A New Approach to Rule 10b-5: Distinguishing the Close Corporation

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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," the Court narrowed their scope. This change in judicial thinking was particularly evident in cases involving the frequently litigated rule 10b-5. For example, the Court limited standing under rule 10b-5 to


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 securities\(^5\) and has held that allegations of mere negligence\(^6\) or breach of fiduciary duty\(^7\) 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 courts\(^9\) and legislatures\(^10\) recognized that the smaller number of participants in a close corporation,\(^11\) the

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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.


9. "[T]here has been a definite, albeit inarticulate, trend toward eventual judicial treatment of the close corporation as \textit{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).


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, necessitate distinguishing this business organization from the large publicly-held corporation.

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. Courts have recognized that the unique characteristics of the close corporation leave many minority shareholders susceptible to oppressive squeeze-out techniques and thus have required a higher fiduciary duty in the close corporation context.

Most rule 10b-5 cases involve close corporations. 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-

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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, CLOSE CORPORATIONS: LAW AND PRACTICE § 1.03 (2d ed. 1971).


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. 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 requirement and the corporate mismanagement exception. The Note then explores the problems inherent in the current restrictive approach to rule 10b-5, which fails to distinguish close corporations, and argues that courts could eliminate these problems by refusing to apply the rule to close corporations. 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.

II. RULE 10B-5

Rule 10b-5 provides a federal remedy for fraud in securities transactions. Courts have interpreted the rule as requiring three elements: a fraud or misrepresentation, a purchase or sale of a security, and that the fraud or misrepresentation occur "in connection with" the transaction. 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 requirement and the corporate mismanagement exception. The Note then explores the problems inherent in the current restrictive approach to rule 10b-5, which fails to distinguish close corporations, and argues that courts could eliminate these problems by refusing to apply the rule to close corporations. 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.


[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.


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

Birnbaum v. Newport Steel Corp. 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. Plaintiffs contended that this premium sale, together with certain misrepresentations, constituted


32. See notes 26-28 supra.


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. 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." This language later became known as the Birnbaum doctrine.

Courts and commentators 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. 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. 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. 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. In accordance with the views of various commentators, courts began to erode the vitality of the purchaser-seller re-

36. Id.
37. Id. at 464.
41. Id.
42. Id.
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.
quirement\textsuperscript{45} by recognizing exceptions for sales,\textsuperscript{46} de facto sales,\textsuperscript{47} aborted purchases and sales,\textsuperscript{48} injunctive actions,\textsuperscript{49} and derivative suits.\textsuperscript{50} Further, some courts completely repudiated the requirement.\textsuperscript{51}

In \textit{Blue Chip Stamps v. Manor Drug Stores},\textsuperscript{52} the Supreme Court reversed this trend by reaffirming the vitality of the Birnbaum standing limitations.\textsuperscript{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.\textsuperscript{54} Although the Court did not specifically address any of the judicially-created exceptions to Birnbaum, \textit{Blue Chip} raises doubts\textsuperscript{55} about their continued validity.\textsuperscript{56}

The corporate mismanagement exception, like the purchaser-seller

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

53. \textit{Id.} at 733.

54. \textit{Id.} at 755.


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requirement, also has a circular history. After a period of acceptance, the doctrine lay dormant until the Supreme Court suddenly revitalized it in *Santa Fe Industries, Inc. v. Green*, 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." It bars the application of rule 10b-5 on the ground that the states have the primary responsibility for protecting individuals from management overreaching. Further, Congress passed section 10(b) of the 1934 Securities Exchange Act to deal with the narrow problem of fraud in direct securities transactions. A federal court will only allow a rule 10b-5 corporate mismanagement claim if the allegation meets the "deception" test under the rule's fraud re-

57. *See* 1 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 Court made clear that "disregard of trust relationships by those whose 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 . . .

59. 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).

60. 1 A. Bromberg, *supra* note 17, at § 4.7(531).


