Kentucky Law Survey: Corporations

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Corporations

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The approach taken to the Corporations section of the present Survey will be similar to that taken in previous Surveys.¹ Part I will be devoted to three significant decisions by the Supreme Court of the United States relating to federal corporation law. Part II, dealing with developments in state corporation law, will direct attention to a Kentucky securities law case, a recent court decision from a Model Act jurisdiction interpreting statutory provisions similar to those contained in the Kentucky Business Corporation Act, and a recent legislative development in Kentucky pertaining to corporate takeovers.

I. FEDERAL CORPORATION LAW

A. SEC Rule 10b-5

The flood of litigation under SEC Rule 10b-5,² which prohibits fraudulent or deceptive conduct in the purchase or sale of securities,³ continues to pour forth from the federal courts.⁴

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¹ For previous corporation law surveys, see Ham, Kentucky Law Survey—Corporations, 64 Ky. L.J. 253 (1975); Ham, Kentucky Law Survey—Corporations, 63 Ky. L.J. 739 (1975).
³ The full text of the Rule reads as follows:
   It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
   (a) To employ any device, scheme, or artifice to defraud,
   (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
   (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.
   Id.
⁴ SEC Rule 10b-5 was promulgated by the Securities and Exchange Commission pursuant to § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1970). The full text of the section reads:
However, recent restrictive interpretations of the Rule by the Supreme Court of the United States will likely result in some slowing of this wave of cases in the future.\(^{5}\) Last year's Survey dealt with one such decision by the Supreme Court in the \textit{Blue Chip Stamps} case,\(^{6}\) which approved the \textit{Birnbaum} standing requirement for plaintiffs in Rule 10b-5 suits.\(^{7}\) Under this requirement a plaintiff must be a purchaser or seller of securities to have standing to bring a Rule 10b-5 damage suit.\(^{8}\) Strict adherence to this requirement, which now seems assured by the \textit{Blue Chip Stamps} decision, will undoubtedly serve to narrow somewhat the class of plaintiffs eligible to bring such suits. As suggested in the previous Survey, it will probably have its most noticeable effect on minority shareholders seeking to find a basis under federal law for bringing private civil damage suits based on allegations of corporate mismanagement.\(^{9}\)

During the past year, the Supreme Court further restricted the scope of Rule 10b-5 by its decision in \textit{Ernst \& Ernst v. Hochfelder},\(^{10}\) which established a scienfer requirement for the

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

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.
\end{quote}

\(^{5}\) The current restrictive attitude of the Court toward the scope and application of § 10(b) and Rule 10b-5 stands in marked contrast to the more expansive attitude taken by the Court in the \textit{Bankers Life} case, decided in 1971, in which Mr. Justice Douglas, writing for the Court, had remarked that "Section 10(b) must be read flexibly, not technically and restrictively." Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 12 (1971).


\(^{8}\) The \textit{Birnbaum} standing requirement was first enunciated in Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir.), \textit{cert. denied}, 343 U.S. 956 (1952), from which the requirement takes its name.

\(^{9}\) \textit{See Ham, Kentucky Law Survey—Corporations}, 64 Ky. L.J. 253, 257 (1975). The availability of the shareholder's derivative suit may mitigate this difficulty to some extent in those cases where the minority shareholder can show the corporation has been wronged as the result of a fraudulent securities transaction. \textit{See}, \textit{e.g.}, Schoenbaum v. Firstbrook, 405 F.2d 215 (2d Cir. 1968), \textit{cert. denied}, 395 U.S. 906 (1969).

\(^{10}\) 425 U.S. 185 (1976).
maintenance of damage suits under the Rule. In reaching this result the Court put at rest a conflict which had existed for many years in the lower federal courts as to whether some form of knowing or intentional conduct was required for liability under Rule 10b-5 or whether negligent conduct was sufficient. One of the early cases focusing attention on the scienter-negligence issue was the decision of the Second Circuit Court of Appeals in the well-known Texas Gulf Sulphur case, in which Judge Waterman, speaking for a majority of the court, held that in a suit for injunctive relief under Rule 10b-5 negligent conduct would be sufficient to sustain such relief. In this same opinion he left the strong inference that he would have considered a similar standard appropriate even in private damage actions. However, other judges who heard the case expressed strong reservations as to imposing civil liability based on mere negligent conduct, and the matter of civil liability based on negligence remained an open question in the Second Circuit for some time. The issue was finally resolved for that

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12 401 F.2d at 855.
13 Id.
14 See, e.g., the concurring opinion of Judge Friendly, who expressed particular concern as to the impact a damage award could have on a corporation based on negligence in the drafting of a press release. He remarked: "The consequences of holding that negligence in the drafting of a press release . . . may impose civil liability on the corporation are frightening." Id. at 866. The open-ended nature of the damages in such cases, due to the potentially large class of affected investors, was underscored by Professor David Ruder in Ruder, Texas Gulf Sulphur—The Second Round, 63 Nw. U.L. Rev. 423, 428-29 (1969).
15 The tendency of judges to straddle the issue if at all possible was well illustrated by the language of Judge Medina in the case of Heit v. Weitzen, 402 F.2d 909 (2d Cir. 1968), cert. denied, 395 U.S. 903 (1969), in which he responded as follows to charges that officials of a corporation had caused it to publish misleading statements as to its net income:

[W]e must now deal with the question of the standard by which the conduct of the defendants is to be judged. Judge Waterman in the Texas Gulf Sulphur opinion held that proof of negligence was sufficient to sustain an action for injunctive relief under Rule 10b-5(2), but at the same time found it not necessary to decide whether negligence absent a showing of bad faith would suffice in a private suit for damages. . . . However, no question of liability for damages was before the Court in Texas Gulf Sulphur and Judge Friendly, in a concurring opinion joined in part by other judges, intimated that the appropriate standard in a private damage action should embody a scienter requirement.

. . . .
circuit in favor of a scienter requirement when the Court of Appeals stated unequivocally that "proof of a willful or reckless disregard for the truth is necessary to establish liability under Rule 10b-5."\(^6\)

At the same time that the Second Circuit was resolving the scienter-negligence issue in favor of a scienter requirement, other federal circuits were expressing approval of a lesser standard,\(^7\) although it appears that the conduct actually involved in the cases in those circuits was knowing or intentional rather than merely negligent.\(^8\) Amid this growing confusion and conflict over the scienter-negligence issue, the Ninth Circuit Court

There is no occasion for us to enter this thicket now as we pass only upon the legal sufficiency of the complaints to allege a claim for relief. This each of the complaints fairly does. The charge that defendants "knew or should have known" adequately alleges actual knowledge of the falsity of the statements, and, alternatively, negligence or lack of diligence in failing to ascertain the true facts. If some form of scienter test is to be applied, as Judge Friendly seems to suggest in his concurring opinion in Texas Gulf Sulphur, we think the alternative allegation of actual knowledge of falsity is amply sufficient as a matter of pleading. And this would seem to be so whether the scienter test ultimately applied be strict or liberal.\(^9\)

\(^6\) Lanza v. Drexel & Co., 479 F.2d 1277, 1306 (2d Cir. 1973). The decision of the court, en banc, was 6-4. The case involved the liability of an outside director of a corporation who had failed to uncover fraudulent misrepresentations made by inside officials of the corporation to prospective purchasers of the corporation's stock. Judge Hays, who wrote a separate dissenting opinion, would have applied a negligence standard in determining the director's liability. Id. at 1319. Judge Timbers, who also wrote a separate dissenting opinion, while stating that he did not necessarily disagree with Judge Hays' views on the scienter-negligence issue, treated the director's conduct as involving "reckless disregard for the truth" within the standard adopted by the majority. Id. at 1321-22.

