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VOLUNTARY RECAPITALIZATIONS, FAIRNESS, AND RULE 10b-5: LIFE ALONG THE TRAIL OF SANTA FE

BY RUTHEFORD B CAMPBELL, JR.*

In corporate recapitalizations, the board of directors will sometimes propose a recapitalization plan which substantially alters the "bundle of rights" represented by preferred shares. Although these plans cannot usually be completed without the approval of a majority of the preferred shareholders, the preferred shareholders are at a disadvantage to protect their interests for several reasons. Thus preferred shareholders who are dissatisfied with the change in their rights will sometimes call upon state courts to enjoin the recapitalization on the grounds that it is unfair or fraudulent; state courts, however, have provided only slight protection for preferred shareholders. In this article, Professor Campbell examines the possibility of protecting preferred shareholders by applying rule 10b-5 of the Securities Exchange Act of 1934 to recapitalizations. He concludes that rule 10b-5 provides substantial protection to shareholders whose rights are altered in a recapitalization.

INTRODUCTION

A corporation's common shareholders often find it advantageous to alter the contractual rights of the corporation's preferred shareholders.¹ This may involve a change in dividend rights, liquidation preferences, redemption provisions, conversion rights or any other right enjoyed by the preferred share-

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¹ One commentator found 34 alterations of preferred shareholders' rights in a study of 79 preferred stocks over a 20-year period from 1932 to 1951. Conrad, *Manipulation of Share Priorities*, 8 VAND. L. REV. 55, 57 (1954). Although one may be inclined to view the alteration of the preferred shareholder contract as a phenomenon of the 1940's, cases still arise with some frequency. See, e.g., *Gruss v. Curtis Publishing Co.*, 534 F.2d 1396 (2d Cir. 1976); *Bove v. Community Hotel Corp. of Newport, R.I.*, 249 A.2d 89 (R.I. 1969).

holders.² Alternatively, there could be a substitution of an entirely new security for the existing preferred share.

Perhaps the most typical situation (or at least the situation that has attracted the most attention) involves a company with a cumulative preferred stock that has arrearages.³ If that company has a change in fortune and begins to generate earnings, the arrearages will constrain the payment of dividends to the common shareholders, since the preferred shareholders' contract requires the payment of arrearages before common shareholders are entitled to any dividend. In this situation the board of directors, which is typically elected by (and therefore representative of) the common shareholders, will sometimes propose a "recapitalization" of the corporation with the usual result that the preferred shareholders receive a new "bundle of rights" in substitution of their former rights (including the accumulated arrearages). The preferred shareholder could receive a new common stock or a new preferred stock with altered liquidation, dividend, conversion or redemption rights.⁴

There are a number of methods available to the corporation that wishes to alter the rights of its preferred shareholders. The most direct is an amendment to the articles of incorporation changing the "preferences, limitations, and . . . relative rights of the preferred shareholders."⁵ Another method involves

² In describing the right to alter shareholders' rights by an amendment to the articles of incorporation, § 58(g) of the Model Business Corporation Act permits an alteration in the "preferences, limitations, and the relative rights" of shares. MODEL BUS. CORP. ACT ANN. § 58(g) (1974 Supp.) [hereinafter cited as MBCA].

³ *Barrett v. Denver Tramway Corp.*, 53 F. Supp. 198 (D. Del. 1943), *aff'd*, 146 F.2d 701 (3d Cir. 1944); *Western Foundry Co. v. Wicker*, 85 N.E.2d 722 (Ill. 1949); *State v. Bechtel*, 31 N.W.2d 853 (Iowa 1948), *cert. denied*, 337 U.S. 918 (1949); *Dratz v. Occidental Hotel Co.*, 39 N.W.2d 341 (Mich. 1949); *Wessel v. Guantanamo Sugar Co.*, 35 A.2d 215 (N.J. Ch.), *aff'd*, 39 A.2d 431 (N.J. 1944); *Buckley v. Cuban Am. Sugar Co.*, 19 A.2d 820 (N.J. Ch. 1940); *Bove v. Community Hotel Corp. of Newport, R.I.*, 249 A.2d 89 (R.I. 1969).

⁴ For a discussion of the various problems associated with these alterations see Becht, *Alterations of Accrued Dividends*, 49 MICH. L. REV. 363, 565 (1951); Becht, *Corporate Charter Amendments: Issues of Prior Stock and the Alteration of Dividend Rates*, 50 COLUM. L. REV. 900 (1950); Becht, *Changes in the Interests of Classes of Stockholders by Corporate Charter Amendments Reducing Capital, and Altering Redemption, Liquidation and Sinking Fund Provisions*, 36 CORNELL L.Q. 1 (1950).

⁵ MBCA § 58(g) (1971) authorizes such alterations. This method was used in *Bailey v. Tubize Rayon Corp.*, 56 F. Supp. 418 (D. Del. 1944); *Barrett v. Denver Tramway Corp.*, 53 F. Supp. 198 (D. Del. 1943), *aff'd*, 146 F.2d 701 (3d Cir. 1944); *Western Foundry Co. v. Wicker*, 85 N.E.2d 722 (Ill. 1949); *State v. Bechtel*, 31 N.W.2d

the use of a "dummy" corporation; the existing corporation incorporates a new company and effects a merger of the old company into the newly formed company, exchanging a new and different security for the old preferred stock.⁶ The result is the same whichever mechanism is used: The contractual rights of the preferred shareholders are altered.

Although these alterations usually cannot be completed without the approval of a majority of the preferred shareholders,⁷ the preferred shareholders sometimes will invoke the equity power of state courts to enjoin the recapitalization, claiming that it was "unfair" or "fraudulent" with respect to them. However, the protection afforded the preferred shareholders in these suits where they have attempted to enforce some equitable constraint has been slight indeed. Courts, relying more on political predilection than analysis, have persistently rambled through the recapitalization cases, often without defining the equitable norms that constrain recapitalizations.⁸ Even in cases applying a defined norm, the analysis is consistently inadequate.⁹ The analysis often consists of a listing of the pre-

853 (Iowa 1948), *cert. denied*, 337 U.S. 918 (1949); *Franzblau v. Capital Sec. Co.*, 64 A.2d 644 (N.J. Super. Ct. 1949); *Wessel v. Guantanamo Sugar Co.*, 35 A.2d 215 (N.J. Ch.), *aff'd*, 39 A.2d 431 (N.J. 1944); *Kamena v. Janssen Dairy Corp.*, 31 A.2d 200 (N.J. Ch. 1943), *aff'd*, 35 A.2d 894 (N.J. 1944).

⁶ This technique was used in *Dratz v. Occidental Hotel Co.*, 39 N.W.2d 341 (Mich. 1949); *Bove v. Community Hotel Corp. of Newport, R.I.*, 249 A.2d 89 (R.I. 1969); *Matteson v. Ziebarth*, 242 P.2d 1025 (Wash. 1952).

⁷ *E.g.*, MBCA § 60 (1974) requires class voting when the amendment to the articles of incorporation alters the rights of preferred shareholders. Also, under the sections governing mergers, consolidations, and sales of assets, shareholders whose rights are altered are entitled to class voting. *Id.* at §§ 73, 79.

⁸ In *Franzblau v. Capital Sec. Co.*, 64 A.2d 644 (N.J. Sup. Ct. 1949) the court spoke of both "unfairness" and "bad faith" as norms applicable to a recapitalization. At another point, however, the court stated: "The fairness or unfairness of corporation action may not be considered where that action is in exercise of a power conferred upon the corporation by the Act under which it was organized [T]he Court . . . cannot operate to nullify the corporate power conferred by the law." *Id.* at 649. *See also* *Bailey v. Tubize Rayon Corp.*, 56 F. Supp. 418 (D. Del. 1944) as an example of a case in which the court apparently was unclear as to the appropriate norm to be applied.

⁹ *Hottenstein v. York Ice Mach. Corp.*, 136 F.2d 944 (3d Cir. 1943), *cert. denied*, 345 U.S. 886 (1945); *Barrett v. Denver Tramway Corp.*, 53 F. Supp. 198 (D. Del. 1943), *aff'd*, 146 F.2d 701 (3d Cir. 1944); *Goldman v. Postal Tel., Inc.*, 52 F. Supp. 763 (D. Del. 1943); *Porges v. Vadsco Sales Corp.*, 32 A.2d 148 (Del. Ch. 1943); *State v. Bechtel*, 31 N.W.2d 853 (Iowa 1948), *cert. denied*, 337 U.S. 918 (1949); *Wessel v. Guantanamo Sugar Co.*, 35 A.2d 215 (N.J. Ch.), *aff'd*, 39 A.2d 431 (N.J. 1944); *Kamena v. Janssen Dairy Corp.*, 31 A.2d 200 (N.J. Ch. 1943); *Zobel v. American Locomotive Co.*, 44

recapitalization rights enjoyed by the shareholder and a comparison of those rights with the post-recapitalization rights enjoyed by the shareholder. Then, with no attempt to quantify the value of or the weight accorded to the particular rights involved, the court concludes that the plan is or is not acceptable.¹⁰

These cases have not failed to catch the eye of legal commentators whose writings typically have demonstrated the disadvantaged position of preferred shareholders who "rebargain" their rights.¹¹ The commentators have pointed out that the board of directors has control over the payment of dividends and is normally composed of persons elected by the common shareholders, that the plan of recapitalization originates with and the timing is controlled by the common shareholders,¹² and that delay encountered by threatened litigation favors junior, over senior, equity holders.¹³ The commentators usually conclude that the power disparity between the hapless and helpless preferred shareholders and the strong and greedy common shareholders necessitates interposing some equitable constraint that limits the concessions extracted from the preferred shareholders.¹⁴ In addition, the commentators often discuss more sophisticated issues such as the measure of claims surrendered by the preferred shareholders, the measure of the new rights received by the former preferred shareholders, and the necessity (or absence thereof) for equality between the two.¹⁵

N.Y.S.2d 33 (Sup. Ct. 1943); *Bove v. Community Hotel Corp. of Newport, R.I.*, 249 A.2d 89 (R.I. 1969); *Matteson v. Ziebarth*, 242 P.2d 1025 (Wash. 1952).

