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Securities Law—Securities Transaction Incident to Corporate Fraud: The Wrenched Connection

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SECURITIES LAW—Securities Transaction Incident To
Corporate Fraud: The Wrenched Connection.

Superintendent of Insurance v. Bankers Life & Casualty Co.,
404 U.S. 6 (1971).

INTRODUCTION

The operative language of Section 10 (b)¹ of the Securities Exchange Act of 1934 and Rule 10b-5² limits their application to fraud "in connection with the purchase or sale of any security." The Supreme Court was given the opportunity to interpret the scope of that phrase in *Superintendent of Insurance v. Bankers Life & Casualty Co.*³

Standish T. Bourne and James F. Begole hit upon a scheme to buy Manhattan Insurance Company with its own assets. The fraudulent scheme was to involve three separate but related stages. Begole would first write a 5,000,000 dollar check. This check would be given to Bankers Life, the owner of all of Manhattan's outstanding

¹ Securities Exchange Act § 10, 15 U.S.C. § 78 j (1970). Section 10 provides in part:

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

• . . .
(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative, or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

² 17 C.F.R. § 240.10b-5 (1972).

Rule 10b-5 provides:

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

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

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

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

³ 404 U.S. 6 (1971), *rev'g* 430 F.2d 355 (2d Cir. 1970).

stock, in exchange for such stock. As the new sole stockholder, he would persuade the board of directors to release 5,000,000 dollars worth of treasury bonds from Manhattan's portfolio, promising to replace them with certificates of deposit of equal value. Last, he would cover his check with the proceeds from the sale of the treasury bonds and get a 5,000,000 dollar loan to buy certificates of deposit which would be pledged as security for the loan.⁴ In January of 1962 the plan was implemented for the benefit of all concerned except the policyholders and creditors of Manhattan, who, it was hoped, would never discover the scheme.

In April of 1963 during an annual audit, the scheme was discovered by the New York Insurance Department which immediately placed Manhattan in liquidation.⁵ Subsequently, the Superintendent of the New York Insurance Department⁶ as liquidator of Manhattan brought suit alleging violation of Section 17 (a) of the Securities Act of 1933.⁷

A motion was made to dismiss the complaint on the grounds that there was a lack of jurisdiction over the subject matter, that the complaint failed to state a claim upon which relief could be granted,⁸ and that the plaintiff lacked the requisite standing to recover damages for alleged violations of the 1933 and 1934 Acts. The District Court for the Southern District of New York held that Manhattan had standing in relation to the sale of its treasury bonds but granted the motion to dismiss because it found that the fraud alleged was not "in connection with the sale" of Manhattan's treasury bonds so

⁴ For a complete discussion of the intricate financial transactions employed to conceal the depletion of Manhattan's assets see 300 F. Supp. 1083, 1089-92 (S.D.N.Y. 1969).

⁵ N.Y. Ins. Law §§ 511, 513 (McKinney 1966). Among other things, liquidation of a New York insurance company may be predicted on the insurer's insolvency.

⁶ By operation of law, the superintendent is vested with the title to all property, contracts and rights of action of the insurer as of the date of the entry of the order of liquidation. N.Y. Ins. Law § 514(2) (McKinney 1966).

⁷ Securities Act § 17 (a), 15 U.S.C. § 77q(a) (1970). The complaint originally alleged that Manhattan was the purchaser of its own stock from Bankers Life, and as a purchaser it sought redress under § 17 (a) of the 1933 Act. Through amendatory allegations presented in open court, Manhattan was able to allege it was the seller of its treasury bonds, and therefore entitled to relief under § 10(b) and Rule 10b-5.

