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Section 10(b) -- All That Is Unfair Is Not Fraud: Santa Fe Industries, Inc. v. Green

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CASENOTES

Section 10(b)-All That Is Unfair Is Not Fraud: *Santa Fe Industries, Inc. v. Green*¹—The phenomenon of “going private,” whereby the majority stockholders of a publicly held corporation return the company to private ownership by eliminating the minority public stockholders from their equity position in the corporation,² has engendered a large body of legal commentary.³ Some observers suggest that a corporation’s expulsion of its minority stockholders may be an abuse of the controlling stockholders’ power, resulting in the unwarranted oppression of the minority stockholders.⁴ Additionally, it has been noted that the bearish stock market of recent years provides a strong incentive for companies to go private, since the majority stockholders are able to repurchase the corporation’s stock at prices reflecting the depressed market conditions.⁵ As a result, the minority public stockholders may receive less than their initial investment for their shares.⁶

Minority stockholders, faced with being frozen out of a corporation contemplating going private, often seek to challenge the validity of the transaction under state law.⁷ Such challenges have also been instituted

¹ 430 U.S. 462 (1977).

² Moore, *Going Private: Techniques and Problems of Eliminating the Public Stockholder*, 1 J. CORP. L. 321, 321-22 (1976). There are five basic techniques which may be used alone or in combination with one another to effectuate a going private transaction: (a) the repurchase of shares other than through cash tender offers; (b) cash tender offers; (c) exchange offers; (d) reorganization through cash-out merger or sale of assets; and (e) a reverse stock split. *Id.* at 323.

Going private transactions have also been selected by the SEC for regulation under proposed rule 13e-3, which, if enacted, will govern going private transactions by certain issuers through requirements of disclosure and overall fairness. 2 FED. SEC. L. REP. (CCH) ¶ 1 23,703A, 23,706. For a discussion of the proposed rule 13e-3 see Securities Exchange Act Release No. 14185, [Current] FED. SEC. L. REP. (CCH) ¶ 81,366. The resulting effects of going private which will bring the transaction under proposed rule 13e-3 include: the delisting of a class of equity securities from a national securities exchange; termination of registration under § 12(g)(4) of the Securities Exchange Act; eligibility for suspension of an issuer’s reporting obligations under § 15(d) of the Securities Exchange Act; and cessation of authorization for quotation of a class of equity securities on an inter-dealer system. *Id.* at 17,245-4.

³ See, e.g., F. O’NEAL, “SQUEEZE-OUTS” OF MINORITY SHAREHOLDERS: EXPULSION OR OPPRESSION OF BUSINESS ASSOCIATES (1975); Borden, *Going Private – Old Tort, New Tort or No Tort?*, 49 N.Y.U. L. REV. 987 (1974) [hereinafter cited as Borden]; Brudney, *A Note on “Going Private”*, 61 VA. L. REV. 1019 (1975) [hereinafter cited as Brudney]; Brudney & Chirelstein, *Fair Shares in Corporate Mergers and Takeovers*, 88 HARV. L. REV. 297 (1974); O’Neal & Janke, *Utilizing Rule 10b-5 for Remedying Squeeze-Outs or Oppression of Minority Shareholders*, 16 B.C. IND. & COM. L. REV. 327 (1975) [hereinafter cited as O’Neal & Janke]; Note, *Going Private*, 84 YALE L. J. 903 (1975) [hereinafter cited as YALE Note].

Several commentators, while expressing general concern with the overall phenomenon of going private, argue that different standards should be developed to govern the various corporate contexts in which going private transactions occur. The three most common situations are: (1) a closely held corporation merging with a shell corporation to eliminate particular stockholders; (2) a parent corporation eliminating public stockholders of a subsidiary; and (3) a public corporation returning itself to private status. Borden, *supra*, at 1040-42. See also Greene, *Corporate Freeze-Out Mergers: A Proposed Analysis*, 28 STAN. L. REV. 487, 508-14 (1976).

⁴ O’Neil & Janke, *supra* note 3, at 327-28; YALE Note, *supra* note 3, at 905-06.

⁵ Borden, *supra* note 3, at 987-89; YALE note, *supra* note 3, at 903.

⁶ Brudney, *supra* note 3, at 1019.

⁷ E.g., *Bryan v. Brock & Blevins Co.*, 490 F.2d 563, 569-71 (5th Cir.), cert. denied, 419 U.S. 844 (1974) (challenge to short-form merger on ground that merger was fraudulent device to eliminate plaintiff upheld); *Singer v. Magnavox Co.*, 380 A.2d 969, 980 (Del. Sup. Ct. 1977) (claim of breach of fiduciary duty in long-form merger upheld); *Tanzer v. International Gen. Indus., Inc.*, 379 A.2d 1121, 1125 (Del. Sup. Ct. 1977) (challenge to long-form merger

under section 10(b) of the Securities Exchange Act of 1934,⁸ and rule 10b-5⁹ promulgated thereunder.¹⁰ Section 10(b) is the general anti-fraud provision of the Act which proscribes manipulative and deceptive acts or practices in connection with a securities transaction. In going private transactions, a critical factor in terms of potential section 10(b) liability is the fact that the majority stockholders may not have engaged in such fraudulent acts as nondisclosure or misrepresentation. The minority stockholders in such situations must therefore attempt to recover under section 10(b) on claims of breach of fiduciary duty and on the inherent unfairness of being forcibly foreclosed from maintaining ownership of their stock. Thus, such a section 10(b) action raises the threshold question whether a claim under section 10(b) and rule 10b-5 can be maintained absent allegations that the

on claim of breach of fiduciary duty upheld; cashed-out stockholders entitled to hearing on fairness of merger terms); *Stauffer v. Standard Brands, Inc.*, 41 Del. Ch. 7, 10-11, 187 A.2d 78, 80 (Sup. Ct. 1962) (challenge to short-form merger on claim of breach of fiduciary duty unsuccessful because appraisal remedy is exclusive in the absence of actual fraud); *Kemp v. Angel*, 381 A.2d 241, 245 (Del. Ch. 1977) (recognition of claim of breach of fiduciary duty in *Singer* extended to short-form merger; preliminary injunction granted and trial on issue of overall fairness ordered); *People v. Concord Fabrics, Inc.*, 83 Misc. 2d 120, 124-25, 371 N.Y.S.2d 550, 554 (Sup. Ct.), *aff'd per curiam*, 50 App. Div. 2d 787, 377 N.Y.S.2d 84 (1975) (injunction granted against long-form merger under state securities statute).

⁸ 15 U.S.C. § 78j(b) (1970). The statute reads in full:

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 or for the protection of investors.

Id.

⁹ 17 C.F.R. § 240.10b-5 (1977). The rule reads as follows:

Employment of Manipulative and Deceptive Devices.

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.

Id.

¹⁰ *E.g.*, *Marshall v. AFW Fabrics Corp.*, 533 F.2d 1277, 1278 (2d Cir.), *vacated and remanded for a determination of mootness*, 429 U.S. 881 (1976) (claim seeking injunction against long-form merger upheld under § 10(b)); *Green v. Santa Fe Indus., Inc.*, 533 F.2d 1283 (2d Cir. 1976), *rev'd*, 430 U.S. 462 (1977) (complaint challenging short-form merger as fraudulent act violating § 10(b) in absence of showing of justifiable corporate purpose upheld); *Kauffman v. Lawrence*, 386 F. Supp. 12, 17 (S.D.N.Y. 1974), *aff'd per curiam*, 514 F.2d 283 (2d Cir. 1975) (claim for injunctive relief against long-form merger denied in absence of allegations of nondisclosure or misrepresentation); *Voegel v. American Sumatra Tobacco Corp.*, 241 F. Supp. 369, 373, 375 (D. Del. 1965) (short-form merger violates § 10(b) when value of stock is misrepresented to minority stockholders); *Dreier v. Music Makers Group, Inc.*, [1973-74 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,406, at 95,410 (S.D.N.Y. 1974) (merger cannot be challenged under § 10(b) on ground of unfairness alone).

defendant engaged in manipulative or deceptive conduct involving nondisclosure or misrepresentation.

In its 1977 Term, the Supreme Court, in *Santa Fe Industries, Inc. v. Green*,¹¹ considered for the first time whether a challenge to a procedurally correct short-form merger¹² can be maintained under section 10(b) on a theory of breach of fiduciary duty absent allegations of nondisclosure or misrepresentation. The Court held that such a claim is not cognizable under section 10(b) since allegations of nondisclosure or misrepresentation are necessary elements of a section 10(b) claim,¹³ and that in their absence, section 10(b) is unconcerned with questions of overall fairness.¹⁴ The decision of the Court of Appeals for the Second Circuit in *Santa Fe*, holding that a complaint alleging breach of fiduciary duty by a majority stockholder is cognizable under section 10(b) in the absence of nondisclosure or misrepresentation,¹⁵ was thus totally rejected by the Supreme Court. In so holding, the Supreme Court determined that, as between section 10(b) of the Securities Exchange Act and state statutory and fiduciary duty law, state law provides the proper forum for resolving issues of overall fairness to minority stockholders raised by the going private phenomenon.

The *Santa Fe* decision marks an important step in interpreting the scope of section 10(b). The Court's ruling that only those complaints alleging manipulation or deception are cognizable under section 10(b) and rule 10b-5 precludes expansion of section 10(b) liability and will therefore significantly affect future federal regulation of corporate affairs under section 10(b).¹⁶ This casenote will examine the correctness of the narrow view of the scope of section 10(b) adopted by the Supreme Court in *Santa Fe* as compared with the broad view advanced by the Second Circuit in its decision in *Santa Fe*. For the purpose of this analysis, the facts of the *Santa Fe* case and the opinions of the courts will first be explicated. The rationale of the Supreme Court's narrow view of section 10(b) which limits the scope of

¹¹ 430 U.S. 462 (1977).

