

NOTES

A NEW APPROACH TO RULE 10b-5: DISTINGUISHING THE CLOSE CORPORATION

I. INTRODUCTION

In the mid-1970's, the Supreme Court reversed the direction of the federal securities laws. Instead of continuing the long tradition of interpreting these laws "flexibly rather than technically or restrictively,"¹ the Court narrowed their scope.² This change in judicial thinking was particularly evident in cases involving the frequently litigated³ rule 10b-5.⁴ For example, the Court limited standing under rule 10b-5 to

1. *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 151 (1975). *See, e.g.*, *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 12 (1971); *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963); *Eason v. General Motors Acceptance Corp.*, 490 F.2d 654, 658-59 (7th Cir. 1973), *cert. denied*, 416 U.S. 960 (1974).

2. *See, e.g.*, *Piper v. Chris-Craft Indus., Inc.*, 430 U.S. 976 (1977) (defeated tender offeror lacks standing under proxy rules); *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977) (deception required for rule 10b-5 cause of action); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) (scienter required to establish rule 10b-5 violation); *Foremost & McKesson, Inc. v. Provident Sec. Co.*, 423 U.S. 232 (1976) (initial purchase not counted for § 16(b) liability); *Cort v. Ash*, 422 U.S. 66 (1975) (no suit for derivative damages for violation of federal election laws by misuse of corporate funds); *Rondeau v. Mosinee Paper Corp.*, 422 U.S. 49 (1975) (for injunctive relief under the Williams Act, private litigant must show irreparable harm); *United Hous. Foundation, Inc. v. Forman*, 421 U.S. 837 (1975) (shares in a state nonprofit housing cooperative are not "securities"); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975) (only actual purchaser and seller have standing under rule 10b-5).

3. The Supreme Court has declared, "rule 10b-5 may well be the most litigated provision in the federal securities laws." *SEC v. National Securities, Inc.*, 393 U.S. 453, 465 (1969). Additionally, the Court has recently characterized rule 10b-5 as a "judicial oak which has grown from little more than a legislative acorn." *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975). One commentator has called the rule the "most potent and the most versatile instrument in the armament of federal securities regulation." Note, *The Controlling Influence Standard in Rule 10b-5 Corporate Management Cases*, 86 HARV. L. REV. 1007, 1007 (1973).

4. The Securities Exchange Commission promulgated rule 10b-5 almost eight years after the enactment of section 10(b) of the 1934 Securities Exchange Act. Section 10(b), 15 U.S.C. § 78(j) (1976), provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

. . . .

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as

actual purchasers and sellers of securities⁵ and has held that allegations of mere negligence⁶ or breach of fiduciary duty⁷ are insufficient to create a rule 10b-5 cause of action.

While the federal courts restricted rule 10b-5,⁸ state courts also began to reassess their approach to another important aspect of corporate law—the treatment of close corporations within the state legal system. With increasing readiness state courts⁹ and legislatures¹⁰ recognized that the smaller number of participants in a close corporation,¹¹ the

the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 10b-5, promulgated under section 10(b) of the Securities Exchange Act of 1934, reads: 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 omit to state a material fact necessary in order to make the statement made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1978).

5. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975).

6. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

7. *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977).

8. In accordance with the present Supreme Court posture, many lower courts have narrowed the scope of rule 10b-5. *See, e.g.*, *St. Louis Union Trust Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 562 F.2d 1040 (8th Cir. 1977), *cert. denied*, 435 U.S. 925 (1978); *Ketchum v. Green*, 557 F.2d 1022 (3d Cir. 1977), *cert. denied*, 434 U.S. 940 (1977); *Ayres v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 538 F.2d 532 (3d Cir.), *cert. denied*, 429 U.S. 1010 (1976); *Thomas v. Roblin Indus., Inc.*, 520 F.2d 1393 (3d Cir. 1975); *Wright v. Heizner Corp.*, 411 F. Supp. 23 (N.D. Ill. 1975), *aff'd in part & rev'd in part on other grounds*, 560 F.2d 236 (7th Cir. 1977), *cert. denied*, 434 U.S. 1066 (1978); *Copperweld Corp. v. Imetal*, 403 F. Supp. 579 (W.D. Pa. 1975).

9. "[T]here has been a definite, albeit inarticulate, trend toward eventual judicial treatment of the close corporation as *sui generis*." *Galler v. Galler*, 32 Ill. 2d 16, 28, 203 N.E.2d 577, 584 (1965). *See also* *Krueger v. Gerth*, 16 N.Y.2d 802, 806, 210 N.E.2d 355, 357 (1965) (Fuld, J., dissenting).

This trend toward distinct treatment of the close corporation has reached the point where many courts are now applying separate standards for close corporations. *See, e.g.*, *Comolli v. Comolli*, 241 Ga. 471, 246 S.E.2d 278 (1978); *Wilkes v. Springside Nursing Home*, — Mass. —, 353 N.E.2d 657 (1976); *Donahue v. Rodd Electrotype Co.*, 367 Mass. 578, 328 N.E.2d 505 (1975); *Cain v. Cain*, — Mass. App. Ct. —, 334 N.E.2d 650 (1975); *68th St. Apartments, Inc. v. Lauricella*, 142 N.J. Super. 546, 362 A.2d 78 (Law Div. 1976), *aff'd*, 150 N.J. Super. 42, 374 A.2d 1222 (App. Div. 1977); *Schwartz v. Marien*, 37 N.Y.2d 487, 335 N.E.2d 334, 373 N.Y.S.2d 122 (1975).

10. Some states have enacted separate subchapters for the close corporation whose shares are not traded on any organized market. *See, e.g.*, CALIF. CORP. CODE § 158 (Deering 1977); DEL. CODE ANN. tit. 6, §§ 341-356 (1974); MD. CORP. & ASS'N CODE ANN. (1975); PA. STAT. ANN. tit. 15, §§ 1371-1386 (Purdon Supp. 1978-79); S. C. CODE §§ 12-16.22(c) (Supp. 1975).

11. The size of an enterprise need not be determinative. For example, Ford Motor Co. was a

lack of an established market for close corporation stock, and the active role of shareholders in the close corporation,¹² necessitate distinguishing this business organization from the large publicly-held corporation.¹³

State courts have been particularly willing to distinguish the close corporation in the area of the fiduciary duty of corporate managers and controlling shareholders to the minority shareholders.¹⁴ Courts have recognized that the unique characteristics of the close corporation leave many minority shareholders susceptible to oppressive squeeze-out techniques¹⁵ and thus have required a higher fiduciary duty in the close corporation context.¹⁶

Most rule 10b-5 cases involve close corporations.¹⁷ One would expect, therefore, that the two recent trends in corporate law, the narrowing of rule 10b-5 and the increasing recognition of the separate status of the close corporation, would result in a third important development—the distinction of close corporations in the application of rule 10b-5. Courts, however, have limited the ambit of rule 10b-5 without distinguishing the close corporation from the publicly-held corpora-

close corporation until 1955. *See generally* 1 F. O'NEAL, CLOSE CORPORATIONS: LAW AND PRACTICE § 1.03 (2d ed. 1971).

12. Most courts and commentators consider these three elements to be crucial in distinguishing the close corporation. *See* *Galler v. Galler*, 32 Ill. 2d 16, 27, 203 N.E.2d 577, 583-84 (1965); *Donahue v. Rodd Electrotype Co.*, 367 Mass. 578, —, 328 N.E.2d 505, 511 (1975). *See generally* 1 F. O'NEAL, *supra* note 11, at § 1.07. For varying definitions of the close corporation, see H. HENN, HANDBOOK OF THE LAW OF CORPORATIONS § 257 (2d ed. 1970); 1 F. O'NEAL, *supra* note 11, at § 1.02; *Israels, The Close Corporation and the Law*, 33 CORNELL L.Q. 488, 491 (1948).

13. Commentators have noted the judicial tolerance for close corporation practices that deviate from those of the publicly-held corporation. *See, e.g.*, *Hornstein, Stockholders' Agreements in the Closely Held Corporation*, 59 YALE L.J. 1040 (1950); Note, *Dissolution of the Close Corporation*, 41 ST. JOHN'S L. REV. 239 (1966). *See generally* F. O'NEAL, "SQUEEZE-OUTS" OF MINORITY SHAREHOLDERS: EXPULSION OR OPPRESSION OF BUSINESS ASSOCIATES § 7.14 (1975).

14. *See, e.g.*, *Comolli v. Comolli*, 241 Ga. 471, 246 S.E.2d 278 (1978); *Wilkes v. Springside Nursing Home*, — Mass. —, 353 N.E.2d 657 (1976); *Donahue v. Rodd Electrotype Co.*, 367 Mass. 578, 328 N.E.2d 505 (1975); *Cain v. Cain*, — Mass. App. Ct. —, 334 N.E.2d 650 (1975); 68th St. Apartments, Inc. v. Lauricella, 142 N.J. Super. 546, 362 A.2d 78 (Law Div. 1976), *aff'd*, 150 N.J. Super. 47, 374 A.2d 1222 (App. Div. 1977).

15. *See generally* F. O'NEAL, *supra* note 13, at § 1.01. In the leading treatise on the subject of squeeze-outs of minority shareholders, Professor O'Neal focuses almost exclusively on squeeze-outs in close corporations. *Id.*

16. *See* notes 183-84 *infra*. Recently, Delaware courts have required a higher fiduciary duty in publicly-held as well as close corporations. *See* note 185 *infra*.

17. "The archetypal 10b-5 case is the purchase by one group in a closed corporation of the interest of another . . ." 1 A. BROMBERG, SECURITIES LAW: FRAUD § 4.2 (1975).

tion.¹⁸ This Note evaluates the deficiencies inherent in this approach and the need for distinct application of rule 10b-5 to close corporations. It begins by reviewing the history of judicial interpretation of rule 10b-5 and its recent narrowing through a revitalization of the purchaser-seller requirement¹⁹ and the corporate mismanagement exception.²⁰ The Note then explores the problems inherent in the current restrictive approach to rule 10b-5, which fails to distinguish close corporations,²¹ and argues that courts could eliminate these problems by refusing to apply the rule to close corporations.²² The Note concludes by assessing the importance of narrowing rule 10b-5 to create optimal corporate laws and maintain consistency and certainty in the securities market.²³

II. RULE 10B-5

Rule 10b-5 provides a federal remedy for fraud in securities transactions.²⁴ Courts have interpreted the rule as requiring three elements:²⁵ a fraud or misrepresentation,²⁶ a purchase or sale of a security,²⁷ and that the fraud or misrepresentation occur "in connection with" the

18. In *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6 (1971), Justice Douglas asserted:

[T]he fact that the transaction is not conducted through a securities exchange or an organized over-the-counter market is irrelevant

[W]e 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.

Id. at 10, 12. See generally 1 A. BROMBERG, *supra* note 17, at § 4.2(70-71); 2 F. O'NEAL, *supra* note 11, at § 8.16. See also *Rochez Bros., Inc. v. Rhoades*, 491 F.2d 402 (3d Cir.), *cert. denied*, 425 U.S. 993 (1973); *Fratt v. Robinson*, 203 F.2d 627 (9th Cir. 1953); *Rude v. Campbell Square, Inc.*, 411 F. Supp. 1040 (D.S.D. 1976); *Bronstein v. Bronstein*, 407 F. Supp. 925 (E.D. Pa. 1976); *Siciliano v. Siciliano*, 405 F. Supp. 814 (W.D. Pa. 1975), *aff'd*, 546 F.2d 419 (3d Cir. 1976); *Allen Organ v. North Am. Rockwell Corp.*, 363 F. Supp. 1117 (E.D. Pa. 1973).

19. See notes 43-56 *infra* and accompanying text.

20. See notes 57-111 *infra* and accompanying text.

21. See notes 112-28 *infra* and accompanying text.

22. See notes 129-238 *infra* and accompanying text.

23. See notes 239-41 *infra* and accompanying text.

24. See note 4 *supra*.

25. In addition to the three requirements listed, see text accompanying notes 26-28 *infra*, a claimant must show a nexus between the violation and "any means or instrumentality of interstate commerce." 17 C.F.R. § 240.10b-5 (1978); see note 4 *supra*. Courts, however, have construed this requirement so broadly that it is not a primary requirement of a 10b-5 claim. See generally F. O'NEAL, *supra* note 13, at § 5.09.

26. See, e.g., *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977); *Popkin v. Bishop*, 464 F.2d 714 (2d Cir. 1972); *O'Neill v. Maytag*, 339 F.2d 764 (2d Cir. 1964).

27. See *Birnbaum v. Newport Steel Co.*, 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952). See also *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975).

purchase or sale of a security.²⁸ The courts, however, have had difficulty determining the precise scope of the rule²⁹ because its language is ambiguous. The rule, for instance, does not expressly provide for a private cause of action³⁰ or that private transactions in close corporation securities³¹ fall within its purview. Furthermore, the rule does not delineate the scope of its three basic requirements.³² Consequently, courts have vacillated between a narrow and a broad reading of the rule.³³

*Birnbaum v. Newport Steel Corp.*³⁴ marked the seminal interpretation of the scope of rule 10b-5. In *Birnbaum*, minority shareholders brought suit after the controlling shareholder rejected an offer of merger, which would have been highly profitable to all shareholders, in favor of selling his controlling stock at a premium.³⁵ Plaintiffs contended that this premium sale, together with certain misrepresentations, constituted

28. See *Birnbaum v. Newport Steel Co.*, 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952). See also *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6 (1971).