¹⁰ *Bailey v. Tubize Rayon Corp.*, 56 F. Supp. 418 (D. Del. 1944); *Bowman v. Armour & Co.*, 160 N.E.2d 753 (Ill. 1959); *Dratz v. Occidental Hotel Co.*, 39 N.W.2d 341 (Mich. 1949).

¹¹ *Dodd, Accrued Dividends in Delaware Corporations—From Vested Right to Mirage*, 57 HARV. L. REV. 894 (1944); *Lattin, A Primer on Fundamental Corporate Changes*, 1 W. RES. L. REV. 3 (1949); *Meck, Accrued Dividends on Cumulative Preferred Stocks—The Legal Doctrine*, 55 HARV. L. REV. 71 (1941); *Note, Protection for Shareholder Interests in Recapitalizations of Publicly Held Corporations*, 58 COLUM. L. REV. 1030 (1958).

¹² *Dodd, Fair and Equitable Recapitalizations*, 55 HARV. L. REV. 780, 791-93 (1942).

¹³ *Brudney, Standards of Fairness and the Limits of Preferred Stock Modifications*, 26 RUTGERS L. REV. 445, 460 n.40 (1973).

¹⁴ *See, e.g., Dodd, supra* note 12, at 817.

¹⁵ *Brudney, supra* note 13; *Latty, Fairness—The Focal Point in Preferred Stock Arrearage Elimination*, 29 VA. L. REV. 1, 24-51 (1942); *Note, A Standard of Fairness for Compensating Preferred Shareholders in Corporate Recapitalizations*, 33 U. CHI. L. REV. 97 (1965).

These writings have, however, served limited purposes only. While they provide work, intellectual stimulation and a degree of notoriety for the authors, and further serve as research tools for other persons writing in the area, the impact of these scholarly endeavors on the courts has been slight. Especially when one considers that commentators such as Dodd,¹⁶ Latty,¹⁷ Lattin¹⁸ and, of late, Brudney¹⁹ have written in this area, the failure of courts to deal with the problem is particularly unfortunate.

The purpose of this article is to suggest that rule 10b-5 of the Securities Exchange Act of 1934²⁰ provides preferred shareholders who are involved in a recapitalization with more protection than can be obtained from state common law. Although in the last few years there has been an erosion of the protection afforded by rule 10b-5,²¹ this writer is convinced that the rule applies to recapitalizations and, accordingly, requires the disclosure of all material information surrounding a recapitalization. Finally, notwithstanding the Supreme Court's decision in the *Santa Fe Industries* case,²² rule 10b-5 can provide an effective constraint against an unfair recapitalization.

¹⁶ Dodd, *supra* note 11; Dodd, *supra* note 12.

¹⁷ Latty, *Exploration of Legislative Remedy for Prejudicial Changes in Senior Shares*, 19 U. CHI. L. REV. 759 (1952); Latty, *supra* note 15.

¹⁸ Lattin, *supra* note 11.

¹⁹ Brudney, *supra* note 13.

²⁰ 17 C.F.R. § 240.10b-5 (1976). Rule 10b-5 states:

It shall be unlawful for any person, directly or indirectly, by the use 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.

²¹ *Sante Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977); *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438 (1976); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976); *Foremost McKesson, Inc. v. Provident Sec. Co.*, 423 U.S. 232 (1976); *Rtndeau v. Mosinee Paper Corp.*, 422 U.S. 49 (1975); *United Hous. Foundation, Inc. v. Foreman*, 421 U.S. 837 (1975); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975).

²² *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977).

I. A SINGLE COMPANY RECAPITALIZATION AS A PURCHASE OR SALE OF A SECURITY

In 1952 the Second Circuit Court of Appeals decided the now-famous case of *Birnbaum v. Newport Steel Corp.*,²³ in which it refused to extend the protection of rule 10b-5 to plaintiffs who were neither purchasers nor sellers of securities.²⁴ Although the tenure of *Birnbaum* was sometimes in doubt,²⁵ the Supreme Court later decided *Blue Chip Stamps v. Manor Drug Stores*,²⁶ in which it adopted the purchaser-seller requirement of *Birnbaum*. In *Blue Chip* the Court refused to extend the protection of rule 10b-5 to plaintiffs who claimed they had refrained from buying shares of the Blue Chip Stamp Company because of material misstatements made by the company. Thus, a recapitalization must constitute a "purchase" or "sale" within rule 10b-5 in order for a shareholder whose rights are altered in a recapitalization to recover under that rule.

The definitions of "purchase"²⁷ and "sale"²⁸ that are contained in the 1934 Act are of no assistance in deciding whether a recapitalization falls within the constraints of rule 10b-5. The Securities Act of 1933, however, provides authority for construing the meaning of these terms, and it appears that this authority can be used as a basis for defining the limits of "purchase" or "sale" under rule 10b-5.²⁹ Under rule 145 of the Securities Act of 1933, "offer" and "sale" are defined to include the submission "for the vote or consent of . . . security holders a plan . . . for [a] reclassification of securities of such corporation . . . , which involves the substitution of a security for another security."³⁰ Thus it appears that any recapitalization signifi-

²³ 193 F.2d 461 (2d Cir. 1952).

²⁴ The court stated that § 10(b) of the Securities Exchange Act of 1934 "was directed solely at that type of misrepresentation or fraudulent practice usually associated with the sale or purchase of securities rather than fraudulent mismanagement of corporate affairs, and that Rule X-10b-5 extended protection only to the defrauded purchaser or seller." 193 F.2d at 464.

²⁵ See generally Lowenfels, *The Demise of the Birnbaum Doctrine: A New Era for Rule 10b-5*, 54 VA. L. REV. 268 (1968).

²⁶ 421 U.S. 723 (1975).

²⁷ 15 U.S.C. § 78c(a)(13) (1970) defines "purchase" to "include any contract to buy, purchase or otherwise acquire" a security.

²⁸ 15 U.S.C. § 78c(a)(14) (1970) defines "sale" to "include any contract to sell or otherwise dispose of" a security.

²⁹ 1 A. BROMBERG, *SECURITIES LAW: FRAUD* § 6.5(2), at 138.1, n.95 (1971).

³⁰ 17 C.F.R. § 230.145 (1976).

cantly affecting the rights of shareholders is a sale of securities under the 1933 Act and so requires registration under the provisions of that Act. It is interesting to note that even prior to the adoption of rule 145,³¹ the position of the Commission was that such reclassifications were sales for the purposes of the antifraud provisions.³²

The 1933 Act provides still more authority for classifying recapitalizations as sales. Section 3(a)(9) exempts from the registration provision "[a]ny security exchanged by the issuer with its existing security holders exclusively"³³ The obvious inference to be drawn from this exemption is that such exchanges involving a single corporation do involve purchases and sales of securities within the 1933 Act; otherwise, there would have been no need for the exemption.

Additionally, the merger cases decided under rule 10b-5 provide authority for classifying recapitalizations as purchases or sales. Those cases have uniformly held that the shareholders of the acquired company were purchasers and sellers of securities and, accordingly, that those shareholders were afforded the protection of rule 10b-5.³⁴ This position was affirmed by the Supreme Court in *SEC v. National Securities, Inc.*³⁵

It is obvious, however, that the analogy between single-company recapitalizations and mergers involving two separate companies is not complete. A merger affects the investment of a shareholder in two distinct ways. First, it alters the corporation in which he has invested. Instead of owning an interest in a company that makes tennis balls, a shareholder may end up

³¹ Rule 133, the "no sale" rule, was repealed by rule 145 in 1972.

³² SEC Release No. 33-3420, 1 FED. SEC. L. REP. (CCH) ¶ 3090.565 (Aug. 2, 1951). One author stated that "the Commission originally believed that the 'no sale rule' dictated a holding that mergers were outside the ambit of general anti-fraud provisions such as Section 10(b)." Comment, 69 COLUM. L. REV. 906, 912 (1969).

³³ 15 U.S.C. § 77c(a)(9) (1970).

³⁴ In *Swanson v. American Consumer Indus., Inc.*, 415 F.2d 1326 (7th Cir. 1969) the court stated: "It is no longer open to question that the exchange of shares in connection with a merger or sale of assets constitutes a 'purchase or sale' within the meaning of Section 10(b) and Rule 10b-5." *Id.* at 1330. See also *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579 (5th Cir. 1974); *Mader v. Armel*, 402 F.2d 158 (6th Cir. 1968); *Dasho v. Susquehanna Corp.*, 380 F.2d 262 (7th Cir. 1967); *Gerstle v. Gamble-Skogmo, Inc.*, 298 F. Supp. 66 (E.D.N.Y. 1969); *Simon v. New Haven Board & Carton Co.*, 250 F. Supp. 297 (D. Conn. 1966); *H.L. Green Co. v. Childree*, 185 F. Supp. 95 (S.D.N.Y. 1960).

³⁵ 393 U.S. 453 (1969).

owning an interest in a company that makes tennis balls *and* coffee pots. Second, the bundle of rights represented by the share of stock may have changed significantly. For example, the shareholder may have had preferred stock in the acquired company and thus was entitled to liquidation preference, dividend preference, etc. His ownership in the acquiring company may be, and often is, of a different nature. It may be in the form of junior equity, with or without voting rights, or it may even consist of debt securities. Thus, the shareholder's claims against the corporation and his rights among the various investors in the corporation may be drastically changed in the merger situation. A recapitalization, on the other hand, alters the shareholder's rights in the second way only. He is still an investor in the same company. It is his rights in that company that have been changed.

