Kentucky Law Survey: Corporations

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INTRODUCTION

Following the format used in previous Surveys, developments in corporation law at the federal level will be discussed first. This discussion will be followed by review of a group of selected cases dealing with corporate law principles at the state level.

At the federal level, the present Survey period was marked by two significant decisions from the Supreme Court of the United States interpreting section 10(b) of the Securities Exchange Act of 1934 and Securities and Exchange Commission Rule 10b-5. The first of these decisions considers the obligations of a "tippee" who comes into possession of nonpublic corporate information. The second decision deals with the extent to which a private civil cause of action may be implied under section 10(b) of the Securities Exchange Act of 1934 for conduct which is also covered by the express civil liability provisions of section 11 of the Securities Act of 1933. Discussion of these two Supreme Court cases will be followed by comments on two cases from the First Circuit Court of Appeals, one examining disgorgement of insider trading profits.
under the federal securities laws and the other evaluating the scope of aiding and abetting liability under those laws.

Discussion of recent developments at the state level will begin with review of a significant decision by the Supreme Court of Delaware dealing with parent-subsidiary mergers. This will be followed by an analysis of the recent decision by the Supreme Court of Kentucky declaring the Kentucky Take-Over Act unconstitutional. The discussion will conclude with analysis of a decision by the Supreme Court of Delaware concerning the right of shareholders to inspect the books and records of a corporation and a decision by the Supreme Court of Utah regarding the authority of a corporate president to initiate legal proceedings on behalf of the corporation.

I. Federal Corporation Law

A. Insider Trading

Perhaps no aspect of Securities and Exchange Commission (SEC) Rule 10b-5, promulgated by the Commission under the authority of section 10(b) of the Securities Exchange Act of 1934, has received as much attention in recent years as the regulation of insider trading.

10 C.F.R. § 240.10b-5 (1983). The full text of this rule reads as follows:

- To employ any device, scheme, or artifice to defraud,
- 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
- To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person in connection with the purchase or sale of any security.

Id.

15 U.S.C. § 78j(b) (1976). This section reads:

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

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4 See SEC v. MacDonald, 699 F.2d 47 (1st Cir. 1983).
8 See CM & M Group, Inc. v. Carroll, 453 A.2d 788 (Del. 1982).
10 17 C.F.R. § 240.10b-5 (1983). The full text of this rule reads as follows:

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(a) To employ any device, scheme, or artifice to defraud,
(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person in connection with the purchase or sale of any security.

Id.
has assumed more significance in recent years than its use by the SEC in policing insider trading activity in the securities of American corporations.\(^{12}\) However, determining the contours of liability under rule 10b-5 for this kind of activity has proven difficult,\(^{13}\) and recent decisions by the Supreme Court of the United States have served notice that liability under section 10(b) and rule 10b-5 is not unlimited.\(^{14}\) This was made particularly evident by the Court's decision in *Chiarella v. United States*,\(^{15}\) in which the Court rejected the position that a printer employed by a financial printing firm could be held liable under section 10(b) and rule 10b-5 for trading on nonpublic market information.\(^{16}\) Recently, the Supreme Court further underscored its restrictive attitude when, in *Dirks v. SEC*,\(^{17}\) the Court refused to extend rule 10b-5 liability to a securities analyst...
who "tipped" material nonpublic information which he had received from inside corporate sources.18

Dirks grew out of the spectacular Equity Funding fraud which received widespread publicity a few years ago.19 Dirks, an officer in a New York broker-dealer firm, had received information from a former officer of Equity Funding of America that the assets of the corporation, which consisted primarily of life insurance policies, were greatly overstated.20 On the basis of an extensive investigation, Dirks was able to substantiate the charges.21 During the investigation, although neither Dirks nor his firm traded in any Equity Funding stock, Dirks revealed his information to a number of clients and investors who liquidated their holdings of Equity Funding securities.22 During this period the price of Equity Funding stock on the market fell sharply resulting in the New York Stock Exchange taking action to halt trading in the stock.23 After California insurance authorities uncovered evidence of the fraud, the Securities and Exchange Commission filed a complaint against Equity Funding, and the Wall Street Journal published a front-page story of the fraud, basing the story largely on information possessed by Dirks.24 Subsequently, in an administrative proceeding, the SEC found Dirks to have aided and abetted violations

18 Id. at 3266-68. There is support in the lower federal courts for subjecting trading tippees to rule 10b-5 liability. See, e.g., Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974). By treating certain institutional investors liable as trading tippees in Shapiro, the Second Circuit Court of Appeals confirmed a similar position as to these institutional investors that had been taken earlier by the Securities and Exchange Commission when, in an administrative proceeding, the Commission had approved a determination by a hearing examiner that the institutional investors should be censored for their conduct. See In re Investors Management Co., 44 S.E.C. 633 (1971). But see Fridrich v. Bradford, 542 F.2d 307 (6th Cir. 1976), cert. denied, 429 U.S. 1053 (1977). See generally Rapp, Fridrich v. Bradford and the Scope of Insider Trading Liability Under SEC Rule 10b-5: A Commentary, 38 Ohio St. L.J. 67 (1977); Rapp & Loeb, Tippee Liability and Rule 10b-5, 1971 U. Ill. L.F. 55.

19 See Robertson, Those Daring Young Con Men of Equity Funding, FORTUNE, August 1973, at 81.

20 103 S.Ct. at 3258.

21 Id.

22 Id.

23 Id.

24 Id. at 3258-59. While Dirks was pursuing his investigation of the fraud charges, he tried to get a representative of the Wall Street Journal to write a story about the alleged fraud but the representative refused to do so for fear of the possible libelous nature of the information. Id. at 3258.
of section 10(b) and rule 10b-5 by revealing his information about the Equity Funding fraud to investors before the information had been made public. However, in deference to Dirks' efforts to uncover the Equity Funding fraud, the SEC only ordered Dirks censured.

On review, the Court of Appeals for the District of Columbia Circuit accepted the judgment of the Commission, adopting the position of the Commission that "tippees" become subject to the same "disclose or abstain" rule as their corporate confidants with regard to material nonpublic corporate information. The Supreme Court then granted certiorari.

Reversing the judgment of the court of appeals, Justice Powell, writing for the Supreme Court, reaffirmed the position taken by the Court in Chiarella that nondisclosure can constitute an actionable fraud only where there exists "a duty to disclose arising

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Where "tippees"—regardless of their motivation or occupation—come into possession of material "corporate information that they know is confidential and know or should know came from a corporate insider," they must either publicly disclose that information or refrain from trading. In addition, under aiding and abetting principles, a non-trading tipper is liable where he knew or should have known that his tippee would be likely to trade.


24 See [1981 Transfer Binder] FED. SEC. L. REP. (CCH) at 83,930-51. An administrative law judge before whom the matter was first heard had concluded that Dirks should receive a 60-day suspension from association with any broker or dealer. Id. at 83,941. In its review of the findings of the administrative law judge, the Commission, while recognizing the importance and value of the work performed by securities analysts in gathering and analyzing information for the benefit of investors, nevertheless determined that "the analysts' role, like that of any other person, is constrained by the well-established proscriptions of the antifraud provisions of the federal securities laws." Id. at 83,950. However, the Commission decided that due to Dirks' previous unblemished record in the securities industry and his role in bringing the Equity Funding fraud to light, the sanction imposed by the administrative law judge was too severe and should be reduced. Id.

27 See Dirks v. SEC, 681 F.2d at 824. Stressing the high standard of ethical behavior expected of broker-dealers, the court of appeals offered the suggestion that Dirks could be considered as having "obligations to the SEC and to the public completely independent of any obligations he acquired" under the tippee doctrine. Id. at 840.

28 Dirks v. SEC, 103 S.Ct. at 371.
from a relationship of trust and confidence between parties to a transaction."29 Rejecting once again the SEC's "equal access" theory as to material nonpublic information,30 Justice Powell observed: "This conflicts with the principle set forth in Chiarella that only some persons, under some circumstances, will be barred from trading while in possession of material nonpublic information."31 He further expressed the opinion that "[I]mposing a duty to disclose or abstain solely because a person knowingly receives material nonpublic information from an insider and trades on it could have an inhibiting influence on the role of market analysts, which the SEC itself recognizes is necessary to the preservation of a healthy market."32 Recognizing, however, the clear need for a ban on some tippee trading, he took the position that such

29 Chiarella v. United States, 445 U.S. at 230. See 103 S.Ct. at 3261. In both Chiarella and Dirks the Court relied heavily on the test for insider trading which had been enunciated by the SEC in the case of In re Cady, Roberts & Co., 40 S.E.C. 907 (1961), where Commissioner Cary, writing for the Commission, had said:

Analytically, the obligation [to disclose or abstain] rests on two principal elements; first, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing.

Id. at 912.

