Vanderbilt Law Review

Volume 29
Issue 6 *Issue 6 - November 1976*

Article 2

11-1976

Fiduciaries and Fairness Under Rule 10b-5

Thomas J. Sherrard

Fiduciaries and Fairness Under Rule 10b-5

*Thomas J. Sherrard**

TABLE OF CONTENTS

I. INTRODUCTION

In the midst of what appears to be a deliberate and perhaps thorough reassessment by the United States Supreme Court of the proper function and scope of section 10(b)[1] and rule 10b-5[2] of the

* Associate Professor of Law, Vanderbilt University. B.A. Duke University, 1966; J.D., University of Florida, 1969.

1. Section 10(b) of the Securities Exchange Act of 1934 declares:

It shall he unlawful for any person, directly or indirectly, by the use of any means

Securities Exchange Act of 1934, the Court of Appeals for the Second Circuit has interposed two back-to-back opinions that conspicuously extend the reach of the rule beyond all previous limits. The two Second Circuit decisions deal with the often discussed but still vaguely defined area of internal corporate mismanagement,[3] one of the three general areas that rule 10b-5 has been found to encompass.[4]

In *Marshel v. AFW Fabric Corp.*,[5] decided on February 13, 1976, the court unanimously sustained a challenge to long-form merger under New York law for the sole purpose of "going private," concluding that despite full disclosure, the merger itself constituted a fraudulent scheme because it represented an attempt by the majority stockholders, in violation of their fiduciary obligations, to utilize corporate funds strictly for personal benefit and for no legitimate corporate purpose.

Five days later, a separate panel decided *Green v. Santa Fe Industries, Inc.*[6] Judge Medina, who authored the majority opinion,[7]

---

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.

15 U.S.C. § 78j(b) (1970).

2. 17 C.F.R. § 240.10b-5 (1976) states:

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 light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

3. The phrase was first employed by Judge Augustus Hand in Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir.), *cert. denied,* 343 U.S. 956 (1952).

4. The two other general categories are insider trading and misleading corporate publicity, the latter having been definitively outlined for the first time in SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied,* 394 U.S. 976 (1969).

5. 533 F.2d 1277 (2d Cir. 1976), *vacated,* 45 U.S.L.W. 3273 (U.S. Oct. 12, 1976) (No. 75-1782).

6. 533 F.2d 1283 (2d Cir. 1976), *cert. granted,* 45 U.S.L.W. 3222 (U.S. Oct. 5, 1976) (No. 75-1753).

7. Each member of the 3-judge panel issued a separate opinion, Judge Mansfield concurring, *id.* at 1294, and Judge Moore vigorously dissenting, *id.* at 1299.

held that the employment of the Delaware short-form merger statute to squeeze out minority public shareholders at an allegedly unfair cash price and without a valid corporate purpose violated rule 10b-5. Although not compelled by the facts to do so, the opinion chose to reject deception as an essential aspect of a rule 10b-5 violation in favor of a test that, broadly viewed, would find a violation under the rule whenever a director, officer, or controlling shareholder causes harm to the corporation or minority shareholders by breaching his fiduciary obligations.[8]

Taken together, the two decisions clearly break with previous cases dealing with corporate mismanagement under rule 10b-5. Specifically, they raise in bold relief questions concerning the interrelationship among deception, fiduciary duties and fairness, and the standard of conduct to be imposed upon corporate managers by the rule. In a broader sense the cases invite an evaluation of the legitimate concerns of federal securities law in an area traditionally reserved to the states, especially in light of recent Supreme Court opinions that suggest a heightened sensitivity to federal-state relationships and a resistance to expansive judicial rulings that would result in federal intrusion into areas of traditional state concern.[9]

It is the purpose of this article to analyze the *Green* and *Marshel* decisions against the backdrop of previous cases in the area of fraudulent mismanagement, to gauge their impact on the future course of the rule's development, to test their premises, and to consider the likelihood that the expansive standards enunciated by the cases will be assimilated by other circuits or by the Supreme Court. In this regard it may be helpful to reflect on an observation made by Arthur Fleischer in 1965 that rule 10b-5 "is now at the most creative, hence valuable, stage of its growth."[10] Much of this creativity can be attributed to the broad and malleable language of the section and rule. Certainly the judicial creativity has proceeded at an ever increasing pace since 1965. What we appropriately may ask is whether this creativity has ceased to have the value once attributed to it, or whether its value is outweighed by other considerations not clearly perceived under the decisions of a decade ago.

II. Defining The Contours of Corporate Mismanagement

The *Green* and *Marshel* decisions mark a watershed in the line

8. *Id.* at 1287.

9. *See* notes 160-62 *infra* and accompanying text.

10. Fleischer, *"Federal Corporation Law": An Assessment*, 78 Harv. L. Rev. 1146, 1175 (1965).

of judicial decisions that have attempted to formulate a comprehensive and consistent test for liability under rule 10b-5 in the area of corporate mismanagement. While these previous judicial efforts have been recorded and analyzed by other commentators,[11] some general observations about this process of refinement are necessary, for, as Judge Medina observed in *Green,* "[W]e do not write on a clean slate."[12] The fundamental inquiry is into the kinds of corporate mismanagement that will justify the imposition of rule 10b-5 liability in order to preserve and protect the federal interest that the rule embodies. In the absence of clearly defined congressional and administrative policies,[13] it has fallen to the federal judiciary to determine the nature and extent of this federal interest.

A. *The Legacy of Birnbaum*

The legacy of *Birnbaum v. Newport Steel Corp.*[14] is an impressive one. In the twenty-odd years of its existence it has remained a force with which practically every subsequent decision in the area must reckon. Its set of rules provide a conceptual framework for analyzing the developments in the mismanagement area. The "rules" it articulated may be characterized as follows: (1) a plaintiff, to have standing to sue for a violation of rule 10b-5 must be purchaser or seller of securities; (2) the fraud alleged must be of the type "usually associated with the sale or purchase of securities;" and (3) section 10(b) and rule 10b-5 were not intended to afford relief in cases in which the fraud alleged is the kind of internal corporate mismanagement traditionally characterized as a breach of fiduciary duty.[15]

---

11. *See, e.g.,* Bloomenthal, *From Birnbaum to Schoenbaum: The Exchange Act and Self-Aggrandizement,* 15 N.Y.L.F. 332 (1969); Jacobs, *The Role of Securities Exchange Act Rule 10b-5 in the Regulation of Corporate Management,* 59 CORNELL L. REV. 27 (1973); Kaplan, *Fiduciary Responsibility in the Management of the Corporation,* 31 BUS. LAW. 883 (1976); Patrick, *Rule 10b-5, Equitable Fraud and Schoenbaum v. Firstbrook,* 21 ALA. L. REV. 457 (1969); Ruder, *Pitfalls in the Development of a Federal Law of Corporations by Implication Through Rule 10b-5,* 59 NW. U.L. REV. 185 (1964); Ruder, *Texas Gulf Sulphur—The Second Round: Privity and State of Mind in Rule 10b-5 Purchase and Sale Cases,* 63 NW. U.L. REV. 423 (1968); Note, *The Controlling Influence Standard in Rule 10b-5 Corporate Mismanagement Cases,* 86 HARV. L. REV. 1007 (1973); Comment, *Schoenbaum v. Firstbrook: The "New Fraud" Expands Federal Corporation Law,* 55 VA. L. REV. 1103 (1969).

12. 533 F.2d at 1286.

13. *See* notes 119-27 *infra* and accompanying text.

14. 193 F.2d 461 (2d Cir.), *cert. denied,* 343 U.S. 956 (1952).

15. *Id.* at 463-64. For an early article analyzing *Birnbaum* see Comment, *Securities Exchange Act of 1934,* 100 U. PA. L. REV. 1251 (1952). *See also* 1 A. BROMBERG, SECURITIES LAW: FRAUD § 4.7 (1975) [hereinafter cited as BROMBERG]; 3 L. LOSS, SECURITIES REGULATION 1468-72 (2d ed. 1961) [hereinafter cited as LOSS].

The viability of the purchaser-seller rule has now been established by the Supreme Court's decision in *Blue Chip Stamps v. Manor Drug Stores.*[16] In *Superintendent of Insurance v. Bankers Life and Casualty Co.,*[17] however, the Court announced the broad rule that the fraudulent conduct of which a plaintiff complains need not be related closely to the necessary purchase or sale of securities. By construing "fraud in connection with the purchase or sale of securities" as encompassing fraud that "touches" the purchase or sale, the Court confirmed the suspicion of many lower courts and commentators that rule 10b-5 was not limited solely to the securities trading process.[18] *Bankers Life* thus rejected that part of the *Birnbaum* opinion which found the rule to be applicable only to those types of fraud "usually associated with the sale or purchase of securities."[19] Despite the sweep of the *Bankers Life* holding, Justice Douglas appeared to accept the existence of some limitation when he admitted that Congress "did not seek to regulate transactions which comprise no more than internal corporate mismanagement."[20]

Taken at face value, this statement is capable of two quite different interpretations. One would hold that the rule can be applied in all mismanagement cases except those in which the managerial misconduct did not involve a securities transaction or in which no reasonable nexus between the securities transaction and the misconduct can be found. This sort of transactional analysis would permit an extraordinarily broad application of the rule, permitting a court to find any unconscionable act violative of federal law as long as such misconduct "touched" the purchase or sale of securities.[21]

16. 419 U.S. 992 (1975).

17. 404 U.S. 6 (1971).

18. *Id.* at 12-13; *see* Cox, *Fraud Is in the Eyes of the Beholder: Rule 10b-5's Application to Acts of Corporate Mismanagement,* 47 N.Y.U.L. Rev. 674, 680-81 (1972).

19. 193 F.2d at 464; *see* Cox, *supra* note 18; Note, *supra* note 11.

20. 404 U.S. at 12.

21. Other language in the opinion by Justice Douglas offers some support for this observation. For example, the opinion observed that:

> The Congress made clear that "disregard of trust relationships by those whom the law should regard as fiduciaries, are all a single seamless web" along with manipulation, investor's ignorance, and the like . . . . The controlling stockholder owes the corporation a fiduciary obligation—one "designed for the protection of the entire community of interests in the corporation—creditors as well as stockholders."

Id. at 11-12. The language in *Bankers Life* apparently persuaded at least one court that the decision supported an extension of rule 10b-5 to conduct constituting a breach of trust. *See* Travis v. Anthes Imperial Ltd., 473 F.2d 515, 527 (8th Cir. 1973). The facts in *Travis,* however, also would appear to support a finding of deception. In general, subsequent decisions

On the other hand, certain of the defendants in *Bankers Life* allegedly engaged in conduct criminal in nature, the embezzlement of corporate funds. Thus the statement by Justice Douglas may be viewed as a realization that certain kinds of misconduct simply are beyond the scope of federal regulation.[22] The problem therefore becomes one of determining the proper standard of conduct to be applied in the mismanagement area. In short, what is the meaning of "fraud" under section 10(b) and rule 10b-5? Is the term to be interpreted as meaning some form of traditional deception or can it legitimately be extended to include misconduct that might be characterized as a breach of fiduciary duties? As is noted below, much of the development of rule 10b-5's application in the mismanagement area has revolved around the appropriate standard of conduct to be applied, especially in light of the purposes and policies of federal securities law.

B. *The Struggle with Deception*

The primary concern of the federal courts in applying rule 10b-5 has been with the concept of deception. Both the policy underlying the federal securities laws in general and the specific language of section 10(b) undoubtedly have been responsible for this emphasis.[23] Arguably, however, rule 10b-5 can be viewed as outlawing a broader range of misconduct because of its reference to the term "fraud" in sections (a) and (c).[24] With little in the way of legislative or administrative history concerning the proper application of these anti-fraud provisions, the courts quite logically have turned to the common law for assistance. Yet the precise scope and nature of "fraud" at common law never has been clearly defined. Indeed, it appears that the

---

and writers have been content to view *Bankers Life* as relating primarily to a definition of the "in connection with" clause and not as creating a new standard of conduct under the rule. *See* Jacobs, *supra* note 11, at 40-43; Note, *supra* note 11, at 1013-14.

22. Certain language in the opinion also supports this view. After observing that Congress did not seek to regulate internal corporate mismanagement, the opinion continued: "But we read § 10(b) to mean that Congress meant to bar deceptive devices and contrivances in the purchase or sale of securities whether conducted in the organized markets or face to face." 404 U.S. at 12.

23. The fundamental purpose of the Securities Act of 1933 is full disclosure. Although the provisions of the Securities Exchange Act of 1934 pursue other regulatory objectives, full disclosure is nonetheless the primary concern of most of the provisions. Even if the full disclosure philosophy is more pertinent to the 1933 Act, both laws have been considered a single, comprehensive scheme of regulation grounded upon the principle of creating a fully informed investing public; *see* Green v. Wolf Corp., 406 F.2d 291 (2d Cir. 1968), *cert. denied*, 395 U.S. 977 (1969).

24. This precise conclusion was reached by Judge Medina in Green v. Santa Fe Industries, Inc., 533 F.2d 1283, 1286-87 (1976).

courts, especially the courts of equity, have refrained deliberately from limiting its breadth. At common law, deceit has been characterized as a species of fraud, covering intentional misstatements and omissions.[25] These acts, if made negligently, also can be actionable in certain circumstances under the broader rubric of misrepresentation.[26] "Fraud," "deceit," and "misrepresentation" often have been used interchangeably, but fundamental to each is the failure to speak accurately, either by affirmative act or by nondisclosure. In equity, however, the concept of fraud has been interpreted more freely. Although no precise distinction between law and equity can be made in this regard, Chancery frequently has equated the concept of fraud with oppression, overreaching, unconscionability, breaches of fiduciary duties, and unfairness.[27]

Despite the expansive view of fraud developed in equity and the frequent statements by federal courts that the rule is not limited to common-law fraud,[28] the early federal decisions applying rule 10b-5 to insider trading and corporate mismanagement limited the rule's application to some form of deception.[29] While a basic deception standard has proved capable of rather consistent application to the insider trading context, in which disclosure of material facts more or less assures equal footing and an informed choice on both sides of a securities transaction, it encountered difficult conceptual problems in the mismanagement area.