\(^7\) See, e.g., Myzel v. Fields, 386 F.2d 718, 734-35 (8th Cir. 1967), cert. denied, 390 U.S. 951 (1968); Stevens v. Vowell, 343 F.2d 374, 379 (10th Cir. 1965); Kohler v. Kohler Co., 319 F.2d 634, 637 (7th Cir. 1963).

\(^8\) See Bucklo, Scienter and Rule 10b-5, 67 NW. U.L. REV. 562 (1972). Furthermore, later decisions in some of these circuits indicated a move in the direction of a more strict scienter standard. For example, in the Tenth Circuit, which had previously indicated approval of a "due care" standard, the Court of Appeals in Clegg v. Conk, 507 F.2d 1351 (10th Cir. 1974), cert. denied, 422 U.S. 1007 (1975) spoke of the need for "something additional by way of scienter or conscious fault than mere negligence . . . ." Id. at 1361. And the Court of Appeals for the Sixth Circuit adopted the Lanza standard of "willful or reckless" conduct in an SEC suit for injunctive relief, even though it had generally been assumed that the test of culpability was less stringent in such suits than in private damage actions. SEC v. Coffey, 493 F.2d 1304, 1314 (6th Cir. 1974), cert. denied, 420 U.S. 908 (1975).
Recognizing that much of the difficulty may have stemmed from attempting to apply one standard for state of mind to all Rule 10b-5 cases, a difficulty already recognized by legal commentators, the court rejected scienter or state of mind as a necessary or separate element in a Rule 10b-5 action and adopted a “flexible duty” standard based on the “extent of the duty that Rule 10b-5 imposes on [the] particular defendant.” The court said that in determining whether the defendant’s duty should be to exercise due care or only not to act intentionally should depend upon all the circumstances of the case including the relative positions of the plaintiff and defendant. Although the “flexible duty” approach appeared to

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" White v. Abrams, 495 F.2d 724 (9th Cir. 1974).

* One commentator, quoted by the court, expressed this viewpoint as follows: Instead of perpetuating the practice of discussing scienter and negligence as absolutes which are capable of being objectively applied, more is gained by recognizing that there is a sliding scale which determines what constitutes sufficiently diligent conduct to avoid 10b-5 liability, and that 10b-5 liability is determinable only within the context of the vagaries of the specific facts presented.

495 F.2d at 734, quoting Mann, Rule 10b-5: Evolution of a Continuum of Conduct to Replace the Catch Phrases of Negligence and Scienter, 45 N.Y.U.L. Rev. 1206, 1209 (1970). Professor Alan Bromberg, in his treatise on Rule 10b-5, has also expressed reservations as to whether a single standard of scienter can be made “to fit the enormous variability of 10b-5 private suits.” A. BROMBERG, 2 SECURITIES LAW: FRAUD, SEC RULE 10b-5 § 8.4 at 513 (1971).

In elaborating on this approach the court said:

[We] feel the court should, in instructing on a defendant’s duty under rule 10b-5, require the jury to consider the relationship of the defendant to the plaintiff, the defendant’s access to the information as compared to the plaintiff’s access, the benefit that the defendant derives from the relationship, the defendant’s awareness of whether the plaintiff was relying upon their relationship in making his investment decisions and the defendant’s activity in initiating the securities transaction in question.

. . . Where the defendant derives great benefit from a relationship of extreme trust and confidence with the plaintiff, the defendant knowing that plaintiff completely relies upon him for information to which he has ready access, but to which plaintiff has no access, the law imposes a duty upon the defendant to use extreme care in assuring that all material information is accurate and disclosed. . . . On the other hand, where the defendant’s relationship with the plaintiff is so casual that a reasonably prudent person would not rely upon it in making investment decisions, the defendant’s only duty is not to misrepresent intentionally material facts.

Id. at 735-36.
have considerable potential for resolving the "scienter" issue under Rule 10b-5,23 further use of that approach now seems foreclosed by the decision of the Supreme Court in Hochfelder.

The suit in Hochfelder was brought by customers of a small Chicago brokerage firm against the accounting firm of Ernst & Ernst to recover damages suffered by the customers as the result of a fraudulent securities scheme in which the president and owner of the brokerage firm converted the customers' funds to his own use.24 The charge against Ernst & Ernst was that the accounting firm had "aided and abetted" the fraudulent scheme by failing to utilize "appropriate audit procedures" in auditing the books of the brokerage firm.25 It was claimed that a proper audit of the internal practices of the brokerage firm would have led to the discovery of the fraudulent scheme.26 There was no claim, however, that Ernst & Ernst had engaged in any fraudulent or intentional misconduct.27 Nevertheless, the Court of Appeals for the Seventh Circuit held that negligent conduct could form the basis for a damage suit against a person for aiding and abetting a third party's violation of Rule 10b-5.28 The Supreme Court reversed, taking the

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23 See Campbell, Elements of Recovery under Rule 10b-5: Scien ter, Reliance, and Plaintiff's Reasonable Conduct Requirement, 28 So. CAR. L. Rev. 653, 702-03 (1975). However, Professor Louis Loss, author of the highly regarded treatise on Securities Regulation, was not so charitable. In his Summary Remarks at an ABA National Institute, he remarked as to the Abrams case: "... I must confess that I don't understand how that opinion could possibly work. How is a judge possibly to charge a jury under the sliding scale test? ... It is a perfectly logical, beautiful view, except, I think, that it is utterly impractical." Proceedings, ABA National Institute, Advisors to Management—Responsibilities and Liabilities of Lawyers and Accountants, 30 Bus. Law. 165-66 (Special issue, March 1975).

24 The president had represented to the customers that their funds would be invested in "escrow" accounts designed to yield a high rate of return. However, the "escrow" accounts were never in fact created, the money invested being immediately converted by the president to his own use. 425 U.S. at 189.

25 Id.

26 The principal practice pointed to in this respect was a "mail rule" employed by the president of the brokerage firm whereby no mail addressed to him or to his attention was to be opened except by him. It was contended that a proper audit by Ernst & Ernst would have revealed the "mail rule," that its existence would then have been disclosed to the Midwest Stock Exchange, of which the brokerage firm was a member, as well as to the Securities and Exchange Commission, and that these disclosures would have led to an investigation of the president which would have led to discovery of the fraudulent scheme. Id. at 190.

27 Id.

28 Hochfelder v. Ernst & Ernst, 503 F.2d 1100 (7th Cir. 1974).
position that § 10(b) of the Securities Exchange Act of 1934, under which Rule 10b-5 was promulgated, requires proof of more than negligent nonfeasance as a precondition to the imposition of civil liability. The position of the Court was that a private action for damages would not lie under § 10(b) and Rule 10b-5 "in the absence of any allegation of 'scienter'—intent to deceive, manipulate, or defraud." In reaching this result the Court emphasized the legislative history of § 10(b), which the Court thought indicated a Congressional intent to deal with practices involving "some element of scienter," and the language of § 10(b), which refers to the use of "manipulative or deceptive" devices or contrivances. To the Court this language was a persuasive indication that § 10(b) was intended to proscribe "knowing or intentional misconduct."