30 103 S.Ct. at 3262. The Commission's "equal access" theory seems to have had its roots in the case of In re Investors Management Co., 44 S.E.C. at 633, in which the Commission, dropping the special relationship portion of its Cady, Roberts test, had stated:

We consider that one who obtains possession of material, non-public corporate information, which he has reason to know emanates from a corporate source, and which by itself places him in a position superior to other investors, thereby acquires a relationship with respect to that information within the purview and restraints of the antifraud provisions.

Id. at 644. Commissioner Smith, who conurred in the result reached in the Investors Management case, nevertheless detected the broadening of the test as formulated by the Commission into one emphasizing "relative informational advantages in the marketplace."

Id. at 648 (Smith, Comm'r, concurring). Referring to such a test as being, in his opinion, too vague to apply with any consistency, he said that he would prefer to continue the traditional emphasis in terms of persons "knowing or having reason to know that the material non-public information became available to them in breach of a duty owed to the corporation not to disclose or use the information for non-corporate purposes."

Id. at 648-50 (Smith, Comm'r, concurring).

31 103 S.Ct. at 3262.

32 Id. at 3263.
a ban should occur only when inside information has been made available to such persons improperly. So, he concluded:

[A] tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach.

The test, he said, for determining whether the insider has breached a fiduciary duty "is whether the insider personally will benefit, directly or indirectly, from his disclosure." This means "absent some personal gain, there has been no breach of duty to stockholders," and, "absent a breach by the insider, there is no derivative breach." Under the inside-trading and tipping rules thus enunciated, Justice Powell found no violation of these rules on the part of Dirks, since the Equity Funding employees did not violate their fiduciary obligations to the shareholders of Equity Funding by informing Dirks of the Equity Funding fraud.

In adopting the "personal gain" test for testing insider trading activity, Justice Powell conceded that "determining whether an insider personally benefits from a particular disclosure, a question of fact, will not always be easy for courts." But, he said:

[I]t is essential, we think, to have a guiding principle for those whose daily activities must be limited and instructed by the SEC's inside-trading rules, and we believe that there must be a breach of the insider's fiduciary duty before the tippee inherits the duty to disclose or abstain. In contrast, the rule adopted by the SEC in this case would have no limiting principle.

In a vigorous dissent, in which Justices Brennan and Marshall concurred, Justice Blackmun once again chastised the Court, as he had done on previous occasions, for taking what he called

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33 Id. at 3264.
34 Id.
35 Id. at 3265.
36 Id.
37 Id.
38 Id. at 3267.
39 Id. at 3266.
40 Id. (footnote omitted).
“another step to limit the protections provided investors by § 10(b) of the Securities Exchange Act of 1934.” Referring to the Court’s position that insider liability depends on breach of a fiduciary relationship between the insider and the trading shareholders and that tippees become liable as participants in the breach after the fact by acting with knowledge of the breach, Justice Blackmun found no support for engrafting a special motivational requirement on the fiduciary duty doctrine requiring the insider to have acted with the improper purpose of personal gain. Adopting the position that “corporate insiders have an affirmative duty of disclosure when trading with shareholders of the corporation,” Justice Blackmun concluded that “[t]he fact that the insider himself does not benefit from the breach does not eradicate the shareholder’s injury.”

In evaluating the significance of Dirks it may well be that, on its facts, it was somewhat of an atypical case. Indeed, Justice Powell conceded that it was in his majority opinion. Thus, Dirks may not greatly affect future insider trading cases. However, what

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41 Id. at 3268 (Blackmun, J., dissenting). In the Blue Chip Stamps case, which established the purchaser-seller standing requirement for plaintiffs suing under § 10(b) and rule 10b-5, Justice Blackmun had charged the Court with exhibiting “a preternatural solicitousness for corporate well-being and a seeming callousness toward the investing public.” See Blue Chip Stamps v. Manor Drug Stores, 421 U.S. at 762 (Blackmun, J., dissenting). A year later, in the Hochfelder case, which established a scienter requirement for liability under § 10(b) and rule 10b-5, he remarked that once again the Court had interpreted these provisions “restrictively and narrowly,” thereby stultifying recovery for the victim. Ernst & Ernst v. Hochfelder, 425 U.S. at 215-16 (Blackmun, J., dissenting). And, in the Santa Fe Industries case, in which the Court stressed the need for a showing of deceptive or manipulative conduct to establish a cause of action under § 10(b) and rule 10b-5, Justice Blackmun spoke of the broad language in Part IV of the Court’s opinion rejecting the use of § 10(b) and rule 10b-5 to reach transactions involving internal corporate mismanagement as “exacerbating the concerns” he had expressed in his dissents in Blue Chip Stamps and Hochfelder. Santa Fe Indus. v. Green, 430 U.S. at 480 (Blackmun, J., concurring in part).

42 103 S.Ct. at 3270 (Blackmun, J., dissenting).
43 Id. at 3271 (Blackmun, J., dissenting).
44 Id. at 3269 (Blackmun, J., dissenting) (citing Chiarella v. United States, 445 U.S. at 227).
45 Id. at 3271 (Blackmun, J., dissenting) (citing A. SCOTT, SCOTT ON TRUSTS § 205, at 1665 (1967); RESTATEMENT (SECOND) OF TORTS § 205 comments c-d).
46 Id. at 3263 n.18.
47 Officials at the Securities and Exchange Commission are reported to have referred to the case as “unique” and “unusual” and to have expressed the opinion that the case should not seriously jeopardize the agency’s enforcement program. See 15 SEC. REG. & L. REP. (BNA) No. 26, at 1293 (July 8, 1983).
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may be of more importance to the future law of insider trading is again the "tone" of the majority opinion which seems to suggest a continued attitude of caution on the part of the Supreme Court in extending the boundaries of insider trading liability under section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5.48

B. Implied Remedies

A second noteworthy Supreme Court case decided during the present survey period was Herman & MacLean v. Huddleston.49 This case considered whether a private civil cause of action may be implied under section 10(b) of the Securities Exchange Act of 1934 where an express civil remedy for the same conduct exists under other provisions of the securities laws.50 Specifically, the issue in Huddleston was "whether purchasers of registered securities who allege they were defrauded by misrepresentations in a registration statement may maintain an action under Section 10(b) notwithstanding the express remedy for misstatements and omissions in registration statements provided by Section 11 of the Securities Act of 1933."51

In Huddleston, Texas International Speedway, Inc. (TIS) had filed a registration statement and prospectus with the Securities and Exchange Commission for a public offering of securities, the proceeds of which were to be used to finance the construction of an automobile speedway.52 Although the entire issue was sold on the offering date, the venture was not successful and resulted in the corporation filing a bankruptcy petition.53 Purchasers of TIS

50 Id. at 690. This problem has plagued the lower federal courts for many years. See Comment, Implied Rights of Action in Federal Legislation: Harmonization Within the Statutory Scheme, 1980 DutcE L.J. 928.
51 103 S.Ct. at 683. Section 11 of the Securities Act of 1933 makes available to purchasers of securities an express civil remedy for misstatements and omissions contained in a registration statement unless the persons designated by the section as responsible for such misstatements or omissions (except for the issuer itself) can establish a due diligence defense. See 15 U.S.C. § 77k (1976).
52 103 S.Ct. at 685.
53 Id.
securities filed a class action in federal district court under section 10(b) and SEC Rule 10b-5 against participants in the offering, including the accounting firm of Herman & MacLean. The plaintiffs claimed that the defendants had fraudulently misrepresented the financial condition of TIS. The district judge concluded that Herman & MacLean and others had violated section 10(b) and rule 10b-5 by having made "fraudulent misrepresentations in the TIS registration statement." He accordingly entered judgment for plaintiffs. On appeal, the Fifth Circuit Court of Appeals held that the plaintiffs in Huddleston should be permitted to maintain a suit under section 10(b) and rule 10b-5 even if defendants' conduct might also subject them to liability under section 11 of the Securities Act of 1933. The Supreme Court granted certiorari on the issue of whether an implied cause of action under section 10(b) of the 1934 Act would lie for conduct which apparently also provided a basis for a damage action under section 11 of the 1933 Act.

