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Corporations - Section 10(b) and Rule 10(b)-(5) of the Securities Exchange Act of 1934

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necessary to invoke the supremacy clause will rarely exist. Alternative methods which have been suggested for correcting discrimination because of sex, especially use of the equal protection clause of the fourteenth amendment or the proposed amendment to the Constitution, could give women the equality under the law, Title VII's goal, without forcing courts to make use of questionable statutory constructions.

Following this reasoning, the *Kober* case would have been decided similarly but by a different rationale. If the court had explained the importance of determining the beneficial or discriminatory character of the state law in each case in order to determine whether the bona fide occupational qualification would be applicable, then *Kober* could have provided the direction needed to unravel the sex provisions of Title VII.

Karen Jacqueline Bernat

CORPORATIONS—SECTION 10(b) AND RULE 10(b)-(5) OF THE SECURITIES EXCHANGE ACT OF 1934—The Second Circuit Court of Appeals has held that a prima facie case has not been presented under section 10(b) and rule 10(b)-(5) when an apparent fraudulent scheme did not collectively infect two separate transactions, nor affect the securities exchange market and/or the investing public.

Drachman v. Harvey, No. 35077 (2d Cir., July 21, 1971).

Plaintiffs brought a derivative cause of action under section 10(b) of the Securities Exchange Act of 1934¹ and rule 10(b)-(5).² On behalf of

1. 48 Stat. 891, 15 U.S.C. § 78j(b) (1970) [hereinafter cited as Act]:

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.

2. 17 C.F.R. § 240.10b-5 (1971):

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 mail 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 light of the circumstances under which they were made, not misleading, or

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Harvey Aluminum Company, they alleged fraudulent transactions between the Harveys, controlling shareholders of Harvey Aluminum, and Martian Marietta Company, a publicly-owned corporation, to effectively secure control of Harvey Aluminum for Marietta.

Marietta acquired control of Harvey Aluminum by: obtaining forty per cent of Harvey Aluminum's outstanding common stock from Harvey in November 1968; paying an additional thirty million dollars as a premium for the sale of "control"; and influencing a redemption call of convertible debenture bonds by Harvey Aluminum on May 23, 1969. The redemption call eliminated the possible dilution of the common stock by the bond investors through the conversion feature of the bonds. This re-call increased the percentage holdings of Marietta in Harvey Aluminum. In order to assure control, Marietta had Harvey agree to remain as the president and a board member of the corporation, though under Marietta's control. Under Marietta's orders, Harvey influenced the redemption call, and upon its completion, Marietta assumed formal control of Harvey Aluminum by causing its designee to be elected president of the corporation.

The United States District Court for the Eastern District of New York dismissed the complaint for failure to state a cause of action under section 10(b) and rule 10(b)-(5).³ The Second Circuit Court of Appeals affirmed.⁴ The court of appeals framed two issues:⁵ whether the fraudulent actions complained of were actionable under section 10(b) and rule 10(b)-(5); and if the redemption call was a "purchase" within the meaning of these federal provisions. The court stated that the stock sale of November 1968 did not affect either the corporation or the securities markets,⁶ nor was the corporation adversely affected as a purchaser or seller by this sale.⁷ The redemption call of the bonds was

(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.

3. *Drachman v. Harvey*, No. 691336 (E.D. N.Y. 1, October 28, 1969).

4. *Drachman v. Harvey*, No. 35077 (2d Cir., July 21, 1971).

5. *Id.*

6. *Id.*, citing *Superintendent of Insurance v. Bankers Life and Casualty Co.*, 430 F.2d 355 (2d Cir. 1970). This case involved a scheme to take over Manhattan Casualty Company for the purpose of looting it. The takeover was facilitated by the use of two securities transactions. The court reasoned that there was no adverse affect to the securities markets nor to the securities investors by the transaction. Therefore, the scheme amounted to no more than fraudulent mismanagement of corporate affairs.