Although the position of the Court that "scienter" is a necessary prerequisite for the imposition of civil liability under Rule 10b-5 was taken in the context of a case involving secondary liability through aiding and abetting, the reasoning of the

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29 See note 4 supra.
30 425 U.S. at 214.
31 Id. at 193. The Court excluded from consideration whether reckless behavior might be sufficient in some circumstances for the imposition of civil liability under § 10(b) and Rule 10b-5 and whether scienter is a necessary element in an action for injunctive relief under the section and rule. Id. at 193 n.12. Of interest in this latter regard is a recent opinion by Judge Ward of the United States District Court for the Southern District of New York, in which he held that the reasoning of the Court in Hochfelder was as equally applicable to injunctive suits brought by the SEC under § 10(b) and Rule 10b-5 as to private damage actions. SEC v. Bausch & Lomb, Inc., [Current Binder] CCH Fed. Sec. L. Rep. ¶ 95,722 (S.D.N.Y. September 16, 1976). On the other hand, still more recently the First Circuit Court of Appeals has held that a showing of intent to deceive is not necessary in a suit by the SEC for injunctive relief, despite the availability of good faith as a defense to a private suit for damages under the Hochfelder decision. SEC v. World Radio Mission, Inc., [Current Binder] CCH Fed. Sec. L. Rep. ¶ 95,751 (1st Cir. 1976).
32 425 U.S. at 201.
33 See note 4, supra.
34 425 U.S. at 197. The decision was 6-2, with Mr. Justice Powell writing for the majority of the Court. In a dissenting opinion, Mr. Justice Blackmun, joined by Mr. Justice Brennan, chastised the majority for interpreting § 10(b) and Rule 10b-5 "restrictively and narrowly," thereby ignoring the interests of defrauded investors, who, as he viewed it, could be "victimized just as much by negligent conduct as by positive deception." Id. at 216. Mr. Justice Stevens took no part in the consideration of the case.
35 Because of its holding that intent to deceive, manipulate, or defraud was re-
Court would appear to be equally applicable to suits involving primary parties. Accordingly, it can be assumed that another broad group of cases, those based on allegations of negligent misconduct, has been removed from the reach of Rule 10b-5.35

B. The Proxy Rules

Another recent Supreme Court decision carrying significant implications for federal corporation law was TSC Industries, Inc. v. Northway, Inc.,37 involving the concept of materiality under Rule 14a-9 of the federal proxy rules.38 Rule 14a-9, which is an antifraud rule similar to Rule 10b-5, was promulgated by the Securities and Exchange Commission under authority granted to it by § 14(a) of the Securities Exchange Act of 1934.39 Rule 14a-9 prohibits false or misleading statements or omissions of material facts in proxy statements required to be submitted to shareholders of a corporation when their vote is needed on corporate matters.40

required to create civil liability under § 10(b) and Rule 10b-5 and the lack of any such charges against Ernst & Ernst, the Court concluded that it did not need to 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. Id. at 191-92 n.7. For a general discussion of secondary liability under the securities laws, see Ruder, Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification, and Contribution, 120 U. Pa. L. Rev. 597 (1972).

35 For a law review comment on the Supreme Court decision in the Hochfelder case, see Note, 9 CREIGHTON L. REV. 775 (1976).
   It shall be unlawful for any person, by the use of the mails or by any means or instrumentality of interstate commerce or of any facility of a national securities exchange or otherwise, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted security) registered pursuant to Section 78l [§ 12] of this title.
   The securities required to be registered under § 12 include shares of companies whose stock is listed for trading on a national securities exchange and shares of companies whose stock is traded over-the-counter if they have assets in excess of $1,000,000 and a class of stock (equity security) held of record by 500 or more persons. 15 U.S.C. § 78l (1970).
40 Rule 14a-9(a) contains the following language:
   No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting or other communication,
Prior to the *TSC Industries* case, the lower federal courts had been in some disagreement as to the proper test to use in establishing the requisite materiality of a fact within the meaning of Rule 14a-9. The Second,41 Third,42 and Fifth43 Circuits had adopted as the basic test for materiality whether a reasonable man *would* attach importance to the facts misrepresented in determining his course of action. In contrast, the Seventh Circuit44 had considered that the policies which underlie § 14(a) and Rule 14a-9 would be best served by a test that included "all facts which a reasonable shareholder *might* consider important."45

The confusion as to the proper test for materiality had been compounded by the Supreme Court itself as a result of expressions regarding materiality contained in two earlier opinions, *Mills v. Electric Auto-Lite Co.*46 and *Affiliated Ute Citizens v. United States.*47 These two cases had dealt with the necessity of proof of causation or actual reliance as prerequisites to liability under Rule 14a-9 and Rule 10b-5.48 In *Mills*, which arose under Rule 14a-9, the Court held that if a misstatement or omission in a proxy statement was found to be "material," there was no need for additional proof of actual reliance.49 Similarly, in *Affiliated Ute Citizens*, involving Rule

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44 Northway, Inc. v. TSC Industries, Inc., 512 F.2d 324 (7th Cir. 1975).
45 Id. at 330 (emphasis added).
48 In *List v. Fashion Park*, Inc., 340 F.2d 457 (2d Cir.), *cert. denied*, 382 U.S. 811, *reh. denied*, 382 U.S. 933 (1965), the Second Circuit Court of Appeals explained, in a Rule 10b-5 case, that the purpose of the "reliance" requirement as an essential element for recovery "is to certify that the conduct of the defendant actually caused the plaintiff's injury." 340 F.2d at 462.
49 The Court said:
Where there has been a finding of materiality, a shareholder has made a sufficient showing of causal relationship between the violation and the injury
10b-5, the Court held that positive proof of reliance, at least in cases of nondisclosure, was not a prerequisite to recovery under Rule 10b-5 if the facts withheld were otherwise "material." In Mills the Court spoke of an omitted fact as "material" if it was of such a character that it might affect the judgment of the reasonable investor, but then referred to the requirement that the defect have "a significant propensity to affect the voting process." In Affiliated Ute Citizens, the Court spoke of withheld facts being material "in the sense that a reasonable investor might have considered them important in the making" of his investment decision. Thus the Supreme Court in TSC Industries had an opportunity to clarify these expressions as to materiality.

In TSC Industries, National Industries, Inc. acquired a substantial stock interest in TSC Industries, after which it secured the approval of the board of directors of TSC for a sale of TSC's assets to National. The proposed sale of assets was approved by the shareholders of both companies and the merger of the two corporations was effected. Northway, Inc., a TSC shareholder, brought a civil damage suit claiming that the joint proxy statement sent to the shareholders of TSC seeking their approval of the asset sale was materially misleading in omitting certain information concerning the degree of control National possessed over TSC and in the favorability of the terms of the proposed transaction to TSC shareholders.

for which he seeks redress if . . . he proves that the proxy solicitation itself, rather than the particular defect in the solicitation materials, was an essential link in the accomplishment of the transaction.

The Court remarked:
Under the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material. . . . This obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact.

An additional claim was made under Proxy Rule 14a-3 that the proxy statement failed to state, as required by that Rule, that the stock acquisition by National had given it control of TSC. 426 U.S. at 442. The Supreme Court accepted the conclusion of the District Court and the Court of Appeals that a genuine issue of fact existed as
Court of Appeals for the Seventh Circuit, applying its test of materiality which emphasized facts which a reasonable shareholder *might* consider important,55 held that the alleged omissions in the proxy statement were material as a matter of law.56 The Supreme Court reversed, treating the omissions as raising issues of fact under the proper test of materiality, which the Court considered to be whether, in regard to an omitted fact, "there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote."57 The Court considered this test to comport best with the broad remedial purpose of Rule 14a-9 to ensure disclosures on the part of corporate management that would enable shareholders "to make an informed choice."58 The Court cautioned that adopting too low a standard of materiality would not only subject a corporation and its management to liability for insignificant omissions or misstatements but would also lead to the possibility of shareholders being overwhelmed by an avalanche of trivial information.59 The Court added that any language in the *Mills* or *Affiliated Ute Citizens* cases suggesting a standard based on information the shareholder *might* consider important should not be considered controlling since the issue of materiality was not the issue before the Court in those cases.60

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55 512 F.2d at 330.
54 426 U.S. at 443.
57 426 U.S. at 449. In adopting this test of materiality, the Court said:
It does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote.
What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder.

