Proxies and the Modern Corporation: Scienter under Sections 14a and 10b of the Securities Exchange Act

Charles S. Telly
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OF THE SECURITIES EXCHANGE ACT

Charles S. Telly*

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* Associate Professor, Oklahoma City University School of Law, Oklahoma City, Oklahoma. B.A., Williams College, 1954; J.D., University of Buffalo Law School, 1958; M.A., University of Arizona, 1962; Ph.D., University of Washington (Seattle), 1967; LL.M., Columbia University School of Law, 1976; J.S.D. Candidate, Columbia University School of Law, 1976 to present.

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I. INTRODUCTION

The purpose of this Article is to show that Rule 14a-9\(^1\) of the Securities Exchange Act of 1934 (Exchange Act)\(^2\), unlike Rule 10b-5\(^3\) of the Exchange Act, does not require scienter. In order to clearly under-

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stand the intended applications of the two different rules, it is necessary to recapitulate the history of proxies, the thinking of major authors that lead to reform, and the thinking on fraud, which culminated in the Securities Exchange Act of 1934. Moreover, an examination of the legislative history of the two rules and their subsequent application by courts will show that each rule serves a different purpose. In particular, the United States Supreme Court rulings in *Ernst & Ernst v. Hochfelder*\(^4\) and the recently decided *Aaron v. SEC*,\(^5\) confirm that scienter is necessary for a violation Section 10b of Rule 10b-5. On the other hand neither Congress nor the courts have decided whether scienter is necessary for a Rule 14a-9 violation.

The central core of this Article was originally intended to be the negligence standard and its relation to Section 14(a)\(^6\) and Rule 14a-9\(^7\) of the Exchange Act. And indeed, it remains a major part. The negligence standard and its relation to Section 10(b)\(^8\) and Rule 10b-5,\(^9\) on the other hand, were intended to be the subsidiary part which would face off against Section 14(a) and Rule 14a-9 and act as a catalyst, as it were, to make the central thesis meaningful and comprehensive. As it turns out, however, the negligence standard as it relates to Section 10(b) and Rule 10b-5 is subsidiary to negligence as it relates to Section 14(a) and Rule 14a-9. But Section 10(b) and Rule 10b-5 do indeed act as a catalyst in the argument. The material dealing with early authors, their fears, and, most important, their forceful analyses of the problems and evils besetting society, is clearly essential to establish the central importance of the proxy in corporate society as it has developed.

A key concept which haunts everything discussed in this Article is that five-letter word—fraud. It is not the thesis, nor was it intended to be, yet it underscores all that is said. More spectacularly, it may be said that the issue of fraud underlies all societies in varying degrees, and how it is treated and understood influences, nay, supports or destroys the very pillars on which the society rests. A legal system can only be meaningful if the people in the society believe in and support it. In order for the legal system to survive, an underlying honesty that shuns fraud must be sewn into the fabric of the society.

\(^7\) 17 C.F.R. § 240.14a-9 (1983).
A simile will serve to introduce the paradigm of this Article. It is shaped like an ellipse, beginning with a small but important starting point of the introduction and thesis which zeroes in on Section 14(a) and Rule 14a-9 and the negligence standard. For the thesis to have the fundamental meaning at the end that it should have, the more expanded part of the ellipse gives the historical background of the corporation, the proxy, the individual, and the new managerial corporation. The ideas of most of the period’s authors move up the ellipse at a thicker or more expanded part since these ideas, although somewhat redundant, are basic to the actions later taken by Congress and the courts, and more importantly, the assumptions later made in this Article.

Next, a very short overview of the Securities Act of 1933 (Securities Act) and the Securities Exchange Act of 1934 is presented. At this point, the thought crosses one’s mind that it should hardly be farther up the ellipse, but it in fact is, because, brief or not, both Acts are based on the beliefs of the reform authors and both were written in order to put those beliefs into action. At the widest part or apex of the ellipse is the analysis of fraud giving the entire thesis an underpinning.

As this Article moves along the ellipse, Section 10(b) and Rule 10b-5 are very high up because much law has been developed from these two important areas. First, legislative intent is covered since it is the most widely discussed aspect of this area. The next most important area concerns case law developed before Ernst & Ernst v. Hochfelder. Because the Hochfelder case is the most important one discussed in Section 10(b) and Rule 10b-5, it is examined next. Following this, the cases that arose after Hochfelder are analyzed to give credence to Hochfelder. Aaron v. SEC is further down the ellipse,

10. See infra Chapter I: Introduction.
11. See infra Chapter II: Historical Background.
12. See infra Chapter III: Principal Authors Contributing to Reform.
16. See infra Chapter V: Scienter and Its Evolution to Include Negligence.
17. See infra Chapter VI: Section 10(b) and Rule 10b-5: Legislative Intent as a Broad Standard.
20. See infra Chapter IX: Articles and Cases After Hochfelder: A Denial of Scienter.
but equally important because the Supreme Court ruled quite distinctly and established its position regarding scienter.\textsuperscript{22}

Continuing down the ellipse, the essential material concerning Section 14(a) and Rule 14a-9 is discussed. Although this material is important to prove the thesis, there is little of it available and it therefore belongs in the lesser part of the ellipse.

The first discussion of Section 14(a) and Rule 14a-9 material concerns legislative intent\textsuperscript{23} Next, the discussion focuses on important case law, especially \textit{Gerstle v. Gamble Skogmo, Inc.},\textsuperscript{24} the leading case in this area.\textsuperscript{25}

Finally, the conclusion is at the end of the ellipse, not because it is unimportant, but because it pulls everything together at the final point.\textsuperscript{26} Thus, the ellipse is finished and the geometric pattern of logical analysis "concluded" and proven."

\section*{II. Historical Background}

\subsection*{A. Shareholder and Corporation}

The business corporation\textsuperscript{27} is made up of many different relations: between those who manage and those who contribute capital, between management and creditors, between management and employees, between the corporation and its customers, between the corporation and the community, and so on.\textsuperscript{28} Some of these relationships, of course, are more basic and therefore more important than others.

The concept of the corporation as the property of the shareholder is a fundamental notion of the legal and economic tradition that evolved after the decline of the medieval period. During the medieval

\begin{itemize}
\item \textsuperscript{22} See infra Chapter X: Aaron: A Scienter Decision.
\item \textsuperscript{23} See infra Chapter XI: Section 14(a) and Rule 14a-9: Legislative Intent as a Broad Standard.
\item \textsuperscript{24} 478 F.2d 1281 (1973).
\item \textsuperscript{25} See infra Chapter XII: Case Law Supporting a Negligence Standard.
\item \textsuperscript{26} See infra Chapter XIII: Conclusion.
\item \textsuperscript{28} J.P. DAVIS, \textit{Corporations: A Study of the Origin and Development of Great Business Combinations and Their Relation to the Authority of the State} 190 (1905); Dodd, \textit{The Modern Corporation, Private Property, and Recent Federal Legislation}, 54 \textit{Harv. L. Rev.} 917 (1941).
\end{itemize}
period, the concept of property was basically ethical and the society an organic one, which discouraged egocentric individual ownership of property. But with the rise of the classical economic model and the liberal economic theme of the eighteenth century, the concept of the right to property ownership became thoroughly embedded in legal and economic thought. As might be expected, the early development of the corporation mirrored the thinking of the eighteenth and nineteenth centuries. This is clearly illustrated by the definition of the corporation by the great legal scholar James Kent, who wrote:

A corporation is a franchise possessed by one or more individuals, who subsist, as a body politic, under a special denomination, and are vested, by the policy of the law, with the capacity of perpetual succession, and of acting in several respects, however numerous the association may be, as a single individual.

The object of the institution is to enable the members to act by one united will, and to continue their joint powers and property in the same body, undisturbed by the change of members, and without the necessity of perpetual conveyances, as the rights of members pass from one individual to another.

The key idea is the one pertaining to property. The shareholders "act by one united will" and thus for themselves and for their own profit. Woven into the definition was the power of the state, which gave the "franchise" and protected, through law, the third party involved—the creditors. Thus the corporation was created to benefit three groups: the shareholders, the general public (state), and the creditors.

As the corporation developed, state legislators were determined to protect those three parties in various ways:

(1) The corporation was required to be clearly defined and limited in scope. Thus it could carry on only the business authorized by the state, and managers could do no more than follow the mandate

30. Id. at 160-63; Telly, supra note 29, at 436-42.
31. 2 J. Kent, Commentaries on American Law 267 (3d ed. 1836).
given by the state. As a result, the stockholders knew quite clearly in what business their capital was invested.

(2) Capital contributions were rigidly supervised. The corporation could not commence business until a designated amount of shares had been paid for. Also, it was expected that additional issues of shares would be paid for at a specified minimum, called the par value. If shares were sold for less than par value, the shareholders would be required to make up the difference to creditors for the balance, if the corporation became insolvent. This ruling was designed to protect creditors, assuring them that bills would be paid from contributed cash. Not only was the creditor protected, but the stockholder was also protected from dilution of his interest, since each shareholder's percentage of ownership would relate to his percentage of payment. 34

(3) The state also carefully scrutinized and controlled the capital structure of each corporation according to a charter approved by the legislature. Usually the charter specified only one kind of stock, but sometimes there was a division into both preferred and common stock.

The common law courts added three more protections:

(4) Major decisions of the corporation had to be approved or voted on by the shareholders. Everyday decisions about the operation of the organization were to be made by the delegated representatives, the board of directors. But major changes in such areas as the capital structure, the purpose of the enterprise, dissolution, or merger had to be submitted to the shareholders, and if a proposed change was fundamental, the vote had to be unanimous.

(5) The common law also protected the relation of the stockholder to the corporation by providing that new monies could be invested only by the original shareholders. This law of "preemptive right" allowed the shareholder the privilege of subscribing to any additional stock issued by the corporation in accordance with his previous percentage of interest so that he always had the opportunity to maintain this percentage of interest.

(6) Dividends could be paid only out of surplus profits from the operation of the business. This rule was developed to protect creditors by disallowing the shareholder payment of dividends from capital that

34. If the corporate charter did not state that all of the capital had to be subscribed to the corporation before business could begin, it was held that it was implied in share subscriptions that payment could not be called for until all of the capital had been subscribed. See, e.g., Cabot & West Springfield Bridge v. Chapin, 60 Mass. (6 Cush.) 50, 52 (1856); Salem Mill Dam Corp. v. Ropes, 23 Mass. (6 Pick.) 23, 40 (1827).
was reserved primarily for payment of debts. The rule also forced the corporation to maintain a sound financial position which, in the long run, helped it operate successfully in the business environment and ultimately make more profits to pay the shareholder.

Thus, the corporation described above is that of an entity having many relationships, but with a primary one in which the shareholders possessed strong personal control over the corporation. The corporation was thus a property right of the shareholders derived from the money they expended for that right. The shareholders were a group of owners, who delegated certain powers of management, but who were clearly protected in their property rights by carefully fixed rules. Management, as a group of agents who operated a business for a group of owners, was clearly confined in its actions by the legal property rights of shareholders. Although they had more general powers than most agents, the managers were accountable and were jealously governed in all general policy matters by the shareholders. The position of the shareholders could be considered analogous to that of a captain and his officers at sea in relation to the owners in port. The captain and his officers navigated the ship, but the destination, ship repairs, the nature of the cargo, and decisions about profits and losses were determined before the voyage and could only be changed by the property owners.

B. The Nature of Proxies

1. Common Law Rule

The concept of a proxy is extremely important in understanding the nature of the change in control from the shareholder to the corporate managers. We have seen that control rested with the shareholder, whose direct relation to those who managed for him was undeniable. The shareholder owned a share and had a vote that directly influenced the actions of the manager, who was simply an agent of the shareholder.

A proxy is a person appointed to exercise a right or privilege that pertains to the appointor; usually this is the right to vote at shareholders' meetings. The expression comes to Anglo-American law from the civil law of the continent and is apparently related to "procuracy," which denotes the profession of a "proctor" or "procurator," an officer

of the civil courts system, corresponding to an attorney in common law. In addition, the word “proxy” describes the instrument or power under which the appointed person acts.36

At common law, however, the right to vote by proxy was unknown.37 The rule arose from the nature of the earlier forms of corporations, the municipal and charitable corporations. There was no pecuniary interest associated with membership in these particular corporations. Voting was a privilege based on a personal trust which the individual had at his discretion, and therefore, by its very nature, it could not be delegated. The trust translated into an obligation for the members to attend meetings in person and execute the trust. Although it was not necessarily stated, the individual trust relationship was implied and formed part of the fundamental nature of all corporate charters. The Court of Appeals for the District of Columbia stated that, “The voting privilege [in the early corporations] was in the nature of a personal trust, committed to the discretion of the members as an individual, and hence not susceptible of exercise through delegation.”38

Generally, the early English corporations were analogous to the political organizations that were developing. In accordance with the prevailing political theory of the corporation, corporate rights arose only when the charter was issued from the Crown, which gave the community, or group of individuals, sovereign power to exercise the special privileges granted by the crown.39 Each individual, as a holder of such sovereign power, had one vote. This right to vote was an extremely important trust expected of rational men who wished to be members of the corporation (analogous to government) to vote for the betterment

36. Id. at 343.
39. This has been well documented throughout the definitive books on the subject. See, e.g., Davis, supra note 28, at 92-129; 1 J.S. Davis, Essays in the Earlier History of American Corporations (1917); Dodd, American Corporations Until 1860 (1954); Dubois, The English Business Company After the Bubble Act, 1720-1800 (1938); Livermore, Early American Land Companies, Their Influence On Corporate Development (1939); Axe, supra note 37, at 38; Bergerman, Voting Trusts and Non-Voting Stock, 37 Yale L.J. 445, 447 (1928); Williston, supra note 37, at 108-14.
of all.\textsuperscript{40} Fundamental to this thinking was the concept of an inalienable property right. Although this organization was created by the state, a person who was part of the corporation gained a right in the corporation that could be interpreted only as a property right during this period in England.\textsuperscript{41} There was one exception to this common law rule. Voting by proxy was allowed for the peers of England, but this custom had originated from grants from the Crown.\textsuperscript{42}

2. Common Law Rule as Applied to Corporations

Once the common law rule had been formulated for eleemosynary and public corporations, it was natural to apply it to corporations for profit.\textsuperscript{43} Holdsworth,\textsuperscript{44} one of the finest common law historians, and J. S. Davis,\textsuperscript{45} a corporate historian, agree that the modern business corporation developed from the guild organization which regulated trade in the city or village.\textsuperscript{46} In the same manner, huge, well-known commercial corporations, such as The Russian Company (founded in 1555 as the first joint stock company), The East India Company, and the Hudson's Bay Company, were given power to regulate trade in foreign lands. The next step in the development of the modern business corporation was an organization without monopoly powers which was created for the single purpose of earning profit for its members.\textsuperscript{47} Thus, the law that had been evolving in regard to the older eleemosynary and public corporations was applied to the new, for profit corporations. One author emphatically concluded that no distinction existed “in the early law between any of the four very different kinds of corporations—guild, town, church and business.”\textsuperscript{48}

3. Express Authority to Vote by Proxy

Consistent with the doctrine of common law, it was later held that an express corporate charter authority or an express bylaw was invalid

\textsuperscript{40} Telly, \textit{supra} note 29, at 440.
\textsuperscript{41} \textit{Id.} at 438.
\textsuperscript{42} Maupin, \textit{supra} note 36, at 344; see, e.g., Phillips v. Wickham, 1 Paige Ch. 590, 598 (N.Y.Ch. 1829); 14 C.J. Corporations 907 n.56 (1919); \textit{Proxies in Parliament}, 4 L. Rev. (Engl.) 253.
\textsuperscript{43} See Taylor v. Griswold, 14 N.J.L. 222, 232-36 (1834); see, e.g., Maupin, \textit{supra} note 35, at 343.
\textsuperscript{44} W. Holdsworth, \textit{8 A History of English Law} 199 n.5 (1925).
\textsuperscript{45} J.S. Davis, \textit{supra} note 39, at 110.
\textsuperscript{46} See also, Bergerman, \textit{supra} note 39, at 447 (stating that modern business corporations developed from the guild organization).
\textsuperscript{47} \textit{Id.}
\textsuperscript{48} \textit{Id.} at 446-47.
unless some statutory authority could be found. The following two examples will suffice to illustrate this point. First, an Illinois-Wabash agreement of 1774 explicitly allowed the use of proxies at corporate meetings. Second, the articles of association of the Ohio Company organized in 1786 specifically provided for proxy voting. However, most corporations did not place this right in their charters until the middle or latter part of the nineteenth century. Several courts that addressed the issue of express authority to vote by proxy approved corporate bylaws that provided for proxy voting. For instance, in State ex rel. Kilbourn v. Tudor, the judge felt strongly that after the corporation passed a bylaw permitting proxies, they should be allowed.

4. Analysis

This brief presentation on the common law concerning proxies thus shows the underlying philosophy of the early corporation and the central place and power of the stockholder, who had an inherent right to vote and thus control the corporation that could not be diluted or lost by a proxy. States strongly protected this right. In New York, for example, the laws of 1880 did not allow the buying and selling of railroad proxies. In an Ohio case, the court ruled that a stockholder who sold his right to vote was analogous to selling his right to vote at the polls. Therefore, such a sale was illegal as a violation of duty and trust.

Furthermore, several cases made it very clear that the corporation could not acquire the right to vote the shares of its stockholders by proxy or otherwise. In 1896, one commentator stated that: “In view of this rule, it may be seriously doubted whether proxies given to the officers of a corporation are valid, since such officers would thereby be placed in a position to pass upon their own conduct in the administration of the corporate affairs.”

49. Livermore, supra note 39, at 229.
50. Id. at 138.
51. Axe, supra note 37, at 42.
53. 5 Day 329, 331-36 (Conn. 1812) cited with approval in People ex rel. Christzman v. Crossley, 69 Ill. 195, 197 (1873).
54. Maupin, supra note 35, at 345.
57. Maupin, supra note 35, at 345.
C. The New Managerial Corporation

1. Introduction: Industrial Revolution in the United States

After the Civil War, this nation achieved what had never been accomplished before in the history of the world. In a short span of fifty years, it went through a metamorphosis from a modest agricultural nation to the largest industrial nation in the world.\(^{58}\) It had been assumed that it would take many years to settle the vast domain that was America. History shows us that this assumption was wrong. Granted, the expansion westward had been an ongoing occurrence since Daniel Boone crossed over the Alleghenies and Lewis and Clark charted the vast stretches of the Northwest into Montana and Washington. Moreover, the discovery of gold in Sutter's Mill in 1849 and the subsequent gold fever acted as a tremendous impetus for westward advancement. However, from 1870 to 1910, an incredible expansion occurred that was produced primarily by business in a vast free enterprise economy. William Greenleaf accurately stated that, "The economic development of the United States since the Civil War encompasses the most rapid and striking transformation of a major social order in the history of mankind."\(^{59}\)

There is no doubt that the Civil War helped spur Northern industries. After the war, the corporations looked for new ways to maintain the production capacities that the war had demanded and that they had furnished through industrial expansion. It was natural to assume that after the war their attention would turn toward developing the vast continent that stood ready to be exploited. Since England had just gone through the early phases of the original industrial revolution, it was easy for America to follow in the footsteps of the country that had so much to do with its beginning. Most authorities claim the wealth of the land as the main reason for the growth and progress of America. In the author's opinion, however, the prime factor was the English legal roots that established a constitution and freedom that enabled the building of a nation in an atmosphere of peace.


\(^{59}\) Greenleaf, supra note 58, at 1.
Within this legal structure was the concept of the eighteenth and nineteenth century economic model, grounded on the right to property and the right of business to operate with little or no interference.\(^6\) Once that is understood, then, as Greenleaf\(^6\) and Rostow\(^6\) both maintained, in every society, whether ancient or modern, a specific form of "organized economic activity," like the wool trade in England in the fifteenth century or Dutch shipping and commerce in the seventeenth century, becomes the central "focus" of the "advanced energies and techniques" of economic growth.\(^6\) Both agreed that in the United States the railroad was the single most important force for economic development and change. The railroad provided faster and more dependable transportation than land or water; it increased Western settlement; it created a land of cities all tied together in one national marker; its enormous requirements for capital helped create a securities market; and during the early developmental years, it was the single largest user of labor and capital, which had a multiplying effect on investment in the public and private sectors.\(^6\)

Because the railroads needed tracks, bridges, and locomotives, steel had to be produced. Huge iron ore deposits in the Lake Superior region were discovered in 1844 and contributed iron to the huge steel industry that developed.\(^6\)

Coal became the most important source of power, and enormous deposits of coal were found throughout the United States. Coal was necessary to drive the locomotives, to produce steel, and to heat the nation.\(^6\)

\(^6\) Telly, supra note 29, at 442-45.
\(^6\) GREENLEAF, supra note 58, at 10.
\(^6\) GREENLEAF, supra note 58, at 10.
\(^6\) Id.; see also ROSTOW supra note 62, at 55. It should be noted that Robert W. Fogel disagreed that growth was from a single technological change. R. FOGEL, RAILROADS AND AMERICAN ECONOMIC GROWTH: ESSAYS IN ECONOMIC HISTORY 236 (1964). He maintained, through different sections in the book, that other means of transportation could have been used just as effectively, and that the enormous revolution was induced by a multiplicity of innovations. On the other hand, Fishlow felt that although Fogel may have had a point, and that other means of transportation could have served the purpose that the railroads did, the fact was that the railroads actually did serve that purpose. FISHLow, AMERICAN RAILROADS AND THE TRANSFORMATION OF THE ANTI-BELLUM ECONOMY 303-605 (1965). As far as this Article is concerned, the point that the railroads were central to the development of the industrial revolution in America seems well taken.
\(^6\) E. KIRKLAND, supra note 58, at 435-37; GREENLEAF, supra note 58, at 15, 125-42; H. FAULKNER, supra note 60, at 417-18.
\(^6\) Id. at 433-34; H. FAULKNER, supra note 58, at 417-18.
In 1859, the first oil well was drilled in the United States near Titusville, Pennsylvania. It was drilled in order to gain a more abundant supply of an illuminant product, but it soon became an important source of fuel and lubricant for the new machines of the age.  

In addition to the development of mineral resources and the “basic industries,” new inventions added to the frantic pace of economic expansion. An invention that revolutionized urban society was the telephone, which was only one of the applications of a very significant discovery—electricity, a new source of power and lighting. The list of new machines that led to change in the industry and commerce of the nation in that period seems endless.  

It is important to mention that the population of the country increased enormously in those fifty years, primarily because of large families. There was little poverty, since as soon as a child was old enough he or she would marry and the couple would move West to settle on what land they wished to farm.  

The second reason for growth was that between 1860 and 1920 nearly 28,500,000 foreigners sought these shores, equalling the total population of the country in 1850. This enormous increase in people meant a huge market in this country for the goods that were being produced. Many of these immigrants went West to settle on available land. Professor J. R. Commons opined that more immigrants came because of companies’ needs for cheap labor, the provision of low passenger fare, and their wish to sell land, than to escape the stringent conditions in Europe, Asia, and Africa. Whatever the reasons, these immigrants provided the largest consumer market in the world.  

Viewed economically, this kind of population was extremely important. Most immigrants who came to this country were between 15 and 40 years old—the most productive age groups. This growing popu-
lation also provided an abundant labor supply and an expanding market. Furthermore, industries and farms continually added to investment to meet the needs of more people and more households.  

2. The New Corporate Form

The corporations that began to develop during these fifty years were large organizations that merged with others to become immense organizations. The railroads were the first of these organizations because, as indicated above, they were the initial impetus for the industrial revolution in America. Initially, they became the largest and most powerful business. The managers who ran the railroads became modern business administrators with special skills and training. As Chandler noted, "The operational requirements of the railroads demanded the creation of the first administrative hierarchies in American business. The men who managed these enterprises became the first group of modern business administrators in the United States. Ownership and management soon separated."  

Most railroad managers expected to work up the administrative ladder. They progressively became professionals, and in time their ideology dominated the major thrust of railroad policies.

The railroads created a mass distribution system in the United States unknown before in history. It was not long before mass production industries began to market their goods through this mass distribution system. The next step was to market the goods as effectively as possible, and so two ancillary business institutions came into play—the credit agency and the advertising agency. James Buchanan Duke accomplished this very effectively with cigarettes; he controlled the leaf tobacco, the manufacture of cigarettes, and the contracts with the retailers who sold the goods. But when the competition followed suit, then all of them concentrated on advertising and the profits were reduced. In order to control the competition Duke and his four competitors merged and formed the American Tobacco Company.  

The stories of the match, flour, soup, soap, and photography industries are all similar to the tobacco story. Other industries had their own quirks and differences, but on the whole they developed into enor-

72. G. FITE & J. REESE, supra note 58, at 280.
74. Id. at 289-92.
mous vertically integrated firms, and eventually into horizontal ones that became huge, powerful entities.\textsuperscript{75}

Why did the United States become the seed-bed for managerial capitalism? The answer probably lies in the size and nature of its domestic market, which became in the fifty-year period already discussed, the largest and fastest growing in the world. It was also the most homogeneous. This market not only encouraged mass marketers, but it hastened the adoption of new technologies. Americans pioneered new machines and mass production, and also the manufacture of standardized machines by mass production methods.\textsuperscript{76}

Two results of the new managerial corporation are especially relevant to this Article. First, it became apparent that enormous power was lodged in the huge corporate forms that were created. Second, the owner stockholders were no longer the controllers of the corporation, which they legally owned. Instead, the managers, who were non-owners, attained the position of corporate control.

\section*{III. Principal Authors Contributing to Reform}

\subsection*{A. Introduction}

The rise of the huge corporations and their enormous power did not bring much clamor for specific reforms, but it did cause many people to become distraught at the growing menace of these huge corporations. They feared that a new feudalism had already arisen or might arise from such a concentration of power. There was genuine concern in this country that democracy was on the verge of being lost and big business taking over.\textsuperscript{77} However, despite the opposition of big business, the Sherman Anti-Trust Law was passed in 1890. A sigh of relief swept the nation because everyone thought that now the trusts would be controlled. Yet, for several years nothing happened. But at the turn of the century, many of the trusts were in fact broken up, the most important instances being the Oil and Tobacco Trust cases in 1911.\textsuperscript{78}

The entire nation was excited about Teddy Roosevelt's adamant behavior towards "trusts" and his "trustbusting." It was the big news of the day. Many writers of this era described the destructive nature of

\footnotesize{\textsuperscript{75} Id. at 498-500.  
\textsuperscript{76} Id.  
\textsuperscript{77} Interview with Dr. Shaw Livermore, Dean of the Business and Public Administration College of the University of Arizona (May 15, 1962).  
\textsuperscript{78} United States v. American Tobacco Co., 221 U.S. 106 (1911); Standard Oil Co. of New Jersey v. United States, 221 U.S. 1 (1911).}
huge trusts and their monopoly power in a democratic free enterprise society, but no one dealt with the problems created by them in relation to the stockholder.

Although ahead of their time, a few writers during this period expressed concern that shareholders' rights were being eroded. This thinking ultimately led to new laws for the restoration and protection of these rights. A discussion of the more important writers and their ideas is provided in order to facilitate greater understanding of the laws which are central to this Article.

B. Influential Books


One of the first books concerned with the trust problem was written by William W. Cook, who gained fame for his definitive work in corporation law. His book entitled *The Corporation Problem*, published in 1891, is a fine work dealing with the large corporations and trusts and the monopoly power they wield. Although he does not specifically deal with the stockholder, Cook, in his thorough analysis, suggested that the managerial plutocracy which acts through corporations should be careful. The vast interests that they represent make it dangerous for them to go against the American people, who look upon the corporations as a threat to the republic, and who in a crisis rise to the occasion.