In affirming the holding of the court of appeals that plaintiffs could maintain their section 10(b) action under the 1934 Act regardless of the availability of the section 11 action under the 1933 Act, the Supreme Court stated that "[t]he resolution of this issue turns on the fact that the two provisions involve distinct causes of action and were intended to address different types of wrongdoing." The Court pointed out:

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44 Id.
45 Id. at 685-86.
46 Id. at 686.
49 103 S.Ct. at 686. While affirming the decision of the court of appeals on the cause of action issue, the Supreme Court reversed the position of the court of appeals that plaintiffs in § 10(b) suits must establish their case by clear and convincing evidence rather than by a preponderance of the evidence. Id. Noting that "[t]he Court of Appeals relied primarily on the traditional use of a higher burden of proof in civil fraud actions at common law," but that "an important purpose of the federal securities statutes was to rectify perceived deficiencies in the available common law protections by establishing higher standards of conduct in the securities industry," the Supreme Court said that "[w]e therefore decline to depart from the preponderance-of-the-evidence standard generally applicable in civil actions." Id. at 691-92.
50 Id. at 687.
While a Section 11 action must be brought by a purchaser of a registered security, must be based on misstatements or omissions in a registration statement, and can only be brought against certain parties, a Section 10(b) action can be brought by a purchaser or seller of "any security" against "any person" who has used "any manipulative or deceptive device or contrivance" in connection with the purchase or sale of a security.\textsuperscript{61}

Furthermore, the Court observed, since proof of scienter on the part of a defendant is necessary under section 10(b) of the 1934 Act,\textsuperscript{62} whereas mere negligent conduct may be sufficient under section 11 of the 1933 Act,\textsuperscript{63} the added burden of proving scienter which attaches to suits filed under section 10(b) "will not 'nullify' the procedural restrictions that apply to the express remedies."\textsuperscript{64} The Court had expressed this concern in Hochfelder when it adopted the "scienter" requirement for section 10(b) actions.\textsuperscript{65} Stressing that "[t]he effectiveness of the broad proscription against fraud in Section 10(b) would be undermined if its scope were restricted by the existence of an express remedy under Section 11,"\textsuperscript{66} the Court "reject[ed] an interpretation of the securities laws that displaces an action under Section 10(b)."\textsuperscript{67}

The decision by the Supreme Court in Huddleston on the im-

\textsuperscript{61} Id. at 687-88 (emphasis in original).
\textsuperscript{62} Id. at 688. The scienter requirement was imposed by the Supreme Court in Hochfelder, where the Court decided that a private damage action would not lie under § 10(b) and rule 10b-5 "in the absence of any allegation of 'scienter'—intent to deceive, manipulate, or defraud." Ernst & Ernst v. Hochfelder, 425 U.S. at 193.
\textsuperscript{63} 103 S.Ct. at 687. The negligence standard under § 11 of the 1933 Act stems from the defense given defendants (other than the issuer) by the section, allowing them to escape liability if they exercised "due diligence." See 15 U.S.C. § 77k(b).
\textsuperscript{64} 103 S.Ct. at 689. The procedural restrictions alluded to by the Court relate to such things as the requirement in § 11 that a plaintiff may be required to post a bond for costs and the short statute of limitations provided for in § 13 of the 1933 Act. Id. at 688 n.18.
\textsuperscript{65} See Ernst & Ernst v. Hochfelder, 425 U.S. at 185. Referring to the procedural limitations imposed under the 1933 Act, the Court in Hochfelder stated: "We think 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." Id. at 210 (footnote omitted). To do so "would allow causes of action covered by [the express actions] to be brought instead under § 10(b) and thereby nullify the effectiveness of the carefully drawn procedural restrictions on these express actions." Id. (footnote omitted).
\textsuperscript{66} 103 S.Ct. at 690.
\textsuperscript{67} Id.
plied remedy issue, while reasonable enough as a matter of legal theory, may come as somewhat of a surprise in view of the recent efforts on the part of the Court to reduce the number of plaintiffs eligible to bring rule 10b-5 actions.\textsuperscript{68} Equally significant was the Court's reference to the statement, first made by the Court in \textit{SEC v. Capital Gains Research Bureau, Inc.}, \textsuperscript{69} and later repeated in \textit{Superintendent of Insurance v. Bankers Life & Casualty Co.},\textsuperscript{70} that section 10(b) of the 1934 Act should be read flexibly, not technically and restrictively.\textsuperscript{71}

This revitalized liberal language by the Court may have taken further root as a result of the recent action by the Court in vacating a judgment of the Fifth Circuit Court of Appeals and remanding the case for further consideration in light of the Court's ruling in \textit{Huddleston}. In \textit{Chemetron Corporation v. Business Funds, Inc.},\textsuperscript{72} Chemetron had claimed it had been defrauded as the result of a stock manipulation scheme in violation of section 9(a) of the Securities Exchange Act of 1934,\textsuperscript{73} as well as SEC Rule 10b-5 under section 10(b) of the 1934 Act.\textsuperscript{74} Section 9(e) of the 1934 Act expressly makes available a private civil damage action in favor of those persons who sustain damages as a result of any act or transaction prohibited by section 9.\textsuperscript{75} The Fifth Circuit Court of

\textsuperscript{68} See Lowenfels, \textit{supra} note 14, at 891.
\textsuperscript{69} 375 U.S. 180, 195 (1963).
\textsuperscript{70} 404 U.S. 6, 12 (1971).
\textsuperscript{71} 103 S.Ct. at 690.
\textsuperscript{72} 103 S.Ct. 1245 (1983).
\textsuperscript{73} 15 U.S.C. § 78i(a) (1976).
\textsuperscript{74} See Chemetron Corp. v. Business Funds, Inc., 682 F.2d 1149, 1155-56 (5th Cir. 1982), \textit{vacated}, 103 S.Ct. at 1245. Chemetron also asserted violations of the Texas securities laws. \textit{Id.} at 1155. These claims are discussed in Part III, B. of the court's opinion. \textit{Id.} at 1170-82.
\textsuperscript{75} 15 U.S.C. § 78i(e) states:

Any person who willfully participates in any act or transaction in violation of subsections (a), (b), or (c) of this section, shall be liable to any person who shall purchase or sell any security at a price which was affected by such act or transaction, and the person so injured may sue in law or in equity in any court of competent jurisdiction to recover the damages sustained as a result of any such act or transaction. In any such suit the court may, in its discretion, require an undertaking for the payment of the costs of such suit, and assess reasonable costs, including reasonable attorneys' fees, against either party litigant. Every person who becomes liable to make any payment under this subsection may recover contribution as in cases of contract from any person who, if joined in the original
Appeals held that, since the fraudulent conduct alleged by Chemetron came within the manipulative practices condemned by section 9(a), Chemetron could not maintain its suit under section 10(b).\textsuperscript{76} In adopting this position the court was influenced by the fact that the requirements for maintaining a suit under the express civil liability provisions of section 9(a) were different in material respects from those required under section 10(b).\textsuperscript{77} The court noted that ""[w]hile Rule 10b-5 permits recklessness to fulfill its scienter requirement,""\textsuperscript{78} the language and legislative history of section 9 ""do not permit us to loosen its scienter requirement by permitting recklessness to suffice."

In addition, the court observed that the fraudulent conduct proscribed by section 9(a), as implemented by section 9(e), must ""affect"" the price of securities, whereas the fraud under section 10(b) and rule 10b-5 need only ""touch"" the sale or purchase of securities.\textsuperscript{80} Thus, the court said, to recognize a cause of action under rule 10b-5 would impermissibly nullify ""Congress' deliberate and careful limitations on the express statutory remedy"" under section 9(a).\textsuperscript{81} The jury had found that the manipulative conduct charged by Chemetron had not ""affected"" the price of the stock that Chemetron had acquired.\textsuperscript{82} It appeared, however, that suit, would have been liable to make the same payment. No action shall be maintained to enforce any liability created under this section, unless brought within one year after the discovery of the facts constituting the violation and within three years after such violation.

\textsuperscript{76} 682 F.2d at 1169-70.

\textsuperscript{77} Id. at 1162.

\textsuperscript{78} Id. It perhaps should be observed that while the Fifth Circuit Court of Appeals, and courts in other circuits have treated ""recklessness"" as within the scienter standard enunciated by the Supreme Court in Ernst & Ernst v. Hochfelder, 425 U.S. at 185, the court in Chemetron recognized that the Supreme Court in Hochfelder expressly refrained from committing itself on that issue. 682 F.2d at 1161 n.15. In Hochfelder, the Supreme Court remarked: ""In certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act. We need not address here the question whether, in some circumstances, reckless behavior is sufficient for civil liability under § 10(b) and Rule 10b-5."" 425 U.S. at 194 n.12.

\textsuperscript{79} 682 F.2d at 1162.

\textsuperscript{80} Id. The ""touching"" concept as to liability under rule 10b-5 had its origins in the statement made by Justice Douglas in Bankers Life where he remarked: ""The crux of the present case is that Manhattan suffered an injury as a result of deceptive practices touching its sale of securities as an investor."" Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. at 12-13 (emphasis added).

\textsuperscript{81} 682 F.2d at 1163.

\textsuperscript{82} Id. at 1162.
the manipulative conduct had ultimately contributed to the collapse of the corporation whose stock Chemetron had purchased. The Supreme Court granted certiorari but immediately vacated the judgment of the Fifth Circuit Court of Appeals and remanded the case for further consideration in light of its decision in *Huddleston*.