*Id.*

54 *Id.* at 448.
59 *Id.* at 448-49.

Referring to *Mills* the Court pointed out that the reference to the omitted information having a significant propensity to affect the voting process was added to the general statement that the information be of a kind that might affect the voting judgment of the reasonable shareholder to avoid the danger, as stated in *Mills*, that a cause of action could be based on trivial defects having no relation to the interests sought to be served by § 14(a). *Id.* at 447.

As to the reference in *Affiliated Ute Citizens* to the facts withheld being material in the sense that a reasonable investor might be influenced by them, the Court said
The decision of the Supreme Court in the *TSC Industries* case choosing the higher threshold of materiality for Rule 14a-9 cases is in line with the recent restrictive interpretations of the Court under the Securities Acts. If a similar attitude toward materiality can be expected on the part of the Court in Rule 10b-5 cases, as seems likely, another step will have been taken by the Court to reduce the volume of potential litigation under these Acts.\(^1\)

C. **Insider Trading**

A third Supreme Court case of importance in the corporate securities area was *Foremost-McKesson, Inc. v. Provident Securities Co.*,\(^2\) which put at rest a sharp conflict among the federal circuits as to the scope of short-swing trading liability under § 16(b) of the Securities Exchange Act of 1934.\(^3\) Section 16(b) provides that a corporation may recover any profits realized by a director, officer, or 10 percent beneficial owner of the corporation's stock, from a purchase and sale, or sale and pur-

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1. The Second Circuit Court of Appeals in the *Gerstle* case stressed as an additional reason for adopting a test of materiality based on "probability" rather than "possibility," the heavy damages that could result in view of its position that negligent conduct was sufficient to warrant recovery under Rule 14a-9. *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1302 (2d Cir. 1973). The Supreme Court specifically refrained from considering in the *TSC Industries* case "what showing of culpability is required to establish the liability under § 14(a) of a corporation issuing a materially misleading proxy statement, or of a person involved in the preparation of a materially misleading proxy statement." 426 U.S. at 444-45 n.7. As the Court of Appeals pointed out in *Gerstle*, the considerations for establishing a standard of culpability under Rule 14a-9 may be different from those for establishing such a standard under Rule 10b-5, particularly in view of the absence in § 14(a) of the evil sounding language of "manipulative or deceptive device or contrivance" contained in § 10(b). 478 F.2d at 1298-1301. The Supreme Court also seemed to recognize this possible difference in its opinion in the *Hochfelder* case. 425 U.S. at 209 n.28.


3. 15 U.S.C. § 78p(b) (1970). The trading prohibitions of § 16(b) apply only to corporate "insiders," defined in § 16(a) as including "[e]very person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any equity security (other than an exempted security) which is registered pursuant to section 78l [§ 12] of this title, or who is a director or an officer of the issuer of such security . . . ." 15 U.S.C. § 78p(a) (1970). The term "equity security" is broadly defined in the Exchange Act as including any stock of a corporation or any security convertible into stock of the corporation. 15 U.S.C. § 78c(a)(11) (1970).
chase, of the corporation's stock within a period of 6 months. The section exempts any transaction where the beneficial owner was not such both "at the time of" the purchase and sale, or the sale and purchase, of the stock. The question which had given rise to difference of opinion was whether the purchase which made a person a 10 percent owner could be counted in establishing his status as a beneficial owner "at the time of purchase." In other words, there was disagreement as to whether for a person to be a 10 percent owner "at the time of purchase" he must have acquired such status "before the purchase" or whether it was enough that he possessed such status "immediately after the purchase."

One of the first cases involving this question arose in the Second Circuit where the Court of Appeals upheld the position of the District Court that the purchase which makes a person a 10 percent owner may itself be counted in determining 10 percent beneficial ownership under § 16(b). The District

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"The relevant language of § 16(b) reads:

For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. . . .


The last sentence of § 16(b) reads, in part:

This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved . . . .

Id.

423 U.S. at 235.

Id. at 240. The reference to "immediately after the purchase" is sometimes spoken of as "simultaneously with the purchase." Id.

Court had felt such a position was required since otherwise it would be possible for a person to escape liability in a sale-repurchase sequence where after making an initial purchase of stock which put him in the 10 percent class he sold out his interests and then repurchased them. Later, the Eighth Circuit agreed with the Second Circuit position. However, when the issue came before the Ninth Circuit Court of Appeals in the Provident Securities case, that court held to the contrary, taking the position that the initial purchase by which a person increases his holdings to 10 percent should not be counted in determining § 16(b) liability. The court saw no inconsistency in taking the "before the sale" approach in the purchase-sale sequence while at the same time using an "immediately after the purchase" approach in a sale-repurchase sequence to meet the potential for abuse in the latter situation.

On review of the Provident Securities case, the Supreme Court upheld the decision of the Court of Appeals and agreed that "in a purchase-sale sequence, a beneficial owner must account for profits only if he was a beneficial owner 'before the purchase.'" However, the Supreme Court refused to express an opinion on the view taken by the Court of Appeals that the phrase "at the time of" as used in the exemption clause of § 16(b) could mean different things in different contexts.

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69 Stella v. Graham-Paige Motors Corp., 104 F. Supp. 957 (S.D.N.Y. 1952). The court remarked that if the "before the purchase" construction were placed upon the exemption clause "it would be possible for a person to purchase a large block of stock, sell it out until his ownership was reduced to less than 10%, and then repeat the process ad infinitum." Id. at 959.

70 Emerson Electric Co. v. Reliance Electric Co., 434 F.2d 918 (8th Cir. 1970), aff'd on other grounds, 404 U.S. 418 (1972). The central issue before the Supreme Court in Emerson Electric involved whether in a two-step sale by a 10 percent beneficial owner the second sale comes under § 16(b) if as a result of the first sale the beneficial owner reduced his ownership below 10 percent. The Court held that the second sale fell outside the scope of the section so long as the two sales were not legally tied to each other.

71 Provident Securities Co. v. Foremost-McKesson, Inc., 506 F.2d 601 (9th Cir. 1974).

72 Id. at 614.

73 Id. at 614-15.

74 423 U.S. at 249, 250.

75 Id. at 242 n.15. The Court remarked: "The view of the Court of Appeals that 'at the time' may mean different things in different contexts is not unique.... We express no opinion here on this view." Id.
While the Provident Securities case awaited review by the Supreme Court, the Seventh Circuit joined the Ninth Circuit in adopting the "before the purchase" position as to liability under § 16(b). The Court of Appeals looked to the legislative history of the section and reasoned that it showed that the aim of Congress in enacting the section was to deal with a unitary event involving "a specific type of two-part transaction consisting either of a purchase and subsequent sale, or a sale and subsequent repurchase," and was not aimed at "every separate purchase or sale as to which some use of inside information is a theoretical possibility." The court further reasoned that, under such an interpretation of § 16(b), a beneficial interest at the close of a short-swing transaction becomes irrelevant, and thus avoids the necessity of giving a dual meaning to the words "at the time of" in the exemption clause as was done by the Ninth Circuit in Provident Securities to meet the sale-repurchase transaction. The court did not consider that the language of the exemption clause changed the basic meaning of the section. They read the clause as simply confirming the requirement that a beneficial owner must have insider status at the beginning of a short-swing transaction.