The first difficulty is illustrated by two 1964 decisions of the Second Circuit. Both cases involved derivative actions under rule 10b-5 alleging that the corporations had been harmed by fraudulent acts committed by management. In *Ruckle v. Roto American Corp.*,[30] the complaining shareholder-director of the corporation, argued that defendants, to perpetuate their control, caused the corporation to issue 75,000 treasury shares to the president at an unrea-

25. F. HARPER & F. JAMES, THE LAW OF TORTS § 7.1 (1956).

26. *Id.* § 7.6.

27. An early description of the broad reach of "fraud" in equity stated:

> Fraud, indeed, in the sense of a court of equity properly includes all acts, omissions and concealments which involve a breach of legal or equitable duty, trust, or confidence, justly reposed, and are injurious to another, or by which an undue and unconscientious advantage is taken of another.

Moore v. Crawford, 130 U.S. 122, 128 (1889). For a notable recent state court decision in which the New Jersey Supreme Court equated the term "fraud" with unconscionability, see Kugler v. Romain, 58 N.J. 522, 279 A.2d 640 (1971).

28. *See, e.g.*, A.T. Brod & Co. v. Perlow, 375 F.2d 393, 397 (2d Cir. 1967); O'Neill v. Maytag, 339 F.2d 764, 768 (2d Cir. 1964). *See also* SEC v. Capital Gains Research Bureau, 375 U.S. 180, 191-95 (1963).

29. *See, e.g.*, McClure v. Borne Chemical Co., 292 F.2d 824 (3d Cir. 1961); Hooper v. Mountain State Securities Corp., 282 F.2d 195 (5th Cir. 1960).

30. 339 F.2d 24 (2d Cir. 1964).

sonably low price while concealing material information from plaintiff in his capacity as a director. The court enjoined the consummation of the transaction, finding that the corporation was a seller of securities and had itself been the victim of deception because of the concealment of information from one of its directors. In dictum the opinion suggested that a corporation could be defrauded even though the entire board was informed fully if all directors have an interest adverse to that of the entity.[31] Implicit in this rationale is the argument that a conflict of interest on the part of those who owe fiduciary obligations to the entity could prevent them from acting in the best interest of the corporation. The corporation would suffer the same harm whether or not actual deception existed.

The precise problem perceived by the *Ruckle* decision occurred in *O'Neill v. Maytag*.[32] There a shareholder of National Airlines, in a derivative suit for damages against Pan American World Airways and the directors and officers of National, alleged that a reexchange of shares between the two companies pursuant to an order of the Civil Aeronautics Board involved an exchange ratio unfair to National. Plaintiff contended that all the directors of National agreed to this ratio in order to eliminate Pan Am's threat to their control. Admitting that the conduct by the National directors constituted a breach of fiduciary duty, the court found "no serious claim of deceit" which it held to be necessary to invoke rule 10b-5.[33] *Ruckle* was distinguished on the ground that one of the directors in that case actually had been deceived.[34]

The dictum in *Ruckle* finds support from the agency rule that the knowledge of a director (agent), although customarily imputed to the corporation (principal), will not be imputed if the director is acting adversely to the interests of the corporation.[35] It is significant

31. The court stated:

> 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.

Id. at 29.

32. 339 F.2d 764 (2d Cir. 1964).

33. *Id.* at 767.

34. *Id.* at 768.

35. RESTATEMENT (SECOND) OF AGENCY § 282 (1958). The general rule, to which § 282 is an exception, is that the knowledge of an agent acting within the scope of his authority will serve to bind the principal. *Id.* § 268. It is generally agreed, however, that neither the rule of imputation of knowledge nor its exceptions are defined clearly in the cases, and it is therefore quite difficult to find any consistency in the application of these general rules. *See generally*, W. SEAVEY, HANDBOOK OF THE LAW OF AGENCY § 102 (1964) [hereinafter cited as SEAVEY]. This confusion may to some extent explain the unwillingness of the court in *O'Neill* to adopt the dictum in *Ruckle*.

that the *O'Neill* decision, while recognizing the existence of such a principle,[36] found it inapplicable to a cause of action under rule 10b-5. Its failure to do so, while perhaps artificial when viewed from a result-oriented analysis, is not without its inherent logic. If the thrust of rule 10b-5 depends on the nature of the conduct rather than its harmful effects, and if the standard of conduct imposed is one of actual deceit, *O'Neill* merely concludes that the entity cannot be deceived in the traditional sense if none of its directors were deceived. On the other hand, the dictum in *Ruckle,* while perfectly defensible from the point of view of agency law, can be said to espouse a standard quite different from traditional deceit, a standard that more properly could be founded on the fiduciary relationship itself.[37] Therefore, *O'Neill* appears to affirm the logic of *Birnbaum;* rule 10b-5 does not provide a remedy for breaches of fiduciary duties.

C. *Schoenbaum and the "New Fraud"*

In the years immediately following the *O'Neill* decision, the courts generally adhered to the position that a plaintiff in a mismanagement case must allege and prove some form of actual deceit in order to recover under rule 10b-5.[38]

The major problem with a strict deception rule, however, was its failure to address the kind of abuse recognized by the dictum in *Ruckle,* in which the corporation and ultimately the shareholders cannot receive the independent, disinterested judgment of the board to which it is entitled because of a conflict of interest on the part of all directors.[39]

---

36. 339 F.2d at 767.

37. *See* SEAVEY, *supra* note 35, at § 149.

38. *See, e.g.,* Vine v. Beneficial Fin. Co., 374 F.2d 627 (2d Cir. 1967); Entel v. Allen, 270 F. Supp. 60 (S.D.N.Y. 1967); Carliner v. Fair Lanes, Inc., 244 F. Supp. 25 (D. Md. 1965). All too often in corporate mismanagement cases the courts fail to analyze the issue of deception. *See* cases cited in Jacobs, *supra* note 11, at 51 n.148.

39. The strict deception test also created a second difficulty. Recovery under a deceit theory demands proof of reliance and causation (among other requirements). Several decisions seeking to apply the *O'Neill* standard found themselves obliged to follow a rigid rule of causation and reliance. As a result, these decisions were compelled to employ a tortured kind of logic to justify a desired result. A striking example of this strained reasoning is Voege v. American Sumatra Tobacco Corp., 241 F. Supp. 369 (D. Del. 1965). The plaintiff alleged a violation of rule 10b-5 by virtue of a short-form merger wherein the cash payment for her shares substantially was below its fair value. The court found that the defendant had concealed material information about the true value of the stock in a previous tender offer. The plaintiff, however, had not sold her shares pursuant to the offer, and thus, the defendant contended, could not have relied upon the deception. Nonetheless, the court found that when she purchased her stock (some years earlier), the plaintiff had relied upon an implied repre-

The conflict between a pure deception standard under rule 10b-5 and a desire by the courts to provide relief in cases in which serious abuses were perceived led to the creation of a new theory of liability in *Schoenbaum v. Firstbrook.*[40] In a derivative action, Aquitaine Company of Canada, Ltd., the controlling shareholder of Banff Oil, Ltd., was charged with using its control to cause the issuance to it of a large block of treasury stock at an unfair price. The price allegedly was unfair because at the time of the transaction the controlling shareholder possessed inside information about a substantial oil discovery that, had it been made public, vastly would have increased the value of the treasury shares sold. The Second Circuit, in a panel decision, affirmed the district court's grant of summary judgment for Aquitaine, finding that although defendant directly controlled three of the nine corporate directors, there was no proof that the corporation was deceived because full disclosure had been made and the transaction had been approved by a majority of the "disinterested" directors.[41] On rehearing en banc, the court reversed and held that a triable claim existed, and if plaintiff established that defendant exercised a "controlling influence" over the entire board of directors, the transaction satisfied section (c) of rule 10b-5.[42] As if unsure of its ground, the court further stated, in what can only be read as an alternative holding, that "[m]oreover, Aquitaine and the directors of Banff were guilty of deceiving the stockholders of Banff (other than Aquitaine)."[43]

The controlling influence standard enunciated by the court has been heralded as the "new fraud" in the mismanagement area.[44] Unquestionably it rejects the traditional deception rationale of

sentation that she would be dealt with fairly in any subsequent merger. The unfairness of the challenged merger, according to the court, made the implied representation false and also established reliance. As one commentator noted: "One would have to go back at least several hundred years to find such a palpable creation of a fiction to enable a court to seize jurisdiction not otherwise conferred on it." R. JENNINGS & H. MARSH, SECURITIES REGULATION 1230 (3d ed. 1972). At the other extreme, Barnett v. Anaconda Co., 238 F. Supp. 766 (S.D.N.Y. 1965), represents an extraordinarily restrictive and technical view of deception and reliance in an effort to absolve a defendant from liability. *See* Note, *supra* note 11, at 1023-25.

40. 405 F.2d 200 (2d Cir.), *rev'd on reh. en banc*, 405 F.2d 215 (1968), *cert. denied*, 395 U.S. 906 (1969).

41. 405 F.2d at 211. This same result would perhaps be reached under the law of most states. *See, e.g.*, DEL. CODE ANN. tit. 8, § 144 (1975).

42. 405 F.2d at 218-19. The en banc opinion adopted the reasoning of Judge Hays's dissent in the panel decision. Paribas, a second defendant, was absolved of liability since it was held not to have exerted a controlling influence over Banff.

43. *Id.* at 220.

44. *See, e.g.*, Bloomenthal, *supra* note 11; Jacobs, *supra* note 11; Note, *supra* note 11; Comment, *supra* note 11.

earlier cases. The standard's significance lies in its recognition of the artificiality and inadequacy of a deception requirement when the controlling shareholder exercises its control to impair the independent, disinterested judgment of the board of directors. In this situation, full disclosure to the board is illusory.[45] It is noteworthy that this holding is quite similar, if not identical, to the dictum in *Ruckle*.[46]

The *Schoenbaum* decision thus outlines a two-step approach to corporate mismanagement cases. It requires first, a determination that a controlling influence had been exercised over the decisionmaking body[47] and secondly, a finding that this influence was employed for an "improper" purpose which benefited the control person and resulted in harm to the corporation. Given the facts in *Schoenbaum*, this improper purpose applies at least to instances of self-dealing by officers, directors, or controlling shareholders. The standard also would hold liable directors who succumbed to this controlling influence and therefore breached their fiduciary obligation to the corporation.[48]

Additionally, although the case is limited to the question of improper influence over the board of directors, it would not appear difficult to extend the rationale to improper influence over shareholders as well. Thus, when a controlling shareholder who engages in self-dealing possesses sufficient voting power to approve a transaction despite minority opposition, a court could find that the majority shareholder's "controlling influence" effectively precluded the corporation from exercising an independent, disinterested judgment

45. The effect of a controlling influence perhaps was characterized best by the Fifth Circuit in Shell v. Hensley, 430 F.2d 819, 827 (5th Cir. 1970):

> When the other party to the securities transaction controls the judgment of all the corporation's board members or conspires with them or the one controlling them to profit mutually at the expense of the corporation, the corporation is no less disabled from availing itself of an informed judgment than if the outsider had simply lied to the board. In both situations the determination of the corporation's choice of action in the transaction in question is not made as a reasonable man would make it if possessed of all the material information known to the other party to the transaction.

46. *See* 339 F.2d at 29.

47. Decisionmaking body refers to that person or group of persons within the corporate entity empowered by state law, corporate charter, bylaws or resolution to effectuate a transaction. Depending upon the transaction and the grant of power, it could be the shareholders, board of directors or duly authorized officer, such as the president. *See* Note, *supra* note 11, at 1026 n.83.

48. Although the court's discussion in *Schoenbaum* concentrated on the improper conduct of the controlling shareholder, Aquitaine, the complaint also charged the board of directors with a violation of rule 10b-5 and the court made no attempt to exclude them from the scope of its holding. *See also* Rekant v. Desser, 425 F.2d 872 (5th Cir. 1970).

on the issue.[49]

Neither *Schoenbaum* nor subsequent decisions adopting its rationale articulate clearly the legal framework upon which the controlling influence standard is based. Presumably it is merely an application of the broad fiduciary standard developed under state law, tailored by the federal decisions to resolve conflict of interest transactions under rule 10b-5 that were not covered adequately by a deception standard. This interpretation suggests that liability in such cases will involve questions of good faith and fairness. Thus a defendant charged with exerting or succumbing to a controlling influence may be absolved from liability if the transaction is shown to be fair.[50] The controlling influence test, however, does not purport to apply rule 10b-5 to the full range of fiduciary conduct recognized by the states, even though commentators have viewed it as an important step in that direction.[51]

The alternative holding of *Schoenbaum,* finding that the defendants' conduct operated to deceive independent shareholders, originates in a previous opinion by the Third Circuit in *Pappas v. Moss.*[52] On facts quite similar to *Schoenbaum,* the *Pappas* court stated that "deception could be fairly found by viewing this fraud as though the 'independent' stockholders were standing in the place of the defrauded corporate entity."[53]

It is clear that *Schoenbaum's* alternative holding contemplates a deception test quite different from the traditional concept of deceit espoused by *O'Neill.* Pragmatically, the *Schoenbaum* court was correct in recognizing that the shareholders were the parties actually harmed by defendants' conduct. Technically, however, the corporation was the only party entitled to seek relief. Therefore, by finding that the independent stockholders were in reality the deceived parties, the opinion can be viewed as imposing a duty upon management to make full and fair disclosure to shareholders in all situations in which self-dealing or conflicting interests may harm the corporation, even though state law or internal corporate policies otherwise would not require such disclosure.

