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## LIMITATIONS ON RULE 10b-5

ARTHUR J. MARINELLI, JR.\*

The federal securities acts of 1933 and 1934 sought to protect the investing public against fraud and manipulation by replacing the doctrine of *caveat emptor* with a system of full disclosure.<sup>1</sup> Section 10(b) of the Securities Exchange Act of 1934 gives the Securities and Exchange Commission the power to promulgate rules in order to prohibit "any manipulative or deceptive device or contrivance."<sup>2</sup> In 1942 the Commission adopted rule 10b-5<sup>3</sup> to implement the "catch-all" provision of section 10(b)<sup>4</sup> which can be viewed as a grant of wide-ranging discretion to the SEC.

Although all of the elements necessary for recovery in a 10b-5 action are not yet settled, the general requirements have been identified by the courts:<sup>5</sup> that the defendant come within the juris-

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<sup>1</sup> See *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963).

<sup>2</sup> Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (1970), provides:

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

. . . .

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

<sup>3</sup> Securities and Exchange Commission Rule 10b-5, 17 C.F.R. § 240.10b-5 (1974) [hereinafter referred to as 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 a fraud or deceit upon any person, in connection with the purchase or sale of any security.

<sup>4</sup> Freeman, *Conference on Codification of the Federal Securities Laws*, 22 Bus. Lwyr. 793, 922 (1967) (Milton Freeman drafted rule 10b-5).

<sup>5</sup> A case which sets forth a good review of the necessary elements for recovery is *Rochez Bros. v. Rhoades*, 491 F.2d 402 (3rd Cir. 1974).

diction of the rule;<sup>6</sup> that the proscribed activities be "in connection with the purchase or sale of any security;"<sup>7</sup> that the defendant possess the necessary scienter;<sup>8</sup> that there exist an "untrue statement of a material fact;"<sup>9</sup> that there exist a causation-in-fact;<sup>10</sup> and finally, that a security be involved.<sup>11</sup>

The cause of action impliedly granted by rule 10b-5 has often given plaintiffs a better chance of recovery than have traditional state remedies. Other advantages of a 10b-5 action soon became apparent to investors. The statute of limitations under rule 10b-5 is more favorable than other federal securities provisions since it is subject to the generous time periods of state statutes; the tolling of the statute, however, is a matter of federal law rather than state law.<sup>12</sup> Rule 10b-5 is a broad antifraud provision in the federal securities laws: it prohibits fraud, misrepresentation, half-truths, concealment of after-acquired information and omissions.<sup>13</sup> It applies to conduct in many areas, including insider trading,<sup>14</sup> exchange and tender offers,<sup>15</sup> mismanagement,<sup>16</sup> market manipulation,<sup>17</sup>

<sup>6</sup> Rule 10b-5 merely requires an instrumentality of interstate commerce. *Myzel v. Fields*, 386 F.2d 718, 727-28 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968).

<sup>7</sup> 17 C.F.R. § 240.10b-5 (1973). A comparable requirement is contained in § 10(b) of the 1934 Act, 15 U.S.C. § 78j (1970), *see Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975); *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir.) *cert. denied*, 343 U.S. 956 (1952).

<sup>8</sup> *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

<sup>9</sup> 17 C.F.R. § 240.10b-5(b) (1973). For a discussion of the "materiality" doctrine, *see List v. Fashion Park, Inc.*, 340 F.2d 456 (2d Cir. 1965). *See, e.g., TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438 (1976); *Herbst v. International Tel. & Tel. Corp.*, 495 F.2d 1308 (2d Cir. 1974).

<sup>10</sup> *See Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153-54 (1972), where the Court stated that in "the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. . . . This obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact."

<sup>11</sup> *See, e.g., SEC v. Glenn Turner Enterprises*, 474 F.2d 476 (9th Cir. 1973). In this case the court held a pyramid sales plan to be a security; *United Hous. Foundation, Inc. v. Forman*, 421 U.S. 837 (1975) (stock of cooperative housing project not security within meaning of securities laws).