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7 Id. at 346.
7 Id.
7 Id. at 348. The court commented that an ambiguity was created by the use of the word "both" in the exemption clause. The court reasoned that it was possible to read the word "both" to refer to the separate components of the two types of short-swing transactions, or it was possible to read the word to refer to the two types of transactions as transactions. Neither construction, thought the court, was absolutely apparent. The court said:

If Congress had intended the first construction it could easily have said "both at the time of the purchase and at the time of the sale." Similarly, if Congress had intended the second construction it could have said "both at the time of the purchase and sale transaction or the sale and purchase transaction." . . . Given the legislative history of section 16(b) . . . we believe Congress intended by the language in question merely to indicate that in the case of both types of short-swing transactions, a person, to be charged with a section 16(b) violation, must only have had insider status prior to the initial purchase or sale.

Id.

A side effect of the reasoning in the Allis-Chalmers case is to put in doubt the position of the Second Circuit Court of Appeals in Adler v. Klawans, 267 F.2d 840 (2d Cir. 1959), that an officer or director who makes an initial purchase before obtaining
The Supreme Court noted the approach to the exemption clause taken by the Seventh Circuit but did not consider the occasion called for an assessment of that approach.\textsuperscript{80} The Court, confining itself to a consideration of the exemption clause itself, treated the legislative history of that clause as indicating an intent on the part of Congress "to preserve the requirement of beneficial ownership before the purchase" in a purchase-sale sequence.\textsuperscript{81} Therefore, the decision may have only limited value in settling the scope of liability under § 16(b) in other contexts. The decision is, however, consistent with other recent interpretations of § 16(b) by the Court limiting the potential scope of liability under the section.\textsuperscript{82}

II. STATE CORPORATION LAW

A. Securities Regulation

The only significant Kentucky case directly concerned with corporation law during the past Survey year was \textit{City of Owensboro v. First U.S. Corp.},\textsuperscript{83} which dealt with the proper statute of limitations to apply to a securities fraud claim

\textsuperscript{80} 423 U.S. at 243 n.16. Likewise, the Court refrained from expressing any view "on the proper analysis of a case where a director or officer makes an initial transaction before obtaining insider status." \textit{Id.}

\textsuperscript{81} \textit{Id.} at 248. Noting the strict nature of the liability imposed by § 16(b), a virtual liability without fault, the Court used, as an added justification for its position, the assumption that if Congress had intended to impose such a liability, it would have done so "expressly or by unmistakable inference." \textit{Id.} at 252. The Court also seemed to take comfort in the presence of § 10(b) and Rule 10b-5 as a viable source of recovery for those investors harmed as the result of an actual misuse of material inside information. \textit{Id.} at 255.


\textsuperscript{83} 534 S.W.2d 789 (Ky. 1975). Two lower federal court cases arising in Kentucky involving interpretation and application of the antifraud provisions of the federal securities laws were Brown v. Commonwealth, 513 F.2d 333 (6th Cir. 1975), \textit{cert. denied}, 423 U.S. 839 (1976) (eleventh amendment of United States Constitution protects state from being sued by one of its citizens for damages alleged to have resulted from violations of antifraud provisions of federal securities laws), and \textit{SEC v. Senex Corp.}, 399 F. Supp. 497 (E.D. Ky.), \textit{aff'd}, 534 F.2d 1240 (1975) (knowledgeable assistance in suppressing unfavorable circumstances surrounding nursing home project constitutes sufficient violation of Rule 10b-5 under the aider-abettor doctrine to warrant injunctive relief).
brought under the Kentucky Securities Act (Blue Sky Law).84

The City of Owensboro case involved a suit by the city of Owensboro against First U. S. Corporation charging that First U. S. Corporation had sold certain bonds to the city on the basis of fraudulent misrepresentations. The suit was brought under the civil remedies section of the Kentucky Securities Act,85 which prohibits the sale of securities by means of misrepresentations or omissions of material fact unknown to the buyer of the securities.86 The section permits the seller to defend such a suit by sustaining the burden of showing that he did not know or in the exercise of reasonable care could not have known of the misrepresentations or omissions.87 The Act limits the time for bringing such suits to a period of 2 years from the date of sale.88 The city of Owensboro did not bring suit within the 2 years thus prescribed by the Securities Act.89 However, the action was brought within the 5 year period allowed under the general statute of limitations in Kentucky for actions based on fraud.90

The Supreme Court of Kentucky upheld the decision of the trial judge in dismissing the case under the 2 year statute.91

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84 KY. Rev. STAT. ch. 292 (Supp. 1976) [hereinafter cited as KRS].
85 KRS § 292.480(1).
84 Id.
86 KRS § 292.480(3), amended to 3 years, KRS § 292.480(3) (Supp. 1976).
87 Id.
88 KRS § 292.480(3), amended to 3 years, KRS § 292.480(3) (Supp. 1976).
89 When an amended complaint was filed, adding additional defendants, it was argued that even though this amended complaint was filed more than 5 years after the date of sale, the wrongful conduct of the additional defendants was not discovered by the plaintiffs until less than 5 years before the amended complaint was filed. 534 S.W.2d at 790.
90 The time period for bringing actions based on fraud under the Kentucky general statute of limitations is 5 years. KRS § 413.120(12). The time does not begin to run until after discovery of the fraud. KRS § 413.130(3). However, the action must be commenced within 10 years after the commission of the fraud. Id.
91 534 S.W.2d at 790.
The Court relied on its earlier decision in *First State Bank of Pineville v. Slusher*, in which the Court had approved its previous position that the presence of a specific limitations period in a Blue Sky Law evidenced a legislative design to make that the governing period. This appears to be the general rule.

The city of Owensboro made the further argument that its claim could be supported as a federal claim under § 17(a) of the Securities Act of 1933, which likewise proscribes fraud in the sale of securities, since that section contains no limitations period for actions brought under it, and therefore the

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92 101 S.W.2d 661 (Ky. 1937).
93 534 S.W.2d at 791. The Court in *Slusher* considered the statute of limitations issue to have been settled in *Thomas v. Fidelity & Cas. Co.*, 80 S.W.2d 8 (Ky. 1935), in which the Court had applied the 2 year limitation period to a case involving charges of fraudulent conduct on the part of a dealer in securities in the sale of corporate stock.
94 See 3 L. Loss, SECURITIES REGULATION 1640 (2d ed. 1961). The author there states: "When there is a special statute of limitations in the blue sky law, it prevails, of course, over a general statute of limitations which might otherwise be applicable."
96 The full text of the section reads:

It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud, or
(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

97 There is an obvious similarity in the language of § 17(a) and Rule 10b-5. See note 3, supra. This results from the fact that § 17(a) was used as the source for the drafting of Rule 10b-5. As explained by Judge Friendly in the *Texas Gulf Sulphur* case:

The derivation of Rule 10b-5 is peculiar. Although the authority for the Rule comes from § 10(b) of the Securities and Exchange Act of 1934, the draftsmen turned their backs on the language of that section and borrowed the words of § 17 of the Securities Act of 1933, simply broadening these to include frauds on the seller as well as the buyer.