And so it will be in regard to the corporations. They will continue to vex the minds of men and to appear as ominous spectors and omens of ill. But the American people, clear in

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79. The number of books is almost without end. See, e.g., CLARK, THE PROBLEM OF MONOPOLY: A STUDY OF A GRAVE DANGER AND OF THE NATURAL MODE OF AVERTING IT (1904); CLOUD, MONOPOLIES AND THE PEOPLE (4th ed. 1873); W. COOK, TRUSTS: THE RECENT COMBINATIONS IN TRADE, THEIR CHARACTER, LEGALITY AND MODE OF ORGANIZATION, AND THE RIGHTS, DUTIES AND LIABILITIES OF THEIR MANAGERS AND CERTIFICATE HOLDERS (2d ed. 1888); GUNTEN, TRUSTS AND THE PUBLIC (1899); JENKS, THE TRUST PROBLEM (1900); JENKS & CLARK, THE TRUST PROBLEM (1917); RIPLER, TRUSTS, POOLS AND CORPORATIONS (1905); SPETHING, BOSSISM AND MONOPOLY (1906); STEVENS, INDUSTRIAL COMBINATIONS AND TRUSTS (1913); VAN HISE, CONCENTRATION AND CONTROL: A SOLUTION OF THE TRUST PROBLEM IN THE UNITED STATES (1912); VON HALLE, TRUSTS OR INDUSTRIAL COMBINATIONS AND COALITIONS IN THE UNITED STATES (1895).

80. W. COOK, A TREATISE ON THE LAW OF STOCK AND STOCKBROKERS AS APPLICABLE TO RAILROAD, BANKING, INSURANCE, MANUFACTURING, COMMERCIAL, BUSINESS, TURNPIKE, BRIDGE, CANAL, AND OTHER PRIVATE CORPORATIONS (1887).


82. Id. at 250-53.
their intellectual powers, honest in their purposes, and decisive in their acts, have no need to fear them. 'The Corporation Problem' will be solved, and the solution when it comes, will be satisfactory, thorough, and complete. 83

Although Cook's book is similar to those works which failed to address the relationship of trusts and their monopolies with the shareholder, 84 he does voice an overall concern and warns of the underlying problems.


One book of this period is unusual in that it does specifically discuss the shareholder. In Commercial Trusts: The Growth and Rights of Aggregated Capital, 85 published in 1901, John R. Dos Passos noted that although there is no law on the subject of shareholders, none is needed because the shareholders have the right through a court of equity or of common law to open the corporate books. And that is the end of his discussion. 86 Effectively, this author does not see any problem at all for the stockholder, and yet obviously such a problem has been raised or he would not have addressed it.

3. The Lawyer and the Community—Woodrow Wilson (1910)

Another important theorist to discuss the stockholder problem and trusts was the fine historian and political scientist, Woodrow Wilson. While serving as president of Princeton University, he delivered a major address entitled "The Lawyer and the Community" to the American Bar Association on August 30, 1910. 87 In his address, he concerned himself with the new corporate organization that had arisen and the responsibility the lawyer had vis-à-vis the individual and the corporation. He maintained that the individual had been submerged into the organization and that those who controlled the organization had extraordinary power. More specifically, he stated:

Most men are individuals no longer so far as their business, its

83. Id. at 253.
84. See supra note 79 and accompanying text.
86. Id. at 126-28.
87. Wilson, The Lawyer and the Community, 35 A.B.A. 419 (1910). Following Wilson's address, he was nominated and elected to the office of Governor of New Jersey in November, 1910, and then served as President of the United States from 1912-1921.
activities or its moralities, is concerned. . . . [T]heir individuality and independence of choice in matters of business they have lost. . . . They are not at liberty to ask whether what they are told to do is right or wrong. They cannot get at the men who ordered it,—have no access to them. They have no voice of counsel or of protest. 88

Woodrow Wilson was clearly concerned that individuals had no rights within the corporation and that those who manage had all the power. He went on to assert that the task of the law is to “rehabilitate the individual,” not to make him superior or to destroy the corporation but, “to undo enough of what we have done in the development of our law of corporations to give the law direct access again to the individual—to every individual in all his functions.” 89 Thus, Wilson proposed that the individual’s rights be restored to him so that the corporation would not have all the power.

Moreover, Woodrow Wilson presented an anomaly. He mentioned that those who have power could not have gained by themselves the vast capital they employed as if it were their own. “[Y]et they have not the full legal responsibilities of those who supplied them with it.” 90

4. Other People’s Money and How the Bankers Use It—Louis D. Brandeis (1913)

A fourth important author was the great lawyer and later Justice of the Supreme Court, Louis D. Brandeis. He wrote a series of articles in Harper’s Weekly on the money trust which had a nationwide impact. These articles were subsequently compiled into a book, entitled Other People’s Money, 91 that was published in 1913, and was equally influential.

Brandeis began his book by analyzing the corporations and specifically saying that they are owned primarily by small investors, “who do not participate in the management of the company.” 92 Then he stated

88. Id. at 426.
89. Id. at 427.
90. Id. at 428.
91. L. BRANDEIS, OTHER PEOPLE’S MONEY AND HOW THE BANKERS USE IT (1913). Brandeis was so admired for the positions he supported that he was nominated for Justice of the Supreme Court by President Woodrow Wilson. Because Brandeis was unpopular among powerful corporations, his appointment was in doubt. After considerable debate, and with Wilson’s firm support, the appointment was approved. A. MASON, BRANDEIS: A FREE MAN’S LIFE 491-508 (1946); A. LIEF, BRANDEIS: THE PERSONAL HISTORY OF AN AMERICAN IDEAL 9-10, 345, 395 (1936).
92. Id. at 7.
that stockholders buy stocks and bonds on the New York Stock Exchange, which had over 1,600 issues aggregating to over 26 billion dollars. These small investors, who are not professionals, he continued, are unable to make intelligent judgments about stocks because they lack the "ability," the "facilities," the "training," and the "time," to investigate their investments properly.93 Thus these people needed the advice of experts who do have the knowledge, judgment, facilities, and incentive to make a thorough investigation. He pointed out that more than half the owners of the stock of many large corporations at the time were women. These women and other small investors depended upon the banker's judgment, and of course this dependency gave great power to the bankers.94

This kind of control was not enough, claimed Brandeis, as the bankers became promoters and arranged mergers for substantial fees. And in times of crises, the bankers became "Reorganization Managers" and acquired control of many corporations. That was not enough either, Brandeis said, as they also became directors of many companies through their powerful influence or because of their control of customers' proxies.95

Another means of control, continued Brandeis, was to gain access to those who were the large security buyers. The insurance companies acquired huge aggregates of capital daily, which in turn needed to be invested. It was thus "natural" for the investment bankers to wish to control the corporations that received such large amounts of money. The mutual insurance companies were supposedly controlled by the stockholders, but an investigative committee concluded, "The so-called control of life insurance companies by policy holders through mutualization is a farce" and "its only result is to keep in office a self-constituted, self-perpetuating management."96 Thus the core of Brandeis' argument was that the stockholders had lost power in the corporations.

93. Id. at 8.
94. Id. The point was that these women were widows who had been the beneficiaries stock left by their husbands, who had been knowledgeable in accumulating it, whereas the widows had little knowledge about the stocks and were dependent on the banker's judgment.
95. Id. at 10-11.
96. Id. at 15. Other examples of investment bankers' control included mergers and interlocking directorates.
5. Drift and Mastery: An Attempt to Diagnose the Current Unrest—Walter Lippman (1914)

The fifth author that is of concern is the columnist, critic, and political theorist, Walter Lippman, who wrote a penetrating analysis of the modern American society of 1914 in a book entitled Drift and Mastery. 97 He began by saying that the major question in that exceptionally difficult time was “how business methods are to be altered, not whether they are to be altered.” 98 He went on to say that this is clearly one of the central weaknesses of democracy. 99 In the first chapter he focused on the problem—corruption and loss of trust in business and government, the central fabric of American democratic society. One of the pillars of both business and government is private property, he said, but it had been modified and businessmen were conducting quasi-public enterprises. He asserted that they must learn that “it is no longer altogether their business . . . They are talking more and more about their ‘responsibilities,’ Their ‘stewardship.’” 100

In chapter two, Lippman analyzed the old classical economic ideas of individuals in an exchange relationship who contract as equals. He said that in effect those rules do not mean much in modern society because huge trusts are not individuals. Moreover, the corporations are not even administered by owners but by managers “divorced from ownership,” who are being trained in the universities. Thus, there must be a change from the profit motive, he said, to the “satisfaction of services rendered and uses created . . .” 101 In chapter three, Lippman attacked private property and said that large industries cannot be conducted as long as the old principles of private property are left intact. Then he drove home the key points of his thesis: “Scattered all over the globe, changing from day to day, the shareholders are the most incompetent constituency conceivable.” 102 According to Lippman, shareholders do not know or care to know what is happening to the corporation. He referred to them as a “heterogeneous collection with a single motive, and from that material some people pretend to expect a high sense of

97. W. LIPPMAN, DRIFT AND MASTERY: AN ATTEMPT TO DIAGNOSE THE CURRENT UNREST (1914).
98. Id. at XIX.
99. Id. at XX.
100. Id. at 23.
101. Id. at 46-49.
102. Id. at 57 (emphasis added).
Lippman was careful to add that he did not mean to imply that by owning a share of stock one is necessarily ignorant or tyrannical, but there is little benevolence that can be attained by owning a share of stock because, "It is too abstract, too scattered, too fluctuating." He concluded that the large-scale corporation has separated ownership from management. Ownership has been "diffused and diluted till it means very little more than a claim to residual profits after expenses are paid, after bondholders are satisfied, and perhaps, after insiders have decided which way they wish the stock market to fluctuate."

He added that private property is meaningless since stockholders have been deprived of their property rights and transformed into moneylenders. In addition, control has moved from the industries themselves into the hands of investment experts and banks.

Lippman then analyzed the purchaser of goods, who cannot have full knowledge about the producer, that requires the government to step in and equalize the bargain by regulating the quality of goods and the reasonableness of prices.

The gist of his conclusions was that antitrust should not mean breaking up big business into small businesses. Instead, all that is needed is order and purpose in the business world and administrative methods to harness the great resources of our country—"industrial statesmanship," he called it. In a larger sense, what is required is a vision of democracy that can deal reasonably with the problems of today and come to logical conclusions for tomorrow.

6. Absentee Ownership and Business Enterprise in Recent Times: The Case of America—Thorstein Veblen (1923)

The sixth important author is Thorstein Veblen, whose influential book, Absentee Ownership, was published in 1923. It was his last book and probably the best summary of his doctrine. In the majority of his writings, he argued against business and its domination in Amer-
ican society. In his introductory chapter, Veblen discussed the concept of absentee ownership. Absentee owners are those who own the business as stockholders but do not work the business, or those who own stock and control the business but do not work directly to produce the manufactured goods, or managers who run the business and make large salaries but do not own the business nor directly produce the manufactured goods. Thus, absentee owners reap the benefits but do not directly produce the goods. According to Veblen, law and politics serve the needs of the absentee owners but not the majority of the population. Moreover, corporations, rather than producing the maximum output of goods at low cost in the interests of the general population, produce instead a moderate output at inflated prices.\(^{110}\)

Veblen's entire thesis was a scathing diatribe against the Western democracies. Veblen said that "due process" has become so expansive that only absentee owners have rights under the law. These rights were established in the sixteenth, seventeenth, and eighteenth centuries, and are considered immutable, even though society since the industrial revolution has changed immensely. Veblen contended that within this society have arisen the corporations, which all people have been trained to respect and which have become "sovereign" with tenure in perpetuity.

Veblen then discussed two more major ideas. First was the idea of handicraft and natural right. After feudal allegiance no longer brought man material advantage, he drifted to towns where industry started. Trade, the essence of industry, "runs on this natural right of free bargain," which means a working man's inalienable right to sell his labor-produced goods.\(^{111}\)

The second idea concerned the natural right of investment. Ownership of natural resources rests upon the ancient feudal ground of privilege and vested interest rather than upon the right of workmanship.\(^{112}\) Veblen said: "These owners own these things because they own them. That is to say, title of ownership in these natural resources is traceable to an act of seizure, legalized by statute or confirmed by long undisturbed possession."\(^{113}\) Not all ownership of natural resources is absentee ownership since those who work land they own, like the farmer, have a natural right equal to the craftman's right. Soon,

\(^{110}\) Id. at 3-10.
\(^{111}\) Id. at 40-49.
\(^{112}\) Id. at 51.
\(^{113}\) Id.
continued Veblen, the landed interest vested with title and absentee ownership shifted from a small marketplace "huckster" to an "absentee investor who took care of business," who by "degrees" grew to be a "merchant prince." 114

Veblen said that Adam Smith spoke of the handicraft era, but it was after Smith that:

[T]he businesslike management of industrial concerns begins to shift from a footing of workday participation in the work done, to that of absentee ownership and control... This rearrangement of economic factors, and division of economic activities, was brought on by the increasing scale of the industrial plant and operations, wherever and so far as the new technology of the machine process took effect. 115

The net product produced, Veblen asserted, came from (1) the state of the industrial arts, and (2) the growth of population. 116 Ultimately, modern industry is a system of mechanical processes directed by expert knowledge and brought to fruition by modern technology and raw materials. Veblen concluded that the "natural right of investment becomes... a vested right of use and abuse over the current industrial knowledge and practice." 117

Veblen also analyzed the era of free competition, when the "Captains of Industry" emerged. 118 These "Captains," defined as absentee owners and controllers of industrial equipment and resources, became very successful and set the standards of the community's aims and ideals. This period, until the mid-nineteenth century, was one not only of free competition but also of increasing output that resulted in an increased population. At this point, Veblen made an astute observation and noted that the free competitive system was "dying at the top," and was no longer the norm in the "key industries." 119 Three features developed: (1) industry became excessively productive because of greater technological development; (2) the supply of industrial products overtook demand; and (3) the use of credit increased substantially. Thus, concluded Veblen, new changes were coming about to destroy the old competitive system. 120

114. Id. at 56.
115. Id. at 58 (emphasis added).
116. Id. at 62.
117. Id. at 68.
118. Id. at 70.
119. Id. at 77.
120. Id. at 79.
In the latter half of the nineteenth century, continued Veblen, corporations goals shifted from productive work to profitable business. This shift lead to salesmanship and an “industrial corporation,” whose interests, to acquire gain, but not to primarily produce goods reflected those of the absentee owner. Ultimately, asserted Veblen, the corporation “is an incorporation of credit, capitalized on the basis of funds invested and to the amount of its prospective earning capacity.”

Veblen was upset with the way in which the country town has changed from a little community of self-made individuals to one imposed upon by big businesses. He also was very disturbed by the manner in which “free enterprise” big businesses had taken over the country’s virgin timber and oil and wasted so much of the resources in the process of making personal gain. He made an extremely sarcastic attack on such waste by absentee ownership:

The whole of this routine of waste and inefficiency is a matter of course under the American plan of seizure and conversion; and it is at least a blameless exercise of private initiative, commonly regarded as a meritorious work. It is, in effect, no more than an exemplary working-out of the American citizen’s dearest constitutional rights, and there is no fault to be found with it all on any score of irregularity. In its time and under the given conditions of law and custom it is sound business enterprise; just as the Big Business and monopoly control in which it invariably heads up is also sound business. It is all in the day’s work. It has seemed necessary here to recall these workday incidents of business-as-usual in oil, just because they show a concrete and exemplary working-out of absentee ownership as it affects the country’s natural resources.

At this point in Veblen’s book, there is a juncture between Part I, that described the past, and Part II, in which Veblen’s description of the “New Order of Business” begins. Society was now catching up with the new order that had gripped the country, as would be expected when an older, established system of usages, beliefs, laws, and customs must overtake the new. This was especially true in America, “where the rate and volume of change in the material conditions of life during

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121. Id. at 82-85.
122. Id. at 93.
123. Id. at 142-65.
124. Id. at 200-01.
this interval have been large and swift beyond example."125 The new order arose when the working majority of the country's industrial resources came under absentee ownership on a large scale; a form of ownership that was impersonal, dispassionate, and totally immune to neighborly personalities and sentimental considerations.126

In this new order, Veblen maintained, the country's key industries have been progressively taken over by the absentee owners of the nation's credit institutions.127 These key industries dominate by curtailing the power and materials necessary for the rest of the manufacturing industries. Underlying all of this, is the incentive of business not to produce goods but to make money.128

In his conclusion, Veblen said:

In the last analysis the nation remains a predatory organism, in practical effect an association of persons moved by a community interest in getting something for nothing by force and fraud. . . . It is a residual derivative of the predatory dynastic State, and as such it still continues to be, in the last resort, an establishment for the mobili[z]ation of force and fraud as against the outside, and for a penali[z]ed subservi-ence of its underlying population at home.129

Veblen thus made a drastically harsh condemnation of American society. He said that these absentee owner businessmen, in control as "Captains of Industry," and the managers, trained in business schools and who worked their way up to control giant corporations, have become new feudal lords, who, by force and fraud, control the wealth of the nation. The laborers and small stockholders have no say, and consequently have lost their country, even though the trappings of democracy still exist.

7. Main Street and Wall Street—William Z. Ripley (1927)

The seventh author is William Z. Ripley, the Nathaniel Ropes Professor of Political Economy at Harvard University, who wrote Main Street and Wall Street in 1927.130 This is a seminal work because, as the introductory personal note said: "This book is not just a treatise on economics; nor is it a handy manual for investors. It purports to go

125. Id at 207.
126. Id. at 212-13.
127. Id. at 231-32.
128. Id. at 248.
129. Id. at 442.
130. W. RIPLEY, MAIN STREET AND WALL STREET (1927).
deeper than that, down toward the root of things,"¹³¹ that is, the
problems in our democracy. For Ripley, democracy has had basic ide-
als, such as “to promote a greater equality of opportunity among men”
and a “fairer show at conserving the fruits of such activity thereaf-
ner,”¹³² and these ideals must be stimulated and preserved by govern-
ment. Ripley then made a strong statement, “Property should never be
allowed to degenerate into an instrument of oppression.”¹³³ Ripley
wanted us to understand the role of property in our civilization, so that
democracy can act to maintain it as a viable fruit for all the people.

Ripley was careful to say that his study was a weapon of “honey,”
not of “sting.”¹³⁴ The essays were not attacks on our democratic sys-
 tem, nor were they muckraking. During a great period of prolonged
prosperity in 1927, he felt that we should recognize what is sound and
good but that “we should inquire deeply concerning those things which
might better serve the common good than is now the case.”¹³⁵

Ripley acknowledged the value of the books authored by Bran-
deis,¹³⁶ Lippman,¹³⁷ and Veblen,¹³⁸ but he said that Veblen’s book,
while “stimulating,” was “perhaps too promiscuously accusative.”¹³⁹
Ripley’s book was a sincere effort to look at the corporation and some
of the major problems that had arose, so that he could suggest reforms.

Ripley pointed out that America was the unsurpassed world leader
in its annual crop of corporate charters. Each of the forty-eight states
produced its share of new corporations, but the state that produced the
most was the one with the easiest laws. Much of the competition be-
tween states for corporate favor arose from the desire to increase public
revenue.¹⁴⁰

This competition for corporation chartering for revenue purposes
resulted in undesirable charters, which trampled on the old common
law rights of the shareholders. Among those common law rights was
preemption, where new stocks were offered to existing shareholders
before being offered to the general public so that the original share-

¹³¹. Id. at V.
¹³². Id.
¹³³. Id.
¹³⁴. Id. at VI.
¹³⁵. Id.
¹³⁶. L. BRANDEIS, supra note 91.
¹³⁷. W. LIPPMAN, supra note 97.
¹³⁸. T. VEBLEN, supra note 109.
¹³⁹. W. RIPLEY, supra note 130, at VI.
¹⁴⁰. Id. at 16-37.
holders could maintain their former voting rights and control. After 1919, a new law became prevalent among the states, effectively abolishing that common law right by allowing a corporate charter to authorize new stock without having to offer it to the shareholders.\footnote{141.}

The second "innovation" was the non-par capital stock. The common law rule was that all stock had to be issued with a par value and any issue of shares for less than par value was unlawful because it diluted the prior securities issued. But, if the stock was selling at less than the par value, then a corporation could be embarrassed when it needed further capital because it could not raise the money. Thus, the new invention of non-par stock had done away with the safeguard for the shareholders, and indeed allowed for a higher danger of misrepresentation by the corporation to the investing public.\footnote{142.}

The third problem was the liability of the directors. The common law liability rule was that a director could not under any circumstances act for himself and at the same time act as an agent for the corporation, or he would be absolutely liable for any losses to the corporation. Now the law had changed to allow the directors to do this without any subsequent liability, as long as there is no fraud in the transaction. Ripley objected to this new law because it allowed the director, as an insider, to have undue influence over the corporation.\footnote{143.}

The fourth problem was the new holding company, which allowed one company to hold stock in another company. The old English common law forbade a corporation from holding stock in another. New Jersey expressly allowed this in 1889. It had caused a great intermingling of corporations, and allowed a huge corporation to control those corporations in which it held shares and leave the minority shareholders with almost no rights.\footnote{144.} Ripley opined that: "Some way ought to be found by which minorities shall have more of an opportunity, if not to block action detrimental to their interests, at least to assure a full opportunity for the presentation of their case before final action be taken."\footnote{145.}

Fifth, Ripley was concerned with the situation of private property in our civilization.\footnote{146.} Managers of the corporations are salaried and

\footnotesize{\begin{itemize}
\item \textbf{141.} \textit{Id.} at 37-46.
\item \textbf{142.} \textit{Id.} at 46-54.
\item \textbf{143.} \textit{Id.} at 55-61.
\item \textbf{144.} \textit{Id.} at 73-77.
\item \textbf{145.} \textit{Id.} at 76.
\item \textbf{146.} \textit{Id.} at 85.
\end{itemize}}
thus independent of year-to-year fluctuations of the corporation. Shareholders, under the old common law, had voting rights and thus control, but in recent years many stockholders had lost their voting rights because of the introduction of different classes of stock, most of which were non-voting ones.

Moreover, and extremely important, the number of shareholders in the corporations has increased enormously. As Ripley maintained, "[T]he larger the number of shareholders, the more easily may a small concentrated block of minority shares exercise sway over all the rest." When there are few owners, fifty-one percent is probably necessary for dominance, but with many owners (300,000 for example), fifteen percent or less can seldom be outvoted at an election.

Why do the shareholders allow this to go on? The reason, asserted Ripley, is that investors are very docile and act like a flock of sheep; many times it is difficult to get the stockholder to vote at all. However:

[T]he fact remains that the power, even if rarely exercised, . . . was there; and every once in a blue moon some resolute individual or stockholder could rise in his place and organize a protective committee or dissenting group—and, if nothing else happened, at least there was a thorough ventilation of what sometimes proved to be a musty or unsafe tenement.

And, of course, it was always encouraging when one individual, acting alone, forged ahead to act for the benefit of all.

Yet, all of the right to control is "closed out forever once people who own that property have allowed themselves to be utterly divorced from the exercise of their natural right to elect the directors and to influence, if not to determine, the corporate policy." Ripley lamented that the trend of diminishing the responsibility and accountability of the property owners continues.

It is important to note that in 1927 there was great prosperity and the depression of 1929 had not hit. Ripley made this prophetic observation:

The house is not falling down—no fear of that! But there are queer noises about, as of rats in the wall, or of borers in the timbers. I believe that the trouble has to do with the growing

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147. Id. at 95.
148. Id.
149. Id. at 96 (from an address by Robert F. Herrick).
150. Id. at 98.
151. Id. at 99.
dissociation of ownership of property from responsibility for the manner in which it shall be put to use. And now is the time for action. It is not yet too late.\textsuperscript{152}

After discussing the ways in which corporations have trampled on the common law rights of shareholders, Ripley mentioned a few solutions such as cumulative voting, shareholder audit committees, and perhaps most important, more disclosure of information to the stockholders.\textsuperscript{153}

Too much of the business of corporations was being carried on in "twilight" rather than in the open light of day. Perhaps that was not too unacceptable when the corporations were owned by only a few shareholders, but when Main Street\textsuperscript{154} and Wall Street\textsuperscript{155} crossed at right angles, there was a need for a universal disclosure of information.\textsuperscript{156} Ripley cited examples such as the failure of Westinghouse to have an annual meeting for ten years (1897-1905) and the U. S. Express Company to hold one at all.\textsuperscript{157}

Another problem noted, was that proxy information was insufficient, with blank proxies in some cases being sent out to stockholders to sign. Certain companies (Singer Manufacturing Company, for example) never sent out financial data to the shareholders.\textsuperscript{158} Others send colorful pictures of factories and offices, but not financial data; and any reports presented contained material that was of little use.\textsuperscript{159}

Thus, Ripley's point was that a very important right of the stockholders was access to or disclosure of adequate information. Not only did the stockholders need to know, but the state and general public also had the right to know what was happening, since incorporation was a privilege granted by the state. With adequate information, the stock exchanges could act intelligently and so could the stockholders and general public. Ergo: "This, then, is the ultimate defense of publicity. It is not as an adjunct to democratization through the exercise of voting power, but as a contribution to the making of a true market price. This is a point but half appreciated at its real worth."\textsuperscript{160}

In line with this concept of disclosure, Ripley felt that the balance

\begin{flushright}
\textsuperscript{152} \textit{Id.} at 116.
\textsuperscript{153} \textit{Id.} at 135-55.
\textsuperscript{154} \textit{Id.} at 156-57. Main Street referred to widespread ownership of corporations. \textit{Id.}
\textsuperscript{155} \textit{Id.} at 156-57. Wall Street referred to the aggregation of financial and directorial power in the capital centers. \textit{Id.}
\textsuperscript{156} \textit{Id.}
\textsuperscript{157} \textit{Id.} at 159.
\textsuperscript{158} \textit{Id.} at 162.
\textsuperscript{159} \textit{Id.} at 160-64.
\textsuperscript{160} \textit{Id.} at 169-70.
\end{flushright}
sheet and the income statement should both be made available to the shareholders.161 Too many happenings in the world affected a company's business and the shareholder had a right to know how the company is reacting. Then, if the shareholder agreed with these reactions, he could either stick with the company or get out.162

Corporate directors needed to be more careful of their "obligation" to pay dividends. Ripley cited the Lehigh and Wilkes-Barre Coal Company, which paid no dividends for years and did not issue reports.163 The method of assessing the value or net worth of the corporation needed to be made clear. With the concept of no par value now accepted and the liberties taken with placing a great deal of value on something like good will, the valuation could be very misleading.164

Ripley's last major point was that corporations should, by rigorous initiative from within, adequately present to the shareholders all pertinent facts. The New York Stock Exchange had done admirably, he asserted, but its influence was limited to corporations which were registered with it.165

Ripley concluded by saying that the crux of the problem of United States corporations in 1927 was the way the property owner, the shareholder, had lost many of his common law rights and had been disparagingly treated by corporate management. In short, the rights of the shareholder vis-à-vis the corporation and its management needed to be drastically improved.

8. The Modern Corporation and Private Property—Adolph A. Berle, Jr. and Gardiner C. Means (1932)

The final book is The Modern Corporation and Private Property, written in 1932 by Adolph A. Berle, Jr. and Gardiner C. Means.166 Because of the importance of this book, each of the four parts will be

161. Id.
162. Id. at 177-78.
163. Id.
164. Id. at 191-207.
165. Id. at 208-09.
166. A. BERLE & G. MEANS, supra note 33. This book was read nationwide and was so successful it has been reprinted several times. It was the first printed by Commerce Clearing House in 1932. Then it was reprinted by Macmillan Company in 1932 and again in March, April, June (twice), October, 1933; February, November, 1934; October, 1935; September, 1936; April 1947; December, 1948; March, 1968. Harcourt Brace Jovanovich, Inc. has recently reprinted it.