⁸ In Manhattan's suit the objections concerning jurisdiction over the subject matter and failing to state a claim upon which relief could be granted were one in the same because Manhattan was attempting to invoke the court's subject matter jurisdiction by raising a federal question under § 10(b) and Rule 10b-5.

as to make out a recognizable claim under Section 10 (b) and Rule 10b-5.⁹ After a divided Court of Appeals for the Second Circuit affirmed,¹⁰ the case came before the Supreme Court on a writ of certiorari for the Court's consideration of whether a cause of action based on the sale by Manhattan of its treasury bonds had been pleaded under Section 10 (b) and Rule 10b-5. The Supreme Court held that the alleged fraud in the bond sale was cognizable under Section 10 (b) and Rule 10b-5 and, accordingly, reversed and remanded the case to the district court.

The purpose of this article is to point out: (1) the impact of the Court's decision on the prior legislative and judicial development of Rule 10b-5; and (2) the lack of guidance given by the rule and the need for administrative clarification.

FEDERAL FRAUD: DEVELOPMENT OF 10b-5

Prior to the Securities Act of 1933 the only federal statute under which securities fraud could be prosecuted was the mail fraud statute.¹¹ Presently, however, there are three general federal anti-fraud provisions, Section 17 (a) of the Securities Act of 1933, Section 15 (c) (1)¹² of the Securities Exchange Act of 1934, and Rule 10b-5 promulgated under Section 10 (b) of the Securities Exchange Act of 1934. Under these provisions¹³ three possible types of relief are available: injunctive or administrative action by the commission, criminal prosecution for willful violation, and private actions by buyers and sellers for rescission or damages.

The Securities Exchange Act of 1934 was enacted in response to the disastrous speculation of 1928 and 1929,¹⁴ and a Presidential call for "securities legislation which has teeth in it."¹⁵ Congress originally proposed to deal with securities fraud under a catch-all phrase known as Section 9 (c). Section 9 (c) read in effect, "Thou shalt not devise any other cunning devices."¹⁶ However, in view

⁹ 300 F. Supp. 1083, 1104 (S.D.N.Y. 1969).

¹⁰ 430 F.2d 355, 361 (2d Cir. 1970).

¹¹ 18 U.S.C. § 338 (1940), *as amended*, 18 U.S.C. § 1341 (1970).

¹² Securities Exchange Act § 15(c) (1), 15 U.S.C. § 78o (c) (1) (1970).

¹³ For a general discussion of the distinctions between the three sections see 3 L. LOSS, *SECURITIES REGULATION* 1423-30 (2d ed. 1961).

¹⁴ S. REP. NO. 1455, 73d Cong., 2d Sess. 81 (1934).

¹⁵ H.R. REP. NO. 1383, 73d Cong., 2d Sess. 2 (1934).

¹⁶ *Hearings on H.R. 7852 and 8720 Before the House Comm. on Interstate and Foreign Commerce*, 73d Cong., 2d Sess. 115 (1934).

of the numerous objections interposed by the securities industry¹⁷ concerning the seemingly limitless power conferred by Section 9 (c), Congress enacted Section 10 (b) as it presently reads. Section 10 (b) was not a proscriptive statute as such but merely vested broad discretionary rule-making powers in the Securities and Exchange Commission to prohibit any manipulative or deceptive device or contrivance "in connection with the purchase or sale of any security."

In 1942 the Securities and Exchange Commission adopted Rule X-10b-5 to protect sellers, as well as purchasers,¹⁸ of the securities from fraudulent practices.¹⁹ Milton V. Freeman, one of the draftsmen of the rule, described the origin of Rule X-10b-5 as follows:

It was one day in the year 1943, I believe. I was sitting in my office in the S.E.C. building in Philadelphia and received a call from Jim Treanor who was then the Director of the Trading and Exchange Division. He said, "I have just been on the telephone with Paul Rowen," who was then the S.E.C. Regional Administrator in Boston, "he has told me about the president of some company in Boston who is going around buying up the stock of his company from his own shareholders at \$4.00 a share, and he has been telling them that the company is doing very badly, whereas in fact, the earnings are going to be quadrupled and will be \$2.00 a share for this coming year. Is there anything we can do about it?" So he came upstairs and I called in my secretary and I looked at Section 10(b) and I looked at Section 17, and I put them together, and the only discussion we had was where "in connection with the purchase or sale" should be, and we decided it should be at the end.

