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Corporations - Securities Exchange Act of 1934 - Rule 10b-5 - Fraud

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CORPORATIONS—SECURITIES EXCHANGE ACT OF 1934—RULE 10b-5—FRAUD—The Supreme Court of the United States has held that a cause of action under rule 10b-5 must be based on conduct that could be considered manipulative or deceptive; breach of fiduciary duty without deceit is not fraud under the rule.

Santa Fe Industries, Inc. v. Green, 430 U.S. 462 (1977).

By July, 1974, Santa Fe Industries had acquired a 95% interest in Kirby Lumber Corporation.¹ Santa Fe then executed a short-form merger in accordance with Delaware law,² without prior notification to the minority stockholders of Kirby and without an apparent business purpose other than the removal of the minority interest. After the merger, Santa Fe offered the minority stockholders \$150 per share for their holdings,³ and provided them with complete information about the merger plan and full financial details.⁴

1. Sixty percent of the Kirby stock was acquired in 1936 by Santa Fe Natural Resources, a wholly-owned subsidiary of Santa Fe Industries. Subsequent purchases increased ownership until 95% of the Kirby stock was controlled by Santa Fe Resources, which transferred the stock to Forest Products, Inc. (another Santa Fe Industries subsidiary) in exchange for all of Forest Products' stock. *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 465-66 (1977).

2. The board of Forest Products approved a merger with Kirby, stating that a "new" Kirby would be the surviving entity. Stockholders of the "old" Kirby were asked to submit their shares for cash. *Id.* Delaware corporation law permitted a parent corporation owning at least 90% of the stock of a subsidiary to merge with that subsidiary by means of the "short-form" process. Advance notice was not required, but notification within 10 days of the effective merger date was necessary. DEL. CODE tit. 8, § 253 (1975). A dissatisfied shareholder's only remedy was to petition the Delaware Court of Chancery for a judicially supervised appraisal. *Id.* § 262. The judicial interpretation of this statute leaves little doubt that its purpose was to benefit the corporation, not the minority shareholder. See *Stauffer v. Standard Brands, Inc.*, 41 Del. Ch. 7, 187 A.2d 78 (Sup. Ct. 1962) (purpose of short-form merger was to provide the parent corporation with a means of eliminating the minority shareholder's interest); *Federal United Corp. v. Havender*, 24 Del. Ch. 318, 11 A.2d 331 (Sup. Ct. 1940) (purpose of short-form merger was to simplify the procedure for mergers of parent corporations and subsidiaries). This interpretation of the statute is consistent with the notion that minority stockholders do not have a vested right to remain shareholders of a corporation. See *Coyne v. Park & Tilford Distillers Corp.*, 37 Del. Ch. 558, 146 A.2d 785 (Ch. 1958), *aff'd* 38 Del. Ch. 514, 154 A.2d 893 (Sup. Ct. 1959).

3. An appraisal was conducted by the investment banking firm of Morgan, Stanley & Company which was accused of participation in the fraud. The appraisal was based upon financial statements of the five previous years and forecasts for the next five years. It also included evaluation of property and mineral rights as well as an adjustment for the assumption that the shares would be broadly distributed and freely traded. The final figure arrived at by Morgan Stanley was \$125 per share. 430 U.S. at 466.

4. *Id.* Stockholders were also notified of their right to seek judicially supervised appraisal. See note 2 *supra*.

The minority stockholders objected to the offer and, rather than pursuing their state remedy of a judicially supervised appraisal, brought an action in the United States District Court for the Southern District of New York,⁵ charging violations of section 10(b) of the Securities Exchange Act of 1934⁶ and rule 10b-5 of the Securities and Exchange Commission (SEC).⁷ The minority stockholders argued first that their shares were so grossly undervalued as to constitute fraud under rule 10b-5.⁸ Secondly, they asserted that, because the merger was accomplished without prior notice and for the sole purpose of eliminating the minority interest, the merger itself should be considered a violation of rule 10b-5.⁹ No misrepresentation or failure to disclose relevant facts, however, was claimed.¹⁰

5. *Green v. Santa Fe Indus., Inc.*, 391 F. Supp. 849 (S.D.N.Y. 1975), *rev'd in part*, 533 F.2d 1283 (2d Cir. 1976), *rev'd*, 430 U.S. 462 (1977) (reinstating district court decision).

6. Section 10 of the Securities Exchange Act of 1934, 15 U.S.C. § 78j (1970) [hereinafter referred to as section 10(b)] provides in relevant part:

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.