¹² A short-form merger differs from a long-form merger in that a short-form merger is effectuated solely by resolution of the boards of directors of the merging corporations whereas shareholder approval is required in a long-form merger. Under the Delaware merger statute a short-form merger may be effectuated only when one of the merging corporations controls at least 90% of the stock of the other. DEL. CODE tit. 8, § 253(a) (1975). In all other cases, the long-form merger procedure must be followed. DEL. CODE tit. 8, §§ 251, 252 (1975). See N.Y. BUS. CORP. LAW § 905 (McKinney 1977) (short-form merger requires ownership of 95% of the other corporation's stock).

¹³ 430 U.S. at 474.

¹⁴ *Id.* at 476.

¹⁵ *Green v. Santa Fe Indus., Inc.*, 533 F.2d 1283, 1291 (2d Cir. 1976), *rev'd*, 430 U.S. 462 (1977).

¹⁶ The Supreme Court heard two private actions under § 10(b) between 1975 and 1977, and in each case read § 10(b) narrowly. In *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), the Court denied standing under rule 10b-5 to a non-purchasing or non-selling plaintiff, and affirmed the rule laid down in *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461, 463-64 (2d Cir.), *cert. denied*, 342 U.S. 956 (1952), that only actual purchasers and sellers of securities have standing to sue under the rule. 421 U.S. at 731, 754-55. In *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), the Supreme Court addressed the question whether a claim under § 10(b) and rule 10b-5 may be stated on a theory of negligent nonfeasance or whether scienter must be alleged. Resolving the conflict among the circuits, the Court held that scienter is an essential element of a claim under rule 10b-5. *Id.* at 193 & n.12, 214. For a discussion of the restrictive posture of the Court in this area and with respect to other provisions of the federal securities statutes, see Lowenfels, *Recent Supreme Court Decisions under the Federal Securities Laws: The Pendulum Swings*, 65 GEO. L. REV. 891 (1977).

that section to complaints alleging manipulation or deception will be examined. Having discussed the narrow view of section 10(b) adopted by the Supreme Court, this casenote will examine the broad view adopted by the Second Circuit in its decision in *Santa Fe*, under which section 10(b) is read expansively to encompass complaints alleging breach of fiduciary duty and unfairness in securities transactions. The issue raised in *Santa Fe* regarding the propriety of judicially creating federal fiduciary standards of fairness under section 10(b) will then be examined with reference to the two views of section 10(b). The rationale proffered by the Second Circuit for recognizing federal fiduciary duties in the context of short-form mergers will be discussed and contrasted with the Supreme Court's refusal to utilize section 10(b) to redress claims of unfairness. It will be submitted that the *Santa Fe* Court properly refused to read section 10(b) as encompassing claims of unfairness and breach of fiduciary duty not perpetrated by manipulation or deception.

I. THE *SANTA FE* DECISION

The short-form merger challenged in *Santa Fe* was undertaken by Santa Fe Industries, Inc., a Delaware corporation, to obtain one hundred percent ownership of Kirby Lumber, a company in which Santa Fe controlled ninety-five percent of the stock.¹⁷ The merger was effectuated pursuant to section 253 of the Delaware General Corporation Laws.¹⁸ This Delaware statute provides that a parent corporation which controls at least ninety percent of the stock of a subsidiary may, upon resolution of the parent's board of directors, merge that subsidiary with the parent corporation and make cash payments for the shares of the minority stockholders.¹⁹ Significantly, the statute does not require that the merger be undertaken to serve a justifiable corporate purpose.²⁰ The board of directors of the par-

¹⁷ 430 U.S. at 465. Kirby was controlled by Santa Fe through a wholly owned subsidiary, Santa Fe Natural Resources, Inc., which owned the Kirby stock. *Id.* at 465 n.2.

¹⁸ *Id.* at 465. DEL. CODE tit. 8, § 253(a) (1975) provides in relevant part:

In any case in which at least 90% of the outstanding shares of each class of the stock of a corporation . . . is owned by another corporation . . . the corporation having such stock ownership may either merge the other corporation . . . into itself and assume all of its or their obligations, or merge itself . . . into . . . the other corporations by executing, acknowledging and filing . . . a certificate of such ownership and merger setting forth a copy of the resolution of its board of directors to so merge and the date of the adoption; provided, however, that in case the parent corporation shall not own all of the outstanding stock of all the subsidiary corporations, parties to a merger as aforesaid, the resolution of the board of directors of the parent corporation shall state the terms and conditions of the merger, including the securities, cash, property, or rights to be issued, paid, delivered, or granted by the surviving corporation upon surrender of each share of the subsidiary corporation

Thirty-seven other states have short-form merger statutes comparable to Delaware's. *Green v. Santa Fe Indus., Inc.*, 533 F.2d 1283, 1299 (2d Cir. 1976) (Moore, J., dissenting), *rev'd*, 430 U.S. 462 (1977).

¹⁹ DEL. CODE tit. 8, § 253(a) (1975).

²⁰ *Green v. Santa Fe Indus., Inc.*, 430 U.S. 462, 479 n.16 (1977). *See also* *Stauffer v. Standard Brands, Inc.*, 41 Del. Ch. 7, 10-11, 187 A.2d 78, 80 (Sup. Ct. 1962) (purpose of statute is to provide corporate majority with means for the elimination of the minority). Subsequent to *Santa Fe*, the Delaware Court of Chancery ruled that for a short-form merger to be valid, it must be shown to be fair to the minority stockholders. *Kemp v. Angel*, 381 A.2d 241, 245 (Del. Ch. 1977).

ent corporation is empowered under the statute to initiate the merger without shareholder approval and without previously notifying them of its action.²¹ Section 262 of the Delaware statute grants frozen out minority stockholders who are dissatisfied with the offering price of the merger the right to have the value of their shares appraised in the Court of Chancery.²²

Santa Fe, Kirby's parent corporation, effectuated the Kirby merger through use of a dummy corporation.²³ The board of directors of the dummy corporation voted to merge with Kirby and offer \$150 per share to Kirby's minority stockholders.²⁴ The minority stockholders were notified of the merger the next day, and were sent an information statement which fully disclosed the financial status of Kirby and reported the process by which the stock had been valued.²⁵ Under Delaware law, the minority stockholders' only alternatives were either to accept the majority's offer, or to reject it and seek appraisal of their stock's value in the Court of Chancery.²⁶

Plaintiff Green rejected Santa Fe's offer and decided not to pursue his appraisal rights under Delaware law.²⁷ Instead, Green brought suit in the United States District Court for the Southern District of New York against Santa Fe, derivatively on behalf of Kirby²⁸, and as a class action on behalf of the minority stockholders of Kirby.²⁹ The plaintiffs sought to have the merger set aside, or alternatively, to recover the fair value of their stock.³⁰ The plaintiffs alleged that the merger scheme violated section 10(b) of the Securities Exchange Act of 1934 and rule 10b-5, on the ground that the merger and the proffered cash exchange constituted a "device, scheme or artifice to defraud" carried out solely to benefit the majority stockholders at

²¹ DEL. CODE tit. 8, § 253(a)-(d) (1975). Notice of the merger must be sent to the stockholders within ten days of the effective date of the merger. *Id.* at § 253(d). Santa Fe sent notice the day after the merger was consummated, which notice alerted the stockholders to their appraisal rights. 430 U.S. at 466. Santa Fe fully complied with the requirements of § 253 in accomplishing the merger. *Id.*

²² DEL. CODE tit. 8, § 262 (1975). The statute itself is silent on the exclusivity of the appraisal remedy but it had been held to be exclusive, subject only to the power of equity to deal with illegality and fraud. *Stauffer v. Standard Brands, Inc.*, 41 Del. Ch. 7, 9-10, 187 A.2d 78, 80 (Sup. Ct. 1962).

²³ 430 U.S. at 466 n.3.

²⁴ *Id.* at 466. Prior to the merger Santa Fe obtained independent appraisals of Kirby's physical assets and its oil and gas interests. The asset appraisals were submitted to Morgan Stanley & Co. for an appraisal of the value of Kirby stock. Morgan Stanley concluded that the stock had a fair market value of \$125 per share. *Id.*

²⁵ *Id.*

²⁶ See *Stauffer v. Standard Brands, Inc.*, 41 Del. Ch. 7, 10-11, 187 A.2d 78, 80 (Sup. Ct. 1962); *Vine v. Beneficial Fin. Co.*, 374 F.2d 627, 635 (2d Cir.), *cert. denied*, 389 U.S. 970 (1967).

²⁷ The plaintiffs filed for an appraisal in the court of chancery, but later withdrew the petition. 430 U.S. at 466-67 & n.4.

²⁸ *Green v. Santa Fe Indus., Inc.*, 391 F. Supp. 849, 850-51 (S.D.N.Y. 1975), *rev'd*, 533 F.2d 1283 (2d Cir. 1976), *rev'd*, 430 U.S. 462 (1977). Jurisdiction was based on § 27 of the Securities Exchange Act of 1934, 15 U.S.C. § 78aa (1970), which creates exclusive jurisdiction in the federal district courts for all suits arising under the provisions of the Act or the rules and regulations promulgated thereunder. Pendant jurisdiction over state law claims of breach of fiduciary duty was also claimed. 391 F. Supp. at 851.

²⁹ 391 F. Supp. at 850-51.