<sup>12</sup> *See Janigan v. Taylor*, 344 F.2d 781, 783-84 (1st Cir. 1965), *cert. denied*, 382 U.S. 879 (1965); Martin, *Statutes of Limitations in 10b-5 Actions: Which State Statute Is Applicable* 29 BUS. LWYR. 443 (1974); Ruder & Cross, *Limitations on Civil Liability Under Rule 10b-5*, 1972 DUKE L. J. 1125, 1142-1150 (1972).

<sup>13</sup> These are common 10b-5 violations. *SEC v. National Bankers Life Ins. Co.*, 324 F. Supp. 189, 195 (N.D. Tex.), *aff'd*, 448 F.2d 652 (5th Cir. 1971).

<sup>14</sup> *See Comment, Insiders Liability Under Rule 10b-5 for the Illegal Purchase of Actively Traded Securities*, 78 YALE L.J. 864 (1969).

<sup>15</sup> *See Dugan and Fairfield, Chris-Craft Corp. v. Piper Aircraft Corp.: Liability in the Context of a Tender Offer*, 35 OHIO ST. L.J. 412 (1974).

broker-dealer activities,<sup>18</sup> and fiduciary activities.<sup>19</sup>

Although there is no language in either section 10(b) or rule 10b-5 which expressly provides for a private cause of action for damages, ever since the seminal case of *Kardon v. National Gypsum Company* twenty federal courts have recognized a private cause of action, which right is now firmly established.<sup>21</sup> Judge Kirkpatrick set forth in the *Kardon* case two theories upon which an implied right of action is based. The first theory posited that "disregard of the command of a statute is a wrongful act and a tort,"<sup>22</sup> the second that violation of "a statutory enactment that a contract of a certain kind shall be void almost necessarily implies a remedy in respect of it."<sup>23</sup>

Because there are so many advantages to using the rule, "10b-5 is generating almost as much litigation as all the other general antifraud provisions together, and several times as much as the express liabilities."<sup>24</sup> Increasingly, however, courts have placed limitations on the reach of rule 10b-5.<sup>25</sup> In addition to establishing purchaser-seller standing rules, scienter standards, and materiality requirements, courts have set standards of conduct for plaintiffs.<sup>26</sup> Suits have in a few cases been barred by application of the

<sup>18</sup> See Jacobs, *The Role of SEC Rule 10b-5 in the Regulation of Mismanagement*, 59 CORNELL L. REV. 27 (1973); Comment, *The Liability of Outside Directors Under Rule 10b-5*, 49 N.Y.U.L. REV. 551 (1974).

<sup>19</sup> See *Green v. Jonhop*, 358 F. Supp. 413 (D. Ore. 1973); Jacobs, *Regulation of Manipulation by SEC Rule 10b-5*, 18 N.Y.L.F. 511 (1973).

<sup>20</sup> See Jacobs, *The Impact of Securities Exchange Act Rule 10b-5 on Broker-Dealers*, 57 CORNELL L. REV. 869 (1972).

<sup>21</sup> *Heyman v. Heyman*, 356 F. Supp. 958 (S.D.N.Y. 1973); Comment, *SEC Rule 10b-5: Constructive Fraud and the Liabilities of Fiduciaries* 35 OHIO ST. L.J. 934 (1974).

<sup>22</sup> 69 F. Supp. 512 (E.D. Pa. 1946) (motion to dismiss); 73 F. Supp. 798 (E.D. Pa. 1947) (on the merits); 83 F. Supp. 613 (E.D. Pa. 1948) (findings of fact and law).

<sup>23</sup> See, e.g.; *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975); *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 13 n.9. (1971).

<sup>24</sup> 69 F. Supp. at 513.

<sup>25</sup> *Id.* at 514.

<sup>26</sup> See 1 A. BROMBERG, *SECURITIES LAW: FRAUD* § 2.5(6) (1973). See also, *SEC v. National Sec., Inc.*, 393 U.S. 453, 465 (1969), where the Court stated that section 10(b) and rule 10b-5 of the 1934 Securities and Exchange Act "may be the most litigated provisions in the federal securities laws."