The action taken by the Supreme Court in *Chemetron* raises the question as to what message the Court was seeking to convey to the Fifth Circuit Court of Appeals. Was the Court in effect saying that it had decided in *Huddleston* that the existence of express civil remedies under the securities laws should not be deemed to interfere with the use of section 10(b) and rule 10b-5 regardless of the effect that allowing use of section 10(b) and rule 10b-5 might have on the express civil remedies in view of the need for a "cumulative construction of the securities laws"? If so, such a position by the Court would seem to conflict with the concern the Court had expressed in cases such as *Hochfelder* that section

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83 *See id.* at 1155.
84 *Chemetron Corp. v. Business Funds, Inc.*, 103 S.Ct. at 1245.
85 It is interesting to note that the Fifth Circuit Court of Appeals was the same court that had decided the *Huddleston* case before it went to the Supreme Court. Although the Fifth Circuit Court of Appeals decided *Chemetron* before the Supreme Court had handed down its decision in *Huddleston*, the distinction which the Fifth Circuit Court of Appeals drew in *Chemetron* between a situation like that in *Chemetron* where recognition of an implied cause of action would operate to nullify an express remedy and that involved in *Huddleston* where recognition of the implied cause of action would merely supplement the express remedy seemed to find support in the opinion written by Justice Powell for the Supreme Court in *Huddleston*. Powell stated that in relation to the added burden of proving scienter in suits brought under section 10(b) of the 1934 Act, "invocation of the Section 10(b) remedy will not 'nullify' the procedural restrictions that apply to the express remedies" under the 1933 Act. *See Herman & MacLean v. Huddleston*, 103 S.Ct. at 689.
86 *Cf. id.* Some of the language used by Justice Powell in *Huddleston* might suggest such a conclusion. For example, in commenting on the purpose of the 1933 Act to provide protection to investors in registered securities, he said: "It would be anomalous indeed if the special protection [sic] afforded to purchasers in a registered offering by the 1933 Act were deemed to deprive such purchasers of the protections against manipulation and deception that Section 10(b) makes available to all persons who deal in securities." *Id.* at 688.

Since the preparation of this Article, the Fifth Circuit Court of Appeals has held on remand in the *Chemetron* case that, in view of the "broad and unrestrictive analysis" of express and implied remedies by the Supreme Court in *Huddleston*, Chemetron should not be denied its section 10(b) remedy because of the presence of the express civil remedy under section 9(a) of the 1933 Act. *See Chemetron Corp. v. Business Funds, Inc.*, [Current Binder] *FED. SEC. L. REP. (CCH) ¶ 99,541* (5th Cir. Oct. 31, 1983).
10(b) should not be construed so as to nullify the effectiveness of the express civil liability provisions of the securities acts. 87 The view stated above would also seem to conflict with the Court's emphasis in Huddleston that permitting the section 10(b) action under the 1934 Act would not serve to nullify the section 11 action under the 1933 Act in view of the added burden of proving scienter in section 10(b) actions. 88 It may well be that such is not the message the Court had in mind in remanding the Chemetron case, but certainly Chemetron would appear to provide a further opportunity for the Court to clarify its position as to the proper relationship between express and implied remedies under the securities acts. 89

C. Disgorgement

In SEC v. MacDonald, 90 the Court of Appeals for the First Circuit had an opportunity to consider the allowable recovery of profits under the "disgorgement" theory in insider trading cases brought by the Securities and Exchange Commission. 91 The court stated:

The Commission correctly states the present question to be whether, where a corporate officer fraudulently purchased com-

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87 See note 58 supra.
88 103 S.Ct. at 689.
89 Such clarification seems all the more needed since the Court's action in Chemetron might be thought to be inconsistent with its decision in Touche Ross & Co. v. Redington, 442 U.S. 560 (1979). There the Court, dealing with § 17(a) of the Securities Exchange Act of 1934 (which imposes certain record keeping requirements on broker-dealers), held that § 17(a) of that Act did not create a private cause of action in view of the presence of an express civil liability provision in § 18(a) of the Act. Noting that the express remedy provided for in § 18(a) is available only to persons who have purchased or sold a security at a price which has been affected by false or misleading statements and that by allowing the action under § 17 would extend liability to those who were merely customers of a broker-dealer, the Court remarked: "[W]e are extremely reluctant to imply a cause of action in § 17(a) that is significantly broader than the remedy that Congress chose to provide." Id. at 574. For further discussion of the Redington case, see Ham, Kentucky Law Survey—Corporations, 68 Ky. L.J. 495, 500-04 (1979-80).
90 699 F.2d 47 (1st Cir. 1983).
pany shares "while in possession of material non-public information [he should be required, in an action brought by the Commission,] to disgorge the entire profits he realized from his subsequent sale of those securities about a year later, rather than limiting disgorgement to an amount representing the increased value of the shares at a reasonable time after public dissemination of the information." \(^9\)

In *MacDonald*, the Securities and Exchange Commission charged the defendant, MacDonald, with unlawful insider trading activity as chairman of the board of directors of Realty Income Trust (RIT), a real estate investment trust. \(^9\) MacDonald had learned of the acquisition by RIT of the Kroger Building in Cincinnati, Ohio, and of promising negotiations pointing toward a profitable long-term lease of vacant space in the building to Kenner Products, which would raise the occupancy of the building to ninety-five percent. \(^9\) A report on the proposed lease was made to the board of trustees of RIT, including defendant, on December 15, 1975. \(^9\) The next day defendant's wife, acting on his behalf, purchased 100 shares of RIT stock through her broker at a price of 4 1/4. \(^9\) On December 23, 1975, defendant went to the broker's office and made a purchase of 9,500 shares at 4 5/8. \(^9\) On the following day, December 24, 1975, RIT issued a press release announcing its acquisition of the Kroger Building and the proposed lease of space in the building to Kenner Products. \(^9\) As a result of this announcement the price of RIT stock went up in two days of trading from 4 5/8 to 5 1/2 and closed the year at 5 3/4. \(^9\) Defendant did not dispose of his stock until 1977, when he sold it at an average price of roughly $10 per share. \(^9\) The SEC brought suit under section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5 to require defendant to disgorge his entire profits realized on the

\(^{92}\) 699 F.2d at 52.
\(^{93}\) Id. at 48.
\(^{94}\) Id.
\(^{95}\) Id.
\(^{96}\) Id.
\(^{97}\) Id.
\(^{98}\) Id. at 48-49.
\(^{99}\) Id. at 49.
\(^{100}\) Id.
purchase and sale of the 9,600 shares of RIT stock. The district court ordered defendant to disgorge the sum of $53,012, which represented the profit realized by defendant when he sold his 9,600 shares of RIT stock in 1977 at roughly $10 per share.

On appeal, the First Circuit Court of Appeals rejected the position of the district court that the profits recovered from defendant could include profits attributable to circumstances unrelated to the undisclosed information. The court of appeals noted that one of the limits that had emerged in cases applying the "disgorgement" theory was that "where the fraudulently obtained securities are publicly traded, and hence readily available, the defrauded sellers can recover only those accretions occurring up to a reasonable time after they discovered the truth." The court reasoned:

When a fraudulent buyer has reached the point of his full gain from the fraud, viz., the market price a reasonable time after the undisclosed information has become public, any consequence of a subsequent decision, be it to sell or to retain the stock, is res inter alios, not causally related to the fraud.

The court rejected the position of the Commission that in the interests of promoting investor confidence and the integrity of the nation's capital markets, the limitation on disgorgement of profits should be confined to private damage actions between in-

\[101\] Id. at 48.
\[102\] Id. at 52. The $53,012 so recovered was to be used for restitution to defrauded shareholders. Id.
\[103\] Id. at 54-55.
\[104\] Id. at 53. This is sometimes discussed in terms of "cover." The aim is to enable the injured investor to regain the position the investor would have been in but for the unlawful sale. See Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90 (10th Cir.), cert. denied, 404 U.S. 1004 (1971).
\[105\] 699 F.2d at 54. The court further remarked: "Conscious hedging aside, when a seller of publicly traded securities has learned of previously undisclosed material facts, and decides nevertheless not to replace the sold securities, he cannot later claim that his failure to obtain subsequent stock appreciation was a proximate consequence of his prior ignorance." Id. at 53.
\[106\] Id. at 55. The prevailing opinion on the disgorgement issue was an en banc opinion (with Chief Judge Coffin and Circuit Judge Bownes dissenting). The en banc opinion followed the grant of a petition for rehearing filed by the SEC from a panel decision by Chief Judge Coffin and Judges Aldrich and Breyer, in which Chief Judge Coffin dissented. The unanimous panel opinion on issues of materiality and scienter was left undisturbed. Id. at 52 n.3.
dividends and should not apply when the Commission is the plaintiff. This suggestion did not appeal to the court as "equitable" since the court thought it could act quite arbitrarily "to charge one class of insiders more than others who had committed precisely the same fraudulent act" depending on when the respective investors sold their stock. So, the court concluded: "On remand the district court should determine a figure based upon the price of RIT stock a reasonable time after public dissemination of the inside information."