7. *Drachman v. Harvey*, No. 35077 (2d Cir., July 21, 1971), citing *Birnbaum v. Newport Steel Corp.*, 193 F.2d. 461 (2d Cir.), *cert. denied*, 343 US 956 (1952). *Birnbaum* stands as authority for the following propositions:

(1) section 10(b) protects only defrauded purchasers and sellers,

considered a transaction independent of the stock sale. It was acknowledged as legally effected, free of any fraud "in connection with" this securities transaction,⁸ and not facilitated by a manipulative device infected by fraud upon the market or the investing public.⁹ Therefore, the actions complained of were not within the Act's protection. There being no section 10(b) or rule 10(b)-(5) cause of action, the purchase issue was mooted.

The Act's provisions police the fraudulent security transaction. This is to be distinguished from mere corporate mismanagement, which is a general fiduciaries problem, adequately enforced by state law.¹⁰ The federal law requires the fraudulent activity be "in connection with" the purchase or sale of any security.¹¹ The purchaser-seller requirement is recognized as a decisive factor in distinguishing the federal fraud cause of action from the corporate mismanagement area.¹²

Birnbaum v. Newport Steel Corporation,¹³ established the defrauded or seller requirement. In *Birnbaum*, a president of a corporation rejected a merger which would have been profitable to all shareholders, and subsequently sold his stock privately for a huge profit. The court dismissed the section 10(b) and rule 10(b)-(5) cause of action, stating that the deceptive practices governed by these provisions were related only to the buyer or seller of securities and had no relation to a breach of fiduciary duty by a corporate insider to a corporation or to shareholders who were neither purchasers nor sellers.¹⁴ The effect of *Birnbaum* was to create a narrow class of individuals who were permitted to allege fraud under this federal cause of action, and to leave federally unprotected a broad class of persons adversely affected by a fraudulent securities transaction, but not active sellers or purchasers in the particular transaction. The clear judicial trend, however, while it has shown continued admiration for the *Birnbaum* doctrine,¹⁵ has been toward regula-

(2) rule 10(b)-(5) was directed solely at that type of misrepresentation or fraudulent practice usually associated with the sale or purchase of securities.

8. *Drachman v. Harvey*, No. 35077 (2d Cir., July 21, 1971), citing Superintendent of Insurance v. Bankers Life and Casualty Co., 430 F.2d. 355, 360-61 (2d Cir. 1970).

9. *Drachman v. Harvey*, No. 35077 (2d Cir., July 21, 1971), citing Superintendent of Insurance v. Bankers Life and Casualty Co., 430 F.2d. 355, 361.

10. See e.g., *O'Neill v. Maytag*, 339 F.2d. 764, 767-68 (2d Cir. 1964) *Birnbaum v. Newport Steel Corp.*, 193 F.2d. 461, 464 (2d Cir. 1952).

11. 17 C.F.R. § 240.10b-5 (1971).

12. *Birnbaum v. Newport Steel Corp.*, 193 F.2d. 461, 464 (2d Cir. 1952).

13. *Id.*

14. *Id.*

15. See *Rekant v. Dresser*, 425 F.2d. 872, 873, 877 (5th Cir. 1970) where the court stated: "Bloody but unbowed, *Birnbaum* still stands." See also Comment, "Another Demise of the *Birnbaum* Doctrine: Tolls the Knell Parting Day?" 25 U. MIAMI L. REV. 131, 142 (1970).

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tion of internal corporate affairs where transactions in securities were involved and the corporation was involved in the securities transaction.¹⁶

It is submitted that active in *Drachman* was an actionable section 10(b) and rule 10(b)-(5) cause of action by virtue of fraudulent corporate affairs in connection with the purchase of a security. To perfect this federal cause of action section 10(b) and rule 10(b)-(5) require the establishment of a security. It has been recognized that a convertible debenture bond is a security as the term is used in the provision of the Act,¹⁷ which prohibits manipulative and deceptive devices in securities transactions. There must also be a purchase or sale of this security. Since *Birnbaum*, courts have categorized an event as a purchase or sale by looking to the substance of the transaction, not wholly to its form, and have deemed any transaction which reflects of a purchase character to be a purchase.¹⁸ The requirement of a purchaser or seller for a section 10(b) and rule 10(b)-(5) cause of action has resulted in recognition of a purchase or sale problem in a variety of less than clear-cut situations.¹⁹ In response to authority which have fulfilled this requirement,²⁰ the redemption call of convertible debentures by Harvey Aluminum should have been recognized as a purchase of a security by Harvey Aluminum.