Two other books written in this period may appeal to the reader. See, Sears, The New Place of the Shareholder (1929); I. WORMSER, FRANKENSTEIN, INCORPORATED (1931). Although much was offered in both books on the current discussion, because of their length, it was decided not to include them.
discussed. Book I, Property in Flux: Separation of the Attributes of Ownership Under the Corporate System, explained the nature of the corporation and how it rested on two developments: (1) the factory system, which came about because of the industrial revolution and which caused a large number of workers to come under a single management; and (2) the placing of the wealth of many people through shareholders, under the central control of managers. When there is a huge multiplication of ownership, the control passes to the managers through their use of proxy machinery to become a self-perpetuating body, even though they may own but a small fraction of the outstanding stock. This separation of control allows huge aggregations of property and therefore the development of huge corporations, whose equity or stock is sold through the stock exchange. The corporation has thus become a different organization. As Berle and Means expressed it: 

In creating these new relationships, the quasi-public corporation may fairly be said to work a revolution. It has destroyed the unity that we commonly call property—has divided ownership into nominal ownership and the power formerly joined to it. Thereby the corporation has changed the nature of the profit seeking enterprise.\textsuperscript{167}

Berle and Means discussed very briefly the genesis and rise of the corporation, but the important part of this section concerned the enormous concentration of economic power in America in 1930. Their thesis and the facts and figures that backed it up showed that the two hundred largest nonbanking corporations in the United States possessed almost half of the corporate wealth in the country.\textsuperscript{168} Furthermore, Berle and Means asserted that the rates of growth of this group were much more rapid than those of all other corporations.\textsuperscript{169} Their conclusions were (1) The huge corporation had come to dominate most major industries in the United States. (2) An increasing portion of business was carried on by this form of industry. (3) There seemed to be no immediate limit to this increase. (4) This form of industrial unit was rapidly becoming the one with which American economic, social and political life must deal.\textsuperscript{170} These conclusions lead to several others: (1) It was becoming nec-

\textsuperscript{167} A. Berle & G. Means, supra note 33, at 6-7.
168. Id. at 19. It is interesting to note that not long after this thesis was presented, Fortune magazine came out with their now famous Fortune 500 in 1955.
169. Id. at 35-37.
170. Id. at 44.
necessary to think in terms of these large units rather than in terms of small units that compete with each other. (2) Competition had changed from free competition to huge dominant corporations, where the principles of oligopoly are important. (3) More goods were being produced for producing organizations, which in turn made further goods; quality suffers because there is no incentive to the general public. (4) The nature of capital had changed; more and more it was composed, not of goods, but of organizations. (5) Finally, a society in which production was governed by blind economic forces was being replaced by a society in which production is controlled by a few individuals.\textsuperscript{171}

Accompanying the concentration of economic power and making it possible, was an even wider dispersion of stock ownership. Evidence was presented to show the wide dispersion of stock ownership in the two hundred largest corporations,\textsuperscript{172} and it was even happening in the smaller corporations. The dispersion of ownership had gone so far that generally, "the larger the company, the more likely is its ownership to be diffused among a multitude of individuals."\textsuperscript{173} This dispersion was a continuing process. Once under way, it proceeded very swiftly,\textsuperscript{174} with the ownership of stock by officers and directors decreasing.\textsuperscript{175}

Further conclusions reached include the following: (1) The position of ownership had changed from active to passive. Rather than having direct physical ownership, the owner now only had a piece of paper, and without physical control over the instruments of production, the owner had very little control. (2) The intangible values of the spirit that went with ownership in the past were now lost to the owner, similar to the worker's loss of satisfaction in producing an entire piece of goods. (3) The value of a person's wealth depended on forces outside himself and his own efforts and was determined instead by those individuals in command and by the marketplace. (4) Individual wealth had become very liquid and subject to constant fluctuation in the organized markets. (5) Wealth was no longer in a form that could be directly used by the owner, like land. Instead, only through sale in the market could the owner obtain direct use of it. (6) The owner was left with a symbol of ownership, while a managerial group had actual

\textsuperscript{171} Id. at 45-46.
\textsuperscript{172} Id. at 48-49.
\textsuperscript{173} Id. at 52.
\textsuperscript{174} Id. at 53-57.
\textsuperscript{175} Id. at 52.
control.\textsuperscript{176}

The concept of control divorced from ownership was so unfamiliar and so central to the corporate system, that Berle and Means devoted an entire chapter to it, and it deserves further analysis here. In the election of a board of directors, the shareholder's personal vote counts for little or nothing at the meeting unless he has a large block of stock. Thus the shareholder is reduced either to not voting at all or "handing over his vote to individuals over whom he has no control and in whose selection he did not participate."\textsuperscript{177} In neither case would the shareholder be able to exercise any control, since control would be in the hands of those who selected the proxy committee, who in turn elect the next directors. Since the proxy committee is appointed by the management in power at the time, management could dictate who would succeed them. When ownership is spread out, management becomes a self-perpetuating body, even when it has very little ownership of stock itself. This kind of management control, "though resting on no legal foundation, appears to be comparatively secure where the stock is widely distributed."\textsuperscript{178} When there is serious mismanagement of the company, stockholders may combine to oust the management, but, generally, control is quietly exercised for many years without shareholders having a chance to choose between two opposing groups.

Berle and Means studied the two hundred largest corporations carefully and showed that control had to a "very considerable extent become separate from ownership."\textsuperscript{179} They concluded Book I with these salient words:

In examining the break up of the old concept that was property and the old unity that was private enterprise, it is therefore evident that we are dealing not only with distinct but often with opposing groups, ownership on the one side, control on the other—a control which tends to move further and further away from ownership and ultimately to lie in the hands of the management itself, a management capable of perpetuating its own position. The concentration of economic power separate from ownership has, in fact, created economic empires, and has delivered these empires into the hands of a new form of absolutism, relegating "owners" to the position

\textsuperscript{176} \textit{Id.} at 66-68.

\textsuperscript{177} \textit{Id.} at 87 (emphasis deleted).

\textsuperscript{178} \textit{Id.} at 88.

\textsuperscript{179} \textit{Id.} For an entire discussion of how control was separated from ownership see \textit{id.} at 90-118 (tables on pp. 95-116).
of those who supply the means whereby the new princes may
exercise their power.180

Book II was entitled, Regrouping of Rights: Relative Legal Position
of Ownership and Control. It showed how the legal position of owner-
ship had become a hollow concept through the deft use of the proxy to
manipulate the shareholder.

Much of what Berle and Means stated at this point pertained to
the first part of this Article relating to the common law rights of the
shareholder. They also showed the gradual changes that came about
through the growth of the nation, the corporation, and the laxity in
state statutes, leaving the shareholder with only a titular right to the
corporation, but no actual rights or control.

The foundation of the original corporation, maintained Berle and
Means, was the corporation contract, which was originally thought of
as providing a set of more or less rigid participations exercised through
the rights of shareholders.181 The most important of these was the pre-
emptive right to the corporate assets, based on the concept that these
assets were owned among the shareholders on a pro rata basis depend-
ning on how many shares they owned.

Various classes of stock allowed greater or lesser participation in
assets or earnings to be set up in the corporation contract. Furthermore,
the combination of these participations could insure a prior
claim on earnings, or a prior claim on dividends, or any other arrange-
ment which the drafters of the corporate charter determined were in the
best interests of all. Whatever the participations, they were established
and sanctioned by the state through legislative charter, and, since they
were executed in a legal and contractual manner, the assumption was
that they were not easily changeable.182

This rigidity, however, had been lost because the states had eased
regulations in the drafting of corporate charters, causing a freedom of
contract. No single change had caused this loss of rigidity, but it had
evolved as the board of directors had slowly used their power through
proxies to gain more and more control, by varying the original pro rata
rights of the shareholder in assets and earnings.183

Management used two mechanisms to accomplish this task:

180. Id. at 124.
181. Id. at 127-34, 154; see supra note 36 and accompanying text for a discussion of common law
   protections.
182. A. BERLE & G. MEANS, supra note 33, at 154.
183. Id.
(1) diluted participations and (2) unascertained participations.\textsuperscript{184}

Basically, diluted participation means "the reduction of the pro rata part of assets and earnings accruing to each share through the issue of additional shares not representing a corresponding contribution to the corporate capital."\textsuperscript{185} These devices deprived the shareholder of his right to preserve his pro rata position in the corporation, or, to the extent that he had lost that position, his right of compensation through the sale of his preemptive right.\textsuperscript{186}

Par value shares, as indicated earlier, meant that a fixed minimum contribution had to be received from each purchaser of the original issue, and that it had to be cash. It was not until later that payment could be by other means. When directors were allowed to determine the value of the stock, the change was drastic. Par value was at first $100 or more, but later it became customary to designate any par value desired, until finally, the directors issued at will shares authorized in the charter.\textsuperscript{187} These last two steps destroyed the concept of par value\textsuperscript{188} and allowed the directors to dilute the stock.\textsuperscript{189}

Parasitic shares are shares that are divided into classes. For example, Class A receives two thirds of the dividend and Class B receives one third. If the board of directors chooses to increase the number of Class A shares, then in effect Class B shares become parasitic in that they automatically absorb some of the earning power of Class A stock. Thus the directors have the power to issue more shares of one class which reduces the share of earnings for that class.\textsuperscript{190}

Any number of variations can occur.\textsuperscript{191} Sometimes directors make a decision to effect a merger. The exchange of shares may turn out to be grossly inadequate and cause one set of shareholders to suffer dilution in value of their shares.\textsuperscript{192} Purchase by the corporation of its own stock is another device; if the shares are bought at unrealistically high prices, the values of all of the shares decreases.\textsuperscript{193} Another device is the removal of the preemptive right altogether from the corporate

\textsuperscript{184} Id. at 154-55.
\textsuperscript{185} Id. at 154-55.
\textsuperscript{186} Id. at 155.
\textsuperscript{187} Id.
\textsuperscript{188} Id.
\textsuperscript{189} Id.
\textsuperscript{190} Id. at 160.
\textsuperscript{191} Id. at 160-62.
\textsuperscript{192} Id. at 172-73.
\textsuperscript{193} Id. at 172-73.
Unascertained participation means that, "An extreme grant of power has been taken and secured by directors where statutes have permitted corporate charters to authorize the issue of securities whose precise claim on the corporate earnings and assets is not to be ascertained until later." As an example, Berle and Means cited the stock purchase warrant, which today would be the stock option. In any case, they work in the same manner by permitting the holder to subscribe to a designated number of shares at a price stated on the option for a specified number of years or even permanently. This device, when exercised, obviously means a dilution of the shareholders' stock. Generally, the power to issue these options or warrants rests exclusively with the board of directors, who are subject to no control in the issuance thereof.

Another unascertained participation is the securities convertible at the option of the corporation into other securities. The point that Berle and Means made is that the securities are subject to the will of the directors, not of the shareholders.

Next, Berle and Means discussed the routing of earnings by the directors to the shareholders. The primary device, they maintained, was allowing the directors to determine when dividends would be paid. This was a powerful control since the only limitation imposed by law was that the earnings must not be withheld to an unreasonable degree, which allowed extremely wide latitude.

Another means of control was through noncumulative preferred dividends that did not have to be paid. Usually, the preferred dividend was limited to, say, seven percent, and if it was not paid, the common stock dividend would not be paid either. If the directors elected not to pay one year, but then decided the next year to pay the preferred, there would be more money for the common stock dividend since the preferred dividend was not paid the year before.

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194. Id. at 174-76.
195. Id. at 180.
196. Id. at 180-81.
197. Id. at 180-85.
198. Id. at 187-88.
199. Id. at 189-90; see also Dodge v. Ford Motor Co., 204 Mich. 459, 170 N.W. 668 (1919). The court held that Henry Ford, as controlling shareholder and chairman of the board, could not refuse to pay dividends when the corporation made a substantial profit.
201. Id. at 190-91.
Berle and Means then discussed the power to alter the original contract rights of security holders by a majority or two-thirds vote of the shareholders to amend the corporate charter accomplished through the proxy machinery which is effectively controlled by the directors, as discussed above.\footnote{202}

At first the power to make such a change was quite difficult, but the courts have gradually made it very easy.\footnote{203} For example changes can be voted in order to retire part of the preferred stock. This could be accomplished by a bond issue, or by a reduction in the preferred shareholder's dividends. In addition, there could be an amendment to change the voting rights of a certain class of stock or to change dividend rights between two classes of stock and make them the same, and so on.\footnote{204}

Berle and Means concluded with these salient words on this device:

Most changes in contract positions proposed by amendments go through; and the management and control in practice rely on the possibility of using this power as a last resort where their corporation did not at the outset provide itself with a sufficient number of the mechanisms. . . . If put to their trumps a management can usually make a showing of "business exigency"; and if it is far—seeing it can set the stage to indicate such business exigency long in advance. A shareholder who objects must sustain the burden of proof of unfairness, in which case he is commonly at a hopeless disadvantage in coping with the "control" which has both the funds and the information of the corporation at its free disposal. As a result, the power of amendment of the corporate charter . . . remains the residual expedient of the "control"—an expedient often used with telling effect.\footnote{205}

While the legal position of management has not really changed, it was not very shareholder-oriented in the beginning. All the manager must do is follow three main rules of conduct. First, pay a fair amount of attention to business. Second, display loyalty to the corporate interests. Finally, at a minimum, make reasonable business decisions. Basically, this only requires that the manager not serve his personal interests

\footnote{202. \textit{Id.} at 207}
\footnote{203. \textit{Id.} at 208-12.}
\footnote{204. \textit{Id.} at 208, 210-11, 214-18.}
\footnote{205. \textit{Id.} at 218-19.}
where they are adverse to the corporation and that he use reasonable business judgment.

Thus, Berle and Means emphasized that the pro rata rights of the shareholders have been taken by management by diluting the preemption through corporate devices until these rights are almost nonexistent.

The stockholder in the modern corporation had thus surrendered "definite rights" for "indefinite expectations." Berle and Means stated it well: "In almost no particular is he [stockholder] in a position to demand that they [management] do or refrain from doing any given thing." The result is that the interests of the shareholder are made subservient to the will of the controlling managers. The legal doctrine that the judgment of the directors must prevail as to the best interests of the enterprise was the same as saying that the interests of the individual must be sacrificed to the economic needs of the enterprise as a whole, and the directors made the decision as to what those needs were.

Book III is Property in the Stock Markets: Security Exchanges and Liquidators as Appraisers. It discussed stock markets, primarily from the standpoint of their functions. Berle and Means said that there must be disclosure in the process of introducing securities into the public market, and there must not be false statements or there must be liability for deceit. This requirement arose from the common law case Bedford v. Bagshaw.

There were also a few remarks about the difficult concept of disclosure requirements imposed on corporations by the New York Stock Exchange. Book IV is called Reorientation of Enterprise: Effects of the Corporate System on Fundamental Economic Theory. It analyzed the traditional concept of property and said that traditional theories are no longer adequate. Instead, new theories of property, profits, and the corporation needed to be developed.

C. Reviews of The Modern Corporation and Private Property

Each of the books discussed above was important and did much to influence the thinking of the time. Because the Berle and Means book was the most important and influential of all, a few comments from

206. Id. at 277.
207. Id.
reviewers seem appropriate. E. Merrick Dodd, one of the great corporate law thinkers, wrote: "Despite its failure to deal with the possibilities of reform through legislation, the picture which it presents . . . should prove of material assistance to the advocates of such reform."210 An equally significant scholar in corporate law, H. W. Ballantine, commented that he felt this book would help economists, lawyers, and legislators "with reference to the possible regulation of corporate management and the functioning of our stock exchanges."211

Other reviews showed tremendous respect and far-reaching effects the book had on the 1930's era. Joseph V. Kline, a New York lawyer and knowledgeable contemporary, wrote: "Here we have the law, the logic, and the philosophy of the New Deal."212 Mr. Kline also quoted from Professor Beard's book review in the N.Y. Herald-Tribune, showing dramatically the impact the book had: "'In time to come this volume may be proclaimed as the most important work bearing on American statecraft between the publication of the of the immortal Federalist . . . and the opening of the year 1933.'"213

Kline continued by maintaining that most people realized that "Professor Berle was one of the prominent members of the 'brain trust' which supplied the economic sinews for the speeches of the Democratic candidate, and is now one of the chief economic advisors of President Roosevelt."214 The point was that Berle and Means' book had much to do with the New Deal legislation.

In the Yale Law Journal, Nathan Isaacs reviewed the book favorably and presented what in his estimation was the major thesis of the book, the separation of ownership and control:

Their definition and analysis of control are a major contribution to this whole study. It is not merely majority voting power . . . not even legal voting power where securities are so widely scattered. . . . It is . . . that with proxy machinery developed as it is and with the attitude and understanding of stockholders such as they are, a small group at the center of affairs exerts actual control.215

Jerome Frank, a research associate at the Yale Law School, who

214. Kline, supra note 212, at 557.
later became an eminent legal scholar and Chairman of the SEC, made an extremely forceful statement:

THIS book will perhaps rank with Adam Smith's *Wealth of Nations* as the first detailed description in admirably clear terms of the existence of a new economic epoch. For what, in effect, the authors tell us is this: Without our knowing it, we have been passing through a revolution comparable to the so-called industrial revolution—analagous to the feudal system—the corporate system of economic government. . . . Those few men [who control 200 corporations] do not rely for their control on ownership . . . of the shares of stock . . . . The owners . . . are almost completely divorced from the power to influence their management.\(^{216}\)

Frank went on to say that if the new corporate epoch continued, we would be confronted with new rulers, and “the ordinary stockholder [will be] in a rather hopeless condition.”\(^{217}\)

One derogatory review was written by Professor I. Maurice Wormser at Fordham University, who was disturbed because he thought that the book pretended to be a study of the break-up of private property. He complained that the book “is marred throughout by its sweeping condemnations as well as its general trend, . . . that the authors are engaged in 'A study of the break up of Private Property.' ”\(^{218}\) The reviewer “assures them [Professor Berle and Dr. Means] that neither they nor their children, nor their grandchildren, will see in this country 'the break up of private property.' ”\(^{219}\)

### IV. Historical Overview of Federal Securities Acts

Federal securities legislation did not spring forth full grown from the philosophy of the New Deal. Instead, it evolved from a history of state regulation and several centuries of legislation in England.\(^{220}\) In the late 1920’s and early 1930’s, before the depression, the country was swept by a corporate reform movement,\(^{221}\) a movement that received a

\(^{216}\) Frank, Book Review, 42 *Yale L.J.* 989 (1933) (footnotes omitted).

\(^{217}\) *Id.* at 991 (footnotes omitted).


\(^{219}\) *Id.*


powerful impetus from the stock market crash of October 1929. The Roosevelt New Dealers decided that the best overall philosophy for the new Securities Exchange Act was a disclosure philosophy.22 Much can be said about this era and the disclosure philosophy, but President Roosevelt stated it appropriately in his message to Congress: “This proposal adds to the ancient rule of caveat emptor the further doctrine ‘let the seller also beware.’ It puts the burden of telling the whole truth on the seller. It should give impetus to honest dealing in securities and thereby bring back public confidence.”223 Effectively, disclosure meant that the seller was bound by the law to lay bare the facts about the securities he was selling so that the public could decide whether to buy them.

The gist of Roosevelt’s message, however, was at the end of the address where he emphasized that, “[w]hat we seek is a return to a clearer understanding of the ancient truth that those who manage banks, corporations, and other agencies handling or using other people’s money are trustees acting for others.”224 This statement reflected the philosophy of Justice Louis D. Brandeis. As stated by an historian of that era, Ralph F. de Bedts, “[t]he goal of a legitimate relationship between fiduciary and depositor or investor was stated in simple Brandeisian terms even including the title of Brandeis’ work within its context.”225 Thus, the major thrust of New Deal thinking was that those who managed other people’s money should be in a fiduciary relationship to those people, whether depositors or investors.

On the basis of this philosophy of disclosure and fiduciary relationship, the Securities Act of 1933 and the supplementary Securities Exchange Act of 1934 were passed by the New Deal Congress.

The Securities Act of 1933 is concerned with the initial distribution of securities. Its purpose is to require full and fair disclosure of the character of securities sold in interstate commerce and through the

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222. See 1 L. Loss, supra note 220, at 121-28.
224. Id.
mails, and to prevent fraud in their sale. The Act seeks to accomplish this by requiring the filing of a registration statement containing material information about the issue and the securities, and the use of a prospectus in attempts to sell the securities.

The Securities Exchange Act of 1934, on the other hand, is concerned with postdistribution trading. It is not as structured as the Securities Act because it deals with all that is not concerned with the initial distribution process. Initially, it deals with "second-hand trading," that is, trading of securities after their initial issuance; with fraud in securities trading and manipulation of the markets; and with regulation of the markets, including control of the amount of credit that goes into those markets. Finally, it also includes the solicitation of proxies for listed and registered securities.

Within the Exchange Act are two specific sections important to the framers of the Act. These two sections are Section 10, concerned with fraud, and Section 14, concerned with proxies. The remainder of this Article will focus on those two Sections and on the two Rules promulgated by the Securities and Exchange Commission (SEC) to further the purposes of those Sections, Rule 10b-5 and Rule 14a-9. It will also deal with their relationship to each other, and the role of scienter.

V. SCIENTER AND ITS EVOLUTION TO INCLUDE NEGLIGENCE

A good definition for scienter has proved elusive. Professor Loss has stated that the term "has been variously defined to mean everything from knowing falsity, with an implication of mens rea, through the various graduations of recklessness, down to such non-action as is virtually equivalent to negligence or even liability without fault." Morris and Morris, in their torts hornbook, said very carefully, "In cases where scienter is required, liability cannot be based on mere negligence."

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226. 1 L. Loss, supra note 220, at 130; McCormick, Understanding the Securities Act and the S.E.C. 24 (1948); Berle & McGill, Cases and Materials on Corporate Finance 662 (1942); H. Blumenthal & Wing, Securities Law: Cases, Text, Problems 1-9 (1933).

227. See, e.g., 1 L. Loss, supra note 220, at 130-31; Blumenthal & Wing, supra note 226, at 1-12.

228. 3 L. Loss, supra note 220, at 1432; see also, 2 A. Bromberg, Securities Law: Fraud Section 8.4 (503) at 204.103 (1975); W. Prosser, Handbook of the Law of Torts §§ 105 at 684 (4th ed. 1971). It is also interesting to note that Corpus Juris Secondum begins the definition of the word scienter with: "It has been said that the word 'scienter' is not a word of mystery or magic meaning . . ." 79 C.J.S. Scienter 456 (1952). That such a statement was made illustrates that the concept has been a difficult one in law.

However, they effectively agreed with Professor Loss when they said, “But certain kinds of sloppiness somewhat similar to negligence have been held to satisfy the requirement of scienter.” Later, after analyzing a few cases, the authors concluded:

Thus in some cases, proof supporting a finding of lack of due care is sufficient to satisfy the scienter requirement and sustaining a finding of fraud. . . . Proof adequate to support a finding of negligence, therefore, may be sufficient to sustain a finding of fraud—even in the face of defendants’ protestations from the witness stand that they honestly believed they had reported truthfully.

Bucklo has also written on the scienter issue and obviously feels that scienter is “many-faceted” and thus truly difficult to define. More importantly, Bucklo zeroed in on the major problems. She begins with an extensive use of Keeton’s excellent discussion on fraud and states that there are five states of mind that may be found when a defendant commits fraud: (1) The defendant may be convinced of the truth of his representation, because it is based on knowledge of facts that constitute a reasonable basis for belief. (2) The defendant may be convinced of the truth of his representation, but it is based on limited knowledge of facts that do not constitute a reasonable basis for belief. (3) The defendant may not have a reasonable basis for believing his representation to be true or false. (4) The defendant may know that his representation is false. (5) The defendant may know that his representation is false and intend to mislead the listener. The third example is such reckless behavior that it constitutes constructive knowledge of the misrepresentation. In such a case, the defendant would be held liable at common law. Constructive fraud is generally the phrase applied to such conduct. The fourth example, in the same vein, is actual knowledge of the falsity of the misrepresentation. The fifth example is the common law intent to defraud or to act with malice. In both

230. Id.
231. Id. at 293-94 (emphasis in original).
234. These five have been adapted from Bucklo, supra note 232, at 568; Keeton, supra note 240, at 589.
235. See C. MORRIS & C. MORRIS, JR., supra note 229, at 293-94; W. PROSSER, supra note 228, § 107 at 701; Bucklo, supra note 232, at 568; Keeton, supra note 233, at 590.
instances, the defendant would be liable under common law fraud.\textsuperscript{236}

The important focus is the distinction between the second and third examples because that constitutes the difference between simple negligence and gross negligence. In the second example, it may be said that there is some factual basis for the defendant's belief in his statement. There is no bad faith, but there is lack of diligence on the defendant's part. This differs from example number one in which the court will find the defendant innocent. In example three the defendant's lack of knowledge is attributable to fault on his part.

Therefore, Keeton and Bucklo strongly advocate that scienter "should be interpreted to mean knowledge of facts, either actual or constructive."\textsuperscript{237} Constructive knowledge means that the defendant's lack of knowledge results from conduct "sufficiently careless that knowledge will be attributed."\textsuperscript{238} Even though the court might not be convinced that the defendant actually knew the facts, "his lack of knowledge is inexcusable."\textsuperscript{239} On the other hand, negligence is conduct not wholly innocent, but not so careless that it is inexcusable. The gist is, was the failure to make a diligent investigation "so unreasonable that the defenses of due diligence and good faith are unavailable[?]"\textsuperscript{240}

The entire argument is brought into full focus in the fine presentation by the famous torts theorist Leon Green.\textsuperscript{241} Green initially states that "neither alternative, 'actual fraud' on the one hand, nor 'innocent misrepresentation' on the other, is sufficient as a doctrine for any jurisdiction."\textsuperscript{242} Then, he adds, that no matter how vigorously one alternative is insisted upon, "sooner or later it is modified so as to accommodate the opposite extreme."\textsuperscript{243} The reason for this, Green maintains, is that in some instances the courts have taken the adamant position that the defendant must be held to stand by his representations, while in other cases, it has been looked at by the courts as equally unbearable that a person be held totally liable for what his words or acts imply.\textsuperscript{244} Green feels that the reason the courts can go either way

\begin{thebibliography}{99}
\bibitem{236} C. Morris & C. Morris, Jr., supra note 229, at 292-93; W. Prosser, supra note 228, § 105 at 686-87; Bucklo, supra note 232, at 568; Keeton, supra note 233, at 590.\textsuperscript{237}
\bibitem{237} Id.
\bibitem{238} Id.
\bibitem{239} Id.
\bibitem{240} Id.
\bibitem{241} L. Green, Deceit, 16 Va. L. Rev. 749 (1930).\textsuperscript{241}
\bibitem{242} Id. at 751.\textsuperscript{242}
\bibitem{243} Id.
\bibitem{244} Id.\textsuperscript{244}
\end{thebibliography}
is that dealings between people are often loose affairs involving much
"talk and rambling negotiation,"245 The doctrines of "actual fraud" and negligence are employed so that the different interests and habits
of people may be served.246

Green feels that there is no one way to classify these cases other
than to recognize the wide variation in deceit cases and that the concept
of scienter covers a wide range from actual fraud to nothing more than
an unintentional false statement.247 He gives examples of this in a con-
tinuum. First is the "honest liar formula" followed by many American
jurisdictions. Quoting from Lord Herschell:

First, in order to sustain an action of deceit, there must be
proof of fraud, and nothing short of that will suffice. Sec-
ondly, fraud is proved when it is shown that a false repres-
entation has been made (1) knowingly, or (2) without belief in
its truth, or (3) recklessly, careless whether it be true or false.
Although, I have treated the second and third as distinct
cases, I think the third is but an instance of the second, for
one who makes a statement under such circumstances can
have no real belief in the truth of what he states. To prevent a
false statement being fraudulent, there must, I think, always
be an honest belief in its truth. And this probably covers the
whole ground, for one who knowingly alleges that which is
false, has obviously no such honest belief.248

Green suggests that although this formula looks very clear, in reality it
is not very definite and in fact allows the judge a maximum of power to
decide each case. The jury evaluates the evidence and the judge can go
either way.249 An actual illustration of this concept is Derry v. Peek250
where the misstatement was softened to a point where a majority of the
judges said the statement was not false.