Whether this kind of rule is realistic is debatable. That the court actually believed an insider would inform shareholders of his

49. This would seem to be the converse of the rationale in Barnett v. Anaconda Co., 238 F. Supp. 766 (S.D.N.Y. 1965).

50. For a comparison of the controlling influence standard with the test employed by the states in conflict of interest transactions, see Note, *supra* note 11, 1036-40.

51. *See id.;* Comment, *supra* note 11.

52. 393 F.2d 865 (3d Cir. 1968).

53. *Id.* at 869.

misconduct is unlikely, especially when state law does not require shareholder approval for the transaction in question.[54] Accordingly, like the controlling influence test, the alternative holding in *Schoenbaum* seems directed to resolving the loophole created by *O'Neill's* strict deception rationale, which it does by establishing a basis for liability that has at least a tenable connection to deceit. This approach arguably avoids the direct application of rule 10b-5 to breaches of fiduciary duty by creating a broader duty on behalf of management to make disclosures.

A problem with this alternative disclosure standard relates to the uncertainty of its application. Broadly employed, it would require directors, officers, and control persons to disclose to shareholders all transactions in which any conflict of interest may exist. Further, in order to avoid later challenges, it may be necessary not only to disclose the transaction but also to seek shareholder approval or ratification of its terms. Failure to do this would subject directors and others to liability not merely for breaches of fiduciary duties but also for deception. Presumably, failure to disclose any transaction deemed to be material and in which a potential conflict of interest existed could be actionable under such a standard. While some disclosure to shareholders of transactions that could involve conflicts of interest may well be appropriate, such a rule in its present form is far too uncertain in its scope or application.

What detracts from the forcefulness of the controlling influence standard is the court's unwillingness to forsake completely the requirement of deception. Accordingly, justification for an expansive reading of the opinion to encompass fiduciary responsibilities under the rule seems doubtful. Instead, both the controlling influence test and the alternative finding that the independent shareholders were deceived serve to resolve the particular problem raised by cases such as *O'Neill* by providing relief to a corporation whose interests have been compromised by its entire board of directors.

D. *Popkin v. Bishop*

The scope of the *Schoenbaum* holding was reevaluated by the Second Circuit in *Popkin v. Bishop*,[55] in which minority stockholders sued derivatively to enjoin a proposed merger on the ground that the exchange ratios were unfair to the shareholders of the corporations to be acquired in the merger. The merger had been required

54. The Second Circuit in *Popkin v. Bishop* expressly recognized that it would be highly unlikely for insiders to make these kinds of disclosures. 464 F.2d 714, 720 (2d Cir. 1972).
55. *Id.* at 714.

by a stipulation of settlement in a previous action against the controlling shareholder.[56] The court assumed, for purposes of the decision, that the exchange ratios indeed were unfair. Finding proof of deception essential to a claim of this type, the court held that the absence of allegations of deception and the presence of full disclosure to all shareholders satisfied the federal interests under rule 10b-5 and affirmed the lower court's dismissal of the complaint.

In reaching its decision, the court declared that *Schoenbaum's* "emphasis on self-dealing did not eliminate non-disclosure as a key issue in rule 10b-5 cases."[57] Relying on this language, some commentators have viewed the decision as a step backwards.[58] *Popkin,* rather than retreating, appears to have attempted to determine some realistic rules-of-the-road for applying federal law in the mismanagement area. Indeed, the *Popkin* court admitted self-dealing alone may be actionable under the rule,[59] but also appeared to weigh the effectiveness of state law remedies in determining whether federal liability should be imposed. The court stated:

> [I]n this case, armed with the information fully disclosed under compulsion of the federal proxy regulations and Rule 10b-5, appellant was placed in a position to sue under state law to enjoin the merger as unfair . . . . The federal injunctive remedy appellant sought could offer him no greater protection.[60]

The decision's primary significance lies in its attempt to articulate a workable set of rules to aid in the determination of when federal law should apply to afford relief against claims of mismanagement. Those rules may be stated as follows:

(1) When state law demands shareholder approval before the corporation may enter into a transaction, federal law requires only that the shareholders receive full and fair disclosure. This would apply even when a controlling shareholder has the absolute power to secure the requisite shareholder vote because a complaining minority stockholder may seek extra-corporate relief in the state courts.

(2) When state law does not require prior shareholder approval, a federal court may examine the nature of the alleged misconduct without regard to the existence of full disclosure. This proposition seems to reaffirm the controlling influence test,

56. *Id.* at 716.
57. *Id.* at 719.
58. *See, e.g.,* Note, *supra* note 11, at 1040.
59. 464 F.2d at 719.
60. *Id.* at 720.

although *Popkin* would limit its application to improper influence at the board of directors level.

(3) Rule 10b-5 is first and foremost a full disclosure rule. "Section 10(b) of the Exchange Act and Rule 10b-5 are designed principally to impose a duty to disclose and inform rather than to become enmeshed in passing judgments on information elicited."[61] Hence the deception requirement should not be sacrificed in favor of a new standard of conduct except in those situations in which the interests of the corporation cannot be defended by an independent, disinterested party (*i.e.*, a minority shareholder). An allegation of unfairness alone (even if resulting from a fiduciary breach) is not sufficient to invoke federal jurisdiction under rule 10b-5.

Although the decision in *Popkin* appears to recognize that rule 10b-5 will apply to self-dealing absent deception in those transactions in which shareholder approval is not required by state law,[62] an analysis of the opinion also suggests that the court was probing for another standard more closely related to a form of deception. According to the opinion, most self-dealing transactions can be consummated without shareholder approval. Since those engaged in self-dealing with the approval of the board of directors will not want to disclose the nature of their conduct to the shareholders, traditional rules of deceit will not provide an adequate remedy. In such cases the court indicated that it approved of the alternative holding in *Schoenbaum* that the independent shareholders were deceived, even though a more traditional view would argue that the independent shareholders would not be entitled to disclosure. The effect of this analysis by the court would be the imposition on those engaged in self-dealing of an obligation to disclose such activity to the independent shareholders. Arguably, the "impropriety of the misconduct" upon which a court may focus would include not merely the self-dealing but also the failure to disclose it to the independent shareholders.[63]

Whichever of the above rationales may be adopted, the decision is important because it demonstrates a serious judicial effort to find some limit to the sweep of rule 10b-5. Implicit in this attempt is the recognition that a dividing line should exist between the application of federal and state law remedies and that the dividing line is full

61. *Id.* at 719-20.
62. *Id.* at 719.
63. *Id.*

disclosure to the shareholders. The federal interest terminates when full prior disclosure has been made to all shareholders; at that point, the shareholders are free to evaluate their choices concerning their course of action. The application of federal law to situations in which state law provides adequate relief is unnecessary and may be unwise.

The influence of the *Popkin* rationale upon subsequent decisions has not been easy to measure. Within the Second Circuit, judges again have placed emphasis on the issue of disclosure[64] and have refused to consider allegations of unfairness, without more, as sufficient to raise a federal question.[65] Outside the Second Circuit, several courts have taken a more expansive view of the kinds of misconduct reached by rule 10b-5.[66] In *Bryan v. Brock & Blevins*

64. *E.g.*, Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374 (2d Cir. 1974); Marshel v. AFW Fabric Corp., 398 F. Supp. 734 (S.D.N.Y. 1975); Green v. Santa Fe Industries, Inc., 391 F. Supp. 849 (S.D.N.Y. 1975); Tanzer Economic Associates, Inc. v. Haynie, 388 F. Supp. 365 (S.D.N.Y. 1974); Kaufmann v. Lawrence, 386 F. Supp. 12 (S.D.N.Y. 1974); Broder v. Dane, 384 F. Supp. 1312 (S.D.N.Y. 1974); Dreier v. The Music Makers Group, Inc., [1973-74 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,406 (S.D.N.Y. 1974); Levine v. Biddle Sawyer Corp., 383 F. Supp. 618 (S.D.N.Y. 1974); *cf.* Lewis v. Siegel, [1972-73 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,992 (S.D.N.Y. 1973), in which the court characterized the case as one of the rare exceptions to which *Popkin* refers when the court need not examine the propriety of the conduct.

65. A case in point is Kaufmann v. Lawrence, 386 F. Supp. 12 (S.D.N.Y. 1974), in which the plaintiff sought to enjoin an exchange offer by the corporation for the purpose of going private. The district court, finding the alleged false statements and omissions immaterial, declared that the essence of the complaint was that the transaction was unfair and observed: "Whether the offer is fair or unfair or a good or bad transaction, however, does not raise a federal question." *Id.* at 16. Of particular significance is the court's statement reaffirming the holding, and arguably the premises, of *Popkin.* Admitting that the securities laws must be liberally construed, the court remarked:

> [T]here is nothing invalid *per se* in a corporate effort to free itself from federal regulations, provided the means and the methods used to effectuate that objective are allowable under the law. Nor has the federal securities law placed profit-making or shrewd business tactics . . . beyond the pale. Those laws . . . are satisfied if a full and fair disclosure is made, so that the decision of the [stockholders] to accept or refuse the exchange offer can be said to have been freely based upon adequate information.

Id. at 17. *See also* Dreier v. The Music Makers Group, Inc., [1973-74 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,406 (S.D.N.Y. 1974) ("the treatment of minority shareholders may well have been grossly unfair but it was completely open." *Id.* at 95,410).

66. *See, e.g.,* Bailey v. Meister Brau, Inc., [1975-76 Transfer Binder] CCH FED. SEC. L. REP. ¶ 95,543 (7th Cir. May 6, 1976); Travis v. Anthes Imperial Ltd., 473 F.2d 515 (8th Cir. 1973); Albright v. Bergendahl, 391 F. Supp. 754 (D. Utah 1974); Bryan v. Brock & Blevins Co., 343 F. Supp. 1062 (N.D. Ga. 1972), *aff'd on other grounds,* 490 F.2d 563 (5th Cir. 1974). *But cf.* Wright v. Heizer Corp., [1975-1976 Transfer Binder] CCH FED. SEC. L. REP. ¶ 95,399 (N.D. Ill. 1975); Grimes v. Donaldson, Lufkin & Jenrette, Inc., 392 F. Supp. 1393 (N.D. Fla. 1974). Arguably, the flexible duty test developed by the Ninth Circuit in White v. Abrams, 495 F.2d 724, 735-36 (9th Cir. 1974), would encompass fiduciary breaches in the absence of deception. The viability of the flexible duty standard, however, at least insofar as it would

Co.,[67] the district court found that a merger under Georgia law for the sole purpose of eliminating a minority shareholder was actionable under the rule. Although the court referred to the controlling shareholder's failure to disclose two items of information, its finding of deception did not appear to be a significant part of its holding. The Fifth Circuit affirmed the lower court decision[68] but refused to consider the question of liability under rule 10b-5. Instead, it analyzed the fiduciary duties owed by a controlling shareholder to the minority and found state law sufficient to impose liability.[69]

The *Bryan* decision is one response to allegations by minority shareholders that they have been squeezed out of the corporation unlawfully by an overreaching majority. The legality of eliminating minority interests has received much recent publicity because of the efforts of a number of publicly owned enterprises to return to private ownership by the controlling group. The legitimacy and fairness of the "going private" phenomenon has been criticized strongly by some commentators as a breach of trust on the part of the majority, and has precipitated the promulgation by the SEC of proposed rules to regulate efforts to "go private."[70] Since minority interests may be eliminated under state law even with prior full disclosure in many instances, the federal courts again have assessed the propriety of limiting the scope of the rule, as *Popkin* suggested, to full disclosure.[71] From this context, the *Green* and *Marshel* decisions emerge.

III. THE FEDERAL FIDUCIARY STANDARD

The preceding historical overview illustrates that the extension of rule 10b-5 to the mismanagement area proceeded on two fronts. One witnessed the rejection of the concept of judicial self-restraint

sanction liability for negligence, was discredited by the Supreme Court in Ernst & Ernst v. Hochfelder, 96 S. Ct. 1375, 1381 n.12 (1976).

67. 343 F. Supp. 1062 (N.D. Ga. 1972).

68. Bryan v. Brock & Blevins Co., 490 F.2d 563 (5th Cir. 1974).

69. *Id.* at 571.

70. *E.g.*, Borden, *Going Private—Old Tort, New Tort or No Tort?*, 49 N.Y.U.L. REV. 987 (1974); Brudney, *A Note on "Going Private,"* 61 VA. L. REV. 1019, 1023-25 (1975); Sommer, *"Going Private": A Lesson in Corporate Responsibility*, 278 BNA SEC. REG. L. REP. D-1 (Nov. 20, 1974); Note, *Going Private*, 84 YALE L.J. 903 (1975). For a more detailed discussion see the articles cited by Judge Mansfield in his concurring opinion in Green v. Santa Fe Industries, Inc., 533 F.2d 1283, 1295 (2d Cir. 1976). In 1975, in response to the phenomenon, the SEC proposed rules to regulate substantively and in a broad fashion, attempts by reporting companies to "go private." Proposed Regs. § 240.13e-3A, -3B, 40 Fed. Reg. 7947 (1975).