The decision to dismiss by the majority was based on their inability to connect the fraud with a purchase or sale as required by rule 10(b)-(5). But this was a fraudulent scheme in connection with a purchase to assure control of the corporation. It commenced with the original stock sale to Marietta and terminated upon successful completion of the recall of the convertible debentures. Within this scheme was Harvey Alu-

16. Comment, *The Expanding Uses of Rule 10 b-5*, 10 B.C. IND. AND COM. L. REV. 313, 324 (1968-1969).

17. *Drachman v. Harvey*, No. 35077 (2d Cir., January 18, 1972); *Weitzen v. Kearns*, 271 F. Supp. 616, 619 (S.D. N.Y. 1967).

18. *Dasho v. Susquehanna Corp.*, 380 F.2d 262 (7th Cir. 1967); *Vine v. Beneficial Finance Co.*, 374 F.2d. 627 (2d Cir. 1967).

19. See *Kahan v. Rosenstiel*, 424 F.2d. 161 (3d Cir. 1970), where omission of material facts in offer of stock sale gave a cause of action under the Act even though the shareholder was not a purchaser or seller; *Cranffe Co. v. Westinghouse Air Brake Co.*, 419 F.2d. 787 (2d Cir. 1969), where the court held a valid rule 10(b)-(5) cause of action when deceptive practices prevented the public from entering into securities transactions; *Dasho v. Susquehanna Corp.*, 380 F.2d. 262 (7th Cir. 1967), where directors and officers caused the corporation to re-acquire its shares indirectly, and thus the corporation was considered a purchaser; *Vine v. Beneficial Finance Co.*, 374 F.2d 627 (2d Cir. 1967), where a fraudulent scheme of two corporations resulted in a merger, and plaintiff, who neither surrendered his shares pursuant to merger nor accepted the offer to sell his shares, was still considered a forced seller; *Goodman v. H. Hentz & Co.*, 265 F. Supp. 440 (N.D. Ill. 1967), where a rule 10(b)-(5) cause of action was not eliminated when fraudulent circumstances prevented the purchase or sale. Cf. *Rekant v. Dresser*, 425 F.2d. 872 (5th Cir. 1970), where issuance by a corporation of treasury stock was a purchase and issuance of a note was a sale within the purview of rule 10b-5.

20. *Ruckle v. Roto American Corp.*, 339 F.2d. 24, 27-28 (2d Cir. 1964). See note 19, *supra*.

minum's purchase of bonds which served as the vehicle to perpetrate the fraud. It was the purchase that signified that Marietta had secured its position to control Harvey Aluminum. Therefore, the purchase of this security in connection with the fraudulent activity satisfy the elements of the section 10(b) and rule 10(b)-(5) cause of action.

It is important to realize that a court has before it a general duty, empowered by the federal government, "to prevent inequitable and unfair practices and to insure fairness in securities transactions."²¹ The mechanical application by the court, to define a federal cause of action, was an attempt to link a purchase or sale with the fraud. But the real question should have been if any activity, misrepresentation, or omitted fact would have been important to a reasonable, even if speculative, investor of securities,²² through satisfaction of the "in connection with" test doesn't require that the fraudulent activity affect the value of securities.²³

Literal adherence to *Birnbaum* under section 10(b) and rule 10(b)-(5) limits the injured party to be either a defrauded purchaser or a defrauded seller.²⁴ For example, in *Hoover v. Allen*,²⁵ there was a scheme to increase defendant's control of the corporation by depressing the stock value and encouraging investors to sell their stock back to the corporation. The plaintiffs, in a derivative cause of action, alleged wastage of corporate assets, but the court viewed the investors as sole victims of the fraudulent scheme and denied the cause of action for failure to show injury to the purchaser corporation.²⁶ Conversely, in *Hooper v. Mountain States Securities Corporation*,²⁷ a trustee in bankruptcy brought an action on behalf of the seller-corporation. It was alleged that the corporation was misled by fraud when it issued its stock in return for spurious assets. In holding the corporation as a seller,²⁸ the court said that a corporation, injured by a sale or purchase of

21. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 847-48 (2d Cir. 1968).

