Rule 10b-5 and Santa Fe--Herein of Sue Facts, Shame Facts, and Other Matters

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I. INTRODUCTION

One of the most fascinating stories in modern legal times involves the development of Securities and Exchange Commission rule 10b-5 (the Rule). Its growth has been marked by the impressive expansion of a federal common law surrounding it, an occasional effort to curb its impact, and a remarkable resilience and potency enabling it to continue to thrive and be of great importance. This Article considers developments and complications arising from a leading Supreme Court decision,

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1 17 C.F.R. § 240.10b-5 (1983) which states:
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.
Rule 10b-5 was promulgated under § 10(b) of the Securities Exchange Act of 1934, which 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—
(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.

2 With regard to rule 10b-5, one of the great experts in the securities field, Professor Loss, has said:
The 10b-5 story tempts the pen. For it is difficult to think of another instance in the entire corpus juris in which the interaction of the legislative, administrative rulemaking, and judicial processes had produced so much from so little. What is more remarkable is that
Santa Fe Industries, Inc. v. Green, whose holding limited the use of the Rule, but whose language, as will be explained, has spawned a number of difficult and interesting issues regarding the application of the Rule. As will be seen, efforts to deal with such issues have led in some cases to formidable examples of judicial ingenuity or sophistry, depending on one’s point of view. The extent to which courts have reasoned their way to conclusions allowing for the continued application of rule 10b-5 raises questions about the consistency of their decisions with Santa Fe. This Article reviews Santa Fe, as well as a number of cases dealing with problems emanating from Santa Fe and analyzes various issues arising therefrom. Central to the discussion will be the merits of three doctrines—which are referred to hereafter as the “sue fact” doctrine, the “shame fact” doctrine, and the “constructive deception” doctrine. The Santa Fe story, which includes the sequels discussed herein, furnishes a good illustration of the vitality and regenerative power of rule 10b-5 in the hands of the judiciary and the interesting mental gymnastics in which the courts indulge in salvaging as much as possible of the efficacy of the Rule in the face of an apparent setback. The story affords an opportunity to assess the worth and propriety of the salvaging operation.

II. Santa Fe

In Santa Fe a majority shareholder eliminated the minority interest in its subsidiary under a Delaware statute authorizing a parent owning at least ninety per-

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For discussion of the sue fact doctrine, see infra notes 52 & 91 and accompanying text.

For discussion of the shame fact doctrine see infra notes 46 & 47 and accompanying text.

For an explanation of the term constructive deception see infra notes 30-38 and accompanying text.
cent of the subsidiary to merge with it and pay cash for the shares of the minority shareholders without giving them advance notice or obtaining their consent, but requiring notification to them within ten days after the effective date of the merger. Dissatisfied shareholders could petition the Delaware court for payment of the fair value of their shares as determined by a court-appointed appraiser subject to review by the court. The majority shareholder obtained independent appraisals of the physical assets of the subsidiary along with a much lower appraisal from an investment banking firm. It then offered the minority shareholders an amount per share only slightly greater than the lower appraisal. The minority shareholders were notified the day after the merger became effective, advised of their right to obtain an appraisal in the Delaware court, and sent an information statement containing relevant financial data, appraisals of assets, and the investment banking firm appraisal. Instead of pursuing their Delaware appraisal remedy, certain minority shareholders brought an action in federal court on behalf of the corporation and the minority shareholders seeking either to set aside the merger or recover what they claimed was the fair value of their shares. They asserted that the purpose of the merger was to freeze out the minority at a wholly inadequate price, that the merger took place without prior notice to minority shareholders, that the majority shareholder had obtained a fraudulent appraisal from the investment banking firm and offered twenty-five dollars above that appraisal to lull the minority shareholders into believing the offer was generous, and that this course of conduct violated rule 10b-5.

The case reached the Supreme Court after the Second Circuit Court of Appeals reversed a dismissal of the action by the district court. In so doing the Second Circuit held that rule 10b-5 extends to "breaches of fiduciary duty by a majority against minority shareholders without any charge of misrepresentation or lack of disclosure." The court decided that full disclosure would not eliminate a claim of fraud because it is the merger and the undervaluation which constitute the fraud, and that absent a valid corporate purpose for the merger, the most brazen disclosure of that fact to minority shareholders would not mitigate the fraudulent conduct.

The Supreme Court, in reversing the Second Circuit decision, differed sharply

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7 Based on the appraisal of the physical assets the per share value was $640. Santa Fe, 430 U.S. at 466.
8 Id. The per share value according to the investment banking firm was $125.
9 Id. The amount offered was $150.
11 The court set forth its holding as follows:

We hold that a complaint alleges a claim under rule 10b-5 when it charges, in connection with a Delaware short-form merger, that the majority has committed a breach of its fiduciary duty to deal fairly with minority shareholders by effecting the merger without any justifiable business purpose. The minority shareholders are given no prior notice of the merger, thus having no opportunity to apply for injunctive relief, and the proposed price to be paid is substantially lower than the appraised value reflected in the Information Statement.

Id. at 1291.
with the idea that fraud under rule 10b-5 could be interpreted so broadly as to encompass the alleged fiduciary misconduct involved in this case. The Court held that the language of the statute under which rule 10b-5 was adopted, section 10(b) of the Securities Exchange Act,\(^\text{12}\) must control in the interpretation of the Rule, and that such language gave no indication that Congress meant to prohibit conduct not involving manipulation or deception.\(^\text{13}\) The Court stressed that "the case comes to us on the premise that the complaint failed to allege a material misrepresentation or material failure to disclose"\(^\text{14}\) and that "manipulation," as used in the statute, is virtually a term of art which does not embrace the conduct alleged in the complaint.\(^\text{15}\)

In what has become famous as footnote fourteen\(^\text{16}\) of its opinion, the Court disposed of the contention that the failure of the majority shareholder to give advance notice of the merger was a material nondisclosure. The Court held that such failure could not be material because plaintiffs did not indicate how they could have acted differently with prior notice. The Court accepted the conclusion of both courts below that under Delaware law the minority shareholders could not have enjoined the merger because an appraisal proceeding was their sole remedy in the Delaware courts for any alleged unfairness in terms of the merger. Therefore, the disclosure which did exist in the information statement,\(^\text{17}\) coupled with the lack of materiality of any nondisclosure linked to the failure to give notice, eliminated the element of deception as a basis for invoking rule 10b-5.

\(^{12}\) See supra note 1 for text of § 10(b).

\(^{13}\) Santa Fe, 430 U.S. at 472-73.

\(^{14}\) Id. at 474.

\(^{15}\) The Court discussed manipulation as follows: "'[M]anipulation' is 'virtually a term of art when used in connection with securities markets.' ... The term refers generally to practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity." Id. at 476 (quoting Hochfelder, 426 U.S. at 199).

\(^{16}\) This footnote reads as follows:

In addition to their principal argument that the complaint alleges a fraud under clauses (a) and (c) of rule 10b-5, respondents also argue that the complaint alleges nondisclosure and misrepresentation in violation of clause (b) of the Rule. Their major contention in this respect is that the majority stockholder's failure to give the minority advance notice of the merger was a material nondisclosure, even though the Delaware short-form merger statute does not require such notice .... But respondents do not indicate how they might have acted differently had they had prior notice of the merger. Indeed, they accept the conclusion of both courts below that under Delaware law they could not have enjoined the merger because an appraisal proceeding is their sole remedy in the Delaware courts for any alleged unfairness in the terms of the merger. Thus, the failure to give advance notice was not a material nondisclosure within the meaning of the statute or the Rule ....

\(^{17}\) Santa Fe, 430 U.S. at 474 n.14 (citations omitted).
In Part IV of its opinion, the court further indicated that, while the language of the statute was sufficiently clear to be dispositive of the case, even if it were not, additional considerations weighed heavily against permitting a cause of action under rule 10b-5 for the alleged breach of fiduciary duty. First, the Court pointed out that the fundamental purpose of the Securities Exchange Act is to implement a full disclosure philosophy, that fairness in the terms of the transaction is at most a tangential concern, and that it was reluctant to imply a cause of action where it is unnecessary to ensure the fulfillment of the congressional purpose. Second, the Court indicated that another factor in ascertaining whether Congress intended to create a federal cause of action is "whether the cause of action [is] one traditionally relegated to state law." The Court, pointing to the appraisal remedy afforded by Delaware, acknowledged that the existence of the state remedy is not dispositive of the question of whether Congress meant to provide a similar federal remedy, but concluded that it is entirely appropriate in this instance to relegate plaintiffs to whatever remedy is created by state law. What was troubling to the Court was that a contrary holding would bring within rule 10b-5 "a wide variety of corporate conduct traditionally left to state regulation," pose "a danger of vexatious litigation," and result in an "extension of the federal securities laws [which] would overlap and quite possibly interfere with state corporate law." As to this latter point, the Court opined that "federal courts applying a 'federal fiduciary principle' under rule 10b-5 could be expected to depart from state fiduciary standards at least to the extent necessary to ensure uniformity within the federal system," and expressed a reluctance in the absence of a clear indication of congressional intent "to federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overidden."