The second formula, Green continues, is the allowance of a charge
of scienter where there is a false statement knowingly made by the de-
fendant, as long as what is stated is not merely a matter of opinion,
estimate, or judgment, but "susceptible of actual knowledge."251 This
also looks like a cleancut formula, but in actuality the courts follow a
continuum in reaching their decisions, such that the court's power is

245. Id.
246. Id. at 752.
247. Id.
248. Id. at 752-53 (quoting Derry v. Peek, 14 App. Cas. 337, 374 (1889)).
249. Id. at 753.
250. 14 App. Cas. 337 (1889).
251. L. Green, supra note 241, at 753-54.
probably as wide and equal to the discretion exercised by the court in *Derry*.

The third formula dispenses with the "sciente" element, notes Green, but the wide range of decisions in this third formula does not provide a clear answer. A Texas case noted that, "If the representations are untrue, it is immaterial that they may have been made without fraudulent intent." A Florida case ended with the same conclusion, although stated differently.

Green thus concludes that the formulas are not so very different, but are equally elastic, allowing a broad range of action by the courts to use their own judgment or to permit the employment of a jury. The choice of formula then, is relatively immaterial and Green quotes Williston as saying that the issue is "who shall bear the loss."

The overall conclusion asserted by Green is that the courts will decide according to the facts of the particular case. The best example, he argues, is *Glanzer v. Shepard*, which followed the holding in *Derry*. Green suggests, although the court in *Glanzer* said it was applying the negligence theory, its decision was in fact "but a screen which permitted the court to employ a doctrine equivalent to the ‘innocent misrepresentation’ doctrine, but in a way to avoid embarrassment from its seeming adherence to the formula in *Derry v. Peek*.

In other words, although the court claimed it followed the "innocent misrepresentation" doctrine and, therefore, the negligence theory, it in fact decided on a deceit theory. He emphasizes this idea when he says:

> It is rather striking that the court does not advert to the “deceit” theory at all. The case illustrates the wealth of legal theories at the command of courts generally, as well as the great capacity which the Chief Judge of the New York Court of Appeals and his associates have demonstrated on many occasions for utilizing legal theories without destroying their integrity as means of articulating more acceptable judgments.

The best way to emphasize this final point, continues Green, is to quote

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252. See id. at 754-55.
253. Id. at 756 (quoting Scale v. Baker, 70 Tex. 283, ___ S.W. 742, 744 (1888)).
255. L. Green, supra note 241, at 757.
256. Id. (quoting Williston, Liability for Honest Misrepresentation, 24 Harv. L. Rev. 415, 434 (1911)).
257. 233 N.Y. 236, 135 N.E. 275 (1922).
258. L. Green, supra note 241, at 760. 
259. Id.
from a statement made by Justice Lamm of the Missouri Supreme Court:

_Fraud is kaleidoscopic, infinite._ Fraud being infinite and taking on protean form at will, were courts to cramp themselves by defining it with a hard and fast definition, their jurisdiction would be cunningly circumvented at once by new schemes beyond the definition. Messieurs, the fraud-feasors, would like nothing half so well as for courts to say they would go thus far, and no further in its pursuit . . . . Accordingly, definitions of fraud are of set purpose left general and flexible, and, thereto courts match their astuteness against the versatile inventions of fraud-doers. 260

In analyzing Green's position it is apparent that he believes that the law of deceit, although seemingly between the intentional conduct of a party and the unintentional conduct, is in fact not so. The problem is far more complex, and because actual situations are numerous and varied, the courts have taken the best approach by making decisions case by case. The bottom line is that fraud and negligence, intentional and unintentional conduct, are too vague to call and thus must be decided case by case. Green concludes:

But the point to be stressed here is that _whatever sort of judgment is desired, the formulas which have been evolved and their coteries of attendant phrases provide the most flexible accommodation without in the least impairing their own integrity or that of the judicial process_. A science of law could ask little better by way of intellectual machinery for handling these varied and difficult cases. 261

Of course, Bucklo would not say that this is exactly what she means. Her point is that such unintentional conduct as she has described is deceit and should be recognized as such. Green, on the other hand, is saying that on some occasions, there should be liability, and on others, there should not be and that the decision should be left up to the courts. Would Bucklo accept this? It is difficult to know, but surely she would accept it over the argument that allows liability only if there is intent and that excludes altogether any conduct where intent _cannot_ be shown.

There is more. When Green wrote his definitive article, he made reference to the position that liability in such situations should be held

261. _Id._ at 770 (emphasis in original).
only if there is definite proof of intent and made several references to
an article in the *Harvard Law Review* by Professor Bohlen.\textsuperscript{262} Professor Bohlen took great offense and wrote a second article which was a scathing polemic against Green's position on deceit.\textsuperscript{263} Succinctly put, his position is:

One who states that a fact exists which he knows does not exist, or who misstates his own state of mind in regard thereto, as by saying that he knows its existence when he is conscious that he merely believes it to exist, does intentionally mislead him to whom the information is given. He may not intend to mislead the other to his harm; indeed, he may hope that the future will make true that which he knows to be at the time a misstatement, or he may mislead the other for what he himself believes to be the other's good. But, even so, he does intend to mislead. If, however, he honestly believes that not only the facts but his conviction as to their existence are exactly what his statement represents them to be, he can have no intention to mislead. At most he is guilty of negligence in that he has failed to exercise diligence and competence in ascertaining the basis of his statement or failed to use the judgment of a reasonably intelligent man upon the data which he has carefully and accurately collected.\textsuperscript{264}

The point, of course, is that if the person does not intend to mislead, he is guilty of negligence but not fraud, which Bohlen views differently. The basis of the tort action in negligence is not intentional conduct, as compared to fraud. Bohlen concludes: "This article is written in the hope it may cause courts to realize that in negligent misrepresentation the important thing is the negligence. . . . Accordingly, the liability should be determined by the general principles of the law of negligence . . . ."\textsuperscript{265} Bohlen was much more adamant in his second article. He seemed to feel that Green had misunderstood his position, and therefore, Bohlen wrote this second article as a polemic against Green's article:

I now repeat what I meant to say, and what I believe I did say in my Harvard Law Review article—that it is apt to lead to false analogies to speak of negligent conduct which

\textsuperscript{262}. Bohlen, *Misrepresentation As Deceit, Negligence, or Warranty*, 42 Harv. L. Rev. 733 (1929).

\textsuperscript{263}. Bohlen, *Should Negligent Misrepresentations Be Treated as Negligence or Fraud?* 18 Va. L. Rev. 703 (1932).

\textsuperscript{264}. Bohlen, *supra* note 262, at 738 (citations omitted).

\textsuperscript{265}. Id. at 746.
leads to unintended misinformation as fraud, which, both in
the law and in public opinion implies a conscious purpose to
mislead.\textsuperscript{266}

His point is that both the law and the general public interpret fraud to
mean a “conscious purpose to mislead.” And, he continues, there is a
grave danger that what is a conscious dishonesty where clearly an ac-
tion in fraud may arise, will now become actionable in tort, although
there is no conscious effort to deceive. He elaborates on this position
and reasons that:

Our law should be made safe for democracy. For good
or evil, it is administered by legally trained judges and un-
trained jurymen. So long as this is so, it is obviously harmful
to the proper administration of our law that a word, which is
understood by laymen to mean one thing, and one thing only,
should “in law” mean something different or be arbitrarily
given an additional meaning which is absolutely contradic-
tory to the sense in which it is properly understood. The ordi-
nary man regards the word fraud as necessarily implying
conscious dishonesty. Is it not preserving the idea of law as a
mystery which only its priests and initiates can understand, to
brand conduct as fraudulent “in law,” when in fact it is not
fraudulent at all but at most merely careless?\textsuperscript{267}

Thus, Bohlen is saying that the concepts of fraud and negligence are
clear to judges, lawyers, and common people, and should remain so.
Then, Bohlen makes his most flagrant statement: “True realism should
condemn and not approve any formula because it enables judges to
give lip service to a false ideal of an absolutely immutable law while
changing the law by word jugglery.”\textsuperscript{268} Finally, Bohlen accuses Green
of wanting a legal system in which judges make the decisions, resulting
in a government of men and not of laws: “To paraphrase Dr. Oliver
Wendell Holmes, ‘We know your god, but we call him the devil.’ After
all it is a matter of taste. \textit{De gustibus non est disputandum}.”\textsuperscript{269}

Does the Green position cause problems? Not really, because
many times the obvious issues are easily solved, and the ambiguous
ones can be resolved by the courts in accordance with the facts. Al-
though this does not completely satisfy Bucklo or Bohlen’s, it remains a
practical and meaningful approach.

\textsuperscript{266} Bohlen, \textit{supra} note 262, at 706.
\textsuperscript{267} \textit{Id.} at 711-12.
\textsuperscript{268} \textit{Id.} at 715.
\textsuperscript{269} \textit{Id.}
A further clarification of the Green position is made by Williston, known for his comprehension about difficult legal issues.\textsuperscript{270} He begins his article by saying that often areas of the law have grown up with little regard to each other when in fact there is a logical and intimate connection. “It is impossible that such a situation can be allowed to exist permanently,”\textsuperscript{271} he says, and then he proceeds to show that deceit initially was not a clear concept for early common law lawyers.\textsuperscript{272} He continues by showing that although warranty of title and warranty of quality are dependent upon intent, the doctrine of estoppel is not, since it is considered as a rule of evidence only, and an action cannot be founded upon it.\textsuperscript{273} But, says Williston, “To speak of conclusive evidence of something admittedly false may be a useful formula, but it disguises the truth. An estoppel is in effect a conclusive admission of the truth of a nonexistent fact.”\textsuperscript{274} This means that in each case there is a cause of action because of the damaging misrepresentation, and fraudulent intent has nothing to do with it. Williston asserts: “It is difficult to see how the law of estoppel and the doctrine of \textit{Derry v. Peek} can permanently be kept in separate compartments when law and equity are fused and pleading, reduced to a mere statement of the facts of case.”\textsuperscript{275}

Williston maintains that there is plenty of authority to place the bench and bar on notice of the merit of holding one liable for a false statement when the person making the statement is reasonably supposed to have, or should have, knowledge of the information. He suggests quite strongly that the use of the words \textit{fraud} and \textit{deceit} have “exercised an unfortunate influence in the development of the law on the subject.”\textsuperscript{276} Those words, he maintains, import a consciously dishonest conduct by the defendant, and a legal fiction, such as “constructive fraud” or “legal fraud,” is not the way to solve the problem. Instead, the issue should be looked at in a straightforward manner. The major question posed would then be a determination of who should bear the loss, once the defendant has acted in such a manner. With the issue thus resolved, the law should not be looked at illogically as in \textit{Derry v. Peek}, but logically. \textit{The actor has induced someone to act}. 

\begin{itemize}
\item \textsuperscript{270} Williston, supra note 256, at 434.
\item \textsuperscript{271} \textit{Id.} at 415.
\item \textsuperscript{272} \textit{Id.} at 416.
\item \textsuperscript{273} \textit{Id.} at 425.
\item \textsuperscript{274} \textit{Id.}
\item \textsuperscript{275} \textit{Id.} at 426-27.
\item \textsuperscript{276} \textit{Id.} at 434.
\end{itemize}
Therefore liability should ensue. This is only morally and legally correct and desirable, and continues Williston, this position is supported in the dissent of Pasley v. Freeman, the original and leading case for holding a person liable for knowingly making a false statement. Similar cases in modern decisions in several states support that view.

The second qualifying principle, Williston proceeds, should be that if there was reasonable ground for believing that the statements were true, no liability should ensue. But when the person has acted negligently and had reasonable grounds to believe that his statement was untrue, liability should ensue. To hold someone liable for any statement made when there is no intent is unreasonable but, to hold him liable for actions that are negligent and that cause harm to someone else is perfectly reasonable and meaningful in legal theory and practice.

With the Green-Williston approach, the arguments that Bucklo and Bohlens get into are resolved, not by looking at the "fraud" and "intent" problems controlled by old common law prejudices, but by looking at the problem itself, recognizing the negligence and finding a remedy. When there is actual intent, then the courts should treat the problem like the fraud cases described by Keeton—that is, by imposing clear liability. But when the problem involved is that of fault, then the question is whether there was injury and whether the defendant acted negligently. If the degree of negligence is minimal, then no liability is imposed. Yet, the question of how to measure the degree of negligence is difficult to resolve and is best left to the courts to determine, case by case.

Finally, Professor George B. Weisiger has made some thoughtful contributions to this area. He is careful to point out that the old rules of negligence related primarily to personal injury and property damage cases. In the area of commercial law, a different approach has often been applied in the case of negligence. The question posed is, if negligence is the theory applied, what will the judges do with it, and which of the above theories of negligence will they apply? But, as Weisiger says, "The degree of protection given any interest changes ac-

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277. 3 T.R. 51 (1789).
280. Id. at 195-96.
He goes on to say that certain individual interests have to disappear as business becomes more complex. For example, the absolute individual rights to the air above one's land have to be abandoned for new methods of transportation. A further example is business transactions, which have become much different from what they were before the advent of a huge complex society. The sale of chattel was originally followed by a delivery of goods into the hands of the purchaser, who could assure himself of the weight of the goods if he had any doubt. But when it has become customary to sell goods by weight to a person two thousand miles away and the buyer subsequently sells the goods without seeing them, the seller's certificate of weight is relied upon. When it becomes the practice of a buyer to rely on the certificate of weight by the seller, then there must be a requirement that the weighing be done with reasonable care. If the buyer is thereby harmed by the failure of reasonable care, then the weigher should take the loss.\textsuperscript{283}

The key to Weisiger's thinking is eminently illustrated in the following statement:

\begin{quote}
Duties arise as it becomes difficult or inexpedient for the plaintiff to protect his own interests, or when he may properly assume that they will not be invaded by the defendant's conduct. In this respect an interest grows in legal significance as individuals must depend more on each other.\textsuperscript{284}
\end{quote}

Thus, Weisiger's point is that as business society grows larger and more complex, individuals must depend on each other, causing more liability to arise. The courts will initially protect the plaintiff from intentional harm. The next step, however, leads to negligence as a basis for liability because of the plaintiff's right of reliance. Moreover, the courts may allow recovery in limited cases based on the doctrine of absolute liability where expectation by the plaintiff is so warranted.\textsuperscript{285}

One must conclude that the Bucklo and Bohlen arguments are too polar. The problem really is not one of intent, but allocation of loss. If there has been intent, clearly the actor is liable. Where there has not been intent, the court may decide from the facts that the actor should be held liable because, even if he did not know the falsity of certain statements, he should have known so under the circumstances. When

\begin{footnotes}
\item[282] Id. at 874.
\item[283] Id. at 874-75.
\item[284] Id. at 875.
\item[285] See id.
\end{footnotes}
parties are acting face to face and each is aware of the surrounding facts, then intention and only intention should suffice for the basis of liability. Times have changed, however, and the defendant must be liable for some negligent acts that are not intentional.

VI. SECTION 10(b) AND RULE 10b-5: LEGISLATIVE INTENT AS A BROAD STANDARD

A. General Legislative Intent

There is no question that legislators wished to alleviate the fraud that was rampant in the buying and selling of securities, both in primary issuance (Securities Act) and in secondary trading (Exchange Act). In speaking for the Securities Act, the sponsor of the Senate proposal, Senator Fletcher, made some introductory remarks about the “saturnalia of speculation throughout the country” and the many securities that had become worthless to investors:

The purpose of the bill is to protect the investing public and honest business. The basic policy is that of informing the investor of the facts concerning securities to be offered for sale in interstate and foreign commerce and providing protection against fraud and misrepresentation. That is the general purpose of the bill. The aim is to prevent further exploitation of the public by the sale of unsound, fraudulent, and worthless securities through misrepresentation; to place adequate and true information before the investors; to protect honest enterprise, seeking capital by honest presentation, against the competition afforded by questionable securities offered to the public through crooked promotion.

This is a broad statement about fraud and misrepresentation. No other sections of the Securities Act pertain to section 10(b) or to fraud.

In the House of Representatives Report, Sam Rayburn of the Committee on Interstate and Foreign Commerce, reproduced verbatim the message that the newly inaugurated President, Franklin D. Roosevelt had delivered to Congress:

In spite of many State statutes, the public in the past has sustained severe losses through practices neither ethical nor honest on the part of many persons and corporations selling securities.

286. 77 Cong. Rec. 2982 (1933).
287. Id. at 2982-83.
288. See id. at 2916-55, 2978-84, 2986-3000.
Of course, the Federal Government cannot and should not take any action which might be construed as approving or guaranteeing that newly issued securities are sound in the sense that their value will be maintained or that the properties which they represent will earn profit.

There is, however, an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public.

This proposal adds to the ancient rule of caveat emptor, the further doctrine "let the seller also beware." It puts the burden of telling the whole truth on the seller. It should give impetus to honest dealing in securities and thereby bring back public confidence.

The purpose of the legislation I suggest is to protect the public with the least possible interference to honest business. This is but one step in our broad purpose of protecting investors and depositors. It should be followed by legislation relating to the better supervision of the purchase and sale of all property dealt in on exchanges, and by legislation to correct unethical and unsafe practices on the part of officers and directors of banks and other corporations.

What we seek is a return to a clear understanding of the ancient truth that those who manage banks, corporations, and other agencies handling or using other people's money are trustees acting for others.289

The Committee interpreted the message to Congress as making the following three points. (1) It is a situation that is so bad that action is demanded. This action compels "full and fair disclosure."290 (2) The principles of the President's message are "full disclosure," that "the . . . action . . . by the Federal Government for such disclosure . . . should be so devised as not to . . . be construed as an approval or guarantee of a security issue,"291 and "a demand that the persons, whether they be directors, experts, or underwriters, who sponsor the investment of other people's money should be held up to high standards of trusteeship."292 (3) "The imposition of standards of trustee-

290. Id. at 2.
291. Id. at 2.
292. Id. at 2.
ship. Honesty, care and competence are the demands of trusteeship.”

These three points from the President's message stressed the necessity of formulating security laws to protect the general public. The Committee seemed to be saying that the laws should treat those in positions of knowledge (insiders) like trustees or fiduciaries. Such words surely assumed a broad liability on the part of those who hurt others by their actions. Thus, it is not intent that is at issue, but past actions themselves which had hurt the general public.

B. Difficulty of Interpretation

Much time has been spent by this author and by many others on a subject that defies analysis. It is very difficult to know exactly what the legislators intended. In the introduction to the book, The Modern Theme, by Ortega y Gasset, Jose Ferrater Mora said:

The best way to tackle a problem, he [Ortega] often concluded, is to “catch it by the horn.” And problems—real problems, that is—are like bulls: roaring, powerful, and terrifying. Thinkers must be skillful in addition to being thoroughly trained in the rules of the game. They must kill the problems—try to solve them—but also hold them in respect, namely, let the problems be what they are, and not coat them with large doses of optimism or “utopianism.”

In spite of the many times the present writer has studied the House of Representatives Reports, the Senate Reports, and the Congressional Record of the 73rd Congress, nothing definitive on the problem of whether negligence, recklessness or scienter were intended can be deduced. Bromberg and Lowenfels noted in their excellent treatise: “Nor does the legislative history offer any clear guidance.” And, after a lengthy discussion, they concluded, “Although there are straws to grasp at on both sides, the words of the Securities Exchange Act Section 10(b) and Rule 10b-5 and the legislative history are simply insufficient to answer the scienter question firmly.” Arnold S. Jacobs confirms this

293. Id. at 3.
296. 3 A. BROMBERG & L. LOWENFELS, supra note 295, § 8.4(506), 204.109.
conclusion in his fine treatise by saying: “The legislative history of Section 10(b) is so meager that little can be drawn from it concerning the scope of 10b-5.” Nevertheless, an analysis of the available material will be attempted, simply to lay the issue to rest.

C. History of the Fraud Provisions of the Securities Act

The Securities Act and the anti-fraud provisions were aimed at abuses in the sale of new issues or distributions of securities that were outstanding. The three main statutory anti-fraud provisions enacted in 1933 were Sections 11, 12(2) and 17(a). The second clause language, which is in all three sections, went through several different versions. The final wording was composed by Middleton Beaman, chief legislative draftsman of the House.

Section 17(a) is the more important provision because it has the most general anti-fraud language and Rule 10b-5 was later copied from it. Section 17(a) went through several versions. The first version was introduced by Representative Rayburn and Senator Robinson:

[I]t shall be unlawful for any person, firm, corporation or other entity in any interstate sale, promotion, negotiation, advertisement, or distribution of any securities defined by this Act willfully to employ any device, scheme, or artifice to defraud or to obtain money or property by means of any false pretense, representation or promise, or to engage in any transaction, practice, or course of business relating to the interstate purchase or sale of any securities which operates or would operate as a fraud upon the purchaser.

A second version by Representative Rayburn weeks later was much closer to the final phrasing:

Fraudulent Interstate Transactions

Sec. 16(a) It shall be unlawful for any person in the sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails—

297. 5 A. Jacob, Litigation and Practice Under Rule 10b-5, § 5.01, 1-159 to -58 (previously published as 5 A. Jacob, The Impact of Rule 10b-5, § 5.01, 1-126 (rev. ed. 1980)).


(1) to employ any device, scheme or artifice to defraud, or
(2) to obtain money or property by means of any untrue
statement of, or omission to state, a material fact, or
(3) to engage in any transaction, practice or course of busi-
ness which operates or would operate as a fraud upon
the purchaser.\textsuperscript{303}

The bill was reported and passed by the House with this language, but
the Conference Committee between the House and Senate emerged
with a slightly different version and it became the law:

\textbf{Fraudulent Interstate Transactions}

Sec. 17. (a) It shall be unlawful for any person in the sale of
any securities by the use of any meansor instruments of trans-
portation or communication in interstate commerce or by the
use of the mails, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud, or
(2) to obtain money or property by means of any untrue
statement of a material fact or any omission 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 (3) to engage
in any trans-
action, practice, or course of business which operates or
would operate as a fraud or deceit upon the purchaser.\textsuperscript{304}

As can be seen, Clauses 1 and 3 did not change from the second version
to the last, but Clause 2 was changed by the deletion of “false pretense . . .
or promise,” and by the addition of “material” and “fact,” as well
as the addition of the reference to omissions which make statements
misleading.

Clause 1 was probably copied from the phrase “having devised . . .
any scheme or artifice to defraud” in the mail fraud statute.\textsuperscript{305}
The Clause 3 language was probably taken from the New York Securi-
ties Fraud Statute.\textsuperscript{306} In 1954, Section 17(a) was amended to read “un-
lawful . . . in the offer or sale . . .”\textsuperscript{307} It would appear that none of the
above points to a scienter standard. In addition, when the thinking in
Chapter V is added, the argument against scienter is increased.

\textsuperscript{303} H.R. 5480, 73d Cong., 1st Sess., § 16(a) (1933).
\textsuperscript{306} 1929 N.Y. Laws ch. 649, 1984-90 (as codified and amended in N.Y. GEN. BUS. LAW
§ 352(e)(McKinney 1968)).
D. History of the Exchange Act: Provisions Other Than Section 14(a), Section 10(b), and Rule 10b-5

The Exchange Act was aimed primarily at the trading markets and not at the new issue markets. The intent was to protect investors against any manipulation of stock prices. To accomplish this, the law regulated the stock exchange, over-the-counter (OTC) transactions, and reporting requirements for all issues of securities listed on the stock exchange.\(^{308}\) This law was extended in 1964 to include the major OTC securities.\(^{309}\) Section 9 of the Exchange Act was part of the original 1934 Act and has not been materially amended.\(^{310}\) Generally, it prohibits wash sales, matched orders, and other market operations. It also prohibits false or misleading statements. Because it is a self-operative part of the law, it does not require any SEC rules to implement it.

Section 15(c)(1) of the Exchange Act was enacted in 1936 to prohibit the use by broker-dealers of "any manipulative, deceptive or other fraudulent device or contrivance."\(^{311}\) It was modeled on Section 10(b), and was self-operative, but it also gave the SEC authority to define terms. There are a number of more specific SEC rules under Section 15(c)(1) outlawing various practices and requiring disclosures.\(^{312}\) Section 15(c)(2) was added in 1938, and has to do primarily with fictitious quotations.\(^{313}\)

In 1975 extensive amendments to the Exchange Act were made, but the fraud provisions were left alone except for a few minor changes to Section 15(c)(1) and (2).\(^{314}\)

Again, none of the above points to a scienter standard and if the thinking in Chapter V above is included, the argument against scienter increases.

E. History of Exchange Act: Section 10(b)

Section 10(b) was initially introduced into Congress by Senator Fletcher and Representative Rayburn as Section 9(c):

Regulation of the Use of Manipulative Devices.

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

(c) To use or employ in connection with the purchase or sale of any security registered on a national securities exchange any device or contrivance which, or any device or contrivance in a way or manner which the Commission may by its rules and regulations find detrimental to the public interest or to the proper protection of investors.\textsuperscript{315}

After hearings in the House on H.R. 7852, a second version of the bill was introduced by Fletcher and Rayburn which read:

Regulation of the Use of Manipulative Devices.

It shall be unlawful for any person, directly or indirectly, by use of any means or instrumentality of interstate commerce or of the mails or of any facility of any national securities exchange . . . (c) 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 device or contrivance which the Commission may by its rules and regulations find detrimental to the public interest or to the proper protection of investors.\textsuperscript{316}

In both of the above versions, Section 9(a)\textsuperscript{317} dealt with short sales and Section 9(b)\textsuperscript{318} dealt with stop loss orders.

A third version, introduced in the House by Representative Rayburn, was a Section 9 dealing only with short sales and stop loss orders. This version completely deleted Section 9(c), which dealt specifically with “other devices and contrivances.”\textsuperscript{319} Section 9 was passed by the House in this third form. No reason was given in the House hearings or the \textit{Congressional Record} for leaving out the “devices and contrivances” language.

While these events were happening in the House, the Senate created its own version and passed it as Section 10(b):\textsuperscript{320}

Regulation of the Use of Manipulative and Deceptive Devices

Sec. 10. 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


\textsuperscript{316} S. 3420 and H.R. 8720, 73d Cong., 2d Sess., Section 9(c) (1934).

\textsuperscript{317} Id.

\textsuperscript{318} Id.

\textsuperscript{319} H.R. 9323, 73d Cong., 2d Sess. (1934), and 78 Cong. Rec. 8027 (1934).

\textsuperscript{320} S. 3420, 73d Cong., 2d Sess., Section 10(b) (1934).
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 which the Commission may be its rules and regulations declare to be detrimental to the interests of investors.321

After the House and Senate had conferred, the final version of Exchange Act Section 10(b) was enacted into law. It read:

Regulation of the Use 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 . . . (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 in investors.322

Again, the other part of Section 10 is 10(a), which deals with short sales and stop loss orders.323

How does the final version differ from the first one? The specific differences are quite obvious. First, the two key terms, “manipulative” and “deceptive,” were added. Second, the word “deceptive” was added to the heading. Lastly, the limitation to listed securities, meaning those listed on national securities exchanges, was omitted. Important phrases like “any person,” “directly or indirectly,” “in connection with,” and “purchase or sale” remained from the earlier versions, and the authority to make rules remained with a federal agency, first with the FTC, then the SEC.324

The final wording, which relied upon the Senate version extensively, was agreed to in the Conference Committee.325 But nothing appears in any of the records to show who wrote it.

The word “device” probably came from the Securities Act, Section

321. Id.
324. The FTC was the original agency created to administer the Securities Act. With the passage of the Exchange Act, the SEC was created to administer both acts.
325. H.R. 1838, 73d Cong., 2d Sess., 32-33 (1934); 78 CONG. REC. 10,261 (1934).
17(a)\textsuperscript{326}, and the word "deceptive" from the Securities Act, Section 17(a).\textsuperscript{327} "Manipulative" was in the heading of all three versions of 10(b), but was not in the body of Section 10(b) until the Senate passed its modification. Section 10(b) has not been modified in any way since its passage.