62. *See* *infra* 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. Hochfield*, 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.  

Courts have vacillated in their approach to the deception require-

ment.  Many courts initially held fraudulent mismanagement of cor-

porate affairs actionable under rule 10b-5 only if the claimed deception arose from misstatement or nondisclosure. This strict standard, how-

ever, created difficulties because of the possibility of manipulating se-

curities transactions through the use of a controlling influence in the corporation as well as through deception. Thus, in Schoenbaum v. Firstbrook, 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. But in Popkin v. Bishop, 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.  

The Supreme Court, in Santa Fe Industries, Inc. v. Green, recently resolved the confusion over the applicable standard for the deception require-

ment. 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 sharehold-

ers. Although the parent strictly complied with the statutory require-

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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.  


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


69. 405 F.2d at 211.  

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

71. Id. at 727.  


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. 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." 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.

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. A case, of course, meets the "in connection with" requirement when the fraud concerns the value or consideration offered in exchange for the securities. The "in connection with" problem, however, becomes more significant when the securities transaction is part of a larger scheme to defraud the corporation. In this context, one must determine whether the necessary nexus exists between the transaction and the fraud.

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

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.
80. Id.
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.
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, misstate-
ments, 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.


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.


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 transactions\(^98\)

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91. See, e.g., Competitive Assocs., Inc. v. Laventhal, 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 no 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.


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.

and permitting "recovery for otherwise unassailable transactions by viewing a scheme involving many transactions as though they were one plan."\textsuperscript{99} For example, in Drachman v. Harvey,\textsuperscript{100} the Second Circuit upheld a rule 10b-5 claim by linking as one scheme two transactions,\textsuperscript{102} "neither of which standing alone would violate rule 10b-5."\textsuperscript{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.\textsuperscript{104} In Bio-Medical Sciences, Inc. v. Weinstein,\textsuperscript{105} the court narrowed the "in connection with" requirement by relying on Blue Chip Stamps,\textsuperscript{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.\textsuperscript{107} For example, in Ketchum v. Green\textsuperscript{108} and Tully v. Mott,\textsuperscript{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

\textsuperscript{99} See 5a. JACOBS, supra note 97, at § 115.02 (5-12).
\textsuperscript{100} 453 F.2d 722 (2d Cir.), rev'd on rehearing en banc, 453 F.2d 736 (2d Cir. 1971).
\textsuperscript{101} In the first hearing of the Drachman case, before Bankers Life, the court refused to link the "two transactions." Id. at 731.
\textsuperscript{102} 453 F.2d 736 (2d Cir. 1971) (en banc).
\textsuperscript{103} 453 F.2d at 732.
\textsuperscript{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. Laventhal, Krekstein, Horwath & Horwath, 516 F.2d 811 (2d Cir. 1975); Crofoot v. Sperry Rand Corp., 408 F. Supp. 1154 (E.D. Cal. 1976).
\textsuperscript{108} 557 F.2d 1022 (3d Cir. 1977).
\textsuperscript{109} 540 F.2d 187 (3d Cir. 1976).
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 "hardest of the several restrictions which have been used to contain the inexorable growth of private rights of action under rule 10b-5." 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.

corporate mismanagement exception and the purchaser-seller require-
ment 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 "nullif[i]es not only the corporate laws of Delaware with respect to short-form corpo-
rate 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 regu-
lating 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 fed-
eral 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.

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
matter of fact.\textsuperscript{116} The threat of vexatious litigation has also spurred courts to narrow the scope of rule 10b-5.\textsuperscript{117} As Justice Rehnquist noted in \textit{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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{120} These statutes were designed to


\textsuperscript{117} \textit{See} Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).


\textsuperscript{120} \textit{See}, e.g., Cary, \textit{supra} note 115, at 668 (state cannot effectively provide a responsible corporate statute); Cohen, \textit{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").
encourage entrepreneurs to incorporate within the state. As a result, both the statutes and the judicial decisions have given little protection to minority shareholders. Thus it has been suggested that the courts should use rule 10b-5 to provide more adequate protection for minority shareholders. Further, some have argued that courts


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.