The Court further explained its reluctance by pointing out that investors in committing funds rely on the applicability of state law to govern corporate internal affairs rather than federal law except where the latter "expressly requires certain responsibilities of directors with respect to stockholders," adding that "[t]here choice was fairly presented, and they were furnished with all relevant information on which to base their decision.

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18 Id. at 477-80.
20 Santa Fe, 430 U.S. at 477-78.
21 Id. at 478 (quoting Piper v. Chris-Craft Indus. Inc., 430 U.S. 1, 40 (1976), quoting Cort v. Ash, 422 U.S. 66, 78 (1975)).
22 Santa Fe, 430 U.S. at 478.
23 Id.
24 Id. at 478-79 (quoting Blue Chip Stamps, 421 U.S. at 740).
25 Santa Fe, 430 U.S. at 479.
26 Id. (footnote omitted).
27 Id.
28 Id. (quoting Cort, 422 U.S. at 84).
may well be a need for uniform federal fiduciary standards to govern mergers' such as the one being challenged, "[b]ut those standards should not be supplied by judicial extension of section 10(b) and rule 10b-5 to 'cover the corporate universe.'" 29

The importance of state corporate law to the viability of a rule 10b-5 action thus emerged in two separate and significant ways in *Santa Fe*: 1) It contributed to an interpretation of section 10(b), emphasized in Part IV of the Court's opinion, designed to preserve the efficacy of state corporate law by refusing to permit the development of a uniform federal corporate law covering a wide range of fiduciary misconduct without express congressional action; 2) It led the Court to conclude in footnote fourteen that a certain nondisclosure was not material because state law afforded no remedy that would have been triggered by the disclosure. Both of these elements of *Santa Fe*, Part IV and footnote fourteen, are of considerable importance in subsequent cases and receive much attention hereafter.

III. DEVELOPMENT OF THE PRINCIPLES OF *Santa Fe*

A. Background

In analyzing the development of the principles of *Santa Fe*, the impact of footnote fourteen and Part IV need to be explored. Indeed, both have been the subject of considerable attention from others. 30 The story of this development becomes entangled at times with the constructive deception doctrine, as in *Goldberg v. Meridor*, 31 to be discussed shortly, but at other times is involved in cases 32 in which that doctrine has no significance. Thus, issues regarding footnote fourteen and Part IV may well persist even if the constructive deception doctrine should be scuttled. In any event, such issues deserve consideration on their own merits. One should be careful, therefore, in criticizing or praising the decisions of *Goldberg* and its progeny to distinguish between one's pique or pleasure over the constructive deception doctrine and the treatment given by courts to footnote fourteen or Part IV of *Santa Fe*.

The doctrine of constructive deception, as dealt with herein, arises in cases in which a shareholder, although not personally involved in buying or selling securities, wants to utilize rule 10b-5 to right a wrong committed against a corpora-


tion in a securities transaction on the ground that the corporation was deceived in the transaction. An example would be a derivative suit involving the issuance of shares by a subsidiary corporation to its parent for inadequate consideration where the directors of the subsidiary are fully informed of the inadequacy and are themselves committing a breach of fiduciary duty. If in the corporate governmental structure the decision as to the issuance of the shares is to be made solely by the directors, then the question which arises is how can a corporation be deceived when its directors are fully aware of the material facts? While the directors are guilty of mismanagement, where is the "deception" of the corporation for purposes of rule 10b-5, as required by Santa Fe, when the corporate decisionmaking body is not deceived? After all, should not the knowledge of the directors be attributed to the corporation, thus precluding deception of the corporation? Prior to Santa Fe, an answer given was that it was not necessary to show deception of the directors. It was enough to show deception of the shareholders, the real owners of the property, which could be established by showing that the directors withheld from them certain information. Admittedly, showing that the corporation was deceived in a transaction involves some imagination where the directors authorizing the transaction were all aware of the pertinent facts. Nevertheless, as a technical matter, courts have no difficulty in refusing to impute to the corporation certain facts known to directors in certain situations, such as where the directors have a conflict of interest with the corporation or are controlled by those benefitting from their action. Thus, in Schoenbaum v. Firstbrook, a case preceding Santa Fe, which involved the alleged issuance of shares by a corporation to a controlling shareholder for inadequate consideration, one of the grounds on which the applicability of rule 10b-5 was apparently predicated was that the Rule reaches the situation where the controlling shareholder and directors of the subsidiary deceived the other shareholders of the subsidiary in the issuance of the shares. Although this matter will be considered further, it is well to note at this point that this use of the constructive deception doctrine does not necessarily conflict with Santa Fe; indeed, the majority opinion in Santa Fe specifically cites Schoenbaum as a case involving deception.

When the term constructive deception is used in this Article, it is used to connote the deception of the corporation which occurs from deceiving shareholders, not directors, and which results from not imputing the knowledge of directors to the corporation. Of course, deception of a fictitious entity will always be of a fictitious sort, so that even a case in which the board of directors as a decisionmaking

14 Schoenbaum, 405 F.2d at 215.
15 Id. at 219-20.
16 The discussion by Judge Friendly is persuasive on this point. See infra notes 42 & 73 and accompanying text.
17 Santa Fe, 430 U.S. at 475 n.15.
body is deceived, could be called a constructive deception case;\textsuperscript{38} but, that is not how the term is used herein.

B. \textit{The Goldberg Decision}

The Second Circuit, faced the question of what effect \textit{Santa Fe} had on the constructive deception doctrine, dealt with the application of footnote fourteen and considered the impact of Part IV in \textit{Goldberg v. Meridor}.\textsuperscript{39} In that case, shares of a subsidiary corporation were issued to its parent in exchange for liabilities and assets of the parent. A derivative suit alleging that the transaction was grossly unfair to the subsidiary and violated rule 10b-5 was filed. Plaintiff, a minority shareholder, contended that there had been no disclosure to him of the fraudulent nature of the transaction, and asserted that there was improper disclosure with respect to two press releases on the transaction.

In resolving the case before it, the circuit court, after allowing amendments to the complaint which the district court had refused to permit, held that the complaint alleged deceit upon the minority shareholders and misrepresentation regarding the transaction, and that, unlike \textit{Santa Fe}, the conduct here violated the fundamental purpose of the Securities Exchange Act to implement a philosophy of full disclosure.\textsuperscript{40} The court refused to "read [\textit{Santa Fe}] as ruling that no action lies under rule 10b-5 when a controlling corporation causes a partly owned subsidiary to sell its securities to the parent in an unfair transaction and fails to make a disclosure, or ... makes a misleading disclosure."\textsuperscript{41} Moreover, the court rejected the notion that \textit{Santa Fe} overruled constructive deception doctrine precedents, such as \textit{Schoenbaum}, pointing out that they were distinguished in \textit{Santa Fe} as not supporting the position "that a breach of fiduciary duty by majority shareholders without any deception, misrepresentation, or nondisclosure" violates rule 10b-5.\textsuperscript{42}

Still, the court faced the contention of defendants that the failure to make a public disclosure or even the making of a misleading disclosure would have no effect since no action by shareholders was needed to approve the transaction. Furthermore, the dissenting judge contended "that the defendants' acts were not material

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\textsuperscript{38} For further discussion of this point see infra pp. 211-15.

\textsuperscript{39} \textit{Goldberg}, 567 F.2d at 212.

\textsuperscript{40} \textit{Id.} at 218. The court stated:

Here the complaint alleged "deceit ... upon UGO's minority shareholders" and, if amendment had been allowed as it should have been, would have alleged misrepresentation as to the UGO-Maritimecor transaction at least in the sense of failure to state material facts "necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading," Rule 10b-5(b). The nub of the matter is that the conduct attacked in \textit{Green} did not violate the "fundamental purpose" of the Act as implementing "philosophy of full disclosure" ... the conduct here attacked does (footnote omitted).

\textsuperscript{41} \textit{Id.} at 217-18.

