Notre Dame Law Review

Volume 47 | Issue 5 Article 8

6-1-1972

Case Comment

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SECURITIES EXCHANGE ACT OF 1934 — RULE 10b-5 — EXPANSION TO NON-CONVENTIONAL SECURITIES FRAUDS (MISAPPROPRIATION) AND INSIDER'S FIDUCIARY BREACH — PROTECTION OF CORPORATE CREDITORS THROUGH RULE 10b-5.—Manhattan Casualty Company was wholly owned by Bankers Life and Casualty Company. In January of 1962, Bankers Life agreed to sell all the stock of Manhattan to James F. Begole for $5,000,000. Begole allegedly conspired with Standish T. Bourne and others to pay for this stock, not out of his own funds, but with Manhattan's assets. The conspirators were alleged to have obtained, through a note brokerage firm (Garvin, Bantel & Company), a $5,000,000 check from Irving Trust Company, although they have no funds on deposit there. On the same day they purchased all the stock of Manhattan from Bankers Life for $5,000,000. As stockholders and directors, they installed John F. Sweeny as president of Manhattan.

Manhattan then sold its United States Treasury bonds for $4,854,552.61. Manhattan's board of directors was allegedly deceived into authorizing this sale by the misrepresentation that the proceeds would be exchanged for a certificate of deposit of equal value. The proceeds of $4,854,552.61, plus enough cash to bring the total to $5,000,000, was credited to an account of Manhattan at Irving Trust and the $5,000,000 Irving Trust check was charged against it. As a result, Begole took all the stock of Manhattan, having used $5,000,000 of Manhattan's assets to purchase it.

To conceal the fraudulent scheme, Manhattan obtained a second $5,000,000 check from Irving Trust. With this Sweeny, Manhattan's new president, bought a $5,000,000 certificate of deposit in the name of Manhattan from Belgian American Trust. Sweeny endorsed the certificate of deposit over to New England Note, a company allegedly controlled by Bourne. Bourne endorsed the certificate over to Belgian American Banking as collateral for a $5,000,000 loan from Banking to New England. The proceeds were then used to repay Irving's second $5,000,000 check. Though Manhattan's assets had been depleted, its books reflected only the sale of its Treasury bonds and the purchase of the certificate of deposit. They did not show that its assets had been used by Begole to pay for his purchase of the stock of Manhattan or that the certificate of deposit had been assigned and pledged.

In 1963, the Superintendent of Insurance of the State of New York, as Liquidator of Manhattan, commenced an action. Plaintiff's complaint based his single claim for recovery alternatively on three different transactions alleged to confer jurisdiction under § 10(b) of the Securities Exchange Act of 1934[1] and SEC rule 10b-5[2]: (1) the sale of the stock of Manhattan by Bankers Life to Begole; (2) Manhattan's sale of the Treasury bonds; and (3) the transactions involving the certificates of deposit.[3] The United States District Court for Southern District of New York dismissed the complaint on all three grounds for fail-

1 15 U.S.C. § 78j(b) (1971).
2 17 C.F.R. § 240.10b-5 (1971).
3 Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 n.10 (1971).

ure to state a claim upon which relief could be granted.[4] The Court of Appeals for Second Circuit affirmed, by a divided bench.[5] The United States Supreme Court granted certiorari, reversed and, limiting its decision[6] to Manhattan's sale of Treasury bonds, *held*: where insiders dupe their corporation into believing that it would receive the proceeds of a sale of securities owned by it and misappropriate the proceeds for their personal use, there is redress under § 10(b) and rule 10b-5, despite the fact that the insiders own all the stock of the corporation. *Superintendent of Insurance v. Bankers Life & Casualty Co.*, 404 U.S. 6 (1971).

Section 10(b) of the Securities Exchange Act makes it unlawful to use "in connection with the purchase or sale" of any security "any manipulative or deceptive device or contrivance" in contravention of the rules of the Securities Exchange Commission. SEC rule 10b-5[7] was promulgated under this section. Though neither § 10(b) nor rule 10b-5 expressly provides for civil remedies, it has been held in the 1946 case of *Kardon v. National Gypsum Co.*[8] that § 10(b) provides an implied private right of action for defrauded investors. And, as the Supreme Court noted in *Bankers Life*, "it is now established that a private right of action is implied under § 10 (b)."[9]

In 1952, the Second Circuit in *Birnbaum v. Newport Steel Corp.*,[10] gave rule 10b-5 a narrow construction. In *Birnbaum*, Newport's minority shareholders derivatively and individually brought an action under rule 10b-5 against the former controlling shareholder who was also the president and director of Newport. Plaintiffs alleged that the defendant sold his 40% controlling interest in Newport and received double the market price, after rejecting negotiations for a merger which would have produced proportional benefits for all shareholders. The court dismissed the action on the three interrelated grounds that rule 10b-5 "[1] was directed solely at that type of misrepresentation or fraudulent practice usually associated with the sale or purchase of securities [2] rather than at fraud-