There were many arguments in the Senate about regulation of the stock exchange, margin rules, shortswing insider trading, registration, reporting requirements, and so on. The many pages of House hearings contain little reference to Section 10(b) which appeared to have been generally noncontroversial. Even in floor debates in Congress, material about Section 10(b) is almost nonexistent. When Senator Fletcher commented on Section 9(c), as Section 10(b) was then called, he said: "The Commission is also given power to forbid any other devices in connection with security transactions which it finds detrimental to the public interest or to the proper protection of investors."\textsuperscript{328} Once again, none of the above points to a scienter standard, and when added to the thinking in Chapter V the argument for scienter is even weaker.

A statement often quoted is that made by one of the brightest men of the New Deal, Thomas G. Corcoran, who apparently helped draft the Section 9(c). He said of Section 9(c): "Subsection (c) says, Thou shalt not devise any other cunning devices. Of course subsection (c) is a catch-all clause to prevent manipulative devices. . . . I do not think there is any objection to that kind of clause. The Commission should have the authority to deal with new manipulative devices."\textsuperscript{329} Many courts in attempting to define 10(b) have cited this statement by Corcoran.\textsuperscript{330} Of course, when Corcoran spoke, Section 9(c) was not as broad as it was after its final form as Section 10(b), which included transactions in unlisted securities and deceptive devices, in addition to manipulative devices. The statement by Corcoran seems to make it quite clear that Section 10(b) was intended to be a general, expansive, and broad section.

\textsuperscript{327} Id.
\textsuperscript{328} 78 CONG. REC. 2271 (1934).
\textsuperscript{329} Hearings on H.R. 7852 and H.R. 8720 before House Committee on Interstate and Foreign Commerce, 73d Cong., 2d Sess. 115 (1934).
F. Rule 10b-5 Promulgated to Expand Section 10(b)

Obviously, the various practices that any law is intended to hold unlawful can be particularized. On the other hand, as is generally the case in matters when an agency like the SEC is created, it is desirable to allow the agency to use its rule-making powers to develop its own approach in accordance with the guidelines established by legislative enactment.331

In accordance with this line of reasoning, the SEC, in 1942, adopted Rule 10b-5 pursuant to the authority granted in Section 23(a)332 of the Securities Exchange Act of 1934. It provided as follows:

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.333

As stated above, Sections 12(2) and 17(a) of the Securities Act protected buyers of securities against particular misstatements and omissions. Section 15(c)334 of the Securities Exchange Act of 1934 prohibited fraudulent practices in the sale of securities and the purchase of securities, but it pertained only to brokers and dealers. Section 9 of the Act prohibited certain practices in order to protect buyers and sellers, but it pertained only to listed securities. The conclusion is that before the adoption of Rule 10b-5, there was no general federal protection for a person who was induced by fraud to sell securities. Thus, Rule 10b-5 filled a need.

333. Originally Rule X-10B-5, SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (1983). The rule was originally numbered X-10B-5 when all Exchange Act rules were prefixed by an X. This designation remained until 1956-1957 when there was a general renumbering and it turned into 10b-5. The old label sometimes continues to be used informally.
Section 10(b) and Rule 10b-5 do not specifically give any private right of action to any person who has been injured by a violation, and apparently the rule was not intended to do so. Milton V. Freeman, an SEC attorney, stated that the rule "was intended to give the Commission power to deal with this problem [fraudulent purchases]. It had no relation in the Commission's contemplation to private proceedings." It was not until 1947 in Kardon v. National Gypsum Co. that this remedy was generally implied by the courts.

As indicated, Section 10(b) and Rule 10b-5 do not specifically give any private right of action to any person who has been injured by a violation; they only make it unlawful. Because other sanctions of the Securities Act and the Exchange Act which created civil liability clearly state the liability and its limitations, arguments were made that Section 10(b) was not written with any intent of creating a civil liability. But cases after Kardon argued that a private right of action was available for a violation of Rule 10b-5.

It was not until 1971 in Superintendent of Insurance v. Bankers Life Casualty Co. that the United States Supreme Court considered a case involving such a private right of action. The court, however, did not decide within the body of the opinion that such a right existed, merely recognizing it in a footnote. Eventually the Supreme Court expressly sustained a private cause of action under Section 10(b) and Rule 10b-5 in Blue Chip Stamps v. Manor Drug Stores.

It is easy to conclude that when the SEC promulgated Rule 10b-5, it wanted a broad interpretation in order to perform its duties as a protective agency. Additional support of this conclusion has been the Supreme Court's expansion of Rule 10b-5 to include a private right of action.

337. See Securities Act of 1933, §§ 11, 12, 13, & 15 (codified as amended §§ 77k-m, 77o); Securities Exchange Act of 1934, §§ 9, 16, & 18 (codified as amended §§ 78i, 78p & 78s).
339. See Osborne v. Mallory, 86 F. Supp. 869 (S.D.N.Y. 1949); Fishman v. Raytheon Mfg. Co., 188 F.2d 783 (2d Cir. 1951); Fratt v. Robinson, 203 F.2d 627 (9th Cir. 1953); Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961).
VII. CASE LAW BEFORE HOCHFELDER: PRIMARILY A NEGLIGENCE STANDARD

The first major case decided by the SEC in 1943 using the newly promulgated Rule 10b-5 was Ward La France Truck Corp. The facts are presented briefly to exemplify a usual fact situation where fraud is present and Section 10(b) and Rule 10b-5 are the appropriate legal remedies. Two parties, La France, president, and Grossman, treasurer, of Ward La France Truck Corporation owned eighty percent of the stock of the company. A significant improvement in the operating condition of the company occurred in 1942 due to orders from the United States Government, but shareholders were not advised of this improvement. The company, through a third party, bought the corporation's shares on the open market at $3.25 and $5.75 per share. The shareholders were not advised that the third party was buying the shares for Ward La France Truck Corporation and that La France and Grossman had negotiated to sell the company stock to Salta Company (Salta) for $45.00/100 per share and thereafter liquidate the company. Nor were they informed of the amount to be paid on liquidation ($25.00/100) and the generally improved financial condition of the company. Salta thereafter bought stock for $6.00 per share and failed to disclose the above information. The SEC noted that many similar fact situations were occurring and consequently brought an action for a Section 10(b) and Rule 10b-5 violation.

The SEC did not make a detailed analysis of Section 10b or Rule 10b-5. Instead, it made a broad statement in the early part of the case: "The nondisclosure of the amount likely to be and actually paid to La France and Grossman acted as a deceit upon the shareholders by leaving them completely in the dark as to the real value of their interest in the corporation." Then, the SEC quoted verbatim Section 10(b) and Rule 10b-5 and stated without any further analysis:

It is our opinion that the purchase of the securities under the circumstances set forth herein unaccompanied by appropriate disclosure of material fact, constituted a violation of Rule X-10B-5. We believe adherence to the standards set forth in the rule would have prevented the transactions disclosed in the

343. 13 S.E.C. 373 (1943).
344. Id. at 374-75.
345. Id. at 377.
346. Id. at 376-77.
347. Id. at 380.
In short, the SEC was saying that since there was no disclosure, there was liability under Rule 10b-5. To reinforce this reasoning, the SEC, in a footnote, noted that, "The standards adopted by the Commission . . . make applicable to securities the same broad antifraud provisions which Congress impassed in Section 17(a) of The Securities Act of 1933, in connection with the sale of securities." 349

The SEC thus used the term "deceit" broadly and held the defendants liable for their actions, which were detrimental to the shareholders and contrary to the fraud provisions of Section 10(b) and Rule 10b-5. Neither intent nor scienter was ever mentioned as part of the decision.

In a case decided shortly thereafter, the Court of Appeals for the Second Circuit, in *Fischman v. Raytheon Mfg. Co.*, 350 followed the holding in *La France*. The case involved several allegations by both preferred and common stockholders. The part of the case that is important here was the court's discussion of Section 10(b) and Rule 10b-5. The court held that proof of fraud is a requirement in suits under Section 10(b) and Rule 10b-5. If, the court continued, conduct is actionable under Section 11 of the Securities Act and, "there is the added ingredient of fraud, then that conduct becomes actionable under Section 10(b) of the 1934 Act and the Rule [Rule 10b-5]." 351 In a footnote, the court agreed with the SEC's holding in *La France* that Rule 10b-5 was very much the same as Section 17 of the Securities Act, except that it related to fraudulent purchases as well as fraudulent sales. 352 There being no further analysis, this case agreed with *La France* in establishing a broad generalization of fraud applicable to Section 10(b) and Rule 10b-5.

*Hooper v. Mountain States Securities Corp.*, 353 was specific in its statements on the broad approach to fraud in 10b-5. After determining that there was a fraudulent scheme, the question was whether the issuing corporation was a seller under Rule 10b-5. In discussing this the court said, "It [Rule 10b-5] greatly expands the protection frequently so hemmed in by the traditional concepts of common law misrepresentation and deceit. . . ." 354 In a footnote, the court made reference to

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348. *Id.* at 381.
349. *Id.* at 381 n.8.
350. 188 F.2d 783 (2d Cir. 1951).
351. *Id.* at 787.
352. *Id.* at 787 n.2.
353. 282 F.2d 195 (5th Cir. 1960).
354. *Id.* at 201.
what it claimed was an excellent commentary on Rule X-10B-5.\textsuperscript{355} The article cited by the court concluded: \textquotedblleft Moreover, in sustaining these actions, they [the courts] have announced that Rule X-10B-5 imposes standards of disclosure higher than those of the common law.\textquotedblright\textsuperscript{356} Finally, in the court’s continued discussion of Rule 10b-5, it noted: \textquoteleft Quite obviously the broad purpose of this legislation was to keep the channels of interstate commerce, the mail, and national security exchanges pure from fraudulent schemes, tricks, devices and all forms of manipulation.\textsuperscript{357} This very broad statement about Rule 10b-5 obviously implied that it was intended to cover all forms of manipulation. Thus, it seems inescapable that the court meant the intent of Rule 10b-5 to cover fraud in a broad sense and not narrowly in a scienter sense. The court further demonstrated the breadth of the intent of the Rule by citing \textit{Kopald-Quinn & Co. v. United States}\textsuperscript{358} and quoting verbatim: \textquoteleft We think the construction thus urged for the Act [Securities Act] unduly narrows the language used in it, unduly limits its scope and effect.\textsuperscript{359} What more can be said? The court, in effect, has concluded that Section 10(b) and Rule 10b-5 in particular be interpreted in the broadest manner in order to protect both the \textquoteright public interest\textquoteright and \textquoteright investors.\textquoteright Further, it rejected the limitation of 10b-5 to common law fraud, but suggested that a higher standard had been accepted by previous court decisions. The court concurred with these decisions and with the \textquoteright excellent comment\textquoteright cited from the \textit{Yale Law Journal}.

In a 1961 decision, \textit{Ellis v. Carter},\textsuperscript{360} the appellees argued that the appellant must allege and prove genuine fraud and not a mere misstatement or omission for a valid action under subparagraph (2) of Rule 10b-5. The court rebutted the appellee’s argument:

\begin{quote}
This is in effect a challenge to the validity of subparagraph (2) of the rule. It is predicated on the idea that a proscription of material misstatements and half-truths without using fraud or \textit{scienter} language is not a permissible implementation of section 10(b).
\end{quote}

We disagree. Section 10(b) speaks in terms of the use of \textquoteleft any manipulative device or contrivance\textquoteright in contravention of

\begin{itemize}
\item \textsuperscript{355} \textit{Id.} at 201 n.4 (citing to Comment, \textit{The Prospects for Rule X-10B-5: An Emergency Remedy for Defrauded Investors},” \textit{59 Yale L.J.} 1120 (1950)).
\item \textsuperscript{356} Comment, \textit{supra} note 355, at 1122.
\item \textsuperscript{357} \textit{Hope}, 282 F.2d at 202.
\item \textsuperscript{358} \textit{101 F.2d 628} (5th Cir. 1939).
\item \textsuperscript{359} \textit{Id.} at 632.
\item \textsuperscript{360} \textit{291 F.2d 270} (9th Cir. 1961).
\end{itemize}
rules and regulations as might be prescribed by the Commission. It would have been difficult to frame the authority to prescribe regulations in broader terms. Had Congress intended to limit this authority to regulations proscribing common-law fraud, it would probably have said so. We see no reason to go beyond the plain meaning of the word "any," indicating that the use of manipulative or deceptive devices or contrivances of whatever kind may be forbidden, to construe the statute as if it read "any fraudulent" devices. \(^\text{361}\)

Thus, the court's holding that terms broader than "any manipulative device or contrivance" could not be used, clearly affirmed the position that Section 10(b) and Rule 10b-5 were to be interpreted broadly and proof of scienter was not a necessary element.

Shortly after Ellis, the Court of Appeals for the Ninth Circuit decided Royal Air Properties, Inc. v. Smith. \(^\text{362}\) In that case, the court, said "In an action brought under Section 10(b), common law fraud need not be alleged or ultimately proved." \(^\text{363}\) Moreover, the court went on to say that all that is necessary is "[p]roof of a material misstatement or an omission of a material fact in connection with the purchase or sale of a security to make out a prima facie case." \(^\text{364}\)

This statement by the court specifically allowed for a negligence standard and denied a scienter standard; "misstatement or omission of a material fact" were clearly considered terms referring to negligent acts.

The case of SEC v. Capital Gains Research Bureau, Inc. \(^\text{365}\) is one of the most significant cases pertaining to the Securities Acts because of its careful analysis of the intent of the Acts, the meaning of disclosure, and the difference between common law fraud and equitable fraud. The court, through Justice Goldberg, also made a classic analysis of New Deal legislation.

The facts of the case were relatively simple. The defendants published two investment advisory services, one of which was the subject of the proceeding. The report was mailed to subscribers who paid an annual subscription price. Between March 15, 1960, and November 7, 1960, the defendants purchased shares of a particular security shortly

\(^{361}\) Id. at 274.
\(^{362}\) 312 F.2d 210 (9th Cir. 1962).
\(^{363}\) Id. at 213.
\(^{364}\) Id.
before the advisory report recommended it for long-term investment. Each time this occurred, there was an increase in the market price and in the volume of trading of the recommended security shortly after the distribution of the report. Then, shortly thereafter, the defendants sold their shares of these securities at a profit; however, no information about these transactions was disclosed to their clients.

Based on these facts, the SEC requested a preliminary injunction in order to effectuate the Investment Advisers Act of 1940. The injunction would have required the defendants to make full disclosure of the purchase of the recommended securities "within a very short period prior to the distribution of a recommendation..." and of "[t]he intent to sell and the sale of said securities... within a very short period after distribution of said recommendations." This case is extremely pertinent because, although it dealt with the Investment Advisers Act of 1940, this Act is very similar to Section 10(b) and Rule 10b-5 and, the fact situation was analogous to the fact situations that are usually dealt with in Section 10(b) and Rule 10b-5 cases. Moreover, the court itself recognized the case's importance and analyzed the Securities Acts.

The district court had denied a request for a preliminary injunction. It held that "the words 'fraud' and 'deceit' are used [in the Investment Advisers Act] in their technical sense," and that the Commission needed to show the defendants' intent to injure clients or the actual loss of money to clients. The court concluded: "To give these subdivisions further effect would require a breadth of interpretation impermissible in a statute for wilful violations of which criminal sanctions are provided."

366. Id. at 183.
368. 375 U.S. at 183. It should be noted that in Capital Gains, suit was brought pursuant to § 209(e) of the Investment Advisers Act of 1940, 15 U.S.C. § 80b-9(e) (1982), a provision similar to § 20(b) of the Securities Act of 1933 and § 21(d) of the Securities Exchange Act of 1934, empowering the SEC to seek an injunction for violations of the Act.
369. 375 U.S. at 183.
370. The SEC charged that the defendants had violated § 206 of the Investment Advisers Act, 15 U.S.C. § 80b-6 (1982), which contains language similar to Rule 10b-5:
   It shall be unlawful for any investment advisor, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly—
   (1) to employ any device, scheme or artifice to defraud any client or prospective client,
   (2) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative.
372. Id. at 898.
373. Id. at 899.
The Court of Appeals for the Second Circuit, sitting en banc, affirmed the district court's decision by a 5 to 4 vote with a strong dissent. The majority opinion agreed with the reasoning of the District Court. The more elaborate dissenting opinion discussed the origination of the New Deal laws, their intent to alleviate problems in the markets, and the intent that the laws be construed broadly.

The dissent stated that the securities laws were passed to change the common law, which was premised on the maxim *caveat emptor* to the new philosophy of "let the seller also beware." According to the dissent, the new securities statutes were not intended to follow the old common law rule of deceit but were intended to be broadly interpreted to deal with new financial community practices. Finally, the dissent concluded:

Perhaps the worst feature is that it sanctions and indeed endorses a low standard of business morality. . . . The form of scalping here engaged in is a shocking business. . . . This regulatory statute was explicitly aimed to protect the loyal investment adviser against the tipsters and touts and the less desirable members of the profession generally. In all probability, it will be those devoted fiduciaries who will be hardest hit by this decision which levels all to one low standard.

The final decision was in the hands of the Supreme Court. The major issue was whether Congress had intended fraud and deceit to be interpreted in their narrow and technical sense or in a broad remedial construction which would include nondisclosure of material facts. The Court's opinion, written by Justice Goldberg, began with the premise that all federal securities legislation had a fundamental purpose: to substitute the philosophy of full disclosure for the philosophy of *caveat emptor* and thus, "to achieve a high standard of business ethics in the securities industry." Justice Goldberg, then showed through the Congressional committee reports and hearings, that the intent of Congress was clearly a broad interpretation. Therefore, the solution was not a derogation of common law fraud, but rather a "process by which the courts have adapted the common law of fraud to commercial trans-

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375. *Id.* at 614.
376. *Id.*
377. *Id.* at 619-20. Scalping was the Wall Street name for the kind of practice that the SEC was trying to enjoin in this case.
actions of our society."  

Intent and injury have always been essential for damages in suits between parties in arm's length transactions, but this was an action for an injunction to require a fiduciary to disclose his dealings to his clients. Common law fraud has changed and no longer requires all of its elements be shown when all that is sought is equitable relief. The Court quoted from Hanbury on *Modern Equity*: "[E]quity regarded [fraud] . . . as a conveniently comprehensive word for the expression of a lapse from the high standard of conscientiousness that it exacted from any party occupying a certain contractual or fiduciary relation toward another party."  

From Story's *Equity Jurisprudence*, the Court quoted: "Fraud, indeed, in the sense of a court of equity, properly includes all acts, omissions and concealments which involve a breach of legal or equitable duty, trust, or confidence, justly reposed, and are injurious to another, or by which an undue and unconscientious advantage is taken of another."  

After presenting these quotes, Justice Goldberg concluded that Congress had to be aware of these developments in the common law of fraud and therefore expected the courts to take cognizance of them as they applied to the securities laws.  

At the conclusion of the decision, it became obvious to Justice Goldberg that the important issue was the element of intent in a fraud action. Again emphasizing his point pertaining to the intent of the Securities Acts, he stated: "Failure to disclose material facts must be deemed fraud or deceit within its intended meaning, for, as the experience of the 1920's and 1930's amply reveals, the darkness and ignorance of commercial secrecy are the conditions upon which predatory practices best thrive." To force the SEC to show intent would "effectively nullify the protective purposes of the statute."  

Finally, Justice Goldberg concluded by saying that the entire purpose of the statute is misconceived if the argument becomes one of honest motive versus dishonest motive. The point of disclosure is to expose everything to the light of day, an analogy from Dean Shulman's article, in which he said that what is required is "a picture, not simply of the show window, but of the entire store . . . not simply truth in the statements volunteered,

379.  *Id.* at 192.
380.  *Id.* at 193 (quoting HANBURY, *MODERN EQUITY* 643 (8th ed. 1962)).
381.  *Id.* at 194 (quoting 1 STORY, *EQUITY JURISPRUDENCE* § 187).
382.  *Id.* at 200.
383.  *Id.*
but disclosure." 384

Clearly, the opinion in this case is a very powerful statement about the Securities Acts and their interpretation. Moreover, it focuses in on the main issue of fraud, analyzes it, and concludes forcefully that intent is indeed necessary to prove common law fraud, but when there is a fiduciary relation with another, the equitable doctrine of disclosure does not require a showing of intent.

Justice Harlan was the only dissenter in Capital Gains.385 His interpretation of the majority opinion was enlightening when he said that the court had "established [an] absolute rule of disclosure . . . ."386 Later in 1963, the Court of Appeals for the Seventh Circuit, in Kohler v. Kohler Co.,387 determined that scienter was not a necessary element of fraud:

[T]he statute was meant to cover more than deliberately and dishonestly misrepresenting or omitting material facts which ordinarily are badges of fraud and deceit . . . .

[K]nowledge of the falsity or misleading character of a statement and a bad faith intent to mislead or misrepresent are not required to prove a violation of the statute upon which a civil remedy for damages will lie.388

In Stevens v. Vowell,389 the Court of Appeals for the Tenth Circuit also followed the reasoning of Capital Gains: "It is not necessary to allege or prove common law fraud to make out a case under the statute or rule. It is only necessary to prove one of the prohibited actions such as the material misstatement of fact or the omission to state a material fact."390

In 1968, the Court of Appeals for the Second Circuit decided SEC v. Texas Gulf Sulphur Co.,391 another major decision addressing the area of law discussed in Capital Gains. On November 12, 1963, an exploration group of Texas Gulf Sulphur Co. (TGS) completed drilling the first hole in an area believed to contain important mineral deposits. On the same day, visual evaluation of the drill core sample confirmed

384. Id. at 201 (quoting to Shulman, Civil Liabilities and the Securities Act, 43 YALE L.J. 227, 242 (1933)).
385. 375 U.S. at 180 (Harlan, J., dissenting).
386. Id. at 206.
387. 319 F.2d 634 (7th Cir. 1963).
388. Id. at 637.
389. 343 F.2d 374 (10th Cir. 1965).
390. Id. at 379.
391. 401 F.2d 833 (2d Cir. 1968) (en bane).
their expectations. Before the information was disclosed to the public, particular insiders of TGS purchased its common stock. Moreover, during the same period of time, particular insiders either revealed information or recommended purchase of TGS stock to their friends and relatives, who also purchased TGS stock and calls. On April 12, 1964, TGS issued a press release announcing that a strike of at least twenty-five million tons of ore had been made. However, on April 8, four days before this announcement was made, TGS commented upon rumors concerning the mineral discovery in another press release that the SEC maintained was misleading and deceptive.

Shortly thereafter, the SEC initiated a civil action under Rule 10b-5 against the TGS insiders who had purchased TGS stock without disclosing the results of the initial discoveries. The SEC also brought an action against TGS for the misleading press release on April 12 and requested injunctive relief and a decree of rescission of the insiders’ purchases of stock.

The lower court dismissed the complaint against TGS and all but two of the individual defendants who had purchased TGS stock between April 9 and the press conference on April 16. These two defendants appealed from the part of the decision holding that they had violated Section 10(b) and Rule 10b-5, and the SEC appealed from the remainder of the decision. Pursuant to stipulation by the parties, the question of appropriate remedies was deferred and only the question of liability was at issue on appeal. The court of appeals held that the other individual defendants who knew of the drilling results, as well as the corporation, had violated Rule 10b-5, and remanded the case to the district court for determination of the appropriate relief.

In the district court decision, the defendants asserted that the SEC must establish the elements of common law fraud, but the appeals court concluded that this was not the law and said that “recent decisions, even in private suits, do not require proof of these elements in actions charging violation of Rule 10b-5.” Then, the court examined

392. Id. at 843.
393. Id. at 845-46.
395. 401 F.2d 842.
396. Id. at 864.
397. 258 F. Supp. at 277. See Royal Air Properties, Inc. v. Smith, 312 F.2d 10 (9th Cir. 1962); supra notes 362-64 and accompanying text; Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961); supra notes 360-61 and accompanying text.
SEC v. Capital Gains Research Bureau and quoted at length from that case. What is important to notice is that the court emphasized two parts of the case. The first was when the Supreme Court said: “It would defeat the manifest purpose of the Investment Advisers Act of 1940 for us to hold, therefore, that Congress, in empowering the courts to enjoin any practice which operates ‘as fraud or deceit,’ intended to require proof of intent to injure and actual injury to clients.” The second was when the court noted: “Congress intended the Investment Advisers Act of 1940 to be construed like other securities legislation ‘enacted for the purpose of avoiding frauds’ not technically and restrictively, but flexibly to effectuate its remedial purposes.”

The district court then carefully developed the law: “To establish violations of Section 10(b) and Rule 10b-5, the Commission must prove that the defendants engaged in a ‘course of business’ which operated as a ‘fraud or deceit . . . in connection with the purchase or sale of any security.”

Finally, the court discussed fraud in terms of insiders and their actions. Intent was not the issue, duty was. The court, quoting Cochman v. Channing Corp., said:

The Securities Exchange Act was enacted in part to afford protection to the ordinary purchaser or seller of securities. Fraud may be accomplished by false statements, a failure to correct a misleading impression left by statements already made, or, as in the instant case, by not stating anything at all when there is a duty to come forward and speak.

Thus, the district court clearly established that scienter or intent was not necessary in a Section 10(b) and Rule 10b-5 case. Common law fraud was not the criterion, but rather it was a duty that arose between the parties. Actions and relationships between the parties, not intent, was the underlying element. In essence, the court was referring to liability for negligence.

The analysis of the Court of Appeals dealt in part with the concepts of scienter and fraud. First, the court asked if good faith was a valid defense under Rule 10b-5 and answered it in the negative. The

400. Id. 258 F. Supp. at 277 (quoting 375 U.S. at 195) (emphasis added).
401. 258 F. Supp. at 278.
404. 401 F.2d 833 (2d Cir. 1968)(en banc).
analysis of the law was superb. The law was broad in order to protect
the investing public, the court noted, and thus "[i]n an enforcement
proceeding for equitable or prophylactic relief, the common law stan-
dard of deceptive conduct [was] modified in the interests of broader
protection for the investing public so that negligent insider conduct [be-
came] unlawful." Then Judge Waterman, author of the court's opin-
ion, continued his analysis in a footnote by applying the reasoning of
an excellent law review article. He concluded the analysis with a
strong statement for a negligence standard for Rule 10b-5 by stating:
"This requirement, whether it be termed lack of diligence, constructive
fraud, or unreasonable or negligent conduct, remains implicit in this
standard, a standard that promotes the deterrence objective of the
Rule."

The opinion also discussed the historical background of Section
10(b) and repeated much of the material already discussed above on
the legislative history of Section 10(b). The court's important state-
ment was a quote of Judge Learned Hand about the interpretation of
statutes found in Crawley v. United States:

[U]nless they explicitly forbid it, the purpose of the statutory
provision is the best test of the meaning of the words chosen.
We are to put ourselves so far as we can in the position of the
legislature that uttered them, and decide whether or not it
would declare that the situation that has arisen is within what
it wishes to cover. Indeed, at times the purpose may be so
manifest as to override even the explicit words used.

The court then discussed the concept of fraud directly, saying that if
intent or wrongful purpose was required, the defendants would not es-
cape liability if they seek an "advantage," unless "the advantage fails to
materialize to the degree contemplated, or cannot be demonstrated."