71. *See* Wright v. Heizer Corp., [1975-1976 Transfer Binder] CCH FED. SEC. L. REP. ¶ 95,399 (N.D. Ill. 1975); Albright v. Bergendahl, 391 F. Supp. 754 (D. Utah 1974); Bryan v. Brock & Blevins Co., 343 F. Supp. 1062 (N.D. Ga. 1972), *aff'd on other grounds*, 490 F.2d 563 (5th Cir. 1974).

propounded by *Birnbaum,* the rule now being that the mere characterization of misconduct as internal corporate mismanagement will not of itself prevent scrutiny by the federal courts. While the courts have declared that rule 10b-5 "reaches beyond traditional stock transactions and into the board rooms of corporations,"[72] such broad pronouncements tell us little more than that the rule is not to be interpreted restrictively. At the same time the courts have made clear that some limit upon the scope of the rule does exist, as indicated by the Supreme Court's admission that "Congress by §10(b) did not seek to regulate transactions which constitute no more than internal corporate mismanagement."[73]

It is on the second front that the federal courts have attempted to define the limit. The question has been whether "fraud" under the rule can occur even when there has been full disclosure. A requirement of proof of deception, to sustain an action under 10b-5, while offering greater certainty of application and arguably possessing a more defensible posture in light of congressional policy, nonetheless is of limited value, as the decisions illustrate, in situations in which a controlling shareholder can effect a desired transaction even with full disclosure. The results in recent decisions have shown an increased concern with fairness and fiduciary duties, or what may be characterized as a "helpless victim" mentality.

This conflict between a deception standard and one that would impose liability for fiduciary breaches also suggests a deeper, and hitherto unarticulated, conflict concerning the extent to which the federal courts should intrude into matters regulated by state statutory and decisional law. State law also is concerned with deceptive acts, but federal overlap can be justified by express congressional policy. Fiduciary obligations have no such clear support.[74] These conflicts were addressed by two panel decisions of the Second Circuit. The result was an interpretation of "fraud" under the rule to encompass fiduciary breaches independent of deception.

A. *The Green and Marshel Decisions*

In *Green v. Santa Fe Industries, Inc.,*[75] the issue involved the validity under rule 10b-5 of a short-form merger under Delaware law pursuant to which plaintiffs, the minority shareholders of Kirby

---

72. Popkin v. Bishop, 464 F.2d 714, 718 (2d Cir. 1972).

73. Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 12 (1971).

74. *See* notes 119-27 *infra* and accompanying text.

75. 533 F.2d 1283 (2d Cir. 1976), *cert. granted,* 45 U.S.L.W. 3222 (U.S. Oct. 5, 1976) (No. 75-1753).

Lumber Corporation, were forced to relinquish their stock ownership for an allegedly inadequate cash price. As permitted by Delaware law, the merger was approved by the directors of Kirby and of Forest Products, Inc., the latter entity having been incorporated solely to effectuate the transaction, without advance notice to the minority shareholders. After the merger was accomplished, the minority shareholders of Kirby were provided with a detailed information statement concerning the transaction, including notification of the right to receive $150 cash per share in return for the surrender of their stock and of the right of appraisal afforded those shareholders disputing the valuation.

Rather than exercise their appraisal rights, plaintiffs brought a class action in federal court on their own behalf and as representatives of the five percent minority shareholders of Kirby, charging that the merger violated section 10(b) and rule 10b-5. Their complaint was comprised of four basic assertions: first, the controlling shareholder utilized the Delaware short-form merger law to freeze out the minority shareholders against their will; secondly, the merger itself served no legitimate corporate purpose but was solely for the benefit and gain of the controlling shareholder; thirdly, although full disclosure had been made, the disclosure came only after consummation of the merger; and fourthly, the unilaterally determined cash price to be paid for the minority shares was grossly undervalued and thus was unfair to the minority shareholders.[76]

Judge Medina held that rule 10b-5 properly could be applied to the transaction. Finding at the outset that the availability of concomitant relief under state law was immaterial to the determination whether federal law should be applied,[77] he declared that subsections (a) and (c) of the rule made it plain that "misrepresentation or lack of disclosure are [sic] not essential ingredients of the claim for relief by the minority."[78] The rule instead must be viewed as encompassing the fiduciary duties "owed by the majority to the minority in corporations large and small."[79] Three separate opinions were written by the three-judge panel, one of which was a vigorous dissent by Judge Moore. Judge Mansfield's concurring opinion reiterated the view espoused by Judge Medina that rule 10b-5

76. *Id.* at 1285. The complaint also charged that Morgan Stanley & Co., which had been retained by defendant Santa Fe to value the shares of stock to be exchanged by the minority for cash, willfully had aided and abetted the defendant Santa Fe in undervaluing the stock. *Id.* at 1292.

77. *Id.* at 1286. *See also* notes 119-22 *infra* and accompanying text.

78. *Id.* at 1287.

79. *Id.*

appropriately could be applied to breaches of fiduciary duties in the absence of any allegation of deception.[80]

Having established that federal securities law may be utilized to enforce a fiduciary standard, the court did not explain clearly how that standard of conduct was breached in this case. According to the opinion, the defendant breached its duty by the unilateral consummation of a short-form merger without a justifiable business purpose.[81] Presumably, a plaintiff would also be required to show that such conduct resulted in unfair treatment in order to recover.[82] The court, however, did not indicate to what extent the question of fairness was relevant to a finding of liability, although one would conclude that if the court intended to employ a general standard of fiduciary conduct, the question of fairness would be of considerable importance in the final decision. Notably, the court refused to find that a charge of unfair valuation, without more, was sufficient to invoke federal liability. The majority opinion, however, justified this refusal by noting that such a question was "not the case before us."[83] The opinion also mentioned the absence of prior disclosure to the minority as significant, but given the court's approval of the *Marshel* holding, one can conclude that this issue was not fundamental to the opinion.[84]

In his dissent Judge Moore denounced the majority and concurring opinions as "totally without factual anchor"[85] and found the justifiable corporate purpose rule to be "a completely irrational concept."[86] Concluding from a review of past decisions that the "essence of fraud" under rule 10b-5 "is deliberate deception or concealment,"[87] he condemned the majority's rule as extending to the plaintiffs "an independent, substantive right totally unrelated to the anti-fraud scheme of the federal securities laws and in complete derogation of a valid state rule regulating corporate activity."[88]

80. *Id.* at 1294 (Mansfield, J., concurring).

81. *Id.* at 1291.

82. The holding by Judge Medina refers specifically to the majority's "fiduciary duty to deal fairly with minority shareholders." *Id.*

83. *Id.* The court found, however, that the defendant, Morgan Stanley & Co., could not be found liable for a violation of rule 10b-5 since they were not alleged to have participated in the controlling shareholder's fiduciary breach nor to have benefitted unjustly by the low valuation.

84. Indeed, the opinion observes that the lack of prior disclosure, and thus the unavailability of premerger injunctive relief, is merely "*further justification* for the intervention of the federal courts to remedy any fraudulent conduct." *Id.* (emphasis added).

85. *Id.* at 1300 (Moore, J., dissenting).

86. *Id.* at 1308.

87. *Id.* at 1301.

88. *Id.* at 1307.

Marshel v. AFW Fabric Corp.[89] was decided by a separate panel five days before *Green.* While the logic of the opinion is somewhat more obscure than *Green,* its holding may well be more expansive. *Marshel* involved a suit by minority shareholders of Concord Fabrics, Inc. to enjoin a proposed merger which would eliminate the more than 1,000 public shareholders. After Concord and its controlling shareholders had made public offerings of the company's stock in 1968 and 1969, the market price of the shares fell from a high of twenty-five dollars in 1969 to one dollar in late 1974. In 1975, two controlling shareholders embarked on a plan to return the company to their private control.

When a proposed tender offer by the corporation met with resistance by minority shareholders, the decision was made to merge Concord with AFW Fabric Corp., which had been organized as a vehicle for the merger. Under the plan of merger the controlling shareholders in Concord would become the sole shareholders of AFW, and the public shareholders would receive three dollars cash for each share. The proxy materials sent to the public shareholders stated that the accomplishment of the merger was inevitable because the controlling shareholders held the required votes. Additionally, the proxy statement declared that the purpose of the merger was to enable the controlling shareholders to regain their status as the sole stockholders and directors of the company and to allow them to act "solely with regard to their own interests."[90] Although the question of full disclosure was not addressed specifically by the opinion, it appears from the decision that full disclosure had been made.[91]

Judge Hays, writing an opinion for a unanimous panel, reversed the lower court's denial of a preliminary injunction, holding that the transaction was violative of rule 10b-5 as a fraudulent scheme to eliminate minority shareholders without a valid corporate purpose and that the scheme was intended solely to serve the interests of the controlling shareholders. Like Judge Medina's decision in *Green,* the *Marshel* decision ignored defendants' assertions that they complied in every respect with the New York merger statute, which did not require proof of a valid corporate purpose for the transaction.

89. 533 F.2d 1277 (2d Cir. 1976), *vacated,* 45 U.S.L.W. 3273 (U.S. Oct. 12, 1976) (No. 75-1782).

90. *Id.* at 1279.

91. Judge Smith, in a concurring opinion, intimated that full disclosure had been made or at least that the plaintiffs had not challenged the transaction on the ground that such disclosure was lacking. *Id.* at 1282 (Smith, J., concurring).

The opinion emphasized that the absence of a valid corporate purpose itself is to be viewed as a fraud both on the corporation and the minority shareholders. Unlike *Green,* however, the *Marshel* decision made no express reference to the unfairness of the cash price, although the minority shareholder was characterized as a "helpless victim" of the fraudulent scheme.[92] Further, except for a single reference to fiduciary duties of controlling shareholders,[93] the opinion did not contain a discussion of the application of the rule to breaches of fiduciary duties. What gives *Marshel* special significance, however, is the court's willingness to impose federal liability even though full disclosure had been made to the minority shareholders prior to the merger. This aspect of the decision is underscored by the existence of an injunction against the merger granted by a state court based on the disclosures in the proxy materials prior to the Second Circuit's opinion.[94] Therefore, the practical effect of this decision, when coupled with *Green*'s express recognition of a broad fiduciary standard under rule 10b-5, would seem to be the elimination of any requirement to allege or prove deception in order to invoke federal jurisdiction under the rule. Both cases also demonstrate an indifference to the availability and adequacy of state law remedies, issues that were of importance to the court in *Popkin v. Bishop.* A puzzling aspect of both decisions, however, is their apparent unwillingness to overrule expressly the decision in *Popkin.*

B. *Popkin v. Bishop: Distinguished or Overruled?*

The thrust of the Second Circuit's opinion in *Popkin* is that proof of deception is essential to a claim under rule 10b-5, at least in those instances in which prior shareholder approval is required under state law.[95] As Judge Smith's concurring opinion stated, it is difficult to reconcile *Marshel* with *Popkin.*[96] *Green,* however, is arguably in accord with the *Popkin* rule because the minority shareholders of Kirby were not informed of the merger until after it had taken place. Nevertheless, other language in Judge Medina's opinion tends to weaken the conclusion that the cases can be reconciled

92. *Id.* at 1282.

93. "The controlling shareholders of Concord have devised a scheme to defraud their corporation and the minority shareholders to whom they owe fiduciary obligations. . . ." *Id.*

94. People v. Concord Fabrics, Inc., 83 Misc. 2d 120, 371 N.Y.S.2d 550 (1975). Moreover, Judge Hays acknowledged the existence of the injunction. 533 F.2d at 1280 n.3. The state court proceeding was brought by the Attorney General of the State of New York alleging that the transaction violated the anti-fraud provisions of the Martin Act, the state's Blue Sky Law.

95. Popkin v. Bishop, 464 F.2d 714, 719-20 (2d Cir. 1972).

96. 533 F.2d at 1282 (Smith, J., concurring).

on this ground. First, the *Green* opinion notes that the absence of prior disclosure to the minority shareholders is merely "further justification" for the holding.[97] Secondly, the opinion expressly approves of the *Marshel* holding.[98] Taken together, these two points intimate that even prior full disclosure would not have altered the court's decision in *Green*.

The two decisions offer an altogether different rationale to justify their departure from a full disclosure requirement. Both conclude that the transactions orchestrated by the defendants in and of themselves constituted fraudulent schemes under rule 10b-5. Under this theory, even full prior disclosure is irrelevant because the "fraud" exists despite disclosure; the misconduct itself justifies the imposition of federal liability. Viewed independently from other language in the opinions, this conclusion is both simple and logical. Rule 10b-5 prohibits fraud in connection with a securities transaction. Fraud has been and can be construed as encompassing breaches of fiduciary duties. Defendants allegedly have breached such duties; therefore, rule 10b-5 properly may be applied to afford relief. Leaving aside the policy considerations attendant to such a conclusion, what diffuses and obscures, if not wholly undermines, the impact of this conclusion are the courts' efforts to reconcile it with *Popkin v. Bishop*.

Popkin stands for the proposition that deception is a vital issue in rule 10b-5 cases. Both the *Green* and *Marshel* opinions attempt to distinguish *Popkin* on the ground that the merger in that case was not a scheme to defraud the minority but was compelled by the provisions of a previous settlement agreement. According to Judge Medina, the transaction in *Green* had no justifiable corporate purpose, but "in *Popkin* there was a corporate business purpose so strong as to be as a practical matter compelling."[99] The complaint in *Popkin* thus went only to the unfair terms of an otherwise justifiable merger transaction, whereas in *Green* and *Marshel* the transactions themselves operated as a fraud.