We called the Commission and we got on the calendar, and I don't remember whether we got there that morning or after lunch. We passed a piece of paper around to all the commissioners. All the commissioners read the rule and they tossed it on the table, indicating approval. Nobody said anything except Summer Pike who said, "Well," he said, "we are against fraud aren't we?"²⁰

Thus, a rule which began as an attempt to correct a blatant and unsophisticated swindle must be now used to resolve the limits of federal control of corporate misdeeds. As a consequence of this reflexive action on the part of the S.E.C., the Congressional mandate for clarity and guidance has been shifted to the federal judiciary.

¹⁷ *Hearings on S. Res. 84, 56, and 91 Before the Senate Comm. on Banking and Currency*, 73d Cong., 1st & 2d Sess. 6624, 6634, 6899, 6910, 6936-38 (1933-34).

¹⁸ The four possible constructions of Rule 10b-5 in determining whether Rule 10b-5 also applies to purchasers are discussed in *Ellis v. Carter*, 291 F.2d 270, 273 (9th Cir. 1961).

¹⁹ See SEC Sec. Ex. Act Release No. 3230 (May 21, 1942).

²⁰ *Conference on Codification of the Federal Securities Laws*, 22 BUS. LAW 793, 922 (1967).

The first case under Rule 10b-5 was *Ward La France Truck Corp.*²¹ which was brought by the S.E.C. seeking injunctive relief against two officers of Ward La France. The officers with inside information concerning a future merger were purchasing Ward La France shares over-the-counter without proper disclosure. The Commission concluded there had been a violation of the rule, and the officers were directed to pay back the difference between the market price and the price at which they had acquired the stock from the defrauded stockholders. In 1946 Rule 10b-5 was interpreted in *Kardon v. National Gypsum Co.*²² to allow a private cause of action for a seller, and five years later the Second Circuit recognized a similar right in purchasers.²³ Whether a private cause of action exists under Section 10 (b) and Rule 10b-5 has been a source of controversy²⁴ ever since the *Kardon* case, but today, either by way of direct holding, *obiter*, or *sub silentio*, ten of the eleven courts of appeals²⁵ have recognized a private cause of action.

The courts which recognized a private right of action had to face the question of what wrongs would be corrected by this right of action. The number of wrongs for which redress could be sought under Rule 10b-5 was curtailed at an early stage in the judicial development of Rule 10b-5 with the Second Circuit decision in *Birnbaum v. Newport Steel Corp.*²⁶ The fraud in *Birnbaum* came

²¹ 13 S.E.C. 373 (1943).

²² "In view of the general purpose of the Act, the mere omission of an express civil liability is not sufficient to negative what the general law implies." 69 F. Supp. 512, 514 (E.D. Pa. 1946). The court based its holdings that a private right of action exists under § 10(b) and Rule 10b-5 upon two grounds: (1) RESTATEMENT OF TORTS § 286 (1934); and (2) Securities Exchange Act § 29(b), 15 U.S.C. § 78cc(b) (1970).

²³ *E.g.*, *Fishman v. Raytheon Mfg. Co.*, 188 F.2d 783 (2d Cir. 1951).

²⁴ The Supreme Court has already held that a private right of action exists under the proxy provisions of the Act. *J.I. Case Co. v. Borak*, 377 U.S. 426 (1964). Although it has never expressly decided whether a private right of action is similarly implied for violations of § 10(b) and Rule 10b-5, it has upheld complaints based upon that right without discussion of the question. *Surowitz v. Hilton Hotels Corp.*, 383 U.S. 363 (1966). *But see Conference on Codification of the Federal Securities Laws*, *supra* note 20, at 922, wherein Freeman states that he does not believe the draftsment of Rule 10b-5 intended to confer a private right of action. *See A. BROMBERG, SECURITIES LAW: FRAUD—SEC RULE 10b-5 § 2.4(2)* (1967).