29. See generally Bauman, *The Future of Rule 10b-5: A Comment on Jacobs, The Impact of Rule 10b-5*, 4 SEC. REG. L.J. 332 (1976); Jacobs, *The Role of the Securities Exchange Act Rule 10b-5 in the Regulation of Corporate Management*, 59 CORNELL L. REV. 27 (1973); Note, *Federal "Going Private" Standard: A New Direction for the Second Circuit?*, 45 FORDHAM L. REV. 427 (1976).

30. Some commentators point out that the rule's drafters did not intend to provide a private right of action. See 6 L. LOSS, *SECURITIES REGULATION* 3870 (3d ed. 1969); O'Neal & Janke, *Utilizing Rule 10b-5 for Remediating Squeeze-Outs or Oppression of Minority Shareholders*, 16 B.C. IND. & COM. L. REV. 327, 331 (1975); Ruder, *Civil Liability Under Rule 10b-5: Judicial Revision of Legislative Intent?*, 57 NW. U.L. REV. 627, 632-38 (1963). The judiciary has developed the private right of action under rule 10b-5. See *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 13 n.9 (1971); *Holdsworth v. Strong*, 545 F.2d 687 (10th Cir. 1976), *cert. denied*, 430 U.S. 955 (1977); *Schaefer v. First Nat'l Bank*, 509 F.2d 1287 (7th Cir. 1975), *cert. denied*, 425 U.S. 943 (1976); *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946). Many courts have upheld a rule 10b-5 private right of action without discussion. See, e.g., *Rochez Bros., Inc. v. Rhoades*, 491 F.2d 402 (3d Cir. 1973), *cert. denied*, 425 U.S. 993 (1976); *Janigan v. Taylor*, 344 F.2d 781 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965); *Rude v. Campbell Square, Inc.*, 411 F. Supp. 1040 (D.S.D. 1976). See generally 1 A. BROMBERG, *supra* note 17, at § 2.4(1) n.47 (27).

31. See Patton, *The "Purchase or Sale" Restriction of SEC Rule 10b-5: Judicial Extension of a Federal Remedy*, 18 CATH. U.L. REV. 463 (1968). See generally 2 F. O'NEAL, *supra* note 11, at § 8.16; 64 HARV. L. REV. 1018 (1951).

32. See notes 26-28 *supra*.

33. Compare *Birnbaum v. Newport Steel Co.*, 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952), with *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6 (1971); *Green v. Santa Fe Indus., Inc.*, 533 F.2d 1283 (2d Cir.), *rev'd*, 430 U.S. 462 (1977); *Marshel v. AFW Fabric Corp.*, 533 F.2d 1277 (2d Cir.), *vacated*, 429 U.S. 881 (1977). Compare *Schoenbaum v. Firstbrook*, 405 F.2d 200 (2d Cir.), *rev'd on other grounds*, 405 F.2d 215 (2d Cir. 1968), *cert. denied*, 395 U.S. 906 (1969), and *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977), with *Popkin v. Bishop*, 464 F.2d 714 (2d Cir. 1972).

34. 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952).

35. *Id.* at 462.

fraud within the ambit of rule 10b-5.³⁶ The Second Circuit denied relief, holding that section 10(b) was "directed solely at the type of misrepresentation or fraudulent practice usually associated with the sale or purchase of securities rather than at fraudulent mismanagement of corporate affairs, and that rule 10b-5 extended protection only to defrauded purchasers or sellers."³⁷ This language later became known as the *Birnbaum* doctrine.

Courts³⁸ and commentators³⁹ often cite the *Birnbaum* doctrine for the proposition that plaintiff must be a purchaser or seller of a security to have standing under rule 10b-5. The doctrine, however, narrows the scope of the rule in two distinct ways.⁴⁰ First, the *Birnbaum* doctrine limits the class of plaintiffs who can assert claims under rule 10b-5 by granting standing only to actual purchasers and sellers of securities.⁴¹ Second, it limits the class of defendants cognizable under the rule by requiring that their fraudulent activities be of the kind "usually associated" with securities transactions rather than merely corporate mismanagement.⁴² These two limitations have come to be known as the purchaser-seller requirement and the corporate mismanagement exception. Both doctrines have served as important vehicles for judicial expansion and contraction of the scope of rule 10b-5.

Turning first to the purchaser-seller requirement, the courts, following *Birnbaum*, began to transform the limitation to facilitate access to the federal courts.⁴³ In accordance with the views of various commentators,⁴⁴ courts began to erode the vitality of the purchaser-seller re-

36. *Id.*

37. *Id.* at 464.

38. See *Chasin v. Mencher*, 255 F. Supp. 545 (S.D.N.Y. 1965); *O'Neill v. Maytag*, 230 F. Supp. 235 (S.D.N.Y.), *aff'd*, 339 F.2d 764 (2d Cir. 1964); *Cooper v. North Jersey Trust Co.*, 226 F. Supp. 972 (S.D.N.Y. 1964).

39. See *Boone & McGowan, Standing to Sue Under SEC Rule 10b-5*, 49 TEX. L. REV. 617 (1971); *Lowenfels, The Demise of the Birnbaum Doctrine: A New Era for Rule 10b-5*, 54 VA. L. REV. 268 (1968); *Ruder, Current Developments of the Federal Law of Corporate Fiduciary Relations: Standing to Sue Under Rule 10b-5*, 26 BUS. LAW. 1289 (1971).

40. See Note, *SEC Rule 10b-5— "In Connection With the Purchase or Sale of Any Security" Restriction: Need for Analytical Precision*, 5 COLUM. J. LAW & SOC. PROB. 28, 29 (1969).

41. *Id.*

42. *Id.*

43. See *Mutual Shares Corp. v. Genesco, Inc.*, 384 F.2d 540 (2d Cir. 1967); *A.T. Brod & Co. v. Perlow*, 375 F.2d 393 (2d Cir. 1967); *Vine v. Beneficial Fin. Co.*, 374 F.2d 627 (2d Cir.), *cert. denied*, 389 U.S. 970 (1967).

44. See *Boone & McGowan, supra* note 39; *Fuller, Another Demise of the Birnbaum Doctrine: "Tolls the Knell of Parting Day"?*, 25 U. MIAMI L. REV. 131 (1970); *Lowenfels, supra* note 39;

quirement⁴⁵ by recognizing exceptions for sales,⁴⁶ de facto sales,⁴⁷ aborted purchases and sales,⁴⁸ injunctive actions,⁴⁹ and derivative suits.⁵⁰ Further, some courts completely repudiated the requirement.⁵¹

In *Blue Chip Stamps v. Manor Drug Stores*,⁵² the Supreme Court reversed this trend by reaffirming the vitality of the *Birnbaum* standing limitations.⁵³ The Court held that a nonshareholder, who claimed to have been dissuaded from purchasing shares of stock by fraudulent statements, could not sue under rule 10b-5.⁵⁴ Although the Court did not specifically address any of the judicially-created exceptions to *Birnbaum*, *Blue Chip* raises doubts⁵⁵ about their continued validity.⁵⁶

The corporate mismanagement exception, like the purchaser-seller

Ruder, *supra* note 39. *But see* Bradford, *Rule 10b-5: The Search for a Limiting Doctrine*, 19 *BUFFALO L. REV.* 205 (1970); 10 *B.C. IND. & COM. L. REV.* 313 (1969).

45. Courts relaxed the *Birnbaum* purchaser-seller requirement by including within its scope investors who had suffered injury from a securities fraud, but who had not in fact purchased or sold securities. *See, e.g.*, *Eason v. General Motors Acceptance Corp.*, 490 F.2d 654 (7th Cir. 1973), *cert. denied*, 416 U.S. 960 (1974); *James v. Gerber Prods. Co.*, 483 F.2d 944 (6th Cir. 1973); *Crane Co. v. Westinghouse Air Brake Co.*, 419 F.2d 787 (2d Cir. 1969), *cert. denied*, 400 U.S. 822 (1970); *Vine v. Beneficial Fin. Co.*, 374 F.2d 627 (2d Cir.), *cert. denied*, 389 U.S. 970 (1967).

46. *Vine v. Beneficial Fin. Co.*, 374 F.2d 627 (2d Cir.), *cert. denied*, 389 U.S. 970 (1967).

47. *James v. Gerber Prods. Co.*, 483 F.2d 944 (6th Cir. 1973).

48. *A.T. Brod & Co. v. Perlow*, 375 F.2d 393 (2d Cir. 1967); *Stockwell v. Reynolds & Co.*, 252 F. Supp. 215 (S.D.N.Y. 1965).

49. *E.g.*, *Landy v. FDIC*, 486 F.2d 139 (3d Cir. 1973), *cert. denied*, 416 U.S. 960 (1974); *Vincent v. Moench*, 473 F.2d 430 (10th Cir. 1973); *GAF Corp. v. Milstein*, 453 F.2d 709 (2d Cir. 1971), *cert. denied*, 406 U.S. 910 (1972); *Mutual Shares Corp. v. Genesco, Inc.*, 384 F.2d 540 (2d Cir. 1967).

50. *E.g.*, *Herpich v. Wallace*, 430 F.2d 792 (5th Cir. 1970); *Britt v. Cyril Bath Co.*, 417 F.2d 433 (6th Cir. 1969); *Schoenbaum v. Firstbrook*, 268 F. Supp. 385 (S.D.N.Y. 1967), *rev'd on other grounds*, 405 F.2d 215 (2d Cir. 1968), *cert. denied*, 395 U.S. 906 (1969).

51. *See, e.g.*, *Manor Drug Stores v. Blue Chip Stamps*, 492 F.2d 136 (9th Cir. 1973), *rev'd*, 421 U.S. 723 (1975); *Eason v. General Motors Acceptance Corp.*, 490 F.2d 654 (7th Cir. 1973), *cert. denied*, 416 U.S. 960 (1974); *Karvelas v. Sellas*, 376 F. Supp. 1010 (N.D. Ill. 1974); *Tully v. Mott Supermarkets, Inc.*, 337 F. Supp. 834 (D.N.J. 1972), *rev'd*, 540 F.2d 187 (3d Cir. 1976).

52. 421 U.S. 723 (1975).

53. *Id.* at 733.

54. *Id.* at 755.

55. In response to *Blue Chip*, recent judicial decisions have rigidly applied the purchaser-seller requirement. *See, e.g.*, *Thomas v. Roblin Indus., Inc.*, 520 F.2d 1393 (2d Cir. 1975) (trustee in bankruptcy lacks standing to sue under rule 10b-5); *Copperweld Corp. v. Imetal*, 403 F. Supp. 579 (W.D. Pa. 1975) (nonpurchaser lacks standing to seek injunctive relief); *Thompson v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 401 F. Supp. 111 (W.D. Okla. 1975) (upheld aborted purchaser-seller exception to rule 10b-5 applicability).

56. *See* Gallagher, *10b-5 After Blue Chip Stamps: How Stands the Judicial Oak?*, 80 *DICK. L. REV.* 1 (1975); *Jacobs, Standing to Sue Under 10b-5 After Blue Chip Stamps*, 3 *SEC. REG. L.J.* 387 (1976).

requirement, also has a circular history. After a period of acceptance,⁵⁷ the doctrine lay dormant⁵⁸ until the Supreme Court suddenly revitalized it in *Santa Fe Industries, Inc. v. Green*,⁵⁹ This exception precludes a rule 10b-5 action where the cause of action is essentially for corporate mismanagement, including such conduct as "conflict of interest transactions, . . . compensation, premium sales of control, division of corporate opportunities—in short the whole gamut usually associated with duties of care and loyalty."⁶⁰ It bars the application of rule 10b-5 on the ground that the states have the primary responsibility for protecting individuals from management overreaching.⁶¹ Further, Congress passed section 10(b) of the 1934 Securities Exchange Act to deal with the narrow problem of fraud in direct securities transactions.⁶² A federal court will only allow a rule 10b-5 corporate mismanagement claim if the allegation meets the "deception" test⁶³ under the rule's fraud re-

57. See I A. BROMBERG, *supra* note 17, at § 4.7(532) and authorities cited therein.

58. In *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6 (1971), the Court noted:

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.

. . . .
We agree that Congress by § 10(b) did not seek to regulate transactions which constitute no more than internal corporate mismanagement. 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 The controlling stockholder owes the corporation a fiduciary obligation

Id. at 11-12. See *Popkin v. Bishop*, 464 F.2d 714, 718 (2d Cir. 1972) ("assertions by a defendant that the misconduct . . . amounts to 'just' corporate mismanagement will not cut off a plaintiff's federal remedy"); *Drachman v. Harvey*, 453 F.2d 722, 725-30 (2d Cir.), *rev'd on other grounds on rehearing en banc*, 453 F.2d 736 (2d Cir. 1972) (no defense to rule 10b-5 claim that alleged wrongdoing is unassailable under state law); *McClure v. Borne Chem. Co.*, 292 F.2d 824, 834 (3d Cir. 1961), *cert. denied*, 368 U.S. 939 (1961) (rule 10b-5 not subordinated to, or limited by, state law). See also *Hanraty v. Ostertag*, 470 F.2d 1096, 1098 (10th Cir. 1972); *Rekant v. Desser*, 425 F.2d 872, 881-82 (5th Cir. 1970); *Britt v. Cyril Bath Co.*, 417 F.2d 433 (6th Cir. 1969); *Dasho v. Susquehanna Corp.*, 380 F.2d 262 (7th Cir.), *cert. denied*, 389 U.S. 977 (1967).