This distinction, although indicating a factual difference between the cases, is untenable for two reasons. First, *Popkin* makes no reference to such a test to support its holding. Judge Medina appears to read into that decision a consideration that simply is not there. A more fundamental objection also exists. It may be unwise for courts to distinguish between situations in which the transaction

97. 533 F.2d at 1291.
98. *Id.*
99. *Id.*

as a whole constitutes a fraudulent scheme and those in which the transaction itself is not challenged but the alleged fraud relates to the manner in which it is carried out. Admittedly, evidence of self-dealing may be found more readily in those cases in which the entire transaction is challenged as having no legitimate business purpose. Nevertheless, the terms of an otherwise justifiable transaction can be manipulated for the benefit of a controlling shareholder and to the detriment of the corporation or the minority.[100] Consequently, such a distinction seems unwarranted because a breach of fiduciary duty can occur in either case.

A further comparison of the *Green* and *Marshel* holdings with the rules enunciated by *Popkin* demonstrates that the Second Circuit significantly has altered its approach to the application of rule 10b-5. *Popkin* emphasized that nondisclosure is a "key issue in Rule 10b-5 cases."[101] *Green* declared that "in such cases . . . no allegation or proof of misrepresentation or nondisclosure is necessary."[102] *Popkin* asserted that when "shareholder approval is fairly sought and freely given, the principal federal interest is at an end."[103] The defendants in *Marshel* would appear to have complied with this rule by making what was termed by Judge Smith as "full, even brazen disclosure."[104] Moreover, such disclosure precipitated an injunction under state law preventing the consummation of the merger, action ignored by the *Marshel* court but which bolsters a basic assumption of the *Popkin* court—that a fully informed shareholder is not a "helpless victim" since he can seek relief in state courts. It thus seems apparent that only under the most restrictive and artificial kind of construction can these decisions be reconciled with *Popkin*.

C. *The Limits of the Federal Fiduciary Standard*

The *Green* opinion clearly states, and *Marshel* implies, that the term "fraud" as used by rule 10b-5 must be read to encompass misconduct traditionally characterized as a breach of fiduciary duty. Given the language of the rule, the view of fraud espoused by

100. An example migbt be found in Scboenbaum v. Firstbrook, 405 F.2d 200, *rev'd en banc*, 405 F.2d 215 (2d Cir. 1968), *cert. denied*, 395 U.S. 906 (1969). In *Schoenbaum*, Aquitaine, the defendant, argued that its purchase of treasury stock from the corporation was necessary to finance the costs of exploring for oil. The sale of tbe treasury stock to Aquitaine had a justifiable corporate purpose. The extraordinarily low purchase price of the stock, however, was the ground upon which the alleged self-dealing was based.

101. 464 F.2d at 719.

102. 533 F.2d at 1287.

103. 464 F.2d at 720.

104. 533 F.2d at 1282 (Smith, J., concurring).

courts of equity, and the frequent references to fiduciary obligations in decisons such as *Bankers Life*, this extension of the rule is not illogical. Nor was it unexpected.[105] The two opinions, however, leave several questions unresolved. Is this new standard to be limited to a narrow range of transactions or is it to apply to all forms of conduct that may be characterized as fiduciary breaches? What is the precise meaning of "justifiable corporate purpose" and does its use by the two decisions impose limits upon the potential compass of rule 10b-5?

(1) Federal Law as Encompassing All Breaches of Fiduciary Duties in Corporate Transactions

Given the sweep of the language employed by Judge Medina and by Judge Mansfield in his concurring opinion, the decision in *Green* would appear to sanction the imposition of the rule in any corporate transaction involving a breach of fiduciary duty. The only limitations would be the requirement that plaintiff be a purchaser or seller of securities and that the misconduct alleged "touch" the securities transaction in question. The practical effect of such an interpretation would be to extend the net of rule 10b-5 to a significant number of managerial activities heretofore confined to state law.[106] For example, an allegation of fiduciary breach in connection with a merger, exchange of shares, or any transaction regarded as a purchase or sale by shareholders would be covered. Any purchase or sale by the corporation in which the perpetuation of control arguably is involved would give rise to a derivative action by shareholders.

Some indication of the possible breadth of this new standard is offered by *Seigal v. Merrick*,[107] a recent decision in the Southern District of New York. Relying on *Green* and *Marshel*, the court held that rule 10b-5 properly could be applied against directors who caused the corporation to purchase the shares of the largest stockholder at a premium in order to preserve the directors' control. No allegation or proof that any of the directors were deceived was necessary. Moreover, the court held that the burden was on defendants to prove their good faith as well as in the inherent fairness of the transaction to the corporation and shareholders.[108] A requirement of

105. *See, e.g.*, Kaplan, *supra* note 11, at 924-25.
106. *See id.*
107. [1975-1976 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 95,467 (S.D.N.Y. Mar. 11, 1976).
108. *Id.* at 99,370.

good faith and fairness has long been the broad fiduciary standard adopted by state courts.[109]

On the other hand, there is some likelihood that *Green* and *Marshel* will not be interpreted so broadly. For example, in *Marsh v. Armada Corp.*,[110] the Sixth Circuit found the application of *Green* and *Marshel* to be quite limited. Noting that both decisions declined to overrule *Popkin v. Bishop*, the court observed that "[t]hese two decisions cannot be read apart from the milieu of 'going private' merger transactions."[111]

In *Marsh* plaintiffs brought a class action for damages alleging that defendant's conduct in a tender offer followed by an acquisitive merger violated rule 10b-5. Armada Corporation had made a tender offer for shares of Hoskins Manufacturing Company and also had disclosed its intention to merge the two companies should it acquire majority control. It also disclosed its intention upon acquiring control to eliminate quarterly dividends that had been paid regularly to Hoskins shareholders for the previous forty years. Upon obtaining control of Hoskins, Armada did eliminate the dividends, which plaintiffs charged constituted a fraudulent scheme to drive down the value of Hoskins stock in order to accomplish the merger on terms favorable to Armada but unfair to those Hoskins shareholders who were forced to surrender their shares.

The Sixth Circuit found that "*Popkin* contains the more appropriate test to apply in this case."[112] It distinguished *Green* and *Marshel* on the grounds that those cases involved "going private" transactions that were in essence sham transactions designed to benefit controlling shareholders and in which the minority shareholders were "helpless victims." It declared that when plaintiffs do not challenge the purpose of the merger, as they did not in *Marsh*, the rule in *Popkin* demands that some form of deception be alleged and proved. The Sixth Circuit appears therefore to view *Green* and

109. *See, e.g.*, Jones v. H.F. Ahmanson & Co., 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969); Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971). *See also* Harriman v. E.I. du Pont de Nemours & Co., [1975-1976 Transfer Binder] CCH FED. SEC. L. REP. ¶ 95,386, at 98,934-938.

110. [1975-1976 Transfer Binder] CCH FED. SEC. L. REP. ¶ 95,496 (6th Cir. April 5, 1976). Even in the Second Circuit, at least one decision has sought to distinguish *Marshel* and *Green*. Merrit v. Libby, McNeil & Libby, 533 F.2d 1310 (2d Cir. 1976). Although *Merrit* deals only with the procedural aspects of a preliminary injunction, it demonstrates an attitude not to accept a broad per se prohibition against any transaction that operates to squeeze out minority interests.

111. *Id.* at 99,525. *See also* Nash v. Farmers New World Life, [1975-1976 Transfer Binder] CCH FED. SEC. L. REP. ¶ 95,519 (S.D. Ohio, Mar. 30, 1976).

112. *Id.*

Marshel only as specific exceptions to *Popkin.* This conclusion is reinforced by the court's general declaration that "we decline to equate a breach of fiduciary duty with fraud."[113]

(2) The Limits of the "Justifiable Corporate Purpose" Standard

Whether or not *Green* and *Marshel* will be construed to extend liability under rule 10b-5 to the broad range of fiduciary breaches recognized under state law may well depend on the meaning of the term "justifiable corporate purpose."[114] Unfortunately, neither opinion makes clear how and under what circumstances this test is to be applied, nor is it apparent whether this test operates as an independent rule or whether it is merely one aspect of a broader fiduciary standard established by the Second Circuit. Accordingly, several alternative explanations of the business purpose test are suggested.

A restrictive view of this rule is suggested by *Marsh v. Armada Corp.* Under this view, Judge Medina's sweeping references to fiduciary breaches may be regarded as surplusage, and the cases would be considered only to create a "sham transaction" exception to the general requirement of deception. This interpretation is based on the refusal of both *Green* and *Marshel* to overrule expressly *Popkin v. Bishop.*

On the other hand, failure to find a justifiable corporate purpose for a transaction may be regarded simply as another way of stating that the defendant's conduct constituted self-dealing. Under this approach the test can be viewed as the specific application of a broader fiduciary standard to a particular kind of transaction by adapting the general standard to give it meaning within the framework of the particular set of facts. Proof of a valid business reason for the transaction would be evidence that the defendant acted in the best interests of the corporation or the shareholders. Under this approach, the business purpose would have to be significant enough

113. *Id.* at 99,524.

114. This term, or some variation of it, has been employed by other courts. For recent federal decisions discussing the concept see Grimes v. Donaldson, Lufkin & Jenrette, Inc., 392 F. Supp. 1393 (N.D. Fla. 1974); Albright v. Bergendahl, 391 F. Supp. 754 (D. Utah 1974); Tanzer Econ. Assoc., Inc. v. Haynie, 388 F. Supp. 365 (S.D.N.Y. 1974); Bryan v. Brock & Blevins Co., 343 F. Supp. 1062 (N.D. Ga. 1972), *aff'd on other grounds*, 490 F.2d 563 (5th Cir. 1974). State courts have likewise considered the concept. *See, e.g.*, Jones v. H.F. Ahmanson & Co., 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969); Schulwolf v. Cerro Corp., 380 N.Y.S.2d 957 (Sup. Ct. 1976), *distinguishing* People v. Concord Fabrics, Inc., 83 Misc. 2d 120, 371 N.Y.S.2d 550 (1975); Tanzer Econ. Assoc., Inc. v. Universal Food Specialties, Inc., 383 N.Y.S.2d 472 (Sup. Ct. 1976). More recently, the Delaware Court of Chancery refused to inquire into the business purposes of a merger in Singer v. The Magnavox Co. (Del. Ct. Ch., Oct. 29, 1976), discussed in 378 BNA SEC. REG. & L. REP. A-3 (Nov. 17, 1976).

to "justify" the benefits received by the fiduciary at the expense of the corporation or the independent shareholders. The decision in *Seigal v. Merrick* would argue in favor of this interpretation.

Under either interpretation, the decisions, by requiring proof of a justifiable corporate purpose in order to avoid liability under rule 10b-5, have provided a built-in defense. A defendant apparently can be absolved from liability by proof of a valid corporate purpose for the transaction even if the facts otherwise suggest that he has breached a fiduciary duty and that the transaction was unfair. One wonders whether the courts would approve of such a result, but the language of the opinions does not preclude it. It seems unlikely, however, that a court would absolve a defendant if the business reasons for the transaction were inconsequential compared to the magnitude of the breach of trust. Just what evidence will establish such a purpose is subject to speculation. Presumably, any reasons showing that the corporation will benefit from the transaction, even if the benefits are not monetary in nature, could satisfy the requirement.[115]

A final question regarding the nature of this new federal standard is whether it was intended to measure not only the conduct of the defendants but also the fairness of the transaction. State corporate law customarily requires one charged with a breach of a fiduciary obligation to bear the burden of proving that he acted in good faith and that the transaction was intrinsically fair.[116] Evidence of good faith will not absolve a defendant if the transaction was unfair,[117] and conversely, the fairness of the transaction or the absence

115. The possible reasons are obviously numerous and will vary in each case. In connection with a short-form merger for the purpose of going private, one writer has suggested that valid reasons may include "the savings of the substantial expenses incurred in securities law public disclosure requirements, freedom from the worry of the impact of corporate decisions on stock prices, the elimination of the necessity of complying with disclosure requirements whicb may interfere with attractive merger negotiations . . . the elimination of the worry of what can be an expensive minority lawsuit for what in bindsight is viewed . . . as a breach of fiduciary duty owed to the minority and the removal of the risk of a violation of the securities laws." Brodsky, *Going Private—Is It Over?* 42 N.Y.L.J., Mar. 3, 1976, at 2, col. 2. For a discussion of a consolidation of operations as constituting a valid business for a merger, see Grimes v. Donaldson, Lufkin & Jenrette, Inc., 392 F. Supp. 1393 (N.D. Fla. 1974); Tanzer Econ. Assoc., Inc. v. Universal Food Specialties, Inc., 383 N.Y.S.2d 472 (Sup. Ct. 1976). *See generally* Kerr, *Going Private: Adopting a Corporate Purpose Standard*, 3 SEC. REG. L.J. 33 (1975). The decisions tbat have considered the meaning of the term "justifiable corporate purpose" or a similar term have not attempted a comprehensive definition.

116. *See, e.g.*, Jones v. H.F. Ahmanson & Co., 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969); Spiegel v. Beacon Participations, Inc., 297 Mass. 398, 8 N.E.2d 895 (1937); M. FEUER, PERSONAL LIABILITIES OF CORPORATE OFFICERS AND DIRECTORS 47-48 (2d ed. 1974).

117. *See* Hawes & Sherrard, *Reliance on Advice of Counsel as a Defense in Corporate and Securities Cases*, 62 VA. L. REV. 1, 53-54 (1976).

of measurable injury will not bar a claim against a fiduciary who has acted in bad faith.[118] Nevertheless, the issue of fairness is notably underplayed in both Second Circuit opinions. Indeed, the issue is broached by Judge Hays only to distinguish *Popkin* as a case involving unfairness, which suggests that the question of unfairness is not vital to the *Marshel* decision. While Judge Medina in *Green* makes reference to the unfair treatment of the minority, the court leaves unexplained the role of fairness in the new federal fiduciary standard. Under this rationale, a defendant who had engaged in self-dealing without a justifiable corporate purpose could not escape liability by showing that the transaction was otherwise fair. Nonetheless, despite the lack of clarity in the decisions on this question, one must conclude that the issue of fairness is implicit in the decisions of both cases. If fraud under rule 10b-5 is interpreted as covering the full range of fiduciary breaches, there is every reason to expect, as demonstrated by the holding in *Seigal v. Merrick,* that the federal standard will be at least as comprehensive as the state law rule, and thus fairness will be an essential element of the federal test. As Part IV indicates, it is highly questionable whether section 10(b) and rule 10b-5 do or should regulate the fairness of the terms of securities transactions.