\textsuperscript{42} \textit{Id.} at 218 (quoting \textit{Santa Fe}, 430 U.S. at 472). See also infra note 73 and accompanying text.
since plaintiff has failed adequately to allege what would have been done had he known the truth."43 The court answered these contentions in part as follows:

When, as in a derivative action, the deception is alleged to have been practiced on the corporation, even though all the directors were parties to it, the test must be whether the facts that were not disclosed or were misleadingly disclosed to the shareholders "would have assumed actual significance in the deliberations" of reasonable and disinterested directors or created "a substantial likelihood" that such directors would have considered the "total mix" of information available to have been "significantly altered." ... Here there is surely a significant likelihood that if a reasonable director of [the subsidiary] had known the facts alleged by plaintiff rather than the barebones of the press releases, he would not have voted for the transaction with [the parent].44

This expression of the test—in terms of failure to notify shareholders about facts which would be of significance to disinterested directors, even in a context in which all directors are parties to a deception—seems curious. Indeed, the Ninth Circuit has disagreed with the Second Circuit stating that the proper test regarding materiality is what would have been considered significant by a reasonable shareholder.45 At any rate, the reason for the curious elaboration of the test in Goldberg is not completely clear from the opinion. Perhaps the court was suggesting that as a ground for the decision it could be assumed that public disclosure of the undisclosed facts would have shamed the subsidiary's directors into voting against the transaction and that the deception, therefore, caused the transaction.46 The language of the opinion, however, does not expressly assert that nondisclosure of such a fact, referred to hereafter as a "shame fact," would be an appropriate basis for a rule 10b-5 action.47 Another possible interpretation of the court's language concerning the significance of facts to disinterested directors emerged from the district court opinion on remand: "the primary holding of the court [is] that the press releases were

43 Goldberg, 567 F.2d at 218.
44 Id. at 219 (quoting TSC Indus. v. Northway, 426 U.S. 438, 449 (1978)).
45 Kidwell ex rel. Penfold v. Meikle, 597 F.2d 1273, 1293 n.10 (9th Cir. 1979).
46 Hazen, supra note 30, at 833, sets forth such an interpretation: Although the decisionmakers in [Goldberg] were not deceived, the court noted that public disclosure might have shamed the subsidiary's directors into voting against the transaction with its parents.
47 The concept of utilizing disclosure to encourage the directors into different, more reasonable conduct is an echo of a pre Santa Fe causation analysis taken by the same court in Schlick v. Penn-Dixie Cement Corp. (footnotes omitted).

A relevant passage from Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374, 384 (2d Cir. 1974), cert. denied, 421 U.S. 976 (1975), stated:

By virtue of the disclosure either modification or reconsideration of the terms of the merger by those in control might be effectuated. We cannot assume that even a rapacious controlling management would necessarily want to hang its dirty linen out on the line and thereby expose itself to suit or Securities Commission or other action—in terms of reputation and future takeovers (footnote omitted).

47 Nor does the court's citation of Shell v. Hensley, 430 F.2d 819 (5th Cir. 1970), cited in Goldberg, compel such a conclusion.
materially deceptive if they were likely to have affected the judgment of a reasonable director, concerning the merits of the transfer."48 The district court held that the complaint stated a claim under this "reasonable director" theory, pointing to allegations that there is a significant likelihood that a reasonable and independent director of the subsidiary with full knowledge of the facts would not have voted for the transaction and that there was at least one director, who was deceived, who voted in favor of the transaction.49 Still another possible explanation of the court's language concerning the significance of facts to disinterested directors may lie in the principle that if the undisclosed fact would not be material to disinterested directors, it should not be the basis of an action by the shareholders under rule 10b-5.50 Put another way, if the corporate machinery requires only a decision by the directors as to a particular transaction, and the fact which is not disclosed would not be regarded as material to the corporate decision makers, that is to the hypothetical, disinterested directors, then it should not be considered material to the corporation for purposes of a rule 10b-5 derivative action.

The majority in Goldberg went on to explain its position in terms of footnote fourteen by pointing out that minority shareholders, if informed, would not have been without a remedy. State injunctive relief would have been available if, as alleged, they had not been lulled into security by deceptive disclosures.51 Thus, the importance of undisclosed or incorrect information to a litigation decision by minority shareholders was stressed.

While recognizing the possibility of a shame fact doctrine being incorporated into the Goldberg theory, since that case does not effectively address this issue, the assumption in this Article is that the language of Goldberg should not be considered as authority to either sanction or preclude claims on the basis of such a doctrine where an appropriate state law remedy is unavailable. Clearly, however, Goldberg recognizes that the deception of minority shareholders regarding litigation or "sue facts" can overcome the materiality hurdle of footnote fourteen.52

49 Id. at 109. Moreover, in distinguishing Santa Fe from Goldberg, the court pointed out that "it is alleged here that a reasonable director, who would have been able to stop the exchange, might also have been misled by the press releases." Id. at 108-09 n.5.
50 See infra note 126 and accompanying text. See also infra pp. 211-15.
51 The court stated:
Beyond this Goldberg and other minority shareholders would not have been without remedy if the alleged facts had been disclosed. The doubts entertained by our brother as to the existence of injunctive remedies in New York ... are unfounded. The UGO-Maritimecor transaction was not of the sort that would afford UGO's stockholders any right of appraisal. Where an appraisal remedy is not available, the courts of New York have displayed no hesitancy in granting injunctive relief .... Goldberg, 567 F.2d at 219.
52 Borden, "Sue Fact" Rule Mandates Disclosure to Avoid Litigation in State Courts, SEC '82, 201, 204-05, explains the "sue fact" doctrine as requiring:

[The disclosure not only of information relevant to an investment decision but also information

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Finally, in rejecting the defendant's reliance on certain statements from Part IV of *Santa Fe*, the court stressed the Supreme Court position that the existence of a particular state law remedy does not dispose of the question of whether Congress meant to permit a similar federal remedy. It pointed out that it would be difficult to find a cause of action more traditionally relegated to state law than the one sanctioned as a claim under rule 10b-5 in the *Superintendent of Insurance v. Bankers Life & Casualty Co.* case, and indicated that the Court had not directed the dismissal of cases "where it was claimed that fiduciaries had failed to disclose their self-dealing or had made a misleading disclosure, even though no disclosure was required by state law."  

IV. **Goldberg—Complications and Developments**

In considering the validity of the Second Circuit's approach to *Santa Fe* in *Goldberg* and the complications and developments arising from the latter case, a number of issues merit discussion. In order to analyze that portion of the *Goldberg* opinion which relies on footnote fourteen of *Santa Fe* to trigger a cause of action under rule 10b-5, and the position of *Goldberg* regarding Part IV of *Santa Fe*, it is convenient for the moment to postpone any further discussion of whether the constructive deception doctrine can survive *Santa Fe*. This is a useful way to approach the matter, particularly since a number of cases which do not really involve constructive deception have nevertheless followed the lead of *Goldberg* in its treatment of Part IV and in its utilization of footnote fourteen as a basis for a rule 10b-5 action. Thus, even if the constructive deception doctrine would be scrapped, the problems of *Goldberg* and its progeny surrounding the use of footnote fourteen and the impact of Part IV would still need to be reckoned with.

relevant to a decision to sue under state law, whenever such law provides a remedy to the shareholder. The doctrine had its genesis in Footnote 14 in *Green* ....

A few definitions may assist in this discussion. A "sue fact" is, in general, a fact which is material to a sue decision. A "sue decision" is a decision by a shareholder whether or not to institute a representative or derivative suit alleging a state-law cause of action. Sue facts come in two varieties. There are those which are also relevant to an investment decision, meaning a decision to buy or sell securities either directly or by virtue of a vote, consent, authorization or an appraisal demand. Then there is a whole spectrum of additional facts which may not be relevant to an investment decision but which may be relevant to a sue decision. Although the terminology is awkward, we shall call the first category "Investment Sue Facts" or "I Sue Facts" and the second category "Non-Investment Sue Facts" or "NI Sue Facts."

13 *Goldberg*, 567 F.2d at 220-21. The court, quoting *Piper*, 430 U.S. at 40, noted that "it would be hard to think of a cause of action more 'traditionally relegated to state law' than the one asserted in the *Superintendent of Insurance case ....'" This case made "'just plain stealing' a fraud under rule 10b-5, on the basis that [the defendant] failed to tell the directors 'in advance that he was going to steal ....'" *Id.* (quoting R. Jennings & H. Marsh, *CASES AND MATERIALS ON SECURITIES REGULATION* 997-98 (4th ed. 1977)). The case referred to is *Superintendent of Ins. v. Bankers Life & Casualty Co.*, 404 U.S. 6 (1971).

14 *Goldberg*, 567 F.2d at 221.

15 See, e.g., *Mayer*, 721 F.2d 59; *Madison Consultants*, 710 F.2d 57.
A. Is Goldberg Consistent with Santa Fe?

First, is the Goldberg decision inconsistent with the Santa Fe opinion and particularly Part IV thereof? Part IV of the Santa Fe opinion is best understood by remembering that it represents an effort to explain why the congressional purpose underlying section 10(b) should not be construed as reaching a case of breach of fiduciary duty where deception or manipulation, as the Court construes those terms, is not present. If one does not accept that analysis, then the temptation will arise to confer on Part IV a momentum of its own which would be unjustified by the facts of the case before the Supreme Court,64 a case in which the failure to disclose material facts was not at issue.