The decision in MacDonald no doubt came as a disappointment to the Commission, which has frequently sought to use the "disgorgement" of profits as a policing tool in insider trading cases. As a result, the decision will no doubt provide the Commission with additional incentive to induce Congress to enact the Insider Trading Sanctions Act, with its treble damage remedy, proposed by the Commission. However, it should be noted that the court in MacDonald limited its decision to publicly traded securities where sellers can 'cover' by replacing the securities sold. The First Circuit reaffirmed its position in Janigan that, in the context of a closely held corporation, it is appropriate to require disgorgement of all profits, including even those profits that might

107 Id. at 55. Chief Judge Coffin, in his dissenting opinion, remarked:

Unlike a private plaintiff, the SEC does not sue for injury to itself; nor does it sue solely for the losses of sellers immediately injured by the defendant's fraud. Rather, it sues for the whole injury inflicted by the fraud. That injury includes the damage done to investor confidence and the integrity of the nation's capital markets, and is necessarily greater than the profits at issue in a private suit.

... Although what we might all call private equity can give adequate protection to the individual, it seems to me that public equity in the contemporary world should permit a court, in the exercise of its discretion under 15 U.S.C. § 78u(d), to safeguard the integrity of the securities markets as a whole by imposing, in a proper case, the civil sanction of full disgorgement of the actual profits of an illegal bargain.

Id. at 55, (Coffin, J., dissenting).

108 Id. at 54.

109 Id. at 55.

110 This is not the first case, however, in which the SEC has been rebuffed by the courts. Similar decisions have refused to permit recovery of profits not causally related to the insider trading. See, e.g., SEC v. Blatt, 583 F.2d 1325, 1335 (5th Cir. 1978); SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1104-05 (2d Cir. 1972).

111 See note 12 supra.

112 699 F.2d at 53.

represent increases well beyond those that might have been foreseen by the buyer. Under such circumstances where the defrauded seller has no market available through which to reinvest in the company's shares, "'[i]t is more appropriate to give the defrauded party the benefit even of windfalls than to let the fraudulent party keep them.'"

D. Aiding and Abetting

Another recent case, Cleary v. Perfectune, Inc., presented the Court of Appeals for the First Circuit with an opportunity to consider the extent to which liability for aiding and abetting under section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5 can consist solely of silence and inaction. Liability for aiding and abetting is, of course, a form of secondary liability under the federal securities laws.

In Cleary, plaintiffs purchased shares of stock in Perfectune, Inc., on the basis of an Offering Memorandum which plaintiffs claimed was fraudulent. The corporation had been organized by John W. McHugh to operate a chain of automobile tune-up centers. In the Offering Memorandum, McHugh had listed defendants as directors without their knowledge or consent. However, defendants were aware that McHugh was promoting Perfectune, and each defendant received a copy of the Perfectune Offering Memorandum. None of the defendants objected to being listed as a director, and none of the defendants made any effort to inform the SEC, state authorities, or plaintiffs that they had been listed as directors of Perfectune without their knowledge.

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114 699 F.2d at 53.
115 Id. (quoting Janigan v. Taylor, 344 F.2d at 786).
116 700 F.2d 774 (1st Cir. 1983).
117 Id. at 776.
118 For a general discussion of all phases of secondary liability, including aiding and abetting, see Ruder, Multiple Defendants in Securities Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification and Contribution, 120 U. PA. L. REV. 597 (1971-72).
119 700 F.2d at 776.
120 Id at 775.
121 Id. at 776.
122 Id.
or consent. The Perfectune failed, whereupon plaintiffs filed a suit under section 10(b) and rule 10b-5 in the United States District Court for the District of Massachusetts to recover the purchase price paid by them for the Perfectune stock. Defendants were charged as aiders and abettors of McHugh's alleged wrongful conduct in issuing and disseminating a fraudulent Offering Memorandum. The district court granted summary judgment for the defendants on the ground that "the defendants were not liable to the plaintiffs as aiders and abettors under § 10(b) and rule 10b-5 because the plaintiffs failed to raise genuine questions of material fact concerning the elements of such liability."

On appeal, the First Circuit Court of Appeals held that, since the inaction and silence of the defendants was the sole basis on which their aiding and abetting liability could be based, and since the recognized elements for invoking aiding and abetting liability under section 10(b) and rule 10b-5 were not met, the granting of summary judgment to defendants was proper. The court invoked a tripartite test for establishing aider and abettor liability under section 10(b) and rule 10b-5 which included the following elements: (1) commission of a primary violation of section 10(b) and rule 10b-5; (2) general awareness on the part of the secondary party of having played a role in an improper activity; and (3) knowing and substantial assistance of the primary violation by the secondary party. The court determined that while genuine questions of material fact had been raised concerning the primary violation

123 Id.
124 Id.
125 Id.
126 Id.
127 Id.
128 Id. at 777.
129 Id. at 778.
130 Id. at 777. These elements were first enunciated by the Sixth Circuit Court of Appeals in SEC v. Coffey, 493 F.2d 1304 (6th Cir. 1974), cert. denied, 420 U.S. 908 (1975), where the court said:

Without meaning to set forth an inflexible definition of aiding and abetting, we find that a person may be held as an aider and abettor only if some other party has committed a securities law violation, if the accused party had general awareness that his role was part of an overall activity that is improper, and if the accused aider-abettor knowingly and substantially assisted the violation.

Id. at 1316.
of section 10(b) and rule 10b-5, genuine questions of material fact were absent in regard to defendants' awareness of their role in an improper activity and in regard to defendants giving knowing and substantial assistance to any alleged violations.

As to the requirement of awareness of a role in an improper activity, the court declared:

Courts generally have held that in the absence of a duty of disclosure, a defendant should be held liable as an aider and abettor only if the plaintiff proves that the defendant had actual knowledge of the improper activity of the primary violator and of his role in that activity.

Since plaintiffs had failed to show any actual awareness on the part of defendants of the impropriety of McHugh's activity, and since there were no facts which established a duty of disclosure on the defendants, the court concluded that plaintiffs had failed to produce evidence which would create genuine questions of material fact sufficient to prevent summary judgment.

On the issue of knowing and substantial assistance, the court noted a disagreement among courts regarding "the standard to be applied to determine whether inaction, such as the failure of the defendants in this case to inform anyone that they were not directors at the time the Offering Memorandum was issued, can constitute knowing and substantial assistance of the primary violation." The court further stated:

Several courts have suggested that absent an independent duty to act, inaction cannot constitute the assistance necessary to support the imposition of liability for aiding and abetting. Other courts have held that in the absence of an inde-

131 700 F.2d at 777.
132 Id. at 777-78.
133 Id. at 778-79.
134 Id. at 777. The court pointed out that when a duty of disclosure is present, such as where a person possesses inside information or is an accountant or broker possessing special obligations, "courts have been willing to impose liability on the basis of a recklessness standard." Id.
135 Id. at 778.
136 Id. at 777.
137 Id. at 778.
138 Id.
dependent duty to act mere inaction will constitute substantial assistance only where there was a conscious intention to further the principal violation.\textsuperscript{139}

Since plaintiffs had failed to produce any evidence from which an inference could be drawn that defendants through their inaction were consciously intending to further McHugh’s allegedly fraudulent activity, the court decided that it did not need to choose between the two standards.\textsuperscript{140}

Although \textit{Cleary} is only one of many cases in the lower federal courts that have considered aiding and abetting liability under section 10(b) and rule 10b-5,\textsuperscript{141} it does provide an instructive analysis of the difficulties the courts have had in determining the extent to which silence and inaction can form the basis for aiding and abetting liability.\textsuperscript{142} Of course, the entire concept of aiding and abetting as a permissible source of liability under section 10(b) and rule 10b-5 still remains unanswered by the United States Supreme Court, which has specifically refrained from passing on that issue in its recent antifraud decisions.\textsuperscript{143}

\section*{II. State Corporation Law}

\subsection*{A. Cash-out Mergers}

Turning to developments in state corporation law, the most noteworthy recent case is one from the Supreme Court of

\textsuperscript{139} \textit{Id.} (citations omitted).

\textsuperscript{140} \textit{Id.} at 778-79.

\textsuperscript{141} For a discussion of such cases see Comment, \textit{Establishment of Liability for Aiding and Abetting Fraud Under Rule 10b-5 and the Common Law}, 25 U.C.L.A. L. Rev. 862 (1978).