IV. Testing the Premises of the Decisions

A. *Framing the Fundamental Issue*

Perhaps the most remarkable and controversial aspect of the *Green* and *Marshel* opinions is their willingness to impose rule 10b-5 liability despite the availability of remedies for the same misconduct under state law, a position contrary to the philosophy underlying the decision in *Popkin v. Bishop.* Arguably, Judge Medina in *Green* concluded that the appraisal remedy provided inadequate relief to shareholders whose interests were eliminated through a short-form merger. The entire panel in *Marshel* deemed irrelevant the prior state court injunction of the very transaction it was asked to enjoin.

This aspect of the cases raises a fundamental question about whether the decision to expand rule 10b-5 should be dependent in some fashion upon the availability or adequacy of relief for the same conduct under state law. More specifically, should the federal courts, in the absence of clear congressional guidance, find fiduciary misconduct violative of rule 10b-5 if that misconduct traditionally

118. *See, e.g.*, Diamond v. Oreamuno, 24 N.Y.2d 494, 248 N.E.2d 910, 301 N.Y.S.2d 78 (1969); New York Medical College & Hospital for Women v. Diffenbach, 125 Misc. 698, 211 N.Y.S. 799 (1925); 3 W. Fletcher, Private Corporations § 838 (perm. ed. rev. 1975).

has been the subject of regulation under state law? If state law does provide remedies for those harmed by breaches of trust on the part of corporate managers and controlling shareholders, is the adequacy of such remedies a proper subject of federal concern?

It is submitted that these questions provide the proper point of departure to resolve whether the expansion of federal law announced by *Green* and *Marshel* can be sustained. The answer to these questions involves a three-step analysis: first, it must be determined whether Congress either expressly or by clear implication intended section 10(b) and rule 10b-5 to encompass fiduciary duties of corporate management; secondly, if no clear congressional purpose can be found, it is necessary to determine whether there nonetheless exists a legitimate federal interest in prohibiting fiduciary breaches in connection with the purchase or sale of securities; and thirdly, if such a federal interest exists, whether that interest outweighs competing considerations. Such considerations include the impact of a federal fiduciary standard on state and federal law, the likelihood that a federal rule will create standards of conduct that overlap or are inconsistent with those developed by the states, whether the courts should fashion a superstructure of federal corporation law on an administrative rule that has never received express congressional approval, and the possible harmful effects federal intervention may have on the delicate balance of federal-state relationships.

B. *Statutory Coverage and Congressional Policy*

The primary consideration in judging whether certain kinds of misconduct are proper subjects of enforcement by the federal securities laws is the presence or absence of a reasonably clear statutory directive to that effect.[119] When the federal statutory provision expressly or by reasonably clear implication proscribes certain conduct, clearly the federal standard is applied; the analysis suggested herein need not be pursued further.[120] For example, the law of every state grants a cause of action for deceit. Section 10(b), however, expressly declares deceptive acts to be unlawful, and thus federal courts have a clear mandate to apply federal law in deception cases arising under the 1934 Act, notwithstanding the existence of alternative remedies under state law.

119. *See* Ernst & Ernst v. Hochfelder, 96 S. Ct. 1375 (1976); J.I. Case Co. v. Borak, 377 U.S. 426, 433 (1964).

120. *See* 1 BROMBERG, *supra* note 15, at § 2.7.

Unlike its reference to deception, section 10(b) contains no express language purporting to regulate fiduciary duties. Arguably, the phrase "manipulative . . . device or contrivance" could be interpreted to include schemes involving a breach of trust,[121] and the SEC has viewed manipulation as embracing a broad range of conduct.[122] Whether or not inferences can be drawn about the breadth of this phrasing, no clear intent by Congress to impose a federal fiduciary standard is evidenced. Likewise, the legislative history of the statute does not contain direct evidence contradicting this conclusion.[123]

Judge Medina supports his holding in *Green* by reference to sections (a) and (c) of the rule prohibiting fraud, further noting that the express sanctions against misrepresentations or omissions in section (b) manifest an intent by the Commission to free the notion of fraud under the rule from the constraints placed upon it by the common law.[124] Admitting that the Commission's rules have the force and effect of substantive law and that the Commission has been afforded by Congress broad discretion in the rulemaking process,[125] the Supreme Court recently reiterated in *Ernst & Ernst v. Hochfelder* that the first and foremost consideration in assessing the validity of a standard of conduct under the rule is the language of the statute.[126] The scope of the rule must be dependent upon the underlying legislative authority, and without a more clearly expressed intention in the statutory language to regulate fiduciary duties, the courts must seek other means to justify the imposition of federal liability.

---

121. This possibility was not foreclosed by the Supreme Court in Ernst & Ernst v. Hochfelder, 96 S. Ct. 1375 (1976), in its holding that civil damage actions under rule 10b-5 could not encompass negligent behavior. The Court stated at one point that "[i]n this opinion the term 'scienter' refers to a mental state embracing intent to deceive, manipulate, or defraud." *Id.* at 1381 n.12. At another point, the Court noted that "[t]he words 'manipulative or deceptive' used in conjunction with 'device or contrivance' strongly suggest that § 10(b) was intended to proscribe knowing or intentional misconduct." *Id.* at 1383. Finally, the opinion observed that "[t]here is no indication that Congress intended anyone to be made liable for such practices unless he acted other than in good faith." *Id.* at 1387. Good faith is also a defense to fiduciary breaches. Thus while scienter traditionally has been associated with deceit, the Court does not so restrict the definition. Indeed the language of the opinion is broad enough to include intentional breaches of fiduciary duties.

122. *See* 1 BROMBERG, *supra* note 15, at § 4.6; Jacobs, *Regulation of Manipulation by SEC Rule 10b-5*, 18 N.Y.L.F. 511 (1973). In Ernst & Ernst v. Hochfelder, 96 S. Ct. 1375, 1384 (1976), however, the Supreme Court observed that "manipulative" was "virtually a term of art."

123. *See* 1 BROMBERG, *supra* note 15, at § 2.2. In Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737 (1975), the Court admitted that "we would by no means be understood as suggesting that we are able to divine from the language of § 10(b) the express 'intent of Congress' as to the contours of a private cause of action under Rule 10b-5."

124. 533 F.2d at 1286-87.

125. *See* Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 12 (1971).

126. 96 S. Ct. 1375, 1383 (1976).

The inescapable conclusion is that a plain congressional purpose to regulate fiduciary conduct per se under section 10(b) is nowhere discernible.[127] Nevertheless, there is a similar absence of express intent on the part of Congress to exclude such conduct from the ambit of section 10(b). Consequently, we must proceed to weigh the competing considerations attendant to an expansion of federal law as proposed by *Green* and *Marshel.*

C. *The Competing Considerations*

(1) The Federal Interest

Even if Congress has not expressed its intent to regulate transactions in securities in which the plaintiff's harm results from a breach of trust by the defendant, many courts have found a justifiable federal interest in seeking to prohibit this form of misconduct.[128] Professor Bromberg has identified three such interests:[129] first, a federal forum for the resolution of alleged fiduciary misconduct is superior to a state forum not only because of its ability to circumvent procedural obstacles that may hinder or preclude the bringing of an action in the state courts, but also because the federal courts generally are more successful in reaching the merits of the case; secondly, a federal rule will promote a uniform, nationwide stan-

127. One may argue that the opinions in Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6 (1971), and SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963), would suggest a contrary conclusion. *Bankers Life* referred to a House Report that equated breaches of trust with "manipulation, investor's ignorance, and the like." 404 U.S. at 12. In *Capital Gains,* the Court construed a provision of the Investment Advisors Act of 1940, 15 U.S.C. § 80b-6 (1970), which contains language quite similar to that of rule 10b-5. In granting an injunction against the defendant for "scalping," the Court noted: "The Investment Advisors Act of 1940 thus reflects a congressional recognition 'of the delicate fiduciary nature of an investment advisory relationship,' as well as a congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment advisor—consciously or unconsciously—to render advice which was not disinterested." 375 U.S. at 191-92. Nevertheless, these brief references to legislative history, one of which pertains to a separate statute, cannot be considered determinative. Indeed, they highlight the paucity of evidence that would demonstrate a congressional intent to regulate fiduciary conduct by insiders. Further, neither decision depended upon the question of fiduciary breaches in the absence of deception since in each case the defendants clearly had deceived the other parties to the transaction.

128. *See, e.g.,* Popkin v. Bishop, 464 F.2d 714 (2d Cir. 1972); Drachman v. Harvey, 453 F.2d 722, *rev'd on rehearing en banc,* 543 F.2d 726 (2d Cir. 1972); Shell v. Hensley, 430 F.2d 819 (5th Cir. 1970); Herpich v. Wallace, 430 F.2d 792 (5th Cir. 1970); Rekant v. Desser, 425 F.2d 872 (5th Cir. 1970); Schoenbaum v. Firstbrook, 405 F.2d 200, *rev'd on rehearing en banc,* 405 F.2d 215 (2d Cir. 1968), *cert. denied sub. nom.,* Manley v. Schoenbaum, 395 U.S. 906 (1969). Unfortunately, none of these decisions articulates plainly the nature of the federal interest beyond declaring that the application of the rule in self-dealing situations comports with the congressional objective of protection of investors.

129. 1 BROMBERG, *supra* note 15, at § 4.7.

dard of conduct, an important consideration given the widely dispersed shareholdings at least in publicly owned corporations; thirdly, a strong federal interest exists in assuring that the protections afforded to investors on the public distribution or other sale of securities will not be thwarted by later misconduct diminishing or destroying the value of the original investment. Thus continuity in the protection of investors beyond the initial purchase of securities is an important consideration. Protection against the elimination of minority interests in a going private transaction by controlling shareholders would fall under this third category. A further federal interest may be found in providing relief in situations such as *Schoenbaum,* in which a court can conclude that the denial of a corporation's right to the independent, disinterested judgment of the directors is tantamount to deceit and thus should be subject to the same federal prohibition as other forms of deceit.[130] Finally, and in the broadest sense, it might be suggested that a valid federal interest inheres in seeking to regulate all forms of intentional wrongdoing in connection with the purchase or sale of securities, including conduct that might be characterized as self-dealing, overreaching, or unfair.[131] Such a federal interest is grounded on the protection of investors, an objective of the securities laws and of section 10(b) in particular.

(2) Impact on State Law

The standard enunciated in *Green,* if interpreted broadly, unquestionably will have a debilitating effect on the future development of state law relating to fiduciary duties. Experience demonstrates that procedural attractions alone will cause plaintiffs to invoke federal jurisdiction.[132] This result may be welcomed by some who have inveighed against the loose, management-oriented standards of conduct accepted by state courts and legislatures, and who also have suggested that a federal standard at a minimum has the advantage of imposing a uniform rule.[133] Yet Professor Cary, who

130. *See* notes 52-54 *supra* and accompanying text.

131. The stated purpose of the Exchange Act to protect investors is seductively broad. It suggests a result-oriented approach to the imposition of federal liability under the rule whereby every act or transaction that is harmful to an investor can be prohibited. The Supreme Court, in Ernst & Ernst v. Hochfelder, 96 S. Ct. 1375, 1383-84 (1976), rejected such an approach, finding that liability under the rule also requires that a court focus on the nature of the misconduct.

132. Bloomenthal, *supra* note 11, at 334-35.

133. *See* Cary, *Federalism and Corporate Law; Reflections Upon Delaware,* 83 YALE L.J. 663 (1974).

persuasively has demonstrated the all too frequent absence of adequate protection of shareholders under state law, has suggested that federal oversight in the area of corporate fiduciary duties more appropriately should emanate from Congress rather than by further judicial extension of rule 10b-5.[134]

While the criticisms of state law are not without foundation, it is also true that it has been far from impotent. Cases such as *Jones v. H. F. Ahmanson & Co.*[135] in California and *Diamond v. Oreamuno*[136] in New York merely are illustrative of the ability of state courts to make substantial, innovative, and far-reaching contributions in the field of fiduciary responsibility. Admittedly, the federal decisions construing state law also have participated in the advancement of these standards,[137] but this would appear only to underscore the proposition that state law contains an adequate, if under-utilized, fund of legal principles that would in most instances achieve the same results as would the imposition of a federal fiduciary standard. A decision to expand the scope of rule 10b-5 therefore should consider whether such an expansion will foreclose or diminish greatly a valuable source of judicial creativity at the state level. In this regard, it is relevant to reflect upon the theory that the flexibility and dynamism of American jurisprudence is due in part to the freedom of the states, as laboratories of legal growth, to experiment with various legal and economic principles.[138]

In addition to the considerations outlined above, the rule developed by *Green* and *Marshel* may have an even more significant impact upon the substantive rights granted by state law to the participants in a corporate enterprise. The decisions go further than merely adopting a federal test of fiduciary standards that is coextensive with state law. Both cases involved the use by controlling shareholders of legislatively sanctioned merger procedures to eliminate minority interests. Defendants in both cases contended that they had complied in all respects with the applicable state

---

134. *Id.* at 699-700.

135. 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969) (controlling shareholders owe fiduciary duty to provide correlative benefits to minority). *See also* Berkowitz v. Power/ Mate Corp., 135 N.J. Super. 36, 342 A.2d 566 (1975).

