,262 (Oct. 12, 1971).

Previous judicial interpretation of the term "liability" in section 357(c) of the Internal Revenue Code has produced confusion and frustration for the incorporating cash basis transferor.[9] This section of the Code was adopted to correct two inequities that previously accompanied section 351 transfers[10]—the taxpayer's receipt of a negative basis when the liabilities transferred to his corporation exceeded his adjusted basis[11] and the taxpayer's permanently avoiding tax upon his economic gain from the discharge of a transferred liability.[12] The gain recognized under section 357 must be treated as ordinary income or long-or short-term capital gain according to the nature of the asset transferred[13] and is taxable to each transferor.[14] Section 357(c) was apparently intended to reach and commonly has been applied to transfers of encumbered property, typically mortgaged land and buildings. This is evidenced by the exclusive use in the Treasury Regulations[15] and the House and Senate reports[16] of examples in which only mortgaged property is involved. In *Testor v. Commissioner,*[17] the Seventh Circuit extended the section's application from mortgaged property to the unsecured liabilities of a cash basis taxpayer who economically benefited from the transfer; the taxpayer's liabilities assumed by the corporation exceeded both the adjusted basis and the book or market value of assets transferred.[18] Nevertheless, it was not until the *Peter Raich*[19] case in 1966 that the Commis-

9. "Section 357(c) makes incorporation of a cash basis taxpayer extremely delicate." Burke, *Section 351: The Beginning of Life in Subchapter C,* 24 Sw. L.J. 742, 789 (1970); *cf.* Burke & Chisholm, *Section 357: A Hidden Trap in Tax-Free Incorporations,* 25 TAX L. REV. 211, 212 (1970).

10. Although § 351 was first enacted as § 202 of the Revenue Act of 1921, § 357(c) was not added until 1954. For a summary of the history of §§ 351 and 357 see Note, *Section 357(c) and the Cash Basis Taxpayer,* 115 U. PA. L. REV. 1154-57 (1967). The rationale for nonrecognition under a § 351 transfer is that incorporation is little more than a change of form of ownership, and any resulting gain is only a paper profit. White, *Sleepers That Travel with Section 351 Transfers,* 56 VA. L. REV. 37 (1970); *see* Portland Oil Co. v. Commissioner, 109 F.2d 479, 480 (1st Cir. 1940).

11. *See* Note, *supra* note 10, at 1161.

12. *See id.* at 1162.

13. INT. REV. CODE OF 1954, § 357(c); Treas. Reg. § 1.357-2 (1961). The income must be allocated among the transferred assets on the basis of their relative fair market values. Treas. Reg. § 1.357-2 (1961). For a critical analysis of the allocation procedure see Burke, *supra* note 9, at 789.

14. Rev. Rul. 142, 1966-1 CUM. BULL. 66.

15. Treas. Reg. § 1.357-2 (1961).

16. S. REP. No. 1622, 83d Cong., 2d Sess. 270 (1954); H.R. REP. No. 1337, 83d Cong., 2d Sess. A129 (1954).

17. 327 F.2d 788 (7th Cir. 1964), *aff'g* 40 T.C. 273 (1963).

18. *Accord,* Arthur L. Kniffen, 39 T.C. 553 (1962); Peter W. DeFelice, 25 CCH Tax Ct. Mem. 835 (1966).

19. 46 T.C. 604 (1966).

sioner persuaded the Tax Court to undertake a literal interpretation of "liabilities" when the liabilities assumed did not exceed the market value of assets transferred. In *Raich,* a cash basis taxpayer transferred accounts receivable having a zero basis,[20] plus liabilities in an amount exceeding the adjusted basis of all property transferred.[21] In spite of taxpayer's argument that the accounts receivable should be viewed as having a basis sufficient to offset the liabilities assumed,[22] the Tax Court held for the Commissioner; after noting that the legislative history offers no affirmative indication of any Congressional design beyond the plain meaning of the statutory language,[23] the court applied section 357(c) literally to the taxpayer's balance sheet and forced him to recognize gain. The Tax Court reached this conclusion despite its recognition that if taxpayer had chosen the accrual method of accounting in the operation of his proprietorship, he would have had a basis for his accounts receivable and as a result would not have recognized income. These divergent results based on the accounting method have been sharply criticized.[24] Although the Internal Revenue Service recognized the anomaly in the court's interpretation of section 357(c), it declared it would follow the *Raich* decision for other taxpayers.[25]

In the instant case the court first reviewed the purpose behind section 351 and its interrelationship with section 357(c). The court agreed that if the word "liabilities" in section 357(c) were read literally, as was done in *Raich,* then the Tax Court reached the proper result. The instant court, however, distinguished "accounting" liabilities from "tax" liabilities[26] and concluded that section 357(c) should apply only to the latter; the court then determined that payables of a cash basis taxpayer should be considered accounting liabilities, not tax liabilities.