7. 17 C.F.R. § 240.10b-5 (1977) [hereinafter referred to as rule 10b-5 or rule] provides:

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

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

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

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

8. 391 F. Supp. at 852. The plaintiffs argued that the \$125 per share appraisal of Morgan Stanley drastically understated the value of Kirby stock and that the corporation, knowing this, committed fraud when they offered only \$150 per share to the minority stockholders. Based upon a pro rata evaluation of Kirby's assets, plaintiffs calculated a price per share of at least \$772. *Id.* at 852-53.

9. *Id.* The plaintiffs contended that rule 10b-5, through its anti-fraud provisions, required prior notification. Also, plaintiffs asserted that the majority, by forcing the minority to sell their stock against their will without a valid business purpose, fraudulently acquired the minority interest.

10. No appellate decision before *Santa Fe* and *Marshel v. AFW Fabric Corp.*, 533 F.2d 1277 (2d Cir.), *vacated and remanded for mootness*, 429 U.S. 881 (1976), had explicitly

The district court dismissed the complaint for failing to state a cause of action under federal securities laws. Since full and fair disclosure was made, the alleged inadequacy of the offering price was not sufficient to support a claim under the rule. The court also rejected the shareholders' second argument, pointing out that Delaware corporation law required neither prior notification of a short-form merger nor the presence of a business purpose. In the absence of a state requirement, rule 10b-5 would not demand notification or business purpose, and, in the absence of actual fraud or deceit, the court would not analyze the motives of corporate directors.¹¹

On appeal to the United States Court of Appeals for the Second Circuit, the case was reversed in part.¹² The court corrected the generally held "erroneous assumption" that misrepresentation or lack of disclosure was needed to allege a claim under rule 10b-5.¹³ While acknowledging that the rule was obviously intended to prevent fraud in the classic sense, the court held that the rule also encompassed any "breach of legal or equitable duty, trust, or confidence."¹⁴ The court of appeals could find no justifiable business purpose in the merger of Santa Fe and Kirby and construed this to be a breach of the majority shareholders' fiduciary duty.¹⁵ This breach was held to be a violation of rule 10b-5, even though no deceit was found.¹⁶

rejected the nondisclosure or misrepresentation requirements as necessary elements in a cause of action under rule 10b-5. *See* 89 HARV. L. REV. 1917 (1976).

11. 391 F. Supp. at 852. As authority for this position the court cited *Grimes v. Donaldson, Lufkin & Jenrette, Inc.*, [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,722 (N.D. Fla. 1974) (minority shareholder's request for a permanent injunction barring merger that would force him to accept cash for his shares was denied).

12. 533 F.2d 1283 (2d Cir. 1976), *rev'd*, 430 U.S. 462 (1977). The dismissal of the complaint against Morgan Stanley for failure to show misrepresentation or participation in the merger was affirmed.

13. *Id.* at 1286. The court pointed out that only rule 10b-5(b) discussed fraudulent practices in terms of nondisclosure and misrepresentation. As the court interpreted the entire rule, subdivisions (a) and (c) expanded the concept of fraud to actions other than a failure to fully disclose or truthfully represent.

14. 533 F.2d at 1290, *citing* SEC v. Capital Gains Research Bureau, 375 U.S. 180, 194 (1963).

15. The majority has the right to control the corporation but it owes a fiduciary duty to the minority. *See* *Pepper v. Litton*, 308 U.S. 295 (1939); H. HENN, LAW OF CORPORATIONS § 240 (2d ed. 1970); Note, *Going Private*, 84 YALE L. REV. 903 (1975).

16. 533 F.2d at 1291. The court stated that whether excessively low valuation alone would support a cause of action under rule 10b-5 was not the case before it. *Id.* Apparently, the court preferred to treat the question of undervaluation as one aspect of the broader issue of breach of fiduciary duty.