136. 24 N.Y.2d 494, 248 N.E.2d 910, 301 N.Y.S.2d 78 (1969) (insider trading constitutes breach of fiduciary duty to corporation even if corporation did not trade).

137. *See, e.g.*, Perlman v. Feldmann, 219 F.2d 173 (2d Cir. 1955); Seagrave Corp. v. Mount, 212 F.2d 389 (6th Cir. 1954); Zahn v. Transamerica Corp., 162 F.2d 36 (3d Cir. 1947).

138. *See* Lochner v. New York, 198 U.S. 45, 75 (1905) (Holmes, J., dissenting); *cf.* Apodaca v. Oregon, 406 U.S. 404 (1972) (Powell, J., concurring); Williams v. Florida, 399 U.S. 78 (1970) (Harlan, J., concurring).

statutory provisions. The courts declared, however, that such compliance was irrelevant to the question of federal liability, and that federal law prohibited the employment of otherwise valid corporate procedures if a justifiable business purpose did not exist for the transaction. Because the state statutes permitted such procedures without demanding proof of a corporate purpose, the *Green* and *Marshel* decisions clearly go beyond subsuming state fiduciary standards under rule 10b-5. They impose a federal condition to the exercise of a substantive right granted by state statutes.[139]

As Judge Moore observed in his dissent in *Green,* those states that permit short-form mergers in effect have declared that the squeezing out of minority shareholders may be accomplished even if the purpose of the controlling shareholder is to benefit himself. What might otherwise be found to constitute self-dealing in such cases is not prohibited.[140] If unfairness exists, it is rectified by providing complaining shareholders with statutory appraisal rights or injunctive relief.

The federal requirement of a justifiable corporate purpose raises questions about the continuing viability of various forms of transactions permitted and regulated under state corporate law in which such a requirement is not imposed. Presumably, such transactions will not be sustained unless the federal condition is met. The practical effect will be to remove all but the most mechanical aspects of the transaction from the jurisdiction of the state courts. Even if the state courts adopt a corporate purpose test, it arguably will be dependent upon and subject to review by the federal courts, and all of this without a clear congressional mandate. Not only will the authority of state decisions be subject to uncertainty, but the availability of a federal forum also may lead to inconsistent rules in each level. Admittedly, this problem is not new; for example, the federal deception standard under rule 10b-5 may well differ from the test of common law deceit recognized by a particular state. The difference in this situation, however, arises because the power of the federal judiciary to fashion its own deception standard is at least grounded in the language of the statute expressly outlawing deceptive acts. Admittedly, the problem of inconsistent rules under federal and state law may decline in importance if practically every

139. *See* Dyer, *An Essay on Federalism in Private Actions Under Rule 10b-5,* 1976 UTAH L. REV. 7.

140. 533 F.2d 1283, 1305 (Moore, J., dissenting) (quoting Stauffer v. Standard Brands, Inc., 41 Del. Ch. 7, 187 A.2d 78, 80 (1962)). *See generally* Vorenberg, *Exclusiveness of the Dissenting Stockholder's Appraisal Right,* 77 HARV. L. REV. 1189 (1964).

case is brought in the federal forum. But this only ameliorates the impact of the problem; it does not resolve it, especially since the federal standard formulated by the Second Circuit is new and undeveloped and cannot yet be said to apply equally or consistently to the full range of fiduciary duties.

Another consideration in assessing the impact of a federal fiduciary standard on state law is raised by the majority's observation in *Green* that "the enforcement of the fiduciary duty owed by the majority to the minority in corporations large and small should not be overlooked."[141] Although the availability of private relief under rule 10b-5 never has turned on whether the securities of the corporation were publicly held, there is logic in an argument that the management and internal affairs of the close corporation should not be a subject of federal concern. The regulation by the Exchange Act of larger, publicly owned enterprises and the emphasis upon prevention of fraud in the sécurities markets for the protection of the public investor indicate congressional priorities in favor of regulating primarily large, public corporations. Further, the emerging theory of the close corporation as a contractual relationship among the parties[142] argues strongly that the close corporation is quite a different organizational form from the public company, requiring different legal approaches to its unique problems. The enactment in numerous jurisdictions of special provisions to govern the organization and relationships in close corporations further supports the desirability of primary regulation by the states.[143] While a federal fiduciary standard may not intrude unduly upon the regulatory framework of the close corporation, such an assumption should not be made without an analysis of the competing policy considerations.

(3) Impact on Federal Law

The impact here of a broad reading of the *Green* and *Marshel* decisions is quite predictable. The federal courts will become the primary forum for all claims that management or controlling shareholders have breached their fiduciary duties.[144] As noted, one advantage is uniformity of standards, although this benefit is attenuated by the possibility of varying tests employed by each Circuit. Further

141. 533 F.2d at 1287.

142. *See* 1 F. O'NEAL, CLOSE CORPORATIONS § 3.53 (1971).

143. *See, e.g.,* DEL. CODE ANN. tit. 8, §§ 341-56 (1975).

144. This quite clearly has become the case in the area of insider trading. *See* Ruder, *Pitfalls in the Development of a Federal Law of Corporations by Implication Through Rule 10b-5,* 59 NW. U.L. REV. 185 (1964).

burdening the already crowded federal dockets with what could be a sizable volume of new cases would exacerbate the well-recognized problem of congestion and delay in the administration of justice in the federal courts.[145] This problem should not outweigh the primary obligation of the courts to provide a forum for the adjudication of meritorious complaints. Nevertheless, in the absence of a more clearly prescribed congressional mandate or an overriding federal policy requiring the assertion of federal jurisdiction over fiduciary breaches, especially when relief is otherwise available under state law, the decision to expand the contours of rule 10b-5 should involve a balancing of the need to provide a federal cause of action for fiduciary breaches of corporate managers against the burden upon the federal courts to afford speedy and effective remedies to others who are entitled to the federal forum by express statutory mandate.

(4) The Superiority of Federal Relief

As noted previously a federal prohibition of fiduciary breaches undoubtedly would oblige the federal courts to scrutinize the fairness of a challenged transaction.[146] The fiduciary standard under state law generally requires that the defendant bear the burden of proving that he acted in good faith and that the transaction was inherently fair.[147] In cases such as *Green* and *Marshel,* in which plaintiffs challenge the validity of a merger or similar transaction, state law has purported to insure against unfair treatment of minority shareholders by offering them the alternative of judicial appraisal. Commentators have agreed generally that the statutory appraisal remedy is cumbersome, expensive, and often ineffective,[148] but it is conceded nonetheless that appraisal does have some value, if only "as a last-ditch check on . . . abuse of discretion by insiders."[149]

Even if we accept these criticisms as a reason to invoke federal jurisdiction, whether the federal courts will be able to provide a

145. The increasingly heavy caseload in the federal courts and the fear that the administration of justice will suffer if the courts continue to be overburdened has been a recurring issue raised by Chief Justice Burger. *See, e.g.,* Burger, *Yearend Report,* 62 A.B.A.J. 90 (1976); Burger, *Yearend Report,* 61 A.B.A.J. 303 (1975).

146. *See* notes 116-18 *supra* and accompanying text.

147. *See* note 116 *supra.*

148. *See, e.g.,* Brudney & Chirelstein, *Fair Shares in Corporate Mergers and Takeovers,* 88 HARV. L. REV. 297, 304 (1974); Eisenberg, *The Legal Roles of Shareholders and Management in Modern Corporate Decisionmaking,* 57 CAL. L. REV. 1, 76-79 (1969); Vorenberg, *Exclusiveness of the Dissenting Stockholder's Appraisal Right,* 77 HARV. L. REV. 1189 (1964).

149. Brudney & Chirelstein, *supra* note 148, at 304. For an example of a case where appraisal has provided an adequate remedy for shareholders who have been squeezed out, see Endicott Johnson Corp. v. Bade, 37 N.Y.2d 585, 338 N.E.2d 614, 376 N.Y.S.2d 103 (1975).

superior form of relief is not clear. The range of remedial choices available to the court in *Green* was outlined by Judge Mansfield in his concurring opinion:

> Upon a showing that the merger had no legitimate corporate purpose, the district court should, if feasible, set it aside or, if the merger cannot effectively be voided, award damages between the fair buy-out price and the unfair, unilateral buy-out price set by the corporate insiders.[150]

Except for the possibility of setting aside the merger, the determination made by a federal court of a fair value for the interests of the complaining minority is equivalent to the determination involved in an appraisal proceeding under state law. To be sure, the federal courts, unshackled by statutory guidelines or prior decisional law prescribing the elements to be considered in reaching a "fair value," would be in a better position to adopt valuation techniques suggested by critics of the present state appraisal remedy, although there is no assurance that the federal courts will do so. Moreover, state courts also could decide to adopt these techniques. Hence, the efforts of the federal judiciary to reach a fair value could well duplicate the state law approach.

Judge Mansfield also referred to the alternative of setting aside the transaction, a remedy that does not exist in those jurisdictions that consider the right to an appraisal to be the exclusive remedy.[151] Nevertheless, unscrambling a transaction may not be practicable in most cases in which shareholders have changed their positions in reliance on the transaction or in which the tracing of shares through numerous subsequent transactions would be impossible.[152] Although Judge Mansfield observes that the avoidance of a short-form merger would occasion fewer such problems,[153] a court may be reluctant to impose this remedy. Avoidance contemplates a restoration of the minority to its previous shareholder position, a result that suggests a return to a vested rights theory[154] and may otherwise be ill-advised

150. 533 F.2d 1283, 1294 (Mansfield, J., concurring). *See also* Merrit v. Libby, McNeil & Libby, 533 F.2d 1310, 1314 (2d Cir. 1976).

151. *See* Borden, *Going Private—Old Tort, New Tort or No Tort?*, 49 N.Y.U.L. REV. 987, 1023-24 (1974); Vorenberg, *supra* note 148, at 1207-08.

152. Justice Harlan, writing the majority opinion in Mills v. Electric Auto-Lite Co., 396 U.S. 375, 386 (1970), stated that while setting aside a merger is a possible remedy, no statutory policy compels the court to "unscramble a corporate transaction merely because a violation occurred."

153. Green v. Santa Fe Industries, Inc., 533 F.2d 1283, 1294 (Mansfield, J., concurring).

154. *See* Borden, *supra* note 151, at 1020-21. The rule announced in *Green* and *Marshel* differs somewhat from a strict vested rights approach, since restoration of the minority to its previous equity position in the corporation would only occur in those cases where no justifiable corporate purpose existed for the transaction that occasioned their elimination as shareholders.

because of the predictable hostility between the two factions.

Finally, the federal courts may afford injunctive relief prior to the transaction in question. In a case such as *Marshel,* this remedy merely duplicates the state law remedy and thus seems superfluous.

(5) Federal-State Relationships

A decision to extend rule 10b-5 beyond full disclosure also requires attention to the independence and separate identity of federal and state legal systems. Because the rule espoused by *Green* and *Marshel* would contemplate the intrusion of federal law into an area of traditional state regulation, the question whether this intrusion would contravene principles of federalism is of considerable importance in determining whether such an expansion of rule 10b-5 is justified.

Judge Moore raised this issue in his dissent in *Green* when he characterized the majority opinion as ignoring the dictates of *Erie R.R. Co. v. Tompkins,*[155] engaging in an unwarranted value judgment about the adequacy of state law and proceeding to formulate its own "better rule."[156] Although the *Erie* doctrine would seem inapplicable to these decisions on the ground that the decisions are relying on a valid congressional enactment that arguably authorizes federal intervention, the point made by Judge Moore does identify what should be an important concern of the courts when the congressional purpose is unclear.

In *J. I. Case Co. v. Borak*[157] the Supreme Court reflected on the extent to which federal intervention by implication into an area regulated by state law would be permissible. The Court held that the congressional objective of providing "fair corporate suffrage" justified the implication of a private right of action under section 14(a) of the Securities Exchange Act for damages arising from false and misleading proxy statements. The opinion declared that "we believe that the overriding federal law applicable here would . . . control the appropriateness of the redress despite the provisions of state corporation law."[158] The Court further noted that the failure to grant a federal right of action ultimately may frustrate the purposes of the Exchange Act because relief provided under state law for the kind of violation alleged may be either nonexistent or wholly inadequate.[159]

155. 304 U.S. 64 (1938).
156. 533 F.2d 1283, 1307 (Moore, J., dissenting).
157. 377 U.S. 426 (1964).
158. *Id.* at 434.
159. *Id.* at 435.

In the recent decision of *Cort v. Ash*,[160] the Supreme Court refused to grant a private right of action under a federal statute imposing criminal sanctions for corporate contributions in federal elections. Justice Brennan, writing for a unanimous Court, found a relevant consideration to be whether "the cause of action [is] one traditionally relegated to state law, in an area basically the concern of the States, so that it would be inappropriate to infer a cause of action based solely on federal law."[161] The Court concluded that a private right of action could not be granted, in part "because implication of a federal right of damages on behalf of a corporation under [the statute] would intrude into an area traditionally committed to state law without aiding the main purpose of [the statute]."[162]

The *Cort v. Ash* holding relates particularly to the present analysis because it involved an action by a shareholder alleging that management's authorization of campaign expenditures by the corporation constituted a breach of fiduciary duty. Moreover, although the Court declared plaintiff's only avenue of relief to be under state law, it was by no means clear that any such relief would be available, or if available, that it would be adequate.[163]

The significance of the *Cort* opinion lies in its express recognition of the importance of federal-state relationships in any decision to expand federal law into an area governed by state law. When the federal interest in regulating certain types of conduct can be found only by judicial implication, *Cort v. Ash* not only proposes a balancing process, but also suggests that a vital consideration in such a process is the availability of relief for the same misconduct under state law. Although the Supreme Court in *Borak* embarked on a similar analysis, the decisions have several important differences. First, while both decisions were concerned with the issue of an implied private right of action under federal statutes, the Court in

160. 422 U.S. 66 (1975).

