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ADDRESS

OF

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THE ENFORCEMENT OF FIDUCIARY OBLIGATIONS

Enforcement of fiduciary obligations is a primary objective of the federal securities laws. Their purpose is largely to fulfill the expectations of trust and confidence which a public investor must of necessity place in corporate managers and professionals in the securities field. This necessity for trust may arise from the investor's relative unfamiliarity with a complex subject as to which the professional is expert or from his relative ignorance of facts in dealing with an "insider". It is also a consequence of the diffusion of ownership of the modern corporation. Scattered investors, whether naive or sophisticated, are forced to trust their affairs to persons with whom their contacts are necessarily impersonal and remote.

The professionals in the securities field--promoters, investment bankers, brokers, dealers, indenture trustees and protective committees--have assiduously cultivated the trust and confidence of investors. At the same time they have desired, with the aid of their lawyers, to avoid, so far as possible, the legal status of a fiduciary and to minimize any legal obligations as such. A familiar example is the device by which promoters sought to insulate their responsibility for receiving stock in exchange for over-valued property by having their contract ratified by unanimous vote of the outstanding stock after full disclosure to themselves as sole stockholders. There was the pre-Securities-Act prospectus which merely set forth a letter from the issuer to the offering banker and stated, with a disclaimer of responsibility, that the information contained in the letter was that upon which the banker relied in contracting for the securities. There were the common exculpatory provisions of trust indentures and protective committee deposit agreements. Promoters and corporate lawyers could choose the most favorable state of incorporation among states that competed for the revenue of chartering corporations to do business elsewhere and to sell their stock primarily among out of state investors.

I do not mean to suggest that there was anything necessarily sinister in the adoption of the various devices to minimize the legal responsibility of the corporate managers and professionals in the security business. They were doubtless prompted in many instances by the good faith desire to minimize business risks, and by fear of "strike suits." Of course there would be objections from the point of view of the healthy functioning of the economy at large if the risks of engaging in the securities business or in acting as a corporate manager were too great. A balance must be struck. Prior to the advent of federal securities legislation, however, the balance was so greatly overweighted against the investor as to encourage an attitude of irresponsibility upon the part of those holding positions of trust. This contributed to the "orgy of speculation, which culminated in the disastrous stock market crash of 1929. /At this point I am quoting from the Commission's Tenth Annual Report, p. 2./ Experience of a decade of feverish activity subjected to little or no regulation by the Federal Government clearly revealed the need for legislation that would curb financial malpractice and require those using and soliciting the use of other people's money to conform at least to the minimum standards of fiduciaries or trustees— all to the end that investors might be protected and the public interest furthered."

In dealing with the problem Congress did not attempt to create a self-contained system of federal rights and remedies for corporate security holders. Instead, limited federal protection was accorded in areas deemed critical, while leaving to private contract, state incorporation laws and to the common law, the general delineation of investors' rights and remedies, insofar as not in direct conflict with federal law. The federal effort was largely to improve and strengthen the opportunities for self-help and self-reliance on the part of individual investors. Care was taken, among other things, to avoid any governmental responsibility for the actual direction of the flow of private capital into industry. Instead, the emphasis has been upon disclosure, opportunity for informed exercise of investors' voting rights, elimination of conflicts of interest, and imposition of increased responsibility upon those who purport to act in the interest of investors.

The approach has varied from statute to statute. The Securities Act of 1933 cuts across the legal devices by which promoters, and those engaged in the distribution of securities, attempted to avoid their responsibility for adequate disclosures to the ultimate purchasers of securities. Thus, civil liability for misleading statements in a registration statement runs to the ultimate purchaser irrespective of privity of contract and is placed upon all those who play a significant part in the distribution of a security. Where a misstatement is inadvertant the extent of the liability does depend upon the particular person's opportunity for ascertaining the facts, but there is no attempt to relate disclosure obligations to the existence or non-existence of a fiduciary relationship. 1/ Perhaps more important than this civil liability, are the provisions for advance administrative scrutiny to compel adequate disclosures in the registration statement and prospectus. Among the required disclosures are promoters' profits and underwriters' spreads which it was the prior practice to withhold from the investor. The Trust Indenture Act, applicable to indubitable fiduciaries leaves enforcement of their fiduciary obligations to private suits but outlaws the type of exculpatory provisions which prevailed prior to the Act.

1/ See Section 11. The Act as originally passed made the standard of reasonableness of investigation and of belief in the truth of a statement "that of a person occupying a fiduciary relationship." This was one of the provisions modified in 1934 to alleviate fears that the civil liabilities of the Act were too drastic. The amended provisions imposes the standard of reasonableness "required of a prudent man in the management of his own affairs."

requires that trust indentures impose upon the trustee certain minimum standards of fiduciary responsibility and eliminate certain specified conflicts of interest. It thus imposes on the Commission a minimum of administrative duties. Indeed, Section 302(e) expressly provides that the Commission is not empowered to conduct an investigation to determine whether an indenture is being complied with or to enforce its provisions. At the opposite extreme, the Public Utility Holding Company Act provides a relatively pervasive system of regulation for a limited class of companies. A major concern of that Act is preventing a parent holding company from abusing its fiduciary position. The Commission has authority to pass on all transactions between companies in the same holding company system and with affiliates, among other things to "maintain competitive conditions." The Investment Company Act of 1940 provides for a somewhat similar scrutiny of transactions between registered investment companies and affiliates. It prohibits such transactions unless exempted by the Commission after a finding that they are "reasonable and fair and do not involve overreaching."