Notwithstanding the fact that the analogy between mergers and recapitalizations is not complete, the reasons are compelling for treating the two situations similarly. In both instances shareholders are making investment decisions; by casting their votes they are deciding whether to retain their existing "bundle of rights." Although the alteration of the rights of a shareholder in a merger situation includes an alteration in the group of assets the corporation owns,³⁶ that fact alone should not be determinative of the existence of a "sale." Rather, one should focus on the fact that the rights of the shareholder can be significantly altered in both recapitalizations and mergers. One need only read the "classic" recapitalization cases³⁷ to understand that shareholders are affected significantly (and often adversely) by recapitalizations.³⁸ Accordingly, those shareholders who are required to vote for or against a proposed recapitalization need the special fraud protection provided by rule 10b-5.

In holding that a merger was a sale, the Seventh Circuit stated that "the complex nature of a merger enhances the opportunities for fraud and this increases the need for antifraud

³⁶ In *SEC v. National Sec., Inc.*, 393 U.S. 453, 467 (1969) the Court stated that a merger "resulted in their [the shareholders] losing their status as shareholders in Producers and becoming shareholders in a new company."

³⁷ See the cases cited *supra* in notes 3, 5, 6, 8, 9 and 10.

³⁸ In 1 L. LOSS, *SECURITIES REGULATION* 514 (student ed. 1961), the author indicates that such alterations would be sales for purposes of the 1933 Act.

protection.”³⁹ Arguably, the opportunity for fraud is even greater in recapitalization because of the usual absence of appraisal rights⁴⁰ and because the realities of power and politics of recapitalization cause preferred shareholders to be in a significantly disadvantaged position.⁴¹

In determining whether a recapitalization is a purchase or sale within the meaning of rule 10b-5, one is not limited to analogy and secondary authority (although such precedent is most helpful), since there are a limited number of cases in which direct consideration is given to the question of whether a recapitalization involves a sale of securities. In one such case, *In re Penn Central Securities Litigation*,⁴² the holders of Penn Central Company (Railroad) exchanged their stock for stock in Penn Central Holding Company (Holding), which had been formed by shareholders in Railroad and had no assets. The plaintiffs, shareholders in Railroad, claimed that since the recapitalization significantly altered their rights as shareholders, it was a purchase or sale of a security. The plaintiffs emphasized that the recapitalization had changed their preemptive rights, cumulative voting rights, and the par value of their stock.⁴³

The district court held that the “reorganization [did] not constitute a purchase or sale under § 10(b) or Rule 10b-5

³⁹ *Dasho v. Susquehanna Corp.*, 380 F.2d 262, 267 (7th Cir. 1967).

⁴⁰ Under the Model Act, appraisal rights are available only for mergers, consolidations and sales of assets. MBCA § 73 (1974). If, of course, the recapitalization were effected by a merger, consolidation, or sale of assets with a “shell corporation” (i.e., a corporation with no assets), appraisal rights would be available.

⁴¹ See Brudney, *supra* note 13.

⁴² 347 F. Supp. 1327 (E.D. Pa. 1972), *aff'd*, 494 F.2d 528 (3d Cir. 1974).

⁴³ Plaintiffs claimed the following differences between the Railroad and Holding stock:

(1) Railroad stock consisted of one class . . . while Holding Co.’s articles . . . provide for two classes [one of which was preferred] . . . The creation of authorized preference stock placed the common stockholders of Holding Co. in a lower priority classification . . . (2) Railroad stock had preemptive rights which Holding Co. common stock does not. (3) Railroad’s capital stock account was carried at \$10 per share while the common stock of Holding Co. is carried at a stated value of \$1 per share. (4) Common stockholders of Holding Co. are entitled to cumulative voting in the election of directors while the stockholders of Railroad did not have this right. (5) Holding Co. has fewer classes of and a shorter term of office for directors than did railroad.

347 F. Supp. at 1337.

. . ."⁴⁴ because the changes were merely "internal corporate action" that "could have been accomplished by amending the articles of incorporation . . ."⁴⁵ The court stated that "such internal corporate action has never been considered to fall within the statutory coverage of § 10(b) or Rule 10b-5."⁴⁶ The court distinguished the reorganization from the typical merger (which the court recognized was subject to rule 10b-5) by stating:

For the purposes of § 10(b) and Rule 10b-5, the critical characteristic of a traditional merger is the combination of assets of two corporate structures and the resulting change in stockholders' interests. Internal corporate changes alone cannot accomplish the same alteration in the nature of the corporate entity and the stockholders' interest.⁴⁷

The plaintiffs changed their emphasis on appeal to the Third Circuit⁴⁸ and claimed that the transaction was within rule 10b-5 because the reorganization resulted in the loss of their appraisal rights, obstructed their ability to intervene in the bankruptcy proceedings of Railroad, and permitted diversification by Holding, which previously had not been available to Railroad. The Third Circuit held, however, that the reorganization was not within the scope of section 10(b).

What is unclear from the Third Circuit's opinion is whether a single company recapitalization could ever trigger rule 10b-5. At some points the language of the court indicates that a significant alteration in the rights of the shareholder would be a purchase or sale within the meaning of rule 10b-5.⁴⁹ In other passages, however, the opinion seems to characterize all recapitalizations as "internal corporate restructuring," which does not constitute a purchase or sale within rule 10b-5.⁵⁰

In a subsequent case, *Schnorbach v. Fuqua*,⁵¹ the plaintiffs attempted to distinguish *Penn Central* and to convince the

⁴⁴ *Id.* at 1338.

⁴⁵ *Id.* at 1337.

⁴⁶ *Id.*

⁴⁷ *Id.* at 1338.

⁴⁸ Penn Cent. Sec. Litigation, 494 F.2d 528 (3d Cir. 1974).

⁴⁹ *Id.* at 534, 537.

⁵⁰ *Id.* at 538, 539.

⁵¹ 70 F.R.D. 424 (S.D. Ga. 1975).

court that a reverse stock split was a sale within the meaning of rule 10b-5. Under the terms of the exchange, each owner of 100 shares of 10 cents par value common stock would exchange for 1 share of \$10 par value common stock. The court held, however, that the plaintiffs did not "establish that FTI was changed sufficiently after the Plan of Recapitalization to constitute, in effect, a 'new' entity analogous to a corporation surviving a merger."⁵²

In at least one case, *Ingenito v. Bernec Corp.*,⁵³ a court indicated that a recapitalization is within rule 10b-5 if the altered rights are significant. In *Ingenito* the court stated:

Without attempting to define the precise contours of a § 10(b) event, we find that threshold § 10(b) jurisdiction is established where, as here, there is alleged a substantial modification of an investment contract creating fresh rights and obligations of the parties and the investor gives some consideration, either a promise of future payments or the relinquishment of a significant right.⁵⁴

Obviously, the cases just mentioned are not conclusive. Although *Ingenito* clearly states that "substantial modifications" of shareholder rights are sales, the language of the *Penn Central* cases and the *Schnorbach* case seems to limit the concept of purchase or sale to situations in which new assets are added to the company. Nevertheless, it seems clear that any significant alteration of a shareholder's rights should be deemed a sale under rule 10b-5.

First, there is substantial authority supporting such a position.⁵⁵ In addition to the *Ingenito* case, it appears that the

⁵² *Id.* at 439.

⁵³ 376 F. Supp. 1154 (S.D.N.Y. 1974).

⁵⁴ *Id.* at 1182. Unfortunately, the value of the *Ingenito* case as precedent is limited by the unique investment contract involved in the case. The plaintiffs had purchased cattle with the sellers (defendants) providing certain maintenance services. It was the alteration of these maintenance contracts that generated the litigation. Thus, drawing factual analogies from *Ingenito* to the more usual alteration of a right of a shareholder is difficult.

⁵⁵ In addition to the material cited in the text, there is other authority supporting the notion that significant recapitalizations are sales of securities. The most helpful case is *SEC v. Associated Gas & Elec. Co.*, 24 F. Supp. 899 (S.D.N.Y. 1938), in which the court held that the alteration of the maturity date of a debt security was a sale within the meaning of the Securities Act of 1933 and consequently required compliance with the registration provisions of that act. Both *U.S. v. Wernes*, 157 F.2d 797 (7th

position of the Securities and Exchange Commission is that such alterations do constitute a sale.⁵⁶ Also, one cannot ignore the authority under the 1933 Act in which it appears plain that such alterations of significant rights involve a sale of securities.⁵⁷ Finally, the analogy provided by the merger cases lends significant support to the notion that recapitalizations are sales under rule 10b-5.⁵⁸

Beyond the weight of precedent, there are other compelling reasons for defining a recapitalization as within the constraints of rule 10b-5. To do so would, for example, provide a remedy for persons harmed by nondisclosure and misstatements that occur in connection with a recapitalization. Without such a remedy, innocent shareholders who have approved a recapitalization because of misstatements and nondisclosure would be denied relief and thus would be treated unfairly.

This notion can best be demonstrated by an example. Assume that X corporation has a capital structure consisting of common and preferred stock. The preferred stock has an annual dividend of \$2 per share plus the right to share equally with the common shareholders all earnings in excess of the amount necessary to satisfy the fixed \$2 dividend. Further, preferred has a liquidation preference of \$100. X's board of directors decides it would be advantageous to the common shareholders to stop sharing the excess profits with the preferred, because management anticipates a significant increase in income. In order to obtain the necessary vote of the preferred shareholders, management of X decides to increase the liquidation preference to \$150 and states that because X has lost its

Cir. 1946) and *World Wide Energy Ltd.* [1971-72 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 78,648, are somewhat confusing and therefore limited in value. Professor Loss had indicated that, at least under the 1933 Act, the alteration of significant parts of the shareholders' contracts would be a sale of a security. 1 L. Loss, *supra* note 38, at 514. Another author has stated, however, that "[a]n amendment changing stockholders' rights does not constitute a purchase or sale." A. JACOBS, *THE IMPACT OF RULE 10b-5*, § 117.02, at 5051 (1974).