The United States Supreme Court granted certiorari¹⁷ and, in its subsequent opinion, emphasized the importance of this case to the administration of the federal securities laws.¹⁸ The Supreme Court accepted the district court decision that undervaluation of the shares of minority stockholders alone would not support a complaint under rule 10b-5.¹⁹ The Court, however, reversed the court of appeals, finding instead that the *Santa Fe* short-form merger was neither manipulative nor deceptive under federal regulations,²⁰ and holding that rule 10b-5 could only be applied in instances of actual manipulation or deception.²¹

Writing for a majority of the Court, Justice White first focused on the language of section 10(b) and rule 10b-5. He emphasized the statute's use of the words "manipulative or deceptive" in conjunction with "device or contrivance"²² to underscore the Court's holding that rule 10b-5, as a derivative of section 10(b), could not be presumed to apply where deception or manipulation did not exist.²³ Since neither the district court nor the court of appeals found any omission or misstatement in the information provided to the minority stockholders by Santa Fe Industries, the merger was not accomplished through deception. The Supreme Court then rejected the proposition that a breach of fiduciary duty, without any deception, would violate rule 10b-5.²⁴ The Court recognized that "manipulation" as used in this statutory context was a "term of art" referring to practices intended to mislead investors by artifi-

17. 429 U.S. 814 (1976).

18. 430 U.S. at 471.

19. *Id.* True and complete information had been given to the stockholders of Kirby. This would have allowed them to decide whether to accept the offered price or to bring an action in state court for appraisal. If, as the Court indicated, the purpose of § 10(b) was to promote full disclosure, then the legal duty of the corporation to the minority shareholders under the federal law had been met once complete information was made available.

20. *Id.* at 476. By implication, at least under Delaware law and similar statutes in other states, prior notification of short-form merger is not required and forced sale through merger is permitted if full disclosure is made.

21. *Id.* at 474.

22. See note 6 *supra*.

23. 430 U.S. at 472. The requirement that a device or contrivance be manipulative or deceptive set the limits for rule 10b-5. Section 10(b) gives the SEC the power to prescribe rules as necessary, but only to give effect to the statute, not to make new law. Consequently, the scope of rules such as 10b-5 cannot exceed that of the supporting statute. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) (scope of rule 10b-5 cannot exceed authority granted under §10(b)). If manipulation or deception does not exist, then § 10(b) does not apply; and if § 10(b) does not apply, then rule 10b-5 is not applicable.

24. 430 U.S. at 476.

cially affecting securities markets.²⁵ Corporate mismanagement or unfair treatment of minority shareholders by the majority, however, was not, in the opinion of the Court, manipulation.

To marshal additional support for rejecting a section 10(b) cause of action for breaches of fiduciary duty alone, the majority further addressed the issues of the implied provision for a private cause of action under section 10(b) and the traditional responsibility of the states in regard to fiduciary standards and corporate law.²⁶ Since Congress had not expressly provided a private cause of action for violations of section 10(b),²⁷ the majority warned that one should not be implied when unnecessary to ensure fulfillment of Congress' purpose in adopting the Securities Exchange Act. Because the Act was designed to promote full disclosure in securities transactions,²⁸ the majority was especially reluctant to allow a cause of action where, as in *Santa Fe*, no lack of disclosure had been claimed. The majority also cautioned against interference with corporate regulation—an area traditionally left to the states.²⁹

Justices Blackmun and Stevens, in their separate concurring opinions, agreed with the majority that the language of the statute was dispositive,³⁰ but they expressed concern over the majority's additional statement that an implied cause of action may not be permitted to serve a merely "subsidiary purpose" of federal legislation.³¹ Justices Blackmun and Stevens believed that this line of reasoning could cause denial of recovery under the statute for inappropriate reasons, for example, denial of a cause of action to reduce the danger of vexatious litigation.³²

25. *Id.* The key word is "artificially." The Court pointed to activities such as wash sales and rigged prices as indicative of manipulation. *Santa Fe* was making use of existing market conditions to purchase the stock; it was not attempting to artificially affect securities activity.

26. 430 U.S. at 477.

27. A private cause of action is recognized under § 10(b). See *Kardon v. Nat'l Gypsum Co.*, 73 F. Supp. 798 (E.D. Pa. 1947) (violation of rule 10b-5 gave rise to a private cause of action although no express provision was made for civil liability).

28. 430 U.S. at 477. See *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 151 (1972) (philosophy of full disclosure substituted for philosophy of caveat emptor).

29. 430 U.S. at 479. The majority was concerned that federal fiduciary standards established under rule 10b-5 would likely depart from existing state standards, and that the law of securities transactions would be federalized, impinging on much of the state's domain. They were unwilling to go so far absent clear congressional intent.

30. *Id.* at 480.

31. See *Cort v. Ash*, 422 U.S. 66 (1975) (cause of action must be consistent with the underlying purpose of the legislative scheme).