<sup>27</sup> For a discussion of limiting federal control of internal corporate affairs under rule 10b-5, see Ruder, *Pitfalls in the Development of a Federal Law of Corporations by Implication Through Rule 10b-5*, 59 Nw. U.L. REV. 185 (1964). See also Bromberg, *Are There Limits to Rule 10b-5?* 29 BUS. LWYR. 167 (1974).

<sup>28</sup> See Note, *The Due Diligence Requirement for Plaintiffs Under Rule 10b-5*,

*in pari delicto* defense,<sup>27</sup> and in at least one case an action was not allowed under 10b-5 when a state remedy was available.<sup>28</sup>

#### PURCHASER-SELLER STANDING RULE

The Supreme Court has limited the class of plaintiffs in a private damage action under rule 10b-5 by its holding in *Blue Chip Stamps v. Manor Drug Stores*.<sup>29</sup> There the Court for the first time affirmed the "purchaser-seller" rule laid down in *Birnbaum v. Newport Steel Corporation*.<sup>30</sup> This rule limits standing to sue under rule 10b-5 to those plaintiffs who have purchased or sold securities actually involved in the alleged fraud. In the *Blue Chip* case, the plaintiffs were neither purchasers nor sellers of securities, but they claimed to have been persuaded not to purchase stock because of fraudulent misrepresentations in the prospectus.

The Supreme Court, speaking through Mr. Justice Rehnquist,<sup>31</sup> held that an offeree who had neither bought nor sold any of the shares offered in an allegedly misleading prospectus could not maintain a private action for money damages under rule 10b-5.<sup>32</sup> The majority based its decision on an admittedly vague legislative history, the long-standing acceptance of the *Birnbaum* rule by virtually all lower federal courts,<sup>33</sup> and finally what they described as "policy considerations."<sup>34</sup>

The Court concluded that congressional failure to reject *Birnbaum*, when it would have been a simple matter to amend section 10(b) so as to include fraud "in connection with the purchase or sale of, or any attempt to purchase or sell, any security,"<sup>35</sup> was an important argument for accepting the purchaser-seller re-

1975 DUKE L.J. 753 (1975).

<sup>27</sup> See *James v. DuBreuil*, 500 F.2d 155, 159-60 (5th Cir. 1974); *Kuehnert v. Texstar Corp.*, 412 F.2d 700, 704 (5th Cir. 1969). See generally Comment, *Rule 10b-5: The In Pari Delicto and Unclean Hands Defenses*, 58 CAL. L. REV. 1149 (1970). The *in pari delicto* defense bars recovery by a plaintiff who has knowingly taken part in the defendant's wrongdoing. In securities cases this would most often involve plaintiffs who knowingly use "inside" information.

<sup>28</sup> *Santa Fe Industries Inc. v. Green*, 430 U.S. 462 (1977).

<sup>29</sup> 421 U.S. 723 (1975).

<sup>30</sup> 193 F.2d 461 (2d Cir.), cert. denied, 343 U.S. 956 (1952).

<sup>31</sup> In the six-three decision Justices Stewart, White, Marshall and Powell joined in the opinion.

<sup>32</sup> 421 U.S. at 755.

<sup>33</sup> *Id.* at 731.

<sup>34</sup> 421 U.S. at 737.

<sup>35</sup> *Id.* at 732 (emphasis deleted).

quirement.<sup>36</sup> The opinion also noted that when Congress had specified in the 1933 and 1934 Acts the class of plaintiffs that could bring private actions, it had not extended the right to sue to persons not deemed to be purchasers or sellers of securities.<sup>37</sup>