⁵⁶ In response to a no-action request, the Staff of the Division of Corporation Finance of the SEC "was unable to conclude that a new security is not being offered" when a company amends its articles so as to make non-voting securities voting. *First Pyramid Life Ins. Co. of Am.*, 382 SEC. REG. & L. REP. (BNA) C-1 (Dec. 15, 1976).

⁵⁷ See notes 29-33 and accompanying text *supra* for a discussion of the 1933 Act.

⁵⁸ See notes 34 and 35 and accompanying text *supra* for a discussion of the merger cases.

largest customer, liquidation of X is a real possibility. In fact, X has not lost its largest customer and has just signed a contract with another large customer, which greatly increases the projected earnings of X.

If the preferred shareholders approve this recapitalization, it is difficult to conclude that preferred shareholders should be denied recovery under rule 10b-5. Clearly, there is a need to allocate fairly any loss that the preferred shareholders suffer because of the misstatements of management. It seems manifestly unfair to deny preferred shareholders the right to a remedy under rule 10b-5 if the misstatements resulted in the approval of a recapitalization unfavorable to preferred shareholders. The innocent preferred shareholders should not bear that loss.

In addition to insuring a proper allocation of loss, the availability of rule 10b-5 would have a second and somewhat related beneficial effect on recapitalizations. Because a corporation (and its management) would incur liability under rule 10b-5 for failure to disclose any material information about the recapitalization, the rule would encourage the disclosure of information to the preferred shareholders and thus insure that they have available the information essential to make an informed investment decision. Obviously, responsible management and corporate counsel engaged in the recapitalization would exercise care to disclose all material inside information.

In light of the power and politics of the recapitalization, this forced disclosure is significant. As was earlier mentioned, the preferred shareholders are somewhat at the mercy of the more powerful common shareholders in a recapitalization proceeding. The problem is exacerbated by the fact that the preferreds usually will not have access to the same information about the company as will the commons who are proposing the recapitalization. As a result, the corporation (which seems to be a euphemism for the common shareholders) could combine a display of power with a failure to disclose material information in order to cudgel and cajole the preferreds out of their rights. Although forced disclosure would not diminish the raw power of the commons, the accuracy of the corporate picture presented to preferreds could make them more tenacious in rebargaining their rights. Referring to the previous hypothetical, the preferreds would realize that liquidation is not a signif-

icant danger and that the earnings outlook for the company is much improved. Obviously that information would be significant in deciding which terms of the rebargain the preferreds would be willing to accept.

In summary, any single company recapitalization that significantly alters the rights of shareholders should be deemed a purchase or sale of securities and fall accordingly within the protection of rule 10b-5. Such an approach would be consistent with at least some precedent and would help ameliorate the power disparity present in most recapitalizations.

II. MATERIAL MISSTATEMENTS AND NONDISCLOSURES

As was discussed in the foregoing section, the application of rule 10b-5 to recapitalizations would forbid the use of material misstatements and nondisclosures in connection with management's attempt to secure the necessary votes to effect a recapitalization. Its practical effect would be to force any company attempting to rebargain the significant rights of its preferred shareholders to take steps reasonably calculated⁵⁹ to insure that all preferred shareholders have all material information about the particular transaction. Absent such action, the company would risk a violation of rule 10b-5.

Since a company would be liable only to disclose facts which are "material," the impact of rule 10b-5 is limited by the definition of materiality. In *TSC Industries, Inc. v. Northway, Inc.*,⁶⁰ the Supreme Court apparently settled the dispute over the definition of materiality⁶¹ by holding: "[A]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote."⁶² The problem, of course, is applying this rather general norm to a particular recapitalization.⁶³

⁵⁹ As a legal matter, merely unreasonable conduct on the part of the company would not be a basis for 10b-5 liability after *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), which rejected negligence as a sufficient basis for recovery under rule 10b-5. Sound counsel, however, would cause issuers to use reasonable care in disclosing all material facts.

⁶⁰ 426 U.S. 438 (1976).

⁶¹ Compare *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1301-02 (2d Cir. 1973) and *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579, 603-04 (5th Cir. 1974) with *TSC Indus., Inc. v. Northway, Inc.*, 512 F.2d 324, 330 (7th Cir. 1975).

⁶² 426 U.S. at 449.

⁶³ It should be noted that the *TSC Industries* case was decided under rule 14a-9

Engaging in extensive discussion of factual patterns which may be material in various recapitalizations is beyond the scope of this article. However, in order to demonstrate the value of applying rule 10b-5 to recapitalizations it is necessary at least to describe briefly examples of the types of disclosures which would be necessitated by the rule.

In a recapitalization, a shareholder decides whether to surrender an existing bundle of rights (the give-up) in exchange for a new bundle of rights (the receipt). Accordingly, any fact that significantly affects the value of either the give-up or the receipt should be deemed material and should be disclosed by the company to shareholders voting on the recapitalization. Clearly, then, facts that have a significant impact on corporate income would be material and should be made available to the shareholder.⁶⁴ For example, the preferred shareholders of X corporation may be presented with a proposal to alter the dividend preferences and cumulative rights of their preferred stock. Because those provisions are designed to provide protection for the preferreds in times of economic stress, the preferred shareholders would need to know the company's economic outlook in order to determine intelligently whether the exchange is advantageous. If the outlook for the company is gloomy, the shareholder may be reluctant to surrender such protections; if the outlook is bright, the value of such rights is diminished.

Another fact that would seem to be material in most recapitalizations would be a change in the asset value of the corporation,⁶⁵ since it can have a significant impact on the value of

of the Securities Exchange Act of 1934. Although that rule applies only to the solicitation of proxies from securities registered under the 1934 Act, the elements necessary for recovery under rule 14a-9 and rule 10b-5 are similar. *See, e.g., Mills v. Elec. Auto-Lite Co.*, 396 U.S. 375 (1970) (involving rule 14a-9) and *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128 (1972) (involving rule 10b-5). *See also* *Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 480 F.2d 341 (2d Cir. 1973), in which the Second Circuit used 10b-5 definitions to decide a case under § 14(e) of the Securities Exchange Act of 1934.

⁶⁴ There are a number of examples of facts that may affect the income of a corporation and thus be deemed material. *See SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968); *Ganigan v. Taylor*, 344 F.2d 781 (1st Cir. 1965). *Cf.* 1 A. BROMBERG, *SECURITIES LAW: FRAUD* § 7.4(4)(b) (1971) (materiality of corporate acquisitions and their impact on the value of the corporation).

⁶⁵ *Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 480 F.2d 341 (2d Cir. 1973) (involving § 14(e) of the 1934 Act, but the court followed the principles developed under rule 10b-5 regarding the elements of violations); *Speed v. Transamerica Corp.*, 99 F. Supp. 808 (D. Del. 1951).

both the give-up and the receipt. For example, to the extent that the asset value of a corporation is substantial, a liquidation preference in a preferred shareholder's contract provides real protection because it permits a preferred shareholder to recognize value even in the face of the economic failure of the corporation. Therefore, in order to evaluate whether a surrendered or altered liquidation preference is significant, the shareholder needs to know the real value of the assets underlying the preference. Without such information a preferred shareholder who believes that there are insufficient assets to cover his liquidation preference may concede a portion of that preference. Quite obviously, the preferred shareholder would be less willing to concede part of his liquidation preference if there were real assets sufficient to satisfy the preference.

In addition to factors that indicate the company has certain earning capabilities or asset value, there are other types of disclosures that would have to be made by the company if rule 10b-5 were deemed applicable to statutory recapitalizations. Any manifestations of the value of either the give-up or the receipt that are inconsistent with the proposed exchange and that are known to management should be revealed to the voting shareholders.⁶⁶ Thus, for example, if the management has unsuccessfully attempted to place the new securities at the price of fifty dollars but values them at seventy-five dollars for the purposes of the exchange, failure to reveal the attempted placement of the stock may be the nondisclosure of a material fact that could generate 10b-5 liability.

These examples are not exhaustive of the type of disclosure that must be made under rule 10b-5. They are sufficient to demonstrate, however, the value of applying rule 10b-5 to recapitalizations. If management were permitted to propose a recapitalization plan without adequate disclosure of material facts, preferred shareholders might unintentionally approve a plan that is contrary to their self-interest. Requiring the disclosure of all material facts surrounding a recapitalization will benefit preferred shareholders by providing them with the in-

⁶⁶ *Childs v. RIC Group, Inc.*, [1971-72 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 93,333 (D. Ga. 1970); *Kardon v. National Gypsum Co.*, 73 F. Supp. 798 (E.D. Pa. 1947).

formation necessary to make an informed judgment about the recapitalization.

Beyond enabling the preferred shareholders to make an informed judgment, forcing complete disclosures in a recapitalization may have another related beneficial effect. It may give the otherwise disadvantaged preferred shareholders additional clout to counter the advances of the common shareholders. To the extent that management is required to disclose facts indicating that the recapitalization is unfair, preferred shareholders will be less willing to accept the bargain. Thus, for example, it will be more difficult for the corporation to obtain the preferreds' consent to lower their liquidation preference if management is required to reveal that there are sufficient assets available to satisfy the present, larger liquidation preference and that management intends to liquidate as soon as the liquidation preference is altered.

III. RULE 10b-5 AND FAIRNESS

Notwithstanding the fact that the rule 10b-5 disclosure requirements may give the preferred shareholders the information necessary to make an informed judgment and may also provide them with some facts to use in the bargaining process, the common shareholders and their surrogates still possess the raw power to extract substantial concessions from the preferred. As a practical matter, the scattered and unorganized preferred shareholders have little chance to repel the advances of the organized, well-financed and powerful common shareholders.⁶⁷ It is difficult for preferred shareholders to reject a plan of recapitalization proffered by management in situations where management recommends the plan and implicitly (or perhaps explicitly) threatens to limit dividends if the plan is not approved.⁶⁸

History indicates that this opportunity for advantage has not escaped the watchful eye of the common shareholders. Especially in times of economic stress⁶⁹ and in periods of cyclical

⁶⁷ See BRUDNEY & CHIRELSTEIN, *CORPORATE FINANCE CASES AND MATERIALS* 210 n.v (1972).