405. Id. at 855.
406. Id. at 855 n.21. That note provided:

Even at common law, the essentially private remedy of rescission which is sought here
does not require more than a showing of negligence and frequently even less than that,
see Restatement of Contracts, § 476, Comm. b (1932); and the common law concept of constructive fraud still available to private plaintiffs, see Trussell v. United Under-
writers, Ltd., 288 F. Supp. 757, 772 (D. Colo. 1964), has been expanded from
recklessness, see Prosser, Torts, Section 102, pp. 715-17 (3rd ed. 1964), to include
nonreckless negligent misrepresentations or omissions, see Note, 63 Mich. L. Rev. 1070,
1965).
407. Id. at 855 referring to the analysis in Note, 63 Mich. L. Rev. 1070, 1079 (1965).
408. Id. at 860.
409. 272 F.2d 433 (2d Cir. 1959).
410. 401 F.2d at 861 (quoting Crawley v. United States, 272 F.2d at 445).
411. 401 F.2d at 861.
Moreover, and more important to the court, was that the investing public would still be hurt, irrespective of the intent. The point was that management had initiated the statements and others were hurt; therefore, someone should be liable. The court asserted that:

[The] investing public is hurt by the exposure to false or deceptive statements irrespective of the purpose underlying their issuance. It does not appear to be unfair to impose upon corporate management a duty to ascertain the truth of any statements the corporation releases to its shareholders or to the investing public . . . .

On the other hand, as in all negligence actions, if corporate management could demonstrate diligence in ascertaining that the information it published was true and disseminated in good faith, then Rule 10b-5 would be upheld. The court concluded that it was much better to describe specifically what had happened, than to speculate on the basis of unknown facts.

Surely the court in *Texas Gulf Sulphur* has made a provocative statement about Section 10b and Rule 10b-5. After a detailed analysis of case law and the legislative reasoning behind enactment of the law, the court concluded that scienter is not necessary for Section 10(b) and Rule 10b-5. Rather, a negligence standard was appropriate, because those who initiated the action should be liable if they bought stock before the information was publicly disseminated and could have, but failed, to determine the truth of the statements made.

The holding strongly supports a negligence standard. The dissent, written by Judge Moore, agreed with the lower court that the two who bought stock before the information was publicly available should be liable. It was with the press release that they disagreed. The dissenters felt that the higher court should not reinterpret the facts presented to the lower court. Finally, they believed a negligence standard was too broad.

It is Judge Friendly's concurring opinion that has drawn much comment. Although he agreed with the first part of the opinion, he hesitated on the importance of the press release: "The consequences of holding that negligence in the drafting of a press release . . . may im-

412. *Id.*
413. *Id.* at 862.
414. *Id.* at 870.
415. *Id.* at 878.
416. *Id.* at 871.
417. *Id.* at 881.
pose civil liability on the corporation are frightening." After discussing negligence, he agreed to concur provided it was understood that he felt that the lower court's opinion could have been affirmed on this issue. When the district court denied the injunction, the court acted on the basis that no violation had occurred. However, a violation had occurred in the press release and, thus, the case would be remanded to the district court for a determination in accordance with the court of appeals' opinion. Consequently, it was a concurring opinion made with some reluctance, but a concurring opinion nonetheless. This reluctance of Judge Friendly on the issue of negligence was perhaps prophetic of things to come. Regardless, the conclusion is that the opinion by Circuit Judge Waterman in Texas Gulf Sulphur is an accurate negligence interpretation of fraud.

The last major case is White v. Abrams from the Ninth Circuit. This opinion was the culmination and synthesis of the opinions above. The facts were simple yet, because of their nature, important. As maintained throughout this Article, the circumstances of 10b-5 cases often relate to two parties who are in a position of trust. In addition, the concept of intent is difficult to determine. Furthermore, one party clearly acts on the basis of information given or not given by the other party resulting in detrimental reliance. The facts in White are similar to this pattern. Abrams was a long and trusted friend and advisor of White, who had made a number of successful investments through Abrams. Abrams solicited loans from private lenders for the Richmond Corporations. White, on the basis of Abrams' recommendation, bought a number of promissory notes and stock from the Richmond Corporations, which later went bankrupt. White and others sued under Section 10(b) and Rule 10b-5, charging that Abrams had misrepresented certain facts. The counts alleged that Abrams represented that he had investigated Richmond and found it financially sound, having had large earnings and an ability to pay high interest on the loans. Further, it was alleged that Abrams failed to disclose that he had received a large commission and sold similar securities and loans to others at higher rates of interest.

The lower court rendered a verdict for the plaintiff, and substan-

418. Id. at 864.
419. Id. at 866.
420. 495 F.2d 724 (9th Cir. 1974).
421. Id. at 726-27.
tial damages were awarded for violating Rule 10b-5. On appeal, the defendant contended that the jury instructions dealing with the question of material misrepresentations were erroneous and improper. The following instruction was given to the jury:

If you find that the defendant made a material misrepresentation to plaintiffs in connection with the sale to plaintiffs of a promissory note or share of stock, the law is that the defendant has violated the Federal Securities law even if you find that the defendant did not know the falsity of the misrepresentation he made to the plaintiff.

Judge Wallace, author of the opinion, emphasized that this statement was not in conformity with security law since it assumed an absolute standard of liability rather than a negligence or scienter standard. In reversing and remanding, the court noted that the purpose of security law is to qualify the rule of caveat emptor and not to create a scheme of investor's insurance.

Thus, the major question posed was what criteria should be used for liability under Section 10(b) and Rule 10b-5. The court's answer was that it should not be based on "easily defined and well-known theories such as common law fraud," but rather on "the totality of the factual context" as measured by the duty imposed on the defendant. The proper analysis, then, was to focus on the duty of the defendant and apply a flexible standard to take into account different situations.

The court adamantly rejected the scienter standard when it said: "We believe that the cases and commentators demonstrate that any attempt to limit the scope of duty in all 10b-5 cases by the use of one standard for state of mind or scienter is confusing and unworkable. Consequently, we reject scienter or any other discussion of state of mind as a necessary and separate element of a 10b-5 action."

The court then tried to redefine the flexible duty standard by quoting from Mann's law review article:

Instead of perpetrating the practice of discussing scienter and negligence as absolutes, which are capable of being objectively applied, more is gained by recognizing that there is a sliding scale which determines what constitutes sufficient dili-
gent conduct to avoid 10b-5 liability, and that 10b-5 liability is determinable only within the context of the vagaries of the specific facts presented.428

Judge Wallace proposed that courts adopt a case-by-case analysis, using the “sliding scale” or flexible duty standard. The court should look at the goals of securities fraud legislation by considering several important factors: (1) the relationship of the defendant to the plaintiff; (2) the defendant's access to the information as compared to the plaintiff's access; (3) the benefit the defendant derives from the relationship; (4) the defendant's awareness of the plaintiff's reliance on their relationship; and, (5) the defendant's activity in initiating the transactions in question.429 In this way the courts will develop the standards that apply for each situation, remaining cognizant that areas will remain to be handled due to unique and difficult aspects that may arise. Such is the problem when dealing with the difficult areas of fraud and its many facets. Unless it is approached in this way, there will not be a remedy for plaintiffs who have been wronged since the common law remedy of deceit is unable to deal with such modern situations.

In conclusion, White v. Abrams is the culmination of the thinking on fraud and deceit pertaining to Section 10(b) and Rule 10b-5. It saw through the maze of decisions and their sometimes spurious reasoning and zeroed in on the major problem—securities fraud is complex. It cannot be handled simply by a scienter standard, because the old common law doctrines of fraud and deceit, which developed around transactions involving land and particular intangibles of wealth, are no longer suited to the sale of intangibles such as advice and securities which have arisen in the modern world. Accordingly, legal doctrines must be adapted in order to fit new merchandise and new forms of wealth.430 The ultimate answer must not be a scienter standard431 but a flexible standard of duty.432

428. Id. at 734.
429. Id. (emphasis added).
430. Id. at 732 (quoting Mann, Rule 10b-5 Evolution of a Continuum of Conduct to Replace the Catch Phrases of Negligence and Scienter, 45 N.Y.U. L. Rev. 1206, 1209 (1970)).
431. Id. at 733-34.
A. Majority Opinion

Ernst and Ernst v. Hochfelder\(^{433}\) was the first Supreme Court decision to challenge the Section 10(b) and Rule 10b-5 requirement of negligence. In that case, private investors who had been swindled in a fraudulent scheme devised by Leston Nay, president of First Securities Co. of Chicago, brought an action against the accounting firm of Ernst and Ernst. For twenty-six years the plaintiffs had placed funds in escrow accounts which Nay had stated were capable of yielding a high rate of return. The money intended for these accounts had gone instead to Nay’s own use. After Nay’s suicide in 1968, the scheme was discovered and an action was brought against the defendant.\(^{434}\) The complaint alleged that Ernst and Ernst had negligently aided and abetted Nay’s violations of Rule 10b-5 in its failure to discover First Securities’ “mail rule,” which prohibited the opening of Nay’s personal mail. The plaintiffs maintained that the defendant’s irregular practice of failing to list the “mail rule” in its annual audit of the company prevented an investigation of Nay, which surely would have uncovered the fraudulent escrow scheme perpetrated by Nay.

The district court granted the defendant’s motion to dismiss for failure to state a claim.\(^{435}\) The Court of Appeals for the Seventh Circuit, however, reversed the district court’s decision and remanded the case for trial.\(^{436}\) In delivering the opinion for the court, Chief Judge Swygert said that the lower court’s decision was to be reversed because “it is our view there are genuine issues of material fact in dispute which go to the very question of liability.”\(^{437}\) Justice Swygert then proceeded to the very heart of the question: whether Ernst and Ernst could be held liable for aiding and abetting Nay’s fraudulent scheme. The court had already ruled on this in its recent decision in Hochfelder and Martin v. Midwest Stock Exchange,\(^{438}\) in which the court held that a claim for aiding and abetting based solely on inaction could be maintained.

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\(^{433}\) Up to this period in time, another line of lower federal court cases had taken a minority position and adopted a less logical and reasonable position that since there was common law fraud, scienter was necessary for Section 10(b) and Rule 10b-5. See Carras v. Burns, 516 F.2d 251 (4th Cir. 1975); SEC v. Coffey, 493 F.2d 1304 (6th Cir. 1974) cert. denied, 420 U.S. 908 (1975).


\(^{436}\) \textit{Id.} at 189-190.

\(^{437}\) \textit{Id.} at 191.

\(^{438}\) 503 F.2d 1100 (7th Cir. 1974).
under Rule 10b-5 if it were shown that, "the party charged with aiding and abetting had knowledge of or, but for a breach of duty of inquiry, should have had knowledge of the fraud, and that possessing such knowledge the party failed to act due to an improper motive or breach of a duty of disclosure."\textsuperscript{439} The court then stated that the three elements quoted comprised a flexible duty standard which "should be amplified according to the peculiarities of each case."\textsuperscript{440} Moreover, when the defendant, through action or inaction, had facilitated fraud on someone else, a claim for aiding and abetting could be made by demonstrating:

1. that the defendant had a duty of inquiry;
2. the plaintiff was a beneficiary of that duty of inquiry;
3. the defendant breached the duty of inquiry;
4. that concomitant with the breach of duty of inquiry, the defendant breached a duty of disclosure; and
5. there is a causal connection between the breach of duty of inquiry and disclosure and the facilitation of the underlying fraud; that is, adequate inquiry and subsequent disclosure would have led to the discovery of the underlying fraud or its prevention.\textsuperscript{441}

On the basis of the flexible duty standard, the court of appeals reversed the district court holding that this was not an appropriate case for summary judgment. It is important to note that the court made a unanimous ruling and did not hesitate in presenting the law to the district court as the flexible duty standard.

Following the decision by the court of appeals and other courts, the Supreme Court made an unexpected decision in \textit{Ernst and Ernst v. Hochfelder}.\textsuperscript{442} when it granted certiorari in order to resolve the question of "whether a private cause of action for damages will lie under § 10(b) and Rule 10b-5 in the absence of any allegation of 'scienter'—intent to deceive, manipulate, or defraud."\textsuperscript{443} The analysis of Justice Powell, who authored the majority opinion, was in four parts.

1. Text of Section 10(b)

The analysis dwelled upon the vocabulary of Section 10(b). Justice Powell said that "manipulative," "device," and "contrivance,"

\textsuperscript{439} \textit{Id}. at 1104.
\textsuperscript{441} 503 F.2d at 1104; \textit{see also Hochfelder and Martin}, 503 F.2d at 374.
\textsuperscript{442} 503 F.2d at 1104.
\textsuperscript{443} \textit{Id}.
whether they are read in the "commonly accepted meaning" or as a "term of art," all suggested "intentional or willful misconduct." Taken together, these words defined a "conduct quite different from negligence."

2. Legislative History of the Exchange Act

Justice Powell began with an admission that "the extensive history of the 1934 Act is bereft of any explicit explanation of Congress' intent," but he stubbornly persisted that the evidence did not contradict the above textual analysis of Section 10(b). He then discussed the early draft of the Exchange Act, saying that Section 9(c), the predecessor of Section 10(b), had undergone three changes before the final version, finding that "neither the intended scope of § 10(b) nor the reasons for the changes in its operative language are revealed explicitly in the legislative history of the 1934 Act, which deals primarily with other acts of the legislation." This statement was a revealing admission by Justice Powell; however, he undauntingly continued: "There is no indication, however, that § 10(b) was intended to proscribe conduct not involving scienter." Justice Powell then pointed out Thomas G. Corcoran's statement that Section 10(b) "is a catch-all clause to prevent manipulative devices. I do not think there is an objection to that kind of clause. The Commission should have the authority to deal with new manipulative devices." Justice Powell explained Corcoran's statement by saying: "It is difficult to believe that any lawyer, legislative draftsman, or legislator would use these words if the intent was to create liability of or merely negligent acts or omissions." Justice Powell was thus convinced that, although vague, the legislative history did not indicate that Section 10(b) was intended to proscribe conduct not involving scienter.

3. Statutory Scheme of Securities and Exchange Acts

Justice Powell explained that the SEC had argued that Congress

445. Id. at 193.
446. Id.
447. Id.
448. Id.
449. Id. at 201.
450. Id.
451. Id. at 202.
452. Id.
had been explicit when it required willful conduct, citing Section 9 of the Exchange Act, but, since 10(b) was not expressly restricted by its terms to willful, knowing, or purposeful conduct, it should not be construed to mean any more than negligent conduct.453

Justice Powell, however, felt that the structure of the Acts did not support such a position and cited Sections 11, 12, and 15 of the Securities Act, which have express remedies not applicable under Section 10(b).454 Justice Powell concluded that these procedural limitations indicate that:

The judicially created private damages remedy under § 10(b)—which has no comparable restrictions—cannot be extended, consistently with the intent of Congress, to actions premised on negligent wrongdoing. Such extension would allow causes of action covered by §§ 11, 12(2), and 15 to be brought instead under § 10(b) and thereby nullify the effectiveness of the carefully drawn procedural restrictions on these express actions.455

Thus, Justice Powell concluded that because the Acts are complementary, and because there are explicit restrictions on the other sections in the Securities Act, a negligence action under 10(b) should not be permitted because it will nullify the other acts. The nullification would come about since all actions would be brought under Section 10(b) in order to avoid the restrictions of the other sections.

4. Rule 10b-5: Disallowance of Negligence Standard

The SEC contended that Rule 10b-5 was cast in such language that standing alone it encompassed both intent and negligence. However, Powell and the Court felt that scienter was required for two reasons. First, because of the history of the Rule when it was adopted,456 and second, because the Rule was adopted pursuant to the authority granted to the SEC under Section 10(b). This rule-making power, Justice Powell maintained, was not power to make law and thus could not override the power granted by Congress.457 The conclusion reached was that the history of Section 10(b) did not allow for negligence and, therefore, Rule 10b-5 could not.

453. Id. at 203.
454. Id. at 207.
455. Id. at 207.
456. Id. at 209.
457. Id. at 210.
B. Dissenting Opinion

Justices Blackmun and Brennan dissented.458 Their dissent was short but to the point. Justice Blackmun wrote that the ruling by the majority was narrow and unjustified, stating: “Perhaps the Court is right, but I doubt it.”459 Going to the heart of the problem, he remarked, “[A]n investor can be victimized just as much by negligent conduct as by positive deception, and . . . it is not logical to drive a wedge between the two, saying that Congress clearly intended the one but certainly not the other.”460 He continued, saying that the language of Rule 10b-5 was “clearly and succinctly, to extend beyond common-law fraud, and to apply to negligent omission and commission.”461 This was, Justice Blackmun believed, in accordance with Congress’ intent, that the Rule be construed “not technically and restrictively, but flexibly to effectuate its remedial purposes.”462

The dissent, in view of earlier discussions in this article, seems to be correct. The majority opinion seems weak, at best. Interestingly, since the Court in Hochfelder made a decision based on the private action only and said nothing about an SEC injunctive suit, it is possible to assume that the Court decided that scienter was necessary for a private right of action, but not for a suit by the SEC for injunctive relief.

IX. Articles and Cases after Hochfelder: A Denial of Scienter

Authors of law review articles written after the Hochfelder decision had a field day, primarily because the Hochfelder case decided that scienter was necessary in a Section 10(b) and Rule 10b-5 action only in a private right of action, and because the Court’s reasoning and cases supporting the scienter argument were weak. Most of the articles disagreed with Hochfelder and spent most of their analyses showing that even if it were conceded that scienter was necessary for a private action under Section 10(b) and Rule 10b-5, surely the court did not mean that scienter was necessary for an SEC injunctive suit.463

458. The Court assumed that Milton Freeman’s remarks showed that Rule 10b-5 was hastily adopted and nothing in the events that led up to its drafting changed the impression that it was not intended to require scienter. See supra note 335.
461. Id. at 216.
462. Id.
463. Id. at 217.
The reasoning was that injunctive action by the SEC is its most effective remedy and the Hochfelder decision did not intend to dilute SEC's effectiveness as an agency. A few articles went further and argued that even if scienter were necessary for both a private right and the SEC injunctive action, it did not follow that gross negligence or recklessness would be excluded.

It is interesting that neither the decisions nor the commentators after Hochfelder followed the decision. SEC v. Bausch and Lomb, Inc. was the first case to follow Hochfelder. Because Bausch and Lomb was being adjudicated when the Hochfelder decision was handed down, the district court felt compelled to follow what it thought was decided in Hochfelder, even in regard to a suit for injunctive relief by the SEC. The court said: "This court believes that the Hochfelder holding must be read to impose a scienter requirement in this suit for injunctive relief brought by the SEC. Although not obliged to reach the question by the facts of that case, the Supreme Court used reasoning which appears to compel that result." Armed with such thinking that scienter was required for an injunctive action by the SEC, the district court felt that the SEC failed to establish that the defendant had acted with the requisite intent and, therefore, denied the injunction. A few other cases followed Bausch and Lomb and agreed with the holding in Hochfelder, but, for the most part, the Bausch and Lomb reasoning was not followed.

In the first case which disagreed with the Hochfelder ruling, the Court of Appeals for the First Circuit, in SEC v. World Radio Mission, Inc., ordered a preliminary injunction to be issued against a reli-

464. Id. (quoting SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 195 (1963)).
468. Id. at 1240.
gious organization and its leader in order to prevent violations of Section 17(a) of the Securities Act of 1933 and Rule 10b-5 of the Securities Exchange Act of 1934. In making a determination of the case, the court stated that in an SEC enforcement case, if the conduct was “injurious to the public, good faith, however much it may be a defense to a private suit for past actions, . . . should make no difference.” The court dismissed the contention that Hochfelder required a determination of scienter in an SEC injunction action under Section 17(a), because it said Section 17(a) is not affected by the ruling in Hochfelder. Although the court did not reach the issue of whether scienter must be proved in an action based solely on Rule 10b-5, it strongly implied that scienter need not be established when it said: “We do think it implausible to suppose that Congress intended to provide a mechanism for the SEC to protect the public from the injurious schemes of those of evil intent and yet leave the public prey to the safe conduct perpetrated by the careless or reckless.” This language shows that the court felt strongly about protecting the public from careless or reckless acts when securities were involved.

In SEC v. Geotek, the District Court of the Northern District of California specifically rejected the scienter requirement in Rule 10b-5 injunctive actions. The SEC sought an injunction based on Section 10(b) and Section 17(a), alleging that material misstatements and omissions and been made in some basic documents. The court, after analyzing World Radio Mission, reasoned that the Hochfelder analysis did not apply to the language of Section 17(a). Therefore, the court utilized a negligence standard for 17(a) like the court had in World Radio Mission. But the court went much further, saying: “We have decided to apply the strict standard of negligence (i.e. ordinary care or due diligence) as to all SEC claims against defendants.” Although it is questionable whether intent influenced the court’s decision in the case, the court did establish a very strong negligence standard.

In SEC v. Universal Major Industries Corp., the Court of Appeals for the Second Circuit again made a distinction between a 10b-5

470. 544 F.2d 535 (1st Cir. 1976).
471. Id. at 540 (citations omitted).
472. Id. See also id. at 541 n.10 (discussing the implications of requiring scienter for § 10b on § 17a).
473. Id.
private action and an SEC injunctive suit. An injunction was issued against an attorney for aiding and abetting violations of Section 5475 of the Securities Act of 1933. The court rejected the appellant's main argument that Hochfelder required proof of scienter and reaffirmed the court's position on negligence by saying: "[I]n SEC proceedings seeking equitable relief, a cause of action may be predicated upon negligence alone, and scienter is not required." Moreover, the court emphasized that "Hochfelder, which was a private suit for damages, does not undermine our prior holdings."

X. AARON: A SCIENTER DECISION

A. Introduction

In Aaron v. SEC the Supreme Court chose to resolve the issue left open in Hochfelder, holding that the SEC must also establish scienter to obtain injunctive relief under Section 10(b) and Rule 10b-5. Justice Stewart's majority opinion relied wholly on the Hochfelder analysis. It is, in all candor, a very disappointing analysis.

Peter Aaron was a managerial employee of E. L. Aaron and Company, a registered broker-dealer. His responsibility was to oversee the firm's personnel and maintain due diligence files for securities in which the firm served as a market maker. One of the securities in which the firm made a market was the common stock of Lawn-A-Mat Chemical and Equipment Corp. (LAM). Two sales representatives, supervised by Peter Aaron, repeatedly made false and misleading statements to prospective purchasers in soliciting orders for LAM stock. An attorney representing LAM communicated with the petitioner twice by phone and notified him that the two sales representatives were making false and misleading statements. Since Aaron maintained the due diligence files, he had an additional reason to know that the statements were untrue. Aaron assured the lawyer that the misrepresentations would cease, but in fact he took no affirmative steps to prevent their recurrence. Aaron's only response was to inform one of the sales representatives of the attorney's complaint and direct the sales representative to communicate with the attorney.

475. Id. at 726.
476. 546 F.2d 1044 (2d Cir. 1976).
478. Id.
479. Id. (citations omitted).
The SEC sought an injunction against Aaron and filed a complaint in the district court. The Commission alleged that the petitioner had violated and aided and abetted violations of three provisions—Section 17(a), Section 10(b) and Rule 10b-5.\footnote{Id at 682.} The district court granted injunctive relief.\footnote{Id at 683.} Although it was noted that negligence alone might suffice to establish a violation, the district court concluded that the petitioner's intentional failure to terminate the false and misleading statements made by the two employees, knowing they were fraudulent, was sufficient to establish scienter under the securities acts.\footnote{Id.}

B. Court of Appeals' Reasons for Negligence

The court of appeals affirmed the judgment\footnote{[1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,043 at 91,686-87.} but refused to follow the district court's reasoning. Circuit Court Judge Timbers adamantly disagreed with Hochfelder's scienter requirement, saying:

[W]e hold that the scienter requirement enunciated in Hochfelder is not applicable to government enforcement actions brought under §§ 10(b) and 21(d) of the 1934 Act. Consistent with the pre-Hochfelder decisions of this Court, we continue to hold that allegations and proof of negligence alone will suffice, for the reasons stated below.\footnote{Id.}

The circuit court then proceeded to discuss the reasoning in Hochfelder and the suggestion by some that its reasoning should also apply to SEC injunction actions. The court discussed the cases preceding Hochfelder and concluded:

The Court's decision in Hochfelder in our view has not altered the fact that different policy considerations should govern in SEC enforcement actions, in contrast to private damage actions, under § 10(b). Indeed, the Court itself appears to have recognized this when it expressly left open the question now before us.\footnote{605 F.2d (2d Cir. 1979).}

The court then examined the three factors that the Supreme Court relied on in concluding that scienter was required in private damage actions under 10(b). In discussing the first factor, the language of Section 10(b), the court, contrary to the Supreme Court's decision, did not believe that the language of the section alone was determinative of the
issue given the diversity of judicial interpretations.\textsuperscript{487}

The court of appeals asserted that when statutory language is unclear, courts have ruled that legislative history is applicable.\textsuperscript{488} This lead to a discussion of the second factor—legislative history of Section 10(b). The court noted that the Supreme Court had stated in\textit{Hochfelder} that the legislative history of 10(b) was "'bereft of any explicit explanation of Congress' intent.'"\textsuperscript{489}

Furthermore, in\textit{Hochfelder} when the Court had examined requirements for a private right of action under Section 10(b), it looked to the common law of misrepresentation and deceit. But in defining the requirements for an SEC injunction action based on Section 10(b), the Court had looked to Section 21(d) of the Exchange Act.\textsuperscript{490} Legislative discussion of § 21(d) indicates that scienter was not intended to be required in SEC injunction actions.\textsuperscript{491}

The third factor considered was the relation of Section 10(b) to other statutory remedies. The court of appeals maintained that an examination of the statutory scheme showed that no comparable provisions would be nullified by allowing SEC enforcement actions to be predicated on a showing of negligence. In fact, a negligence standard would "harmonize" the Exchange Act requirements with similar requirements in the Securities Act.\textsuperscript{492}

Finally, the court discussed the appellant's contention that\textit{Hochfelder} required a finding of scienter for SEC injunction actions brought pursuant to Section 17(a). The court said that it followed from its holding on Section 10(b) that "a fortiori scienter is not a requisite element of a government enforcement action to enjoin violations of § 17(a) of the 1933 Act."\textsuperscript{493} Also, regarding Section 17(a), although a few courts had ruled the other way, the court of appeals followed the holding in\textit{SEC v. Coven},\textsuperscript{494} which held unequivocally that scienter was not required in an SEC injunction action under Section 17(a).\textsuperscript{495}

It is refreshing to see the appellate court logically discuss the issues. It would seem that the Supreme Court would answer the court's

\begin{footnotesize}
\begin{itemize}
\item\textsuperscript{487} Id. at 619.
\item\textsuperscript{488} Id. at 621 (citing to\textit{Hochfelder}, 425 U.S. at 194 n.12).
\item\textsuperscript{489}\textit{Aaron}, 605 F.2d at 621.
\item\textsuperscript{490} Id. (quoting\textit{Hochfelder}, 425 U.S. at 201).
\item\textsuperscript{491}\textit{Aaron}, 605 F.2d at 621-22.
\item\textsuperscript{492} Id. at 622 (footnote omitted).
\item\textsuperscript{493} Id. at 622-23 (footnote omitted).
\item\textsuperscript{494} Id. at 623.
\item\textsuperscript{495} 581 F.2d 1020 (2d Cir. 1978).
\end{itemize}
\end{footnotesize}
pointed arguments against an extension of the Hochfelder reasoning from scienter for a private right under 10(b) to scienter for an SEC injunction under 10(b). Unfortunately, the Supreme Court did not.