The Court found it proper to consider policy arguments where congressional enactment and administrative regulations did not offer conclusive guidance.<sup>38</sup> The inconclusive nature of the underlying legislative history of section 10(b) and rule 10b-5 as “to the contours of a private cause of action”<sup>39</sup> is pointed up in remarks like those by Senator Fletcher, who stated that the purpose of the 1934 Act was “to insure to the public that the security exchanges [would] be fair and open markets.”<sup>40</sup> The Court noted that since the judiciary itself had implied and developed the cause of action, the judiciary must decide who might bring suit under the rule.<sup>41</sup> The policy argument which seemed to be an overriding concern of the majority was a “widespread recognition that litigation under rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general.”<sup>42</sup> The vexatious litigation which concerned the Court was the nuisance lawsuit<sup>43</sup> which would impede business activity, force settlements of unmeritorious claims, and possibly involve costly and abusive discovery procedures. In the absence of the *Birnbaum* rule, the Court feared that the outcome of a suit for securities fraud would turn largely on which testimony the jury might believe.<sup>44</sup>

Justice Blackmun in his dissenting opinion stated that the fears of the majority were speculative and that sensible standards of proof of fraud, causation, and damages would arise to distinguish the meritorious claims from the frivolous.<sup>45</sup> He argued that the Court exhibited “a preternatural solicitousness for corporate well-being and a seeming callousness toward the investing public quite out of keeping . . . with [the Court’s] own traditions and

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<sup>36</sup> *Id.* at 733.

<sup>37</sup> *Id.* at 733-34.

<sup>38</sup> *Id.* at 737.

<sup>39</sup> *Id.*

<sup>40</sup> 78 CONG. REC. 2271 (1934).

<sup>41</sup> 421 U.S. at 737.

<sup>42</sup> *Id.* at 739.

<sup>43</sup> *Id.* at 740-41.

<sup>44</sup> *Id.* at 743.

<sup>45</sup> *Id.* at 770-71. Justice Blackman was joined in his dissent by Justices Brennan and Douglas.

the intent of the securities law."<sup>46</sup> The dissent thought the language of section 10(b), which proscribes fraud by "any person," and rule 10b-5, which proscribes fraud by any "person" upon "any person,"<sup>47</sup> suggested that neither the plaintiff nor the defendant need be a purchaser or a seller. The dissent argued that fraud must be connected with the transaction and that fraud need only be "in connection with" the transaction and not a part of the transaction itself.

The *Blue Chip* case affirmed the purchaser-seller rule of the *Birnbaum* case in the context of an action for money damages. After *Birnbaum* the courts developed a number of extensions and modifications of the purchaser-seller rule.<sup>48</sup> The majority opinion in *Blue Chip* indicates that further liberalization of the existing modifications of the *Birnbaum* rule will not be favored and that even accepted modifications may be in jeopardy. The Court noted that it had previously held that the purchaser-seller rule does not limit the right of the SEC to seek injunctive relief.<sup>49</sup> The decision in *Blue Chip* should not affect the aborted-transaction rule, which involves a plaintiff who has entered into an agreement to purchase or sell securities but who is prevented from completing the transaction because of a defendant's fraud. The aborted-transaction rule is based on a statute which provides that a plaintiff holding a contract for the purchase or sale of securities is considered to be a purchaser or seller. It is difficult to predict with certainty the outcome of a case involving a forced seller, but strict adherence to the *Birnbaum* rule would require that the constructive purchase or sale provide only one possible set of price terms.

The *Blue Chip* holding may limit but does not destroy the existing and long-standing modifications to the *Birnbaum* doctrine. Future litigation will determine the scope and viability of the exceptions and modifications to *Birnbaum*. The effect of the decision will be to bar many actions by persons who are damaged by 10b-5 violations but who are not actual purchasers or sellers of securities. The decision reinstates consistency in determining who can sue under section 10(b) and rule 10b-5 and prevents abuses by plaintiffs who would bring nuisance suits. The case also will pre-

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<sup>46</sup> *Id.* at 762.

<sup>47</sup> See note 3 *supra*.

<sup>48</sup> The three major categories are the injunction exception, the forced-seller rule and the aborted-transaction rule.

<sup>49</sup> 421 U.S. at 751 n.14.

vent a flood of federal litigation and is justified by the long-standing acceptance of the *Birnbaum* rule.