³⁰ 430 U.S. at 467.

the minority's expense without any justifiable corporate purpose and without prior notice to the minority stockholders.³¹ Thus, the plaintiffs contended that the merger was a fraudulent act violating section 10(b), despite the fact that Santa Fe had complied with the notice requirements of the Delaware merger statute and had disclosed all material information in the information statement.³² The complaint set forth as an additional claim an allegation that the stock was grossly undervalued by Santa Fe, and that this undervaluation itself constituted actionable fraud under rule 10b-5.³³

Santa Fe filed a motion to dismiss the plaintiffs' complaint, which motion the district court granted.³⁴ In so doing, the court stated that section 10(b) neither modifies the notice requirements of the Delaware merger statute nor imposes an independent requirement that a justifiable corporate purpose be served for a short-form merger to be valid.³⁵ The court concluded that a complaint challenging a procedurally correct short-form merger is not cognizable under section 10(b) if defendants have made a full and fair disclosure of the material facts.³⁶ Since it was conceded that Santa Fe had fully complied with the notice requirements of the Delaware statute, and since the court found that Santa Fe had not misrepresented the value of Kirby's assets, the court held that the complaint failed to state a claim under rule 10b-5.³⁷ The court further held that offering an inadequate price for the minority's stock in a going private transaction does not alone

³¹ 391 F. Supp. at 852.

³² *Id.* at 853-54.

³³ *Id.* at 852. The plaintiffs claimed that the Kirby stock had a value of at least \$772 per share. This figure reflected the liquidation value of Kirby's assets, and was accepted as true by the district court for the purposes of Santa Fe's motion to dismiss. However, the court noted that liquidation value is generally not determinative in an appraisal of fair market value. *Id.* at 853. The plaintiffs also contended that Santa Fe's offering price was raised \$25 over that recommended by Morgan Stanley as part of a scheme to lull the minority stockholders into accepting the offer in the belief that Santa Fe was generous. *Id.* at 852.

Morgan Stanley was also a named defendant. The complaint alleged that Morgan Stanley knowingly participated in the fraudulent undervaluation of the Kirby stock. *Id.* The complaint against Morgan Stanley was dismissed by the district court, which dismissal was affirmed on appeal. 391 F. Supp. 849, 856 (S.D.N.Y. 1975), *rev'd on other grounds*, 533 F.2d 1283, 1293-94 (2d Cir. 1976).

³⁴ 391 F. Supp. at 856.

³⁵ *Id.* at 853. The court viewed § 10(b) as a disclosure provision, the objective of which is to be achieved in conjunction with state law. *Id.* The court also relied on rules promulgated by the SEC to regulate going private transactions as indicative of the SEC's conclusion that rule 10b-5 did not reach the acts complained of in *Santa Fe*. *Id.* at 854-55. The proposed rules would have required a valid business purpose for the merger and disclosure prior to the effectuation of the transaction. See Proposed Rules 13e-3A and 13e-3B, 2 FED. SEC. L. REP. (CCH) ¶ 23,704-05; Securities Act Release No. 5567, [1974-75 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,104. The SEC has recently proposed an additional rule, rule 13e-3, to regulate going private transactions. This rule would maintain the disclosure requirements, but would replace the requirement of a valid business purpose with one of overall fairness. Securities Exchange Act Release No. 14185, [Current] FED. SEC. L. REP. (CCH) ¶ 81,366; 2 FED. SEC. L. REP. (CCH) ¶¶ 23,703A, 23,706.

³⁶ 391 F. Supp. at 854.

³⁷ *Id.* at 853-54. The court also ruled that even if the information statement did not constitute full disclosure, the complaint failed to allege causation between the alleged deception and the plaintiffs' injury since Santa Fe's offering price was not accepted by the plaintiffs. *Id.* at 855.

constitute bad faith or overreaching by the majority and therefore is not itself a violation of section 10(b).³⁸

Plaintiff appealed the district court's decision to the United States Court of Appeals for the Second Circuit.³⁹ A divided court reversed the district court's dismissal,⁴⁰ holding that a cause of action under section 10(b) is stated when a complaint alleges that the majority stockholders breached their fiduciary duty by effecting a short-form merger for no justifiable business purpose.⁴¹ The Second Circuit also concluded that allegations of nondisclosure or misrepresentation are not necessary to state a claim under rule 10b-5.⁴² The court based its conclusion that allegations of nondisclosure or misrepresentation are not essential elements of a claim under rule 10b-5 both on the long history of cases under section 10(b) relying on allegations of breach of fiduciary duty,⁴³ and on the need to read section 10(b) broadly to effectuate its purpose of protecting investors from injuries suffered in securities transactions.⁴⁴

The Second Circuit considered a broad reading of section 10(b) necessary since going private transactions involve a large potential for abuse of the majority stockholders' control of the corporation with concomitant injury to the minority stockholders.⁴⁵ In particular, the court pointed out that the Delaware short-form merger statute permits the majority stockholders to determine unilaterally the timing and the terms of the merger.⁴⁶ Further, the court emphasized that the majority stockholders may act without giving prior notice of the merger to the minority stockholders, thereby precluding the possibility that minority shareholders could seek pre-merger relief.⁴⁷ The Second Circuit concluded that full dis-

³⁸ *Id.* at 854. The court concluded that the complaint revealed only that the parties disagreed on the fair market value of the stock, and that since the relevant facts giving rise to the dispute were fully revealed, § 10(b) was inapplicable. *Id.* The plaintiffs conceded on oral argument before the court that if the difference between the offering price and true value were so slight that reasonable minds could differ, the complaint would fail. *Id.* at 853 n.1.

³⁹ 533 F.2d 1283, 1285 (2d Cir. 1976).

⁴⁰ *Id.* at 1294. Judge Moore dissented on the grounds that the court had unjustifiably utilized § 10(b) to override valid state law and to find fraud in the effectuation of a legitimate corporate transaction. *Id.* at 1299-1309.

⁴¹ *Id.* at 1291. The exact nature of the business purpose test was not discussed by the court. Nor did the court reach the claim that gross undervaluation of the stock alone states a claim under rule 10b-5. *Id.*

⁴² *Id.* at 1287. For text of rule 10b-5 see note 9 *supra*.

⁴³ *Id.* at 1287, 1289-91. The court relied heavily on its decision in *Schoenbaum v. Firstbrook*, 405 F.2d 215 (2d Cir. 1968) (en banc), *cert. denied*, 395 U.S. 906 (1969), where it held that a violation of rule 10b-5 was stated when plaintiffs alleged that the controlling stockholder had engaged in improper self-dealing and breach of fiduciary duty in the absence of nondisclosure or misrepresentation. *Id.* at 219-20.

⁴⁴ 533 F.2d at 1290. *See* *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 12 (1971) ("[s]ection 10(b) must be read flexibly, not technically and restrictively"). *See also* *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 151 (1972); *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967).

⁴⁵ 533 F.2d at 1287.

⁴⁶ *Id.* at 1289. The court considered the majority's power to effectuate a short-form merger on its own terms potentially injurious to the minority stockholders since the majority are likely to effect the merger at a time when the stock's value is particularly low. Further, the majority may offer an inadequate price for the stock which, if accepted by the minority, would result in an unwarranted benefit to the majority. *Id.*

⁴⁷ *Id.* at 1291. Although the Second Circuit considered the unavailability of pre-merger relief to be particularly significant, it was not essential to the recognition of a § 10(b) claim. Indeed, five days before its decision in *Santa Fe* the Second Circuit had upheld a claim for a

closure is not "the crucial inquiry" in the context of a short-form merger because post-merger disclosure of financial information does nothing to mitigate the fraudulent act of merging for no justifiable corporate purpose.⁴⁸

Defendant Santa Fe petitioned the Supreme Court for certiorari, which the Court granted.⁴⁹ The court reversed the Second Circuit,⁵⁰ and in a 6-2-1 decision,⁵¹ held that section 10(b) proscribes only manipulative and deceptive conduct,⁵² and thus, that a complaint alleging only a breach of a majority stockholders' fiduciary duty, absent allegations of nondisclosure or misrepresentation, does not state a cause of action under section 10(b).⁵³

Writing for the majority, Justice White maintained that the determination of the proper scope of section 10(b) turned solely upon the language⁵⁴ and upon the legislative history of that section.⁵⁵ In so doing, he seemingly rejected the broad, remedial view of section 10(b) adopted by the Second Circuit.⁵⁶ Instead, Justice White concluded that the language of section 10(b) gives "no indication that Congress meant to prohibit any conduct not involving manipulation or deception."⁵⁷ Similarly, the legislative history of section 10(b), in Justice White's view, gives no indication that Congress intended section 10(b) to reach any conduct not involving manipulation or deception.⁵⁸ Justice White therefore concluded that only claims alleging manipulative or deceptive conduct are cognizable under section 10(b).⁵⁹

After concluding that section 10(b) requires an allegation of either deception or manipulation, the Court next considered whether the plaintiffs' complaint set forth a claim that Santa Fe's short-form merger involved de-

preliminary injunction against a proposed long-form merger in a case where pre-merger relief under state law was obtainable. *Marshel v. AFW Fabric Corp.*, 533 F.2d 1277, 1278, *vacated and remanded for a determination of mootness*, 429 U.S. 881 (1976).

⁴⁸ 533 F.2d at 1292. In *Popkin v. Bishop*, 464 F.2d 714 (2d Cir. 1974), the court denied a claim for a preliminary injunction against a long-form merger in the absence of allegations of nondisclosure or misrepresentation, holding that once full disclosure is insured, § 10(b) is unconcerned with questions of fairness. *Id.* at 720. *Popkin* was distinguished in *Santa Fe* on its facts since the merger in *Popkin* was being undertaken to serve a compelling corporate purpose. *Id.* at 1291. The court recognized, however, that its decision in *Popkin* could be criticized because it failed to take into account the fact that full disclosure in the *Popkin* situation was ineffective to the extent that the minority stockholders were powerless to affect the outcome of the stockholder vote. *Id.*

⁴⁹ 429 U.S. 814 (1976).