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 congestionally 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 purpose 130—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.

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


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).

ties.\textsuperscript{131} Thus it seems inappropriate to apply rule 10b-5 to the privately-held close corporation.\textsuperscript{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.\textsuperscript{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."\textsuperscript{134} In the close corporation, controlling shareholders frequently use squeeze-outs to manipulate corporate decisionmaking.\textsuperscript{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,\textsuperscript{136} or entrepreneurs in a partnership have through dissolution.\textsuperscript{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,\textsuperscript{138} his case...

\textsuperscript{131} See generally F. O'Neal, supra note 13, at 8.07, supra note 11, at 8.07; Note, Freezing Out Minority Shareholders, 74 Harv. L. Rev. 1630 (1961).

\textsuperscript{132} See generally F. O'Neal, supra note 13, at 8.07, supra note 11, at 8.07; Note, Freezing Out Minority Shareholders, 74 Harv. L. Rev. 1630 (1961).

\textsuperscript{133} See generally F. O'Neal, supra note 13, at 8.07, supra note 11, at 8.07.

\textsuperscript{134} See generally F. O'Neal, supra note 13, at 8.07, supra note 11, at 8.07.

\textsuperscript{135} See generally F. O'Neal, supra note 13, at 8.07, supra note 11, at 8.07.

\textsuperscript{136} See generally F. O'Neal, supra note 13, at 8.07, supra note 11, at 8.07.

\textsuperscript{137} See generally F. O'Neal, supra note 13, at 8.07, supra note 11, at 8.07.

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.\footnote{139. See note 123 supra and accompanying text.} 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.\footnote{140. See F. O'Neal, supra note 13, at § 3.03.} The business judgment rule immunizes management from liability where the transaction is within its authority and the power of the corporation.\footnote{141. Id.} It springs from the courts' hesitancy to substitute its judgment for that of management on business policy questions.\footnote{142. See H. Ballantine, Corporations § 231 (rev. ed 1946).} The majority rule concept, in contrast, recognizes the right of the majority shareholders to govern the corporation.\footnote{143. See F. O'Neal, supra note 13, at § 3.03.} These two principles have led many state courts\footnote{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).} to refuse to aid squeeze-out victims unless the majority has acted in a grossly abusive manner.\footnote{145. See F. O'Neal, supra note 13, at § 3.03.}

Realizing the inequities of the state courts' orientation,\footnote{146. See notes 120-23 supra and accompanying text.} the federal courts have broadened the scope of rule 10b-5 to include breach of fiduciary duty within close corporations.\footnote{147. See note 18 supra and accompanying text.} 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.\footnote{148. See notes 166-84 infra and accompanying text.}

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."\footnote{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).} This concept of a fiduciary relationship evolved slowly in the corporate setting.\footnote{150. See F. O'Neal, supra note 13, at § 7.13.}
as running only towards the corporation.\footnote{151} But courts later recognized that directors and officers, as well as controlling shareholders, owe a fiduciary duty to minority shareholders.\footnote{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.\footnote{153} Some courts applied a lenient standard, requiring bad faith and abuse of discretion,\footnote{154} and other courts recognized a strict fiduciary standard.\footnote{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"\footnote{156} test to determine whether the officers and directors of a close corporation had adhered to their fiduciary duty.\footnote{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.\footnote{158}

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

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\begin{itemize}
\item 151. Id. at § 713 n.4 and authorities cited therein.
\item 152. Id. at § 713 nn.6 & 7 and authorities cited therein.
\item 153. Id.
\item 160. Some courts treated the fiduciary duties of directors as running only in favor of the cor-
\end{itemize}
a denial of relief for minority shareholders. For the strict trust approach, which voided a transaction if a plaintiff could show a conflict of interest, 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 fairness—a task that often proved to be relatively easy. Thus the federal courts were forced to extend rule 10b-5 to grant relief to oppressed close corporation shareholders.