4 Superintendent of Ins. v. Bankers Life & Cas. Co., 300 F. Supp. 1083 (S.D.N.Y. 1969).

5 Superintendent of Ins. v. Bankers Life & Cas. Co., 430 F.2d 355 (2d Cir. 1970).

6 *See* Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 n.10 (1971). The Court expressed "no opinion as to Manhattan's standing under § 10(b) and Rule 10b-5 on other phases of the complaint." *Id.* For the discussion of the standing problem, *see generally* Ruder, *Current Developments in the Federal Law of Corporate Fiduciary Relations—Standing to Sue Under Rule 10b-5*, 26 BUS. LAW. 1289 (1971); Kellogg, *The Inability to Obtain Analytical Precision Where Standing to Sue Under Rule 10b-5 Is Involved*, 20 BUFF. L. REV. 93 (1970); Lowenfels, *The Demise of The* BIRNBAUM *Doctrine: A New Era for Rule 10b-5*, 54 VA. L. REV. 268 (1968).

7 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,
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> (a) To employ any device, scheme, or artifice to defraud,
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> (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
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> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security. 17 C.F.R. § 240.10-5 (1971).

8 69 F. Supp. 512 (E.D. Pa. 1946).

9 Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 n.9 (1971). *Cf.* Tcherepnin v. Knight, 389 U.S. 332 (1967); J.I. Case Co. v. Borak, 377 U.S. 426 (1964); Dykstra, *Civil Liability Under Rule 10b-5*, 11 UTAH L. REV. 207, 210 (1967).

10 193 F.2d 461 (2d Cir. 1952).

ulent mismanagement of corporate affairs, and . . . [3] extended protection only to the defrauded purchaser or seller."[11] The first ground represents an attitude to limit the proscribed fraudulent conduct to conventional securities frauds; the second ground shows a reluctance to apply rule 10b-5 to corporate fiduciary breaches; and the third ground relates to the problem of standing to sue under rule 10b-5.[12]

Though § 10(b) began with a flavor of public markets, the Fifth Circuit in *Hooper v. Mountain States Securities Corporation*[13] held that § 10(b) is applicable "even though the transaction is conducted directly between the buyer and seller and not through a securities exchange or an organized over-the-counter market."[14]

And despite *Birnbaum,* several district courts recognized as frauds cognizable by rule 10b-5 those acts which are not "usually associated with the sale or purchase of securities."[15] Among them was the District Court for Southern District of New York in *Cooper v. North Jersey Trust Company of Ridgewood.*[16] That case involved "no wrongdoing alleged affecting the value of the stock itself . . . ."[17] Plaintiff had borrowed money for his purchases of stock from First Discount Corporation and pledged the securities with defendant Trust Company to secure the loan made by Discount. It was alleged that Trust Company and Discount were in conspiracy to convert the plaintiff's securities and that Trust Company at the request of Discount, wrongfully sold the securities. The issue before the court was: ". . . does the Rule cover the case in which the purchase of stock is a vital aspect of a continuing scheme and plaintiff received his full value . . . but ultimately retained nothing as a result of the fraudulent arrangement?" Answering, the court said:

> In the face of this broad language [of § 10(b)] . . . the outlawed activity is not limited to the portion of the transaction involving an exchange of consideration by the purchaser for the stock. The Rule also covers an entire transaction aimed at extracting money from the purchaser through a loan . . . to finance a stock purchase with the ultimate intent of converting the stock so purchased . . . .[18]

Meanwhile, the Tenth Circuit in *Stevens v. Vowell*[19] held actionable the misrepresentation that the proceeds of securities sold would all be used in the business of the corporation to be formed. There, Worldwide Corporation sought

11 *Id.* at 464.
12 *See* A. BROMBERG, SECURITIES LAW, FRAUD, SEC RULE 10b-5 § 4.7(3), at 88.1.
13 282 F.2d 195 (5th Cir. 1960), *cert. denied,* 365 U.S. 814 (1961).
14 282 F.2d at 201.
15 Birnbaum v. Newport Steel Corp., 193 F.2d 461, 464 (2d Cir. 1952); *e.g.,* Parker v. Baltimore Paint and Chemical Corp., 244 F. Supp. 267 (D. Colo. 1965) (buyer corporation allegedly dominated the management of seller corporation and misused its power so as to deprive the seller of the benefits of the sale price which the buyer had agreed to pay); Dauphin Corporation v. Sentinel Alarm Corporation, 206 F. Supp. 432 (D. Del. 1962) (Dauphin issued its stock to Sentinel in exchange for the latter's $200,000 note, which was then surrendered to Sentinel as a result of an allegedly false agreement and legal opinion).
16 226 F. Supp. 972 (S.D.N.Y. 1964).
17 *Id.* at 977.
18 *Id.* at 978.
19 343 F.2d 374 (10th Cir. 1965).

to form the new corporation. The misrepresentation was made by a franchised representative of Worldwide in the course of soliciting plaintiff Vowell to invest in the new corporation, while the representative was to get a 10% commission on the sums invested.