⁶⁸ Dodd, *supra* note 12; Brudney, *supra* note 13.

⁶⁹ *Goldman v. Postal Tel., Inc.*, 52 F. Supp. 763 (D. Del. 1943); *Matteson v. Ziebarth*, 242 P.2d 1025 (Wash. 1952).

business changes,⁷⁰ management has been inclined to propose and effectuate recapitalizations involving substantial shareholder rights.⁷¹ Importantly, these proposed recapitalizations have come at times when the particular provision that is the subject of the recapitalization proposal provides needed protection for the preferred shareholder. Thus, for example, in *Goldman v. Postal Telegraph, Inc.*,⁷² an alteration of the preferred's liquidation right was proposed at the very time that liquidation was a distinct reality for Postal. Similarly, in *Western Foundry Co. v. Wicker*,⁷³ management proposed a recapitalization eliminating accrued dividends and making the preferred stock non-cumulative. This was done because there were large dividend arrearages owed to the preferred and those arrearages were preventing the common shareholders from enjoying the benefits of the increased income of the company.

In light of the power disparities between the common and preferred shareholders and in view of the common shareholders' propensity to exploit that disparity, it is clear that some limit should be imposed on the power of the common shareholders to extract concessions from the disadvantaged preferred shareholders. Unhappily, neither the state legislatures nor the state courts have imposed any meaningful constraints on recapitalizations.

State legislatures have imposed certain procedural requirements on the recapitalization mechanism,⁷⁴ including the requirement that the majority of the affected shares approve the recapitalization. Although these procedural protections af-

⁷⁰ *Barrett v. Denver Tramway Corp.*, 53 F. Supp. 198 (D. Del. 1943); *Western Foundry Co. v. Wicker*, 85 N.E.2d 722 (Ill. 1949); *Dratz v. Occidental Hotel Co.*, 39 N.W.2d 341 (Mich. 1949).

⁷¹ *Gruss v. Curtis Publishing Co.*, 534 F.2d 1396 (2d Cir. 1976); *Hottenstein v. York Ice Mach. Corp.*, 136 F.2d 944 (3d Cir. 1943); *Bailey v. Tubize Rayon Corp.*, 56 F. Supp. 418 (D. Del. 1944); *Barrett v. Denver Tramway Corp.*, 53 F. Supp. 198 (D. Del. 1943); *Goldman v. Postal Tel., Inc.*, 52 F. Supp. 763 (D. Del. 1943); *Porges v. Vadsco Sales Corp.*, 32 A.2d 148 (Del. 1943); *Western Foundry Co. v. Wicker*, 85 N.E.2d 722 (Ill. 1949); *State ex rel. Weede v. Bechtel*, 31 N.W.2d 853 (Iowa 1948); *Dratz v. Occidental Hotel Co.*, 39 N.W.2d 341 (Mich. 1949); *Franzblau v. Capital Sec. Co.*, 64 A.2d 644 (N.J. 1949); *Wessel v. Guantanamo Sugar Co.*, 35 A.2d 214 (N.J. 1944); *Kamena v. Janssen Dairy Corp.*, 31 A.2d 200 (N.J. Ch. 1943); *Zobel v. American Locomotive Co.*, 44 N.Y.S.2d 33 (1943); *Bove v. Community Hotel Corp. of Newport, R.I.*, 249 A.2d 89 (R.I. 1969); *Matteson v. Ziebarth*, 242 P.2d 1025 (Wash. 1969).

⁷² 52 F. Supp. 763 (D. Del. 1943).

⁷³ 85 N.E.2d 722 (Ill. 1949).

⁷⁴ *E.g.*, MBCA §§ 58-60 (1974).

ford some relief to the preferred shareholders, the remedy is partial at best. At the heart of the problem is the power disparity between the common shareholders and the preferred shareholders, and there is no rule forbidding the coercion of the preferred shareholders by common shareholders.⁷⁵ Accordingly, the common shareholders can use their advantageous political position to force preferred shareholders to vote for a recapitalization that is contrary to their best interests; this, of course, neutralizes any protection afforded by voting requirements.

In considering the absence of any legislative protection, it is also important to recall that shareholders who have their preferred contract altered in a recapitalization usually do not have the right to dissent and exercise appraisal rights.⁷⁶ Although there is debate as to the effectiveness of appraisal rights,⁷⁷ such rights do permit the dissenting shareholder to obtain "fair value" for his securities and would seem to put at least some pressure on the common shareholders to give a reasonably fair bargain to the preferred shareholders.

It is also unfortunate that courts have not filled this hiatus in legislative protection by imposing any meaningful equitable constraints on the rebargaining process. Relying more on political predilection than on cogent reasoning, courts generally have held that recapitalization plans meet the state norms of fair-

⁷⁵ The exception to this is NEB. REV. STAT. § 21-2059 (1974), which states: In case of any proposed amendment of the articles of incorporation changing the existing priority rights, or provisions of any class of shares outstanding, a shareholder adversely affected may apply to any court of competent jurisdiction to restrain and enjoin the corporation from adopting such amendment on the ground of fraud or unfairness. On the filing of such application the court shall, upon notice to all shareholders, hold a hearing upon the issue of the alleged fraud or unfairness of the proposed amendment, at which all shareholders shall have the right to appear and produce evidence. After such hearing the court shall enjoin the proposed amendment if the proponents fail to show that, to a reasonable probability, it is fair, just, and equitable to all shareholders affected thereby.

It is interesting that in its more than 25 years of existence, this statute has never been construed and has never served as more than the basis for comment by scholars. See, e.g., Brudney, *supra* note 13, at 457 n.32; BRUDNEY AND CHIRELSTEIN, *supra* note 67.

⁷⁶ For example, there is no such right under the Model Act.

⁷⁷ Compare Manning, *The Shareholder's Appraisal Remedy: An Essay for Frank Coker*, 72 YALE L.J. 223, 228-29, 260-61 (1962) with Eisenberg, *The Legal Roles of Shareholders and Management in Modern Corporate Decision-Making*, 57 CALIF. L. REV. 1, 71-74, 84-86 (1969).

ness.⁷⁸ These decisions are often based on reasons that border on the absurd⁷⁹ and are often rendered in the face of rather clear evidence that the exchange ratio was uneven.⁸⁰ Even in those situations where courts have enjoined the recapitalizations,⁸¹ the analyses often become so clouded that it is difficult to determine exactly which theory the court is applying.⁸² Some courts even have gone so far as to enjoin a recapitalization on an apparent technicality in order to avoid making the difficult decision of whether the recapitalization met the fairness test.⁸³

Thus, there is no effective state mechanism (either legislative or judicial) available to protect preferred shareholders from an unfair alteration in their preferred stock contract. It becomes apparent, then, that one must look elsewhere for constraints that can protect the preferred shareholders from the power of the common shareholders.

The availability of rule 10b-5 as a remedy for unfairness has been the subject of scholarly comment⁸⁴ and court decisions,⁸⁵ although no court has ever applied the concept directly to recapitalizations. Rather, the concept has been applied in

⁷⁸ *Bailey v. Tubize Rayon Corp.*, 56 F. Supp. 418 (D. Del. 1944); *Goldman v. Postal Tel., Inc.*, 52 F. Supp. 763 (D. Del. 1943); *Dratz v. Occidental Hotel Co.*, 39 N.W.2d 341 (Mich. 1949); *Franzblau v. Capital Sec. Co.*, 64 A.2d 644 (N.J. 1949); *Bove v. Community Hotel Corp. of Newport, R.I.*, 249 A.2d 89 (R.I. 1969); *Matteson v. Ziebarth*, 242 P.2d 1025 (Wash. 1952).

⁷⁹ In *Western Foundry Co. v. Wicker*, 85 N.E.2d 722 (Ill. 1949), the elimination of accumulated dividends was held to be fair, apparently because the plan was overwhelmingly approved by preferred shareholders, there was no earned surplus out of which dividends could have been paid and the common shareholders had sacrificed 50% of the par value of their shares. *Id.* at 722-23.

⁸⁰ *Goldman v. Postal Tel., Inc.*, 52 F. Supp. 763 (D. Del. 1943); *Dratz v. Occidental Hotel Co.*, 39 N.W.2d 341 (Mich. 1949); *Matteson v. Ziebarth*, 242 P.2d 1025 (Wash. 1952).

It is probable that most recapitalizations altering any substantial right of the preferred shareholder are motivated by a desire on the part of common shareholders to acquire part of the value of the preferred shareholder. See *Dodd*, *supra* note 12, at 783-84, where he states, "Usually the primary motive for such recapitalizations is not to facilitate new issues of common shares but to improve the prospect of dividends for the holders of the existing common shares."

⁸¹ *E.g.*, *Kamena v. Janssen Dairy Corp.*, 31 A.2d 200 (N.J. Ch. 1943).

⁸² *E.g.*, *State ex rel. Weede v. Bechtel*, 31 N.W.2d 853 (Iowa 1948); *Wessel v. Guantanamo Sugar Co.*, 35 A.2d 215 (N.J. Ch. 1944).

⁸³ *Bowman v. Armour & Co.*, 160 N.E.2d 753 (Ill. 1959).

⁸⁴ *Sherrard, Fiduciaries and Fairness Under Rule 10b-5*, 29 VAND. L. REV. 1385 (1976).