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

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


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).


duty by failing to offer minority shareholders an equal opportunity to repurchase shares from one member of the controlling group because they had not acted "with utmost good faith and loyalty to the other shareholders." 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. The Donahue court did recognize that the difficulty of obtaining dissolution distinguished the close corporation. But, the court asserted, this difference made the higher fiduciary standard in the close corporation even more imperative.

The Supreme Judicial Court later modified the Donahue standard in Wilkes v. Springside Nursing Home. The court indicated that the "utmost good faith" test should be tempered with a business purpose test to avoid hampering effective management. A balance must be struck between the "majority's right to self-ownership" and their fiduciary obligation to the minority shareholders. To achieve this balance, the court enunciated a two-part test. First, the controlling shareholder must establish a legitimate business purpose for the action. 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.

Although Wilkes gave majority shareholders somewhat greater latitude than Donahue, 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. 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.
176. Id. at —, 353 N.E.2d at 663.
177. Id.
178. Id.
179. Id.
180. Id.
the trend is spreading beyond Massachusetts as other courts apply the Donahue standard\(^{183}\) 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 public\(^{185}\) and close corporations.\(^{186}\) This may have been stimulated by the constriction of

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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).


186. See note 184 supra.
rule 10b-5. As the Court has narrowed its scope, state courts have dramatically increased the duties of corporate managers and majority shareholders, particularly in the area of squeeze-out mergers.

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

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

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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).


195. Id.

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

197. See, e.g., Najjar v. Roland Intr’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., 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. 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. Although Tanzer v. International General Industries, Inc. modified the first prong of the Singer test by requiring a "bona fide" rather than a "valid" business purpose, this change has had little impact on the Delaware Supreme Court's willingness to protect squeezed-out minority shareholders. Following Tanzer, the Delaware courts have continued to recognize a high standard of fiduciary duty in squeeze-out merger cases.

Although there has been an increase in the protection of minority shareholders in both publicly-held and close corporations, 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 corporation 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).
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.
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 1934, 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.

ling shareholders squeezing-out minority shareholders.\textsuperscript{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.\textsuperscript{216} With the state courts adopting a higher fiduciary standard,\textsuperscript{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 \textit{v.} Usery,\textsuperscript{218} has recently regenerated the principle that the tenth amendment\textsuperscript{219} restrains the federal government from usurping state power.\textsuperscript{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,\textsuperscript{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.\textsuperscript{222} And, in

\textsuperscript{215} See 2 F. O'Neal, \textit{supra} note 11, at § 1.07.
\textsuperscript{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 deprived 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, \textit{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 \textit{supra} and accompanying text.
\textsuperscript{217} See notes 183-84 \textit{supra} and accompanying text.
\textsuperscript{218} 426 U.S. 833 (1976).
\textsuperscript{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.
\textsuperscript{220} 426 U.S. at 842.
\textsuperscript{221} See note 147 \textit{supra} and accompanying text.
\textsuperscript{222} See note 187 \textit{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


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).


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.\footnote{See note 33 supra and accompanying text.} The application of rule 10b-5 to close corporations, where lawsuits typically relate less directly to the purchase or sale of a security,\footnote{See F. O'Neal, supra note 13, at iv-v (Supp. 1977).} has been a major cause of uncertainty over the rule's scope. Because there is no secondary trading of securities,\footnote{See 1 F. O'Neal, supra note 11, at § 1.07.} 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 courts\footnote{See notes 5-7 supra and accompanying text.} and consequently courts have inconsistently interpreted the rule.\footnote{See note 37 supra.} But with the state courts' trend toward a higher fiduciary duty,\footnote{See notes 183-84 supra and accompanying text.} 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,\footnote{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).} 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.\footnote{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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