More recently, in *A.T. Brod & Co. v. Perlow*[20] the Second Circuit discarded the first ground of *Birnbaum* that rule 10b-5 "was directed solely at that type of misrepresentation or fraudulent practice usually associated with the sale or purchase of securities . . . ."[21] The *Brod* case involved an action by a broker against its own customers for the recovery of losses suffered when defendant customers refused to pay for securities previously ordered which had decreased in value by the settlement date. The complaint alleged that defendants' purchase order was made with intent to pay only if the securities increased in value by the settlement date. The lower court dismissed on the grounds that "[1] [p]laintiff is not an investor, and [2] no fraud is alleged as to the investment value of the securities [3] nor any fraud 'usually associated with the sale or purchase of securities * * *' "[22] The Second Circuit rejected all these limitations on the scope of rule 10b-5. It relied mainly on the broad language of § 10(b) and rule 10b-5 and on "the Supreme Court's postulation that the securities laws should be construed 'not technically and restrictively, but flexibly to effectuate * * * [their] remedial purposes.' "[23] Reversing, the court stated:

> [We do not] think it sound to dismiss a complaint merely because the alleged scheme does not involve the type of fraud that is "usually associated with the sale or purchase of securities." We believe that § 10(b) and Rule 10b-5 prohibit *all* fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception. Novel or atypical methods should not provide immunity from the securities laws.[24]

Following *Brod* and *Cooper,* the Seventh Circuit in *Allico Nat. Corp. v. Amalgamated Meat Cutters & Butcher W.*[25] also found a fraud cognizable by rule 10b-5 in the absence of fraud usually associated with the securities transactions. In *Allico,* defendant union, upon discovering that a third party would pay a higher price, breached a prior agreement to sell 100% of the stock in a wholly owned life insurance company to plaintiffs. Plaintiffs alleged that defendant union "wrongfully obtained possession" of 25,000 shares of the life insurance company's stock which had previously been sold to plaintiff for cash, but which were being held in escrow pending consummation of the agreement. The court held that the alleged wrongful conduct not only occurred "in connection with" a securities transaction, but also "sufficiently . . . [constituted a] device, scheme, or artifice to defraud, and [one] . . . operating as a fraud or deceit upon plaintiffs."[26] The court reasoned that:

20 375 F.2d 393 (2d Cir. 1967).
21 193 F.2d at 464.
22 375 F.2d at 396.
23 *Id.*
24 *Id.* at 397.
25 397 F.2d 727 (7th Cir. 1968).
26 *Id.* at 729.

> Even if a breach of contract in order to make a more favorable contract would not in itself be sufficient, we have more here. The motivation not only is said to induce a breach of contract . . . but also to induce the *conversion* of plaintiffs' pledged 25,000 shares.[27]

There has been great uncertainty with regard to the applicability of § 10(b) to situations involving management's breaches of fiduciary duties. It should be recalled that the Second Circuit in *Birnbaum* was reluctant to apply § 10(b) to "fraudulent mismanagement of corporate affairs."[28] However, the Third Circuit in *McClure v. Borne Chemical Company,*[29] by way of dictum, observed that § 10(b) "imposes broad fiduciary duties on management vis-à-vis the corporation and its individual stockholders."[30]

In 1964, the Second Circuit reached different results in the similar cases of *Ruckle v. Roto American Corporation*[31] and *O'Neill v. Maytag.*[32] *Ruckle* involved the issuance of 75,000 shares to insiders at an inadequate price. Plaintiffs alleged that majority directors, in authorizing the issuance of those shares, withheld from the others the latest financial statement and other pertinent information. The court applied § 10(b), saying:

> . . . in other contexts, such as embezzlement and conflict of interest, a majority or even the entire board of directors may be held to have defrauded their corporation. When it is practical as well as just to do so, courts have experienced no difficulty in rejecting such cliches as the directors constitute the corporation and a corporation, like any other person, cannot defraud itself.[33]

In *O'Neill,* the same court affirmed the dismissal of the complaint by the lower court. The complaint contained allegations to the effect that the insiders caused the corporation to purchase its own securities from a disinterested third party for the purpose of retaining their control of the corporation. After observing that there was "[n]o serious claim of deceit, withheld information or misstatement of material fact in this case,"[34] the court held that "where the duty allegedly breached is only the general duty existing among corporate officers, directors and shareholders, no cause of action is stated under Rule 10b-5 unless there is an allegation of facts amounting to deception."[35]

The *O'Neill* court distinguished *Ruckle* on the ground that in *Ruckle* there

27 *Id.* at 729, 730 (emphasis added).
28 *See* note 12 *supra* and accompanying text.
29 292 F.2d 824 (3d Cir. 1961).
30 *Id.* at 834.
31 339 F.2d 24 (2d Cir. 1964).
32 339 F.2d 764 (2d Cir. 1964).
33 Ruckle v. Roto American Corp., 339 F.2d 24, 29 (2d Cir. 1964).
34 O'Neill v. Maytag, 339 F.2d 764, 767 (2d Cir. 1964).
35 *Id.* at 767-68; *accord,* Pettit v. American Stock Exchange, 217 F. Supp. 21 (S.D.N.Y. 1963). In *Pettit,* defendants allegedly conspired with an insider to defraud the corporation by causing it to issue stock for a worthless consideration. The court said:

> [C]ourts have been disinclined to allow "innumerable facets of internal corporate affairs" to be included within federal question jurisdiction on the basis of a purchase or sale of securities that is only incidental to a major mismanagement issue.