22. *Id.* at 850; List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir.), cert. denied, 382 U.S. 811 (1965).

23. See Glickman v. Schweickart and Co., 242 F. Supp. 670 (S.D. N.Y. 1965), where a wrongful conversion of purchased stock was only a factor for the court to employ section 10(b) and rule 10(b)-(5). The court held the wrongdoing of misrepresentation related to the purchase was a sufficient nexus to satisfy the in connection with test for a federal remedy to apply; Cooper v. North Jersey Trust Co., 226 F. Supp. 972 (S.D. N.Y. 1964) wherein the court held that a fraudulent inducement to purchase securities at a loss was a rule 10(b)-(5) cause of action because the transaction involved a purchase of stock as a vital aspect of a continuing scheme.

24. 193 F.2d. at 464.

25. 241 F. Supp. 213 (S.D. N.Y. 1965).

26. *Id.* at 227-29.

27. 282 F.2d. 195 (5th Cir. 1960).

28. *Id.* at 201-02.

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securities, has a private right of action under section 10(b) and rule 10(b)-(5).²⁹ In the instant case, the fraudulent activity did produce substantial injury to the purchaser-corporation, Harvey Aluminum: the recall of the bonds reflected no business purpose; Harvey Aluminum was denied valuable working capital because it had to finance the purchase of the bonds; and the recalled bonds were borrowed funds at a substantially lower interest rate than otherwise commercially available, thereby incurring a greater interest expense for Harvey.³⁰

Though establishment of injury to Harvey Aluminum is sufficient to satisfy the *Birnbaum* doctrine,³¹ it is submitted that the scope of individuals injured by fraudulent activity, but excluded by *Birnbaum*, has been effectively whittled down.³² *A. T. Brod and Company v. Perlow*³³ has indicated this trend. In *Brod* the Second Circuit Court of Appeals stated that to interpret section 10(b) and rule 10(b)-(5) as only related to fraud "in connection with" the purchase or sale of securities is much too narrow an interpretation. These rules and regulations were promulgated for both investors and the public interest,³⁴ to prohibit all fraudulent schemes in connection with the purchase or sale of securities.³⁵ The Act's provisions also require fair play and abstention on the part of the corporate insider from taking unfair advantage of the minority shareholder or any uninformed outsider.³⁶

In *Pettit v. American Stock Exchange*,³⁷ a fraud consisting of a three-year conspiracy of illegal and fraudulent distributions of stock enabled defendants to fund a corporation and still retain majority ownership. The court reasoned that all the transactions were indispensable to the successful completion of the fraud. In a motion for dismissal, defendants were precluded in their defense to prove injury solely to investors, though this was a derivative suit for the corporation and the corporation

29. *Id.* at 203. *Accord*, *Drachman v. Harvey*, No. 35077 (2d Cir., January 18, 1972); *Globus v. Law Research Service, Inc.*, 418 F.2d. 1276, 1291-92 (2d Cir. 1969) *cert. denied*, 397 U.S. 913 (1970); *Mutual Shares Corps. v. Genesco Inc.*, 384 F.2d. 540 (2d Cir. 1967); *Dasho v. Susquehanna*, 380 F.2d 262 (7th Cir. 1967); *Weber v. Bortle*, 272 F. Supp. 201 (S.D. N.Y. 1967).

30. See note 29 *supra*.

31. See note 29 *supra*.

32. See note 19 *supra*.

33. 375 F.2d 393 (2d Cir. 1967). A stockbroker, under section 10(b) and rule 10(b)-(5), alleged a fraudulent contrivance by defendants who refused to pay plaintiff for securities when their stock value dropped. The court determined this cause of action valid, and stated that the Act's provisions were to prevent all persons from a fraudulent device in connection with a purchase or sale of securities.

34. *Id.* at 396.