\textsuperscript{142} The court also considered the possible liability of defendants for aiding and abetting in violation of § 17(a) of the Securities Act of 1933, which broadly condemns fraudulent conduct “(in the offer or sale of)” securities. \textit{See} 700 F.2d at 779-80. Conceding that “[t]he standards to be applied in a case of aiding and abetting a violation of § 17(a) are less well-settled than those applied in cases involving a violation of § 10(b) and rule 10b-5,” the court nevertheless concluded that the tripartite test used for § 10(b) actions should also be extended to § 17(a) actions. \textit{Id.}

\textsuperscript{143} See, e.g., \textit{Ernst \\& Ernst v. Hochfelder}, 425 U.S. at 191 n.7. The Court stated: In view of our holding that an intent to deceive, manipulate, or defraud is required for civil liability under § 10(b) and Rule 10b(5), we need not consider whether civil liability for aiding and abetting is appropriate under the section and the rule, nor the elements necessary to establish such a cause of action. \textit{Id.}
Delaware, *Weinberger v. UOP, Inc.*, in which the court eliminated the "business purpose" requirement for testing the legality of cash-out mergers previously adopted by the Delaware Supreme Court in the *Singer/Tanzer* sequence of cases.

In *Weinberger*, Signal Companies, Inc., a diversified holding company, seeking to invest surplus cash which it had obtained through sale of one of its wholly owned subsidiaries, acquired a 50.5% interest in the outstanding shares of UOP, Inc. Subsequently, as the result of a feasibility study made by two directors of Signal, who also served on the board of directors of UOP, Signal determined to acquire the remaining 49.5% of UOP shares through a cash-out merger in the range of $20 to $21 per share, although the feasibility report had concluded that "it would be a good investment for Signal to acquire the remaining 49.5% of UOP shares.

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44 457 A.2d 701 (Del. 1983).

45 Id. at 715. The *Singer/Tanzer* sequence involved the trilogy of *Singer v. Magnavox Co.*, 380 A.2d 969 (Del. 1977); *Tanzer v. International Gen. Indus.*, Inc., 379 A.2d 1121 (Del. 1977); *Roland Int'l Corp. v. Najjar*, 407 A.2d 1032 (Del. 1979). In *Singer*, the Supreme Court of Delaware had expressed the "business purpose" test in the following language:

> We hold, therefore, that a § 251 merger [long form merger], made for the sole purpose of freezing out minority stockholders, is an abuse of the corporate process; and the complaint, which so alleges in this suit, states a cause of action for violation of a fiduciary duty for which the Court may grant such relief as it deems appropriate under the circumstances.

This is not to say, however, that merely because the Court finds that a cash-out merger was not made for the sole purpose of freezing out minority stockholders, all relief must be denied to the minority stockholders in a § 251 merger. On the contrary, the fiduciary obligation of the majority to the minority stockholders remains and proof of a purpose, other than such freezeout, without more, will not necessarily discharge it. In such case the Court will scrutinize the circumstances for compliance with the *Sterling* rule of "entire fairness" and, if it finds a violation thereof, will grant such relief as equity may require.

380 A.2d at 980. The *Sterling* case referred to by the court in *Singer* was *Sterling v. Mayflower Hotel Corp.*, 93 A.2d 107 (Del. 1952), involving a proposed merger of Mayflower Hotel Corporation into its parent corporation, Hilton Hotels Corporation. In *Sterling*, the Delaware Supreme Court treated Hilton, the majority shareholder of Mayflower, as bearing the burden of establishing the "entire fairness" of the proposed merger. See 93 A.2d at 109-10.

In *Tanzer*, which followed immediately after *Singer*, the Delaware Supreme Court held that the business purpose required by *Singer* could consist of a legitimate business purpose designed to benefit the majority shareholder. See 379 A.2d at 1124-25. The *Najjar* case extended the *Singer/Tanzer* doctrine to short-form mergers under § 253 of the Delaware General Corporation Law. See 407 A.2d at 1033. The *Singer/Tanzer* sequence of cases is discussed in Ham, *Kentucky Law Survey—Corporations*, 67 Ky. L.J. 457, 472-80 (1978-79).

44  457 A.2d at 704.
at any price up to $24 each.147 Neither the outside non-Signal members of the UOP board nor the minority shareholders of UOP were informed of the feasibility study.148 At the annual meeting of the UOP shareholders, 51.9% of the minority shareholders voted for the merger, which when added to the UOP stock owned by Signal resulted in an approval of the merger by a total of 76.2% of UOP’s outstanding shares.149 On the effective date of the merger which followed, each share of the UOP minority stock was automatically converted into a right to receive $21 in cash.150 Plaintiff, a minority shareholder in UOP, brought a class action in the Court of Chancery of Delaware challenging the legality of the cash-out merger between Signal and UOP.151 The Delaware chancellor found the terms of the merger to be fair to the minority shareholders of UOP and decided for the defendants, who included Signal, UOP and certain officers and directors of those companies.152

On appeal, the Supreme Court of Delaware, disagreeing with the findings of the chancellor that the circumstances of the merger and the price paid the minority shareholders in UOP were fair, reversed the judgment and remanded the case for further proceedings.153 The court held that since Signal was the majority shareholder in UOP, its failure to inform the UOP minority shareholders of the contents of the feasibility study was a breach of fiduciary duty which precluded the merger from meeting the test of fairness.154 However, in considering the proper remedy to give

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147 Id. at 705.
148 Id. at 707.
149 Id. at 708.
150 Id.
151 Id. at 703.
152 Id. Lehman Brothers Kuhn Loeb, Inc., an investment banking company, which had been employed by UOP to render a fairness opinion as to the price offered the minority for their stock, was also named as a defendant in the original action but was later dismissed by plaintiff. Id.
153 Id. at 715.
154 Id. at 711-12. Recognizing the importance of the price information contained in the feasibility report to an informed vote of the minority stockholders of UOP, the court remarked:

[T]he minority stockholders were denied the critical information that Signal considered a price of $24 to be a good investment. Since this would have meant over $17,000,000 more to the minority, we cannot conclude that the shareholder vote
minority shareholders under Delaware law in cash-out mergers, the court concluded the remedy should be an appraisal under the Delaware appraisal statute. But, to give full effect to the appraisal statute, the court added that it was adopting "a more liberal, less rigid and stylized, approach to the valuation process than has heretofore been permitted by our courts." The chancellor had used the "Delaware block" approach in determining the value of plaintiffs' stock, by weighting the three elements of value consisting of assets, market price and earnings, and had rejected a discounted cash flow method of valuing UOP's stock which had been offered by plaintiff. Disagreeing with this restricted approach to valuation, the supreme court commented: "[T]he standard 'Delaware block' or weighted average method of valuation, formerly employed in appraisal and other stock valuation cases, shall no longer exclusively control such proceedings." The court added that it believed "a more liberal approach must include proof of value by any techniques or methods which are generally considered acceptable in the financial community and otherwise admissible in court," which would "obviate the very structured and mechanistic procedure that has heretofore governed such matters."

Although the Delaware Supreme Court made it clear that in the future the appraisal remedy will normally be the only recourse the minority shareholder can expect to have in a cash-out merger,
the court did leave open the possibility of other forms of relief in particularly egregious cases. The court remarked: "The appraisal remedy we approve may not be adequate in certain cases, particularly where fraud, misrepresentation, self-dealing, deliberate waste of corporate assets, or gross and palpable overreaching are involved." However, as to the availability of the "business purpose" test for invalidating a cash-out merger, the court held that such requirement was no longer to have any force or effect. The court noted that in view of "the expanded appraisal remedy now available to shareholders, and the broad discretion of the Chancellor to fashion such relief as the facts of a given case may dictate, we do not believe that any additional meaningful protection is afforded minority shareholders by the business purpose requirement.

It is not likely that the discarding of the Singer/Tanzer business purpose test in Weinberger will detract much from the position of minority shareholders in cash-out mergers because of the ease in showing some legitimate business purpose. However, the relegation of minority shareholders to monetary relief in the context of an expanded appraisal remedy may not represent much of a gain to such minority shareholders in view of the procedural complexities and technicalities which surround the appraisal remedy.

B. Tender Offers

The Kentucky case of most interest decided during the present Survey period was undoubtedly Esmark, Inc. v. Strode, in which

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163 Id. at 714. The court observed that "[w]hile a plaintiff's monetary remedy ordinarily should be confined to the more liberalized appraisal proceeding herein established, we do not intend any limitation on the historic powers of the Chancellor to grant such other relief as the facts of a particular case may dictate." Id.

164 Id. (citation omitted).

165 Id. at 715.

166 Id.


168 This is further compounded by the literal construction courts customarily give to appraisal statutes, demanding that dissenting shareholders strictly comply with the procedural technicalities. See, e.g., F. S. Moseley & Co. v. Midland-Ross Corp., 179 A.2d 295, 296-97 (Del. 1962).

the Supreme Court of Kentucky declared unconstitutional the Kentucky Take-Over Act, enacted in 1976. In doing so, the Court relied heavily on the recent decision by the United States Supreme Court in Edgar v. MITE Corp., declaring a similar Illinois statute unconstitutional.