#### SCIENTER

On March 30, 1976, the United States Supreme Court partially answered one of the most difficult and confusing issues material to a determination of whether rule 10b-5 has been violated. In *Ernst & Ernst v. Hochfelder*,<sup>50</sup> the Court held that scienter on the part of the defendants must be proven before the plaintiff could prevail in a private action for damages under section 10(b) and rule 10b-5. "Scienter" was defined as "a mental state embracing intent to deceive, manipulate, or defraud."<sup>51</sup> Although the *Hochfelder* decision overrules cases which held that negligence was sufficient for a violation of rule 10b-5 in a private action for damage,<sup>52</sup> it does not provide an answer as to whether scienter is a necessary element for injunctive relief as opposed to damages,<sup>53</sup> nor does it give a comprehensive definition as to what "scienter" means.<sup>54</sup> The Court noted that a negligence standard would "significantly broaden the class of plaintiffs who [might] seek to impose liability upon accountants and other experts who perform services or express opinions with respect to matters under the Acts."<sup>55</sup>

Plaintiffs in *Hochfelder* were induced by the president of a Chicago brokerage firm to invest funds in secret escrow accounts. No escrow accounts existed, and the president took the funds for his personal use. After the death of the president and the bankruptcy of the brokerage firm, the plaintiffs brought suit under section 10(b) and rule 10b-5 against Ernst and Ernst, the indepen-

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<sup>50</sup> 425 U.S. 185 (1976).

<sup>51</sup> *Id.* at 193 n.12.

<sup>52</sup> See, e.g., where negligence was held to be sufficient, *White v. Abrams*, 495 F.2d 724 (9th Cir. 1974); *Myzel v. Fields*, 386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968).

<sup>53</sup> The Supreme Court states unequivocally in a footnote: "Since [*Hochfelder*] concerns an action for damages we also need not consider the question whether scienter is a necessary element in an action of injunctive relief under § 10(b) and rule 10b-5." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976). See Lowenfels, *Scienter or Negligence Required for SEC Injunctions Under 10(b) and Rule 10b-5: A Fascinating Paradox* 33 BUS. LWYR. 789 (1978). Compare *SEC v. World Radio Mission, Inc.*, 544 F.2d 535 (1st Cir. 1976) with *SEC v. Bausch & Lomb, Inc.*, 420 F. Supp. 1226 (S.D.N.Y. 1976).

<sup>54</sup> See Hamimoff, *Holmes Looks at Hochfelder and 10b-5*, 32 BUS. LWYR. 147 (1976).

<sup>55</sup> 425 U.S. 185, 214 n.33 (1976).



dent public accountants who worked for the brokerage firm. They charged the accounting firm with aiding and abetting because Ernst and Ernst failed to discover that only the president could open mail addressed to him at his firm even if such mail arrived in his absence, and with negligence because they failed to investigate adequately the internal control and accounting system of the brokerage firm.<sup>56</sup>

Justice Powell, writing for the Supreme Court, based his opinion on the wording of the statute and the rule and on their limited legislative and administrative histories. The Court emphasized the words "manipulative," "contrivance," and "device" in section 10(b) which "made unmistakable a congressional intent to proscribe a type of conduct quite different from negligence."<sup>57</sup> The word "manipulative" implies "intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities."<sup>58</sup> The Court found that whenever Congress chose to provide civil liability for negligence or mistake, it did so specifically, and, further that it provided for procedural restrictions, such as a short statute of limitations which does not apply under section 10(b).<sup>59</sup> Although the Court did not discuss what the necessary scienter would include (since no allegation of fraud was made against Ernst and Ernst), one writer has suggested that the *Hochfelder* definition would extend to situations similar to common-law fraud under which a knowingly false statement was sufficient—the necessary mental state would be conclusively presumed.<sup>60</sup>

*Hochfelder*, like *Ultramares v. Touche*,<sup>61</sup> was designed to protect accountants and other professionals from plaintiffs whose numbers could reach the thousands: "a thoughtless slip or blunder . . . may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class."<sup>62</sup> The *Hochfelder* case gives no indication that the court sought to change the relationship between negligence and fraud which had been established in cases where "heedlessness and reckless disre-

<sup>56</sup> *Hochfelder v. Ernst & Ernst*, 503 F.2d 1100, 1115 (7th Cir. 1974).