²⁵ For a listing of the cases in each circuit see 6 L. LOSS, SECURITIES REGULATION 3871-83 (Supp. 1969).

²⁶ 193 F.2d 461 (2d Cir. 1952). The major significance of *Birnbaum* lies not in its binding effect in terms of precedent, but from the fact that it was decided in the Second Circuit, the center of a vast majority of the security litigation.

about when the president of Newport Steel rejected a favorable merger for the stockholders of Newport in order that he might receive a higher price for his stock. The complaint alleged violations of fiduciary duties on the part of the president and directors, and certain misrepresentations concerning the merger made to the stockholders. The court in examining the legislative history behind Section 10 (b) concluded:

The section was directed solely at that type of misrepresentation of fraudulent practice usually associated with the sale or purchase of securities rather than at fraudulent mismanagement of corporate affairs, and that Rule X-10b-5 extended protection only to the defrauded purchaser or seller.²⁷

The Second Circuit's decision in *Birnbaum* limited the redress available under Rule 10b-5 by imposing two judicial restrictions: (1) the rule does not permit redress for breaches of fiduciary duty²⁸ and (2) an action under the rule is not available to a party who is neither a purchaser nor a seller.²⁹ The S.E.C.³⁰ and numerous courts³¹ have expressed dissatisfaction with the inequity presented by the standing restriction of being a purchaser or seller and have attempted to circumvent the restriction by expanding the classes of injured parties which are to be considered as purchasers or sellers. The courts have dealt with the restriction concerning breaches of fiduciary duties by expanding the comprehensiveness of the phrase

²⁷ *Id.* at 464.

²⁸ *Accord*, *O'Neil v. Maytag*, 339 F.2d 764 (2d Cir. 1964); *Barnett v. Anaconda Co.*, 238 F. Supp. 766 (S.D.N.Y. 1965). See generally *Leech, Transactions in Corporate Control*, 104 U. PA. L. REV. 725, 832-35 (1956). But see *Rekant v. Desser*, 425 F.2d 872 (5th Cir. 1970); *Bahlman, Rule 10b-5: The Case For Its Full Acceptance As Federal Corporation Law*, 37 U. CINN. L. REV. 727, 761-69 (1968).

²⁹ Although the purchaser-seller standing requirement has been modified in numerous ways, it is still the law in the Second Circuit in regard to actions for damages. See *Drachman v. Harvey*, 453 F.2d 722 (2d Cir. 1972). Professor Loss gave his approval of the purchaser-seller requirement as basically correct, 3 L. LOSS, *SECURITIES REGULATION* 1469 (2d ed. 1961), and has not changed his mind, 6 *id.* 3617 (Supp. 1969).

³⁰ The Commission disagrees with the purchaser-seller standing requirement. See Brief for SEC as Amicus Curiae at 7, *Superintendent v. Bankers Life & Cas. Co.*, 404 U.S. 6 (1971).

³¹ See *Coffee v. Permian Corp.*, 434 F.2d 383 (5th Cir. 1970); *Kahan v. Rosentiel*, 424 F.2d 161 (3rd Cir. 1970); *Ruckle v. Roto American Corp.*, 339 F.2d 24 (2d Cir. 1964); *Hooper v. Mountain States Sec. Corp.*, 282 F.2d 195 (5th Cir. 1960). See generally *Ciechon, The Decline of the Purchaser-Seller Requirement of Rule 10b-5*, 14 VILL. L. REV. 499 (1969); *Lowenfels, The Demise of the Birnbaum Doctrine: A New Era For Rule 10b-5*, 54 VA. L. REV. 268 (1968).