Id. at 25. The court, however, upheld the 10b-5 claim because the scheme involved an abuse of the securities trading process.

was a clear allegation of deception in connection with the sale of securities.[36] Thus the applicability of § 10(b) became dependent on the existence of "deception."

The Seventh Circuit, however, seems to have rejected this distinction in the 1967 case of *Dasho v. Susquehanna Corporation,*[37] where it, in a two-judge concurring opinion, said:

> The only possible material difference I can perceive between *Ruckle* and *O'Neill* is that in *Ruckle* there were directors who were not participants in the transaction and thus could be deceived in the ordinary sense . . . . I do not believe it is sound to differentiate between situations which the directors were unanimous in wrongdoing and those where less than all were involved.[38]

However, the Third Circuit found "deception" by reference to "independent" shareholders in *Pappas v. Moss,*[39] where the directors were unanimous in wrongdoing. Defendants, who were all directors of Hydromatics, Inc., controlled 172,057 out of total of 288,000 outstanding shares. Defendants by board action unanimously authorized the issuance of 100,000 shares at less than market value to themselves and to few other purchasers. Defendants argued that there was no deception which was required to bring the claim within rule 10b-5, and they reasoned: "a corporation can only act through its agents; all of its agents (directors) here were aware of the true facts, ergo, the corporation was not deceived."[40] The court, without expressly deciding the question of whether "deception" is required, observed that:

> [I]f a "deception" is required in the present context, it is fairly found by viewing this fraud as though the "independent" stockholders were standing in the place of the defrauded corporate entity at the time the original resolution authorizing the stock sales was passed.[41]

In 1968 this "deception" requirement was elaborated on by the Second Circuit in *Schoenbaum v. Firstbrook.*[42] There the controlling shareholder caused the corporation to sell its shares at the then market price when the entire board knew that such price did not reflect an important oil discovery made by the corporation, which if generally known, it was alleged, would have raised the market price considerably. It appeared that the controlling shareholder who was also a director abstained from the authorization vote. The court held that plaintiff's "claim fails to state a cause of action under § 10(b) because it does not show that the corporation was deceived. The directors . . . were all concededly in full possession of the material information. . . ."[43] According to the court, a

36 O'Neill v. Maytag, 339 F.2d 764, 768 (2d Cir. 1964).
37 380 F.2d 262 (7th Cir. 1967), *cert. denied sub nom.,* Bard v. Dasho, 389 U.S. 977 (1967).
38 380 F.2d at 270.
39 393 F.2d 865 (3d Cir. 1968).
40 *Id.* at 869.
41 *Id.*
42 405 F.2d 200 (2d Cir. 1968).
43 *Id.* at 211.

corporation may be deceived either where some directors have been deceived as in *Ruckle* or where interested directors have participated in the corporate decision as in *Pappas*.[44] Therefore, the court concluded that there was no deception of the corporation because the directors were fully informed and only the non-interested directors participated in the vote authorizing the sale.[45] Upon rehearing, however, the Second Circuit sitting en banc reversed the initial opinion, saying:

> In the present case it is alleged that Aquitaine exercised a controlling influence over the issuance to it of treasury stock of Banff for a wholly inadequate consideration. If it is established that the transaction took place as alleged it constituted a violation of Rule 10b-5, subdivision (3) because Aquitaine engaged in an "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." Moreover, Aquitaine and the directors of Banff were guilty of deceiving the stockholders of Banff (other than Aquitaine).[46]

This implies that the court would not insist on the deception requirement[47] in applying rule 10b-5, although reference to the deception upon the minority stockholders was made as an additional ground.

The Second Circuit in *Bankers Life*[48] based its decision mainly on two grounds: (1) the fraud perpetrated upon Manhattan is distinguishable from one cognizable under rule 10b-5; and (2) the fraud was "no more than 'fraudulent mismanagement of corporate affairs' " to which rule 10b-5 was not intended to be applicable.[49] The first ground reflects an attitude to limit the proscribed fraudulent conduct to conventional securities frauds. The court reasoned that the sole object of the fraud perpetrated on Manhattan in this case was "to obtain possession of Manhattan's government bonds for the personal use of the perpetrators";[50] and that "[w]ith respect to the terms of the sale itself neither the purchaser nor the seller of the bonds was deceived or defrauded,"[51] since fair market price was paid and the fraud alleged was merely a "subsequent fraudulent misappropriation of the proceeds received."[52] Thus, according to the court, "[t]he purity of the security transaction and the purity of the trading process were unsullied."[53] And "[t]here was no danger that the securities sold would be overvalued on reaching the public markets."[54] Thus, to become actionable under rule 10b-5, a fraud must have been one perpetrated with respect to "the terms of the sale" or purchase "itself."