⁸⁵ *E.g.*, *Popkin v. Bishop*, 464 F.2d 714 (2d Cir. 1972).

the context of companies that are going private,⁸⁶ selling⁸⁷ or exchanging⁸⁸ their own securities at unfair prices, or merging with another company.⁸⁹ Prior to *Santa Fe Industries, Inc. v. Green*,⁹⁰ the lower federal courts could not agree as to whether rule 10b-5 was a fairness constraint in the context of a purchase or sale of securities. Some courts held that unfairness alone was sufficient to violate rule 10b-5,⁹¹ while other courts demanded that there must be some deception (*i.e.*, some misstatement or nondisclosure of material facts) in order for the rule to be violated.⁹²

At least on the surface, *Santa Fe Industries, Inc. v. Green*,⁹³ appears to have resolved this dispute. In that case, Santa Fe Industries, Inc. (Santa Fe) merged with its subsidiary Kirby Lumber Company (Kirby). Because Santa Fe owned ninety-five percent of the stock of Kirby the merger was effected as a short form merger under applicable Delaware law,⁹⁴ and the minority shareholders of Kirby were offered \$150 per share of common stock. Although under state law there were appraisal rights available to the dissenting shareholders,⁹⁵ the minority shareholders of Kirby did not pursue that remedy. Instead, they sought a remedy under rule 10b-5, alleging that the merger was undertaken for the purpose of freezing out the minority interest in Kirby at a wholly inadequate price.⁹⁶ Significantly, the case came to the Supreme Court "on the premise that the complaint failed to allege a material misrepresen-

⁸⁶ *Green v. Santa Fe Indus., Inc.*, 533 F.2d 1283, *rev'd*, 430 U.S. 462 (1977); *Marshall v. AFW Fabric Corp.*, 533 F.2d 1277 (2d Cir. 1976), *vacated*, 429 U.S. 881 (1976).

⁸⁷ *Schoenbaum v. Firstbrook*, 405 F.2d 200 (2d Cir.), *rev'd en banc*, 405 F.2d 215 (2d Cir. 1968), *cert. denied*, 395 U.S. 906 (1969); *Ruckle v. Roto Am. Corp.*, 339 F.2d 24 (2d Cir. 1964).

⁸⁸ *O'Neill v. Maytag*, 339 F.2d 764 (2d Cir. 1964).

⁸⁹ *Popkin v. Bishop*, 464 F.2d 714 (2d Cir. 1972).

⁹⁰ 430 U.S. 462 (1977).

⁹¹ *Green v. Santa Fe Indus., Inc.*, 533 F.2d 1283 (2d Cir. 1976), *rev'd*, 430 U.S. 462 (1977); *Marshall v. AFW Fabric Corp.*, 533 F.2d 1277 (2d Cir. 1976), *vacated*, 429 U.S. 881 (1976).

⁹² *Marsh v. Amanda Corp.*, [1975-1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,496 (1976); *Popkin v. Bishop*, 464 F.2d 714 (2d Cir. 1972); *O'Neill v. Maytag*, 339 F.2d 764 (2d Cir. 1964).

⁹³ 430 U.S. 462 (1977).

⁹⁴ DEL. CODE § 253 (1974).

⁹⁵ DEL. CODE § 262 (1974).

⁹⁶ 430 U.S. at 467.

tation or material failure to disclose,"⁹⁷ and thus the case squarely presented the question of whether a plaintiff had a remedy under rule 10b-5 for a merger that was unfair in its terms.

The Supreme Court denied relief under rule 10b-5. The Court held that recovery under rule 10b-5 was limited by the language of the underlying statute, section 10(b) of the 1934 Act. Because that statute only addresses situations wherein the use of a "manipulative or deceptive device or contrivance" is involved, the Court stated that "the claim of a fraud and fiduciary breach in this complaint states a cause of action under any part of rule 10b-5 only if the conduct alleged can be fairly viewed as 'manipulative or deceptive' within the meaning of the statute."⁹⁸

The Court was unable to find any conduct that could be considered "deceptive" since the case came to them on the premise that the complaint did not allege material misrepresentation or material failure to disclose. Further, the Court held that there had not been sufficient allegations of "manipulative" conduct. After describing manipulation as "virtually a term of art," the Court limited the scope of that term "to practices . . . that are intended to mislead investors by artificially affecting market activity."⁹⁹ Because the freeze-out did not create such activity, the Court held that there was no manipulation within the meaning of section 10(b).

Although *Green* holds that unfairness alone does not violate rule 10b-5, this writer is convinced that the disclosure requirements of rule 10b-5 provide substantial protection from unfair recapitalizations and, further, provide remedies for the preferred shareholder who is cudgled into accepting an unfair bargain. While these disclosure requirements do not impose exact standards of fairness, they do establish parameters of general fairness that can protect the preferred shareholders from the substantial concessions they often are required to make in a recapitalization.

⁹⁷ *Id.* at 474.

⁹⁸ *Id.*

⁹⁹ *Id.* at 476. Six of the Justices joined in Part IV of the decision, in which other reasons for not extending rule 10b-5 were cited. *Id.* at 477-80. These appear to be dicta, since the Court admitted that "[t]he language of the statute is . . . 'sufficiently clear in its context' to be dispositive here" *Id.* at 476.

Briefly, the analysis supporting such a remedy is as follows: The application of rule 10b-5 to recapitalizations requires that there be no material nondisclosures or misstatements made to shareholders in connection with a proposed recapitalization. It would be a material misstatement if management proposed a recapitalization and represented to the shareholders that it was "fair" when the terms of the recapitalization were, in fact, unfair to preferred shareholders. Even if management were able to refrain from opining as to the fairness of the terms of the exchange, rule 10b-5 might still be violated if a recapitalization that were substantially unfair were presented to shareholders, since the board of directors in proposing the recapitalization implicitly represents that the terms are fair. Accordingly, whenever the board of directors of a corporation proposes a recapitalization, the board will, either directly or by implication, opine as to the fairness of the terms of the recapitalization. To the extent that the terms are unfair, therefore, there has been a misstatement that should be actionable under rule 10b-5 (if, of course, the other elements of the action are present). This analysis, however, requires extensive explanation.

Under the Model Business Corporation Act, an alteration of the rights of preferred shareholders requires that the board of directors authorize the proposed amendment to the articles and then submit that proposal to the shareholders for their approval.¹⁰⁰ If the board of directors represents to the shareholders that the particular exchange is "fair" when, in fact, the exchange ratio is unfair, that would be a material misstatement and, accordingly, a violation of rule 10b-5.

In *Bowman v. Armour & Co.*,¹⁰¹ the directors adopted a resolution that changed the redemption rights of preferred shareholders from the right to receive \$115 plus accrued and unpaid dividends to the right to receive one \$120 principal value debenture and one stock warrant. The company indicated that the alteration in the redemption right would be followed by a redemption of the preferred stock, and thus the preferred shares were, in effect, exchanged for a debenture and a warrant. It appears in that case that the fair value of the

¹⁰⁰ MBCA § 59 (1974).

¹⁰¹ Unreported case from the Superior Court of Cook County (1959), *rev'd*, 160 N.E.2d 753 (Ill. 1959).

debenture and warrant may have been 20% less than the value of the preferred stock.¹⁰² Accordingly, it would have been a material misstatement for management to state that the recapitalization was "fair," since the disparity between the give-up and the receipt was substantial. Such a material misstatement should be actionable under rule 10b-5.

There are at least two ways a corporation engaged in an unfair recapitalization may attempt to protect itself from liability under rule 10b-5. The first is to disclose all basic information about the company and the proposed recapitalization. If management then urges adoption of the unfair plan and states that the plan is "fair," it could be argued that any reliance by preferred shareholders on management's statement would be unjustifiable. Because any plaintiff that unjustifiably relies on a misstatement is barred from recovery under rule 10b-5,¹⁰³ arguably management could limit its exposure under the rule by massive factual disclosure.

It seems clear, however, that such disclosures should not bar a plaintiff's recovery under rule 10b-5. Notwithstanding the availability of contradictory factual information that may be supplied to preferred shareholders, management's recommendation of fairness could have an impact on a reasonable shareholder's decision to approve the recapitalization. First, management has an inside position, access to information that may not be readily available to shareholders, and an instinct for the future of the company. Because of this, management's statements of fairness may have special significance for shareholders. In addition, while one may wish to debate the question of whether management technically owes a fiduciary duty to the preferred shareholders,¹⁰⁴ it is clear that preferred share-

¹⁰² *Bowman v. Armour & Co.* is reproduced in BRUDNEY & CHIRELSTEIN, *CORPORATE FINANCE CASES AND MATERIALS* 178 (1972). The statement that the discrepancy in value between the debentures and the preferred stock was about 20% is based on information reported by the authors. *Id.* at 185.

¹⁰³ For a discussion of the requirement that the plaintiff must rely justifiably on the defendant's misstatement in order to be able to recover under rule 10b-5, see Campbell, *Elements of Recovery under Rule 10b-5: Scienter, Reliance, and Plaintiff's Reasonable Conduct Requirement*, 26 U. S.C. L. REV. 653 (1975).

¹⁰⁴ A recent Delaware case stated directly that "those who control the corporate machinery owe a fiduciary duty to the minority in the exercise thereof over corporate power and property." *Singer v. Magnavox Company*, 380 A.2d 969, 976 (Del. Supr. 1977).

holders have entrusted their funds to management and have a reasonable expectation that management will faithfully guard their interests in the corporation. To the extent that management does not fulfill this expectation, preferred shareholders usually can sue derivatively to enforce their rights.¹⁰⁵ These expectations reasonably generate credibility for management's recommendation of fairness, even if that recommendation could not be supported by the data provided the shareholders. In short, management's inside position and special relationship to preferred shareholders combine to justify a shareholder's reliance on management's representation of "fairness" (notwithstanding the fact that a sophisticated analysis of the basic information supplied to the shareholders would expose the unfairness).