32. Justice Blackmun pointed to *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723

The competing interests before the Court were well defined. The corporate defendant desired to conduct business under existing state laws without fear of judicially created federal liability. On the other hand, investors, realizing that the legislature could not anticipate every variation of fraud, needed assurance that their interests would not be subject to the comparative ingenuity of lawmakers against thieves, or to the whim of a majority of corporate directors. Into this controversy the Court injected issues of the right to private action under federal securities law and the traditional sovereignty of states in corporate matters. To properly balance these claims, the Court examined statutory language, legislative intent, and previous cases.

Case law revealed a continually broadening definition of fraud under rule 10b-5. In initially applying the rule, the courts adopted a common law fraud analysis.³³ The common law approach had limited usefulness, however, when dealing with securities transactions; elements of fraud were difficult to prove and some important situations, such as partial disclosure, were excluded from the ambit of the rule.³⁴ To accomplish the full disclosure purpose of securities regulation, courts realized that a more flexible interpretation of fraud was needed.³⁵ Furthermore, it became apparent that corporate

(1975) (plaintiff excluded as not a purchaser or seller within meaning of statute), and *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) (statute and rule confined to situation where defendant has intent to deceive) as examples of the restrictive interpretation of rule 10b-5 that preclude recovery. Justice Stevens added *Piper v. Chris-Craft Indus.*, 430 U.S. 1 (1977) (plaintiff excluded because injury was not of the type sought to be avoided by statute).

33. The elements of common law fraud are: misrepresentation of a material fact, statements that are knowingly false, an intent to deceive the plaintiff, reliance, and damages caused by the deception. See *RESTATEMENT OF TORTS* §§ 531, 537, 546 (1938).

34. Courts had difficulty finding an intent to deceive, reliance, and the fact that the person injured was the person who was intended to be deceived. In addition, there were questions concerning the applicability of the law to situations involving half truths and complete omissions by those involved in securities transactions. See 145 *CORPORATE LAW AND PRACTICE* ch. 1.

35. Initially, courts held that rule 10b-5 was applicable only where the fraud was associated with the sale or purchase of securities. See *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952) (current stockholders were not within the class of buyers or sellers and could not bring an action). By expanding the definition of purchase and sale, however, the courts were able to bring under rule 10b-5 activities such as forced sale by short-form merger. *Vine v. Beneficial Fin. Co.*, 374 F.2d 627 (2d Cir.), *cert. denied*, 389 U.S. 970 (1967) (shareholder forced to give up stock as a result of short-form merger deemed a "seller"). Courts were also willing to apply rule 10b-5 when the deception did not directly involve a purchase or sale, but was part of a larger fraudulent scheme. See, e.g., *id.*; *Voegel v. American Sumatra Tobacco Corp.*, 241 F. Supp. 369 (D. Del. 1965) (scheme

mismanagement could be just as devastating to stockholders with full disclosure as without.³⁶ Thus, courts began to suggest that the essence of rule 10b-5 might not be deception at all, but breach of fiduciary duty.³⁷ No attempt had been made to abandon deception, however, until *Schoenbaum v. Firstbrook*.³⁸ In that case, where majority stockholders obtained corporate stock at an inordinately low price, the court held that the minority had two bases for recovery. One was the traditional deception of stockholders, but a second, independent ground was suggested: improper exercise of a controlling influence, with no mention of deception. Commentators found in that decision the elements of a "new fraud" for purposes of rule 10b-5.³⁹

The court of appeals' decision in *Santa Fe* fit neatly into this expansive trend, and the court was able to cite numerous cases intimating that section 10(b) and rule 10b-5 could be read broadly enough to include within fraudulent behavior the abuse of fiduciary

culminating in merger was "in connection with the purchase or sale" for purposes of the rule).

Frequently, when courts venture beyond the literal applications of legislation and into the "gray areas," case law yields some conflicting interpretations. In *Ruckle v. Roto American Corp.*, 339 F.2d 24 (2d Cir. 1964), where the majority of the board of directors withheld information from remaining directors, the court held rule 10b-5 had been violated since fraud had been perpetrated upon the corporation. Shortly afterward, the same court decided *O'Neill v. Maytag*, 339 F.2d 764 (2d Cir. 1964) and held no liability under rule 10b-5 because all directors knew of the plan and therefore there was no deception. If it can be presumed that rule 10b-5 was expanded to protect investors, it seems strange that the rule could protect their interests only when the full board of directors was not involved in the offending activity.