“in connection with the purchase or sale” to include a broader scope of fraudulent activities.³²

With this background, it is not surprising that today the status of the law under Rule 10b-5 is one of confusion and internal contradiction. On the one side there is the decision in *Birnbaum* which has placed an extremely narrow construction on the rule. On the other side, the S.E.C. has taken the position that the operative language of Section 10 (b) and Rule 10b-5, “in connection with the purchase or sale of any security,” was included only to restrict its powers over fraudulent activities to the securities field.³³

To reach a decision in *Superintendent of Insurance* it was necessary for the Supreme Court to enter into this chaos surrounding the scope of Rule 10b-5.

THE MANHATTAN DECISION

The Court viewed the scheme to defraud Manhattan as one involving misrepresentation, authorization of the sale, and misappropriation of the proceeds, and in effect held that, because the act or practice “touched” the sale of Manhattan’s treasury bonds, a claim upon which relief could be granted under Rule 10b-5 was stated. The opinion lends itself to analysis in two respects: (1) the broad interpretation the Court gives Section 10 (b), and (2) the Court’s recognition that the 1934 Act was enacted to protect creditors as well as stockholders.

To understand the significance of the Supreme Court’s broad interpretation of the scope of Rule 10b-5, it is necessary to examine the lower courts’ fragmentation theory.³⁴ The Court of Appeals for the Second Circuit and the District Court for the Southern District of New York had viewed the scheme in a fragmented manner which severely limited the scope of Rule 10b-5. The theory was based on the belief that the purpose of the 1934 Act is limited to preserving the integrity of the securities markets³⁵ and to guarding against the “sullying” of the purity of the security transaction.³⁶ To accomplish

³² See, e.g., *Herpich v. Wallace*, 430 F.2d 792 (5th Cir. 1970); *Gordon v. Lipoff*, 320 F. Supp. 905 (W.D. Mo. 1970); *Ciechron, The Decline of the Purchaser—Seller Requirement of Rule 10b-5*, *supra* note 31, at 511-15.

³³ Brief for SEC as Amicus Curiae at 17, *supra* note 30.

³⁴ The Commission believed that the most serious deficiency in the court of appeals’ opinion was in its effort to fragment the transaction by which Manhattan’s treasury bonds were sold into several parts. *Id.* at 22.

³⁵ 430 F.2d at 361.

³⁶ *Id.*

this purpose the lower courts thought it was necessary to isolate each security transaction and then determine if there was any fraud within that time frame. The court of appeals isolated the fraudulent scheme affecting Manhattan's treasury bonds into two parts: (1) the exchange of Manhattan's treasury bonds for fair consideration, and (2) the subsequent misappropriation of the proceeds from the sale. In viewing the security transaction, the Court of Appeals found this scheme to amount to nothing more than fraudulent mismanagement of corporate affairs³⁷ which is not actionable under Rule 10b-5.

The net effect of the propounded "fragmentation theory" was to make the scope of Rule 10b-5 totally dependent upon a hair line distinction: fraud in connection with a securities transaction being actionable, and the effectuation of a securities transaction in connection with a fraudulent activity not being actionable. This hair line distinction was further elaborated on in *Bailey v. Meister Brau, Inc.*³⁸ wherein the District Court for the Northern District of Illinois announced a degree-relationship test to determine the scope of Rule 10b-5. The court considered the rule emerging from *Superintendent of Insurance* to be:

There must be a determination of the degree to which the securities were involved in the alleged fraud, federal jurisdiction being absent if the securities transaction was incidental to the fraud, or as in the *Manhattan* case, designed to obscure the true nature of the acquisition and means of financing it.³⁹

The flaw in the Court of Appeals' treatment of the scope of Section 10 (b) and Rule 10b-5 in *Superintendent of Insurance* stemmed from its narrow view of the purpose of the 1934 Act. The purpose is not limited to preserving the integrity of the securities markets,⁴⁰ but as the Supreme Court concluded:

The Congress made clear that "disregard of trust relationships by those whom the law should regard as fiduciaries, are all a single web" along with manipulation, investor's ignorance, and the like. H.R. No. 1383, 73 Cong., 2d Sess., p. 6. Since practices "constantly vary and where practices legitimate for some purposes may be turned to illegitimate and fraudulent means, broad discretionary powers" in the regulatory agency "have been found practically essential."⁴¹

³⁷ *Id.* at 360.