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44 *Id.* at 213.
45 *Id.* at 212.
46 Schoenbaum v. Firstbrook, 405 F.2d 215, 219, 220 (2d Cir. 1968) (en banc).
47 Subsequently, the Fifth Circuit in Shell v. Hensley, 430 F.2d 819 (5th Cir. 1970), held that the deception is not a necessary element of a 10b-5 claim asserted on behalf of a corporation. Id. at 827.
48 Superintendent of Ins. v. Bankers Life Cas. Co., 430 F.2d 355 (2d Cir. 1970).
49 *Id.* at 360, 361.
50 *Id.* at 360.
51 *Id.*
52 *Id.*
53 *Id.* at 361.
54 *Id.*

The second ground shows a reluctance to apply rule 10b-5 to corporate fiduciary breaches. The court reasoned that civil liability under § 10(b) is imposed either "in the public interest" or "for the protection of investors." "[T]he public interest cognizable by § 10(b) is limited to preserving the integrity of the securities markets" which was not affected in the fraud alleged and no investor was injured in this case.[55] The court also observed that "[n]o stockholders were defrauded, [and] no investor injured."[56] Since there were no stockholders other than Begole, it is clear no stockholders were defrauded. What the court meant by "investor" is not clear. The court, however, seems to have thought that Manhattan was not injured since the sole owner could not "injure" its corporation. The court, however, did not mention the "deception" requirement rather than fraud. Instead the focus was shifted to the requirement that the fraud be "in connection with the purchase or sale of any security."

This shift became clearer in the subsequent case of *Drachman v. Harvey*.[57] There controlling shareholders, who were also directors of Harvey Aluminum Inc., sold the control for a premium to Martin Marietta. Without disclosing such sale of control, they acted under the control of and in the interest of Martin Marietta. Allegedly they caused the corporation to redeem 5½% convertible debentures at an excessive price in order to prevent the dilution of their control at a time when the corporation was borrowing money at 9% interest rate. The Second Circuit, upon examining its *Bankers Life* decision, reached a general rule concerning the scope of § 10(b):

> In short, § 10(b) liability arises only when the alleged fraud between the parties and/or alleged market manipulation or deception is intrinsic to the securities transaction itself. Where this prerequisite is not met, as here, no federally cognizable interest exists . . . .[58]

The *Drachman* court held that the redemption transaction was not affected by the fraud alleged since "the redemption was effected in accordance with the terms of the debentures" and thus the "purity of the security transaction and the purity of the trading process were unsullied."[59] Therefore, the fraud alleged was not "intrinsic to the securities transaction itself." As to the breach of fiduciary duties, the court observed that "Congress was [not] enacting securities legislation for the purpose of conferring jurisdiction on the federal courts over corporate mismanagement situations absent fraud intrinsic to the securities transaction itself . . . ."[60] This implies that the intrinsicness of fraud to the securities transaction is a criterion to determine not only whether a particular fiduciary breach is within § 10(b), but also whether any fraudulent conduct is within § 10(b) in general.

The Supreme Court in *Bankers Life*, through Justice Douglas, tried to avoid

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55 *Id.*
56 *Id.*
57 — F.2d — (2d Cir. 1971), [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,129, at 91,093.
58 *Id.* at 91,100-101.
59 *Id.* at 91,101.
60 *Id.* at 91,102.

any generalization or abstraction of law. Instead, the Court set forth at the outset its ultimate conclusion that "[t]here certainly was an 'act' or 'practice' within the meaning of Rule 10b-5 which operated as 'a fraud or deceit' on Manhattan . . . ."[61] The Court emphasized that although the full market price was paid for the bonds, "the seller [Manhattan] was *duped* into believing that it, the seller, would receive the proceeds."[62] And it ruled that "Manhattan was injured as an investor through a deceptive device which deprived it of any compensation for the sale of . . . securities."[63] It relied on the broad language of § 10(b) outlawing the use of "any manipulative or deceptive device or contrivance" "in connection with the purchase or sale" of any security. Thus the Court could not agree with the Second Circuit that " 'no investor [was] injured' and that the 'purity of the security transaction and the purity of the trading process were unsullied.' "[64]

According to the Court in *Bankers Life*, "the fact that the transaction is not conducted through a securities exchange or an organized over-the-counter market is irrelevant to the coverage of § 10(b)."[65] It held further that a misappropriation is a type of fraudulent conduct within the coverage of § 10(b), saying "[l]ikewise irrelevant is the fact that the proceeds of the sale that were due the seller were misappropriated."[66] Furthermore, the Court noted that "misappropriation is a 'garden variety' type of fraud compared to the scheme which gave rise to [*Brod*] . . . ."[67] The Court approvingly cited *Brod's* rejection of the contentions that "no fraud is alleged as to the investment value of the securities nor any fraud 'usually associated with the sale or purchase of securities.' "[68] Relying on the findings of Congress, the Court concluded that § 10(b) is not "limited to preserving the integrity of the securities markets" and "must be read flexibly, not technically and restrictively."[69] It found it to be Congress' findings that " 'disregard of trust relationships . . . [is] a single seamless web' along with manipulation, investor's ignorance, and the like"[70] and that broad discretionary powers in the regulatory agency were practically essential.[71]