20. Accounts receivable had a book value of $77,361.66; because they had not yet been taken into income, their basis was zero. *See also* Ray Franconi, 34 P-H Tax Ct. Mem. 503 (1965); Treas. Reg. § 1.166-1(e) (1960); White, *supra* note 10, at 41.

21. The corporation assumed liabilities of $45,992.81, but the assets had a basis of only $11,251.73, so that taxpayer was forced to recognize $34,741.08 as income. 46 T.C. at 611.

22. Taxpayer used 2 alternative arguments: 1) that liabilities must exceed not just the adjusted basis but also the book value of property transferred, and 2) that accounts receivable should be considered to have a basis at least equal to accounts payable. *Id.* at 607.

23. *See Id.* at 609.

24. "A provision intended originally to be a relief provision and which is not concerned with a taxpayer's method of accounting, should not punish a taxpayer merely because he happens to be a cash basis taxpayer. This, however, is the effect of section 351 as modified by section 357(c) and interpreted in *Raich.*" Burke & Chisholm, *supra* note 9, at 232; *see* Note, *supra* note 10, at 1167.

25. Rev. Rul. 442, 1969-2 CUM. BULL. 53.

26. The court defined tax liabilities as "liens in excess of the tax costs." The prime example is mortgaged property.

Conceding that its interpretation did not fit the plain meaning of section 357(c), the court justified the result on principles of statutory construction enunciated by the Supreme Court:[27] when a literal reading produces an arbitrary and unjust result, in light of the purpose of section 351, a court should follow overall policy and not the literal words.[28] Based on the facts of the instant case, the court concluded that the taxpayer had been forced to recognize income solely because of his accounting method and decided that such a result was clearly inequitable; consequently, no income should be recognized.

Although it reached an equitable result for the individual taxpayer, the instant decision is subject to criticism on two grounds; the decision is inconsistent with the explicit wording of the statute and does not address the question of the transferor's basis for his stock. First, the court has stretched the literal meaning of "liabilities" in section 357(c) to give the cash and accrual basis taxpayer similar tax treatment.[29] Unfortunately, the instant holding leaves unanswered several important questions regarding applicability to other cash-basis taxpayer situations—for example whether a taxpayer with liabilities in excess of the full amount of his receivables should also be permitted to avoid recognition.[30] The court may be indicating its approval of the proposition that a cash basis taxpayer should in every case be treated exactly as though he used the accrual method, but the issue was not expressly discussed. More importantly, the court may have created a new judicial doctrine—that one's accounting method should not control the question of one's tax liabilities. This argument might then become available to taxpayers faced with inconsistent accounting-based tax liabilities in other Code section computations. Under the rationale of the instant decision, it thus appears that even the plain meaning of the Internal Revenue Code may be vulnerable to attack by the taxpayer; the court has created a new distinction—tax versus accounting liability—without any legislative history to support this interpretation. Secondly, the instant decision leaves unresolved the computation of the transferor's basis in the newly acquired stock. Under section 358,[31] the basis of the

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27. United States v. American Trucking Ass'ns, 310 U.S. 534 (1940).

28. *Id.* at 543.

29. A strong argument has been made in favor of this tax treatment. Note, *supra* note 10.

30. It could be argued that such a situation fits the parameters of the mortgage cases, but the court does not discuss the issue. *See* Note, *supra* note 10, at 1169.

31. Section 358 of the Internal Revenue Code of 1954 reads in pertinent part: "In the case of an exchange to which section 351 applies . . . [t]he basis of the property permitted to be received under such section without the recognition of gain or loss shall be

stock is the basis of the property transferred—zero when only accounts receivable are transferred by a cash-basis taxpayer—decreased by the amount of money received by the taxpayer. Section 358(d)[32] treats any liability transferred to the corporation as money received; consequently, if 100,000 dollars of receivables with a zero basis and 50,000 dollars in payables are transferred and nonrecognition treatment is accorded, the transferor's stock basis apparently becomes a negative 50,000 dollars. Although the concept of negative basis has not generally been recognized in the tax law,[33] this case demands such a result unless section 358(d) is also reinterpreted. Thus it is quite likely that the reinterpretation of section 357(c) and related provisions is not yet complete; further clarification for the basis of stock may return this issue to the courts.

the same as that of the property exchanged . . . decreased by . . . the amount of any money received by the taxpayer . . . ."

32. Section 358(d) reads:

"*Assumption of Liability.*—Where, as part of the consideration to the taxpayer, another party to the exchange assumed a liability of the taxpayer or acquired from the taxpayer property subject to a liability, such assumption or acquisition (in the amount of the liability) shall, for purposes of this section, be treated as money received by the taxpayer on the exchange."

33. Jack L. Easson, 33 T.C. 963, 970 & n.8 (1960), *rev'd*, 294 F.2d 653 (9th Cir. 1961).