36. The Second Circuit Court of Appeals initially refused to apply rule 10b-5 to corporate mismanagement. See *Vine v. Beneficial Fin. Co.*, 374 F.2d 627 (2d Cir.), cert. denied, 389 U.S. 970 (1967). In dicta, the Third Circuit Court of Appeals agreed that rule 10b-5 "imposes broad fiduciary duties on management vis-a-vis the corporation and its individual shareholders." *McClure v. Borne Chem. Co.*, 292 F.2d 824, 834 (3d Cir. 1961).

37. See *Entel v. Allen*, 270 F. Supp. 60 (S.D.N.Y. 1967) (district court reluctantly interpreted court of appeals decisions as indicating that breach of fiduciary duty alone will support claim under rule 10b-5).

The relationship between rule 10b-5 and minority shareholder interests came into focus with the "decision-making body" theory. See *Simon v. New Haven Board & Carton Co.*, 250 F. Supp. 297 (D. Conn. 1966) (relevant data must be disclosed to decision-making body); Comment, *Schoenbaum v. Firstbrook: The "New Fraud" Expands Federal Corporation Law*, 55 VA. L. REV. 1103 (1969) [hereinafter cited as "*New Fraud*"]. This theory was based on the recognition that the minority really had no power to prevent a course of action agreed upon by the majority. Even with rule 10b-5, the helpless minority interest was still helpless, and thus the seeds of the current controversy were sown. Courts, aware of the potential for abuse of the minority interest by the majority, even without deception, were searching for a method of prevention. Rule 10b-5 was the apparent choice.

38. 405 F.2d 215 (2d Cir. 1968) (en banc), cert. denied, 395 U.S. 906 (1969).

39. See, e.g., "*New Fraud*", supra note 37, at 1103.

responsibility without deception.⁴⁰ The real issue, however, was not whether the case law development justified the result, but whether this expanded concept of fraud was within the boundaries established by Congress in section 10(b).

In determining that rule 10b-5 had been overextended, the Supreme Court correctly concentrated on the underlying statute.⁴¹ *Ernst & Ernst v. Hochfelder*,⁴² decided only one year before *Santa Fe*, reiterated the fundamental premise that the statute must control the interpretation of the rule. The language in section 10(b) in no way indicates that the section was meant to prohibit conduct not involving manipulation or deception. Legislative history is sparse and generally inadequate to support an attempt to extend the scope of the statute.⁴³ Thus, the Court properly concluded that a complaint states a cause of action under *any* part of rule 10b-5 only if the conduct alleged could be viewed as "manipulative or deceptive". The rule should not be applied to resolve tangential issues of fairness.⁴⁴

40. See *Green v. Santa Fe Indus., Inc.*, 533 F.2d 1283, 1284 (2d Cir. 1976) (Mansfield, J., concurring), *rev'd*, 430 U.S. 462 (1977). In the court of appeals' evaluation, *Schoenbaum* "broke new ground" by holding that abuse of fiduciary responsibility could support an action under rule 10b-5 even though the technical niceties of common law fraud had not been met. *Id.* at 1296. The decision was hailed as a recognition of the special vulnerability of minority shareholders to activities such as short-form mergers. See "*New Fraud*", *supra* note 37, at 1117. Nevertheless, evidence of deception was present in that case, so the link to the statutory language of § 10(b) still existed. In support of the abandonment of misrepresentation, Judge Mansfield stated in *Santa Fe* that whatever deception had been found in the supporting cases had little relevance to the conduct giving rise to the liability. It was the breach of fiduciary duty owed to the minority stockholders, and not some minor deception, that was of concern. 533 F.2d at 1299.

41. The court of appeals also discussed rule 10b-5, but failed to look to § 10(b) to ascertain the framework for the operation of the rule. 533 F.2d at 1287. Thus, the court did not consider the limiting language of § 10(b).

42. 425 U.S. 185 (1976).

43. 430 U.S. at 473 n.13. The Court pointed out that the intended scope of § 10(b) was not explicitly revealed in the legislative history of the 1934 Act. The only specific reference in the Senate Report indicated that it was aimed at manipulative and deceptive practices fulfilling no useful function. However, even in that brief statement, the words "manipulative" and "deceptive" are controlling. Various commentators have examined the legislative history of § 10(b) and rule 10b-5 with specific reference to the court of appeals' decision in *Santa Fe*. See, e.g., Banoff, *Fraud Without Deceit*, 17 SANTA CLARA L. REV. 1 (1977) (history and administrative construction do not support court's decision); Rosenfeld, *An Essay in Support of the Second Circuit Decision in Marshel v. AFW Fabric Corp. and Green v. Santa Fe Industries*, 5 HOFSTRA L. REV. 111 (1976) (decision correctly reflects underlying purpose of federal securities laws).