Additionally, it is not clear that merely *negligent* conduct by a plaintiff will bar his recovery under rule 10b-5. Because the *Hochfelder* case held that merely negligent conduct by a *defendant* is not actionable under rule 10b-5,¹⁰⁶ some courts¹⁰⁷ and commentators¹⁰⁸ have indicated that a *plaintiff* who is merely negligent should not be barred from recovery. To hold otherwise, it is thought, would cause the loss to fall on the less blameworthy party, since a plaintiff who was merely negligent would then be barred from recovering from a defendant who intentionally misstated facts. If, therefore, even a negligent plaintiff will still be permitted to recover, it will be even more difficult to bar a plaintiff who relies on management's opinion of fairness, since such reliance would, at most, be classified as negligence.

Another technique available to protect management from a 10b-5 claim in a recapitalization situation involves the use of an outside and independent analyst to express his opinion as to the fairness of the exchange ratio. Under the *Hochfelder*

Traditional corporate lore is that management owes a fiduciary duty to the corporation, which can be enforced by shareholders in a derivative action. Some acts by management, however, can result in direct suits by shareholders against management. See N. LATTIN, *THE LAW OF CORPORATIONS* 272-315, 410-63 (2d ed. 1971).

¹⁰⁵ Typically, statutes dealing with the right to bring derivative suits do not distinguish between preferred and common shareholders. *E.g.*, MBCA § 49.

¹⁰⁶ *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

¹⁰⁷ *Dupuy v. Dupuy*, 551 F.2d 1005 (5th Cir. 1977); *Holdsworth v. Strong*, 545 F.2d 687 (10th Cir. 1976).

¹⁰⁸ Campbell, *supra* note 103, at 664-69.

case,¹⁰⁹ the Supreme Court held that there could be no recovery under rule 10b-5 for conduct of the defendant that was merely negligent. In the recapitalization situation, therefore, a plaintiff must demonstrate that the declaration of fairness by the management was made with a degree of culpability in excess of negligence. If the management of a company engaged in a recapitalization hires a reputable investment banker willing to opine that the exchange ratio is fair,¹¹⁰ that opinion may effectively insulate management from any claim that the degree of culpability required under *Hochfelder* was met. In that situation it probably would be difficult to prove that management's opinion of fairness, if based on the analysis of an expert investment banker, could even be classified as negligent. Clearly, it would not meet the standard of recklessness or intent necessary to satisfy *Hochfelder*.¹¹¹

In light of this, there is the possibility that a clever and aggressive management may shop around until it finds a firm that is willing to give the opinion desired by management as to the fairness of the particular recapitalization. An example of this is found in *Levin v. The Great Western Sugar Co.*,¹¹² which involved a merger between two affiliated companies. In that case, the terms of a merger were submitted to Dillon, Read & Co. for an opinion as to the fairness of the terms of the merger. Dillon was unable to state that the merger was fair and equitable to certain shareholders, so management simply hired Kidder, Peabody & Company, which was able to approve the

¹⁰⁹ *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

¹¹⁰ The procedure of obtaining professional advice in the computation of exchange ratios is common in merger cases. For example, in the now famous case of *Mills v. Elec. Autolite Co.*, 396 U.S. 375 (1970), the plan of merger and the exchange ratio was submitted to Standard Research Consultants, which is a subsidiary of Standard and Poor's Corporation. Because that firm was able to opine that the particular merger was fair and equitable to the Electric Autolite shareholders, the proxy material of Electric Autolite stated: "The Board of Directors of Electric Autolite believes the plan of merger to be fair and equitable to the shareholders of Electric Autolite . . ." This proxy statement is reprinted in W. CARY, 1976 SUPPLEMENT TO CASES AND MATERIALS ON CORPORATIONS 6 (4th ed. 1969).

¹¹¹ Although the Court in *Hochfelder* clearly held that negligence was not actionable under rule 10b-5, the Court specifically reserved the question of whether recklessness is sufficient for a recovery under rule 10b-5. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 194 n.12 (1976).

¹¹² 406 F.2d 1112 (3d Cir. 1969).

merger after some alteration in the terms.¹¹³

One should not imagine, however, that the availability of alternate analysts enables management to obtain outlandish opinions. At least if management stays with reputable investment banking houses, the difference in the recommended exchange ratios among the analysts may not vary significantly.¹¹⁴ The *Levin* case demonstrates the limits within which management may find itself while searching for a favorable opinion. In *Levin*, Dillon, Read & Co. refused to recommend the fairness of a ratio giving the particular shareholder 3/10 of a share of common stock and one share of preferred paying \$1.75 per year. Dillon did conclude, however, that "it was in the ball park."¹¹⁵ The subsequent approval of the plan by Kidder, Peabody occurred only after the company had increased the amount of common received to 1/3 share and increased the dividend on the preferred to \$1.87. Since the earlier offer was deemed to be "in the ball park" by Dillon, obviously the second offer must have been even closer.

Levin would indicate, therefore, that there may not be substantial differences among the exchange ratios that different analysts recommend as fair. Because reputable investment banking firms could incur liability for outlandish opinions as to value and because the firms take pride in their professional reputations, the ratios recommended as "fair" by such firms should be reliable and thus provide protection for the preferred shareholders. As a result, management, in some attempt to insulate itself from 10b-5 liability, may inadvertently engage in a procedure that militates against unfairness to preferred shareholders in the rebargaining process.

If management recommends an exchange as fair and does not utilize an investment banking firm, the application of rule 10b-5 is more direct; consequently, management's exposure to liability would probably increase. In this situation, a recommendation from management that the exchange is "fair" should be considered a material misstatement if the exchange

¹¹³ Even with this change, Dillon, Read was unable to opine as to the fairness of the exchange.

¹¹⁴ Obviously, it is difficult to find support for the statement that reputable investment banking firms probably would not vary significantly in the exchange ratios they would recommend as fair. There is agreement with this proposition among the very few lawyers this author consulted who were familiar with this area.

¹¹⁵ *Levin v. Great W. Sugar Co.*, 406 F.2d at 1115.

ratio is substantially unfair. There would be liability under rule 10b-5 if the plaintiff could show that the recommendation as to the fairness was made with sufficient culpability to satisfy *Hochfelder*.¹¹⁶

Although *Hochfelder* held that mere negligence on the part of the defendant was not sufficient for recovery under rule 10b-5, such a standard would not completely insulate management. Management would not be safe recommending a recapitalization as fair when the exchange ratio is patently unfair, since inferences of culpability could arise from such action. As the disparity between the value of the give-up and the receipt increases, it would be difficult for management to establish that its representations of fairness were merely negligent. Again, therefore, although rule 10b-5 may not enforce exact standards of fairness, it may establish limits that protect preferred shareholders from substantially unfair recapitalizations.

Management may attempt to contain its liability under rule 10b-5 by refraining from making any representations of fairness concerning its proposed recapitalization. It is unclear, however, whether such defensive tactics could protect management if the proposed recapitalization were in fact unfair. In the first place, it may be difficult for management to refrain from making some representations about the fairness of the exchange at some time during the alteration process. Even if management did not make explicit statements as to fairness in the proxy solicitation material (or perhaps even refrained from soliciting proxies at all) it would be difficult for management to avoid some discussion and defense of its proposal at the shareholders' meeting called to approve the plan of recapitalization.

Even in the unlikely event that management could avoid making direct statements as to the fairness of the terms of the recapitalization, it is not clear that management could effectively avoid liability under rule 10b-5. Under the Model Act a recapitalization, whether accomplished by an amendment to the articles of incorporation¹¹⁷ or by a merger into a dummy corporation,¹¹⁸ requires that the board of directors adopt a reso-

¹¹⁶ 425 U.S. 185 (1976).

¹¹⁷ MBCA § 59 (1974).

¹¹⁸ MBCA § 71 (1974).

lution approving the recapitalization and submit that resolution to the shareholders for their approval. As discussed earlier, both the management and the board of directors of a corporation have a special relationship with the shareholders, and this relationship generates some duty to protect the interests of the preferred shareholders. In light of this fact, preferred shareholders who are the subject of a recapitalization should be permitted to indulge in the presumption that the recapitalization proposed by the board of directors is fair. Thus when the board of directors "adopt[s] a resolution setting forth the proposed amendment and . . . direct[s] that it be submitted to a vote of a meeting of shareholders,"¹¹⁹ the reasonable presumption, especially in light of the duties owed to the shareholders by the board of directors, is that the particular proposal is fair. To the extent that such a proposal is unfair and that unfairness is not revealed to the shareholders, there is a misstatement or nondisclosure within the meaning of rule 10b-5.

If the foregoing analysis is correct and the board of directors (by adopting a resolution recommending a particular recapitalization) implicitly certifies the exchange as fair, the availability of rule 10b-5 as a constraint against an unfair exchange ratio would be the same as in the situation where a direct statement of fairness has been made by management. Therefore, if the plaintiff could demonstrate that management's culpability is sufficient to satisfy the *Hochfelder*¹²⁰ standard, the plaintiff would be able to recover. As in the direct misstatement situation, a substantially unfair exchange ratio should be considered demonstrative of fault sufficient to come within the *Hochfelder* criterion, since such a discrepancy clearly implies that management knows such an exchange ratio is unfair and thus inconsistent with its implied representation of fairness.

Admittedly, it is this last part of the analysis that is most difficult to defend, and at least one district court opinion seems to reject the notion that management owes an obligation to characterize certain transactions as unfair. In *Goldberger v. Baker*,¹²¹ the plaintiff alleged that nondisclosures and misstate-

¹¹⁹ MBCA § 59(a) (1974).

¹²⁰ 425 U.S. 185 (1976).