Arguably, the thrust of Part IV is: Corporate mismanagement is traditionally a matter of state law; investors rely on that; the existence of a particular state law remedy is not dispositive of the question of whether Congress meant to provide a similar federal remedy; Congress has intruded on the regulation of corporate affairs to a degree in section 10(b) to reach manipulation (which is a term of art, and which the Court concludes is not involved in Santa Fe) and deception; the fundamental purpose of the Securities Exchange Act is to implement a philosophy of full disclosure in securities transactions, and to assume as a matter of judicial interpretation that Congress meant for section 10(b) to lead to the supplanting of state law in the corporate field where deception or manipulation issues are not involved is wrong. It is important to note, however, that in all of this, there is nothing which says that a state's traditional interest in corporate regulation should preclude a cause of action under rule 10b-5 where a disclosure issue is involved. Indeed, in view of the recognition of the congressional purpose to promote disclosure and the supremacy clause, the mere fact that certain misconduct may be the basis of a state claim does not bar an appropriate federal claim based on inadequate disclosure under rule 10b-5, and federal courts since Santa Fe have so held in Goldberg and in other cases.65

64 An outstanding authority, R. Jennings & H. Marsh, Cases and Materials on Securities Regulation 952 (5th ed. 1982), takes a position which confers such momentum on Part IV and is critical of cases such as Goldberg:

That portion of the opinion states that one important factor in determining whether a cause of action will lie under rule 10b-5 is whether the matter complained of is one which is "traditionally relegated to state law." In other words, it is fair to say that a fundamental thrust of the opinion in Santa Fe Industries case is the philosophy that there is no need to imply a cause of action under rule 10b-5 with respect to complaints about corporate mismanagement if there is an adequate remedy under state law; these cases hold that the existence of a remedy under state law creates a cause of action under rule 10b-5. This would seem to be standing Santa Fe Industries on its head .... (emphasis in original).

Id. (quoting Piper, 430 U.S. at 40). See also Jorden & Grief, supra note 30, at 237-38 for a similar position. On the other hand, other commentators have taken a different tack. One states that when a claim is based on a failure to disclose, it is no longer in an area relegated to state law. See Note, supra note 30, at 1884. See also Hazen, supra note 30, at 866.

In *Healey v. Catalyst Recovery of Pa. Inc.*,\(^\text{58}\) which involved a merger in which a shareholder would be compelled to exchange shares in one corporation for another, the Third Circuit held that where a misrepresentation or omission deprives a shareholder of an opportunity to enjoin a merger under state law there is a cause of action under rule 10b-5.\(^\text{59}\) The court explained that the difference between *Goldberg* and *Santa Fe* is the misrepresentation or omission in the flow of information between the majority and minority shareholders, that the field of federal securities regulation evidences the strong federal interest in the proper flow of information between the parties to a securities transaction, which interest is not diminished because the harm from improper disclosure is the deprivation of a state remedy, and that federal courts have a duty under the supremacy clause of the Constitution to safeguard federal interests. Moreover, the court cautioned against reading Part IV of *Santa Fe* out of context saying:

What was objectionable in *Santa Fe* was use of rule 10b-5 by the federal courts to override traditional areas of state law "absent a clear indication of congressional intent ...." Thus the problem in *Santa Fe* was not merely federal judicial intrusion into areas of state law, but rather federal judicial invasion of areas of state law without explicit federal statutory authority.\(^\text{60}\)

In *Madison Consultants v. FDIC*,\(^\text{61}\) the Second Circuit rejected the argument that relief under rule 10b-5 is available only when state remedies are not, saying that "such a doctrine would eviscerate the Rule, since state common law remedies at least theoretically 'permit redress in most (if not all) 10b-5 areas.'"\(^\text{62}\)

Of course, under *Goldberg* it was precisely the availability of a state remedy that formed a basis for rule 10b-5 relief. Thus, under the *Goldberg* rationale, the very conduct which creates a state cause of action comes indirectly within the regulatory scope of rule 10b-5. While some may see irony—in light of *Santa Fe*—in expanding the scope of federal rule 10b-5 because state law reaches a particular matter,\(^\text{63}\) such an approach is not without a reasonable basis in the sense that in the *Goldberg* case the federal regulatory scheme is being used to advance or reinforce a state regulatory purpose—and not contrary to any state purpose—that is, when the conduct under attack is sanctioned expressly, or at least permitted, by the absence of state law opposing it.\(^\text{64}\) The *Goldberg* case, therefore, does not create a conflict between federal and state law as to what constitutes fiduciary misconduct. Furthermore, the Supreme Court's fear that courts would develop a uniform federal law to replace state law is not exacerbated by *Goldberg* itself.

\(^{58}\) Healey, 616 F.2d 641.

\(^{59}\) Id. at 647.

\(^{60}\) Id. at 646 (quoting *Santa Fe*, 430 U.S. at 479 (citations omitted)).

\(^{61}\) Madison Consultants, 710 F.2d 57.

\(^{62}\) Id. at 66 (quoting 5 A. Jacobs, Litigation and Practice Under Rule 10b-5, § 11.01 at 1-278 (1981)).

\(^{63}\) See supra note 56.

\(^{64}\) Hazen, supra note 30, at 836-37.
While the Goldberg approach may seem theoretically sound, or at least acceptable, in the face of Santa Fe, it may be thought nonetheless to conflict with policies espoused in Part IV. As a practical matter, the Goldberg approach may undermine Supreme Court efforts to recognize the importance of state regulation in dealing with corporate mismanagement to the extent that it may bring rule 10b-5 into play in situations that would be perceived to be state law matters. In view of the popularity of rule 10b-5, the exclusive jurisdiction of federal courts thereunder, and the minimal likelihood of wrongdoers adequately disclosing their misfeasance in advance, federal courts may become primary arenas for battling out what the state law is with regard to various situations. Thus, federal courts acting under rule 10b-5 would become significant exponents of state law, particularly in circumstances where there is often a paucity of state court rulings. Still, the idea of federal courts determining and developing state law even in the corporate field should hardly seem novel or shocking, particularly when one considers their handling of diversity of jurisdiction cases. Moreover, it must be remembered that the impact of rule 10b-5 on the development of state law regarding fiduciary misconduct may be mitigated because of its inapplicability to cases where securities transactions are not involved.

It must be conceded that the theoretical and actual efficacy of the state remedy may differ substantially from that of the federal remedy. Because the state remedy may be in reality a lesser deterrent to the conduct involved than the federal remedy, the availability of the latter would fill a gap in state law in a too supportive manner for the tastes of those whose primary concern is providing a corporate legal environment friendly to management. Indeed, some plaintiffs may perceive that chances for success based on a hypothetical state remedy are better in a rule 10b-5 action where a federal court will determine the applicability of the state remedy to the claim than in a state court deciding the merits of the state claim. Arguably, the possibility that plaintiffs could achieve different outcomes by using rule 10b-5 constitutes a threat to the policies favored in Part IV, but it would be hard to say that this possibility of different outcomes, arising from differing judicial perspectives, should preclude claims under rule 10b-5.

Moreover, while the Goldberg approach would increase the danger of vexatious litigation which could result from a widely expanded class of plaintiffs under rule 10b-5.
10b-5, a danger which concerned the Court in *Santa Fe*, it is hard to conclude that such a danger should really preclude actions which otherwise serve the fundamental purpose of the Securities Exchange Act to implement a philosophy of full disclosure of material facts in securities transactions. It is rather difficult to accept the idea that the possibility of vexatious litigation should carry much weight in determining whether the granting of certain relief is in accord with the legislative purpose.\(^1\) One would imagine that defendants would generally find litigation vexatious, particularly under the securities laws.\(^2\)

Finally, as Judge Friendly, the author of the court's opinion in *Goldberg*, perceived, there is much support in the express language of *Santa Fe* for the *Goldberg* result, even in the face of Part IV.\(^3\) Still, in view of the thrust of the *Santa Fe* opinion to prevent the undue expansion of section 10(b) and rule 10b-5, it would

\(^{71}\) It is recognized that the Court also gave weight to the vexatious litigation argument in restricting the applicability of rule 10b-5 in *Blue Chip Stamps*, 421 U.S. at 739.

\(^{72}\) The dissenting opinion of Justice Blackmun joined in by Justices Douglas and Brennan persuasively addresses the vexatious litigation argument saying:

"The greater portion of the Court's opinion is devoted to its discussion of the 'danger of vexatiousness,' ... that accompanies litigation under rule 10b-5 and that is said to be 'different in degree and in kind from that which accompanies litigation in general.' ... It speaks of harm from the 'very pendency of the lawsuit,' ... something like the recognized dilemma of the physician sued for malpractice; of the 'disruption of normal business activities which may accompany a lawsuit,' ...; and of 'proof ... which depend[s] almost entirely on oral testimony,' ... as if all these were unknown to lawsuits taking place in America's courthouses every day. In turning to, and being influenced by, these 'policy considerations,' ... or these 'considerations of policy,' ... the Court, in my view, unfortunately mires itself in speculation and conjecture not usually ... in its opinions."

Id. at 769-70 (Blackmun, J., dissenting)(citations omitted).