⁵⁰ 430 U.S. 462, 471 (1977).

⁵¹ Justices Blackmun and Stevens concurred in part in the judgment of the Court. Justice Brennan dissented. 430 U.S. at 480.

⁵² 430 U.S. at 473-74.

⁵³ *Id.* at 476-77.

⁵⁴ *Id.* at 472, quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197 (1976), quoting *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 756 (1975) (Powell, J., concurring). The Court stated that the scope of rule 10b-5 can be no broader than the scope of § 10(b). *Id.* at 472-73. The Court also noted that the absence of the SEC in the case as amicus curiae in support of the plaintiffs' claim made it particularly important to adhere to the language of the statute. *Id.* at 473 n.12. The SEC had appeared as amicus curiae for the plaintiffs in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) and *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975). However, in both cases the Court rejected the interpretation of § 10(b) urged by the Commission. *Hochfelder*, 425 U.S. at 197-99; *Blue Chip*, 421 U.S. at 743, 754-55.

⁵⁵ 430 U.S. at 473.

⁵⁶ See 430 U.S. at 471-72, 474-76.

⁵⁷ *Id.* at 473.

⁵⁸ *Id.*

⁵⁹ *Id.* at 473-74.

ception violating section 10(b). Under the facts alleged by the plaintiffs, the Court found no basis for such a claim.⁶⁰ Determining that full disclosure of material facts is the antithesis of deception,⁶¹ the majority noted that the plaintiffs did not contend that the information statement provided to the minority stockholders contained any omissions or misrepresentations.⁶² Given this fact, the majority observed that Santa Fe therefore had in no way acted to deceive the minority stockholders as to the value of their stock, and that on the basis of the data contained in the information statement, the plaintiffs could intelligently exercise their option to "accept the price offered or reject it and seek an appraisal in the Delaware Court of Chancery."⁶³ The majority therefore determined that these factors mandated the conclusion that the defendants had satisfied the full disclosure requirement of section 10(b), and thus, that the short-form merger was not tainted with deception.⁶⁴

After reaching its conclusion that the plaintiffs had failed to set forth a claim of deception, the Court determined that the cases relied on by the plaintiffs and the Second Circuit did not support the proposition that the breach of a fiduciary duty without more violates section 10(b).⁶⁵ In these cases, the Court contended, a breach of fiduciary duty was found to violate section 10(b) because there was present an element of deception.⁶⁶ The Court viewed the existence of deception as the essential element of the section 10(b) claim in each case and therefore found no support in the cases for the Second Circuit's contention that a nondeceptive breach of fiduciary duty violates section 10(b).⁶⁷

⁶⁰ *Id.*

⁶¹ *Id.* at 477-78. The Court apparently considered the minority stockholder's sole interest in the merger to be the protection of their right to receive the fair market value of their stock, and therefore limited its scrutiny of the merger under § 10(b) to insuring that this right was not impaired by nondisclosure or misrepresentation in the information statement. *See* 430 U.S. at 474-76. Justice Stevens expressly stated his view that the minority stockholders had no interest in the motive for the merger under the facts in *Santa Fe*. 430 U.S. at 481 n.2 (Stevens, J., concurring).

⁶² *Id.* at 474. The Court rejected the plaintiffs' contention that the lack of pre-merger notice was a material nondisclosure since the plaintiffs had accepted the conclusion of the lower courts that under Delaware law they could not have enjoined the merger. Thus, the plaintiffs were unable to establish that they would have acted differently had they received notice of the proposed merger. *Id.* at 474 n.14.

⁶³ *Id.* at 474.

⁶⁴ *Id.* at 474-76.

⁶⁵ *Id.* at 474-75 & n.15 and cases cited therein.

⁶⁶ The cases cited by the Court were premised on the "new fraud" theory of § 10(b) liability. Under the "new fraud" theory, a complaint alleging that the majority stockholders exercised a controlling influence over the corporation in a securities transaction to the detriment of the minority stockholders is cognizable under § 10(b) in the absence of actual deception. While several of the "new fraud" cases do contain findings that the minority stockholders were deceived by the controlling stockholders, these specific findings of deception were tangential to the actual holdings of the respective courts under the "new fraud" theory. *See, e.g.,* *Shell v. Hensley*, 430 F.2d 819, 826-27 (5th Cir. 1970); *Schoenbaum v. Firstbrook*, 405 F.2d 215, 220 (2d Cir. 1968) (en banc), *cert. denied*, 395 U.S. 906 (1969); *Pappas v. Moss*, 393 F.2d 865, 867, 869 (3d Cir. 1968). The "new fraud" theory itself, however, may be interpreted as consistent with the narrow view of § 10(b) adopted by the *Santa Fe* Court, so that the difference between the two theories becomes one of semantics rather than of principle. *See* text at notes 132-134 *infra*.

⁶⁷ 430 U.S. at 474-76 & n.15. The Court also refused to determine the definition of fraud under § 10(b) by reference to cases relied on by the Second Circuit defining fraud in contexts other than the Securities Act of 1933 and the Securities Exchange Act of 1934. *Id.* at 471 & n.11 and cases cited therein.

The Court then turned to the question whether the short-form merger was manipulative under the terms of section 10(b). The Court concluded that the merger was not tainted with manipulation.⁶⁸ In reaching this conclusion, the Court initially noted that the term "manipulation," as used in securities law, is "virtually a term of art."⁶⁹ As such, the term "manipulation" encompasses a limited array of practices, such as wash sales, matched orders, and rigged prices,⁷⁰ which are used to artificially affect market activity and thereby to mislead investors as to the true value of a security.⁷¹ In view of its limited definition in the securities context, the Court concluded that the term "manipulation" does not encompass a breach of fiduciary duty such as that alleged in the plaintiff's complaint, the essence of which was that the minority stockholders were treated unfairly by Santa Fe.⁷²

Having concluded that the plaintiffs failed to set forth a cognizable claim under the strict language of section 10(b), the majority presented "additional considerations that weigh heavily against permitting a cause of action under Rule 10b-5 for . . . breach of corporate fiduciary duty" absent a concurrent allegation of deception or manipulation.⁷³ The first consideration suggested by the Court for rejecting a section 10(b) cause of action predicated solely upon breach of fiduciary duty was that an implied cause of action should be recognized under rule 10b-5 only when it is necessary to further section 10(b)'s fundamental purpose.⁷⁴ This fundamental purpose, in the Court's view, is to insure full disclosure of material information in securities transactions.⁷⁵ Consequently, recognizing a claim under section 10(b) for breach of fiduciary duty and unfairness would be utilizing the federal forum to redress what is, at best, a tangential concern of the statute.⁷⁶ The second consideration suggested by the Court was that recognition of such a claim would interfere with state corporation law.⁷⁷ The Court noted that duties of a fiduciary have traditionally been determined by state law.⁷⁸ Moreover, while the Court acknowledged that federal fiduciary standards might well be desirable to govern going private transactions such as the merger in *Santa Fe*, it refused to create such standards judicially under section 10(b) and rule 10b-5 in the absence of express congressional intent.⁷⁹ Accordingly, the decision of the Second Circuit recog-

⁶⁸ *Id.* at 474, 476.

⁶⁹ *Id.* at 476, quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 (1976).

⁷⁰ 430 U.S. at 476-77. See § 9 of the Securities Exchange Act of 1934, 15 U.S.C. § 78i (1970). "Manipulation" also encompasses intracorporate acts which artificially affect stock prices. See *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374, 378-81 (2d Cir. 1974), *cert. denied*, 421 U.S. 976 (1975) (manipulation of stock value as result of misappropriation of corporate assets and subsequent merger on preferential terms violates rule 10b-5); *Cochran v. Channing Corp.*, 211 F. Supp. 239, 242-43 (S.D.N.Y. 1962) (manipulation of stock value by intentional reduction of dividends and subsequent purchase of stock violates rule 10b-5).

⁷¹ 430 U.S. at 477.

⁷² *Id.*

⁷³ *Id.*

⁷⁴ *Id.*

⁷⁵ *Id.* at 477-78.

⁷⁶ *Id.* at 478.

⁷⁷ *Id.* at 478-79.

⁷⁸ *Id.* at 478.

⁷⁹ *Id.* at 479-80. See Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L. J. 663 (1974). Professor Cary argues that there should be a separate federal fiduciary code and that § 10(b) should not be expanded to cover every claim of unfairness. *Id.* at 699-700.

nizing the plaintiffs' complaint under section 10(b) was reversed by the Supreme Court.⁸⁰

The differing results reached in *Santa Fe* by the Second Circuit⁸¹ and Supreme Court⁸² reflect two differing views of section 10(b)'s scope. According to the narrow view adopted by the Supreme Court, section 10(b) encompasses only situations in which deception or manipulation are alleged in connection with the purchase or sale of securities.⁸³ Under the alternative view adhered to by the Second Circuit, section 10(b) is deemed to have broad, remedial purposes such that deception or manipulation are not necessary elements in all claims brought thereunder.⁸⁴ Each of these views is discussed in greater detail below.