³⁸ 320 F. Supp. 539 (N.D. Ill. 1970).

³⁹ *Id.* at 543.

⁴⁰ 404 U.S. at 12.

⁴¹ 404 U.S. at 11-12 (citing note 15 *supra*, at 6, 7).

To accomplish this congressional mandate, the Court announced that flexibility and not restrictiveness⁴² is the rule to be followed in construing Section 10 (b) and Rule 10b-5. The broad operative language of Section 10 (b), "in connection with the purchase or sale of any security,"⁴³ lends strong support to the Court's interpretation of Congress's intent. Clearly without a doubt this is the "loosest linkage"⁴⁴ between the proscribed act and a security transaction that can be found in any security law. By construing Section 10 (b) flexibly, not only fraud of a garden type variety,⁴⁵ but also novel and atypical methods of fraud will be circumscribed by the federal securities laws.

The Court acknowledged that Congress by enacting Section 10 (b) did not seek to regulate transactions which comprise no more than internal mismanagement,⁴⁶ but the Court stated, "Since there was a sale of a security and since fraud was used in connection with it, there is redress under Section 10 (b), whatever might be available as a remedy under state law."⁴⁷ In other words, it is immaterial whether the purchase or sale was part of a larger scheme of corporate mismanagement if the elements of a claim under Section 10 (b) and Rule 10b-5 are otherwise present.⁴⁸

⁴² 404 U.S. at 12. The Court had already determined that the 1934 Act should be broadly construed in *Tcherepnin v. Knight*, 389 U.S. 332 (1967), wherein the Court stated: "In addition we are guided by the familiar canon of statutory construction that remedial legislation should be construed broadly to effectuate its purposes. The Securities Exchange Act quite clearly falls into the category of remedial legislation." *Id.* at 336. See also *SEC v. Capital Gains Bureau*, 375 U.S. 180 (1963).

⁴³ This language should be compared with the much narrower language "in the offer or sale" used in § 17(a) of the 1933 Act. There appears to be no legislative history behind the operative language of § 10(b). Brief for SEC as Amicus Curiae at 10, *Heit v. Weitzen*, 402 F.2d 909 (2d Cir. 1968).

⁴⁴ A. BROMBERG, *SECURITIES LAW; FRAUD—S.E.C. RULE 10-5 § 7.6 (1)* (1967).

⁴⁵ See *A.T. Brod & Co. v. Perlow*, 375 F.2d 393, 397 (2d Cir. 1967).

⁴⁶ Congress failed to enact a federal incorporation statute in 1934. Professor Loss reports: "The Roper Dickinson Report of early 1934, which is part of the legislative history of the 1934 Securities Exchange Act . . . recommended federal incorporation as the most effective way to deal with certain evils connected with market manipulation by directors, and officers, the issuance of stock to insiders for inadequate consideration, incomplete publicity of corporate accounts, and similar problems." 1 L. LOSS, *SECURITIES REGULATION* 109-10 (2d ed. 1961).

⁴⁷ 404 U.S. at 12.

⁴⁸ This position had been adopted earlier in *Rekant v. Desser*, 425 F.2d 872 (5th Cir. 1970).