C. Supreme Court's Reaffirmation of Hochfelder

The Supreme Court reversed the decision of the circuit court, holding that the SEC must establish scienter in an injunction action.\footnote{Id. at 1026-28.} In reaching that result, Justice Stewart, adopted the reasoning in Hochfelder without any reservations and without further analysis of the reasoning. He was satisfied that the Hochfelder interpretation of the statutory language and the legislative history of Section 10(b) and Rule 10b-5 positively governed whenever violation of those provisions were alleged, “regardless of the identity of the plaintiff or the nature of the relief sought.”\footnote{Id. at 691.}

In the Court's analysis, it accepted the conclusion that the dictionary definition or “plain meaning” of the words “manipulative,” “device,” and “contrivance” evidenced a Congressional intent to “proscribe only 'knowing or intentional misconduct.'”\footnote{Id. at 690 (quoting Hochfelder, 425 U.S. at 197-99).} Again, as in Hochfelder, the meaning of the word “deceptive” was not considered. The Supreme Court instead concluded that the Hochfelder interpretation of the plain language of Section 10(b) was so clear that it governed the standard of culpability issue and thus further inquiry was unnecessary.\footnote{Id. at 690 (quoting Hochfelder, 425 U.S. at 202).}

Despite the arguments of the court of appeals, the Court, through Justice Stewart adopted the Hochfelder interpretation of the history of Section 10(b) and Rule 10b-5. It even agreed with the Hochfelder reasoning that the legislative history, although bereft of any specific explanation of Congress' intent, did not indicate that Congress was in favor of conduct that did not involve scienter. Moreover, Justice Stewart accepted the quotation from the spokesman for the legislative drafters in Hochfelder that said the section was “a catch-all clause to prevent manipulative devices.”\footnote{Aaron, 446 U.S. at 690 (quoting Hochfelder, 425 U.S. at 197-99).} Hochfelder concluded, and Stewart agreed, that this description and the legislative history evidenced a purpose to proscribe only conduct involving scienter.

Stewart also referred briefly to the Court's discussion in

\footnote{496. Id. at 1026-28.} \footnote{497. 446 U.S. 680, 695 (1980).} \footnote{498. Id. at 691.} \footnote{499. Id. at 690 (quoting Hochfelder, 425 U.S. at 197-99).} \footnote{500. Aaron, 446 U.S. at 690 (quoting Hochfelder, 425 U.S. at 202).}
Hochfelder of the structure of the Securities acts. The Court recognized that the provisions providing express civil remedies in a case involving injunctive relief did not apply.501 But, in agreeing with the Hochfelder reasoning, the Court did not deal with the central problem of distinguishing between an implied private cause of action and an SEC injunctive action. Moreover, the Court decided that the Hochfelder interpretation directly applied to the facts in Aaron because the remedy expressly provided by Section 10(b) was involved, while Hochfelder had only involved an implied cause of action. Justice Stewart continued the Court's reasoning and rejected the SEC's contention that the difference between a private cause of action and an injunctive action required restricting the Hochfelder holding to private actions.

In its argument, the SEC implored the court to follow the Capital Gains502 decision. The SEC argued that Capital Gains emphasized the distinction between law and equity, which was the key to a correct construction of Section 10(b) in a suit for injunctive relief. The Court, however, rejected this reasoning and found Hochfelder to be controlling. The Court agreed with the Hochfelder findings of legislative history for intent, in contrast to the Capital Gains finding of the lack of need for intent. In addition, the Court agreed with Hochfelder's narrow reasoning which interpreted the words, "manipulative," "device," and "contrivance," as referring to intentional conduct. In contrast, the interpretation in Capital Gains, looked to the particular practice involved to see whether it was legal or equitable in order to determine if intent or negligence was appropriate. Finally, Justice Stewart, for the Court, argued that the Capital Gains fact situation involved a statutory provision that regulated a special fiduciary relationship between an investment advisor and his client.503 Such a situation, the Justice maintained, was not one that would have required intent to defraud in a common law action for money damages. Section 10(b), however, unlike the provision in Capital Gains, applied equally to both fiduciary and nonfiduciary transactions in securities, so the situations were not analogous.504 Thus, the Supreme Court concluded that the controlling precedent was Hochfelder and not Capital Gains.

501. Aaron, 446 U.S. at 690 (citing Hochfelder 425 U.S. at 201-02).
502. Aaron, 446 U.S. at 691 n.9.
504. Aaron, 446 U.S. at 694.
D. Dissenting Opinion

Justice Blackmun, joined by Justices Marshall and Brennan, wrote an extremely fine dissent. The dissent emphatically rejected the Court’s holding that the SEC must establish scienter in an injunction action under Section 10(b) and Rule 10b-5.\footnote{Id. at 695-96.}

Justice Blackmun began by saying that the issues before the Court were both “important and critical.”\footnote{Id. at 703 (Blackmun, J., dissenting).} He said that Sections 17(a) and 10(b) are the “primary antifraud provisions” of the Securities Acts, and that they are the most important means by which the SEC, through action for injunctive relief, seeks “protection against deception in the marketplace.”\footnote{Id. at 704.}

Then Justice Blackmun fired a very broad shot at the majority opinion by noting how disappointing and drastic the result was:

[T]hey are the key weapons in the statutory arsenal for securing market integrity and investor confidence . . . . If the Commission is denied the ability effectively to nip in the bud the misrepresentations and deceptions that its investigations have revealed, honest investors will be the ones who suffer. Often they may find themselves stripped of their investments through reliance on information that the Commission knew was misleading but lacked the power to stop or contain.\footnote{Id. (statutory citations omitted).}

The dissenters emphatically rejected the majority’s wholesale reliance on Hochfelder because they believed there were “sound reasons for distinguishing between private damages actions and public enforcement actions under these statutes, . . . .”\footnote{Id. at 705.} Justice Blackmun attacked the reasoning in Hochfelder that emphasized the statutory language and its “plain meaning.” He said that the phrases, “device, scheme or artifice to defraud,” in Section 17(a)(1) and the phrases, “manipulative or deceptive device or contrivance,” in Section 10(b), are said to connote “knowing or intentional misconduct.”\footnote{Id. at 705.} The Court in Hochfelder, he continued, assumed that this incorporated a scienter requirement which was historically found in fraud at common law.

The dissent found two flaws in this “wooden analysis.” First, there was a desire on the part of Congress to substitute the full disclo-
sure philosophy in place of *caveat emptor*. Given this broad desire, it is difficult to read the language of Sections 17(a)(1) and 10(b) to include misrepresentations that require scienter. If intent was desired, then the word “willfully,” which Congress used elsewhere in the securities laws, was “conspicuously missing.”\textsuperscript{511} Ultimately, Justice Blackmun concluded that Congress wished to “identify a range of behavior, including but not limited to intentional misconduct, and that they admit an interpretation, in the context of Commission enforcement actions, that reaches deceptive practices whether the common-law condition of scienter is specifically present or not.”\textsuperscript{512} Moreover, Justice Blackmun pointed out that the lower courts were hopelessly divided on these issues, and thus reasonable minds could differ on the terminology Congress used.

The second response was that the Supreme Court recognized in *SEC v. Capital Gains Research Bureau*\textsuperscript{513} that scienter was not required. *Capital Gains* specifically recognized the equitable pattern of not requiring scienter. Justice Blackmun supported this line of thinking in *Capital Gains* by citing numerous commentators who had agreed with the principle for “more than a century.”\textsuperscript{514}

In addition, Justice Blackmun maintained that the significance of the common law tradition was buttressed by the state precursors of the federal securities laws. When the federal laws were being debated in 1933, many states had already enacted their own blue-sky laws, and when Congress decided to deal with the problem it drew from the experience of the state statutes. The most prominent law was the Martin Act of New York.\textsuperscript{515} Significantly, in that Act, and other similar laws, proof of scienter was not a prerequisite for relief. Justice Blackmun finalized his position by expressing, “I am convinced that Congress was aware of this tradition.”\textsuperscript{516}

Justice Blackmun then made a separate argument. The Court's decision, he said, failed to appreciate the structural interrelationship among equitable remedies in the Exchange and the Securities Acts. The pattern of both Acts was to grant to the SEC broad authority to seek enforcement without scienter. In both Acts, “state of mind is

\textsuperscript{511} Id. at 706 (footnote omitted).
\textsuperscript{512} Id. at 707.
\textsuperscript{513} See supra footnote 365 and accompanying text.
\textsuperscript{514} Id. at 710 (citations omitted).
\textsuperscript{515} N.Y. GEN. BUS. LAW §§ 352-353 (Consol. 1921).
\textsuperscript{516} Aaron, 446 U.S. at 712.
treated with some precision. Congress used terms such as 'knowing,' 'willful' and 'good faith,' when it wished to impose a state of mind requirement." Congressional omission of those terms in the statutes authorizing the SEC to sue for injunctive relief was in sharp contrast to their inclusion in the sections that allowed criminal prosecution. The majority decision allowed the SEC to gain relief for some negligent act under 17(a) of the Securities Act, but Rule 10b-5 was promulgated to fill an important gap. Rule 10b-5 was meant to apply to both purchasers and sellers under Section 10(b), whereas Section 17(a) applied only to sellers. Therefore, Justice Blackmun contended that the SEC promulgated Rule 10b-5 in order for it to operate in harmony with Section 17(a). He supported that argument with a quotation from United States v. Benjamin:

"False and misleading statements about securities 'can be instruments for inflicting pecuniary loss more potent than the chisel or the crowbar.'"

Justice Blackmun conclude his dissent by noting that the statutory language did not in any way compel the decision reached by the Court. "[Consideration of] history, statutory structure, legislative purpose, and policy all strongly favor an interpretation of § 17(a) and § 10(b) that permits the Commission to seek injunctive relief without first having to prove scienter." Thus the minority opinion was a devastating attack on the majority's reasoning.

E. Recklessness: A Continuing Issue

The Court in Aaron, like the Hochfelder decision did not decide if recklessness constituted scienter for purposes of Section 10(b). Such a refusal has left open the possibility that scienter might be flexibly construed. Indeed, some courts after Hochfelder have interpreted the requirement flexibly and found that recklessness is sufficient for scienter. The Supreme Court's response to the issue of whether recklessness will suffice for purposes of Section 10(b) and Rule 10b-5 is unclear at this point, even though recklessness satisfied the requirement

517. Id. at 713-714.
518. 328 F.2d 854 (8th Cir. 1964).
519. 446 U.S. at 716 (quoting United States v. Benjamin, 328 F.2d 854, 863 (8th Cir. 1964)).
520. 446 U.S. at 717.
of scienter in actions for fraud at common law.\textsuperscript{522}

Regardless of the outcome of the "recklessness" issue, the Aaron decision remains a strict standard of culpability in SEC injunction actions. The only gratifying thing that can be said is that if a small crack was left open, perhaps it will widen as the lower courts deal with the issue. Eventually, it might force the Supreme Court to deal with the issue and perhaps change the position it announced in Aaron.

XI. SECTION 14(a) AND RULE 14a-9: LEGISLATIVE INTENT AS A BROAD STANDARD

A. Proxy Laws: Evolution of the Rules

Proxy laws in the federal system stem from an acknowledgement by Congress that there was a need for protecting the stockholder but a lack of recognition of what laws to pass to alleviate the need. Congressional hearings that led to passage of the Securities Exchange Act of 1934 identified the serious abuses and the need:

Fair corporate suffrage is an important right that should attach to every security bought on a public exchange. Managements of properties owned by the investing public should not be permitted to perpetuate themselves by the misuse of corporate proxies, insiders having little or no substantial interest in the properties they manage have often retained their control without an adequate explanation of the management policies they tend to pursue.\textsuperscript{523}

Although Congress recognized the need, it was unable to specify in Section 14(a) the standards by which the SEC would administer the statute. Congress did realize, however, that those standards would have to be technical and complex, and therefore broad powers were granted to the SEC. The only statutory basis for federal regulation of proxies is Section 14(a) of the Exchange Act, which reads as follows:

It shall be unlawful for any person, by the use of the mails or by any means or instrumentality of interstate commerce or of any facility of a national securities exchange or otherwise, 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, to solicit or to per-


mit the use of his name to solicit any proxy or consent or au-
 thorization in respect of any security (other than an exempted 
security) registered pursuant to Section 12 of this title.\textsuperscript{524}
The only standards to deduced from the statute are those that seem 
fundamental or inherent in such terms as “public interest” and “protec-
tion of investors.”

The proxy rules that developed had their genesis in early rules 
promulgated by the SEC and have “naturally” changed as the agency 
began to recognize changing needs. In other words, any bureaucracy, 
as it functions, begins to develop more and more precise rules for its 
constituency to follow. The rules promulgated under Section 14(a) had 
been formed with one idea in mind—to assure that the shareholders of 
a company are informed of the facts regarding resolutions to be voted 
on at corporation shareholder meetings required by law. The informa-
tion is necessary, since generally there is no other way for the share-
holder to gather information about the issues in order to vote on them. 
In short, proxy laws are based fundamentally on disclosure.

One set of commentators have noted that “[i]n recent years the 
regulation of proxies has been probably the most dynamic phase of 
Securities and Exchange Commission activity.”\textsuperscript{525} One reason they 
gave was that although much of the SEC work had become quite “reg-
ularized,” many of the problems related to proxies were basically un-
resolved.\textsuperscript{526} Proxy rules have great significance because they do in fact 
relate directly to the shareholders. Professor Loss has pointed out that 
proxy rules are “very likely the most effective disclosure device in the 
SEC scheme of things.”\textsuperscript{527}

The SEC published its first set of proxy rules, known as the “LA 
Rules,” on September 24, 1935. These seven Rules were rudimentary 
and experimental. As Chairman Purcell said in the House Hearings: 
Now, of course, the Commission knew that these rules would 
not give adequate information to stockholders. It adopted the 
rules merely as a means of finding out what types of informa-
tion should be required in complying with the Congressional 
direction and also in the interim to prohibit false information 
from being circulated to stockholders. It anticipated that later 
it would be able to adopt affirmative rules of the type Con-

\textsuperscript{525}. \textsc{Cary} \& \textsc{Eisenberg}, \textsc{Corporations, Cases and Materials} 276 (5th ed. una-
brided, 1980).
\textsuperscript{526}. \textit{Id}.
\textsuperscript{527}. \textsc{L. Loss}, \textsc{Securities Regulation} 1027 (2d ed. 1961).
Because the "LA Rules" were inadequate, a new set of rules was promulgated in 1938 and published as Regulation X-14. This regulation and several amendments remained the law until the Securities Acts Amendments of 1964.

Pursuant to its rule-making authority, the SEC promulgated twelve new rules which are cited as Rules 14a-1 through 14a-12. Only Rule 14a-9 deals with fraud or misleading statements and is relevant to this Article. That rule provides:

Rule 14a-9. False or Misleading Statements

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

(b) The fact that a proxy statement, form of proxy or other soliciting material has been filed with or examined by the Commission shall not be deemed a finding by the Commission that such material is accurate or complete or not false or misleading, or that the Commission has passed upon the merits of or approved any statement contained therein or any matter to be acted upon by security holders. No representation contrary to the foregoing shall be made.

A note to Rule 14a-9 provides:

The following are some examples of what, depending upon particular facts and circumstances may be misleading within the meaning of this section:

529. L. Loss, supra note 527 at 527.
(a) Predictions as to specific future market values ["earnings or dividends" has been eliminated].

(b) Material which directly or indirectly impugns character, integrity or personal reputation, or directly or indirectly makes charges concerning improper, illegal or immoral conduct or associations, without factual foundation.

(c) Failure to so identify a proxy statement, form of proxy and other soliciting material as to clearly distinguish it from the soliciting material of any other person or persons soliciting for the same meeting or subject matter.

(d) Claims made prior to a meeting regarding the results of a solicitation. 532

It should be specifically understood that an action may be brought for any violation of the twelve proxy rules. "[A]tttempts to enjoin the voting of proxies or to undo corporate action generally include allegations of fraud in the solicitation of proxies." 533 Therefore the allegation of fraud in the solicitation of proxies is generally inseparable as a part of enforcement actions.

The proxy provisions do not include administrative stop orders. The SEC must bring an injunction action in a federal district court in order to stop the use of false and misleading material or any other breach of the proxy rules. The SEC generally uses the administrative procedures for processing proxy materials. Rule 14a-6(a), 534 for example, requires that material soliciting proxies must be filed with the SEC in advance of distribution.

B. Legislative Intent

The central point in any discussion of proxies is that proxy laws are intended to be different from the laws relating to new issues and secondary trading of securities. The House of Representatives sponsors stated that their bill was grouped under six headings: "(a) control of credits; (b) control of manipulative practices; (c) provision of adequate and honest reports to securities holders by registered corporations; (d) control of unfair practices of corporate insiders; (e) control of ex-

532. Id. § 240.14a-9.
535. The bill that would eventually become the Securities Exchange Act of 1934 after appropriate discussion and compromise with the Senate Committee and a resulting joint bill that was passed by the House and Senate.
changes and over-the-counter markets; (f) administration. The House Report discussed proxy regulation under the heading "Control of Unfair Practices by Corporate Insiders." The Report made it clear that solicitation proxies by corporate management involved a fiduciary duty between management and stockholders. Specifically the House Report said:

A renewal of investors' confidence in the exchange markets can be affected only by a clearer recognition upon the part of the corporate managers of companies whose securities are publicly held of their responsibilities as trustees for their corporations. Men charged with the administration of other people's money must not use inside information for their own advantage.

After this preliminary remark, sponsors of the bill got to the heart of their argument:

Fair corporate suffrage is an important right that should attach to every equity security bought on a public exchange. Managements of properties owned by the investing public should not be permitted to perpetuate themselves by misuse of corporate proxies. . . . Insiders have at times solicited proxies without fairly informing the stockholders of the purposes for which the proxies are to be used and have used such proxies to take from the stockholders for their own selfish advantage valuable property rights.

The Senate Report discussed intent with much the same idea:

In order that the stockholder may have adequate knowledge as to the manner in which his interests are being served, it is essential that he be enlightened not only as to the financial conditions of the corporation, but also as to the major questions of policy, which are decided at stockholders' meetings. Too often proxies are solicited without explanation to the stockholder of the real nature of the questions for which authority to cast his vote is sought.

The Senate Report continued with a salient example of a case in which the president of a corporation solicited proxies by means of a letter "which purported to describe certain transactions concerning which

536. H.R. REP. No. 1383, 78th Cong., 2d Sess. 7 (1934).
537. Id.
538. Id
539. Id at 13-14 (emphasis added).
540. S. REP. No. 792, 73d Cong., 2d Sess. 12 (1934) (emphasis added).
ratification by the shareholder was sought." The letter failed to
mention other important details. The solicitation was such a success
that not a single stockholder attended the stockholders' meeting in
person and the proxies were voted in favor of ratifying all of the acts
and proceedings taken by the directors and officers. This may be a
good example of fraud with intent, since there were insiders who
perhaps deliberately concealed from the shareholders the reasons for
which their proxies were being sought. On the other hand, such an
example may also illustrate a situation in which the insiders simply
carelessly neglected to inform the shareholders of the reasons for
which their proxies were being sought.

The same example of self-dealing by insiders was given in another
Senate report that had to do with practices on the stock exchange.
The report began with the first two sentences of the Senate report
quoted above and then detailed a proxy solicitation by the American
Commercial Alcohol Corporation. The report finally made the follow-
ing statement about the proxy: "The letter to the stockholders and the
proxy requested the stockholders to ratify the acts of the very officers
and directors who were betraying them by participating secretly in the
underwriting agreement and pool operation, from which they obtained
substantial profit." The report summarized proposed Section 14 and
concluded:

It is contemplated that the rules and regulations promulgated
by the Commission will protect investors from promiscuous
solicitation of their proxies, on the one hand, by irresponsible
outsiders seeking to wrest control of a corporation away from
honest and conscientious corporation officials; and, on the
other hand, by unscrupulous corporate officials seeking to re-
tain control of the management by concealing and distorting
facts.

The last statement, at first blush, would perhaps lead one to be-
lieve that the Senate was concerned with corporate officials who
engaged in proxy solicitation with a clear intent to deceive. Yet, although
the terms "unscrupulous," "concealing," and "distorting" seemed to
imply intent, if the Senate had wanted to indicate a conscious intent,

541. Id.
542. Id.
543. S. REP. No. 1455, 73d Cong., 2d Sess. 75 (1934).
544. See supra note 540 and accompanying text.
545. S. REP. No. 1455, 73d Cong., 2d Sess. at 75.
546. Id. at 77.
they would have done so. The Senate sought to alleviate the problem of fraud against shareholders. Thus, why would the Senate, intent on protecting the shareholder, impose the limiting concept of intent on proxy solicitation when their overall purpose was to protect the shareholder?

C. Negligence

The very fact that Congress was unable to pass a proxy statute that was specific due to the complexities and technicalities of proxies, in addition to the subsequent passage of a broad Section 14(a), has given impetus to the observation that the proxy laws were intended to be broad. Also, the fact that an "expert," the SEC, had to experiment with the regulations in order to finally arrive at meaningful and workable rules, would reinforce the point that proxy rules are complex. Although the legislative committee hearings seemed to address the blatant fraud that was occurring, none of the hearings referred to a denial of a negligence standard. Thus, a negligence standard may easily be inferred. Most importantly, however, in the argument for a negligence standard was Congress' apparent lack of sophistication in developing specific standards in light of the recognition that there was a definite need for proxy laws. Additionally, on the basis of Chapter V in this Article, it would seem unrealistic to assume that negligence was to be excluded.

XII. CASE LAW SUPPORTING A NEGLIGENCE STANDARD

A. Introduction: Private Right of Action

The number of cases and the development of case law concerned with Section 14(a) and Rule 14a-9 is negligible in comparison to the tremendous volume of case law on Section 10(b) and Rule 10b-5. However the paucity of cases does not mean that courts have not dealt clearly with Section 14(a) and Rule 14a-9. Unfortunately the Supreme Court has not ruled on any case concerning this area of securities law and thus the relevant cases are from the district courts and circuit courts of appeals.

In the important case of J. I. Case Co. v. Borak, the Supreme Court held that shareholders acting individually or derivatively can bring an action to enforce the proxy rules. The Court stated that the

purpose of Section 14(a) was to "prevent management or others from obtaining authorization for corporate action by means of deceptive or inadequate disclosure in proxy solicitation." Although neither the language of the statute nor the legislative history made specific reference to a private right of action, the Court said that Section 14(a)'s chief purposes were "the protection of investors, which certainly implies the availability of judicial relief where necessary to achieve that result," and "private enforcement of the proxy rules [providing] a necessary supplement to Commission action." Thus, Justice Clark, speaking for the entire Court, felt that it was the Court's duty "to provide such remedies as are necessary to make effective the congressional purpose."

B. Early Cases

The first case to adopt negligence as the proper standard for a Section 14(a) and Rule 14a-9 action was Richland v. Crandall, decided in 1967. Basically, the lawsuit arose out of dissatisfaction on the part of four stockholders of the George A. Fuller Company (Fuller) of New Jersey, who owned approximately .1% of the issued stock. These four were unhappy with the decision of their fellow stockholders, who owned 70.6% of the issued shares, to sell the corporation as a going concern and liquidate it in accordance with the incorporation laws of New Jersey.

Before the sale, the four plaintiffs began their suits against Fuller's directors, principal officers, and BCLM, Inc., claiming violations of the Exchange Act. The main point of the complaint was that the officers and directors gained shareholder approval through false proxy material in violation of Section 10(b) and 14(a).

Since this was one of the very first cases to be based on both Section 10(b) and Section 14(a), it is noteworthy that the court's opinion was as positive as it was. The court stated that: "The Section 10(b) claim is apparently based on the theory that violation of Section 14(a) may also constitute a violation of Section 10(b) if accompanied by a  

548. Id. at 431.  
549. Id. at 432.  
550. Id. at 433. See also, Comment, Private Rights from Federal Statutes: Toward a Rational Use of Borak, 63 Nw. L. Rev. 454 (1968).  
552. Id. at 541-42.
purchase or sale of a security." 553 The court answered this statement with the following opinion: "Since Section 14(a) deals specifically with deceptive proxy material, it may well be that Section 10(b) of the Act cannot be invoked by the plaintiffs." 554

This statement was footnoted with a positive and enlightening statement on Section 10(b) and Section 14(a): "The only difference in proof requirements would be that under the decisions in this Circuit plaintiffs, in a suit under Section 10(b), must show an intent to defraud, or at least guilty knowledge on part of the directors." 555 The reason was that Section 10(a) used language which is associated with intent to defraud, specifically, "any manipulative or deceptive device or contrivance," 556 while Section 14(a) and Rule 14a-9 do not contain this kind of language. Their language pertains to a proxy that is "false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statement therein not false or misleading." 557

After this summary, the district court delivered its most positive statement on Section 14(a) and Rule 14a-9:

Accordingly the Court is of the view, and so charged the jury upon submitting to it the class action suit for deliberation, that plaintiffs were required only to prove that the defendants knew or should have known of the statements and material facts, and the Court refused to charge that an intent to defraud need be shown. 558

Thus, the district court recognized quite emphatically in this first case that Section 10(b) was intentionally different from Section 14(a), and thus Section 10(b) required only a negligence standard.

The next case to focus on Section 14(a), Norte & Co. v. Huffines 559 involved an action against the corporate directors, alleging a violation of Section 14(a). The case was decided by the same court that had rendered the Richland opinion. The court reiterated the point made in the previous decision, albeit more in passing than as a major theme of the case, since the court found that the defendants had actual knowl-

553. Id. at 552.
554. Id. at 552-53.
555. Id. at 553 n.12 (citations omitted).
556. Id.
557. Id.
558. Id.
edge of the misstatements and omissions. "Although actual knowledge is not essential to the establishment of a claim based on Section 14(a) of the Exchange Act..." On appeal Section 14(a) was not discussed since the lower court had found intent.

The third case pertinent to Section 14(a) and Rule 14a-9 was the 1970 decision of Berman v. Thompson. This case specifically denied a good faith standard and strongly suggested a negligence standard. "To relieve the defendants of liability because they may have exercised good faith and honest business judgement in not disclosing this information would not be a furtherance of the statutory policy of full disclosure." Clearly, the court strongly felt that the shareholders were entitled to disclosure of all of the material information, not just what the directors wished to tell them. They concluded with the main point that if the management does not give out information, it cannot expect the shareholders to approve action based on that information. "If those who direct the affairs of a corporation deem it in the best interests of the corporation not to disclose certain information, then they may not solicit shareholder approval of a transaction for which that information is material."

C. Gerstle: The District Court Decision

The most important case in the judicial development of Section 14(a) and Rule 14a-9 is Gerstle v. Gamble-Skogmo, Inc. The facts of the case, although long and involved, are important to fully understand the decisions of the lower and higher courts. In Gerstle a class action suit was brought by minority stockholders of General Outdoor Advertising Co. (GOA), challenging its merger with defendant Gamble-Skogmo, Inc. (Skogmo) on the ground that stockholder approval of the merger had been obtained through a misleading proxy statement.

GOA, prior to the merger, had been the largest company in the outdoor advertising business in the United States, as well as a leading advertising concern in Canada and Mexico. Skogmo was engaged in wholesale and retail merchandising of durable and soft goods through subsidiaries, franchise dealers, and discount centers in the United

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560. Id. at 1109-1110.
562. Id. at 1035.
563. Id.
565. 298 F. Supp. at 73.
States and Canada. Between April 1961 and March 1962, Skogmo acquired 50.12% of GOA's common stock. Bertin C. Gamble, chairman of the board of directors and controlling stockholder of Skogmo, was elected to GOA's board of directors in October 1961. By April 1962, two Skogmo vice-presidents and a former consultant to Skogmo had been added to GOA's board, along with an officer, whom Gamble had hired to take charge of the sale of advertising plants.

During 1961 and 1962, problems arose for the outdoor advertising business. After an extensive study, the GOA officer in charge of sales of plants recommended that GOA's advertising plants be sold, and Gamble thereafter announced intentions to sell the less profitable ones. The plant sales officer, however, continued to solicit offers for the sale of all the plants, and by May 31, 1963, the date of the last plant sale before the merger, twenty-five of GOA's plants had been sold.

Skogmo had been studying the merits of a merger with GOA, and by May 1963 decided to seek a statutory merger whereby GOA stockholders would receive for each share of GOA stock a share of $40.00 par value preferred Skogmo stock paying dividends of $1.75 per annum and convertible into common stock. Both boards formally approved this plan on July 2, 1963.