II. TWO VIEWS OF THE SCOPE OF SECTION 10(b)

A. *The Narrow Interpretation of 10(b)*

The narrow view of section 10(b) underlying the Supreme Court's decision in *Santa Fe* is premised on the notion that the primary purpose of both the Securities Act of 1933 and the Securities Exchange Act of 1934 was to replace the prevailing doctrine of caveat emptor with a doctrine requiring full disclosure of material information.⁸⁵ Under this view, it is presumed that if there is full disclosure in securities transactions, all parties will be aware of any material information⁸⁶ and thus will be able to protect their rights and interests fully.⁸⁷ Proponents of this narrow view of section 10(b) find support for their position in the language of section 10(b). Section 10(b) proscribes conduct solely in terms of manipulation, deception and fraud.⁸⁸ Thus, the statute's language does not expressly prohibit every

⁸⁰ Justices Blackmun and Stevens concurred in the judgment of the Court, but refused to join the majority insofar as the "additional considerations" portion of the opinion contained in Part IV was concerned. 430 U.S. at 480-81. Both Justices considered this portion unnecessary to the decision and exacerbative of the restrictive posture of the Court in interpreting § 10(b), a trend against which they had both previously dissented. *Id.* Justice Stevens further contended that the complaint failed to state a claim for breach of fiduciary duty because the minority stockholders were entitled to the fair market value of their stock under Delaware law and full disclosure of all material facts had been made by *Santa Fe*. *Id.* at 481.

⁸¹ 533 F.2d 1283, 1291 (2d Cir. 1976).

⁸² 430 U.S. 462, 476-77 (1977).

⁸³ *Id.* at 473-74.

⁸⁴ 533 F.2d at 1287, 1290.

⁸⁵ SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963). The market practices which prompted the enactment of the 1934 Act are detailed in the legislative history. See S. REP. NO. 792, 73d Cong., 2d Sess. 1-5 (1934).

⁸⁶ See *Popkin v. Bishop*, 464 F.2d 714 (2d Cir. 1972), in which the Second Circuit, speaking of merger transactions subject to shareholder approval under state law, said:

In the context of such transactions, if federal law ensures that shareholder approval is fairly sought and freely given, the principal federal interest is at an end. Underlying questions of the wisdom of such transactions or even their fairness become tangential at best of federal regulation.

Id. at 720. See also *Kauffman v. Lawrence*, 386 F. Supp. 12, 17 (S.D.N.Y. 1974), *aff'd per curiam*, 514 F.2d 283 (2d Cir. 1975).

⁸⁷ See, e.g., 3 L. LOSS, SECURITIES REGULATION 1435 (2d ed. 1961) [hereinafter cited as Loss]; Comment, Schoenbaum v. Firstbrook: *The "New Fraud" Expands Federal Corporation Law*, 55 VA. L. REV. 1103, 1119 (1969).

⁸⁸ For text of § 10(b) see note 8 *supra*.

type of alleged unfairness which may inhere in a securities transaction. Rather, as proponents of this narrow view contend, only those inequitable results caused by manipulative or deceptive acts are within the scope of the remedy provided in section 10(b) and given effect under rule 10b-5.⁸⁹

The operation of section 10(b) is not limited solely to transactions in the securities market. Rather, section 10(b) serves to insure full disclosure of material information in securities transactions effectuated wholly within a corporation itself.⁹⁰ This extension of section 10(b) into the corporate boardroom is consistent with the narrow view of section 10(b) and arises because intracorporate fraud accomplished through deception or manipulation is as likely to occur and is as injurious to investors as fraud effectuated in the securities market. Consequently, the Supreme Court has held that intracorporate acts of deception and manipulation are proper subjects of federal regulation under section 10(b).⁹¹

Intracorporate fraud in securities transactions often stems from the majority stockholders' abuse of their control over the corporation, resulting in harm both to the minority stockholders and the corporation. This control⁹² of the corporation allows the majority stockholders to engage in numerous securities transactions without first seeking minority stockholder approval.⁹³ While transactions effectuated without minority stockholder

⁸⁹ *Santa Fe*, 430 U.S. at 477. The Court has stated that the language of § 10(b) should be read "flexibly, not technically and restrictively." *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 12 (1971). This mandate has served to bring novel and atypical acts of fraud, previously excluded by the courts, within the scope of § 10(b). *Id.* at 10-12. *See* A.T. Brod & Co. v. Perlow, 375 F.2d 393, 396-97 (2d Cir. 1967) (suit by broker alleging fraud on part of customers who actually purchased ordered stock only if market conditions remained favorable is cognizable under § 10(b)). However, the Court in *Bankers Life* also stated its view that "Congress by § 10(b) did not seek to regulate transactions which constitute no more than internal corporate mismanagement." 401 U.S. at 12.

⁹⁰ *See generally* I A. BROMBERG, SECURITIES LAW: FRAUD § 4.7 (Supp. 1972-73) [hereinafter cited as BROMBERG]; Comment, Schoenbaum v. Firstbrook: *The "New Fraud" Expands Federal Corporation Law*, 55 VA. L. REV. 1103 (1969).

⁹¹ *See, e.g.*, *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 12-13 (1971) (fraud under § 10(b) recognized by Supreme Court where defendants misappropriated corporate assets, using them to finance purchase of corporation's stock). In *Bankers Life*, however, the Court, consistent with the narrow view of § 10(b), stated that transactions constituting no more than internal mismanagement are not within the scope of § 10(b). *Id.* at 12. *See generally* Note, *The Controlling Influence Standard in Rule 10b-5 Corporate Mismanagement Cases*, 86 HARV. L. REV. 1007, 1015-20 (1973).

⁹² "Control" is a term of art in securities law. *See* 17 C.F.R. § 240.12b-2(f) (1977). *See also* I LOSS, *supra* note 87, at 770, 778-79; Note, *The Controlling Influence Standard in Rule 10b-5 Corporate Mismanagement Cases*, 86 HARV. L. REV. 1007, 1034-36 (1973).

⁹³ *See, e.g.*, DEL. CODE tit. 8, §§ 141, 161, 170, 253 (1975). The board of directors may generally issue stock, redeem convertible stock, pay dividends, and effect a short-form merger without first seeking shareholder approval. *Id.* Even where shareholder approval is required, the outcome is often predetermined since the controlling stockholders necessarily hold at least a majority of the voting stock. *See, e.g.*, *Popkin v. Bishop*, 464 F.2d 714, 716 (2d Cir. 1972) (shareholder approval of long-form merger unaffected by minority vote); *Swanson v. American Consumer Indus., Inc.* 415 F.2d 1326, 1331 (7th Cir. 1969) (minority stockholders holding 13% of voting stock unable to affect outcome of vote on proposed exchange offer). As a result of a majority's power to effect a given transaction, proof of causation under § 10(b) has been relaxed from that required by traditional theory so that plaintiffs need only establish that the alleged misrepresentations or omissions caused them economic harm. *See* *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374, 380-83 (2d Cir. 1974); *Swanson*, 415 F.2d at 1331-32. Further, reliance on the alleged deception need not be proved in a case challenging a short-form merger under § 10(b). *Vine v. Beneficial Fin. Co.*, 374 F.2d 627, 635 (2d Cir.), *cert. denied*, 389 U.S. 970 (1967).

approval may not involve a breach of an actual duty to disclose, it is well recognized that transactions involving an abuse of corporate control can "deceive" the minority stockholders.⁹⁴ Thus, when a corporation issues stock,⁹⁵ redeems its convertible debentures,⁹⁶ engages in a short-form merger⁹⁷ or any other securities transaction, and plaintiffs allege that the controlling stockholder has acted in a manner which has deceived the stockholders as to the true facts of the transaction, section 10(b) extends to the complaint and examines the manner in which the transaction was carried out to insure that the rights of the minority stockholders are fully protected.⁹⁸

To the extent that section 10(b) acts to remedy harm suffered from a manipulative or deceptive intracorporate securities transaction, it insures that the terms of the transaction are fair to the minority stockholders.⁹⁹ According to the narrow view of section 10(b), fairness presumptively results once all material information is disclosed to the parties concerned. Once this disclosure has been made, all parties are deemed to be on notice of their rights and options. Thus, in an intracorporate context, section 10(b)'s strictures are satisfied once the majority discloses all material information respecting a securities transaction — including a short-form merger — to the minority stockholders.¹⁰⁰ However, if it is shown that the majority stockholders exercised their controlling influence to effectuate a transaction without fully disclosing pertinent information to the minority stockholders, a cognizable section 10(b) claim is established.¹⁰¹ Consequently, under the narrow view of section 10(b), alleging fundamental unfairness of the result stemming from an intracorporate transaction, without more, is insufficient to establish a claim under section 10(b) since inequities may obtain from sources other than nondisclosure.¹⁰²

B. *The Broad Interpretation of Section 10(b)*

The strict view adopted by the *Santa Fe* Court in defining the scope of section 10(b) is not, as noted above, the exclusive approach adopted by courts in resolving the issue of the scope of section 10(b). The alternative view of section 10(b), adopted by the Second Circuit in *Santa Fe*,¹⁰³ may be

⁹⁴ See *Schoenbaum v. Firstbrook*, 405 F.2d 215, 220 (2d Cir. 1968) (en banc), cert. denied, 395 U.S. 906 (1969); *Pappas v. Moss*, 393 F.2d 865, 867, 869 (3d Cir. 1968). See also *Jacobs, The Role of Securities Exchange Act Rule 10b-5 in the Regulation of Corporate Mismanagement*, 59 CORNELL L. REV. 27, 57-61 (1973).

⁹⁵ See, e.g., *Schoenbaum v. Firstbrook*, 405 F.2d 215, 217-18 (2d Cir.) (en banc), cert. denied, 395 U.S. 906 (1969).

⁹⁶ See *Drachman v. Harvey*, 453 F.2d 722, 724-25, 736 (2d Cir. 1972) (en banc).

⁹⁷ See *Vine v. Beneficial Fin. Co.*, 374 F.2d 627, 630-31 (2d Cir.), cert. denied, 389 U.S. 970 (1967); *Voegel v. American Sumatra Tobacco Corp.*, 241 F. Supp. 369, 372 (D. Del. 1965).