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61 Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 9 (1971).
62 *Id.* (emphasis added).
63 *Id.* at 10.
64 *Id.*
65 *Id.* The Court here cited *Hooper v. Mountain States Securities Corporation,* 282 F.2d 195, 201 (5th Cir. 1960).
66 404 U.S. at 10. In a footnote, the Court cited approvingly *Allico Nat. Corp. v. Amalgamated Meat Cutters & Butcher W.,* 397 F.2d 727 (7th Cir. 1968), and *Cooper v. North Jersey Trust Company of Ridgewood,* 226 F. Supp. 972 (S.D.N.Y. 1964). *Id.* at 10, 11 n.7. After holding that a misappropriation is a type of fraudulent conduct, the Court proceeded to cite dicta of *Hooper,* to the effect that a corporation cannot be said to have suffered no loss if it sold its stock for inadequate consideration 282 F.2d 195. The Court's intention to cite this is not readily apparent. This might be interpreted that the Court viewed the misappropriation of proceeds in *Bankers Life* as the same, in substance, as the sale of securities for inadequate consideration. Or the Court might have intended to reemphasize the occurrence of the injury on the part of Manhattan.
67 404 U.S. at 10, 11 n.7. *See supra* note 20 and accompanying text.
68 404 U.S. at 10, 11 n.7. The Court proceeded to cite *Brod's* statement that § 10(b) and rule 10b-5 prohibit *all* fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden-type variety of fraud, or present a unique form of deception. *Id.*
69 *Id.* at 12.
70 *Id.* at 11, 12.
71 *Id.* at 12.

With respect to the problem of fiduciary breach, the Court agreed with the Second Circuit to the extent that "Congress by § 10(b) did not seek to regulate transactions which comprise no more than internal corporate mismanagement."[72] It held, however, that the fact that the fraud was perpetrated by an insider is irrelevant to determining the applicability of § 10(b).[73] The reason given was that "§ 10(b) bans the use of any deceptive device in the 'sale' of any security by 'any person.' "[74] The result is that the Second Circuit failed in an attempt to limit the scope of rule 10b-5. Such action was taken because of its fears of the runaway growth of implied liability and the intrusion of rule 10b-5 into fiduciary realms where state laws are active.[75]

Although fiduciary breaches are not to be specially treated, in view of the fact that Begole owned all the stock of Manhattan, a question arose as to whether Manhattan could be defrauded by Begole and his collaborators. The district court had noted that "[i]n view of the unusual fact that the fraud was practiced . . . only upon creditors and policy holders, it is dubious whether plaintiff corporation was ever defrauded or deceived."[76] The Second Circuit did not indicate any express concern, although it ruled that "no investor [was] injured."[77] The Supreme Court noted, however, that, according to the history of the Securities Exchange Act, "Congress was especially concerned with the impact of frauds on creditors of corporations,"[78] and held:

> [T]he fact that creditors of the defrauded corporate buyer or seller of securities may be the ultimate victims does not warrant disregard of the corporate entity. 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."[79]

Since it did not disregard the corporate entity of Manhattan despite the fact that Begole owned all the stock of Manhattan, the Court could find that Manhattan was duped and injured as an investor by Begole and his associates.

At common law a director or a controlling stockholder owes his corporation a fiduciary obligation. Their dealings with the corporation are subjected to rigorous scrutiny.[80] Such an obligation is enforceable by the corporation directly or through a stockholders' derivative action.[81] In the event of the bankruptcy

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72 *Id.*

73 *Id.* at 10. This implies that there will be no special treatment such as requiring additional elements (*e.g.*, deception) solely because of the involvement of fiduciary breach.

74 *Id.*

75 *See* A. BROMBERG, SECURITIES LAW, FRAUD, SEC RULE 10b-5 § 4.7(1), at 84.2, 85; *cf.* Schoenbaum v. Firstbrook, 405 F.2d 215, 220 (2d Cir. 1968) (en banc) (dissent, saying that the majority opinion "does indeed open the floodgates"); Schoenbaum v. Firstbrook, 405 F.2d 200, 212, 213 (2d Cir. 1968) (panel).

76 Superintendent of Ins. v. Bankers Life & Cas. Co., 300 F. Supp. 1083, 1101 n.16 (S.D.N.Y. 1969).

77 Superintendent of Ins. v. Bankers Life & Cas. Co., 430 F.2d 355, 361 (2d Cir. 1970).

78 Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 12 n.8 (1971).

79 *Id.* at 12.