Closer, perhaps, to the focal point of today's discussion are the various provisions of the Securities Exchange Act which impose specific obligations upon corporate managers for the protection of security holders. These include the filing of financial information with the Commission and the exchange, and keeping it current by annual and other reports; compliance with proxy regulation intended to afford a realistic opportunity to scattered stockholders to exercise the voting rights theoretically accorded by their corporate charter; disclosure by officers, directors and ten per cent stockholders of their beneficial ownership in equity securities of their company; prohibition of short selling by such persons and surrender to the issuer of profits from their short term trading in equity securities of their corporation. The surrender of profits provisions are, of course, applicable irrespective of proof of abuse of his position by the insider and are designed to discourage short swing "speculation" as distinguished from long term shifts in investment position. A six months period between a purchase and sale is used as an arbitrary test of what is deemed speculation as distinguished from investment.

The financial reporting requirements of the Exchange Act apply only to issuers of securities registered on an exchange and to certain issuers of securities registered under the Securities Act of 1933. The proxy and the insider trading provisions apply only where some equity security of the issuer is registered on an exchange. This leaves a serious gap in the scope of investor protection. Many large and important companies with numerous and scattered stockholders are not subject to the Holding Company or Investment Company Acts, do not have equity securities registered on an exchange and have not had occasion to register securities under the Securities Act. Their managements are free to decide for themselves how much information to supply to their security holders, free to engage in continuous speculation in securities of their companies without disclosing their transactions or accounting for any resultant profits, and free to control the proxy machinery so as to minimize stockholder participation in corporate affairs. For several years the Commission has been recommending legislation to fill this gap and to eliminate the "double standard" as to the responsibility of the management of major corporations. Its recommendations have had the support of the President and almost unanimous approval of the securities industry. Proposed legislation has been introduced, currently embodied in the Frear Bill. As yet the Congress has not acted.

One important provision of the Exchange Act does have an important bearing upon enforcing the fiduciary obligations of corporate managers and other insiders whether or not securities of the issuer are registered on an exchange. If the mails or federal instrumentalities are used, Section 10(b) and the Commission's Rule X-10B-5 thereunder make it unlawful "in connection with the purchase or sale of any security"

"(1) to employ any device, scheme, or artifice to defraud,

"(2) 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

"(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person."

One consequence of this rule is to afford additional sanctions for conduct which would unquestionably be held fraudulent at common law, irrespective of the existence of a fiduciary relationship. As applied to the problem of enforcing the fiduciary responsibility of corporate management, the chief importance of Rule X-10B-5 is its impact upon subtler wrongs involving an abuse of insiders' position in dealings in the securities of their company. Here there is at least uncertainty as to the investors' rights at common law, according to Judge Learned Hand "a grave omission in our corporation law." See Gratz v. Claughton, 187 F. 2d 46, 49 (C.A. 2, 1951).

Violation of Section 10(b)(5) may, of course, lead to injunctions by the Commission, or in aggragated cases to criminal prosecution. In addition, there are now quite a number of cases which hold, without exception, that injured security holders are entitled to sue for its violation, and of course to bring their suits in the federal courts. Most of the cases under Rule X-10B-5 have involved the purchase by insiders of outstanding corporate securities without disclosing material facts known to the insider which make the security worth substantially more than would appear from the publicly available information.

In some of the cases an insider has made to public security holders a naked offer to purchase upon stated terms or has instructed a broker to purchase for him. The only inducement has been a price sufficiently above current market quotations to look attractive. The insiders have argued that they have made no misrepresentation, and indeed that they have made no representation at all. A straight forward answer to this argument is that the insider's position and special knowledge imposes a duty to speak, and that silence where there is a duty to speak, operates as a fraud or deceit upon the other party to a transaction. This is the basic theory of Chief Judge Leahy in the District Court for Delaware in his recent decision in Speed v. Transamerica Corp., decided in August 1951. It was also held that "in making an offer of 33-1/3% above the current market price, defendant impliedly represented that the price offered was a fair price at that time."