⁹⁸ *Schoenbaum*, 405 F.2d at 219-20; *Drachman*, 453 F.2d at 737; *Vine*, 374 F.2d at 637; *Voegel*, 241 F. Supp. at 372, 376.

⁹⁹ See 4 BROMBERG, *supra* note 90, § 12.5, at 275-76.

¹⁰⁰ *Santa Fe*, 430 U.S. at 478; *Popkin v. Bishop*, 464 F.2d 714, 720 (2d Cir. 1972).

¹⁰¹ See cases cited in note 98 *supra*.

¹⁰² Most obviously, arguably inequitable results may obtain due to unequal capital in the market or unequal voting strength in the corporation, as well as unfavorable market conditions. Further, even if the Second Circuit's "business purpose" test were adopted, see text at note 41 *supra*, it is not clear whether satisfying that standard would actually remove any inequity inhering in a merger or merely legitimize such results.

¹⁰³ 533 F.2d 1283.

termed the "remedial" or "broad" view. This remedial approach considers the primary purpose of section 10(b) to be that of achieving overall fairness in securities transactions by protecting innocent investors from overreaching by persons possessing superior information or control of the corporate process.¹⁰⁴ Under this broad view of section 10(b), all complaints alleging that innocent investors have been harmed by a securities transaction in which they have no control over the outcome are cognizable. Thus, while the concept of fairness in securities law is defined under the strict view solely in terms of equal access to material information, under the remedial view of fairness, section 10(b) also encompasses those complaints seeking relief from inequitable acts accomplished through means other than non-disclosure or misrepresentation.¹⁰⁵ This latter type of unfairness occurs in the market as a consequence of unequal bargaining power resulting from unequal capital, and, in the intracorporate context, is due to unequal control resulting from the corporate system of majority rule. Advocates of the remedial view maintain that federal securities law should be utilized to mitigate the harm resulting from unequal capital and control in the context of freeze out mergers.¹⁰⁶

Adherents of this broad view find support for their position in the legislative purpose announced in the Securities Exchange Act to provide uniform federal relief for all injuries suffered in connection with a securities transaction.¹⁰⁷ Reflecting this broad purpose of section 10(b) to remedy injuries, the section was described in the legislative history as a "catch-all" provision,¹⁰⁸ and as one intended to encompass claims arising from all inequitable securities transactions effectuated for no justifiable purpose.¹⁰⁹ Thus, the broad approach defines the scope of section 10(b) primarily in terms of whether the plaintiff has incurred injury in connection with a securities transaction and, in the context of short-form mergers, whether the resulting inequity was justified by the existence of a valid purpose for effecting the transaction.¹¹⁰ Accordingly, while the existence of full disclosure is often relevant in determining the lawfulness of a given

¹⁰⁴ *Santa Fe*, 533 F.2d at 1287. See *Charles Hughes & Co. v. SEC*, 139 F.2d 434, 437 (2d Cir. 1943), cert. denied, 321 U.S. 786 (1944); 1 *Loss, supra* note 87, at 130-31; S. REP. NO. 792, 73d Cong., 2d Sess. 1-5 (1934).

¹⁰⁵ *Santa Fe*, 533 F.2d at 1287.

¹⁰⁶ See, e.g. O'Neal & Janke, *supra* note 3, at 327-30; Note, *Going Private: An Analysis of Federal and State Remedies*, 44 *FORDHAM L. REV.* 796, 816 (1976); Comment, *The Second Circuit Adopts a Business Purpose Test for Going Private: Marshal v. AFW Fabric Corp. and Green v. Santa Fe Industries, Inc.*, 64 *COLUM. L. REV.* 1184, 1196-97 (1976); Address by A.A. Somer, Jr., Commissioner, Securities and Exchange Commission, Law Advisory Council Lecture, Notre Dame Law School, South Bend, Indiana, reprinted in [1974-75 Transfer Binder] *FED. SEC. L. REP.* (CCH) ¶ 80,010.

¹⁰⁷ *Drachman v. Harvey*, 453 F.2d 722, 728-29 (2d Cir.), rev'd on other grounds on rehearing en banc, 453 F.2d 736 (2d Cir. 1972). Support for the remedial view of § 10(b) is also claimed from the purpose of Securities Exchange Act to maintain public confidence in the securities market. See *Santa Fe*, 533 F.2d at 1296 (Mansfield, J., concurring); 15 U.S.C. § 78(b) (1970); Note, *The Controlling Influence Standard in Rule 10b-5 Corporate Mismanagement Cases*, 86 *HARV. L. REV.* 1007, 1046 (1973).

¹⁰⁸ *Hearings on H.R. 7852 and H.R. 8720 Before the House Comm. on Interstate and Foreign Commerce*, 73d Cong., 2d Sess. 115 (1934) (Remarks of Thomas G. Corcoran, Stock Exchange Regulation). See also, 1 *BROMBERG, supra* note 90, § 2.2(332), at 22.4 (Supp. 1970-71).

¹⁰⁹ See S. REP. NO. 792, 73d Cong. 2d Sess. 7 (1934).

¹¹⁰ *Santa Fe*, 533 F.2d at 1291.

transaction, under the remedial approach it is not always the "crucial inquiry,"¹¹¹ nor is it determinative of whether section 10(b) has been violated. This concern for protecting investors, furthered by the remedial approach to section 10(b), thus supports the view that if a securities transaction is alleged to have caused inequitable results without simultaneously having served a justifiable purpose, the claim is cognizable under section 10(b) and rule 10b-5.

The so-called "new fraud" theory of section 10(b) liability,¹¹² first announced by the Second Circuit in *Schoenbaum v. Firstbrook*,¹¹³ is premised on the remedial approach to interpreting the scope of section 10(b).¹¹⁴ Under the "new fraud" theory, a claim that the majority stockholders exercised a controlling influence over the corporation to the detriment of the minority stockholders is cognizable under section 10(b) even without actual deception. Therefore, unlike the narrow view of section 10(b), the theory of "new fraud" is not limited in scope to fraud accomplished through traditional acts of manipulation or deception. Because fraud may often be accomplished in intracorporate transactions even in the absence of actual deception¹¹⁵ by virtue of the majority stockholders' control of the corporate processes, the "new fraud" theory focuses on fraud accomplished through improper self-dealing by a corporate majority which results in economic harm to the corporation and its minority stockholders.¹¹⁶

The remedial view's focus on acts of improper self-dealing, rather than acts of nondisclosure or misrepresentation, as the basis of section 10(b) liability in the context of intracorporate securities transactions stems from the absence of arms length bargaining in that context. There is no arms length bargaining in an intracorporate transaction because the controlling stockholders' personal interests in the transaction tend to be adverse to those of the minority stockholders and of the corporation itself, to

¹¹¹ *Id.* at 1292. *But see* *Popkin v. Bishop*, 464 F.2d 714, 720 (2d Cir. 1972) (in context of long-form merger, full disclosure is the only federal interest under § 10(b)).

¹¹² *Popkin v. Bishop*, 464 F.2d 714, 719 (2d Cir. 1972). *See, e.g.*, *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374 (2d Cir. 1974), *cert. denied*, 421 U.S. 976 (1975); *Drachman v. Harvey*, 453 F.2d 722 (2d Cir. 1972) (en banc); *Shell v. Hensley*, 430 F.2d 819 (5th Cir. 1970); *Rekant v. Dresser*, 425 F.2d 872 (5th Cir. 1970); *Pappas v. Moss*, 393 F.2d 865 (3d Cir. 1968).

¹¹³ 405 F.2d 215 (2d Cir. 1968) (en banc), *cert. denied*, 395 U.S. 906 (1969). *Schoenbaum* was a derivative suit by the minority stockholders of Banff Oil, Ltd., claiming that Banff was defrauded by Aquitane Co. of Canada Ltd., Banff's controlling stockholder, when it caused Banff to issue stock to itself just prior to the announcement of a major oil discovery which greatly increased the value of Banff stock. 405 F.2d 200, 204-06. On argument before a three judge panel the district court's award of summary judgment to the defendants was affirmed because the panel found that all of Banff's directors were informed of the terms of the transaction and that this knowledge had to be imputed to the corporation. *Schoenbaum v. Firstbrook*, 405 F.2d 200, 204, 211, 214 (2d Cir. 1968). Sitting en banc, however, the Second Circuit reversed the decision on the "new fraud" theory of liability under rule 10b-5. 405 F.2d 215, 219-20. The court reached an alternative holding that the minority stockholders of Banff were deceived by the sale. *Id.* at 220.

¹¹⁴ See note 66 *supra*.

¹¹⁵ "Actual deception" here refers to both nondisclosure and misrepresentation of material information.

¹¹⁶ See generally Bloomenthal, *From Birnbaum to Schoenbaum: The Exchange Act and Self Aggrandizement*, 15 N.Y.L.J. 332, 332-37 (1969); Comment, *Schoenbaum v. Firstbrook: The "New Fraud" Expands Federal Corporation Law*, 55 VA. L. REV. 1103 (1969).

whom they owe a fiduciary duty of fair dealing.¹¹⁷ Since the controlling stockholders may be empowered to effect a securities transaction without prior disclosure of the transaction's terms to the minority stockholders, minority stockholders may be injured even though there is no act of non-disclosure or misrepresentation which, according to the narrow view of section 10(b), is sufficient upon which to premise section 10(b) liability. Consequently, proponents of the "new fraud" theory advocate utilizing section 10(b) to determine whether the majority stockholders' exercise of control over the corporation has resulted in harm to the minority stockholders rather than limiting the scope of section 10(b) to inquiring whether an actual duty to disclose has been breached.¹¹⁸

The remedial view of section 10(b), adopted by the Second Circuit in *Santa Fe*, seeks to effect the broad purpose underlying the Securities Exchange Act of protecting investors from injuries incurred in securities transactions. Proponents of this remedial view advocate expanding the scope of section 10(b) to encompass complaints arising from intracorporate securities transactions effectuated by the controlling stockholders in the absence of actual deception. According to the remedial view, section 10(b) would thus encompass claims of breach of fiduciary duty, claims which traditionally are the province of state law. Consequently, the broad view of section 10(b) provides for a greater spectrum of federal involvement in state corporate law than is sanctioned by the narrow view which would limit section 10(b) relief to intracorporate transactions involving manipulation or deception.