It appears from the Court's broad interpretation of the purpose of the 1934 Act and its flexible construction of Section 10 (b) that the scope of Section 10 (b) and Rule 10b-5 has been extended to cover fraud whenever it *touches*⁴⁹ the security transaction. In examining the alleged fraud in the sale of Manhattan's treasury bonds, it was therefore necessary for the Court to consider the scheme in its entirety. Using this *touch* concept in regard to the overall scheme, the Court found there certainly was an "act" or "practice" within the meaning of Rule 10b-5 (3) which operated as a fraud or deceit on Manhattan, the seller of government bonds.⁵⁰ The essential difference between the Supreme Court's construction of Rule 10b-5 and that of the lower courts was the time frame examined.⁵¹ The lower courts looked strictly at the time frame encompassing the security transaction, whereas the Supreme Court examined all of the distinct time frames in an integrated manner.

Having concluded that Manhattan had stated a cause of action under Section 10 (b) and Rule 10b-5, it was necessary for the Court to determine if Manhattan was injured as a result thereof.⁵² At first glance it would seem impossible for a closed corporation to have been defrauded to its detriment when the sole stockholder was a perpetrator of the fraud. However, on closer examination it becomes obvious that the victim was the corporate entity.⁵³ And after examining the legislative history behind the 1934 Act,⁵⁴ the Court re-

⁴⁹ 404 U.S. at 12.

⁵⁰ *Id.* at 9.

⁵¹

A.	B.	C.
Begole's purchase of Manhattan's stock from Bankers Life.	Sale of Manhattan's treasury bonds for fair consideration.	The subsequent misappropriation of the proceeds from the sale.

(1) Court of Appeals only examined time frame B.

(2) Supreme Court examined time frames A, B and C in an integrated manner.

⁵² One ground for the district court's dismissal of Manhattan's complaint was that the injury in this case was not incurred by anyone who was the subject of federal concern. 300 F.Supp. at 1083 n. 16 (S.D.N.Y. 1969).

⁵³ It has been established ever since *Hooper v. Mountain States Sec. Corp.*, 282 F.2d 195 (5th Cir. 1960), that an injured corporation can bring an action under § 10(b) and Rule 10b-5. In *Hooper* a trustee in bankruptcy sought relief for Consolidated American Industries, and the court stated, "We decline as we think that Court would, to read into its language a holding that a corporation injured by a sale or purchase of securities has no private right of action under § 10(b) and X-10b-5." *Id.* at 203.

⁵⁴ See note 15 *supra*, at 3, 4. Therein the House Committee recognized the impact of securities fraud on the insurance policyholders. Today

fused to disregard the corporate entity just because the creditors of the corporation were the ultimate victims.⁵⁵

As the Court pointed out, "The controlling stockholder owes the corporation a fiduciary obligation— one 'designed for the protection of the entire community of interests in the corporation— creditors as well as stockholders.'"⁵⁶ Begole's breach of his fiduciary duty to Manhattan caused damage in three respects: (1) Manhattan's creditors and policy-holders extended credit in one form or another which they would not have done had they known the true state of the corporation finances; (2) Manhattan was exposed to the risk of liability for taxes and to persons extending credit in reliance on misrepresentations flowing from the scheme to defraud; and (3) Manhattan's assets were depleted by 5,000,000 dollars.

The Court summed up the notion of corporate disability by citing *Shell v. Hensley*:⁵⁷

When a person who is dealing with a corporation in a securities transaction denies the corporation's directors access to material information known to him, the corporation is disabled from availing itself of an informed judgment on the part of its board regarding the merits of the transaction. In this situation the private right of action recognized under Rule 10b-5 is available as a remedy for the corporate disability.⁵⁸

A claim upon which relief could be granted under Rule 10b-5 having been found to exist by the Court,⁵⁹ the case was reversed and remanded to the District Court for the Southern District of New York for a trial on the merits in regard to the alleged fraud in the sale of Manhattan's treasury bonds.

CONCLUSION

The problem can be more readily understood through the use of a poker game analogy. It is like a poker game carried on by three participants, A, B and C. A and C buy 100 dollars worth of chips⁶⁰

there is even a greater impact with insurance companies continuously increasing their investments in corporate stocks and government bonds. See 2 Securities and Exchange Commission, *Institutional Investor Study Report*, H.R. Doc. No. 92-64, 92d Cong., 1st Sess. 778-80, 847-63 (1971).