35. *Id.* at 397.

36. *Kohler v. Kohler Co.*, 319 F.2d. 634, 642 (7th Cir. 1963).

37. 217 F. Supp. 21 (S.D. N.Y. 1963).

was neither a purchaser nor seller. The court stated that there existed an actionable section 10(b) and rule 10(b)-(5) cause of action since the transactions were part of an overall scheme used for fraudulent manipulation of corporate securities involving both investors and the corporation.³⁸

Drachman also presented a planned overall scheme. The effect of the scheme undermined more than just Harvey Aluminum in connection with its purchase. The main objective was to acquire control of Harvey Aluminum. To succeed in this scheme, the unknowing investor (if not prospective investor), as well as the corporation, had been adversely affected by this plan. The investors of Harvey Aluminum became shareholders of a corporation owned by Marietta, effectively secured by a fraudulent two-phased plan without adequately informing these investors as to the proceedings. The collusion by Harvey, a corporate officer, and Marietta, the acquiring corporation, eliminated any possibility of the Harvey Aluminum shareholders increasing their percentage ownership by converting bonds to stock. Retirement of the outstanding bonds by redemption diminished the working capital of Harvey Aluminum. This, possibly, impaired the operations of the corporation, depressing its stock value per share, in which the shareholders placed their confidence evidenced by their investment in the stock. It is important to recognize that investors on the market were deceived by a scheme, successfully facilitated by the use of a corporate purchase of securities, though the investors were neither purchasers nor sellers.³⁹ The effect of this scheme was to cause inaction by these investors.

Brod advocated use of section 10(b) and rule 10(b)-(5) when fraudulent activity produced a potentially manipulative effect on the market.⁴⁰ In *Drachman*, the activity of Marietta and the Harveys to secure control of Harvey Aluminum, if known to investors, could have been significant to stimulate a present or future choice of action. It is suggested that the information may have produced: a desire by shareholders either to purchase or to sell securities of Harvey Aluminum because of Marietta's

38. *Id.* at 26.

39. *See Crane Co. v. Westinghouse Air Brake Co.*, 419 F.2d. 787, 796 (2d Cir. 1969), where liability arose under rule 10(b)-(5) when third persons were prevented from entering into securities transactions; *Commerce Reporting Co. v. Puretec Inc.*, 290 F. Supp. 715 (S.D. N.Y. 1968), where an agreement to sell securities was aborted by defendant's fraudulent scheme, but the court upheld a section 10(b) and rule 10(b)-(5) cause of action, *Goodman v. H. Hentz & Co.*, 265 F. Supp. 440 (N.D. Ill. 1967), where the court upheld the Act's cause of action when a purchase, which did not occur, was fraudulently represented by defendants.

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

secured control; or motivated bondholders of Harvey to trade in such debentures or convert their bonds to common stock of Harvey corporation. When fraudulent activity is aided by a corporate purchase or sale, any resulting injury to the active purchaser gives rise to the section 10(b) or rule 10(b)-(5) cause of action.⁴¹ But the possible manipulative effect to investors, by such activity, deserves analysis under the Act, when concealment of a scheme causes inaction by investors of the corporation to deal in their securities. Recognition of inactivity as a basis of jurisdiction for section 10(b) and rule 10(b)-(5) should be within the purview of the Act.⁴² Commentators have indicated that the trend of development within these federal laws has shown that corporate mismanagement, which operates as a fraud on the corporation and its shareholders, where some kind of securities transaction is involved, have been recognized as within the jurisdiction of the Act.⁴³

In the noted case, the fraudulent scheme was implemented in connection with a purchase of securities by the injured corporation. This satisfies the guidelines of rule 10(b)-(5) and insures the vitality of *Birnbaum*. The *Birnbaum* doctrine was carved out as a guide to distinguish the Act's cause of action from the corporate mismanagement situation. Though *Birnbaum* has been limited by a number of flanking operations,⁴⁴ the case development has been careful not to eliminate the import of the decision.⁴⁵

The issue which remains unsettled in the courts, is the scope given the "in connection with" test as it relates to the class of persons excluded by *Birnbaum*. The defrauded purchaser or defrauded seller is a starting point, but the link of purchase or sale to the overall scheme deserves a

41. *Birnbaum v. Newport Steel Inc.*, 193 F.2d. 461, 464 (2d Cir. 1952).