<sup>57</sup> 425 U.S. 185, 199 (1976).

<sup>58</sup> *Id.*

<sup>59</sup> *Id.* at 207-08.

<sup>60</sup> Hamimoff, *Holmes Looks at Hochfelder and 10b-5*, 32 Bus. LWYR. 147, 148-49 (1976).

<sup>61</sup> 255 N.Y. 170, 174 N.E. 441 (1931).

<sup>62</sup> *Id.* at 179, 174 N.E. at 444.

gard of consequence may take the place of deliberate intention."<sup>63</sup>

The Supreme Court has chosen to provide a standard that will make it difficult for plaintiffs to recover in private 10b-5 actions for damages. The Court has indicated that the language of the securities acts will determine the development of section 10(b) and rule 10b-5 and that further judicial opinions are likely to pay more attention to the language of the acts than to the purposes behind them.

#### MATERIALITY

In pleading and proving a 10b-5 case dealing with misrepresentation or nondisclosure, materiality is an essential element of the plaintiff's case. Whether a fact is found to be material turns on the circumstances of each case<sup>64</sup> and involves a "balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity."<sup>65</sup> The materiality test is concerned with the reasonable investor and "those facts which affect the probable future of the company and those which may affect the desire of investors to buy, sell, or hold the company's securities."<sup>66</sup> The standards for materiality are especially important since in *Affiliated Ute Citizens v. United States*<sup>67</sup> the Supreme Court eliminated the traditional limitation of reliance under rule 10b-5. There the Supreme Court stated:

Under the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision. This obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact.<sup>68</sup>

Because of the language just quoted concerning what "a reasonable investor might have considered,"<sup>69</sup> a conflict among cir-

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<sup>63</sup> *E.g.* *State Street Trust Co. v. Ernst*, 278 N.Y. 104, 112, 15 N.E.2d 416, 418-19 (1938).

<sup>64</sup> *E.g.*, *SEC v. Shapiro*, 494 F.2d 1301, 1306 (2d Cir. 1974).

<sup>65</sup> *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849. (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969).

<sup>66</sup> *Id.*

<sup>67</sup> 406 U.S. 128 (1972).

<sup>68</sup> *Id.* at 153-54 (citations omitted).

<sup>69</sup> *Id.*

cuits developed on the issue of whether materiality is to be determined by what a reasonable shareholder would, or merely might, find important.<sup>70</sup> The Supreme Court in *TSC Industries, Inc. v. Northway, Inc.*<sup>71</sup> sought to provide a clear definition of materiality since a difference of opinion among the lower courts existed as to whether information was material if it would be considered important by a reasonable shareholder.<sup>72</sup> In *TSC* the Court determined that “[a]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.”<sup>73</sup> The Court clarified its misleading language in *Affiliated Ute* concerning what a “reasonable investor might have considered” by stating that in *Affiliated Ute* “it was not necessary to articulate a precise definition of materiality, but only to give a ‘sense’ of the notion [and that the] quoted language did not purport to do more.”<sup>74</sup> Although the *TSC* case involved the term “material” as it related to SEC rule 14a-9,<sup>75</sup> it should end the controversy concerning the proper test of materiality in 10b-5 actions as well. The *TSC* decision gives further evidence that the Supreme Court is drawing a more distinct line between federal protection of investors through disclosure requirements and state supervision over the corporate entity. Federal securities laws now offer more limited protection to shareholders.

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<sup>70</sup> See, e.g., *Northway, Inc. v. TSC Indus., Inc.*, 512 F.2d 324, 330-32 (7th Cir. 1975), *rev'd*, 426 U.S. 438 (1976); *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1301-02 (2d Cir. 1973).

<sup>71</sup> 426 U.S. 438 (1976).