59. 430 U.S. 462 (1977).

60. I A. BROMBERG, *supra* note 17, at § 4.7(531).

61. See, e.g., *Herpich v. Wallace*, 430 F.2d 792, 808 (5th Cir. 1970); *Mutual Shares Corp. v. Genesco, Inc.*, 384 F.2d 540, 546 (2d Cir. 1967); *Dasho v. Susquehanna Corp.*, 380 F.2d 262, 269-70 (7th Cir.), *cert. denied*, 389 U.S. 977 (1967).

62. See note 4 *supra*.

63. For the purposes of this Note, the term, "deception," includes manipulation of securities transactions. Recent Supreme Court cases, however, have distinguished the deception and manipulation requirements. See *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 474-77 (1977); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195, 199 n.21, 205 (1976).

In *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977), Justice White noted that manipulation is a term of art when used in reference to the securities market. He defined manipulation as "artificially affecting market activity in order to mislead investors." *Id.* at 477.

quirement and the alleged fraud has the requisite connection with the purchase or sale of a security.⁶⁴

Courts have vacillated in their approach to the deception requirement.⁶⁵ Many courts initially held fraudulent mismanagement of corporate affairs actionable under rule 10b-5 only if the claimed deception arose from misstatement or nondisclosure.⁶⁶ This strict standard, however, created difficulties because of the possibility of manipulating securities transactions through the use of a controlling influence in the corporation as well as through deception.⁶⁷ Thus, in *Schoenbaum v. Firstbrook*,⁶⁸ the Second Circuit abandoned the deception test and held that a defendant's misuse of his controlling position for his own benefit could constitute a violation of rule 10b-5.⁶⁹ But in *Popkin v. Bishop*,⁷⁰ the same court rejected this "controlling influence" test and found no violation of rule 10b-5 despite allegations of unfairness due to a controlling influence because defendant had made a full disclosure of all material facts.⁷¹

The Supreme Court, in *Santa Fe Industries, Inc. v. Green*,⁷² recently resolved the confusion over the applicable standard for the deception requirement. In *Green*, a parent company merged with its ninety-five percent-owned subsidiary pursuant to a Delaware short-form merger statute for the avowed purpose of squeezing-out minority shareholders.⁷³ Although the parent strictly complied with the statutory require-

64. For discussions of the application of rule 10b-5 to corporate mismanagement cases, see, e.g., Jacobs, *supra* note 29; Susman, *Use of Rule 10b-5 as a Remedy for Minority Shareholders of Close Corporations*, 22 BUS. LAW. 1193 (1967); Note, *supra* note 3.

65. Compare *Herpich v. Wallace*, 430 F.2d 792 (5th Cir. 1970); *Dasho v. Susquehanna Corp.*, 380 F.2d 262 (7th Cir.), *cert. denied*, 389 U.S. 977 (1967); *Vine v. Beneficial Fin. Co.*, 374 F.2d 627 (2d Cir.), *cert. denied*, 389 U.S. 970 (1967), and *Ruckle v. Roto Am. Corp.*, 339 F.2d 24 (2d Cir. 1964), with *Drachman v. Harvey*, 453 F.2d 722 (2d Cir.), *rev'd on other grounds on rehearing en banc*, 453 F.2d 736 (2d Cir. 1972), and *Mutual Shares Corp. v. Genesco, Inc.*, 384 F.2d 540 (2d Cir. 1967).

66. See, e.g., *A.T. Brod & Co. v. Perlow*, 375 F.2d 393 (2d Cir. 1967); *O'Neill v. Maytag*, 339 F.2d 764 (2d Cir. 1964); *Pettit v. American Stock Exch.*, 217 F. Supp. 21 (S.D.N.Y. 1963). See generally Note, *supra* note 3, at 1014-22.

67. See Note, *supra* note 3, at 1016.

68. 405 F.2d 200 (2d Cir.), *rev'd on other grounds on rehearing en banc*, 405 F.2d 215 (2d Cir. 1968), *cert. denied*, 395 U.S. 906 (1969); accord, *Green v. Santa Fe Indus., Inc.*, 533 F.2d 1283 (2d Cir. 1976), *rev'd*, 430 U.S. 462 (1977); *Marshel v. AFW Fabric Corp.*, 533 F.2d 1277 (2d Cir. 1976), *vacated*, 429 U.S. 881 (1977).

69. 405 F.2d at 211.

70. 464 F.2d 714 (2d Cir. 1972).

71. *Id.* at 727.

72. 430 U.S. 462 (1977).

73. *Id.* at 465-67.

ments and furnished shareholders with all relevant information, the squeezed-out shareholders brought suit seeking rescission and damages under section 10(b) and rule 10b-5.⁷⁴ The Court held that "the claim of fraud or breach of fiduciary duty . . . states a cause of action . . . only if the conduct alleged can be fairly viewed as manipulative or deceptive within the meaning of the statute."⁷⁵ Since the defendants had executed the merger pursuant to the relevant statute and had not made a material misrepresentation or omitted to state a material fact, the Court found there was no violation of the section 10(b) or rule 10b-5 deception test.⁷⁶

In addition to the deception requirement, the requisite relationship between the deception and the securities transaction must also exist for a rule 10b-5 cause of action. In short, the claim must meet the "in connection with" requirement.⁷⁷ A case, of course, meets the "in connection with" requirement when the fraud concerns the value or consideration offered in exchange for the securities.⁷⁸ The "in connection with" problem, however, becomes more significant when the securities transaction is part of a larger scheme to defraud the corporation.⁷⁹ In this context, one must determine whether the necessary nexus exists between the transaction and the fraud.⁸⁰

Courts, at first, strictly construed the statutory language and required a very close connection between the transaction and the fraud.⁸¹ The *Birnbaum* case, though referring to the "in connection with" requirement only in dictum, set the model of strict construction for subsequent cases.⁸² Courts have interpreted *Birnbaum* as requiring that the purchase or sale of securities be "at the crux" of the fraudulent scheme.⁸³

74. *Id.* at 465.

75. *Id.* at 473-74.

76. *Id.* at 474. The Court also noted that the conduct was not manipulative within the meaning of the statute. *Id.* at 476-77.

77: See 1 A. BROMBERG, *supra* note 17, at § 4.7 (570-76).

78. *Id.* See Note, *supra* note 3, at 1010.

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

80. *Id.*

81. *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461, 466 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952).

82. See, e.g., *Hoover v. Allen*, 241 F. Supp. 213 (S.D.N.Y. 1965) "[R]elief [for the minority shareholder] will not be judicially available until the words 'in connection with the purchase or sale' . . . are interpreted less restrictively than in *Birnbaum* . . ." *Id.* at 229.

83. See *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 300 F. Supp. 1083 (S.D.N.Y. 1969), *rev'd*, 404 U.S. 6 (1971), where the court noted:

In 1971, in *Superintendent of Insurance v. Bankers Life & Casualty Co.*,⁸⁴ the Supreme Court reversed the trend of strictly construing the "in connection with" language of rule 10b-5.⁸⁵ Justice Douglas, writing for a unanimous Court, rejected the lower court's requirement⁸⁶ that the purchase or sale be "at the crux of the fraudulent scheme"⁸⁷ or "be the sole object of the fraud."⁸⁸ Rather, the Court required that the injury result from "deceptive practices touching its sale of securities."⁸⁹

In order to sustain a complaint alleging fraud under [rule 10b-5] it must appear with reasonable clarity from the face of the complaint either (1) that a purchase or sale of securities is at the crux of a fraudulent scheme; or (2) that inducing a purchase or sale of securities is the object of a fraudulent scheme; or (3) that fraudulent statements, misstatements, or omissions are made in a manner which is reasonably calculated to influence the investing public, or are of the sort which the reasonable investing public might rely upon; or (4) that the trading process is abused through potential market manipulation or the spread of watered stock.

Id. at 1101. See generally Cox, *Fraud Is in the Eyes of the Beholder: Rule 10b-5 Application to Acts of Corporate Mismanagement*, 47 N.Y.U.L. REV. 674, 680 (1972). See also *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579, 595 (5th Cir.) (purchase must be central to the fraud), *cert. denied*, 419 U.S. 873 (1974); *Drachman v. Harvey*, 453 F.2d 722, 732 (2d Cir. 1971), *rev'd on rehearing en banc*, 453 F.2d 736 (2d Cir. 1972) (fraud must be intrinsic to security transaction); *Herpich v. Wallace*, 430 F.2d 792, 808-09 (5th Cir. 1970) (purchase or sale must be subject or purpose of scheme); *Bailey v. Meister Brau, Inc.*, 320 F. Supp. 539, 543 (N.D. Ill. 1970) (no rule 10b-5 action if purchase is incidental); *Kaminsky v. Abrams*, 281 F. Supp. 501, 505 (S.D.N.Y. 1968) (peripheral connection insufficient).

84. 404 U.S. 6 (1971).

85. Bankers Life & Casualty Co., agreed to sell its wholly owned subsidiary, Manhattan Casualty Co., to James Begole for five million dollars. Prior to the closing, Begole arranged to pay the purchase price with a check issued by Irving Trust Co. Since Begole had no funds on deposit with Irving, he caused Manhattan, after acquiring the company, to sell its government bonds to cover the five million dollar check. Begole and the other conspirators concealed their scheme by manipulating the corporate books. *Id.* at 7.

86. The district court, 300 F. Supp. 1083 (S.D.N.Y. 1969), held that the plaintiffs did not state a cause of action cognizable under rule 10b-5. First, the court noted that Congress had enacted § 10(b) to maintain the integrity of the securities market. *Id.* at 1101. Since Manhattan sold the bonds for their full value, the court reasoned that the integrity of the securities market had not been impaired by the misappropriation of the proceeds after the sale. The court also asserted that the fraud did not lie at the "crux" of the securities transaction. *Id.* at 1098. The Second Circuit, 430 F.2d 355 (2d Cir. 1970), affirmed using essentially the same rationale. *Id.* at 367.

87. 300 F. Supp. 1083, 1101 (S.D.N.Y. 1969).

88. 430 F.2d 355, 360 (2d Cir. 1970).

89. 404 U.S. at 12-13. The Supreme Court's interpretation of the "in connection with" clause is unusually broad. Based on the facts presented, the Court could have concluded that the fraudulent misappropriation was at the crux of the security transaction or that the misappropriation could not be separated from the security transaction. That the Court reevaluated the connection necessary for a rule 10b-5 cause of action and held that the fraud "touched" the transaction indicates the liberality of the Court's interpretation. See generally Ryan, *Bankers Life: Birnbaum Reconsidered*, 4 LOY. CHI. L.J. 47 (1973); Note, *Bankers Life: Paying for a Corporation by Selling its Securities Violates 10b-5*, 1972 DUKE L.J. 465; 50 N.C.L. REV. 943 (1972).

Subsequent courts broadly interpreted *Bankers Life*⁹⁰ by treating "touching" as a synonym for "in connection with."⁹¹ Courts began using rule 10b-5 to cover all fraudulent activities,⁹² not just those usually associated with the sale or purchase of a security.⁹³ And courts applied the rule to misconduct after the sale or purchase,⁹⁴ misconduct "in connection with" someone else's sale,⁹⁵ unconsummated transactions,⁹⁶ and other situations.⁹⁷ Some courts began integrating transactions⁹⁸

90. *See* *Competitive Assocs., Inc. v. Laventhol, Krekstein, Horwath & Horwath*, 516 F.2d 811, 815 (2d Cir. 1975); *Eason v. General Motors Acceptance Corp.*, 490 F.2d 654, 659 (7th Cir. 1973); *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579, 595 (5th Cir.), *cert. denied*, 419 U.S. 873 (1974); *Landy v. FDIC*, 486 F.2d 139, 155 (3d Cir. 1973), *cert. denied*, 416 U.S. 960 (1974); *Walling v. Beverly Enterprises*, 476 F.2d 393, 396 (9th Cir. 1973); *Travis v. Anthes Imperial, Ltd.*, 473 F.2d 515, 521-22 (8th Cir. 1973); *Jannes v. Microwave Communications, Inc.*, 461 F.2d 525, 529 (7th Cir. 1972); *Crofoot v. Sperry Rand Corp.*, 408 F. Supp. 1154, 1156 (E.D. Cal. 1976); *Karvelas v. Sellas*, 376 F. Supp. 1010, 1014 (N.D. Ill. 1974); *Lewis v. Marine Midland Grace Trust Co.*, 63 F.R.D. 39, 47 (S.D.N.Y. 1973).