44. The Court relied on *Ernst & Ernst* as support for holding that, when the statute spoke specifically of manipulation and deception, it should not be extended in scope by the Court

Despite the broad language in the opinions of the cases relied upon by the court of appeals in *Sante Fe*, each breach of fiduciary duty held violative of rule 10b-5 had involved some element of deception.⁴⁵ Anticipating such an attack on the validity of the court's rationale, Judge Mansfield argued that recognition of misrepresentation as the basis of liability in those cases exalted form over substance, in that breach of fiduciary duty had always been the basis of liability.⁴⁶ A more accurate analysis reveals that the courts had been willing to accept minimal instances of deception to give rule 10b-5 as wide a coverage of fraudulent securities practices as possible, while remaining within the constraints of section 10(b).⁴⁷ The Supreme Court's decision in *Sante Fe* implicitly acknowledged this and served as an indication that an outer boundary had been reached in the expansion of rule 10b-5.

As the concurring justices warned, the potential for restrictive interpretation of rule 10b-5 in light of the *Sante Fe* decision certainly exists, but the rule had been overextended, and a decision to assert some control over its expansion should not be viewed as an attempt to foreclose legitimate claimants. It must be remembered that the fundamental purpose of section 10(b) is full disclosure in securities transactions, not a monitoring of the fairness of the bargain.⁴⁸ An implied private cause of action under section 10(b) is only acceptable if necessary to implement the purpose of the statute. Rule 10b-5, therefore, should not become the universal remedy for

without some proof of congressional intent. 430 U.S. at 473-74.

45. Judge Moore, dissenting in the court of appeals decision, highlighted the instances of deception in cases relied upon by the majority. 533 F.2d at 1301.

46. *Id.* at 1299. Judge Mansfield undoubtedly believed that the finding of deception in those cases was irrelevant. The "substance" of the violation was the breach of a fiduciary duty and this should not have been obscured by an attempt to locate minor instances of deception.

47. Gaps in federal securities regulations left various practices uncovered. See notes 34-36 and accompanying text *supra*. Initially, the courts attacked the problems by broadly interpreting rule 10b-5. See notes 35-37 *supra*. However, a rule can only be stretched as far as the outside edges of the supporting legislation. When these limits are reached, other solutions must be sought.

Proposed SEC Regulations indicate that existing legislation is inadequate to meet the problems uncovered in *Santa Fe*. See Proposed Rule 13e-3B(a), 2 FED. SEC. L. REP. (CCH) ¶ 22,705 (1975) (elimination of minority unlawful without valid business purpose); Proposed Rule 13e-3A(c)(1), *id.* at ¶ 22,704 (prior notification of minority stockholders required under short-form merger); and Proposed Rule 13e-3A(c)(2), *id.* (price to be paid to stockholders must exceed the value placed on securities by two qualified independent persons).

48. The Court noted that the fairness of the transaction was merely a "tangential concern." 430 U.S. at 478.

inequities suffered by minority stockholders. Rather than straining the rule to establish national standards of fairness, available state remedies should be pursued. The *Santa Fe* majority's apprehension that extension of rule 10b-5 into new areas of fiduciary misconduct would interfere with state law demonstrates the Court's preference for state action.

The immediate significance of the Supreme Court's decision is evident in the Court's refusal to accept a further expansion of the meaning of "fraud" under rule 10b-5. In reaffirming the requirement that deception be the basis of a claim of fraud, the Court has defined the limits of one dimension of the rule's expanding applicability.⁴⁹ The Court has provided corporations with greater security in transacting business according to state statutes and has given to all parties a clearer conception of what conduct will be subject to the sanctions of section 10(b). The decision can also be viewed as indicating a willingness to limit the role of rule 10b-5 in situations where established business practices permitted by state law, such as the short-form merger without notice found in *Sante Fe*, may be unfair to minority investors though neither manipulative nor deceptive. This is not a question of returning power to the states or curtailing the proper exercise of rule 10b-5, but an admission that existing federal laws do not cover all aspects of corporate behavior. Minority stockholders desiring relief from those unfair practices not legitimately covered by federal regulation will have to seek remedial action from the legislature or existing state statutes rather than from the federal judiciary.

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49. It should be emphasized that defining fraud is only one aspect of controlling rule 10b-5. Virtually every phrase in the rule has been litigated. See 145 CORPORATE LAW AND PRACTICE ch. 1.