⁵⁵ 404 U.S. at 12.

⁵⁶ 404 U.S. at 12 (quoting *Pepper v. Litton*, 308 U.S. 295, 306-307 (1939)).

⁵⁷ 430 F.2d 819 (5th Cir. 1970).

⁵⁸ *Id.* at 827.

⁵⁹ 404 U.S. at 14.

⁶⁰ For purposes of this poker game analogy the chips are analogous to securities because only securities fraud is covered by Rule 10b-5.

from B and then pursuant to their preconceived scheme, they proceed to cheat him. B finally detects the underhanded play on the part of A and C and calls a sudden halt to the game. As the Court of Appeals would have viewed the situation, if at the time B sold his chips to A and C he had received fair consideration for the chips, there would be no actionable fraud. However, the Supreme Court would look not only at the original purchase of the chips but at the entire game to determine if fraud were present.

The poker game analogy is extremely useful if the Supreme Court's opinion is given a literal interpretation. It becomes apparent now that the operative language of Rule 10b-5 requires only that the fraud *touch*⁶¹ the security transaction. Such an interpretation would be in accord with the Court's broad reading of the 1934 Act and its mandate that flexibility is to govern the construction of Section 10 (b). However, a literal interpretation would be in direct contravention of the cautious attitude the Court expressed in 1968 in *S.E.C. v. National Securities*.⁶²

Although Section 10 (b) and Rule 10b-5 may well be the most litigated provisions in the federal securities laws, this is the first time this Court has found it necessary to interpret them. We enter this virgin territory cautiously. The questions presented are narrow ones. They arise in an area where glib generalizations and unthinking abstractions are major occupational hazards.⁶³

But no matter whether the opinion is viewed broadly or narrowly, it represents a futile attempt to clarify the law in the area of Rule 10b-5. The concept, "touching the security transactions," is inherently vague and ambiguous. The use of such a word as *touch* is to speak in terms of a generality which has boundless constructions. Therefore the net effect on the operative language of Rule 10b-5 is but to add another tier of confusion to an already unstable foundation.⁶⁴

Criticism of the Court is not intended for it is nearly impossible to cure a malignant disease when the tools and guidance for such

⁶¹ It is acknowledged that the Court only uses the word *touch* once in reference to the crux of Manhattan's case, but this author feels the significance of the word *touch* lies in the numerous possible constructions of the word by the eleven different circuits, for each circuit still seeks the light in this area.

⁶² 393 U.S. 453 (1968).

⁶³ *Id.* at 465.

⁶⁴ It could be a point of controversy whether or not the Court's use of the word *touch* adds another wrinkle to judicial interpretations of Rule 10b-5 or whether it is merely an elaboration on already existing interpretations, but no matter, for irrefutable certainty is lacking.

cure have not yet been provided. The solution to the state of chaos surrounding Rule 10b-5 lies not with the courts, who must consider the narrow issues before them without serious administrative consideration of the broad problems, but with the creator of Rule 10b-5, the Securities and Exchange Commission. Congress delegated certain authority to the S.E.C. as set out in Section 10 (b). In the area of securities fraud the S.E.C. can proscribe such rules and regulations as are necessary or appropriate in the public interest or for the protection of investors consistent with its congressional grant of authority. S.E.C. dissatisfaction with the judicial treatment of Rule 10b-5 has been expressed in numerous areas.⁶⁵ But after thirty years of internal confusion Rule 10b-5 still reads as it was promulgated in 1942.

Such opinions as *Superintendent of Insurance* clearly indicate the S.E.C. has neglected its duty to clarify the rule. Our judicial system cannot administer justice in a coherent manner when it is impossible to comprehend the rules by which the system is to be governed.

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⁶⁵ See notes 30, 24, and 33 *supra*.