

SHAREHOLDERS' DERIVATIVE SUIT TO ENFORCE A  
CORPORATE RIGHT OF ACTION AGAINST DIRECTORS  
UNDER SEC RULE 10b-5

Since 1946 when it was first held to provide a private right of action,<sup>1</sup> SEC Rule 10b-5<sup>2</sup> has developed into a widely used remedy for defrauded sellers and purchasers of securities.<sup>3</sup> Recovery has been allowed in a variety of situations involving abuses of the securities trading process. It has made no difference that the defrauded seller or purchaser has been a corporation.<sup>4</sup> "[W]hen a corporation has a cause of action under the rule, a stockholder may sue derivatively under the usual conditions."<sup>5</sup> There has, however, been a reluctance to allow such a derivative corporate recovery where the alleged fraud on the corporate seller or purchaser has been committed by the directors of that corporation. This Comment will explore the reasons for that reluctance and their validity.

Rule 10b-5 was promulgated by the Securities Exchange Commission in 1942 pursuant to section 10(b) of the Securities Exchange Act of 1934.<sup>6</sup> Basically, the rule outlaws fraudulent conduct in the interstate sale or purchase of securities:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentalities of interstate commerce, or of the mails, or any facility of any national securities exchange,

- (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 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,

in connection with the purchase or sale of any security.<sup>7</sup>

<sup>1</sup> Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946).

<sup>2</sup> 17 C.F.R. § 240.10b-5 (1964).

<sup>3</sup> See, e.g., Matheson v. Armbrust, 284 F.2d 670 (9th Cir. 1960); Hooper v. Mountain States Sec. Corp., 282 F.2d 195 (5th Cir. 1960), cert. denied, 365 U.S. 814 (1961); Fischman v. Raytheon Mfg. Co., 188 F.2d 783 (2d Cir. 1951); Loss, SECURITIES REGULATION 1763 & nn.260-61 (1961).

<sup>4</sup> New Park Mining Co. v. Cranmer, 225 F. Supp. 261 (S.D.N.Y. 1963); Slavin v. Germantown Fire Ins. Co., 174 F.2d 799, 805-06 (3d Cir. 1949) (dictum); Kremer v. Selheimer, 215 F. Supp. 549, 552 (E.D. Pa. 1963) (dictum); see McClure v. Borne Chem. Co., 292 F.2d 824 (3d Cir.), cert. denied, 368 U.S. 939 (1961).

<sup>5</sup> Loss, *op. cit. supra* note 3, at 1764; see cases cited *id.*, n.264; New Park Mining Co. v. Cranmer, *supra* note 4; Pettit v. American Stock Exch., 217 F. Supp. 21 (S.D. N.Y. 1963); cf. J. I. Case Co. v. Borak, 377 U.S. 426, 431-32 (1964).

<sup>6</sup> 48 Stat. 891 (1934), 15 U.S.C. § 78j (1964), quoted note 22 *infra*.

<sup>7</sup> 17 C.F.R. § 240.10b-5 (1964).

The difficulties faced by the federal courts in a 10b-5 derivative suit by shareholders against directors alleged to have defrauded their corporation fall into two areas. A recovery under the rule requires a showing that the victim was deceived in some way.<sup>8</sup> The conceptual problem of finding that the inanimate corporate entity can be deceived at all becomes especially difficult when those who manage and act for the corporation are fully aware of the situation, and are in fact responsible for it. The second, and more serious, difficulty is the possible effect on our system of federalism of federal court jurisdiction in these cases. The field of corporate management and the duty of directors to their corporations is primarily regulated by state law. To superimpose federal law upon state created duties might undermine the state's regulatory scheme—a result which would be held undesirable by many people. Three recent cases put these issues in perspective.