91. *See, e.g.*, *Competitive Assocs., Inc. v. Laventhol, Krekstein, Horwath & Horwath*, 516 F.2d 811 (2d Cir. 1975); *Eason v. General Motors Acceptance Corp.*, 490 F.2d 654 (7th Cir. 1973), *cert. denied*, 416 U.S. 960 (1974); *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579 (5th Cir.), *cert. denied*, 419 U.S. 873 (1974). *See generally* 1 A. BROMBERG, *supra* note 17, at § 4.7 (574(3)). Bromberg defines the "touching" standard as follows: "Misconduct has 'connection' with a security transaction if it has a not insignificant factual or financial relation with the transaction and affects (or touches) an investor interest in the security." *Id.*

92. In *International Inv. Trust v. Vencap Ltd.*, 519 F.2d 1001 (2d Cir. 1975), Judge Friendly said that the contours of the mismanagement exception "have been receding . . . and despite the need, under *Birnbaum* . . ., to find a connection with the purchase or sale of a security, are likely to recede still further under the continuing impact of *Bankers Life*." *Id.* at 1013-14.

93. *See* *A.T. Brod & Co. v. Perlow*, 375 F.2d 393 (2d Cir. 1967); Note, *supra* note 40, at 32.

94. *E.g.*, *Cooper v. Garza*, 431 F.2d 578, 580 (5th Cir. 1970) (*per curiam*); *Allico Nat'l Corp. v. Amalgamated Meat Cutters*, 397 F.2d 727, 729 (7th Cir. 1968); *Voegel v. American Tobacco Corp.*, 241 F. Supp. 369, 372 (D. Del. 1969); *Cooper v. North Jersey Trust Co.*, 226 F. Supp. 972, 978 (S.D.N.Y. 1964). *See also* 1 A. BROMBERG, *supra* note 17, at § 4.7 (574(3)).

95. *E.g.*, *Allico Nat'l Corp. v. Amalgamated Meat Cutters*, 397 F.2d 727 (7th Cir. 1968); *Vine v. Beneficial Fin. Co.*, 374 F.2d 627 (2d Cir.), *cert. denied*, 389 U.S. 970 (1967); *Bogess v. Hogan*, 328 F. Supp. 1048 (N.D. Ill. 1971). *See also* 1 A. BROMBERG, *supra* note 17, at § 4.7 (573(2)).

96. *Hadsell v. Hoover*, 484 F.2d 123 (10th Cir. 1973); *Walling v. Beverly Enterprises*, 476 F.2d 393 (9th Cir. 1973); *Richardson v. MacArthur*, 451 F.2d 35 (10th Cir. 1971).

97. *See* 5 A. JACOBS, *THE IMPACT OF RULE 10B-5*, § 38.01b (2-34) (1978) and authorities cited therein.

98. *See, e.g.*, *Coffee v. Permian Corp.*, 434 F.2d 383 (5th Cir. 1970) (upheld entire claim though plaintiff had standing on only one transaction), *cert. denied*, 412 U.S. 920 (1973); *Shell v. Hensley*, 430 F.2d 819 (5th Cir. 1970) (upheld entire claim though parts were nonsecurities transactions); *Herpich v. Wallace*, 430 F.2d 792 (5th Cir. 1970) (corporation could sue for all transactions though only some involved breaches). *See also* *Jannes v. Microwave Communications, Inc.*, 461 F.2d 525 (7th Cir. 1972); *Voegel v. American Tobacco Corp.*, 421 F. Supp. 369 (D. Del. 1969); *Cooper v. North Jersey Trust Co.*, 226 F. Supp. 972 (S.D.N.Y. 1964). *But see* *Haberman v. Murchison*, 468 F.2d 1305, 1313 (2d Cir. 1972); *Schoenbaum v. Firstbrook*, 268 F. Supp. 385, 390 (S.D.N.Y. 1967), *aff'd*, 405 F.2d 200 (2d Cir.), *rev'd on rehearing en banc*, 405 F.2d 215 (2d Cir.

and permitting "recovery for otherwise unassailable transactions by viewing a scheme involving many transactions as though they were one plan."⁹⁹ For example, in *Drachman v. Harvey*,¹⁰⁰ the Second Circuit upheld a rule 10b-5 claim by linking as one scheme¹⁰¹ two transactions,¹⁰² "neither of which standing alone would violate rule 10b-5."¹⁰³

But in light of the recent Supreme Court trend limiting rule 10b-5, many lower courts have begun to strictly construe the "in connection with" requirement.¹⁰⁴ In *Bio-Medical Sciences, Inc. v. Weinstein*,¹⁰⁵ the court narrowed the "in connection with" requirement by relying on *Blue Chip Stamps*,¹⁰⁶ even though the latter case does not deal directly with the nexus element. Most courts, however, have justified a closer nexus based on a narrow reading of *Bankers Life*.¹⁰⁷ For example, in *Ketchum v. Green*¹⁰⁸ and *Tully v. Mott*,¹⁰⁹ the Third Circuit rendered a strict interpretation of the *Bankers Life* "touch" test to limit rule 10b-5 and discourage the incursion of federal courts into activities regulated

1968), *cert. denied*, 395 U.S. 906 (1969); *Hoover v. Allen*, 241 F. Supp. 213, 228-29 (S.D.N.Y. 1965).

99. See 5a A. JACOBS, *supra* note 97, at § 115.02 (5-12).

100. 453 F.2d 722 (2d Cir.), *rev'd on rehearing en banc*, 453 F.2d 736 (2d Cir. 1971).

101. In the first hearing of the *Drachman* case, before *Bankers Life*, the court refused to link the "two transactions." *Id.* at 731.

102. 453 F.2d 736 (2d Cir. 1971) (en banc).

103. 453 F.2d at 732.

104. See *St. Louis Union Trust Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.* 562 F.2d 1040 (8th Cir. 1977) (executors brought suit alleging the corporation exercised its stock transfer restriction to further a fraudulent scheme; court held that the transaction did not meet the "in connection with" requirement because the loss was due to the stock transfer restriction or the shareholder's death and not a material nondisclosure), *cert. denied*, 435 U.S. 925 (1978); *Ketchum v. Green*, 557 F.2d 1022 (3d Cir.), *cert. denied*, 434 U.S. 940 (1977) (strict connection requirement; no intermediate steps between fraud and security); *Imperial Supply Co. v. Northern Ohio Bank*, 430 F. Supp. 339 (N.D. Ohio 1976) (must allege nexus between the alleged rule 10b-5 violation and plaintiff's purchase of bank stock); *Bio-Medical Sciences, Inc. v. Weinstein*, 407 F. Supp. 970 (S.D.N.Y. 1976) (issuer brought suit against chief executive officer claiming he defrauded purchasers of its securities; court ruled that the "in connection with" requirement was not met because there was no direct causal nexus between the fraud and the sale); *Myers v. American Leisure Time Enterprises, Inc.*, 402 F. Supp. 213 (S.D.N.Y. 1975) (plaintiff must allege that he bought stock in connection with the claimed violation), *aff'd*, 538 F.2d 312 (2d Cir. 1976). But see *Competitive Assocs., Inc. v. Laventhol, Kreckstein, Horwath & Horwath*, 516 F.2d 811 (2d Cir. 1975); *Crofoot v. Sperry Rand Corp.*, 408 F. Supp. 1154 (E.D. Cal. 1976).

105. 407 F. Supp. 970 (S.D.N.Y. 1976).

106. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975).

107. See e.g., *Ayres v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 538 F.2d 532, 539 (3d Cir. 1976), *cert. denied*, 429 U.S. 1010 (1977); *Vincent v. Moench*, 473 F.2d 430, 434 (10th Cir. 1973); *Blackett v. Clinton E. Frank, Inc.*, 379 F. Supp. 941, 946-47 (N.D. Ill. 1974).

108. 557 F.2d 1022 (3d Cir. 1977).

109. 540 F.2d 187 (3d Cir. 1976).

by state law.¹¹⁰

This trend restricting the "in connection with" requirement will have a strong impact on the vitality of the corporate mismanagement exception. As Professor Folk noted, the "in connection with" element is the the "hadiest of the several restrictions which have been used to contain the inexorable growth of private rights of action under rule 10b-5."¹¹¹ Requiring a close connection between the fraud and the securities transaction will, of course, allow only mismanagement and self-dealing claims that are closely related to a securities transaction to be heard in federal court. And the strict construction of the "in connection with" requirement, when combined with the courts' refusal to adopt a controlling influence test for the deception element, may lead to a revitalization of the corporate mismanagement exception. With both the

110. In *Tully*, plaintiffs, class A shareholders brought suit against defendants, class C shareholders, for violating rule 10b-5 in their purchase of class A treasury shares. *Id.* at 189-91. Plaintiffs alleged that an agreement required that the treasury shares be offered first for sale to class A shareholders. *Id.* The Third Circuit held that the plaintiffs lacked standing because the alleged fraud did not have the requisite connection with the sale of securities. *Id.* at 193-94. The court asserted that the fraud did not occur in the actual sale of stock, but rather in the refusal to sell the remaining class A shares in accordance with the agreement. *Id.* at 194. By requiring a direct causal connection, the *Tully* court circumvented a loose interpretation of the *Bankers Life* "touch" test. *Id.*

In *Ketchum*, plaintiffs alleged they were fraudulently terminated from their positions as president and chairman of the board. Their discharge activated the company's stock retirement plan, forcing them to sell their stock. Plaintiffs refused to surrender their stock and brought suit to enjoin their ouster and to recover damages. *Id.* at 1023-24. The court held that defendant had not violated rule 10b-5 because the deception, if present, had not occurred in connection with the purchase or sale of a security. *Id.* at 1025. Rather, the deception occurred in connection with a struggle for control of the corporation and therefore fell within the corporate mismanagement exception. *Id.*

The *Ketchum* court relied on *Bankers Life* to support its strict interpretation of the "in connection with" requirement, asserting that the *Bankers Life* "touch" test, though commonly interpreted broadly, actually requires a close connection. *Id.* at 1027. The court construed the "touch" test as being limited by the mismanagement exception and asserted that a conflict would not be drawn under rule 10b-5 if the action essentially was for corporate mismanagement. *Id.* at 1027-28.

Ketchum's narrow interpretation of *Bankers Life*, however, seems suspect. Although Justice Douglas, in *Bankers Life*, asserted that Congress did not seek to regulate transactions that constitute no more than internal corporate mismanagement, the thrust of the opinion leans toward broadening the scope of rule 10b-5. *See Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 12 (1971).

Furthermore, in *Bankers Life*, the Court recognized a rule 10b-5 action in a fact situation that the Supreme Court today would likely perceive as falling squarely under the heading of corporate mismanagement.

The Supreme Court, however, denied certiorari in *Ketchum*, 434 U.S. 940 (1977), and it seems that the trend of narrowing the "in connection with" requirement by narrowly reading *Bankers Life* will continue.

111. Folk, *Corporation Law Developments—1969*, 56 VA. L. REV. 755, 812 (1970).

corporate mismanagement exception and the purchaser-seller requirement regaining vitality, the courts are well on their way to restricting a shareholder's ability to secure a federal remedy.

III. DETERMINING THE SCOPE OF RULE 10B-5

A. *Underlying Policy Arguments*

The narrowing of the scope of rule 10b-5 has resulted from the courts' desire to halt the intrusion of the federal securities laws into corporate management, an area traditionally reserved for the states.¹¹² Courts have asserted that Congress did not intend rule 10b-5 to create a federal corporation law¹¹³ and thus have tried to limit its use in the corporate mismanagement context.¹¹⁴ They have recognized that when courts expand the federal securities laws into the mismanagement area,¹¹⁵ even if no preemption of state law occurs as a matter of law, plaintiff's preference for the federal forum leads to preemption as a

112. As Judge Moore pointed out in his dissent to *Green v. Santa Fe Indus., Inc.*, 533 F.2d 1283 (2d Cir. 1975) (Moore, J., dissenting), *rev'd*, 430 U.S. 462 (1977), the broadening of the scope of rule 10b-5 "nullifies] not only the corporate laws of Delaware with respect to short-form corporate mergers, but also, in effect, comparable laws in an additional thirty-seven States." *Id.* at 1299. Furthermore, he asserted the plaintiffs were granted a substantive right "unrelated to the anti-fraud scheme of the federal securities laws and in complete derogation of a valid state rule regulating corporate activity." *Id.* at 1307. The Supreme Court, in *Cort v. Ash*, 422 U.S. 66 (1975), in full accord with Judge Moore's comments, said: "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. See also *Kaminsky v. Abrams*, 281 F. Supp. 501, 505 (S.D.N.Y. 1968) (federal jurisdiction "might well lead the states to abandon their creative and effective role in this area of the law"); *Condon v. Richardson*, 275 F. Supp. 943, 948 (S.D. Ill. 1967), *rev'd*, 411 F.2d 489 (7th Cir. 1969); 1 A. BROMBERG, *supra* note 17, at § 4.7 (513(1-3)).

113. Commentators have noted that rule 10b-5 is spawning a federal law of corporations. See, e.g., Bloomenthal, *From Birnbaum to Schoenbaum: The Exchange Act and Self-Aggrandizement*, 15 N.Y.L.F. 332, 349-50 (1973); Fleischer, "Federal Corporation Law": An Assessment, 78 HARV. L. REV. 1146 (1965); Jacobs, *supra* note 29, at 33-34; 55 VA. L. REV. 1103, 1120-21 (1969).

114. See *Iroquois Indus., Inc. v. Syracuse China Corp.*, 417 F.2d 963 (2d Cir. 1969), *cert. denied*, 399 U.S. 909 (1970) (rule 10b-5 should be limited in its application to areas controlled by state corporation law). See also 1 L. LOSS, *SECURITIES REGULATION* 107-11 (2d ed. 1961) (noting Congress' long resistance to total federal preemption).