\(^{73}\) *Goldberg*, 567 F.2d at 217-18. The court, quoting from *Santa Fe* stated:

"We do not read *Green* as ruling that no action lies under Rule 10b-5 when a controlling corporation causes a partly owned subsidiary to sell its securities to the parent in a fraudulent transaction and fails to make a disclosure or, as can be alleged here, makes a misleading disclosure. The Supreme Court noted in *Green* that the court of appeals "did not disturb the District Court's conclusion that the complaint did not allege a material misrepresentation or nondisclosure with respect to the value of the stock" of Kirby; the Court's quarrel was with this court's holding that "neither misrepresentation nor disclosure was a necessary element of a Rule 10b-5 action," 430 U.S. at 470, and that a breach of fiduciary duty would alone suffice.... It was because "the complaint failed to allege a material misrepresentation or material failure to disclose" that the Court found "inapposite the cases [including Schoenbaum] relied upon by respondents and the court below, in which the breaches of fiduciary duty held violative of Rule 10b-5 included some element of deception," 430 U.S. at 475.... While appellant is wrong in saying that the Court "approved" these cases, there is no indication that the Court would have casually overturned such an impressive and unanimous body of decisions by courts of appeals. To the contrary, the Court used rather benign language about them, saying that they "forcefully reflect the principle that [s]ection 10(b) must be read flexibly not restrictively and that the statute provides a cause of action for any plaintiff who 'suffers an injury as a result of deceptive practices touching its sale [or purchase] of securities, ...,' " citing the Superintendent of Insurance case, supra, 404 U.S. at 12-13. Mr. Justice White simply distinguished these cases as not supporting the position we had taken in *Green*, namely, 'that a breach of fiduciary duty by majority stockholders, without any deception,
seem that a court must be careful to separate those claims of inadequate disclosure which meet the requirements of the Rule from those which do not. To put it another way, the too liberal acceptance of allegations of inadequate disclosure as raising appropriate claims under rule 10b-5 would permit such an easy conversion of breach of fiduciary duty cases involving securities transactions into rule 10b-5 cases as to seriously undermine the principles of *Santa Fe*. It was to demonstrate at least in part, perhaps, that there is still some room for *Santa Fe* to survive in the presence of allegations of inadequate disclosure that footnote eight of the *Goldberg* opinion says: "We do not mean to suggest that § 10(b) or rule 10b-5 requires insiders to characterize conflict of interest transactions with pejorative nouns or adjectives." Moreover, it has been held that it is the inadequate disclosure of material facts which is required to sustain a rule 10b-5 action and not the mere nondisclosure of the improper motive for the transaction or the failure to draw inferences from disclosed facts. Referring to section 10(b) and rule 10b-5, one court held that "[t]hey were not intended to require, under normal circumstances, the disclosure of an individual's motives or subjective beliefs, or his deductions reached from publicly available information." Thus, while it seems doubtful that the facts would often be so adequately stated in securities cases involving fiduciary wrongdoing to avoid the application of rule 10b-5, there are cases which seek to draw the line suggested by footnote eight of *Goldberg*.

B. Footnote Fourteen and the Self-Protective Action Requirement

In cases where there is inadequate disclosure, a viable cause of action under rule 10b-5 must nevertheless meet the materiality requirement suggested by footnote fourteen of the *Santa Fe* opinion. Footnote fourteen, however, does not fully explain either the kind of self-protective action which must be available to the aggrieved shareholders, or the potential for success which such action must afford...

*misrepresentation,* *or nondisclosure,* violates the statute and the Rule." (emphasis by the court).

*Id.* at 217-18. The court further noted:

Defendants also rely on statements in Part IV of the *Green* opinion which lend them some support if taken in isolation and out of context. Thus the Court, quoting from *Piper v. Christie-Craft Industries,* Inc., 430 U.S. 1, 40 (1977), said that one factor in determining whether a case was covered by § 10(b) and rule 10b-5, was "whether the cause of action [is] one 'traditionally relegated to state law ....' " But the Court quickly added, after referring to the Delaware appraisal statute, that "[o]f course, the existence of a particular state law remedy is not dispositive of the question whether Congress meant to provide a similar federal remedy," and it would be hard to think of a cause of action more "traditionally relegated to state law" than the one asserted in the *Superintendent of Insurance* case .... (emphasis added).

*Id.* at 220-21

*Id.* at 218 n.8.

74 *Biesenback v. Guenther,* 588 F.2d 400 (3d Cir. 1978).


for the deception to be considered material or the cause of the loss suffered. Based on footnote fourteen, it will not be enough to say that the shareholder or the corporation via the shareholders has been deceived, but it will be necessary for plaintiffs to show how they might have acted differently if adequate disclosure had occurred. While footnote fourteen indicates that the court envisages a state injunctive remedy as a type of material self-protective action, the language of footnote fourteen should not be read as requiring that such a remedy exists in order for materiality to be established, since the language itself does not squarely decide that point.\footnote{See supra note 16 for text of footnote fourteen.}

Although \textit{Goldberg} deals with this problem by pointing out that a state injunctive remedy would have been available if the defendants had not lulled the minority shareholders into a sense of security by a deceptive disclosure,\footnote{As indicated previously in this Article, some may interpret \textit{Goldberg} as going further and opening the door to a "shame fact" rationale. See supra note 46 and accompanying text. While it is the view of this author that the language itself in \textit{Goldberg} does not go so far, this does not mean that \textit{Goldberg} should be read as precluding such an interpretation. See supra note 47 and accompanying text.} the availability of additional kinds of self-protection has been recognized in other cases\footnote{\textit{Madison Consultants}, 710 F.2d at 57; United States \textit{v. Margala}, 662 F.2d 622 (9th Cir. 1981).} as satisfying the materiality requirement under rule 10b-5. For example, in \textit{United States \textit{v. Margala}}, a criminal prosecution for fraud in the purchase of securities under section 10(b), which involved use of the mails to conceal a complicated scheme to freeze out a corporation's public shareholders and underpay them for their stock, the defendant contended that the facts withheld or misstated were not material, because the public shareholders could not have obtained an injunction against the transaction. The Ninth Circuit, in rejecting the defendant's contention, held that it sufficed if shareholders frozen out by the manipulative scheme could have sold out earlier\footnote{\textit{Id.} at 626. Use of the rationale that a shareholder could have sold out earlier if aware of the facts was questioned by the dissenting Judge in \textit{Goldberg}: "Furthermore, it is hardly fitting for Goldberg to seek equitable remedies on the ground that, properly informed, he could have unloaded his stock on some unsuspecting third party." \textit{Goldberg}, 567 F.2d at 224 n.11; see also Jorden \& Greif, supra note 30, at 225.} or publicly exposed the scheme.\footnote{\textit{Id.}, 662 F.2d 622.} In reaching this conclusion, the court explained that "the importance of the fact to the state is not relevant in itself and is a poor measure of the importance of the fact to the investor."\footnote{\textit{Id.}} The court pointed out that "[a]n investor can protect himself in other ways than by enjoining the

\textit{RULE 10b-5}
transaction." In a more recent case, Madison Consultants Inc. v. FDIC, the Second Circuit also recognized a broader basis than state court injunctive relief for satisfying the materiality test, saying:

The availability of means of self-protection aside from state court relief has been recognized as satisfying the strictures of Santa Fe. See, e.g., United States v. Margala, 662 F.2d 622, 626-27 (9th Cir. 1981) (stockholders "frozen out" by manipulative scheme could have sold out earlier or publicly exposed the scheme, if they had been aware of the truth); Wright v. Heizer, supra, 560 F.2d at 250 (stockholders could have exercised power under state law to veto transaction). We are satisfied that upon a fair reading of Santa Fe, as it has been interpreted in Goldberg v. Meridor and other decisions cited supra, the existence of the various alternative forms of protection available to plaintiff here (e.g., state court injunctive relief, SEC no-action letter, exposure of defendants to the SEC) would satisfy the threshold test for materiality under rule 10b-5.17

These various approaches linking disclosure to potential self-protective actions raise serious issues of statutory interpretation. It is one thing to interpret section 10(b) as reflecting a congressional intent to promote disclosure as to such shareholder actions as voting or investment decisions to buy or sell. It is a step away from that to say that disclosure is called for to enable a shareholder to decide whether to sue—although certainly such a suit is an important potential weapon in the shareholder's arsenal. As the dissenting judge put it in Healey v. Catalyst Recovery of Pa. Inc.:18

By deeming the allegations of materiality legally sufficient merely because Healey alleges availability of injunctive relief, the majority change the emphasis of rule 10b-5 from protection of the reasonable investor to protection of a certain type of litigant. Healey does not contend that the information would have enabled him to make a more informed investment decision. Indeed, he had no investment decision to make because his votes were unnecessary to complete the merger. As in Santa Fe, his options, either to tender his stock or seek appraisal, were fully disclosed to him. The purpose of the federal securities laws, to promote a full and fair disclosure, was fulfilled.19

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15. Id. The court stated:
In this case, BHC's public shareholders might have sold their stock before the freeze-out at a higher price. Another possibility is that they could have exposed the plan and forced Margala and the others to abort it. The record is clear that the scheme relied on deception and that exposure would have led to adverse publicity, civil actions, and state and federal prosecutions. A reasonable BHC shareholder would have successfully protected himself from financial loss by one or both of these means.


17. Id. at 64. The court further stated: "Plaintiffs also allege that they relied by not seeking to raise funds to purchase the shares themselves from the FDIC. Upon remand they should be permitted to offer evidence in support of this claim." Id. at 64 n.4.