_Esmark_ resulted from an effort on the part of Esmark, Inc., a Delaware corporation with its principal business office in Chicago, Illinois, to acquire Reliance Universal, Inc., a Kentucky corporation, with its principal place of business in Louisville, Kentucky, through a series of open market purchases of Reliance stock. James C. Strode, Director of Securities of the Department of Banking and Securities for the Commonwealth of Kentucky, filed suit against Esmark charging Esmark with making a tender offer in violation of the provisions of the Kentucky Take-Over Act. The trial court enjoined Esmark from continuing its purchases of Reliance stock and from making a takeover bid, and ordered divestiture by Esmark of all its Reliance stock in excess of five percent. The Kentucky Court of Appeals upheld the constitutionality of the Kentucky Take-Over Act and affirmed that portion of the trial court judgment enjoining Esmark from further acquisitions of Reliance stock. The court of appeals, however, reversed the order of divestiture on the ground that the Take-over Act was a part of the provisions of the Kentucky Securities Act, which only authorized injunctive relief, not divestiture.

Finding that the provisions of the Kentucky Take-Over Act

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172 Id. at 646. For the text of the Illinois statute, see ILL. ANN. STAT. ch. 121 1/2, §§ 137.51-.70 (Smith-Hurd Supp. 1983-84).
173 639 S.W.2d at 769.
174 Id.
175 Id. at 769-70. The Kentucky Act defined "takeover bid" as any tender offer made to ten or more shareholders of a corporation which, if successful, would result in the offeror becoming the owner of more than five percent of any class of the corporation's stock. See KRS § 292.560(1). The Kentucky Supreme Court in _Esmark_ did not determine whether a "creeping tender offer," such as involved in the open market purchases of Reliance Universal stock by Esmark, should come within the prohibitions of takeover legislation. See 639 S.W.2d at 774.
176 639 S.W.2d at 769-70.
177 See 28 KLS 5, at 2.
paralleled so closely the provisions of the Illinois takeover statute "as to make the holdings in MITE applicable," the Supreme Court of Kentucky reversed the holding of the court of appeals concerning the validity of the provisions of the Kentucky Act. In reversing the court of appeals and finding the Kentucky Act unconstitutional, the Supreme Court gave MITE its broadest possible effect by holding both that the Illinois statute was preempted at the federal level by the Williams Act, and that the Illinois statute was an undue burden on interstate commerce under the commerce clause of the United States Constitution. Actually, the only consensus holding in MITE was that the Illinois Business Take-Over Act constituted an unlawful indirect burden on interstate commerce. However, Justice White wrote a comprehensive opinion in which he found the Illinois Act violated not only the supremacy clause of the United States Constitution, but also the commerce clause of the Constitution. The commerce clause violation arose both because the extraterritorial effect of the Illinois Act constituted a direct restraint on interstate commerce and because, even if the Illinois Act were treated as regulating interstate commerce only indirectly, the burden on such commerce under the Illinois Act was excessive in relation to the local interests served by the statute.

On the preemption issue, Justice White found the Illinois Act to be in conflict with the Williams Act by violating the neutrality position sought to be maintained under the Williams Act as between management of target companies and tender offerors in three respects: (1) by including precommencement notification provisions before a tender offer could become effective, (2) by including

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178 639 S.W.2d at 773.
179 Id. at 775.
180 Id. at 771-73.
181 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (1976).
182 639 S.W.2d at 773-74.
183 U.S. CONST. art. I, § 8, cl. 3.
185 U.S. CONST. art. VI, cl. 2. See 457 U.S. at 630-40 for a discussion of the supremacy clause question.
186 457 U.S. at 640-46.
187 Id. at 635-36.
hearing provisions allowing the Illinois Secretary of State to hold hearings with respect to a tender offer, and (3) by including provisions permitting the Illinois Secretary of State to pass on the fairness of a tender offer. Justice Stephenson, writing for the Supreme Court of Kentucky in *Strode*, found sufficient similarities in the provisions of the Kentucky Take-Over Act to those contained in the Illinois Act to warrant application of the conclusions as to preemption expressed by Justice White in *MITE*. Justice Stephenson likewise found that the extraterritorial provisions of the Kentucky Act violated the commerce clause, both directly and indirectly, in the same manner that Justice White had found the Illinois provisions to violate the commerce clause.

Therefore, although the holding by the Supreme Court of Kentucky as to the constitutionality of takeover statutes of the Kentucky and Illinois type is perhaps somewhat more comprehensive...
than the actual holding of the Supreme Court of the United States as to the constitutionality of the Illinois statute in MITE, the message seems clear that state takeover legislation is going to remain suspect to the extent that it attempts to regulate more than intrastate takeover situations.\footnote{192}

C. Right of Inspection

In another decision handed down by the Delaware Supreme Court during the Survey period, CM & M Group, Inc. v. Carroll,\footnote{193} the court once again considered the scope of a shareholder’s right to inspect the books and records of a corporation.\footnote{194} The plaintiff, Carroll, was one of the founders of Carroll, McEntee and McGinley, Inc., which acted as a broker in United States government securities.\footnote{195} He possessed a fifty-one percent controlling interest in the firm and served as the company’s president and chairman of the board.\footnote{196} Due to personality conflicts which developed between Carroll and key employees of the firm, Carroll relinquished control of the corporation by selling approximately one-third of his shares back to the firm and resigning as president and chairman of the board.\footnote{197} During the period from 1970 to 1980, the Carroll, McEntee firm prospered, growing in size to eight companies.\footnote{198} Management reorganized the corporate structure by forming CM & M as a “holding company for all eight subsidiaries, including Carroll, McEntee.”\footnote{199} Carroll became the largest single shareholder in CM & M, owning approximately one-third of its shares.\footnote{200} Shortly after the 1980 reorganization, Carroll contacted an investment firm concerning the sale of his interest in CM & M.\footnote{201} In addition, Carroll made a written demand on CM & M for inspection of the

\footnote{193} 453 A.2d 788 (Del. 1982).
\footnote{194} \textit{Id.} at 792. The variety of questions that can arise with reference to a shareholder’s right of inspection are myriad. \textit{See generally} W. Cary & M. Eisenberg, \textit{Cases and Materials on Corporations} 344-53 (5th ed. 1980).
\footnote{195} 453 A.2d at 790.
\footnote{196} \textit{Id.}
\footnote{197} \textit{Id.}
\footnote{198} \textit{Id.}
\footnote{199} \textit{Id.}
\footnote{200} \textit{Id.}
\footnote{201} \textit{Id.}
quarterly financial statements of CM & M and Carroll, McEntee but his request was refused. In an ensuing suit brought by Carroll to enforce his right of inspection, the Delaware Chancery Court ordered CM & M to produce for Carroll's inspection and copying certain categories of books and records not in Carroll's possession.

On appeal, CM & M contended that Carroll's request for inspection was not for a "proper purpose" as required by the Delaware General Corporation Law. CM & M argued that Carroll's actual purpose was "to procure all the financial information pertaining to CM & M that some potential third-party buyer might want," and that, therefore, the information was not really for Carroll's inspection to value and sell his stock but for outside third parties who were not shareholders of CM & M.

Rejecting these contentions by CM & M as untenable, the Supreme Court of Delaware supported the position of the court of chancery and ordered inspection. The court stated: "The paramount factor in determining whether a stockholder is entitled to inspection of corporate books and records is the propriety of the stockholder's purpose in seeking such inspection . . . . [O]nce a proper purpose has been established, any secondary purpose or ulterior motive of the stockholder becomes irrelevant." The supreme court concluded: "Having found a proper purpose, the Court properly passed over any ancillary purpose of Carroll's to coerce CM & M to purchase his shares." Recognizing, however, that allowing Carroll a general right of inspection could lead to

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202 Id. at 791.
203 Id.
204 Id. at 792 For the text of the Delaware statute, see Del. Code Ann. tit. 8, § 220 (1975 & Supp. 1982). The Delaware statute defines proper purpose as "a purpose reasonably related to such person's interest as a stockholder." Del. Code Ann. tit. 8, § 220(b). The Kentucky Business Corporation Act also recognizes the shareholder's right of inspection for any proper purpose "at any reasonable time or times." See KRS § 271A.260(2)(1981). This was also the common law rule. See 5 W. Fletcher, Cyclopaedia of the Law of Private Corporations § 2214 (rev. perm. ed. 1976).
205 453 A.2d at 792.
206 Id.
207 Id. at 793.
208 Id. at 792 (citations omitted).
209 Id. at 793 (citations omitted). CM & M had contended that Carroll's request constituted "a thinly-veiled attempt to force CM & M to buy his stock at an unfairly inflated price so that CM & M can prevent the general disclosure of its financial information." Id. at 792.
confidential corporate financial data reaching the hands of persons not genuinely interested in the purchase of his shares, the supreme court held that the Delaware Court of Chancery should exercise its powers to prevent possible abuse of the shareholder’s right of inspection “by placing such reasonable restrictions and limitations as it deems proper on the exercise of the right.” The supreme court, therefore, remanded the case to the court of chancery with carefully drawn directions to modify its judgment to make Carroll’s right of inspection contingent upon the following requirement:

[N] either the plaintiff nor any agent of his shall disclose information obtained as a result of these proceedings to anyone who has not first made a written representation to the plaintiff that he is a bona fide prospective purchaser of Carroll’s stock and executed an agreement of confidentiality, both to be in form approved by the Court of Chancery.