It may be of interest to state the facts of the Transamerica case. Transamerica as a controlling stockholder had written a letter to the public stockholders of Axton-Fisher Tobacco Co. offering to purchase their stock at specified prices without supplying any financial information in connection with the offer. Previously published financial reports had disclosed the then earnings of the company and had, among other things, stated the book value of its tobacco inventory at "average cost" in accordance with accepted accounting practice. After substantial acceptance of the offer Transamerica caused Axton-Fisher to dissolve. In dissolution Transamerica realized an enormous profit over what it had paid for the public shares, principally as a result of selling the Axton-Fisher tobacco inventory to one of the large cigarette manufacturers at a price far above book value. The material facts which the court held Transamerica had wrongfully failed to disclose were: the intention to liquidate Axton-Fisher increased earnings, and the fact that the realizable value of the tobacco inventory was so far above book cost as to make the offer to the public security holders grossly unfair. Transamerica's duty to disclose these material facts as a majority stockholder was derived from Rule X-10B-5 itself, interpreted in accordance with "the primary purposes of the Securities Exchange Act of 1934 . . . to outlaw the use of inside information by corporate officers and principal stockholders for their own financial advantage to the detriment of uniformed public security holders." It was not deemed material to the federal issue to decide what were the disclosure duties of Axton-Fisher's directors and stockholders under the laws of Kentucky as the state of incorporation--a matter which had previously caused some difficulty, although the Judge ultimately concluded that the result under Kentucky law would be the same.

The Speed case also held that plaintiff properly brought his suit as a class action, constituting "at least a good spurious class suit" since the same material information was withheld from all public stockholders who sold in response to Transamerica's offer.

There is also a problem of disclosure where the insiders "bail out' or sell their interest without disclosing materially adverse facts. When controlling stockholders make a public offering through an "underwriter" registration is required under the 1933 Act unless some exemption is applicable. Assuming the registration requirements are not applicable, such sales may violate Rule X-10B-5 (as well as overlapping anti-fraud provisions of Section 17 (a) of the Securities Act), if material information is withheld. A possible argument for a narrow interpretation of the insiders' obligations under these circumstances is the traditional conception that the insider owes no fiduciary obligation to persons who are not yet shareholders. Judge Learned Hand has criticized this limited approach to the fiduciary obligations of a director or officer stating, "it would be a sorry distinction to allow him to use the advantage of his position to induce the buyer into the position of a beneficiary although forbidden to do so /to deal without full disclosure/ once the buyer had become one." See Gratz v. Claughton, 187 F. 2d 46, 49. Judge Hand was not discussing Rule X-10B-5 but merely passing upon the constitutionality of Section 16(b) of the Exchange Act in the light of the common law's grappling with the problem of insider security transactions. Neither the Commission nor the courts have passed squarely on this problem under Rule X-10B-5.

Another type of abuse of an insider's position which may be involved in the sale of a controlling interest relates to the sale of control as such. If the consideration paid is sufficiently above the market value of the shares sold, there may be warrant for inferring that the insider is in effect selling his fiduciary position to a person who is buying to misuse control to the detriment of the non-selling security holders. It has been held, in a different context and on general principles of equity, that a person litigating on behalf of a class is accountable as a fiduciary for profit derived from selling his interest at a price which represents the sale of control over the litigation. I refer to the case of Young v. Higbee, 324 U.S. 204. It has also been held that the seller of a controlling block of stock may be liable to other security holders for damages as a result of selling to persons who might have been expected to loot the company and who did so. See Insuranshares Corp. v. Northern Fiscal Corp., 35 F. Supp. 22.

What of the situation where the minority fears but cannot prove measurable damages as a result of the transfer of control? If the Higbee analogy is applicable, there may be a basis for reaching the profits of the controlling stockholder as the fruits of a breach of fiduciary obligation. Of course, the burden would be on the minority to show that under the circumstances of the case that there really was a breach of fiduciary obligations and it would seem that this would ordinarily be rebutted where one of the terms of the sale is the making of the same offer to the minority shareholders as the majority has bargained for in respect of its own shares. Where the person acquiring control by purchase of part of the securities of a company is subject to the Public Utility Holding Company Act, Section 10(b) of that Act provides that, in passing upon the acquisition, the Commission may condition its approval upon "a fair offer to purchase such of the other securities of the company" as are not involved in the proposed transaction. In a number of Holding

Company Act cases the Commission has required that the minority be accorded an opportunity to get out on the same terms as the person selling a controlling interest.

The Commission has not had occasion to express an opinion as to the applicability of Rule X-10B-5 to this type of transactions. Assuming that a breach of fiduciary obligations is established which amounts to a "fraud", there is a further question whether the words of Section 10(b) "in connection with the purchase or sale of a security" include frauds on persons other than the other party to the transaction. There is one district court holding each way, in neither of which was the Commission a participant. The only reported decision is Birnbaum v. Newport Steel Corp., 98 F. Supp. 506 (S.D.N.Y.), which holds Rule X-10B-5 inapplicable. Since there was no diversity of citizenship the Court did not have occasion to decide whether the complaint stated a cause of action on non-federal grounds.

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This has been only a very rough outline of the statutes administered by the Commission and a rather sketchy discussion of a few current problems as to the scope of Rule X-10-5. I believe that the conclusion is warranted that at least a dent has been made in the legal armour which, prior to the advent of federal legislation, protected corporate managers and professionals in the securities field who might fail to live up to the investors' expectations in respect of their fiduciary obligations.

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