The proxy statement was mailed to shareholders on September 11, 1963, along with notice of a special meeting of stockholders to be held on October 11, 1963. Approval of the merger was made at the October meeting and became effective on October 17, 1963. After the merger was approved, Skogmo again began to sell the plants, and by July 13, 1964, had contracts for the sale of all of the remaining plants in the United States for a total price above GOA's net worth as evidenced in the proxy statement.

Because the GOA plants could be sold at prices that were higher than the value of the plants as a going concern, the minority stockholders' acceptance of the merger terms depended primarily on Skogmo's plans for the plants that had not been sold at the date of the merger. Therefore, the plaintiffs centered their claim on the proxy statement,
asserting that it failed to disclose Skogmo's future plans about the remaining plants.

The proxy statement referred to certain indications that "demonstrated that the market value of a substantial portion of the company's plants was considerably in excess of book value." The proxy statement also looked at previous sales of GOA plants and then stated:

If the merger becomes effective, it is the intention of Gamble-Skogmo, as the surviving corporation, to continue the business of General Outdoor, including the policy of considering offers for the sale to acceptable prospective purchasers of outdoor advertising branches or subsidiaries of General Outdoor with the proceeds of any such sales, to the extent immediately available, being used to further expand and diversify operations now being conducted or which might be acquired and conducted by Gamble-Skogmo or its new, wholly-owned subsidiary, GOA, Inc. There have been expressions of interest in acquiring many of the remaining branches of General Outdoor and discussions have taken place in connection therewith, but at the present time there are no agreements, arrangements or understandings with respect to the sale of any branch and no negotiations are presently being conducted with respect to the sale of any branch.

The plaintiffs sued Skogmo for an accounting subsequent to the merger, alleging that the proxy statement contained violations of Section 10(b), Rule 10b-5, Section 14(a) and Rule 14a-9.

The district court ruled in favor of the plaintiffs. It found that the proxy was inadequate for primarily two reasons. First, Skogmo had in its possession expert appraisals of the GOA plants that had not been sold, "which showed current liquidating values of these assets at figures higher than the historical figures carried in the financial statements attached to the proxy statement, . . ." The district court agreed with the SEC's amicus curiae brief that it was the duty of Skogmo to put the appraised values of the unsold plants into the proxy statement. Second, the court, having found that Skogmo intended to sell the unsold plants soon after the merger, decided that such intention should have been disclosed to the shareholders.

In arriving at its decision, the district court analyzed Section 14(a)

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573. 478 F.2d at 1288.
574. Id.
575. 298 F. Supp. at 103.
and Rule 14a-9. First, it distinguished those items from Sections 17(a) and 12(2) of the Securities Act, saying that the latter two sections are “aimed at fraud resulting from misrepresentations by a seller to a buyer in the sales of securities.”

Also, the court analyzed Section 10(b) and Rule 10b-5, saying that they are “directed against such fraud in both sales and purchases of securities.” However, Section 14(a) and Rule 14a-9 “parallels” that of Rule 10b-5 and most of the precedents of Rule 10b-5 are applicable to Rule 14a-9. The succinct and unquestioned difference was that Section 14(a) and Rule 14a-9, “are limited to misrepresentations made in proxy material or in a statement addressed to a body of stockholders.” Section 10(b) and Rule 10b-5 are general fraud statutes, but Section 14(a) and Rule 14a-9 were created for a specific purpose—to protect the stockholders at their meetings so they can make informed decisions. “Each stockholder has a right to insist that neither he nor his fellow-stockholders be deceived when acting as a body in casting their vote.”

After the court distinguished Section 14(a) and Rule 14a-9 and Section 10(b) and Rule 10b-5, it traced the case law and said there was evidence for a scienter requirement and evidence for a negligence requirement in a Rule 10b-5 action. The main thrust of the Court’s argument was its distinction between Rule 10b-5 and Rule 14a-9. The court affirmed that, “however, the basis for incorporating scienter into a Rule 10b-5 action does not exist in a Rule 14a-9 suit.” Although the court cited cases that supported such conclusions, the more forceful argument was that a literal reading of the Section 14(a) and Rule 14a-9 failed to reveal a scienter requirement. The court asserted: “A literal reading of Section 14(a) and Rule 14a-9 failed to reveal any requirement for scienter. Negligence alone either in making a misrepresentation or in failing to disclose a material fact in connection with proxy solicitation is sufficient to warrant recovery.”

D. Gerstle: The Court of Appeals Decision

The district court’s decision in Gerstle, was appealed to the Court

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576. Id. at 96.
577. Id.
578. Id. This writer disagrees with this statement. The precedents of Rule 10b-5 are established primarily for Rule 10b-5 and are not necessarily intended for Rule 14a-9.
579. Id.
580. Id.
581. Id. at 97.
582. Id.
of Appeals for the Second Circuit. Judge Friendly, wrote the opinion for the court. Judge Friendly has a reputation for being one of the federal bench’s most distinguished judges; his opinions are lucid, well-reasoned, and authoritative—in short, no one better could have decided the case. His hesitancy in the opinion made everyone realize that there were those who felt that Section 10(b) and Rule 10b-5 should require a scienter standard. Therefore his conclusions and analysis in *Gerstle* are most important because he distinguished between 14(a) and 14a-9 and 10(b) and 10b-5 and arrived at a different standard.

The court of appeals upheld the district court’s conclusion that Skogmo had violated Rule 14a-9 when it did not adequately disclose its intention to sell the unsold plants. However, the appellate court denied the lower court’s adoption of the SEC’s position that Skogmo’s non-disclosure of the appraisal values of the remaining plants was illegal. Judge Friendly stated:

Rule 14a-9 has long carried a note giving examples “of what depending upon particular facts and circumstances, may be misleading within the meaning of the rule;” the very first is “(a) Predictions as to specific future market values, earnings or dividends. . . .” [T]he policy embodied in the note to Rule 14a-9 has consistently been enforced to bar disclosure of asset appraisals as well as future market values, earnings, or dividends.

Judge Friendly’s analysis in *Gerstle* of the fraud issue was very important, as he expanded and developed the reasoning of the district court. Judge Friendly asserted that there were four major reasons for determining that Section 14(a) and Rule 14a-9 do not need a scienter standard. First, Rule 10b-5 required more than negligence due to the use of words denoting scienter—“any manipulative or deceptive device or contrivance.” That was not the case for Section 14(a) which “contains no such evil-sounding language.”

Second, although the language of Rule 14a-9 closely paralleled the language of Rule 10b-5, neither rule specifically states that scienter is a requirement and the courts have held to the requirement of scienter for Rule 10b-5 because there “is a concern that without some such requirement the Rule might be invalid as exceeding the Commission’s author-

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583. 478 F.2d 1281 (2d Cir. 1973).
584. *Id.* at 1297.
585. *Id.* at 1299.
586. *Id.*
ity under Section 10(b) to regulate 'manipulative or deceptive devices.'” 587 In contrast, the scope of the rulemaking power given under Section 14(a) “is broad, extending to all proxy regulation 'necessary or appropriate in the public interest or for the protection of investors' and not limited by any words connoting fraud or deception.” 588

Third, it was unwise to require plaintiffs in cases like this to prove scienter, because although in Rule 10b-5 cases an intent is desirable, many corporate statements are issued without legal obligation to do so. Such actions are commendable and desirable and the broad standard of negligence would negate these voluntary and desirable disseminations of information. In contrast, in cases involving the proxy rules, especially like the instant case, the “broad standard of culpability . . . serve[s] to reinforce the high duty of care owed by a controlling corporation to minority shareholders” 589 when the proxy statement is prepared in seeking the acquiescence of the shareholders. Judge Friendly added in a footnote 590 that this was not a case involving the “hurly-burly” of election contests, but a proxy statement in which the defendant had had plenty of time to prepare.

Lastly, the fourth reason related directly to the nature of fraud in the common law. In a tort liability case at common law, when a person gave false information to someone else with the intent to influence the transaction in which the originator of the information had a pecuniary interest, the common law allowed for rescission and restitution and no proof of scienter was necessary. Judge Friendly voiced this last point forcefully, “It is unlikely that Section 14(a) and Rule 14a-9 contemplated less.” 591

Judge Friendly made a calculated and insightful analysis of Section 14(a) and Rule 14a-9. Since the Supreme Court has not ruled on this issue, the Gerstle ruling by the court of appeals is still the accepted interpretation of Section 14(a) and Rule 14a-9.

E. Gould

The next case decided after Gerstle was Gould v. American Hawaiian Steamship Co. 592 handed down in 1972. It is unnecessary to state

587. Id. (citations omitted).
588. Id.
589. Id. at 1300.
590. Id. n.19 (quoting General Time Corp. v. Talley Indus. 403 F.2d 159, 162 (2d Cir. 1968)).
591. Id. at 1300.
the facts other than to say that it was a proxy case in which Section 14(a) and Rule 14a-9 were at issue. The court, in arriving at the decision cited Gerstle as the "only known cases dealing with § 14(a)." 593 The court basically agreed with the reasoning in Gerstle594 and held that a negligence standard applied for a Section 14(a) and Rule 14a-9 violation.

Gould was heard on appeal in the Court of Appeals for the Third Circuit.595 The importance of the decision was its appearance after the famous Hochfelder decision. The question arose, whether Hochfelder and its requirement of scienter for Section 10(b) and Rule 10b-5 would affect the reasoning of a court in a Section 14(a) and Rule 14a-9 case. The court of appeals agreed with the district court that negligence was the appropriate standard under Section 14(a) and Rule 14a-9, and cited the same cases cited by the district court as previously discussed above. The court concluded that unlike Sections 10(b) and 18, "which encompass activity in numerous and diverse areas of securities markets and corporate management, Section 14(a) is specially limited to materials used in soliciting proxies." 596 The court then cited Hochfelder as "confirming" such a view and then stated specifically that, in Hochfelder:

[T]he Supreme Court pointed out that the "operative language and purpose" of each particular section of the Acts of 1933 and 1934 are important considerations in determining the standard of liability for violations of the section in question. We therefore conclude that the district court did not err in applying the standard of due diligence to determine Casey's liability in this case.597

Thus, the court of appeals agreed with the Hochfelder reasoning and applied it to confirm that Section 10(b) and Rule 14a-9 differed from Section 10(b) and Rule 10b-5 in requiring a negligence standard of liability rather than a scienter one.

F. Falstaff

One of the most recent cases concerning proxies and the standard of proof is SEC v. Falstaff Brewing Corp.598 The facts of the case were rather intricate. Falstaff Brewing Corp. (Falstaff), an independent,

593. Id. at 864.
594. Id.
595. 535 F.2d 761 (3d Cir. 1976).
596. Id. at 778.
597. Id.
publicly owned brewer, suffered severe financial losses for several years in the late 1960's and early 1970's. In 1974 Falstaff sold its San Francisco brewery to the General Brewing Corporation which was a company beneficially owned by Paul Kalmanovitz, a wealthy businessman. It was agreed that General Brewing would continue to produce beer under the Falstaff name.\(^{599}\)

After the transaction, the management of Falstaff probed Kalmanovitz to determine if he was interested in investing in Falstaff. On March 10, 1975, Kalmanovitz entered into an agreement with Falstaff, whereby he would invest ten million dollars in cash, and personally guarantee another ten million dollars in loans. In return, Kalmanovitz would receive preferred stock sufficient to give him a majority voting interest in Falstaff and an option to purchase more stock.\(^{600}\) Falstaff immediately sent a proxy statement to its shareholders, who approved of the transaction at an April 28 meeting.\(^{601}\)

After he had gained control of Falstaff, Kalmanovitz failed to report his stock acquisition to the SEC for over a year. Further, Falstaff failed to file certain required reports with the SEC and filed others that the SEC thought were materially misleading.\(^{602}\)

Then, in 1977, Falstaff issued a proxy statement to gain approval for payment of dividends on Kalmanovitz's preferred stock in common stock instead of cash. The SEC contended that this proxy misstated specific material facts and left out others, and then instituted an action to block the 1977 shareholders' meeting and to permanently enjoin Falstaff and Kalmanovitz from violating specific provisions of the Securities Acts.\(^{603}\)

Three points in the court's ruling are relevant here. First, the 1975 proxy statement was false and misleading because it violated Section 14(a) and Rules 14a-3 and 14a-9. Second the 1977 proxy statement was materially deficient in several respects and thus a further violation of Section 14(a) and Rule 14a-9. Third, both defendants violated Section 10(b) and Rule 10b-5 through their errors in the 1975 and 1977 proxy statements and in the 1975 and 1976 reports and through misstatements in a November 1975 letter that Kalmanovitz sent to Falstaff stockhold-

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599. Id. at 94,456.
600. Id. at 94,457-58.
601. Id. at 94,457.
602. Id.
603. Id. at 94,466.
ers. Concluding that there was a reasonable likelihood that the defendants would engage in further misconduct, the district court enjoined them from violating those sections and rules in the future.

Although the parties were found to have violated Section 14(a) and Rule 14a-9, nothing was specifically said in the entire decision about a negligence or scienter standard as to Section 14(a) and Rule 14a-9. The court assumed that statements made in a previous proxy which had become “false and misleading” had to be corrected by a subsequent proxy or that subsequent proxy was also false and misleading:

Section 14(a) and Rules 14a-9 and 12b-20 required that the 1977 Proxy Statement correct statements made in the 1975 Proxy Statement which were or had become false or misleading, to wit, those statements referred to in Paragraphs 10 through 15a of these Conclusions of Law. The failure of the 1977 Proxy Statement to do so rendered its [sic] materially false and misleading.

Further, because the 1977 proxy statement contained no disclosure of Kalmanovitz’s voting control of Falstaff, the district court concluded that, “[t]he failure of the 1977 Proxy Statement to do so rendered it materially false and misleading.”

It is unfortunate that the district court did not specifically refer to scienter and negligence, but it is obvious that it decided that both Section 14(a) and Rule 14a-9 allow a negligence or scienter standard, or both. The fraudulent actions of the defendants were intentional and thus the scienter element was evident. Also, since misleading actions connote negligence, the negligence element was present.

Falstaff was appealed to the Appeals Court of the District of Columbia circuit. Circuit Judge Tamm delivered the opinion for the court, and unanimously affirmed the judgment of the district court. Judge Tamm said nothing specifically about scienter or negligence in relation to Section 14(a) or Rule 14a-9 in the opinion, but mentioned that the counsel for the defendants “vigorously” tried to vacate the injunction against the defendant Kalmanovitz because he maintained that the errors on his part were due to ignorance, and not bad faith.
The court refused to deal with the issue at all and asserted: “Whether actuated by bad faith or simple ignorance of the law, he violated the law, and the pattern of past violations indicates that he is reasonably likely to do so in the future. Judge Corcoran acted properly in enjoining Kalmanovitz from future violations.”

Thus, both courts refused to deal with the issue of scienter in Section 14(a) and Rule 14a-9. It is reasonable, then, to conclude that the two courts argued for a negligence standard since the terms “bad faith” or “simple ignorance” connote a negligence standard.

G. Adams

Another recent case on point is Adams v. Standard Knitting Mills, Inc., decided by the District Court for the Eastern District of Tennessee.

Simply, the facts were that in April 1970, Chadbourn, Inc. (Chadbourn), a North Carolina hosiery manufacturer, merged with Standard Knitting Mills, Inc. (Standard), a small publicly held manufacturer. The shareholders of Standard had agreed to the merger after receiving a proxy statement describing the proposed plan. The shareholders had also received a recommendation from Standard's management favoring the merger. Finally, they had received financial statements of Chadbourn prepared by Chadbourn’s accountants, Peat, Marwick, Mitchell and Company (Peat, Marwick).

About a year after the merger, Chadbourn’s sales of hosiery dropped drastically and unexpectedly, with large losses. Chadbourn was unable to pay dividends on, or redeem, the preferred stock held by former Standard shareholders as had been contemplated under the merger agreement. The shareholders brought suit against Peat, Marwick, alleging that the proxy materials issued had contained false or misleading statements in order to gain shareholder approval of the merger.

First, the district court determined that in the standard proxy statement mailed to shareholders, the incorrect term “common” was used to describe the stock that was subject to a bank loan which restricted the payment of dividends. The court found that Peat, Marwick

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609. Id. at 80.
611. Id. at 90,352-53.
612. Id. at 90,353.
indisputably "had knowledge of the correct term well before the mailing";\textsuperscript{613} that footnote 7(c) was incorrect in describing the dividend restrictions on "common" rather than "capital" stocks; and that Peat, Marwick "did not inform Standard stockholders of the correction or anyone else."\textsuperscript{614}

In dealing with Section 14(a) and Rule 14a-9, the court decided that "the defendant [Peat] had full knowledge of the terms of the loan agreement, the indenture and the restrictions contained therein. . . ."\textsuperscript{615} Armed with this knowledge, Peat, Marwick deliberately chose to misrepresent and delete facts that were significantly material to standard shareholders.\textsuperscript{616} These actions, the court concluded, "deliberately placed [Peat, Marwick] in the role of advocacy in not presenting a complete and accurate picture."\textsuperscript{617} Thus, the district court said that Peat, Marwick's financial statements were not neutral, but "knowingly and deliberately biased," and therefore aided and abetted the proxy solicitation.\textsuperscript{618} On this basis, Peat, Marwick was held liable to the shareholder plaintiffs under "rule 14a-9 promulgated pursuant to § 14."\textsuperscript{619}

The district court refused to deal with the intent or negligence issue. Because the court found deliberate action on the defendant's part, it held the defendants liable under Rule 14a-9, based on intent. However, the court did not argue whether or not Rule 14a-9 should or should not include negligence. The court never considered it as an issue.

On appeal \textit{Adams} was decided by Circuit Judges Weick, Engel and Merritt, with Judge Merritt writing the opinion.\textsuperscript{620} Interestingly, at the beginning of the opinion, Judge Merritt stated for the court: "The primary issue is whether Peat is liable for a negligent error—the failure to point out in the proxy statement sent to stockholders of the acquired corporation that certain restrictions on the payment of dividends by the acquiring corporation applied to preferred as well as common stock."\textsuperscript{621} At no time did the district court discuss negligence as it pertains to Rule 14a-9. Judge Merritt went on to maintain that the evi-

\begin{footnotes}
\footnote{613. Id. at 90,355.}
\footnote{614. Id.}
\footnote{615. Id. at 90,369.}
\footnote{616. Id.}
\footnote{617. Id. at 90,370.}
\footnote{618. Id.}
\footnote{619. Id.}
\footnote{620. 623 F.2d 422 (1980).}
\footnote{621. Id. at 424.}
\end{footnotes}
evidence suggested only a mistake and oversight on Peat, Marwick's part, and not an intent to deceive.

Next, the issue of liability under Rule 14a-9 was discussed and the court conclude that "scienter should be an element of liability in private suits under proxy provisions as they apply to outside accountants."\textsuperscript{622} The court declined "to decide the standard of liability for the corporate issuer of proxy material."\textsuperscript{623} Thus, this case only decided whether Rule 14a-9 applied to outside accountants, not to anyone else.

The court noted several reasons for holding that outside accountants were liable under Rule 14a-9 only upon a showing of scienter, and not negligence.

(1) Outside Accountants Are Different From Corporations.

The court, through Merritt, reasoned that the accountant, unlike the corporation, does not benefit directly from the proxy vote and is not in privity with the shareholders. Moreover, the court asserted, since accountants prepare daily business financial statements that are attached to proxies, the accountant’s potential liability for minor mistakes would be great under a negligence standard.\textsuperscript{624}

(2) Rule 14a-9 Follows Rule 10b-5 and No Other Rules.

The court said that Rule 14a-9 was different from Section 12(2) of the Securities Act, which imposed liability for negligent misrepresentation in a prospectus, because Rule 14a-9 did not require actual reliance on misrepresentation by the investor.\textsuperscript{625} However, it is like Rule 10b-5, because it substituted the less exacting standard of materiality for reliance.\textsuperscript{626}

(3) Legislative History of Section 14(a) and Rule 14a-9.

Judge Merritt reviewed the Senate Report to the Exchange Act, which cited an example from the Senate Committee on Banking and Currency Report.\textsuperscript{627} He concluded that this example evidenced scienter, and found another example from the Senate

\textsuperscript{622}. Id. at 428.

\textsuperscript{623}. Id.

\textsuperscript{624}. Id.

\textsuperscript{625}. Id. at 428-29.

\textsuperscript{626}. Id. at 429 (citation omitted).

\textsuperscript{627}. S. REP. No. 1455, 73d Cong. 2d Sess. 75 (1934).
Committee on Banking and Currency, which had used the words, "unscrupulous," "concealing," and "distorting"—all of which implied knowledge or scienter. After quoting other Congressmen and a presidential aide of the era, Merritt concluded that "The common denominator of all these depictions of the problem is wrongdoing with some degree of knowledge, i.e. scienter . . . ."

(4) Congressional Intent Regarding Subsequent Amendments Indirectly Linked to 14(a).

Merritt then attempted to show that when Congress passed the Williams Act of 1968 governing tender offers, it expressed the desire that "proxy statements and tender offers be governed by the same rules and regulations." In discussing the Williams bill, the court quoted from Representative Williams of New Jersey and Senator Javits to show that Section 14(a) and Section 14(e) were intended to be governed by the same rules and logic. Merritt concluded that Section 14(e) has a scienter requirement and therefore Section 14(a) does also.

Merritt ended his decision by saying, "We conclude that 14(a) and 14(e) should be governed by the same standard of liability insofar as accountants' liability is concerned, and that an action under 14(e) requires proof of scienter." Thus, the majority opinion of the circuit court disagreed with the district court's opinion, and held that scienter was the standard for Rule 14a-9. Therefore, since the majority felt that Peat, Marwick had committed only a negligent act, it was not liable.

The dissenting opinion by Judge Weick was an extremely strong and well written opinion. Weick disagreed on two counts and was so disturbed by the majority's opinion that he did the unusual—he delivered two successive dissents.

In Judge Weick's first dissent, he disagreed with the majority opinion's reviewing and overturning the facts as found by the district court. Weick contended that it is not within the province of the appel-
late division to review the findings of a trial judge and state that they are erroneous. The district court found, Weick noted, "that Peat had acted 'willfully, with intent to "deceive" and "manipulate" and "reckless disregard of the truth,"'" 636 and these findings of fact should have been accepted by the appeals court. Weick concluded that the testimony was taken before an experienced judge:

[Who had the opportunity to and did take testimony of witnesses, observe the demeanor of the witnesses and to make credibility assessments, we are not permitted to set aside his factual findings unless we are satisfied and can demonstrate that they are not supported by substantial evidence and are clearly erroneous.] 637

This majority opinion was made, concluded Weick, in regard to the defendant's intent to defraud under Section 10(b) and Rule 10b-5, and therefore Judge Weick felt that he did not need to address the issues of Peat's liability under Section 14(a) and Rule 14a-9.

In his second dissent, 638 Weick said that the majority opinion was wrong in its interpretation of Section 14(a) and Rule 14a-9. In supporting his position, he maintained that unlike Section 10(b), neither Section 14(a) nor Rule 14a-9 "use language which would even suggest a requirement that the violator must act with scienter." 639 Weick suggested that Section 14(a) allowed the SEC to prescribe rules relating to proxies that are necessary and appropriate for the public interest and that protect the investor. Moreover, Rule 14a-9, which was prescribed by the SEC for that purpose, prohibits proxy solicitation that is "false or misleading," which Weick asserted obviously meant more than a scienter standard. Further, the SEC asserted, and Weick agreed, that there was a violation of Rule 14a-9 because of Peat's false and misleading audit. 640 Finally, the majority, contended Weick, made "short shrift" of the SEC's expertise, whereas they should have given greater deference to the SEC's interpretation of the statute, since past cases advocated that such deference be given to agency's contentions. 641

636. Id. at 437.
637. Id. at 437.
638. Id. at 446-47.
639. Id. at 447 (quoting SEC memoranda supporting its position for rehearing en banc at p. 6-7).
641. Id.
XIII. Conclusion

The economic society represented by the corporation has undergone a metamorphosis that can best be characterized by a change in property relationship so drastic that the shareholder no longer controls the corporation—instead the professional manager does. Because these changes affected the fundamental structure and philosophy of the society, a reform movement began in the 1890's by those who recognized what was happening. Their warnings were finally heeded by the New Deal, which passed the securities laws aimed at needed reforms.

In recent years, the secondary securities fraud area, Section 10(b) and Rule 10b-5, have received most of the publicity because it is the first area in which litigation has begun. But that does not mean that the proxy section, Section 14(a) and Rule 14a-9 of the securities laws, is not important. The proxy section was not simply "thrown in," but was carefully placed and kept short and general in nature, so that the SEC could experiment and try to regain from the corporations some of the rights taken from the shareholders.

The proxy laws constitute one of the most important parts of the securities laws, but they have been the least well defined and developed by the SEC and the courts. What the SEC does in the next few years may well affect the individual and his rights in corporations in the future. Conceivably, however, these matters may too big for the SEC and may instead need to be dealt with by Congress. But as far as fraud is an element in a Section 14(a) and Rule 14a-9 action is concerned, it seems clear that the fundamental importance of the proxy, demands that the law be as general as possible so that the shareholder who has lost so much can have at least a modicum of expectation from the corporate management. To impose a scienter standard is to deny this possibility. Moreover, as distinguished Judge Friendly said in the leading Gerstle case, a proxy is different from other information dispensed by the corporation since management has plenty of time to write it and send it to shareholders. A scienter standard would be altogether too confining and allow the SEC and the shareholder almost no recourse. Thus, the courts have rightly concluded that proxy laws are unique and should embody a negligence standard.

That the United States Supreme Court has imposed a scienter standard on Section 10(b) and Rule 10b-5 seems unreasonable, especially since the legislative background and various cases have indicated a negligence standard. Possibly the Supreme Court felt compelled to
protect management with a scienter standard, because the information dispersed in Section 10(b) and Rule 10b-5 cases is often rushed, and, time is of essence. In any case, the two laws—one dealing with proxy, and the other with secondary stock fraud—are different and therefore should not be treated the same.

Finally, it seems appropriate to conclude with the fundamental idea that fraud is like a specter “haunting” this Article. Fraud today must be looked at as a continuum between intent and negligence. It is a product of certain basic forces and changes that have been operating in our society for a long time, ever since the court of equity was first formulated. If the concept of responsibility for one’s actions without necessary intent were only an expedient response to social pressures, advocates, like Bucklo, who have adopted this concept so forcefully would be less frustrated. Also the differences between the traditional common law idea of necessary intent and the present-day idea of liability for actions that cause harm to others, even though there is no intent, would be less strongly expressed.

The concept of liability to individuals who have no way of protecting themselves and yet, who are necessary in the scheme of equity markets has not become a very intense issue in the law only because of the huge size of corporations and the power wielded by technological managers and stock brokerage houses, to mention but a few factors. The kind of responsibility that we are dealing with may, in fact, be a totally new concept rather than something people are giving lip service to, in order to calm “those out there” who are concerned and are being hurt.

There is much concern on the part of judges and plaintiffs. There is enough evidence for us to be forced to look at the demand, as not superficial and meaningless but a necessary response to real problems and demands for liability for actions that harm even though actual intent may not be probable in a court of law. The answer lies in the court of equity, and Section 14(a) and Rule 14a-9 and Section 10(b) and Rule 10b-5 were promulgated to address this need through our courts. The majority of courts have ruled for a negligence standard for both sets of laws. Therefore, in the proxy laws the demand has been met, and rightly so. But in the secondary securities fraud area the Supreme Court has chosen to go the other way. This quotation from the distinguished Judge Benjamin Cardozo seems appropriate as a final statement:

For the process by which law grows is above all a social pro-
cess. The individual intellect is not as desolate as it seems. The pressure that gives form to manners and morals gives form in the end to law; to judge—made law often, and when on occasion that fails, to law declared by statute. Initiative, ingenuity, idealism will help. For a time the lack of them may deflect and hinder. But the steady pressure goes on and finds in the end the responsive mind.\footnote{B. Cardozo, \textit{The Paradoxes of Legal Science} 136 (1928).}