C. *The Two Views of Section 10(b) as Applied in Santa Fe*

The two views of section 10(b), the narrow view of the Supreme Court and the broad view of the Second Circuit, differ most markedly in the context of intracorporate securities transactions where allegedly fraudulent acts are committed in the absence of actual deception or manipulation. Whereas under the broad view, section 10(b) may properly extend to issues of overall fairness arising from the majority stockholders' exercise of corporate control, under the narrow view, section 10(b) is deemed concerned only with redressing unfairness resulting from acts of manipulation or deception. This difference between the two views of section 10(b) is further highlighted in cases such as *Santa Fe* where a plaintiff alleges that the majority stockholders' actions constituted a breach of fiduciary duty not recognized as such under state corporate fiduciary law.¹¹⁹ Such a claim re-

¹¹⁷ These transactions have been labelled "conflict transactions." 1 BROMBERG, *supra* note 90, § 4.7(000)(1) (Supp. 1972-73). An adverse personal interest is clearly present in a freeze-out merger where the majority stockholders stand to realize higher earnings per share, higher book value per share, and larger proportional control for their holdings at the expense of the minority stockholders who are cashed out at depressed prices. 4 BROMBERG, *supra* note 90, § 4.7 at 400.11.

¹¹⁸ See O'Neal & Janke, *supra* note 3, at 342; Note, *The Controlling Influence Standard in Rule 10b-5 Corporate Mismanagement Cases*, 86 HARV. L. REV. 1007, 1040 (1973); Comment, *Schoenbaum v. Firstbrook: The "New Fraud" Expands Federal Corporation Law*, 55 VA. L. REV. 1103, 1113-14 (1969).

¹¹⁹ *Stauffer v. Standard Brands, Inc.*, 41 Del. Ch. 7, 187 A.2d 78 (Del. Sup. Ct. 1962) (in the absence of actual fraud, appraisal is the exclusive remedy of frozen out minority stockholders). The holding in *Stauffer* was undercut by the Delaware Court of Chancery in 1977, in *Kemp v. Angel*, 381 A.2d 241, where the court granted a preliminary injunction against a

quires federal courts to determine the proper interface between federal and state regulation of corporate affairs. More particularly, the issue becomes whether section 10(b) creates any *federal* fiduciary duties or whether it relies solely upon the fiduciary duties existing in the particular state involved.¹²⁰ With respect to this fiduciary duty issue, the narrow interpretation of section 10(b) suggests that the imposition of federal fiduciary duties is improper, since section 10(b) is concerned solely with issues of nondisclosure and misrepresentation. Conversely, the broad view of section 10(b) suggests that, on occasion, imposing federal fiduciary duties upon parties to securities transactions will be proper since state fiduciary laws may inadequately protect minority stockholders from inequitable results in securities transactions.

The Second Circuit, adopting a broad view of section 10(b), considered the short-form merger effectuated by *Santa Fe* to eliminate the minority stockholders of Kirby Lumber Company an appropriate instance for the recognition of federal fiduciary duties under section 10(b). The recognition of federal fiduciary duties was appropriate in *Santa Fe*, according to the Second Circuit, because Delaware law provided inadequate protection to minority stockholders frozen out in a short-form merger. In this regard, the court impliedly recognized an interest on the part of the minority stockholders in retaining ownership of their stock at least until such time as the majority stockholders could justify a forced divestiture by referring to a valid business purpose.¹²¹ The Second Circuit thus viewed Delaware law as inadequate because the merger statute provided minority stockholders with no right to participate in the decision to merge.¹²² Furthermore, the court noted that under Delaware fiduciary law, minority stockholders have no right to challenge the unfairness of being forcibly divested of their holdings by a merger allegedly undertaken for the sole purpose of furthering the interests of the majority stockholders.¹²³ Rather, the *Santa Fe* plaintiffs' sole remedy was the statutory appraisal proceeding. The Second Circuit determined that the appraisal remedy was similarly inadequate to protect the interests of the minority stockholders since appraisal is concerned only with assessing the fair market value of the stock at the time of the merger rather than with the motive therefore.¹²⁴ Due to the inadequate protection af-

proposed short-form merger and ordered a trial on the question of the overall fairness to the minority stockholders. *Id.* at 245.

¹²⁰ This question has seldom been expressly addressed by commentators or the courts. However, it has been suggested that federal courts lack the power to create fiduciary standards under § 10(b). Borden, *supra* note 3 at 1037-39. See also *Santa Fe*, 533 F.2d at 1304-07 (Moore, J., dissenting); *Diamond v. Oreamuno*, 24 N.Y.2d 494, 503-04, 248 N.E.2d 910, 915, 301 N.Y.S.2d 78, 85 (N.Y. App. 1969) ("the primary source of law in this area ever remains that of the state which created the corporation").

¹²¹ 533 F.2d at 1289-92. This approach appears to be a modification of a strict "vested interest" rationale, which would vest stockholders with a right to veto virtually all transactions. See Borden, *supra* note 3, at 1020-21.

¹²² 533 F.2d at 1289. See DEL. CODE tit. 8, § 253 (1975).

¹²³ *Id.* at 1289, 1291-92. Subsequent to the decision in *Santa Fe*, the Delaware courts have ruled that minority stockholders frozen out in a going private merger may challenge the overall fairness of the transaction. *Singer v. Magnavox Co.*, 380 A.2d 969, 980 (Del. Sup. Ct. 1977) (long-form merger); *Tanzer v. International Gen. Indus., Inc.*, 379 A.2d 1121, 1125 (Del. Sup. Ct. 1977) (long-form merger); *Keimp v. Angel*, 381 A.2d 241, 245 (Del. Ch. 1977) (short-form merger).

¹²⁴ *Id.* at 1289. See DEL. CODE tit. 8, § 262 (1975).

forded to the minority stockholders by Delaware law, the Second Circuit found it both necessary and appropriate to utilize section 10(b) as a forum for redressing any injuries incurred in a short-form merger.

While the Second Circuit's approach may appear reasonable, it is submitted that the strict approach adopted by the Supreme Court provides both the most appropriate analytical framework for interpreting the scope of section 10(b) and the proper result in determining that federal fiduciary standards should not be imposed on short-form mergers under section 10(b). This conclusion is supported by several considerations.

First, the strict view of section 10(b) adopted by the Supreme Court is supported by the language of the statute which, in every section 10(b) case, is "the appropriate starting point."¹²⁵ Reference to the language of section 10(b) reveals that the section is directed at eliminating fraud in connection with securities transactions perpetrated by manipulation of stock prices or deception of parties through nondisclosure or misrepresentation of material information.¹²⁶ While the remedial purpose of section 10(b), to protect investors, militates in favor of a broad reading of this language,¹²⁷ this purpose nevertheless fails to justify recognizing a complaint alleging conduct not within the scope of illegality defined in section 10(b). Similarly, the language of rule 10b-5 must be read in conjunction with that of section 10(b) under which it is promulgated, and rule 10b-5 cannot independently render illegal conduct not proscribed by section 10(b).¹²⁸ Accordingly, it appears that the Supreme Court was correct in refusing to recognize a complaint under section 10(b) in the absence of allegations of manipulation or deception.¹²⁹

The second consideration supporting the determination in *Santa Fe*, that federal courts should not judicially create fiduciary duties under section 10(b) absent allegations of manipulation or deception, is the lack of support for this development in the legislative history of the Securities Exchange Act. It appears from the legislative history that the statute was intended primarily to eliminate the wide spread abuses in the securities market which resulted in the market crash of 1929.¹³⁰ The prohibition of manipulative and deceptive acts in section 10(b) has been correctly extended beyond the market to intracorporate transactions tainted with comparable abuses of inside information and control. This extension has been fully consistent with the statute's goal of insuring a climate of fair dealing in securities.¹³¹ This goal of fairness, presumably achieved through full disclosure of material information, does not, however, sanction the utilization of

¹²⁵ 430 U.S. at 472, quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 212-14 (1976), quoting *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 756 (1975) (Powell, J., concurring).

¹²⁶ For text of § 10(b) see note 8 *supra*.

¹²⁷ *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 12 (1971);

¹²⁸ 430 U.S. at 472-73, quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 212-14 (1976).

¹²⁹ See 89 HARV. L. REV. 1917, 1926 (1976), stating that no appellate decision before that of the Second Circuit in *Santa Fe* and *Marshall v. AFW Fabric Corp.*, 533 F.2d 1277 (2d Cir.), *vacated and remanded for a determination of mootness*, 429 U.S. 881 (1976), had permitted a claim under § 10(b) without some element of nondisclosure or misrepresentation.

¹³⁰ See 15 U.S.C. § 78b (1970). See also Letter of President Roosevelt to Congress (March 29, 1933), S. REP. NO. 47, 73d Cong., 1st Sess. 6-7 (1933); H.R. REP. NO. 85, 73d Cong., 1st Sess. 1-2 (1933).

¹³¹ See, e.g., *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 201 (1962).

section 10(b) by the federal courts as a remedy for the allegedly unfair results of a securities transaction untainted by manipulation or deception.