Kentucky general statutes governing actions based on fraud (or on a statute) should apply. The Supreme Court of Kentucky likewise rejected this argument, taking the position that the 2 year limitations period in the state Securities Act was the most appropriate state statute to apply.

The issue as to the proper statute of limitations to apply to federal claims brought under the implied civil liability provisions of the Federal Securities Acts has been litigated most extensively in relation to Rule 10b-5. The federal courts have uniformly agreed that since there is no general federal statute of limitations applicable to civil actions, local state statutes of limitation should be applied. The selection of the appropriate state limitations statute has been made by applying a "resemblance" test to determine which state statute most closely resembles the federal claim. The result has been a sharp division of opinion as to whether the blue sky or general fraud statute of limitations applies. There is much to be said for the position of the Kentucky Court in adopting the shorter statute of limitations period contained in the Blue Sky Law, since this appears to conform best to the federal policy of using short limitations periods in the express civil liability provisions of the Federal Securities Acts, as well as to the needs of the

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8 534 S.W.2d at 791. The Kentucky general statute of limitations prescribes a 5 year limitations period for actions based on a statute where no other time is fixed by the statute creating the liability. KRS § 413.120(2).

9 534 S.W.2d at 791. The only previous case which appears to have raised this issue under Kentucky law was that of Dudley v. Allen, [1971-1972 Transfer Binder] CCH FED. Sec. L. Rep. ¶ 93,273 (W.D. Ky. October 28, 1971), in which the federal district court applied the general fraud statute without discussion.


12 14 W. FLETCHER, PRIVATE CORPORATIONS § 6780.29 (perm. ed. 1975 rev. vol.).


15 The usual period under these acts for actions based on misstatements and
B. Preemptive Rights

While there were no significant decisions from the Supreme Court of Kentucky during the past Survey year in the traditional areas of corporation law, there was a noteworthy decision by the Supreme Court of Oregon in *McCollum v. Gray*.

That case involved the right of a controlling shareholder in a close corporation to amend the articles of incorporation to eliminate the preemptive right of the minority shareholder.

The preemptive right concerns the right of existing shareholders in a corporation to purchase their proportionate share of any new issues of stock. It has been spoken of as "an inherent, preemptive, and vested right of property." Despite

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omissions in the sale of securities or in documents filed with the Commission is 1 year from discovery of the misstatements or omissions or 3 years from the date of sale or filing. See, e.g., § 13 of the 1933 Act, 15 U.S.C. § 77m (1970)(misstatements or omissions in sale of a security); § 18 of the 1934 Act, 15 U.S.C. § 78r (1970)(misleading statements in filed reports).

104 See Martin, supra note 101, at 454-57. On the other hand, there is some indication that as a result of the Hochfelder decision, with its emphasis on the presence of scienter in Rule 10b-5 actions, courts will turn to those state limitations statutes applicable to actions requiring proof of such element. See Dirksen v. Hynes & Howes Ins. Counselors, Inc., BNA SEC. REG. & LAW REP., No. 383, Dec. 22, 1976, at A-7 (S.D. Iowa 1976). This, of course, could lead to use of the normally longer fraud statute of limitations period.

107 Other Kentucky cases involving corporations include: The Bank Josephine v. C. & J. Quality Elkhorn Coal Co., No. 73-852 (Ky. Feb. 6, 1976)(money advanced by bank to president and principal shareholder of a company in his individual capacity cannot be treated as a corporate debt even though the money was signed over to the corporation by the president where bank did not intend to hold company liable on the debt); Phelps v. Sallee, 529 S.W.2d 361 (Ky. 1975)(order of Commissioner of the Department of Banking and Securities approving articles of incorporation of proposed bank becomes final once issued and cannot be later modified, changed, or set aside where such power of modification is not specifically conferred by the statute creating the agency); Commonwealth v. James Municipal Equip., Inc., 531 S.W.2d 517 (Ky. 1975)(indictment under statute prohibiting contributions to political organizations governed by 2 year statute of limitations provided for violations of the election laws where the penalty is less than confinement in the penitentiary rather than the 1 year limitation statute applicable to misdemeanors generally).


109 11 W. FLETCHER, PRIVATE CORPORATIONS § 5135 (perm. ed. 1971 rev. vol.).

such unequivocal statements, the preemptive right has been subject to a number of exceptions, and can be limited or denied in the articles of incorporation under modern corporation statutes. In fact, some of the newer statutes, including the present Delaware statute, deny the existence of the preemptive right except to the extent that it is recognized and provided for in the articles of incorporation.

In *McCollum*, the plaintiff, McCollum, along with the defendant, Gray, and one Lee Evans, executed a preincorporation agreement to form a corporation in which the three would own an equal interest. After the corporation was formed, Evans sold his interest to Gray, who proceeded to add new shareholders through the issue of additional shares of stock, having first amended the articles of incorporation and bylaws to eliminate the preemptive rights of McCollum. McCollum brought a damage suit contending that Gray's actions in amending the articles and bylaws to eliminate his preemptive rights constituted a breach of the preincorporation agreement. McCollum argued that he had "an implied contractual or vested right that the articles and bylaws of the corporation would not be amended and that his interest in the corporation would remain the same as when he acquired his shares." The Supreme Court of Oregon rejected McCollum's argument, pointing to the provisions of the Oregon Business Corporation Act which permit a corporation through a majority vote of its shareholders to amend its articles of incorporation.

111 See 11 W. Fletcher, *Private Corporations* § 5136 (perm. ed. 1971 rev. vol.). The New York Court of Appeals recognized two of these exceptions in the Stokes case, when it said: "We are thus led to lay down the rule that a stockholder has an inherent right to a proportionate share of new stock issued for money only and not to purchase property for the purposes of the corporation or to effect a consolidation . . . ." 146 N.Y.S. App. at 120-21, 78 N.E. at 1094-95.

112 See, e.g., KRS § 271A.130.


114 See, e.g., ABA-ALI *Model Bus. Corp. Act* § 26 (rev. ed. 1975) [hereinafter cited as Model Act]. However, the Model Act offers an alternative section which preserves the preemptive right except as limited or denied by the articles of incorporation or the statute itself (such as in the case of shares issued for property) for use by those states which prefer the more traditional statutory approach. Model Act § 26A. Kentucky chose the alternate section. See KRS § 271A.130.

115 542 P.2d at 1028.

116 Ore. Rev. Stat. § 57.360(1)(c) (1975). For a similar provision under the Kentucky Business Corporation Act, see KRS § 271A.295(1)(c). The power to amend or
general power of amendment thus possessed by the majority could be so exercised absent a showing of "fraud or other wrongful conduct." Since Oregon, which adopted the Model Business Corporation Act in 1953, and Kentucky, which adopted the Act in 1972, are both Model Act jurisdictions, a decision such as that rendered by the Supreme Court of Oregon in the McCollum case as to the power of amendment of corporate charters carries significant implications for the exercise of a similar power under the Kentucky Business Corporation Act.

The principal argument which has been made in opposition to the exercise of the amending power has been the one advanced in McCollum that its exercise affects vested rights. The vested rights doctrine is of constitutional origin based on the notion that a shareholder's rights become fixed at the time he acquires his stock and cannot be altered without impairing his contract rights or depriving him of his property without just compensation, unless it is with his consent. The impairment of contracts argument has been effectively removed by repeal the bylaws is vested in the board of directors unless reserved to the shareholders by the articles of incorporation under both the Oregon and Kentucky statutes. See ORE. REV. STAT. § 57.141 (1975); KRS § 271A.135(1).