19. Id. at 654 (Aldisert, J., dissenting) (emphasis in original).
Still, one might argue in response to such reasoning that the decision to sue or not to sue is really an investment decision in the sense that a decision to not sue means "let the sale go forward" while a contrary decision seeks to block the sale and retain the investment; therefore, the federal interest in the disclosure of material sue facts is present. As indicated above, the Healey case itself involved such a forced sale situation in that the complaining shareholder would have been compelled to exchange his shares in one corporation for those of another. Madison Consultants also involved a forced sale transaction in that minority shareholders had pledged certain restricted shares which were sold after default to a controlling shareholder who had allegedly misrepresented his intentions to the minority causing the minority shareholder to desist from certain efforts to have the restrictions removed and thereby to avert the loss resulting from the sale. Indeed, in deciding the case, the court first had to explain that the plaintiff as a forced seller had standing under rule 10b-5.90

If a transaction is cast in such a way that the shareholder believes there is no choice but to surrender his shares, when in reality the transaction is fraught with such improprieties that the shareholder could have aborted it—had he only known of them—then the lack of disclosure of the improprieties has triggered a forced sale which could have been prevented. Here, an important shareholder decision is directly affected by lack of disclosure to the shareholder. There is a deception here which does not require much imagination to discuss; a deception which prevents effective shareholder protective action and appears to qualify as material within the meaning of footnote fourteen. While it is true that such deception furnishes the shareholder with a convenient excuse to use rule 10b-5 against corporate chicanery which would otherwise not be subject to the Rule,91 it is not fictitious. If the nondisclosure to an investor of material facts relevant to value is seen as sufficient to invoke rule 10b-5, why should not the nondisclosure of facts which enable the investor to decide if a sale is compulsory not be sufficient? Clearly, facts bearing upon whether there is or is not an investment choice are important in the first instance, even before reaching the other issues concerning the sale. Moreover, providing disclosure adequate for an investor to make a decision as to whether or not to pursue an appraisal remedy, or accept the offer which is made, is suit information also and the failure to properly disclose such information would presumably be actionable under Santa Fe.92 If a shareholder is entitled to one type

90 Madison Consultants, 710 F.2d at 60-61.
91 In reference to certain doctrines involving noninvestment sue facts it has been said:
   It is difficult for the practitioner to understand how he could possibly apply any one
   of these precepts in a disclosure document. In fact, it has been my contention that the doc-
   trines are such that they cannot possibly lead to the inclusion of additional facts in shareholders'
   disseminated documentation but are merely an excuse to bring into federal courts actions
   which would otherwise lie only before state tribunals.
   Borden, supra note 52, at 206.
92 This point is suggested by the Court's language: "[t]he case comes to us on the premise that
   the complaint failed to allege a material misrepresentation or material failure to disclose .... [The minority
of information so that he can make a choice as to whether or not to litigate over price, why should the investor not be entitled to disclosure of the other type of suit information—whether litigation can prevent him from becoming a forced seller?

It may seem rather far-fetched, however, to say that disclosure is being promoted by Congress in section 10(b) to enable the shareholder not merely to make a decision to sue or to somehow take advantage of state or federal law to try to defeat a scheme, but to enable a shareholder to gain self-protection by requiring the disclosure of shame facts which if publicly exposed would preclude directors from voting for a particular scheme. If rule 10b-5 may apply because the particular conduct involved is actionable under state law then at least the regime of federal law may be considered as offering support to the state’s position relative to the conduct. However, if there is no conduct involved in the case that is actionable under state law but a claim under rule 10b-5 is allowed because disclosure of the shameful conduct which is involved would be material by virtue of self-protective action which could be taken in the form of public exposure, then federal law is being used to deal with the conduct in a way that seems not to have been expressly sanctioned in Goldberg. One might speculate as to whether Judge Friendly deliberately avoided the broad language about self protection and returned to the narrower language of Goldberg in Mayer v. Oil Field Systems Corp., a case decided a few months after Madison Consultants, because of doubts about the broader approach. While the express language of footnote fourteen does not really address the issue of whether shame facts may satisfy the materiality requirement, it would be difficult to say, as a matter of law or otherwise, that public exposure could never represent an effective form of self-protective action. It is undeniable, though, that the shame fact theory would undermine the policies promoted by Part IV of Santa Fe in cases where federal courts would be supplying a remedy under rule 10b-5 with respect to obnoxious conduct, not illegal under state law and not otherwise illegal under federal law. Whether Congress intended to utilize section 10(b) to compel the disclosure of such conduct—or whether it fits within the congressional purpose to so interpret section 10(b)—is highly debatable.

shareholders] were furnished with all relevant information on which to base their decision. Santa Fe, 430 U.S. at 474.

Yet, as has been indicated, this is not an unheard of approach. See supra notes 43 & 79 and accompanying text.

Whether such support would be welcome is open to question. See supra notes 69 & 70 and accompanying text. Also a kind of forum shopping may develop such as in a circuit where the complainant only needs to show a bare availability of state court relief or something less than success in the hypothetical state suit. See Ferrara & Steinberg, supra note 30, at 293-94. It should be noted that the Second Circuit position has been clarified so that it no longer accords with the view of it set forth in the Article just cited. See infra note 102 and accompanying text.

This is not to overlook the argument previously referred to, that Goldberg did contemplate broader possibilities of self protection than suits based on state law. See supra notes 46 & 79 and accompanying text.

Mayer, 721 F.2d 59.
In any event, it has been held that where the shareholder has a means of self protection, the question of materiality also requires a finding that a reasonable investor in the position of the shareholder would be likely to have considered the undisclosed facts to be significant in deciding whether to take the self-protective action.\textsuperscript{97}

In addition, there is the question of whether it is necessary to show if the loss would have been avoided by the taking of the self-protective action. In dealing with this problem a variety of positions have been taken (in situations where the self-protective method is a suit) as to what must be shown: 1) the suit would have succeeded;\textsuperscript{98} 2) there was a reasonable probability of success;\textsuperscript{99} 3) there was a prima facie case for relief;\textsuperscript{100} 4) a cause of action for relief would have been stated.\textsuperscript{101} In Madison Consultants the Second Circuit Court of Appeals held that the plaintiff must show by a fair preponderance of the evidence that he "would have succeeded in preventing the loss he in fact suffered."\textsuperscript{102} The court dismissed the "cause of action" and "prima facie" case tests as too weak by pointing out that the former would lead to a finding of causation even in cases where the plaintiff would almost certainly lose, and that the latter was ambiguous and "would require a finding of causation even when the defendant could devastatingly rebut the plaintiff's case."\textsuperscript{103} While the court recognized that the test it adopted may lead to a "trial within a trial," the court felt that the nature of the claim "depends on an appraisal of the [plaintiff's] chances of success in a state court suit."\textsuperscript{104} Just how much of a "trial within a trial" and how complex it may become is indicated by language in Kidwell ex rel. Penfold v. Meikle\textsuperscript{105} regarding the resolution of factual and legal issues. In that case, the court held "that no relief is available ... under rule 10b-5 unless a minority member would have succeeded in getting permanent injunctive relief, or damages in excess of an appraisal remedy, in the state law action,"\textsuperscript{106} and explained that "[t]he question is essentially one of fact, but the federal trial judge should decide any legal issues that would have arisen in the hypothetical state suit as a matter of law in the Rule 10b-5 suit."\textsuperscript{107}

\textsuperscript{97} In Madison Consultants, the court puts it this way:
Since plaintiffs, if they had known the truth, could have taken steps to protect their interest in the several hundred thousand dollars of appreciation of their stock, it is obvious that they should be permitted to prove that the truth was material in the sense that a reasonable investor would likely have considered the information significant in deciding whether to take action to protect himself.

\textsuperscript{98} Mayer, 721 F.2d at 67; Madison Consultants, 710 F.2d at 65; Kidwell, 597 F.2d at 1294.
\textsuperscript{99} Healey, 616 F.2d at 648.
\textsuperscript{100} Alabama Farm Bureau Mut. Casualty Co., 606 F.2d at 614.
\textsuperscript{101} Note, supra note 30, at 1893-98.
\textsuperscript{102} Madison Consultants, 710 F.2d at 65.
\textsuperscript{103} Id.
\textsuperscript{104} Id.
\textsuperscript{105} Kidwell, 597 F.2d 1273.
\textsuperscript{106} Id. at 1294.
\textsuperscript{107} Id.
This approach, which insists on findings predictive of suit success, really ignores a more basic argument that a correct finding in such cases should involve whether the defendant would have desisted or retreated from misconduct by virtue of even the threat of a credible suit or other self-protective action including public exposure which could be triggered by a disclosure. If so, then the lack of disclosure would really be the cause of the loss, and a finding as to who would win the suit would be unnecessary. If the self-protective action is not a suit by the investor or does not involve any state or federal remedy, but only public exposure, it would seem that the question of cause would have to be presented along such lines. If a court is really prepared to decide if nonsuit protective actions would succeed, logically, the court should be willing to determine if suit protective actions, and not the suits themselves, would be successful. The Madison Consultants case could have proceeded on that basis. Acceptance of a shame fact or broad self-protective approach as bases for liability in rule 10b-5 actions would thus have the effect of not only widening the kinds of disclosures which would need to be made, but also of liberalizing the basis on which the cause of the loss could be determined in the sue-fact situation. But determinations regarding the potential success of self-protective actions, it must be recognized, can lead into a rather nebulous area. Presumably too, an even thinner basis of causation would be formulated in circuits which accept standards less demanding than one which would require, as in Madison Consultants, that a plaintiff show by a fair preponderance of the evidence that he would have succeeded in preventing the loss.