¹²¹ [1977-1978 Transfer Binder] FED. SEC. L. REV. (CCH) ¶ 96,203.

ments had been made in connection with certain securities transactions. Specifically, the claim was that the company failed to disclose that it had "received less than fair and adequate consideration for . . . [certain] loans."¹²² Further, there were allegations that the company had failed to disclose that other, prior transactions would "substantially damage" and "decrease the earnings" of the corporation.¹²³

The court held that this complaint did not state a cause of action, since "[i]t allege[d] only that the terms were unfair To hold that such an allegation was sufficient would be tantamount to asking defendants to 'characterize' the transactions with 'pejorative' words, and the failure to use such descriptions is not a 10b-5 violation."¹²⁴ Finally, the court stated that the "[d]efendants cannot be liable for a mere failure to say that their deal was a bad one. This also is not an adequate allegation of deception under Rule 10b-5."¹²⁵

In addition to *Goldberger*, one cannot avoid some consideration of the recent trend of the Supreme Court, which has been to constrict significantly the scope of rule 10b-5. Beginning after its decision in the *Affiliated Ute* case,¹²⁶ the Court has undertaken a substantial reduction in the coverage of the securities laws in general, and rule 10b-5 in particular, and in so doing seems to have developed the rule that the defendant always wins.¹²⁷ Accordingly, this entire analysis may be subject to criticism as inconsistent with that trend.

Nevertheless, there are cases in which representations of fairness have been considered significant by courts. For example, in *Mills v. Electric Auto-Lite Co.*, the Seventh Circuit declared that it was materially misleading for management to recommend a merger as "fair and equitable to the shareholders" when management failed to disclose that there was a conflict of interest.¹²⁸ In *Dennison Mines Ltd. v. Fiberboard*

¹²² *Id.* at p. 92,425.

¹²³ *Id.*

¹²⁴ *Id.* at p. 92,426.

¹²⁵ *Id.* at p. 92,427.

¹²⁶ *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972), expanded rule 10b-5 by holding that reliance could be presumed from materiality.

¹²⁷ For a discussion of these cases, see Lowenfels, *Recent Supreme Court Decisions Under the Federal Securities Laws: The Pendulum Swings*, 65 GEO. L.J. 891 (1977).

¹²⁸ 403 F.2d 429 (7th Cir. 1968), *remanded on other grounds*, 396 U.S. 375 (1970).

Corp.,¹²⁹ another court held it misleading for management to report that Lehman Brothers found a merger fair when it was not revealed that Lehman's opinion was based on asset evaluation that had been supplied by management and not independently investigated by Lehman. Finally, in *Tanzier v. Haynie*,¹³⁰ the plaintiffs claimed a violation of rule 10b-5 in connection with a merger. Although the court held only that all the allegations taken together stated a cause of action, the court seemed especially interested in management's representation of fairness on the terms of the exchange. The court characterized the plaintiffs' allegations as including an assertion of "an array of deception and omissions that are alleged to have rendered materially misleading defendants' repeated assurances that the merger price was 'fair and equitable.'"¹³¹ The court stated that "where there is . . . an affirmative representation by fiduciaries that they have determined a price to be fair and equitable, matters that otherwise might not have to be disclosed may require airing."¹³²

While none of these cases is precisely on point with the recapitalization situation, the cases do demonstrate that representations of fairness have been considered important by courts dealing with corporate reorganizations. In each case the court seemed to assume that the representation had an impact on shareholders and thus necessitated certain actions on the part of management in order to dampen the deception of the statements. Accordingly, these cases may be considered as precedent for this writer's thesis, notwithstanding that the trend of the Supreme Court is toward defining a limited role for rule 10b-5.

In addition to this precedent, at least some courts have not abandoned rule 10b-5 as a remedy for the compelling case. An example is *Goldberg v. Meridor*,¹³³ a case in which the plaintiff, who was a shareholder of Universal Gas & Oil Company

¹²⁹ 388 F. Supp. 812 (D. Del. 1974).

¹³⁰ 405 F. Supp. 650 (S.D.N.Y. 1976).

¹³¹ *Id.* at 654.

¹³² *Id.*

¹³³ [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,162. There are other cases in which lower federal courts have interpreted liberally the recent Supreme Court decisions and trend. See, e.g., *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033 (7th Cir. 1977) (recklessness is sufficient for recovery under rule 10b-5).

(UGO), alleged that UGO sold stock to its parent company, Maritimcor, for less than the fair value of the stock. One glaring problem in plaintiff's 10b-5 theory, however, was identifying the deception demanded by *Green*, since the board of directors of UGO was controlled by the parent, Maritimcor, and thus knew of the undervaluation of the stock of UGO. The court held, however, that the deception requirement of *Green* could be satisfied by alleging deception on the shareholders of UGO, even though those shareholders had no vote on or control over the issuance of the stock to Maritimcor.¹³⁴ It appears, therefore, that at least some courts may be amenable to applying rule 10b-5 to compelling cases, even if the limits of *Green* and the concept of deception must be stretched.¹³⁵

The strongest argument in favor of this writer's thesis is not precedent, however. Rather, it is policy: There is a need to ensure that shareholders who are presented with a proposed recapitalization are given the sufficient, accurate, and intelligible information necessary to enable them to decide whether to exchange their existing bundle of rights for a new bundle of rights. In fact, this policy is the very essence of the *Green* decision, since *Green* clearly recognized that rule 10b-5 is designed to discourage material misstatements and nondisclosures. Accordingly, any decision that encourages full and accurate disclosures is consistent with the policy of rule 10b-5 as interpreted in *Green*.

In charting the boundaries of rule 10b-5, courts should accommodate the realities that exist in particular situations and, accordingly, should discourage misstatements and nondisclosures that *realistically* affect persons involved in securities transactions. If the management of a company involved in a recapitalization states, "This recapitalization is fair," that statement can have an impact on persons determining whether to approve the recapitalization, and management should therefore be held accountable for that statement under rule 10b-5.

¹³⁴ The court stated: "[W]e do not read *Green* as ruling that no action lies under Rule 10b-5 when a controlling corporation causes a partly owned subsidiary to sell its securities to the parent in an unfair transaction and fails to make a disclosure or, as can be alleged here, makes a misleading disclosure." [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,162 at p. 92,265.

¹³⁵ For a similar decision in the Seventh Circuit, see *Wright v. The Heizer Corp.*, [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,101 (7th Cir. 1977).

Even if management also discloses other material information about the company and the terms of the exchange, still management should not be permitted to make such representations of fairness with impunity, if the exchange ratio is substantially unfair. To grant immunity for such misstatements would encourage management to propose an unfair exchange ratio and to inundate the shareholders with reams of documents disclosing all information about the company, accompanying this with a short but prominent statement encouraging the shareholder to approve the recapitalization since "it is fair to all concerned and in the best interests of the company." Realistically, such actions by management would have an impact on shareholders, who may well be baffled by the factual disclosures and would rely on the representation of management, who, after all, are charged with the duty of protecting the interests of shareholders.

There are also sound policy reasons why the management of a company proposing an unfair recapitalization should be forced to disclose the unfairness in direct terms and should not be permitted to avoid liability merely by saying nothing. In general terms, the most compelling reason is that such disclosures would provide shareholders with meaningful information on which to base their decision to accept or reject the proposed recapitalization. It would be useful for shareholders involved in a recapitalization to receive a statement from management concerning the fairness of the proposed exchange. Although other, more basic information would also be material to the shareholders, clearly any shareholder would like to have management's objective and intelligible assessment of the fairness of the recapitalization, since management's inside position may give it certain instincts about the future of the company that are not accurately reflected by raw data.

More importantly, however, one should not overlook the fact that many shareholders simply cannot evaluate a prospectus or other disclosure documents and determine whether a particular exchange ratio is fair. Disclosures of raw data may often be meaningless to shareholders, who have neither the training nor the expertise necessary to determine the fairness of the exchange proposed by management. It would be sound policy to interpret rule 10b-5 in such a way as to encourage a form of disclosure that is understandable to less sophisticated

shareholders. It would therefore be helpful if management were required to disclose in direct terms whether the recapitalization is fair, since that is the type of disclosure that would aid many shareholders in evaluating the recapitalization.

Incidentally, compelling management to make appropriate disclosures about the fairness of a proposed recapitalization would also have the beneficial effect of limiting management's ability to extract unfair concessions from preferred shareholders involved in a recapitalization. Any recapitalization that is substantially unfair would require management to state: "This recapitalization is unfair to preferred shareholders." Obviously management would be reluctant to make such a statement in connection with any proposed recapitalization, since the chance of getting approval from the preferred shareholders would be decreased and management could be open to charges that state fairness constraints had been violated.

Realistically, therefore, management will probably defend the recapitalization as "fair," or possibly management will make no recommendation whatsoever concerning the recapitalization. In either event, however, management could be held liable under rule 10b-5 if the terms of the recapitalization were substantially unfair, since management's action would constitute either an implicit or an explicit recommendation that the merger is fair. Accordingly, rule 10b-5 would serve as a mechanism to test the substantial fairness of the recapitalization.

CONCLUSION

State courts have been ineffective in protecting preferred shareholders from the demands made by common shareholders in the context of recapitalizations. The inability to constrain common shareholders by the use of equitable notions is even more unfortunate when one realizes that there are no appraisal rights for the preferred shareholder who is presented with an unfair recapitalization.

It appears, however, that rule 10b-5 does provide the preferred shareholder with significant protection from the unfair recapitalization. At a minimum, the rule insures against material misstatements and forces the management to disclose to the preferred shareholders all material information about the

recapitalization. While not a complete protection, this can provide the preferred shareholders with basic information about the proposed exchange, which should make the preferred more tenacious in refusing to make substantial concessions.

Additional and meaningful protection can be extended to the disadvantaged preferred shareholders if courts are willing to hold management liable for misstatements as to the fairness of the recapitalization and for failures to disclose in direct terms the unfairness of recapitalizations. This interpretation of rule 10b-5 will protect preferred shareholders from misstatements that, as a practical matter, have an impact on their votes, and it will force management to make disclosures in a form that is intelligible to shareholders. Finally, it may indirectly enforce general standards of fairness in recapitalizations.