542 P.2d at 1030. In addition to the general power of amendment both the Oregon and Kentucky statutes specifically recognize the power of a corporation to amend its articles of incorporation so as "to limit, deny or grant to shareholders of any class the preemptive right to acquire additional or treasury shares of the corporation, whether then or thereafter authorized." ORE. REV. STAT. § 57.355(2)(p) (1975); KRS § 271A.290(2)(p).

OREGON LAWS ch. 549 (1953) (presently ORE. REV. STAT. ch. 57).


See KRS § 271A.290.


The origins of the "impairment of contracts" argument can be traced to the famous Dartmouth College case, decided by the Supreme Court of the United States in 1819, in which it was held that a corporate charter constitutes a contract between the corporation and the state and that it would constitute an impairment of the obligation of contract if the state were to attempt to alter or repeal the charter without having reserved the power to do so. Dartmouth College v. Woodward, 17 U.S. (4 Wheat.) 518 (1819). For a time there existed some question whether the reserved power extended also to the relation of the corporation with its shareholders and to the relations of the shareholders between themselves. See generally Bove v. The Community
through the inclusion of reserved power clauses in either state constitutions\textsuperscript{124} or corporation statutes.\textsuperscript{125} The due process argument has been generally considered to have been effectively negated where the corporation statute specifically permits the alteration of the right in question.\textsuperscript{126} This explains the presence in the Model Act of a detailed clause spelling out specific areas deemed subject to the amending power, including preemptive rights,\textsuperscript{127} as a supplement to the clause providing for the general power to amend the articles of incorporation.\textsuperscript{128} The aim of the Model Act provisions was to remove the vested rights doctrine as a viable argument for obstructing legitimate corporate changes.\textsuperscript{129} However, this does not preclude the courts from

Hotel Corp., 249 A.2d 89, 96-98 (R.I. 1969). It now seems to be generally agreed that the reserved power reaches all three aspects of the corporate charter and thus empowers the legislature to amend corporation statutes so as to authorize corporate action affecting shareholder rights. See 7 W. FLETCHER, PRIVATE CORPORATIONS § 369 at 883 (perm. ed. 1964).

\textsuperscript{124} See, e.g., KY. CONST. § 3, which provides: "[E]very grant of a franchise, privilege, or exemption, shall remain subject to revocation, alteration, or amendment."

\textsuperscript{125} See, e.g., DEL. CODE ANN. tit. 8 § 394 (1974).

\textsuperscript{126} See Halloran, Equitable Limitations on the Power to Amend Articles of Incorporation, 4 PAC. L.J. 47, 50 n.14 (1973). The author of this article states:
The apparent basis for this rationale is that a specific statute makes it clear that the amendment is authorized by the shareholder's contract (which includes the statute), and therefore, the right cannot be vested because the shareholder has consented in advance to the taking of his property.

\textit{Id.}

\textsuperscript{127} MODEL ACT § 58, second paragraph. See also KRS § 271A.290(2).

\textsuperscript{128} MODEL ACT § 58, first paragraph. This paragraph provides:
A corporation may amend its articles of incorporation, from time to time, in any and as many respects as may be desired, so long as its articles of incorporation as amended contain only such provisions as might be lawfully contained in original articles of incorporation at the time of making such amendment, and, if a change in shares or the rights of shareholders, or an exchange, reclassification or cancellation of shares or rights of shareholders is to be made, such provisions as may be necessary to effect such change, exchange, reclassification or cancellation.

See also KRS § 271A.290(1).

\textsuperscript{129} The Comment to § 58 of the Model Act states:
One of the major purposes of the Model Act was to sweep aside the complexities of judicial decisions on vested rights which were increasingly handicapping the conduct of business through the corporate form. Accordingly the amendment power under section 58 is both general and specific. . . . The specific powers to amend relate to those matters which either have been held in the past or, because of their importance, might otherwise be held to be "vested rights." . . . The specification of matters that may be amended necessarily takes them out of the category of "vested rights."
exercising their equitable powers to prevent unjust action by the majority.130 Thus the decision of the Oregon court in McCollum appears consistent with this approach.

C. Tender Offers

A recent legislative development involving the enactment by Kentucky and other states of "takeover" laws regulating tender offers is worthy of special comment since corporate acquisitions through the tender offer route were largely unregulated at either the state or federal level until recently.131 The implications of this new legislation for a company planning a corporate acquisition through the making of a tender offer to the shareholders of a target company are therefore considerable.132

At the federal level, Congress sought to fill this gap in securities regulation by enactment of the Williams Bill in


Further support for this treatment of the preemptive right would seem to be provided by the language of § 26A of the Model Act, which states: "The preemptive right shall be only an opportunity to acquire shares or other securities under such terms and conditions as the board of directors may fix for the purpose of providing a fair and reasonable opportunity for the exercise of such right." See also KRS § 271A.130(2)(e).

133 For a discussion of equitable limitations on the power of amendment written with specific reference to California law, see Halloran, Equitable Limitations on the Power to Amend Articles of Incorporation, 4 Pac. L.J. 47 (1973).

134 An acquisition minded company seeking to obtain control of another company whose management is hostile to such a takeover has three alternative approaches it may use to achieve its goal. It may make a cash tender offer to the shareholders of the target company, it may make a public exchange offer to such shareholders offering to exchange its stock for the stock of the target company, or it may initiate a proxy contest to oust incumbent management. See Hamilton, Some Reflections on Cash Tender Offer Legislation, 15 N.Y.L.J. 269, 273 (1969). Since proxy contests have long been subject to control as the result of the federal proxy rules and public exchange offers are subject to the registration requirements for new security issues under the Securities Act of 1933, the cash tender offer became a popular acquisition device due to its freedom from regulation. Id. at 273-74.

135 The prior freedom enjoyed by a company attempting an acquisition through the route of the cash tender offer was underscored in the following comment made by one of the speakers at a meeting of the Section of Corporation, Banking and Business Law of the American Bar Association on the topic of "Take-over Bids" held in conjunction with the annual meeting of the American Bar Association in July 1971:

It could, and usually did, act without prior warning, could move behind the screen of an agent bank or broker without disclosing its own identity, did not have to disclose any of its future plans for the target company and could accept or reject tenders and change the terms of its offer at will.

1968, which added several provisions to the Securities Exchange Act of 1934. They were designed to afford investors protection in connection with tender offers similar to that which they were receiving with other types of securities transactions. The Williams Act contains provisions empowering the Securities and Exchange Commission to require persons or groups acquiring more than 5 percent of a corporation's stock through a tender offer to reveal to the Commission, the corporation, and its security holders, at the time the tender offer is made:

the size of the holdings of the person or group involved, the source of the funds used or to be used to acquire the shares, any contracts or arrangements relating to the shares, and, if the purpose of the acquisition is to acquire control of the company, any plans to liquidate the company, sell its assets, merge it with another company, or make major changes in its business or corporate structure.

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134 The provisions directly concerned with tender offers are §§ 14(d), (e) and (f) of the Securities Exchange Act of 1934. 15 U.S.C. §§ 78n(d), (e) and (f) (1970). Section 14(d) regulates the making of the tender offer, § 14(e) contains a general antifraud provision similar to Rule 10b-5, and § 14(f) contains a disclosure requirement where a tender offer results in a change in the majority of directors without shareholder action. The Williams Act, as originally adopted, applied only to cash tender offers and not to public exchange offers. The provision in the Act excluding the public exchange offer was deleted by amendments to the Act adopted by Congress in 1970. Act of Dec. 22, 1970, Pub. L. No. 91-567, § 4, 84 Stat. 1497.
135 The Senate Committee Report which accompanied the Williams Bill stated:

The Securities Act of 1933 and the Securities Exchange Act of 1934 provide protection for millions of investors by requiring full disclosure of information in connection with the public offering or trading of securities. These laws have worked well to provide the public with adequate information on which to base intelligent investment decisions, thereby enhancing public confidence in the Nation's securities markets and encouraging the healthy growth and development of those markets.