In cases involving public exposure, rather than suit, as the available self-protective measure, it may be that disclosure would thwart a particular plan or that the conduct involved, though not actionable under state law, would apparently be so reprehensible as to be deterred by the prospect of disclosure. As has been indicated, the use of such conduct to bring rule 10b-5 into play would be questionable. In addition, it may be quite difficult to determine as a matter of fact, on a hypothetical basis, whether certain publicity would abort a particular scheme apart from the question of whether it would lead to a successful suit which would end the scheme, and one must question whether such a determination should be the basis of rule 10b-5 liability. Indeed, courts may view with great reluctance a rule requiring a determination as to whether publicity would abort a transaction which would generally be more difficult to make than an assessment of the potential for success of a suit, although this latter contention may be thought to reflect undue optimism about suit predictability.

It may be that the difficulties of proof as to materiality, cause, or other issues such as scienter, would make it so hard to prevail under rule 10b-5 where the

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108 For example, in an action under rule 10b-5 plaintiff must show that defendant acted with...
broader self-protective approach is used, that such an approach, while tempting, may not be very successful in practice. Still, the practical import of such difficulties may be lessened in the eyes of the prospective plaintiff because of the settlement potential or other advantage of rule 10b-5 cases. In any event, one must still come to grips with the question of whether a defendant should be responsible under rule 10b-5 for not making a disclosure merely because it precludes the pursuit of some self-protective device other than a suit or merely because it might trigger a suit which a defendant would not want to face irrespective of plaintiff's chances of success. Would this not make the question of what must be disclosed, at least in certain situations, difficult to answer, so difficult as to be unfair?109

Of course, it must be conceded that the broader approach of Madison Consultants and Margala, as to the type of self protection required to satisfy footnote fourteen, frees rule 10b-5 from the narrow approach which would make its applicability turn on state law in footnote fourteen cases. Indeed, the Goldberg approach may be criticized in the sense that it makes the application of federal law (that is rule 10b-5) a hostage of state law to the extent that a viable claim under the Rule depends on state law, and that there is an undeniable loss of uniformity.110 While this objection to Goldberg may have some weight and may even point toward the ultimate necessity for congressional action to deal with the matter one way or another, it should not now deprive fraud victims of relief under rule 10b-5.

V. CONSTRUCTIVE DECEPTION

Having reviewed the issues raised by Goldberg with regard to a rule 10b-5 action, apart from the constructive deception doctrine, this Article will now discuss that doctrine in depth. Is the constructive deception doctrine really inconsistent with Santa Fe? Since Santa Fe there have been a number of cases in which circuit

scienter." "Scienter—'a mental state embracing intent to deceive, manipulate, or defraud' ... is an independent element of a rule 10b-5 violation." Dirks 103 S. Ct. at 3265 n.23 (quoting Hochfelder, 425 U.S. at 193 n.13).

109 Even under a narrow approach, counsel advising as to what must be disclosed may have an unenviable task. For further discussion see supra note 91; see also Ferrara & Steinberg, supra note 30, at 286-87.

110 Note, supra note 30, at 1889. Arguably dependence on state law, as a practical matter, may not be as significant as it appears to be. Ferrara & Steinberg, supra note 30, at 295-96 state: In a large number of cases, the applicable state law may be unresolved: for example, the issue may be one of first impression, or the state's high court may not have considered the question. In such a case, a federal court, although ostensibly predicting how the relevant state's high court would rule on the matter, may take into account the federal interest in full and fair disclosure. Even if this result follows, the state's countervailing interest in maintaining areas of independence remains intact because the state high court is the final arbiter. The federal court's interpretation of state law is, in essence, merely a recommendation that the state high court can freely accept or reject when it ultimately determines the matter.

Id. (footnotes omitted).
courts have accepted the continued life of the constructive deception doctrine.\textsuperscript{111} \textit{Santa Fe} stands for opposition to the expansion of rule 10b-5 to cover nondeception or nonmanipulation cases;\textsuperscript{112} arguably, therefore, if one must create deception by using such fictions as those upon which the constructive deception doctrine depends, then such deception is not real enough to be covered by rule 10b-5. Still, Judge Friendly's refusal in \textit{Goldberg} to construe \textit{Santa Fe} as rejecting that doctrine seems correct in light of the Supreme Court's own words.\textsuperscript{113} Because of such words and subsequent circuit court cases embracing the constructive deception doctrine, should an appropriate case come up on review, the Supreme Court would have no difficulty in permitting the doctrine to continue its life notwithstanding the criticism of some commentators.\textsuperscript{114}

In addition, because the corporation is a fictitious entity, it cannot be deceived except to the extent that the law regards it as deceived by virtue of the deception of real persons who are connected with it, such as employees or directors. Consider the following situations: 1) If an outsider sells securities to a corporation which the corporation purchases because of misrepresentations made to its president by the outsider, would it be seriously contended that rule 10b-5 does not apply because there is a fiction involved in saying that the corporation has been deceived? 2) Suppose the president deceives the directors in order to obtain their approval of a deal involving the president selling securities to the corporation. Should the knowledge of the president be attributed to the corporation in such a conflict of interest situation in order to preclude an action under rule 10b-5?\textsuperscript{115} 3) Similarly, if the shareholders are able to protect the corporation, but are the victims of misrepresentations which lull them into a nonprotective stance, should the knowledge of the directors be attributed to the corporation, even if the directors are involved in a conflict of interest situation, so as to preclude an action under rule 10b-5?\textsuperscript{116} 4) Should creditors be precluded from the use of rule 10b-5 on behalf of the corporation where corrupt directors, officers, and shareholders have led the corporation into a securities transaction which is against the interests of the corporation and its creditors while publicly disseminating misrepresentations about the benefits of the transaction to the corporation?\textsuperscript{117}

In a sense it takes a doctrine of constructive deception to justify a rule 10b-5 action in any of the situations set forth above, although admittedly it takes less imagination to arrive at the conclusion that there is deception in case number one than in the other cases. Moreover, it does not seem unreasonable to permit a

\textsuperscript{111} See, e.g., \textit{Kidwell}, 597 F.2d 1273; \textit{Alabama Farm Bureau Mut. Casualty Co.}, 606 F.2d 602.
\textsuperscript{112} See supra notes 12 \& 13 and accompanying text.
\textsuperscript{113} See supra notes 36, 37, 42 \& 73 and accompanying text for relevant discussion of language of the Supreme Court.
\textsuperscript{114} See, e.g., \textit{Jorden \& Greif}, supra note 30 at 237-38 for such criticism.
\textsuperscript{115} There should be no imputation of knowledge in such a situation. 3 W. FLETCHER, Cyclopedia \textbf{OF THE LAW OF PRIVATE CORPORATIONS} § 819 (rev. perm. ed. 1975).
\textsuperscript{116} Id. at § 819. There should be no imputation of knowledge in such a situation.
\textsuperscript{117} Is the corporation really any less deceived in situation 47?
technical or legalistic approach as to what constitutes deception of a corporation to bring certain conduct within the ambit of rule 10b-5 deception of a fictitious entity is involved and a technical or legalistic approach is needed. Congress did not exclude corporations from the protective sweep of section 10(b), and rule 10b-5 does not exclude corporations even though they are fictitious entities. Because it is in accord with legal principles to refuse to attribute to the corporation the knowledge of those who have a conflict of interest with the corporation,118 there is nothing unreasonable about using that approach to justify a 10b-5 action. It may be said that what the constructive deception doctrine is saying in effect is that a fictitious entity is deceived for purposes of rule 10b-5 unless disinterested directors or shareholders are told the material facts.119

However, a major and somewhat troublesome problem presented by this doctrine is the determination of which directors are interested and which disinterested. In Maldonado v. Flynn,120 the Second Circuit concluded that where shareholder approval regarding a matter is not needed, full disclosure to a disinterested board of directors will suffice.121 "For this purpose 'disinterest' is defined as lack of any financial stake by a director in the transaction under consideration ...."122 By way of illustration, among the directors found by the court to be disinterested was one who was a partner in a law firm which received substantial fees from the corporation.123 In this case, the plaintiffs had alleged unfairness to the corporation in the administration of a stock option plan. The defense was that all the directors knew the facts. The test formulated and used by the court seems inappropriate. The question of whether a director is disinterested so as to be able to protect the interests of the corporation with regard to a particular question should really be a question of fact; artificial lines should not be drawn which determine the question based on the role of the director in an abstract sense.124 It should be noted

118 Fletcher, supra note 115, § 819.
119 See, e.g., Alabama Farm Bureau Mut. Casualty Co., 606 F.2d at 602, which stated: However, it is necessary for the impact of a transaction to be described factually to the extent that such information would be significant to a reasonable, disinterested director ... or shareholder .... See Wright v. Heizer Corp., 560 F.2d 236, 247 (7th Cir. 1977), cert. denied, 434 U.S. 1066 (1978) (if shareholder approval not required, disclosure to board of directors sufficient if majority is disinterested; otherwise, disclosure to shareholders is required).
120 Maldonado v. Flynn, 597 F.2d 789 (2d Cir. 1979).
121 Id. at 793.
123 Maldonado, 793-94.
124 Ferrara & Steinberg, supra note 30, at 290, states: Although some courts have held that only the existence of a financial conflict disqualifies the director, the better view is that other disabilities have the same effect. The crucial criterion should not be whether a director is financially interested, but whether he can exercise independent judgment on behalf of the corporation and its shareholders. Any conflict or disability that impairs a director's judgment poses the same threat to the best interests of
that the court also indicated that "[d]omination or control of a corporation or of its board by those benefiting from the board's action may under some circumstances preclude its directors from being disinterested."¹² The court found no claim of such domination or control in the case before it.