115. Commentators have suggested alternatives to expansion of liability under rule 10b-5. See, e.g., Borden, *Going Private: Old Tort, New Tort, or No Tort*, 49 N.Y.U.L. REV. 987, 1037 (1976) (return regulatory power to the states); Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 701-03 (1974) (rejects notion of a federal corporation law as politically unrealistic and suggests as an alternative a "federal Corporate Uniformity Act," which would impose nationwide uniform corporate responsibility standards). See generally Note, *supra* note 29, at 450.

matter of fact.¹¹⁶

The threat of vexatious litigation has also spurred courts to narrow the scope of rule 10b-5.¹¹⁷ As Justice Rehnquist noted in *Blue Chip Stamps*, the plaintiff often has served as a front for lawyers interested primarily in fees payable in the final analysis by the innocent investors.¹¹⁸ In addition, Justice Rehnquist indicated that although these cases have proven difficult to win at trial, they have proven even more difficult to dispose of before trial.¹¹⁹ Inevitably, they have forced corporations into settlement because of the potential for severe disruption of business operations.

Some commentators, however, maintain that these arguments are without merit. First, they have noted that most state corporation laws reflect the interests of management.¹²⁰ These statutes were designed to

116. An important reason for the choice of the federal forum lies in the procedural advantage of suing under rule 10b-5. The Securities Exchange Act calls for exclusive jurisdiction and is accompanied by broad venue and nationwide service of process provisions. Securities Exchange Act of 1934, 15 U.S.C. § 78(aa) (1976). Furthermore, plaintiffs can sue under the Securities Exchange Act and not be subject to the state security for cost statute. See *J.I. Case Co. v. Borak*, 377 U.S. 426 (1964); *McClure v. Borne Chem. Co.*, 292 F.2d 824 (3d Cir.), cert. denied, 368 U.S. 939 (1961). The Securities Exchange Act also provides more liberal rules for payment of attorneys' fees. See *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 390-96 (1970). Finally, the Federal Rules of Civil Procedure may allow more flexibility in such matters as discovery, FED. R. CIV. P. 26-37, and class actions, FED. R. CIV. P. 23. See generally R. JENNINGS & H. MARSH, *SECURITIES REGULATION—CASES AND MATERIALS* 1047-53 (4th ed. 1977); Jennings, *Federalization of Corporation Law*, 31 BUS. LAW. 991, 1001 (1976); O'Neal & Janke, *supra* note 30, at 343-46; Note, *The Prospects for Rule 10b-5: An Emerging Remedy for Defrauded Investors*, 59 YALE L.J. 1120, 1123, 1126 (1950).

The shareholder-plaintiff was also likely to choose a federal forum because, in the past, states' substantive laws of fiduciary duties were favorable to management. This was particularly true in Delaware. See, e.g., *Sinclair Oil Corp. v. Levien*, 280 A.2d 717 (Del. 1971); *Getty Oil Co. v. Skelly Oil Co.*, 267 A.2d 883 (Del. 1970); *Cheff v. Mathes*, 41 Del. Ch. 494, 199 A.2d 548 (1964); *Hariton v. Arco Elecs., Inc.*, 41 Del. Ch. 74, 188 A.2d 123 (1963). See generally Cary, *supra* note 115; Conrad, *An Overview of the Laws of Corporations*, 71 MICH. L. REV. 623 (1973); Eisenberg, *The Model Business Corporation Act and the Model Business Corporation Act Annotated*, 29 BUS. LAW. 1407 (1974); Folk, *Some Reflections of a Corporation Law Draftsman*, 42 CONN. BAR J. 409 (1968).

117. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975).

118. *Id.* at 739. See *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 867 (2d Cir. 1968) (Friendly, J., concurring), cert. denied, 394 U.S. 976 (1969).

119. See, e.g., Boone & McGowan, *supra* note 39, at 648-49; Dooley, *The Effect of Civil Liability on Investment Banking and the New Issues Market*, 58 VA. L. REV. 776, 822-43 (1972); Sargent, *The Sec and the Individual Investor: Restoring His Confidence in the Market*, 60 VA. L. REV. 553, 562-72 (1974).

120. See, e.g., Cary, *supra* note 115, at 668 (state cannot effectively provide a responsible corporate statute); Cohen, *The Development of Rule 10b-5*, 23 BUS. LAW. 593, 596 (1968) ("one of the principal reasons for the various anti-fraud provisions of the federal securities laws . . . was the realization that the national problem could not be dealt with adequately by state law"). See

encourage entrepreneurs to incorporate within the state.¹²¹ As a result, both the statutes¹²² and the judicial decisions¹²³ have given little protection to minority shareholders.¹²⁴ Thus it has been suggested that the courts should use rule 10b-5 to provide more adequate protection for minority shareholders.¹²⁵ Further, some have argued that courts

generally Folk, *State Statutes: Their Role in Prescribing Norms of Responsible Management Control*, 31 BUS. LAW. 1031 (1976); Jennings, *supra* note 116; Kaplan, *Fiduciary Responsibility in the Management of the Corporation*, 31 BUS. LAW. 883 (1976).

121. See Folk, *supra* note 116, at 417. "The next question is whether, indeed, any state today can effectively implement interests other than those of management. . . . My considered conclusion is that this is not possible, even though many will be grieved at the thought that state power to regulate internal affairs of corporations is so drastically circumscribed." *Id.* See generally Jennings, *supra* note 116.

Traditionally, the states have had an opportunity to play an important role in providing balanced corporate regulation The inadequacy of these statutes as instruments of corporate control is common knowledge. They are essentially enabling acts with the accent upon flexibility in facilitating business transactions and providing maximum protection for managerial decisions. They contain many loopholes for an irresponsible management and a minimum of protective provisions in the interest of shareholders.

Id. at 991-92. See also Cary, *supra* note 115, at 666-71; Schwartz, *Federal Chartering of Corporations: An Introduction*, 61 GEO. L.J. 71, 74-78 (1972); Comment, *Law for Sale: A Study of the Delaware Corporation Law of 1967*, 117 U. PA. L. REV. 861 (1969).

122. The Delaware legislature has treated management especially well. As Professor Cary noted, Delaware has clearly won the "race for the bottom" and the spectre of Delaware hurts reform efforts in all of its sister states. Cary, *supra* note 115, at 666; see Folk, *supra* note 116, at 412.

123. See, e.g., *Sinclair Oil Corp. v. Levien*, 280 A.2d 717 (Del. 1971); *Getty Oil Co. v. Skelly Oil Co.*, 267 A.2d 883 (Del. 1970); *Cheff v. Mathes*, 41 Del. Ch. 494, 199 A.2d 548 (1964); *Hariton v. Arco Elecs., Inc.*, 41 Del. Ch. 74, 188 A.2d 123 (1963); *Kors v. Carey*, 39 Del. Ch. 47, 158 A.2d 136 (1960). See generally Cary, *supra* note 115; Jennings, *The Role of the States in Corporate Regulation and Investor Protection*, 23 LAW & CONTEMP. PROB. 193 (1958); Latty, *Why Are Business Corporation Laws Largely "Enabling"?*, 50 CORNELL L.Q. 599 (1965).

124. *But see, e.g.*, *Jones v. H.F. Ahmanson & Co.*, 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969); *Brown v. Halbert*, 271 Cal. App. 2d 252, 76 Cal. Rptr. 781 (1969); *Schnell v. Chris-Craft Indus., Inc.*, 285 A.2d 437 (Del. 1971), *rev'g* 285 A.2d 430 (Del. Ch. 1971); *Vendo Co. v. Stoner*, 58 Ill. 2d 289, 321 N.E.2d 1 (1974); *Kerrigan v. United Sav. Ass'n*, 58 Ill. 2d 20, 317 N.E.2d 39 (1974); *Berkowitz v. Power Mate Corp.*, 135 N.J. Super. 36, 342 A.2d 566 (App. Div. 1975); *Diamond v. Oreamuno*, 24 N.Y.2d 494, 248 N.E.2d 910, 301 N.Y.S.2d 78 (1969).

125. See *Drachman v. Harvey*, 453 F.2d 722, 729 (2d Cir. 1971) ("we are concerned here with an important enforcement provision . . . intended not only to expand the common law, but to create new, far-reaching, and uniform laws of shareholder management relations in congressionally designated areas of substantive corporation law"); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 859 (2d Cir. 1968) (rule 10b-5 was designed to reach the infinite variety of devices by which undue advantage may be taken of investors), *cert. denied*, 394 U.S. 976 (1969); *McClure v. Borne Chem. Co.*, 292 F.2d 824, 834 (2d Cir.) (§10(b) is "part of a statutory scheme which had as its purpose the creation of a new federal law of management-stockholder relations . . . impos[ing] broad fiduciary duties on management vis-a-vis the corporation and its individual stockholders"), *cert. denied*, 368 U.S. 939 (1961).

should expand rule 10b-5 to create a uniform, nationwide standard that would provide greater stability in the securities market.¹²⁶

Whether the ambit of rule 10b-5 should be expanded or restricted has been the subject of frequent debate.¹²⁷ Consequently, the courts have vacillated in their interpretation of the scope of the rule.¹²⁸ Judicial consistency may, however, be possible if courts would distinguish the close corporation in applying rule 10b-5.

B. *Distinguishing the Close Corporation*

Courts have uniformly refused to distinguish the close corporation under rule 10b-5.¹²⁹ This approach is particularly curious in light of the rule's purpose¹³⁰—to protect investors and traders in public securi-

126. See 1 A. BROMBERG, *supra* note 17, at § 4.7 (514(2-3)), where the author notes:

Although there will always be variations in approach and application, these variations are likely to be fewer and less drastic within the federal court system than among the 50 states. Uniformity becomes more appropriate as share ownership becomes more dispersed. There are strong reasons to give an owner of a security listed on the New York Stock Exchange the same protection whether the issuing company is incorporated in California or Delaware, and whether he lives in Illinois or Texas.

See generally Cohen, *supra* note 120; Rosenfeld, *An Essay in Support of the Second Circuit's Decisions in Marshel v. AFW Fabric Corp. and Green v. Santa Fe Industries, Inc.*, 5 HOFSTRA L.R. 111 (1976).

127. See notes 112-26 *supra* and accompanying text.

128. Compare *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), and *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952), with *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6 (1971); *Schoenbaum v. Firstbrook*, 405 F.2d 215 (2d Cir.), *rev'd on other grounds on rehearing en banc*, 405 F.2d 215 (2d Cir. 1968), *cert. denied*, 395 U.S. 906 (1969), and *Marshel v. AFW Fabric Corp.*, 533 F.2d 1277 (2d Cir. 1976), *vacated*, 429 U.S. 881 (1977).

129. See note 18 *supra* and accompanying text.

130. As Professor Jacobs notes, the administrative history of rule 10b-5 reveals the central reason for its promulgation. 5 A. JACOBS, *supra* note 97, at § 5.01 (1-120 to 1-125). Courts that have analyzed the administrative history of rule 10b-5 have concluded that the rule was not intended to cover fraudulent mismanagement, but only "to make the same prohibitions contained in Section 17(a) of the 1933 Act applicable to purchasers as well as to sellers." *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461, 463 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952). Furthermore, in *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969), the Second Circuit declared there is nothing "about Rule 10b-5 which demonstrates that the SEC sought by the Rule not fully to implement the Congressional purpose and objectives underlying Section 10(b)." *Id.* at 860.

The preamble and § 2, which set forth the general purposes of the Act, are the most useful evidence for determining congressional intent. See 5 A. JACOBS, *supra* note 97, at § 5.01 (1-113). The preamble announces that the purpose of the Act is to provide for the regulation of securities exchanges and over-the-counter markets operating in interstate and foreign commerce and through the mails, to prevent inequitable and unfair practices on such exchanges and markets, and for other purposes. 15 U.S.C. § 78(b) (1976).

Section 2 of the Securities Exchange Act of 1933, 15 U.S.C. § 78(j) (1976), provides:

ties.¹³¹ Thus it seems inappropriate to apply rule 10b-5 to the privately-held close corporation.¹³² The courts, however, have justified their continued application of the rule to close corporations on two grounds: (1) the vulnerability of minority shareholders, and (2) the inadequacy of the state court system.

In the close corporation, minority shareholders often leave themselves vulnerable to oppressive squeeze-out techniques.¹³³ Squeeze-outs have been defined as the "use by some owners or participants in a business enterprise of strategic position, inside information, or power of control, or the use of some legal device or technique to eliminate from the enterprise one or more of its owners or participants."¹³⁴ In the close corporation, controlling shareholders frequently use squeeze-outs to manipulate corporate decisionmaking.¹³⁵ This is facilitated by the inability of minority shareholders to avail themselves of the self-help remedy, which members of the publicly-held corporation have through the sale of their shares,¹³⁶ or entrepreneurs in a partnership have through dissolution.¹³⁷ The oppressed minority shareholder, unable to sell his shares or dissolve the corporation, must seek judicial relief.

Since the minority shareholder's suit usually includes a claim of breach of fiduciary duty by the controlling shareholders,¹³⁸ his case

"[T]ransactions in securities as commonly conducted upon the securities exchanges and over-the-counter markets are affected with a national public interest which makes it necessary to provide for regulation and control of such transactions . . ." *Id.* See generally 5 A. JACOBS, *supra* note 97, at § 5.01 (1-113).