80 Pepper v. Litton, 308 U.S. 295, 306 (1939).

81 In some situation, minority shareholders may also recover for their own benefit to the extent of their respective stock interests. Perlman v. Feldmann, 219 F.2d 173 (2d Cir. 1955), *cert. denied,* 349 U.S. 952 (1955).

of a corporation, it is enforceable by the trustee in bankruptcy,[82] since the trustee stands in the shoes of the bankrupt corporation.[83] Thus the fiduciary obligation has been held to be "designed for the protection of the entire community of interests in the corporation—creditors as well as stockholders."[84] However, the enforcement of the fiduciary obligation has traditionally been left to the states. Nonetheless, the private right of action recognized under § 10(b) and rule 10b-5 has been held available as a remedy for the protection of the minority shareholders, through a derivative action, against breaches of the fiduciary obligation.[85] This was accomplished by disregarding the corporate fiction and recognizing the real owners.[86] Where there are minority stockholders, protection of minority shareholders necessarily accompanies that of the creditors. *Bankers Life* means a further encroachment into the state corporate fiduciary law. The fiduciary obligation has become enforceable under the name of federal law for the protection of corporate creditors as well as its stockholders. The Court has made it clear that once § 10(b) requirements are met there is redress under § 10(b), no matter what "might be available as a remedy under state law."[87] *Bankers Life* particularly signifies an acknowledgement of the vulnerability of creditors of a one-man (or one-group) corporation. It impliedly adopts a policy that loss of corporate assets resulting from a fiduciary's fraudulent securities transaction will not go unredressed even absent minority stockholders, thereby maintaining public confidence in the corporation.

Since the involvement of fiduciary breaches has become irrelevant, the question turns to the starting point of what is the scope of fraudulent conduct within § 10(b) and rule 10b-5. As mentioned above, the Court did not set forth any positive definition of an "act" or "practice" which operates as a "fraud" or "deceit." Certainly, this is an area of law where "glib generalizations and unthinking abstractions are major occupational hazards"[88] and "a cautious, case-by-case approach is necessary to the proper development of controlling precedent."[89] Consequently, minimum attributes of fraudulent conduct sufficient to be actionable under rule 10b-5 were not explored. Neither did the Court specify the elements of defendants' conduct which constituted an "act or practice which operated as a fraud or deceit." Instead it made a total valuation of the defendants' conduct as a whole.

Under rule 10b-5, proscribed fraudulent conduct is classified into three

82 Pepper v. Litton, 308 U.S. 295, 307 (1939).
83 11 U.S.C. § 110(a) (1971).
84 Pepper v. Litton, 308 U.S. 295, 307 (1939).
85 *E.g.,* Pappas v. Moss, 393 F.2d 865 (3d Cir. 1968); Schoenbaum v. Firstbrook, 405 F.2d 215 (2d Cir. 1968); Shell v. Hensley, 430 F.2d 819 (5th Cir. 1970).
86 *E.g., Schoenbaum v. Firstbrook,* 405 F.2d 200, 215 (2d Cir. 1968) (panel) (dissent), would deny the interposition of "the corporate fiction between the directors and the minority stockholders who were . . . the real owners of the property with which the directors were dealing"; *Pappas v. Moss,* 393 F.2d 865, 869 (3d Cir. 1968), would replace the defrauded corporate entity with the "independent" stockholders.
87 Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 12 (1971); *accord,* Bloomenthal, *From Birnbaum To Schoenbaum: The Exchange Act And Self-Aggrandizement,* 15 N.Y.L.F. 332, 349, 350 (1969). "The adequacy or inadequacy of the state remedy has never been considered determinative of the right to maintain an action under the federal securities laws." *Id.*
88 SEC v. National Securities, Inc., 393 U.S. 453, 465 (1969).
89 Shell v. Hensley, 430 F.2d 819, 825 (5th Cir. 1970).

categories: (1) "To employ any device, scheme, or artifice to defraud"; (2) "To make any untrue statement of a material fact or to omit to state a material fact . . ."; and (3) "To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person." While the third clause is the most comprehensive, one clause overlaps others. Thus most cases make no effort to distinguish the clauses, lumping all of them together.[90]

However, the Court in *Bankers Life* indicated that, in finding such an act or practice which operated as a fraud or deceit, it had in mind two elements: (1) Manhattan was "duped" into believing that it [Manhattan] would receive the proceeds[91]; and (2) defendants' act or practice "deprived [Manhattan] of the compensation for the sale" of the securities.[92] The Court avoided using "deceived" in favor of "duped." The implication is not clear. However, the fact that Manhattan was "duped" was based on the plaintiff's allegation that Manhattan's board of directors was "deceived" into authorizing the sale of bonds by the misrepresentation that the proceeds would be exchanged for a certificate of deposit of equal value.[93] Under this situation, it would be mere conjecture as to whether the Court rejected the deception requirement of *O'Neill*.[94] At any rate the first element seems to approve the *Cooper* holding that "the outlawed activity is not limited to the portion of the transaction involving an exchange of consideration by the purchaser for the stock."[95] Thus securities transactions, innocent in themselves, may be held violative of rule 10b-5 if they are followed somehow by deprivation of the benefits of the transactions.[96] This became clear by the Court's somewhat surprising statement that "[i]ndeed, misappropriation is a 'garden variety' type of fraud" and by the conclusion that § 10(b) "must be read flexibly, not technically and restrictively."