161. *Id.* at 78; *see* J.I. Case Co. v. Borak, 377 U.S. 426, 434 (1964); Wheeldin v. Wheeler, 373 U.S. 647, 651-52 (1963).

162. 422 U.S. at 85.

163. The Court stated:

> [I]t is entirely appropriate in this instance to relegate respondent and others in his situation to whatever remedy is created by state law. In addition to the *ultra vires* action pressed here, . . . the use of corporate funds in violation of federal law may, under the law of some States, give rise to a cause of action for breach of fiduciary duty. . . . Corporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law expressly requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation.

Id. at 84.

Borak considered the question against a background of nearly twenty years of decisions in the lower federal courts in which an implied private cause of action had been granted under rule 10b-5. Secondly, the plaintiff in *Borak* charged that he had been deceived by false and misleading statements in the proxy materials and, as noted, full and fair disclosure is a central theme of the federal securities laws. In *Cort*, however, the basis of the plaintiff's allegation was a breach of fiduciary duty. Thirdly, the grant of a private remedy under the proxy rules was felt by the Court to be justified by the express congressional objective of insuring fair corporate suffrage, an objective which may support a higher standard of conduct under the proxy rules than under section 10(b) and rule 10b-5.[164] Finally, the *Borak* opinion, in finding private enforcement of the proxy rules to be a "necessary supplement to Commission action,"[165] was concerned with the absence of any relief under state law for victims of deceptive proxy statements. In *Cort v. Ash*, Justice Brennan made specific reference to the availability of relief under state law for the plaintiff. *Green* and *Marshel* may be distinguished from the *Borak* decision for the same reason, for in both cases the question was not the availability of state law remedies but arguably the adequacy of such relief.

D. *Striking a Balance*

The weight of the foregoing considerations militates against a broad interpretation of rule 10b-5 to encompass fiduciary misconduct in the absence of some form of deception. Under a pure federal fiduciary standard, liability would hinge upon a determination of the transaction's fairness. Not only is such a standard conspicuously absent from the language of section 10(b), but also the overriding philosophy of disclosure under the securities laws suggests a congressional unwillingness to regulate the terms of a securities transaction once full disclosure is made.[166] Moreover, the question of fairness would require a federal court to pass judgment on the overall effect of a transaction on the parties involved, but the Supreme Court in *Ernst & Ernst v. Hochfelder*[167] expressed its disapproval of

164. In Ernst & Ernst v. Hochfelder, 96 S. Ct. 1375, 1389 n.28 (1976), the Supreme Court intimated that the "difference between the operative language and purpose of § 14(a) of the 1934 Act . . . as contrasted with § 10(b)" may justify imposition of liability under § 14(a) for negligence alone.

165. 377 U.S. at 432.

166. *See* Popkin v. Bishop, 464 F.2d 714, 719-20 (2d Cir. 1972).

167. 96 S. Ct. 1375, 1383 (1976); *see* Petersen v. Federated Development Co., [current] CCH Fed. Sec. L. Rep. ¶ 95,620, at 90,090 (S.D.N.Y., June 16, 1976).

a result-oriented approach to liability under rule 10b-5. Further, as previously noted, not only would the standards employed by the federal courts be duplicative of state law, but also the federal courts generally would appear no better equipped than state courts to resolve such matters.

Nor does a rule whereby the federal courts scrutinize the business purposes of the transaction serve as a viable alternative to a disclosure requirement. In the absence of allegations or proof of deception, the precise role of a business purpose test to determine liability is not clear. In the final analysis, the employment of such a standard by the Second Circuit in *Green* and *Marshel* appears to be another way of saying that the defendant has breached his trust to the corporation or to the independent shareholders by seeking to serve his own purposes at their expense. As with a broad fiduciary standard, this test requires the courts to scrutinize the merits of the transaction in question and the motives of the defendants. Presumably, if the defendant establishes the transaction to be fair, or if some valid business reason is shown, the defendant will be absolved from liability. Because a business purpose test partakes of many, if not all, of the attributes of a broad fiduciary standard, it is subject to the infirmities of that standard as well as to the additional criticism that the present uncertainty of the definition and application of a business purpose test renders it unacceptable as a workable test of liability under federal law.

Although it seems plain that a broad fiduciary standard under section 10(b) cannot be justified, the question remains whether some lesser incursion of federal law may be appropriate in the absence of deception to remedy conduct that, while not deceptive, nonetheless is tainted by self-dealing or conflicts of interest. In short, should liability under rule 10b-5 require proof of deception (either by affirmative misrepresentation or nondisclosure) in all cases or do situations exist in which the potential for abuse is substantial enough to permit a federal court, as *Popkin* suggested, "to concentrate upon the impropriety of the conduct itself rather than on the 'failure to disclose'?"[168]

In determining whether some limited extension of federal law beyond full disclosure is warranted, the transactions may be divided into two general categories. The first category involves transactions for which prior approval of shareholders is required by state law. The second includes those transactions for which state law requires

168. Popkin v. Bishop, 464 F.2d 714, 719 (2d Cir. 1972).

only approval by the board of directors. This same classification was adopted by the Second Circuit in *Popkin.*[169]

In the first category, the *Popkin* decision appears correct in concluding that when state law requires approval by shareholders prior to the transaction in question and if full disclosure is made to the shareholders, the federal interest is satisfied. Full disclosure operates to afford shareholders a meaningful choice in determining whether or not to approve the transaction. Admittedly, when a majority shareholder controls sufficient votes to assure the outcome of the transaction, a disgruntled minority shareholder is subject to the rule of the majority, at least insofar as the internal corporate processes are concerned. Nevertheless, he is far from being a helpless victim with no alternative but to accept a unilaterally imposed result. Having received full disclosure of the transaction and its terms, he may seek relief from overreaching or oppressive conduct in the state courts. Therefore, in this category, when full disclosure is made to shareholders prior to their approval of the transaction, in which the *Marshel* case may be included, it is difficult to justify the extension of rule 10b-5 beyond a full disclosure requirement.[170]

Perhaps it was of some significance to the court that the corporation in *Marshel* was subject to the Exchange Act's reporting requirements. Judge Hays did indicate his aversion to a going private scheme in which the controlling shareholders take advantage of public financing and later appropriate these benefits to themselves by going private.[171] Judge Mansfield also viewed the merger in *Green* as a going private transaction, although it is not clear from the facts before the court whether the *Green* defendants, having directly secured the benefits of public financing, sought to appropriate those benefits to themselves.[172] Both courts undoubtedly were influenced by the storm of criticism surrounding the going private phenomenon.[173] Moreover, the holdings of the two cases closely parallel rules

169. *See* note 61 *supra* and accompanying text.

170. An exception to this conclusion may be necessary. Section 228 of the Delaware General Corporation Law permits any transaction requiring shareholder approval to be taken without a meeting of shareholders if a written consent to the action taken is signed by the holders of the minimum number of outstanding shares otherwise required by the charter to authorize such action. DEL. CODE ANN. tit. 8, § 228 (1975). A shareholder or group of shareholders thus can consummate a corporate transaction requiring shareholder approval in relative secrecy. Minority shareholders would be presented with a *fait accompli.* A complaining shareholder would be precluded from injunctive relief although arguably he would be entitled to challenge the fairness of the transaction under Delaware law if it involved a breach of the majority's fiduciary obligations. Yet, even here, federal liability can be grounded on a lack of prior full disclosure and need not reach the issue of breach of fiduciary duty.

171. 533 F.2d 1277 at 1280.

172. 533 F.2d 1283 at 1295 (Mansfield, J., concurring).

173. *See* note 70 *supra.*

proposed by the SEC in February 1975 that prohibit going private transactions by reporting companies unless a valid business purpose exists for any such transaction and its terms are otherwise fair.[174]

Clearly a federal interest exists in assuring that public investors are provided with continuing federal protection beyond the initial purchase of their securities. The proxy rules and the reporting requirements under the Exchange Act are ample evidence of this. One nevertheless wonders why this federal interest would not always be satisfied by a full disclosure requirement. Indeed, the full prior disclosure made to the shareholders in *Marshel* precipitated an injunction prohibiting the merger by a state court. This result would appear to satisfy fully the federal interest and suggests that any broader rule is wholly unnecessary to protect the interests of investors, at least in this first category of transactions.

The second category of transactions relates to those that do not require shareholder approval and are within the province of the board of directors of the corporation. It is in these situations that decisions such as *Schoenbaum v. Firstbrook* have demonstrated that serious abuses may escape federal regulation if federal law requires proof of actual deception in every case. Although full disclosure may have been made to all directors, if the directors are tainted by a conflict of interest, then the corporation is deprived of their independent, disinterested judgment, a situation that has been characterized rather persuasively as equivalent to deception.[175] In such cases, a stronger argument exists for expanding federal jurisdiction to encompass fiduciary breaches. On the other hand, such conduct should in most cases give rise to a cause of action for breach of trust under state law, thus raising the question whether concomitant relief in the federal courts is necessary or desirable.[176] Whether federal law should be expanded beyond a full disclosure rule in cases such as *Schoenbaum* is not easily answered. Rather convincing arguments exist on each side of the issue. It is submitted, however, that any such extension of liability should be limited to conflict of interest transactions at the director level.

The *Green* decision also may be classified in this second category of transactions since the short-form merger provision under

174. Proposed Regs. § 240.13e-3A, -3B, 40 Fed. Reg. 7947 (1975).

175. *See* note 45 *supra*.

176. One commentator has suggested that the controlling influence standard, while similar to the state standard regulating conflict of interest transactions, espouses a broader rule than its state law counterpart, and would include not only conflicts wherehy the fiduciary received pecuniary benefits but also any situation in which divided loyalties impaired a disinterested judgment. Note, *supra* note 11, at 1037-39.

Delaware law does not require prior shareholder approval of the transaction. Since the plaintiffs were informed of the merger only after it had been consummated, an argument exists that they were deprived of the opportunity to seek injunctive relief in the state courts. Such an argument would be consistent with the decision in *Popkin v. Bishop,* which noted that the federal interest terminates only in cases in which state law demands *prior* shareholder approval. Additionally, because Delaware law has deemed the appraisal remedy to be exclusive in short-form merger transactions,[177] the opportunity for a meaningful choice of a course of action is similarly restricted when disclosure is made after the merger. *Green* thus may be characterized as a type of non-disclosure case, permitting application of rule 10b-5 as a result of the lack of disclosure prior to the merger rather than of any breach of fiduciary duty.

On the other hand, one plausibly may contend that even the absence of prior disclosure is not sufficient to give rise to a federal claim for relief, because in *Green* the defendants provided full disclosure in time to allow the minority to make an informed choice about the exercise of their appraisal remedy. Whether the federal courts should speculate on the merits and disadvantages of such a remedy in deciding upon federal relief is questionable. Full disclosure did afford the plaintiffs in *Green* a choice, and it is not certain that a federal remedy would improve the possibilities for adequate relief.

In the final analysis, the fairness of the transaction is really the crucial issue in cases such as *Green.* If the cash-out price were "fair", the case for liability under either federal or state law loses much, if not all, of its force. A full disclosure rule, whether before or after the consummation of the merger (but prior to the exercise of appraisal rights) will give disaffected shareholders an opportunity to make their own judgment about fairness and thus to pursue the appropriate state law remedy. Indeed, had *Green* merely imposed a full disclosure rule upon the defendants, the decision would have modified Delaware law, which currently does not require full disclosure to those shareholders who are to be eliminated. Under such a federal requirement, if full disclosure is made, the question of fairness continues to be an issue under state law. If full disclosure is not made by the defendants, federal liability would exist under rule 10b-5, and the federal courts may consider the fairness of the trans-

177. At least when the value of the minority's shares is the only issue in dispute, appraisal has been considered the exclusive remedy. Stauffer v. Standard Brands, Inc., 41 Del. Ch. 7, 11, 187 A.2d 78, 80 (Sup. Ct. 1962).

action when fashioning a remedy.[178] This approach would conform to the congressional objectives of the securities laws and arguably would permit a consistent and well-defined application of federal liability under rule 10b-5 without creating a broad federal fiduciary standard.

V. Conclusion

Application of section 10(b) and rule 10b-5 to the area of internal corporate mismanagement has created a unique set of problems. Perhaps the most fundamental has been the application of the rule to breaches of trust by management in the absence of any form of misrepresentation or nondisclosure. The decisions of the Second Circuit in *Green* and *Marshel,* finding that federal liability may exist despite full disclosure of material facts, represent the culmination of a series of decisions that have witnessed an ever-expanding universe of transactions and behavior falling under federal jurisdiction. Moreover, this extension of federal law has come about by judicial implication of congressional intent. This article, while admitting that valid federal interests may support some broadening of the rule to remedy serious abuses, demonstrates that important countervailing considerations also exist that militate strongly against expanding it beyond a narrow and well-defined range of transactions.

Admittedly, the federal regulation of securities transactions inevitably involves some regulation of internal corporate affairs, and the cases demonstrate the difficulty in drawing a clear line of demarcation excluding certain transactions from federal coverage while including others. But corporate mismanagement is not necessarily synonymous with fiduciary misconduct, and in the absence of a clear intention by Congress to regulate the latter, it makes sense to limit liability in such cases to some form of deception or nondisclosure.

178. *See* Mills v. Electric Auto-Lite Co., 396 U.S. 375, 386 (1970).