131. The legislative and administrative histories of § 10(b) and rule 10b-5 are extremely sparse. See 5a A. JACOBS, *supra* note 97, at § 5.01 (1-109). Thus the Supreme Court has emphasized Congress' choice of words in drafting § 10(b). See, e.g., *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 472 (1977); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197 (1976).

132. See F. O'NEAL, *supra* note 13, at § 7.09.

133. *Id.* at § 1.01.

134. *Id.* For explanation of the various kinds of squeeze-out techniques, see *id.* at §§ 3.01-6.10. See also 2 F. O'NEAL, *supra* note 11, at § 8.07; Note, *Freezing Out Minority Shareholders*, 74 HARV. L. REV. 1630 (1961).

135. See generally F. O'NEAL, *supra* note 13, at § 1.07; 2 F. O'NEAL, *supra* note 11, at § 8.07.

136. See generally F. O'NEAL, *supra* note 13, at § 2.15; 2 F. O'NEAL, *supra* note 11, at § 1.07.

137. See *Donahue v. Rodd Electrotype Co.*, 367 Mass. 578, —, 328 N.E.2d 505, 515 (1975). See generally F. O'NEAL, *supra* note 13, at §§ 3.05, 3.08-.09, 3.15-.16, 9.04-.05; Note, *supra* note 13, at 240-41. See also 2 F. O'NEAL, *supra* note 11, at § 9.09, where the author suggests broadening the grounds for dissolution of close corporations.

138. See, e.g., *Wilkes v. Springside Nursing Home, Inc.*, — Mass. —, 353 N.E.2d 657 (1976); *Donahue v. Rodd Electrotype Co.*, 367 Mass. 578, 328 N.E. 2d 505 (1975); *Cain v. Cain*, — Mass. App. Ct. —, 334 N.E.2d 650 (1975); *68th St. Apartments, Inc. v. Lauricella*, 142 N.J. Super. 546, 362 A.2d 78 (Law Div. 1976), *aff'd*, 150 N.J. Super. 42, 374 A.2d 1222 (App. Div. 1977).

would ordinarily be heard in state court. In the past, however, recovery in this forum was difficult because of the state courts' reluctance to interfere in the internal affairs of the corporation.¹³⁹ In denying relief to the aggrieved shareholder, the state courts have relied on two basic principles: (1) the business judgment rule, and (2) the principle of majority rule.¹⁴⁰ The business judgment rule immunizes management from liability where the transaction is within its authority and the power of the corporation.¹⁴¹ It springs from the courts' hesitancy to substitute its judgment for that of management on business policy questions.¹⁴² The majority rule concept, in contrast, recognizes the right of the majority shareholders to govern the corporation.¹⁴³ These two principles have led many state courts¹⁴⁴ to refuse to aid squeeze-out victims unless the majority has acted in a grossly abusive manner.¹⁴⁵

Realizing the inequities of the state courts' orientation,¹⁴⁶ the federal courts have broadened the scope of rule 10b-5 to include breach of fiduciary duty within close corporations.¹⁴⁷ This extension, however, may no longer be necessary in light of a striking reversal in the state courts' approach to minority shareholders, especially in the area of fiduciary responsibilities in close corporations.¹⁴⁸

A fiduciary relationship arises when "one holds a position of superiority and influence over the interest of another such that the latter is forced to rely upon the good faith and fair dealings of the former."¹⁴⁹ This concept of a fiduciary relationship evolved slowly in the corporate setting.¹⁵⁰ At first, courts interpreted the duties of directors and officers

139. See note 123 *supra* and accompanying text.

140. See F. O'NEAL, *supra* note 13, at § 3.03.

141. *Id.*

142. See H. BALLANTINE, CORPORATIONS § 231 (rev. ed 1946).

143. See F. O'NEAL, *supra* note 13, at § 3.03.

144. See *Baron v. Allied Artists Pictures Corp.*, 337 A.2d 653 (Del. Ch. 1975); *Meyerson v. El Paso Natural Gas Co.*, 246 A.2d 789 (Del. Ch. 1967); *Hand v. Dexter*, 41 Ga. 454 (1871); *Cole Real Estate Corp. v. People's Bank & Trust Co.*, 310 N.E.2d 275 (Ind. Ct. App. 1974); *Green v. Felton*, 42 Ind. App. 675, 84 N.E. 166 (1908); *McQuade v. Stoneham*, 263 N.Y. 323, 189 N.E. 234 (1934); *Earthman's, Inc. v. Earthman*, 526 S.W.2d 192 (Tex. Civ. App. 1975).

145. See F. O'NEAL, *supra* note 13, at § 3.03.

146. See notes 120-23 *supra* and accompanying text.

147. See note 18 *supra* and accompanying text.

148. See notes 166-84 *infra* and accompanying text.

149. B. OLECK, MODERN CORPORATION LAW § 1569, at 624 (1959) (footnote omitted); *accord*, *Finch & Long, The Fiduciary Relation of the Dominant Shareholder to the Minority Shareholders*, 9 HASTINGS L.J. 306, 307 (1958). See also *Pepper v. Litton*, 308 U.S. 295, 306-07 (1939).

150. See F. O'NEAL, *supra* note 13, at § 7.13.

as running only towards the corporation.¹⁵¹ But courts later recognized that directors and officers, as well as controlling shareholders, owe a fiduciary duty to minority shareholders.¹⁵²

Although courts uniformly held that corporate management stood in a fiduciary relationship to the corporation and its shareholders, they did not maintain the same uniformity on the question of the stringency of the duty.¹⁵³ Some courts applied a lenient standard, requiring bad faith and abuse of discretion,¹⁵⁴ and other courts recognized a strict fiduciary standard.¹⁵⁵ This inconsistency could have been avoided if courts had not halted the early common law approach of distinguishing the close corporation.

At the early common law, courts applied a "strict trust"¹⁵⁶ test to determine whether the officers and directors of a close corporation had adhered to their fiduciary duty.¹⁵⁷ They maintained that the same strict fiduciary duties imposed on a trustee in the management of a trust for a beneficiary applied to the directors, officers, and controlling shareholders of a close corporation.¹⁵⁸

State courts later began to apply a more lenient standard,¹⁵⁹ requiring merely good faith and inherent fairness.¹⁶⁰ This test usually led to

151. *Id.* at § 713 n.4 and authorities cited therein.

152. *Id.* at § 713 nn.6 & 7 and authorities cited therein.

153. *Id.*

154. *See, e.g.,* *Burke v. Gulf, M. & O.R.R.*, 324 F. Supp. 1125, 1129 (S.D. Ala. 1971); *Bruce v. E.L. Bruce Co.*, 404 Del. Ch. 80, 82, 174 A.2d 29, 30 (1961); *Allied Chem. & Dye Corp. v. Steel & Tube Co.*, 14 Del. Ch. 1, 18, 120 A. 486, 494 (1923); *Gottfried v. Gottfried*, 197 Misc. 562, 565, 73 N.Y.S.2d 692, 695 (Sup. Ct. 1947); *Gaines v. Long Mfg. Co.*, 234 N.C. 331, 337, 67 S.E.2d 355, 360 (1951).

155. *See, e.g.,* *Jones v. H.F. Ahmanson & Co.*, 1 Cal. 3d 93, 111, 460 P.2d 464, 473, 81 Cal. Rptr. 592, 601 (1969); *Diamond v. Oreamuno*, 24 N.Y.2d 494, 248 N.E.2d 910, 301 N.Y.S. 2d 78 (1969). *See also* note 124 *supra* and cases cited therein.

156. *See, e.g.,* *Munson v. Syracuse, G. & C. R.R.*, 103 N.Y. 58, 74, 8 N.E. 355, 358 (1886). *See generally* 61 IOWA L. REV. 876, 887-93 (1976).

157. *Peckham v. Lane*, 81 Kan. 489, 106 P. 464 (1910); *Stewart v. Harris*, 69 Kan. 498, 77 P. 277 (1904); *Sargent v. Kansas Midland R.R.*, 48 Kan. 672, 29 P. 1063 (1892); *Kavanaugh v. Kavanaugh Knitting Co.*, 226 N.Y. 185, 123 N.E. 148 (1919); *Munson v. Syracuse, G. & C. R.R.*, 103 N.Y. 58, 8 N.E. 355 (1886).

158. *See Bayne, supra* note 156. For later cases that analogize a corporate trustee's duties to the duties of a common law trustee, see *Jones v. H.F. Ahmanson & Co.*, 1 Cal. 3d 93, 111, 460 P.2d 464, 473, 81 Cal. Rptr. 592, 601 (1969); *Zampetti v. Cavanaugh*, 406 Pa. 259, 267, 176 A.2d 906, 910 (1961); *Point Trap Co. v. Manchester*, 98 R.I. 49, 54, 199 A.2d 592, 596 (1964).

159. *Bastain v. Bourns, Inc.*, 256 A.2d 680 (Del. Ch. 1969), *aff'd*, 278 A.2d 467 (Del. 1970); *Agatucci v. Corradi*, 327 Ill. App. 153, 63 N.E.2d 630 (1945); *Everett v. Phillips*, 288 N.Y. 227, 43 N.E.2d 18 (1942). For an analysis of the difference between the strict trust approach and the good faith-inherent fairness standard, see 61 IOWA L. REV. 876, 890-93 (1976).

160. Some courts treated the fiduciary duties of directors as running only in favor of the cor-

a denial of relief for minority shareholders.¹⁶¹ For unlike the strict trust approach, which voided a transaction if a plaintiff could show a conflict of interest,¹⁶² the good faith-inherent fairness test allowed the corporate manager or majority shareholder engaged in a conflict of interest transaction to escape liability by proving its inherent fairness¹⁶³—a task that often proved to be relatively easy.¹⁶⁴ Thus the federal courts were forced to extend rule 10b-5 to grant relief to oppressed close corporation shareholders.¹⁶⁵

Some state courts, however, have recently returned to the strict trust standard.¹⁶⁶ Most notably, a series of Massachusetts cases¹⁶⁷ have applied a standard of “utmost good faith and loyalty”¹⁶⁸ to the other shareholders.

In *Donahue v. Rodd Electrotpe Co.*¹⁶⁹ the Massachusetts court held that a controlling group of shareholders had breached their fiduciary

poration and not to the minority shareholders. See 2 F. O'NEAL, *supra* note 11, at § 8.16. Courts later determined, however, that majority shareholders have a fiduciary duty to the minority shareholders. See, e.g., *Southern Pac. Co. v. Bogert*, 250 U.S. 483, 487-88 (1919), wherein Justice Brandeis noted: “The majority has the right to control . . . It is the fact of control of the common property held and exercised, not the particular means by which or manner in which the control is exercised, that creates the fiduciary obligation.” *Id.* at 487-92. See also *Pepper v. Litton*, 308 U.S. 295, 306 (1939); *Bayliss v. Rood*, 424 F.2d 142, 146 (4th Cir. 1970); *United States v. Gates*, 376 F.2d 65, 77 (10th Cir. 1967); *Overfield v. Pennroad*, 42 F. Supp. 586, 606 (E.D. Pa. 1941).

161. See notes 167-84 *infra* and accompanying text.

162. See *Munson v. Syracuse, G. & C. R.R.*, 103 N.Y. 59, 73, 8 N.E. 355, 358 (1886).

163. See *Pepper v. Litton*, 308 U.S. 295 (1939); *Noe v. Roussel*, 310 So. 2d 806 (La. 1975). See generally 61 IOWA L. REV. 876, 890-91 (1976).

164. See, e.g., *Noe v. Roussel*, 310 So. 2d 806 (La. 1975); *Munson v. Syracuse, G & C. R.R.*, 103 N.Y. 58, 8 N.E. 355 (1886).

165. Courts have noted that rule 10b-5 incorporates at least as strict a fiduciary duty as the state courts that apply a strict fiduciary standard. See *Strong v. Repide*, 213 U.S. 419 (1909); *Barnett v. Kirshner*, 527 F.2d 781 (2d Cir. 1975); *Janigan v. Taylor*, 344 F.2d 781 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965); *List v. Fashion Park, Inc.*, 340 F.2d 457 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965); *St. Louis Union Trust Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 412 F. Supp. 45 (E.D. Mo. 1976). See generally F. O'NEAL, *supra* note 13, at § 5.09.

166. See, e.g., *Comolli v. Comolli*, 241 Ga. 471, 246 S.E.2d 278 (1978); *Zokoych v. Spalding*, 36 Ill. App. 3d 654, 344 N.E.2d 805 (1976); *Wilkes v. Springside Nursing Home*, — Mass. —, 353 N.E.2d 657 (1976); *Donahue v. Rodd Electrotpe Co.*, 367 Mass. 578, 328 N.E.2d 505 (1975); *Murphy v. Country House, Inc.*, 307 Minn. 344, 240 N.W.2d 507 (1976); 68th St. Apartments, Inc. v. Lauricella, 142 N.J. Super. 546, 362 A.2d 78 (Law Div. 1976), *aff'd*, 150 N.J. Super. 42, 374 A.2d 1222 (App. Div. 1977); *Schwartz v. Marien*, 37 N.Y.2d 487, 335 N.E.2d 334, 373 N.Y.S.2d 122 (1975); *Delaney v. Georgia-Pac. Corp.*, 278 Ore. 305, 564 P.2d 277 (1977). See also note 183 *infra*.