42. See *Vine v. Beneficial Finance Co.*, 374 F.2d. 627 (2d Cir. 1967), where the court recognized fraudulent activity which violated the Act's provisions, though there were no active purchasers or sellers. It should be noted that the court in an extended analysis to define a "forced seller"; *Stockwell v. Reynolds & Co.* 252 F. Supp. 215 (S.D. N.Y. 1965), where plaintiffs were induced to retain their shares by defendant, who misrepresented the corporation's financial position. The court stated that a section 10(b) and rule 10(b)-(5) cause of action was as valid when one has been fraudulently induced to retain his stock as when fraudulently induced to sell it. Cf. *Zahn v. Transamerica Corp.*, 162 F.2d. 36 (3d Cir. 1947), where it was determined that omission of material facts to shareholders, who did not redeem their shares because of such omissions, were entitled to damages under breach of fiduciary duty. It is suggested that the date of this case was the reason that breach of fiduciary duty was alleged rather than the Act's cause of action.

43. See Comment, *SEC Rule 10 (b)-(5)- "In Connection with the Purchase or Sale of any Security" Restriction: Need for Analytical Precision*, 5 COLUM. J. LAW AND SOC. PROB. 28, 38 (August, 1969).

44. *De Lancey, Rule 10 b-5-A Recent Profile*, 25 BUSINESS LAWYER 1355, 1370 (July, 1970). See note 19, *supra*.

45. See *Rekant v. Dresser*, 425 F.2d. 872 (5th Cir. 1970); *Dasho v. Susquehanna Corp.*, 380 F.2d. 262 (7th Cir. 1967); *Vine v. Beneficial Finance Co.*, 374 F.2d. 627 (2d Cir. 1967); *Ruckle v. Roto American Corp.*, 339 F.2d. 24 (2d Cir. 1964).

more sophisticated analysis. Novel methods or artifices, regardless of form, should not provide immunity from securities laws.⁴⁶ To limit the role of "in connection with" to active purchasers or sellers is an omission to discover whether those investors, who remained inactive as a result of concealment of the scheme, were the real victims of the deception. The purchase or sale should be recognized only as the necessary vehicle in the type of fraud which is under the jurisdiction of a section 10(b) or rule 10(b)-(5) cause of action. But it is those victims of the fraud, whether or not defrauded purchasers or sellers, "in connection with" the purchase or sale of securities who must be recognized as protected within the boundaries of the Act.

Alan C. Klein

DAMAGES—PERSONAL INJURY—INSTRUCTION TO THE JURY ON FEDERAL INCOME TAX—The United States Court of Appeals for the Third Circuit has held that in personal injury actions trial courts must instruct the jury, upon request of counsel, that any award is not subject to federal income taxes, and therefore, it should not add or subtract taxes in fixing the amount of such award.

Domeracki v. Humble Oil & Refining Company, 443 F.2d 1245 (3d Cir. 1971).

Domeracki, a longshoreman, sustained personal injuries while loading Humble's ship. He brought an action in federal district court alleging the ship was unseaworthy. Humble requested the trial court instruct the jury that if any award were made it would not be subject to federal income taxes.¹ The court refused to give the instruction; judgment was entered on a jury verdict in favor of the longshoreman, and the shipowner appealed contending, *inter alia*, that the refusal resulted in prejudice sufficient to warrant a new trial. Although it refused to re-

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

1. Humble submitted the following charge which the trial court refused: I charge you, as a matter of law, that any award made to the plaintiff in this case, if any is made, is not income to the plaintiff within the meaning of the federal income tax law. Should you find that plaintiff is entitled to an award of damages, then you are to follow the instructions already given to you by this Court in measuring those damages, and in no event should you either add to or subtract from that award on account of federal income taxes.

Domeracki v. Humble Oil & Refining Co., 443 F.2d 1245, 1248-49 (3d Cir. 1971).