Perhaps the question in each case should be framed so as to determine if the director would be reasonably expected to exercise the kind of disinterested judgment which is required. If not, the corporation must be protected by someone else, and absent informed and disinterested directors, the logical protectors are shareholders. Nor should the presence of a minority of sufficiently disinterested directors or one such director be deemed adequate to safeguard corporate interests in the face of adverse majority action. In theory, perhaps one might expect the disinterested director or directors to launch vigorous protective efforts including a lawsuit against the majority action. In actuality, however, reliance that such efforts will materialize may be overly optimistic; a disinterested director or directors may be unwilling or unable for various reasons to make the effort to rock the boat, and it may take the self interest of shareholders to fuel the necessary protective action.

The question of materiality of the deception must be faced in those cases in which it is determined that, because a disinterested majority of directors does not exist, the corporation has been deceived. Judge Friendly's position that materiality depends on what disinterested directors would consider important¹²⁶ seems to flow logically from the premise that there is deception of the corporation because disinterested directors were not aware of a particular fact. Whether the deception should be deemed material under rule 10b-5 should depend, therefore, on how it would have been perceived by such directors. If the particular fact would not have been material to the deceived, disinterested directors, then it would not have been material to their corporate decision and it should not be a basis of a rule 10b-5 action by the corporation. To put it a different way, if a particular fact would be material to the disinterested directors, then at least the corporation has not been deceived in an immaterial way. In cases which depend on footnote fourteen, however, overcoming this hurdle regarding materiality would not solve all problems of materiality. There is still the question of whether the fact is material to the uninformed minority shareholders in Goldberg-type cases. The question of materiality should then move forward to be determined in the light of the shareholder's, and not the director's, perspective. The test would be whether the shareholders would find the fact material in deciding to bring suit or take some other self-protective

¹² Maldonado, 597 F.2d at 795.
¹²⁶ See supra note 44 and accompanying text.
action. It is understandable, therefore, that a court should decide that materiality must be determined on a double-barreled basis in constructive deception cases under rule 10b-5 which rely on footnote fourteen, that is, 1) material to the board and 2) material to the shareholders in determining their respective courses of action. As a practical matter, testing materiality from those different perspectives may make little difference in the outcome of the case; in theory, at least, there is a distinction: the trier of fact must be conscious of the perspective from which the issue is to be determined. In this sense, it seems that Judge Friendly is correct in discussing the perspective of hypothetical, disinterested directors in Goldberg. If, viewed from the disinterested directors' perspective, the deception is immaterial in a constructive deception case, then it should be deemed immaterial to the corporation for rule 10b-5 purposes. As indicated, however, a determination that the fact would be material to such directors does not end the inquiry as to its impact on shareholders which is so important to those who would depend on shareholder action under footnote fourteen.

VI. CONCLUSION

In the wake of Santa Fe there were some state court decisions which evidenced a more protective attitude toward investors. Interestingly, Delaware, a leading state in the race for incorporations, seemed to be at the forefront of these developments. The state race for the business of incorporating businesses has a momentum of its own, however, and there is already evidence of some erosion of investor remedies which has surfaced in Delaware. For example, the recent Delaware case, Weinberger v. UOP while not without any apparent silver lining for minority shareholders in terms of improvement in the Delaware appraisal remedy, makes it significantly more difficult to show that remedies other than an appraisal are available. Conceivably, the sue fact doctrine may have an impact on the

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127 This would depend, of course, on whether the court involved accepts the idea that self-protective action beyond suit justifies the application of rule 10b-5.
128 See supra note 44 and accompanying text.
130 Ferrara & Steinberg, supra note 129, at 3. Referring to corporation law experts:
In view of recent developments, it is somewhat surprising that many of these experts characterized Delaware and other state corporation laws in such pessimistic and hopeless terms as recently as a decade ago. From these developments, many of these experts would now have to admit that Delaware, above all other states, has come a long way toward protecting the rights of shareholders and promoting the fundamental concept of corporate accountability.
131 Id. Weinberger v. UOP, 457 A.2d 701 (Del. 1983).
132 W. H. PAINTER, PROBLEMS AND MATERIALS IN BUSINESS PLANNING 650 (2d ed. 1984) stated: The "business purpose" requirement of the Singer case and its Delaware progeny has now been replaced by a "liberalized" reading of the Delaware appraisal statute and Delaware law is now no longer interpreted as requiring that the transactions have a "business purpose" other than to "cash out" a minority shareholder. Despite the purported "liberalizing" of
development of state remedies for investors, for if a state remedy opens the door to a rule 10b-5 action in the federal courthouse, then that would furnish just another reason for states which want incorporation business to curb remedies. Perhaps a quest for uniformity and a deterioration of state remedies will create more impetus for federal legislation to give investors protection with respect to the kinds of transactions involved in sue fact cases.  

If a broad self-protective approach is accepted as a basis for a rule 10b-5 action on the theory that potential shame or fear of litigation will inhibit management conduct, then conceivably conduct which is not unlawful, or whose suit potential is not assessed by any court, may need to be disclosed. If under a broad self-protective approach a kind of behavior which is not, or may not be, illegal under state standards, becomes nevertheless the basis for a rule 10b-5 action, then this could have considerable impact on state control over the subject of management behavior. This would pose a danger for the development of federal fiduciary standards of behavior that the sue fact doctrine would not pose; provided, of course, that in sue fact cases there is placed on the plaintiff a fairly stringent burden to show potential success in the hypothetical state suit, such as that imposed by Madison Consultants.

As a general proposition, it should be less difficult to determine the merits of a sue fact claim than a shame fact claim. Management should have less difficulty in knowing what to disclose where sue facts are involved, and plaintiffs should have less difficulty in determining whether sue facts exist. Thus, the sue fact doctrine is fairer than the shame fact doctrine to apply in the sense that management, particularly with competent legal advice, has better notice of potential wrongdoing than it could have with respect to the more nebulous shame fact doctrine.

Admittedly, even the sue fact doctrine can lead to rather complex law suits, particularly where the Madison Consultants approach as to cause prevails, but complexity is no basis for denying relief under rule 10b-5. The sue fact idea does have a built in basis for creating nonuniformity at the federal rule 10b-5 level because of its dependence on state remedies, and although this may be undesirable, the federal remedy for persons who have been wronged should not be lost because of it. It is difficult to say if a broader self-protective approach based on such factors as the impact of the fear of suit or shame on the defendant would lead to more or less uniform results, but such an approach would be likely to diminish the relative importance of state law as the regulator of corporate conduct. Perhaps

the Delaware appraisal procedure, one reading of this development is that the Delaware courts have taken at least one step backwards and have begun to unravel what progress has been made in the six years since the Singer decision.

Of course, there may be existing federal law (other than that developed under rule 10b-5) which may be helpful to some plaintiffs in cases involving proxies, tender offers and certain other situations. For a discussion of the problems, limitations and considerations involved in utilizing such laws and their relationship to rule 10b-5 see Hazen, supra note 39, at 843-61; Borden, supra note 52, at 210-11.
the danger of the proliferation of shame fact cases with all of the problems they could create would be minimized because of difficulties of proof as to materiality, scienter, or causation in such cases, but the magnetism of rule 10b-5 as a litigation weapon diminishes that possibility.

*Goldberg* and its progeny do no real violence to the principles of *Santa Fe* by virtue of the sue fact doctrine. Indeed, the seeds of that doctrine were planted by the language of the Supreme Court in *Santa Fe* and were well nurtured by Judge Friendly in *Goldberg*. There is no injustice which arises on account of the sue fact doctrine giving persons who have been wronged a desirable weapon under federal law to use against wrongdoers, because they also have a remedy under state law. However, each effort to extend the sue fact doctrine on the basis of broader self-protective approaches should be carefully scrutinized because of the additional problems which would be engendered. In any event, after all has been said, the problem which remains is that the post *Santa Fe* judicial salvaging operation—the sue fact and other approaches which have been discussed herein—offer roundabout and, at times, or to a degree, undesirable or inappropriate ways to deal with the real villain—fiduciary misconduct. Rule 10b-5, even with its almost mystical properties, is not ideally suited to confront and defeat that villain, particularly after *Santa Fe*. Nor should we realistically expect state corporate law to save the day. If the problem of fiduciary misconduct, as it affects securities transactions and markets, is to be effectively addressed, it should be dealt with through legislation at the national level.