167. See *Wilkes v. Springside Nursing Home*, — Mass. —, —, 353 N.E.2d 657, 661 (1976); *Donahue v. Rodd Electrotpe Co.*, 367 Mass. 578, —, 328 N.E.2d 505, 515 (1975); *Cain v. Cain*, — Mass. App. Ct. —, —, 334 N.E.2d 650, 654 (1975).

168. See *Donahue v. Rodd Electrotpe Co.*, 367 Mass. 578, —, 328 N.E.2d 505, 515 (1975).

169. 367 Mass. 578, 328 N.E.2d 505 (1975).

duty by failing to offer minority shareholders an equal opportunity to repurchase shares from one member of the controlling group¹⁷⁰ because they had not acted "with utmost good faith and loyalty to the other shareholders."¹⁷¹ The court reasoned that the same strict fiduciary duty needed to maintain a stable partnership also applied to the close corporation because of the similarity between the two kinds of business organizations.¹⁷² The *Donahue* court did recognize that the difficulty of obtaining dissolution distinguished the close corporation.¹⁷³ But, the court asserted, this difference made the higher fiduciary standard in the close corporation even more imperative.¹⁷⁴

The Supreme Judicial Court later modified the *Donahue* standard in *Wilkes v. Springside Nursing Home*.¹⁷⁵ The court indicated that the "utmost good faith" test should be tempered with a business purpose test to avoid hampering effective management.¹⁷⁶ A balance must be struck between the "majority's right to self-ownership" and their fiduciary obligation to the minority shareholders.¹⁷⁷ To achieve this balance, the court enunciated a two-part test.¹⁷⁸ First, the controlling shareholder must establish a legitimate business purpose for the action.¹⁷⁹ Second, upon a showing of legitimate business purpose, the minority shareholder may demonstrate that the same legitimate objective could be achieved by a less intrusive course of action.¹⁸⁰

Although *Wilkes* gave majority shareholders somewhat greater latitude than *Donahue*,¹⁸¹ its reaffirmation of the strict fiduciary duty of "utmost good faith and loyalty in the close corporation" is indicative of the trend toward increased protection of minority shareholders.¹⁸² And

170. *Id.* at —, 328 N.E.2d at 508-11.

171. *Id.* at —, 328 N.E.2d at 518.

172. *Id.* at —, 328 N.E.2d at 511-16.

173. *Id.* at —, 328 N.E.2d at 514-15.

174. *Id.*

175. — Mass. —, 353 N.E.2d 657 (1976).

176. *Id.* at —, 353 N.E.2d at 663.

177. *Id.*

178. *Id.*

179. *Id.*

180. *Id.*

181. See Note, *Close Corporations: Strict Good Faith Fiduciary Duty Applied to Controlling Stockholders*, 38 LA. L. REV. 214 (1977); 61 MASS. L.Q. 219 (1977).

182. See F. O'NEAL, *supra* note 13, at 7 (Supp. 1978). Following *Wilkes*, Massachusetts courts have continued to recognize a strict fiduciary duty in close corporations. See, e.g., *Commonwealth v. Corgain*, — Mass. —, 370 N.E.2d 447 (1978); *Ralston v. Anthony*, — Mass. —, 364 N.E.2d 1289 (1977); *Jessie v. Boynton*. — Mass. —, 361 N.E.2d 1267 (1977).

the trend is spreading beyond Massachusetts as other courts apply the *Donahue* standard¹⁸³ or insist upon a higher fiduciary duty in close corporations.¹⁸⁴

Recent cases also reveal this clear trend in the state courts of granting greater protection to minority shareholders in both public¹⁸⁵ and close corporations.¹⁸⁶ This may have been stimulated by the constriction of

183. *See, e.g.*, Toledo Trust Co. v. Nye, 426 F. Supp. 908 (N.D. Ohio 1977); Comolli v. Comolli, 241 Ga. 471, 246 S.E.2d 278 (1977); Trust Co. Bank v. Union Circulation Co., 241 Ga. 343, 245 S.E.2d 297 (1977); Sampson v. Hunt, 222 Kan. 268, 564 P.2d 489 (1977); Ritchie v. McGrath, 571 P.2d 17 (Kan. App. 1977); 68th St. Apartments, Inc. v. Lauricella, 142 N.J. Super. 546, 362 A.2d 78 (Law Div. 1976), *aff'd*, 150 N.J. Super. 42, 374 A.2d 1222 (App. Div. 1977); Delaney v. Georgia-Pac. Corp., 278 Ore. 305, 564 P.2d 277 (1977).

184. *See* Delano v. Kitch, 542 F.2d 550 (10th Cir. 1976) (trial court erred in not advising jury that mere disclosure of personal profit is not enough to satisfy strict fiduciary duty standard); Hilton v. Mumaw, 522 F.2d 588 (9th Cir. 1975) (shareholder's position as officer and director does not relieve other directors of fiduciary duties they owe him as shareholder, especially in close corporation); Toledo Trust Co. v. Nye, 426 F. Supp. 908 (N.D. Ohio 1977) (in close corporation, directors and controlling shareholders owe very highest duty of good faith); Jones v. H.F. Ahmanson & Co., 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969) (strict fiduciary duty in close corporation); Zokoych v. Spalding, 36 Ill. App. 3d 654, 344 N.E.2d 805 (1976) (in two-person corporation, shareholders have duty to act fairly, honestly, and with utmost good faith toward each other); Sampson v. Hunt, 222 Kan. 268, 564 P.2d 489 (1977) (insider has strict fiduciary duty to disclose known facts affecting value of stock); Schwartz v. Marien, 37 N.Y.2d 487, 373 N.Y.S.2d 132, 335 N.E.2d 334 (1975) (close corporation directors required to show not only that sale was for bona fide corporate purpose but also that objective could not have been accomplished by other means that would not have disturbed proportionate stock ownership); Delaney v. Georgia-Pac. Corp., 278 Ore. 305, 564 P.2d 277 (1977) (strict fiduciary duty in close corporation).

Many courts recognize greater protection by analogizing the duties of directors and controlling shareholders in close corporations to the duties imposed on common law trustees. *See, e.g.*, Atkinson v. Marquart, 112 Ariz. 304, 541 P.2d 556 (1975); Credit Managers Ass'n v. Superior Court, 51 Cal. App. 3d 352, 124 Cal. Rptr. 242 (1975); Petty v. Penntech Papers Inc., 347 A.2d 140 (Del. Ch. 1975); Kerrigan v. Unity Sav. Ass'n, 11 Ill. App. 3d 766, 297 N.E.2d 699 (1973); Berkowitz v. Power Mate Corp., 135 N.J. Super. 36, 342 A.2d 566 (1975); Seaboard Indus., Inc. v. Monaco, 442 Pa. 256, 276 A.2d 305 (1971); Williams v. Queen Fisheries, Inc., 2 Wash. App. 691, 469 P.2d 583 (1970); Grongnet v. Fox Valley Trucking Serv., 45 Wis. 2d 235, 172 N.W.2d 812 (1969).

Other courts, however, have recognized the *Donahue* approach, *i.e.*, comparing the duties of officers, directors, and controlling shareholders to the duties partners owe to each other. *See, e.g.*, Comolli v. Comolli, 241 Ga. 471, 246 S.E.2d 278 (1978); Wilkes v. Springside Nursing Home, — Mass. —, 353 N.E.2d 657 (1976); Cain v. Cain, — Mass. App. Ct. —, 334 N.E.2d 650 (1975); 68th Street Apartments, Inc. v. Lauricella, 142 N.J. Super. 546, 362 A.2d 78 (Law Div. 1976), *aff'd*, 150 N.J. Super. 42, 374 A.2d 1222 (App. Div. 1977).

For earlier cases using the partnership approach, see Burg v. Horn, 380 F.2d 897 (2d Cir. 1967); Helms v. Duckworth, 249 F.2d 482 (D.C. Cir. 1957); Illinois Rockford Corp. v. Klup, 41 Ill. 2d 215, 242 N.E.2d 228 (1968); Hathaway v. Porter Royalty Pool, Inc., 296 Mich. 90, 295 N.W. 571 (1941); Krueger v. Gerth, 16 N.Y.2d 802, 210 N.E.2d 355, 263 N.Y.S.2d 1 (1965) (Fuld, J., dissenting). *See generally* F. O'NEAL, *supra* note 13, at §§ 7.13-14.

185. *See, e.g.*, Fisher v. Pennsylvania Life Co., 69 Cal. App. 3d 506, 138 Cal. Rptr. 181 (1977); Singer v. Magnavox Co., 380 A.2d 969 (Del. 1977); Tanzer v. International Gen. Indus., Inc., 379 A.2d 1121 (Del. 1977); Berkowitz v. Power Mate Corp., 135 N.J. Super. 36, 342 A.2d 566 (1975).

186. *See* note 184 *supra*.

rule 10b-5.¹⁸⁷ As the Court has narrowed its scope, state courts have dramatically increased the duties of corporate managers and majority shareholders,¹⁸⁸ particularly in the area of squeeze-out mergers.

In a squeeze-out merger, the corporate managers or controlling shareholders, usually without deception or manipulation,¹⁸⁹ implement a merger to eliminate minority shareholders.¹⁹⁰ Although the courts initially limited the minority shareholder to an appraisal remedy¹⁹¹ or fair valuation of the worth of their shares,¹⁹² some courts have recently begun to protect minority shareholders by enjoining such mergers.¹⁹³ For example, a New York court¹⁹⁴ enjoined a squeeze-out merger, which did not have a proper business purpose,¹⁹⁵ even though the engineers of the merger had not engaged in misrepresentation or deception and had complied fully with the state merger statute.¹⁹⁶

The Delaware courts have demonstrated even greater determination to protect the rights of squeezed-out minority shareholders.¹⁹⁷ In

187. See notes 5-7 *supra* and accompanying text. Although there is no definitive evidence that the Supreme Court's restriction of rule 10b-5 stimulated the recognition of a higher fiduciary duty in the state courts, it seems possible that the realization that minority shareholders could no longer obtain federal relief might have affected state courts' willingness to provide a state remedy for shareholders. This trend in the state courts may have been further stimulated by the insightful views of a leading commentator. See generally F. O'NEAL, *supra* note 13.

188. See notes 185-86 *supra*.

189. See discussion of *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977), in notes 72-76 *supra* and accompanying text.

190. These mergers are typically employed to change a public corporation to a private corporation. The parent company through a merger with the subsidiary forces the liquidation of the minority interest in the publicly-held subsidiary. In compliance with the state merger statute, the parent may eliminate the minority by tendering a cash-out price, which the minority either must accept or have judicially appraised. See generally Borden, *supra* note 115; Brudney, *A Note on "Going Private,"* 61 VA. L. REV. 1019 (1975); Note, *The Second Circuit Adopts a Business Purpose Test for Going Private*, 64 CALIF. L. REV. 1184 (1976); Note, *Going Private*, 84 YALE L.J. 903 (1975).

191. See *David J. Greene & Co. v. Schenley Indus., Inc.*, 281 A.2d 30 (Del. Ch. 1971); *Stauffer v. Standard Brands, Inc.*, 41 Del. Ch. 7, 187 A.2d 78 (1962); *Guth v. Loft*, 23 Del. Ch. 255, 5 A.2d 503 (1939).

192. See Vorenberg, *Exclusiveness of the Dissenting Stockholders' Appraisal Rights*, 77 HARV. L. REV. 1189, 1189 (1969).

193. See, e.g., *Singer v. Magnavox Co.*, 380 A.2d 969 (Del. 1977); *Tanzer v. International Gen. Indus., Inc.*, 379 A.2d 1121 (Del. 1977); *Berkowitz v. Power Mate Corp.*, 135 N.J. Super. 36, 342 A.2d 566 (1975).

194. *People v. Concord Fabrics, Inc.*, 50 App. Div. 2d 787, 377 N.Y.S.2d 84 (1975).

195. *Id.*

196. *Id.* at 788, 377 N.Y.S.2d at 86.

197. See, e.g., *Najjar v. Roland Int'l Corp.*, 387 A.2d 709 (Del. Ch. 1978) (complaint attacking short form merger for sole purpose of squeezing-out minority states cause of action); *Lynch v. Vickers*, 383 A.2d 278 (Del. 1977) (in tender offer, minority shareholders claimed they were co-

Singer v. Magnavox Co.,¹⁹⁸ the Delaware Supreme Court held that majority shareholders, who had effected a merger for the sole purpose of squeezing-out the minority, had violated a fiduciary duty to protect the minority shareholders' interest.¹⁹⁹ The court asserted that such a merger would be valid only when the majority shareholders demonstrated: (1) a valid business purpose for the merger, and (2) that the minority was treated fairly.²⁰⁰ Although *Tanzer v. International General Industries, Inc.*²⁰¹ modified the first prong of the *Singer* test²⁰² by requiring a "bona fide" rather than a "valid" business purpose,²⁰³ this change has had little impact on the Delaware Supreme Court's willingness to protect squeezed-out minority shareholders.²⁰⁴ Following *Tanzer*, the Delaware courts have continued to recognize a high standard of fiduciary duty in squeeze-out merger cases.²⁰⁵

Although there has been an increase in the protection of minority shareholders in both publicly-held and close corporations,²⁰⁶ the trend toward strict fiduciary duties will likely take hold more quickly in the close corporation context. The relatively intimate relationship among shareholders in the close corporation²⁰⁷ and the reliance they place on

erced into selling their shares for a grossly inadequate price because of less than full disclosure, held: fiduciary duty to minority includes complete candor); *Young v. Valhi*, 382 A.2d 1372 (Del. Ch. 1978) (minority shareholder obtained injunction to stop merger involving formation of subsidiary corporation and merger with subsidiary by majority vote, the basic purpose of which was elimination of minority shareholders); *Kemp v. Angel*, 381 A.2d 241 (Del. Ch. 1977) (preliminary injunction issued against short form merger because minority shareholder might persuade court that he was treated unfairly). See also *Singer v. Magnavox Co.*, 380 A.2d 969 (Del. 1977); *Tanzer v. International Gen. Indus., Inc.*, 379 A.2d 1121 (Del. 1977).