Over the years, many cases in Delaware and elsewhere have considered shareholder requests for inspection of the books and records of a corporation. However, this particular decision by the Delaware Supreme Court seems to reflect a particularly perceptive approach to balancing the rights of the shareholder and the interests of the corporation in these types of cases.

D. Authority of President

A recent case decided by the Supreme Court of Utah, Lloydona

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210 Id. at 793-94. The Delaware inspection statute provides that “[t]he Court may, in its discretion, prescribe any limitations or conditions with reference to the inspection, or award such other or further relief as the Court may deem just and proper.” See Del. Code Ann. tit. 8, § 220(c).

211 453 A.2d at 794. As part of its order the supreme court also added the requirement that “[t]he name and address of any such prospective purchaser, together with such representation and agreement, shall be served and filed by the plaintiff in this cause at least 5 days before any such disclosure.” Id. In its order on remand, the supreme court also directed that the court of chancery include in its judgment a stipulation that any violations of the conditions imposed would expose the plaintiff and any prospective purchaser to possible sanctions by the court of chancery, as well as a stipulation that the court of chancery would retain jurisdiction for a period of two years to hear and determine any application for such a sanction. Id.

Peters Enterprises v. Dorius,213 demonstrates that there are still jurisdictions in this country that adhere to the traditional viewpoint214 that the president of a corporation generally has no inherent power merely by virtue of that office to act on behalf of the corporation.215

Lloydonna Peters Enterprises, Inc. (LPE) was owned by four sisters, one of whom was defendant DeLoris P. Dorius.216 Each sister served as a director and officer of the corporation and owned an equal share in the stock of the corporation, whose assets consisted of real property which the sisters had inherited from their mother.217 In December, 1971, DeLoris P. Dorius and her husband purchased an office building, with LPE agreeing to pay a portion of the purchase price in return for a promise by Dorius and her husband that they would convey to LPE an undivided one-half interest on final payment.218 In 1978, when payments on the property were nearly completed, the Doriuses discussed the possibility of a sale of LPE’s interest in the property to them.219 Following appraisals of the property at the instigation of the board of directors of LPE, the Doriuses tendered to Gay P. Driggs, treasurer and director of LPE, a check for $14,000, representing the value of LPE’s interest in the property based on the higher of the two appraisals that had been secured on the property.220 Although all four of the directors of the corporation recognized this appraisal as valid, two of the four directors remained undecided as to whether LPE should sell its interest at the tendered price.221 Despite this lack of agreement, Driggs deposited the Doriuses’ check in LPE’s bank account.222 The Doriuses thereafter treated LPE as having no further interest in the office building and discontinued rental payments which they had previously been making on the property.223

213 658 P.2d 1209 (Utah 1983).
214 See 2A W. Fletcher, supra note 204, at § 557 (rev. perm. ed. 1982).
215 658 P.2d at 1212.
216 Id. at 1210.
217 Id.
218 Id.
219 Id.
220 Id.
221 Id.
222 Id.
223 Id.
About two and one-half years later, without any authorization from the board of directors, Jean P. Hull, as president of LPE, brought a suit for specific performance on behalf of the corporation to require the Doriuses to execute a warranty deed to an undivided one-half interest in the corporation. The Doriuses, claiming lack of authority in Hull to initiate litigation on behalf of LPE, entered a motion to dismiss the suit. The trial court granted the motion to dismiss, and this was affirmed on appeal.

Citing an earlier Utah case in which the court had called attention to the "board action" rule that directors must act as a body and not individually, the Supreme Court of Utah remarked that "this Court has consistently refused to uphold the power of a corporate president to act in behalf of his corporation without authorization from its board of directors." Referring to an exception to the general rule which recognizes the power of the president to act on behalf of the corporation when necessary to preserve the assets of the corporation, the court found no basis for application of the exception in the Dorius case. Noting that through the $14,000 payment tendered by the Doriuses, "LPE has already on hand the sum apparently equal to the value of its interest in the property which Hull claims to be protecting in initiating this suit," the court determined that "LPE faces no 'irreparable loss' in the event of failure to initiate legal action." The court

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224 Id. at 1210-11.
225 Id. at 1211.
226 Id. at 1211-12.
228 658 P.2d at 1211. The court supported this position with the following provision in the Utah Business Corporation Act:

All officers and agents of the corporation, as between themselves and the corporation, shall have such authority and perform such duties in the management of the corporation as may be provided in the bylaws, or as may be determined by resolution of the board of directors not inconsistent with the bylaws.

229 658 P.2d at 1211 (quoting Kamas Sec. Co. v. Taylor, 226 P.2d 111, 115 (1950)).
230 Id. at 1211-12.
231 Id. at 1212. In evaluating the $14,000 payment, the court also noted that all four directors of LPE had accepted as valid the appraisal on which that valuation was based, and that the two directors who had objected to the transaction had made no effort to return the $14,000 payment or to take legal action until nearly two and one-half years later. Id. at 1211-12.
concluded: "The facts of the present case therefore fail to justify any departure from the general rule prohibiting unauthorized acts by a corporate president." \(^{232}\)

It has been said that the rule applied by the Utah court in the *Dorius* case maintains today "a respectable following in just under half the states." \(^{233}\) Kentucky is one of these states. \(^{234}\) The former Court of Appeals of Kentucky remarked:

> It has long been settled in this state that an officer of a corporation has no general authority to execute contracts on behalf of the corporation. Authority to bind the corporation must come either from the by-laws or the board of directors, or the action of the officer must be of the nature that comes within the apparent scope of his employment. \(^{235}\)

A developing viewpoint in some jurisdictions, which has been described as "the liberal and modern rule," is that the president by virtue of his office is presumed to be able to enter into transactions that pertain to the ordinary business of the corporation, unless the contrary appears or it is expressly stated that the president has no such powers. \(^{236}\) One problem with the "ordinary business" approach has been determining what actions are "ordinary" as distinguished from "extraordinary," particularly since what constitutes "extraordinary" action has considerably narrowed

\(^{232}\) *Id.* at 1212. In a dissenting opinion, Judge Durham suggested that the LPE situation came within the exception to the general rule regarding the powers of a corporate president, "that a corporate president may act for the corporation in the absence of authorization from the board of directors in order to preserve or protect corporate assets." *Id.* (Durham, J., dissenting). Treating the deadlock on the board as preventing a valid sale, Judge Durham stated: "In the absence of a valid sale, LPE is being deprived (perhaps permanently) both of title to its undivided one-half interest in property, which may be appreciating in value, and of its share of the past and future rents." *Id.* (Durham, J., dissenting).


\(^{234}\) See, e.g., Har-Bel Coal Co. v. Asher Coal Mining Co., 414 S.W.2d 128 (Ky. 1967). In this case, the Asher Coal Mining Co. was in the business of acquiring coal-bearing lands and then leasing the lands to various business firms for the purpose of extracting and marketing coal. On one occasion, the president of Asher Coal Mining Co., Robert Asher, executed a lease under his own signature alone. The validity of the lease was later challenged on the ground of the lack of authority in the president to act without approval of the board and this challenge was upheld. *Id.* at 130.

\(^{235}\) *Id.* at 130.

under the impact of modern corporate life. Indeed, these modern corporate pressures have even induced courts to recognize the inherent authority of presidents to act where their action is conceded to have been beyond the usual course of business of the corporation. The *Dorius* case would indicate a continued resistance to any such trend.

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238 See, e.g., Yucca Mining & Petroleum Co. v. Howard C. Phillips Oil Co., 365 P.2d 925, 929 (N.M. 1961)(oil well drilling contract). In *Yucca*, the court remarked: Although ordinarily a corporation can only act through its directors as to any matters that are not in the usual course of the daily operation of the business, it is recognized that, with the swift pace of modern business life, it is impossible to expect action by the directors in every transaction, even though it may be termed “unusual.” *Id.* at 929.

239 However, if a president serves also in some other capacity, such as the general manager of the corporation, his power to act on behalf of the corporation may be considered greater than it would have been in his capacity as president alone. See, e.g., Memorial Hosp. Ass’n v. Pacific Grape Prods. Co., 290 P.2d 481 (Cal. 1955)(en banc). For a discussion of the authority of corporate officers, see generally W. Cary & M. Eisenberg, supra note 194, at 185-92.