<sup>72</sup> *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 443 (1976). See generally *The Standard of Materiality in the Context of the Proxy Rules* 38 OHIO ST. L.J. 379 (1977).

<sup>73</sup> 426 U.S. at 449.

<sup>74</sup> *Id.* at 447 n.9.

<sup>75</sup> Rule 14a-9 provides in part:

No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting or other communication, written or oral, containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading.

17 C.F.R. § 240.14a-9(a) (1977).

## AVAILABILITY OF OTHER REMEDIES

The Supreme Court in *Santa Fe Industries, Inc. v. Green*<sup>76</sup> held that the term "manipulative or deceptive" as used in section 10(b) of the 1934 Act does not encompass a breach of fiduciary duty. In *Santa Fe* a short-form merger statute requiring neither the consent of nor advance notice to minority shareholders pursuant to section 253 of the Delaware Corporation Law<sup>77</sup> enabled Santa Fe Industries, Incorporated, to obtain one hundred percent ownership of Kirby Lumber Company. Minority shareholders of Kirby, who were notified of the merger after its completion, attacked the merger in federal court under rule 10b-5 rather than under the appraisal remedy in the Delaware courts.<sup>78</sup> The shareholders argued that the value placed on the shares held by the minority shareholders was so low as to amount to fraud and that the merger lacked a proper business purpose.<sup>79</sup> The complexity of mergers and the large amounts of money involved make them frequent vehicles for fraud.<sup>80</sup> The Second Circuit found that rule 10b-5 reaches "breaches of fiduciary duty by a majority against minority shareholders without any charge of misrepresentation or lack of disclosure."<sup>81</sup>

The Supreme Court reversed the Second Circuit and in doing so gave considerable emphasis to the fact that minority shareholders have a remedy under the appraisal proceeding in Delaware and that internal corporate matters are best left to the states. "Absent a clear indication of congressional intent, we are reluctant to federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden."<sup>82</sup> *Santa Fe* illustrates that although liability under rule 10b-5 of a corporation and its management for acts of alleged corporate mismanagement has not yet been precisely determined, the Supreme Court will place limitations on actions brought under rule 10b-5 which could have been brought under state statutes.

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<sup>76</sup> 430 U.S. 462 (1977).

<sup>77</sup> DEL. CODE ANN. tit. 8, § 253 (1975).

<sup>78</sup> DEL. CODE ANN. tit. 8, § 262 (1975).

<sup>79</sup> 430 U.S. at 468.

<sup>80</sup> See *Dasho v. Susquehanna Corp.*, 380 F.2d 262, 267 (7th Cir.), cert. denied, 389 U.S. 977 (1967).

<sup>81</sup> 533 F.2d 1283, 1287 (2d Cir. 1976).

<sup>82</sup> 430 U.S. at 479.

Recent Supreme Court decisions have shown that new limits which are fixed and firm have been placed on rule 10b-5 actions. The Court seems to want to limit the rule to the regulation of securities and to leave corporate law to the states. The Court has recognized that the elements of recovery in a 10b-5 action are interdependent and must promote fairness and protect the integrity of the market. The recent decisions of the Court provide a starting point for a more understandable and rational framework for the lower federal courts, corporations, and securities lawyers. The Court seems to believe that the 10b-5 action has evolved beyond what was intended by its originators. In *Blue Chip*, the Court stated:

When we deal with private actions under Rule 10b-5, we deal with a judicial oak which has grown from little more than a legislative acorn. Such growth may be quite consistent with the congressional enactment and with the role of the federal judiciary in interpreting it [b]ut it would be disingenuous to suggest that either Congress in 1934 or the Securities and Exchange Commission in 1942 foreordained the present state of the law with respect to Rule 10b-5.<sup>83</sup>

The Court has sought by these limitations to protect the business community from plaintiffs who bring groundless claims or who expect generous settlements for reasons unrelated to the lawsuits brought.

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<sup>83</sup> *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975). See *Mount Clemens Indus., Inc. v. Bell*, 464 F.2d 339, 342-43 n.6 (9th Cir. 1972).