The third consideration supporting the Supreme Court's decision in *Santa Fe* is the opinion's proper rejection of the "new fraud" cases as support for the plaintiffs' claim and the Second Circuit's decision. Although the "new fraud" theory has not been articulated by the courts in terms of manipulation or deception,¹³² it is nevertheless premised on a finding that the minority stockholders were at least constructively deceived by the self-serving actions of the controlling stockholders.¹³³ So understood, the "new fraud" theory is merely an adaptation of the traditional deception theory particularly suited to analyzing intracorporate securities transactions, rather than a formula for creating independent federal duties of fairness under section 10(b).¹³⁴ Although there may exist no cogent reason for abandoning the vocabulary of the "new fraud" theory in favor of the traditional language of deception and manipulation, it does not appear that the two theories are themselves at odds. Accordingly, it appears that the Supreme Court's interpretation of the "new fraud" cases was correct and that the Second Circuit employed an overly broad interpretation of the "new fraud" theory in determining that a complaint alleging a breach of fiduciary duty not recognized as such by state law was within the scope of section 10(b).

The interface between federal and state regulation of corporate affairs is a fourth consideration militating against the creation of federal fiduciary duties under section 10(b) unrelated to eliminating manipulation and deception from securities transactions. As recognized by the Supreme Court in *Cort v. Ash*,¹³⁵ corporations are, in the first instance, creatures of

¹³² The "new fraud" theory defines a § 10(b) violation as the exercise of a controlling influence over a corporation by the majority stockholders to the detriment of the minority stockholders. See, e.g., *Shell v. Hensley*, 430 F.2d 818, 825-26 (5th Cir. 1970); *Schoenbaum v. Firstbrook*, 405 F.2d 215, 219-20 (2d Cir. 1968) (en banc), cert. denied, 395 U.S. 906 (1969); *Pappas v. Moss*, 393 F.2d 865, 869 (3d Cir. 1968).

¹³³ See Jacobs, *The Role of Securities Exchange Act Rule 10b-5 in the Regulation of Corporate Mismanagement*, 59 CORNELL L. REV. 27, 52-59 (1973); Note, *The Controlling Influence Standard in Rule 10b-5 Corporate Mismanagement Cases*, 86 HARV. L. REV. 1007, 1032-36 (1973); Comment, *Schoenbaum v. Firstbrook: The "New Fraud" Expands Federal Corporation Law*, 55 VA. L. REV. 1103, 1113-14, 1117-19 (1969).

¹³⁴ Prior to *Santa Fe*, several lower federal courts rejected claims that § 10(b) imposes federal duties of fairness on majority stockholders in the going private context. See *Kauffmann v. Lawrence*, 386 F. Supp. 12 (S.D.N.Y. 1974), *aff'd per curiam*, 514 F.2d 283 (2d Cir. 1975), where the court stated:

[T]here is nothing invalid per se in a corporate effort to free itself from federal regulations, provided the means and the methods used to effectuate that objective are allowable under the law. Nor has the federal securities law placed profit-making or shrewd business tactics designed to benefit insiders, without more, beyond the pale. Those laws . . . are satisfied if a full and fair disclosure is made, so that the decision of the holders of WRG stock to accept or refuse the exchange offer can be said to have been freely based upon adequate information.

A public company going "private" may indeed raise serious questions concerning protection of the public interest. There is, however, no foundation on the record before me from which the ramifications of that interest within the reach of the federal securities laws might conceivably be explored.

Id. at 17. See also *Dreir v. Music Makers Group, Inc.*, [1973-74 Transfer Binder] FED. SEC. L. REP. (CCH) § 94,406, at 95,410 (S.D.N.Y. 1974) (merger cannot be challenged under § 10(b) on ground of unfairness alone). But see *Albright v. Bergendahl*, 391 F. Supp. 754, 756-57 (D. Utah 1974) (freeze out merger undertaken for no valid business purpose violates § 10(b)).

¹³⁵ 422 U.S. 66 (1975).

state law.¹³⁶ Given this fundamental relationship between corporate fiduciary duties and state law, it is appropriate, in the absence of express federal law to the contrary, to defer to state law for resolution of issues of overall fairness in securities transactions. As noted above, section 10(b) does not expressly govern issues of overall fairness in short-form mergers. Delaware law, on the other hand, expressly provides for the resolution of claims arising from such transactions by means of the statutory appraisal proceeding. The *Santa Fe* Court was thus correct in refusing to override Delaware law on this issue of fairness and in relegating the plaintiffs to their state law remedies.

A final consideration supporting the *Santa Fe* Court's decision is that even if federal standards are found necessary in this context,¹³⁷ section 10(b) does not provide the principles appropriate for this determination. The federal regulation of going private transactions should be effected, if at all, by uniform standards promulgated by Congress or by the Securities Exchange Commission. Piecemeal judicial determinations of fiduciary standards for governing such transactions under the framework of the valid business purpose requirement do not adequately serve the interests of the respective parties. Majority stockholders desiring to take their corporation private have a legitimate interest in having their conduct governed by readily ascertainable requirements. Judicial determinations of the rights and duties of the parties to such transactions, in the absence of established regulations, do not serve this interest but rather impose unnecessary uncertainty of result on majority stockholders. Similarly, minority stockholders frozen out in a going private transaction have an interest in being able to exercise intelligently their rights arising from divestiture of their holdings. Imposing such uncertainties on the parties through judicial determinations of fairness under section 10 (b) is thus inconsistent with the purpose of the Securities Exchange Act to provide a uniform system of regulation where predictability of result is achieved with a minimum of interference with the effective functioning of business affairs.¹³⁸

CONCLUSION

Significantly different approaches to defining the scope of section 10(b) were utilized by the Second Circuit and the Supreme Court in *Santa Fe* in determining whether a claim of breach of fiduciary duty by a majority stockholder in the context of a short-form merger is cognizable under section 10(b). The Second Circuit adopted a broad view of section 10(b) and read the language and purpose of that section expansively so as to bring within its terms a claim alleging merely unfairness of result in a securities transaction. Conversely, the Supreme Court's narrow approach to determining the scope of federal relief available under section 10(b) limited relief to those complaints alleging manipulation or deception in connection

¹³⁶ *Id.* at 84.

¹³⁷ See 430 U.S. at 479-80. Federal regulation of going private transactions has been advocated by the SEC and is articulated in proposed rule 13e-3. 2 FED. SEC. L. REP. (CCH) ¶ 23,703A, 23,706. Similarly, Professor Cary has urged that a federal fiduciary code be enacted by Congress. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L. J. 663, 700 (1974).

¹³⁸ See *Drachman v. Harvey*, 453 F.2d 722 (2d Cir. 1972) (en banc).

with a securities transaction. A careful analysis of the statutory language of section 10(b), its legislative history, and the interface between state and federal regulation of corporate affairs with respect to issues of overall fairness reveals that the *Santa Fe* Court's narrow view of section 10(b) was analytically correct. This narrow view of the scope of section 10(b) was properly utilized in *Santa Fe* by the Court in its ruling that claims of unfairness and breach of fiduciary duty absent allegations of manipulation or deception are not cognizable under section 10(b).

MARGUERITE A. CONAN

Constitutionally Protected Notions of Family: *Moore v. City of East Cleveland*¹—In 1973, Mrs. Inez Moore resided in her East Cleveland home with her son, Dale Moore, Sr., and two grandsons, Dale Moore, Jr. and John Moore, Jr. The two boys were first cousins, John being the son of Mrs. Moore's other son, John Moore, Sr.² East Cleveland had a zoning ordinance which limited residence in any single dwelling unit to a single family.³ This ordinance was unusual in that it defined the term "family" so as to include only a few categories of related individuals. Cohabitation by individuals related as first cousins was not one of these permitted categories, and consequently, the Moore household fell outside the ordinance's definition of a single family.⁴

Mrs. Moore was convicted of violating the zoning ordinance in the East Cleveland Municipal Court,⁵ and her subsequent appeals to the Court of Appeals of Ohio⁶ and the Supreme Court of Ohio⁷ were unsuccessful.

¹ 431 U.S. 494 (1977).

² *Id.* at 496-97.

³ CITY OF EAST CLEVELAND, HOUSING CODE § 1341.08 (1966). Section 1341.08 provides:

"Family" means a number of individuals related to the nominal head of the household or to the spouse of the nominal head of the household living as a single housekeeping unit in a single dwelling unit, but limited to the following:

(a) Husband or wife of the nominal head of the household.

(b) Unmarried children of the nominal head of the household or of the spouse of the nominal head of the household, provided, however, that such unmarried children have no children residing with them.

(c) Father or mother of the nominal head of the household or of the spouse of the nominal head of the household.

(d) Notwithstanding the provisions of subsection (b) hereof, a family may include not more than one dependent married or unmarried child of the nominal head of the household or of the spouse of the nominal head of the household and the spouse and dependent children of such dependent child. For the purpose of this subsection, a dependent person is one who has more than fifty percent of his total support furnished for him by the nominal head of the household and the spouse of the nominal head of the household.

(e) A family may consist of one individual.

⁴ Section 1341.08 excludes many other relational combinations from the ambit of the term "family." For example, households consisting of two brothers or an aunt residing with her niece, cannot occupy a single dwelling unit.

⁵ 431 U.S. at 497. Upon Mrs. Moore's refusal to remove John Moore, Jr. from her household, the city filed a criminal complaint, charging her with violation of the zoning ordinance. Mrs. Moore stipulated to the facts underlying the complaint and was fined twenty-five dollars and sentenced to five days in prison. *Id.*

⁶ *City of East Cleveland v. Moore*, No. 33888 (Ct. App. Ohio July 18, 1975).

⁷ *Moore v. City of East Cleveland*, No. 75-896 (Ohio Nov. 28, 1975).