198. 380 A.2d 969 (Del. 1977).

199. *Id.* at 980.

200. *Id.*

201. 379 A.2d 1121 (Del. 1977).

202. For a discussion of the two-part *Singer* test, see Note, *Singer v. Magnavox Co.: Delaware Imposes Restrictions on Freeze-out Mergers*, 66 CALIF. L. REV. 118 (1978); 31 VAND. L. REV. 183 (1977).

203. 379 A.2d at 1124.

204. In Note, *supra* note 202, the author asserts that although the *Tanzer* test is more lenient than the *Singer* test, *Tanzer* is limited to situations where the majority shareholder is a business or functioning enterprise. In the going private transaction, the interests of a separate functioning enterprise are not at stake; therefore the *Singer* test would apply. *Id.* at 129.

205. See *Najjar v. Roland Int'l Corp.*, 387 A.2d 709 (Del. Ch. 1978); *Young v. Vahli*, 382 A.2d 1372 (Del. Ch. 1978); *Lynch v. Vickers*, 383 A.2d 278 (Del. 1977); *Kemp v. Angel*, 318 A.2d 241 (Del. Ch. 1977).

206. See notes 185-86 *supra*.

207. See F. O'NEAL, *supra* note 13, at § 3.10.

each others' capabilities²⁰⁸ should increase the willingness of courts to protect minority shareholders.²⁰⁹ Further, the minority shareholder in a close corporation, unlike his counterpart in a publicly-held corporation, does not have a ready market for his shares and may therefore be locked into the enterprise.²¹⁰ Because the minority shareholder in a close corporation cannot easily remedy his dissatisfaction with management policy by selling his shares, he has a greater need for the protections of a higher fiduciary duty.²¹¹ And finally, the principle of majority rule has less validity in the close corporation where shareholders invest their money with the expectation of having a voice in all business decisions.²¹²

It thus appears likely that increased protection for minority shareholders will first solidify in the close corporation.²¹³ Further, a leading commentator has predicted that the *Donahue* good faith and loyalty to shareholders test will soon become the accepted standard of fiduciary duty in the close corporation.²¹⁴ This dramatic change at the state level dictates a reevaluation of the use of rule 10b-5 in close corporations.

C. *The Need for Restricted Use of Rule 10b-5 in the Close Corporation Context*

Since close corporation shares are infrequently traded, the stock transfers that have resulted in lawsuits usually have involved control-

208. See, e.g., *Murphy v. Country House, Inc.*, 307 Minn. 344, 240 N.W.2d 507 (1976) (court showed willingness to find a fiduciary relationship because of the corporate organizer's considerable knowledge of corporate business and function and the reliance of another shareholder on the organizer's expertise). See generally 1 F. O'NEAL, *supra* note 11, at § 8.07.

209. See 1 F. O'NEAL, *supra* note 11, at § 1.07.

210. See note 136 *supra* and accompanying text.

211. Note also that most close corporations, unlike publicly-held corporations, are not subject to the registration requirements of § 5 of the Securities Exchange Act of 1933, 15 U.S.C. § 77(c) (1976), and therefore this check on the excesses of majority shareholders is missing. Small corporations can avoid the registration requirements in a number of ways: (1) Securities and Exchange Commission Rule 240, 17 C.F.R. § 230.240 (1978), provides an exemption from registration for certain limited offers and sales of closely-held issuers; (2) an exemption for transactions "not involving any public offering," 15 U.S.C. § 77(d)(2) (1976); and (3) issues "offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a . . . corporation, incorporated by or doing business within such State or Territory." 15 U.S.C. § 77c(a) (11) (1976). See R. HAMILTON, *CASES AND MATERIALS ON CORPORATIONS—INCLUDING PARTNERSHIPS AND LIMITED PARTNERSHIPS* 258 (1976).

212. See F. O'NEAL, *supra* note 13, at § 9.04.

213. See 2 F. O'NEAL, *supra* note 11, at § 8.5.

214. See F. O'NEAL, *supra* note 13, at iv-v (Supp. 1977).

ling shareholders squeezing-out minority shareholders.²¹⁵ The transaction has more closely resembled a breach of fiduciary duty or corporate mismanagement than a fraud "in connection with" the purchase or sale of a security.²¹⁶ With the state courts adopting a higher fiduciary standard,²¹⁷ it no longer seems wise to extend rule 10b-5 to the private transfers of close corporation securities. The serious disadvantages that result from continued extension of rule 10b-5 far beyond its intended context compel this conclusion.

First, the extension of rule 10b-5 to the close corporation, whose shares are not traded in the securities market, has created an unnecessary intrusion by the federal government into state affairs. The Supreme Court, in *National League of Cities v. Usery*,²¹⁸ has recently regenerated the principle that the tenth amendment²¹⁹ restrains the federal government from usurping state power.²²⁰ In light of *National League of Cities*, it is at least arguable by analogy that the application of the federal securities laws to the close corporation, where the litigation more closely resembles state corporate mismanagement cases, represents an unnecessary federal intrusion on a state function.

Furthermore, the limitation of rule 10b-5 to publicly-held corporations would enable aggrieved minority shareholders in close corporations to obtain more effective remedies. As noted above,²²¹ the federal courts' broad reading of rule 10b-5 appears to have resulted in the failure of some state courts to develop a stringent fiduciary standard, leaving the minority shareholder with only a federal remedy.²²² And, in

215. See 2 F. O'NEAL, *supra* note 11, at § 1.07.

216. Professor O'Neal asserts: "A frequent grievance of minority shareholders or of former minority shareholders who have sold their stock is that the majority shareholder or the corporate managers depressed the value of the corporation's stock, typically by keeping dividends to a minimum, in order to buy minority stock at a bargain price." F. O'NEAL, *supra* note 13, at § 7.09. In such a situation, it is difficult to determine whether the manipulation should fall under the heading of corporate mismanagement or fraud "in connection with" a purchase or sale of a security. Courts, however, have been able to circumvent consideration of this issue because of their broad construction of the "in connection with" requirement. See notes 77-110 *supra* and accompanying text.

217. See notes 183-84 *supra* and accompanying text.

218. 426 U.S. 833 (1976).

219. "The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people." U.S. CONST. amend. X.

220. 426 U.S. at 842.

221. See note 147 *supra* and accompanying text.

222. See note 187 *supra* and accompanying text.

many situations, this federal remedy has been inadequate.²²³

For example, if a plaintiff brought suit in federal court under rule 10b-5, he could ordinarily²²⁴ recover only the difference between the fair market value of the securities at the time of the fraudulent transfer and the actual consideration paid.²²⁵ It is unlikely that the plaintiff could recover consequential damages. Although the federal courts have increasingly recognized a rule 10b-5 plaintiff's right to consequential damages,²²⁶ the courts have usually required the plaintiff to establish that the losses were caused by,²²⁷ or were a reasonably foreseeable consequence of,²²⁸ the defendant's misrepresentations. But if the same plaintiff had the option to sue in state court on a breach of fiduciary duty claim, he could obtain a more complete remedy. With such a claim, the plaintiff has the ability not only to recover punitive damages,²²⁹ but also to impose liability on anyone who knowingly assisted in the breach of duty.²³⁰ Furthermore, if the suit is derivative, the corporation can recover its losses, compensation paid during the period of the breach, and profits realized through the misappropriation of corporate property.²³¹ Thus, by restricting the use of rule 10b-5 in close corporations and stimulating the state courts to develop higher fiduciary duties, the minority shareholders could more readily obtain effective remedies for their losses.²³²

223. See *Diamond v. Oreamuno*, 24 N.Y.2d 494, 248 N.E.2d 910, 301 N.Y.S.2d 78 (1969). See also F. O'NEAL, *supra* note 13, at § 7.13.

224. Courts, however, have developed many theories of recovery under rule 10b-5. See 5b A. JACOBS, *supra* note 97, at § 60.03 (11-19 to 11-93).

225. See *id.* at § 260.03(c)(ii)(11-21). See also *Ross v. Licht*, 263 F. Supp. 395, 410 (S.D.N.Y. 1967).

226. See, e.g., *Madigan, Inc. v. Goodman*, 498 F.2d 233 (7th Cir. 1974); *Zeller v. Bogue Elec. Mfg. Corp.*, 476 F.2d 795 (2d Cir.), *cert. denied*, 414 U.S. 908 (1973); *Janigan v. Taylor*, 344 F.2d 781 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965).

227. See, e.g., *Madigan, Inc. v. Goodman*, 498 F.2d 233 (7th Cir. 1974); *Zeller v. Bogue Elec. Mfg. Corp.*, 476 F.2d 795 (2d Cir.), *cert. denied*, 414 U.S. 908 (1973).

228. See *Foster v. Financial Technology, Inc.*, 517 F.2d 1068, 1072 (9th Cir. 1975). See generally 5b A. JACOBS, *supra* note 97, at § 260.03(d) (11-94).

229. See F. O'NEAL, *supra* note 13, at § 8.13. Under rule 10b-5, however, a claimant cannot obtain punitive damages. See 5b A. JACOBS, *supra* note 97, at § 260.03(e)(11-97).

230. Under rule 10b-5, a plaintiff, in a private damage action must show that the aider or abettor had actual knowledge, not merely constructive knowledge of the fraudulent scheme. 5 A. JACOBS, *supra* note 97, at § 40.01 (2-109 to 2-110).

231. *Id.*

232. Although federal courts provide minority shareholders with certain procedural advantages, see note 116 *supra*, these liberal service of process and venue provisions are less helpful in the close corporation context because most close corporation shareholders are involved in the activities of the business or live in the same locality. See 1 F. O'NEAL, *supra* note 11, at § 8.16.

But most importantly, restricting the use of rule 10b-5 to publicly-held corporations may reduce judicial vacillation.²³³ The application of rule 10b-5 to close corporations, where lawsuits typically relate less directly to the purchase or sale of a security,²³⁴ has been a major cause of uncertainty over the rule's scope. Because there is no secondary trading of securities,²³⁵ the rule 10b-5 close corporation lawsuit is more likely to contain corporate law issues. Some federal judges have been reluctant to resolve these issues in the federal courts²³⁶ and consequently courts have inconsistently interpreted the rule.²³⁷ But with the state courts' trend toward a higher fiduciary duty,²³⁸ the application of rule 10b-5 to close corporation mismanagement suits is no longer necessary. If courts adopt this proposal, the result will be greater certainty over the ambit of rule 10b-5.

Despite the Supreme Court's failure to limit rule 10b-5 by distinguishing the close corporation, the restrictive trend is a positive change in the direction of corporate law. Although one may favor increased federal regulation of corporations,²³⁹ such a marked change in the allocation of government powers should be left to the legislature, which can more effectively balance the numerous and competing social interests implicated.²⁴⁰ The result of continuing to extend rule 10b-5 through judicial mandate into the field of corporate fiduciary duty and corporate mismanagement will be further fluctuations, inconsistencies, and uncertainty. This can only create instability in the securities mar-

233. See note 33 *supra* and accompanying text.

234. See F. O'NEAL, *supra* note 13, at iv-v (Supp. 1977).

235. See 1 F. O'NEAL, *supra* note 11, at § 1.07.

236. See notes 5-7 *supra* and accompanying text.

237. See note 37 *supra*.

238. See notes 183-84 *supra* and accompanying text.

239. See note 126 *supra*. See also R. NADER, M. GREEN, & E. SELIGMAN, CONSTITUTIONALIZING THE CORPORATION: THE CASE FOR THE FEDERAL CHARTERING OF GIANT CORPORATIONS (1976); Henning, *Federal Corporate Chartering for Big Business: An Idea Whose Time Has Come!*, 21 DE PAUL L. REV. 915 (1972); Schwartz, *supra* note 121; Comment, 117 U. PA L. REV. 861 (1969).

240. See *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 480 (1977). The Court noted that "[t]here may well be a need for uniform federal fiduciary standards to govern mergers such as that challenged in this complaint. But those standards should not be supplied by judicial extension of § 10(b) and rule 10b-5 to 'cover the corporate universe.'" *Id.*

Even Professor Cary, who has vigorously argued for comprehensive federal fiduciary standards, urges a frontal attack with a new federal statute rather than an extension of rule 10b-5. "It seems anomalous to jigsaw every kind of corporate dispute into the federal courts through the securities acts as they are now written." Cary, *supra* note 115, at 700.

kets and stifle the effectiveness of rule 10b-5 and the federal securities laws.

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