Section 10(b) and rule 10b-5 require that the proscribed fraudulent conduct be "in connection with" the purchase or sale of any security. The "connection" requirement has three aspects:[97] (1) the time aspect, (2) the transactional aspect, and (3) the causation or reliance aspect.[98] Relating to the time aspect is the Second Circuit's statement that "[t]here is a structural difference between

90 A. BROMBERG, SECURITIES LAW, FRAUD, SEC RULE 10b-5 § 2.6 (3), at 52 n.141.
91 Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 9 (1971).
92 *Id.* at 10.
93 *Id.* at 8 n.1.
94 However, there is some evidence to guess that the Court may not require any strict deception, it avoided using "deceived" in favor of "duped"; it cited, in one point, *Shell v. Hensley:* 430 F. 2d 819 (5th Cir. 1970), which expressly rejected the deception requirement; and it held that § 10(b) "must be read flexibly, not technically and restively."
95 Cooper v. North Jersey Trust Company of Ridgewood, 226 F. Supp. 972, 978 (S.D.N.Y. 1964).
96 *See* note 15 *et seq. supra* and accompanying text.
97 A. BROMBERG, SECURITIES LAW, FRAUD, SEC RULE 10b-5 § 7.6(1), at 190.22.
98 Relating to the causation and reliance aspect is *Securities and Exchange Comm'n v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968).

> Therefore it seems clear from the legislative purpose Congress expressed in the Act, and the legislative history of Section 10(b) that Congress when it used the phrase "in connection with the purchase or sale of any security" intended only that the device employed, whatever it might be, be of a sort that would cause reasonable investors to rely thereon, and, in connection therewith, so relying, cause them to purchase or sell a corporation's securities.

Id. at 860.

the sale of the corporation's bonds . . . and the subsequent fraudulent misappropriation of the proceeds received."[99] Relating to the transactional aspect are the Second Circuit's rulings in *Bankers Life* that "[w]ith respect to the terms of the transaction itself neither the purchaser nor the seller of the bonds was deceived or defrauded,"[100] and in *Drachman* that "[t]here is no claim that the alleged fraud in any way infected the redemption transaction nor could there be; the redemption was effected in accordance with the terms of the debentures."[101] The meaning of the phrase "the terms of the sale itself" as used in the Second Circuit's opinion in *Bankers Life* has been clarified by the same court in *Drachman*, as meaning: if the fraud does not affect the payment of the full consideration, it is not "in connection with" the securities transaction.[102] This "connection" requirement became more stringent when the *Drachman* court required that the alleged fraud be "intrinsic to the securities transaction itself."[103] The Supreme Court, however, vigorously refused these narrow approaches suggested by the Second Circuit. According to the Court, the "connection" means no more than "touching."

> The crux of the present case is that Manhattan suffered an injury as a result of deceptive practices *touching* its sale of securities as an investor.[104]

The result is that another attempt of the Second Circuit to limit the scope of rule 10b-5 through the "connection" requirement has definitely failed.[105]

The Securities Exchange Act was conceived to deal with "transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets. . . ."[106] Regulation and control of such securities transactions was partly "to insure the maintenance of fair and honest markets in such transactions. . . ."[107] The Supreme Court, however, decided to read § 10(b) "flexibly, not technically and restrictively." It relied on two findings of the Congress.[108] One is that manipulation, investor's ignorance and disregard of trust relationships were all so subtly interrelated that none of these evils could be isolated for cure of itself alone. The other is that broad discretionary power in the regulatory agency was practically essential in order to deal with constantly

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99 Superintendent of Ins. v. Bankers Life & Cas. Co., 430 F.2d 355, 360 (2d Cir. 1970).
100 *Id.*
101 Drachman v. Harvey, —— F.2d —— (2d Cir. 1971), [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶93,129, at 91,093, 91,101.
102 *See Id.* at 91,100:

> [T]his court [in *Bankers Life*], upon noting the absence of an allegation in the complaint "that the full and fair market price was not paid for those bonds by their purchaser," concluded that "since neither the purchaser nor the seller of the bonds was deceived or defrauded," no 10b-5 claim was stated because the alleged fraud was not "in connection with" the securities transaction.

Id.
103 *Id.* at 91,101.
104 Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 12, 13 (1971) (emphasis added).
105 The only remaining limitation imposed by *Birnbaum* on rule 10b-5 is the standing problem (*i.e.*, "purchaser or seller" requirements). *See* note 6 *supra.*
106 15 U.S.C. § 78b (1971).
107 *Id.*
108 Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 11, 12 (1971).

varying practices. Hence the Court did "not read § 10(b) as narrowly as the Court of Appeals [for the Second Circuit] . . ." and accorded a full face value to rule 10b-5. Also, the Court unlimitedly recognized Congress' concern with the impact of frauds on creditors of corporations, although Congress seems to have been concerned only with situations involving management divorced from ownership.[109]

Bankers Life represents a significant expansion of rule 10b-5 into the area of non-conventional securities frauds in face-to-face transactions, including fiduciary breach situations. Also significant is that it implements a federal policy of protecting creditors of a corporation as well as its minority shareholders through rule 10b-5. The propriety of the continuing expansion of § 10(b) and rule 10b-5 accompanying an encroachment into the area of state fiduciary laws must depend on present and future economic and business demand.

Ho Il Yoon

109 H.R. REP. No. 1383, 73d Cong., 2d Sess. 5 (1934).