There are, however, some areas still remaining where full disclosure is necessary for investor protection but not required by present law. One such area is the purchase of substantial or controlling blocks of the securities of publicly held companies. S.510 would amend the Securities Exchange Act of 1934 by requiring the disclosure of pertinent information and would afford other protections to stockholders . . . .

137 The original figure was 10 percent. This figure was reduced to 5 percent by the 1970 amendments to the Act. Act of Dec. 22, 1970, Pub. L. No. 91-567, § 3, 84 Stat. 1497.
138 S. Rep. No. 550, 90th Cong., 1st Sess. 4 (1968). The detailed requirements are
There are also provisions relating to withdrawal of securities during a tender offer, to pro rata acceptance of shares where an excess amount of shares are tendered, and to assurance of a uniform tender offer price. The Committee reports that accompanied the Williams Bill made it clear that the purpose of the new restrictions and limitations was not to encourage or discourage tender offers generally but to afford increased protection to investors without favoring either side in a tender offer contest.

State legislation regulating tender offers made its appearance at about the same time as the Williams Act but has not displayed the same neutral approach. The state laws contain provisions for prepublication of tender offers and for the holding of administrative hearings. Outwardly aimed at providing additional protection to local investors, these provisions have the potential for strengthening the position of the management of local companies in combating undesirable or unwanted takeovers by outside interests. The takeover law enacted by the 1976 Kentucky General Assembly reflects this local interest approach.


142 The Senate Committee Report stated:

The committee has taken extreme care to avoid tipping the balance of regulation either in favor of management or in favor of the person making the takeover bid. The bill is designed to require full and fair disclosure for the benefit of investors while at the same time providing the offeror and management equal opportunity to fairly present their case.


143 Two of the first state “takeover” statutes were enacted in Virginia and Ohio. See Va. CODE ANN. §§ 13.1-528 et seq. (1973); Ohio REV. CODE ANN. § 1707.041 (Page Supp. 1975). These and other state statutes are reviewed in Moylan, State Regulation of Tender Offers, 58 Marq. L. Rev. 687 (1975) [hereinafter cited as Moylan].

144 It has been said of the state laws:

The states enacting such legislation advance several rationales for assuming authority over tender offers for companies incorporated in or based within their respective boundaries. They . . . proclaim the need to afford investors additional protections in this area. . . . It is submitted, however, that this type of state legislation is a reaction to the fear that such a bid will adversely effect [sic] the local economy.

Moylan at 690.

145 KRS §§ 292.560 et seq. Two additional states enacting takeover statutes during
The Kentucky Act requires a tender offeror to publicize the terms of any proposed takeover bid at least 20 days prior to the making of the tender offer and file copies of all information required by the Act with the state Director of Securities and the target company. The information required is similar to that prescribed by the Williams Act and includes data concerning the business and financial position of the offeror, source and amount of funds to be used in accomplishing the proposed acquisition, particulars as to any contracts or arrangements regarding shares of the target company, and biographical summaries of all directors and executive officers of the offeror for the past 5 years. Within 10 days after the filing of such information, the Director of Securities can order a hearing, either upon his own initiative or upon request by the target company, to determine whether the tender offeror proposes to make a full and fair disclosure of all information material to an investment decision by the shareholders of the target company. The hearing must be held within 40 days of the information filing date and an adjudication must be made within 60 days after the filing date. A “take-over bid” applies to tender offers made to 10 or more record holders of an equity security of a corporation, which if successful would result in the offeror becoming the owner of more than 5 percent of any class of the equity securities of the corporation. The legisla-
tion applies to tender offers made to security holders of corporations organized under Kentucky law or having their principal place of business and substantial assets within the state. An offeror is prohibited from making a takeover bid which is not made to all holders of the security involved residing in the state or which is not made to such resident holders on the same terms as to nonresident holders of the security. There are also regulatory provisions pertaining to pro rata acceptance of shares where more are tendered than called for by the tender offer and assuring the payment of a uniform price to all tendering shareholders where the tender price is increased during the life of the tender offer.

While the above regulatory features of the Kentucky takeover statute pertaining to pro rata acceptance of shares and payment of a uniform tender offer price are common to state takeover statutes generally and complement similar provisions in the Williams Act, other aspects of state takeover legislation may well raise some rather serious constitutional issues when placed alongside the federal legislation. One such issue is preemption, arising from the fact that the special interest nature of the state legislation puts it in opposition to the neutral philosophy of the federal legislation. Another results

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152 KRS § 292.560(1).
153 KRS § 292.590.
154 Id.
155 KRS § 292.590. Certain exemptions from the provisions of the Act are recognized pertaining to public utility holding companies, bank holding companies, savings and loan holding companies, and insurance companies. KRS § 292.630.
156 See notes 140 and 141, supra.
157 See the discussion of the constitutional issues in Moylan at 699-702.
158 Section 28(a) of the Securities Exchange Act of 1934 provides, in part:

> Nothing in this chapter shall affect the jurisdiction of the securities commission (or any agency or officer performing like functions) of any State over any security of any person insofar as it does not conflict with the provisions of this chapter or the rules and regulations thereunder.

from the extraterritorial nature of the state laws which open them to the charge that they violate the commerce clause of the United States Constitution by placing an undue burden on interstate commerce. An additional possible source of tension is the publicity requirement contained in many of the state statutes, including the Kentucky statute, requiring early disclosure of the terms of the proposed takeover bid. In the case of exchange offers, in which the acquiring company offers its own securities for the stock of the target company, this requirement could possibly conflict with the registration requirements of the Securities Act of 1933, which prohibit the release of information to investors in the case of an offer to sell securities prior to the filing of a registration statement with the Securities and Exchange Commission. Whether these are viable objections to the state legislation will some day need to be resolved. In the meantime, companies contemplating tender offers must be particularly careful to take account of state as well as federal law in planning their takeover strategy.

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109 See Moylan at 700-02.
110 See note 146, supra. New York dropped a requirement such as this from its statute. See BNA Sec. Reg. & Law Rep., No. 386, Sept. 1, 1976, at A-5. There is, however, a registration requirement in the New York statute whereby an offeror must file a registration statement containing certain prescribed information regarding a tender offer with the state attorney general and the target company at least 20 days before the making of the offer. N.Y. Bus. Corp. Law, Art. 16, §§ 1602-1603, P-H Corp. Serv., N.Y., 305-06 (1976).
111 See § 5(c) of the 1933 Act. 15 U.S.C. § 77e(c) (1970). This section provides:

   It shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell or offer to buy through the use or medium of any prospectus or otherwise any security, unless a registration statement has been filed as to such security . . . .

112 Moreover, publicizing the terms of an exchange offer might not be considered as within the limited disclosures exempted from § 5(c) under SEC Rule 135. 17 C.F.R. § 230.135 (1976). For a case adopting such a position in regard to a press release announcing the terms of an exchange offer, see Chris-Craft Indus., Inc. v. Bangor Punta Corp., 426 F.2d 569 (2d Cir. 1970).
113 For a general discussion of tender offers and takeover strategy, see E. Aranow & H. Einhorn, Tender Offers for Corporate Control (1973).