*Barnett v. Anaconda Co.*<sup>9</sup> was a district court decision on a motion to dismiss the complaint. Defendant Anaconda owned seventy-three percent of the stock of a subsidiary, Wire and Cable. The complaint alleged that directors of Anaconda, being a majority of the board of Wire and Cable, transferred all the assets of the subsidiary to a new firm, totally controlled by Anaconda, for a grossly insufficient amount of Anaconda stock. Despite the Anaconda interests' control of the more than two-thirds of Wire and Cable stock required for approval of the transaction, the plaintiff sought to bottom his complaint on the issuance to other shareholders of a proxy statement containing false and misleading statements. A minority shareholder whose proxy was so solicited brought suit against Anaconda both representatively, for the true value of shares held by the minority stockholders, and derivatively on behalf of Wire and Cable, to recover some thirty-five million dollars by which defendant was unjustly enriched. The court found that the transaction was "a sale of Anaconda stock to Wire and Cable for all of Wire and Cable's assets,"<sup>10</sup> but dismissed the complaint on the ground that any deception in the proxy statements could not have been causative of the injury to either the individual plaintiffs or the subsidiary corporation. This finding followed from the fact that the Anaconda directors could have voted the amount of Wire and Cable stock necessary to effectuate the transaction without the help of any minority stockholders who might have been misled by the proxy solicitation, "and no internal corporate procedures under Delaware law were available to the minority to block it."<sup>11</sup> The court assumed that plaintiff had "stated some claim for relief under state law,"<sup>12</sup> but said that the federal securities acts were not meant to cover such cases of "fraudulent mismanagement of corporate affairs." <sup>13</sup>

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<sup>8</sup> *E.g.*, *O'Neill v. Maytag*, 339 F.2d 764, 768 (2d Cir. 1964).

<sup>9</sup> 238 F. Supp. 766 (S.D.N.Y. 1965).

<sup>10</sup> *Id.* at 774.

<sup>11</sup> *Id.* at 776.

<sup>12</sup> *Id.* at 769.

<sup>13</sup> *Id.* at 775, quoting *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461, 464 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952).

In *Ruckle v. Roto Am. Corp.*,<sup>14</sup> a derivative suit, plaintiff sought to enjoin the directors of Roto American from issuing a block of the corporation's stock. It was alleged that the defendant majority directors had deceived the entire board into agreeing to the issuance of treasury shares to be sold to the president or voted as he directed by withholding pertinent financial data from the minority directors and by arbitrarily ascribing a value of three dollars per share to the stock. The district court refused to grant the injunction on the ground that this was a case of fraudulent mismanagement by directors not covered by rule 10b-5.<sup>15</sup> The Court of Appeals for the Second Circuit reversed, holding that corporate issuance of securities is a sale under the rule and that this conduct, fraud by a majority of the directors against the corporation, could constitute a violation of the rule.

In *O'Neill v. Maytag*,<sup>16</sup> decided by the same court, plaintiff brought a derivative suit, alleging that the directors of National Airlines had given up securities worth about thirteen million dollars belonging to the corporation in exchange for National stock worth about eleven million dollars in order to eliminate the threat which this National stock, in other hands, posed to the directors' control of the corporation. Plaintiff's theory was that payment of this almost two million dollar differential for personal reasons was either a "scheme to defraud" the corporation, or an "act, practice, or course of business which operates or would operate as a fraud" on the corporation "in connection with the purchase or sale of any security."<sup>17</sup> The court of appeals, affirming the district court's dismissal,<sup>18</sup> held that there can be no recovery under rule 10b-5 where there is no allegation of deception, and that such cases of violation of general fiduciary duties are not cognizable under the rule.

The situation presented in all three cases is one in which the directors of a corporation engaged in a purchase or sale of securities on behalf of the corporation which resulted in some kind of advantage to the directors, or as in *Barnett*, to the parent corporation to which they owed their primary loyalty, and a corresponding loss to the corporation. In each case the corporation was the buyer or seller of securities.<sup>19</sup> Redress under these circumstances must, of course, be by a derivative action. Since a corporate management act was involved as well as a purchase or sale of securities, the two difficulties of finding deception and satisfying the federal-state allocation of powers are present.

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<sup>14</sup> 339 F.2d 24 (2d Cir. 1964).

<sup>15</sup> *Id.* at 27. The district court order is unreported.

<sup>16</sup> 339 F.2d 764 (2d Cir. 1964).

<sup>17</sup> SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (1964), quoted in full in text at note 7 *supra*.

<sup>18</sup> 230 F. Supp. 235 (S.D.N.Y. 1964).

<sup>19</sup> The issuance of stock by the corporation in *Ruckle* was a sale of securities for the purposes of rule 10b-5. See *Hooper v. Mountain States Sec. Corp.*, 282 F.2d 195, 200-03 (5th Cir. 1960), *cert. denied*, 365 U.S. 814 (1961); 65 COLUM. L. REV. 725 (1965).

The injured plaintiff who wishes to recover under rule 10b-5 must show that he has been deceived. While it might seem that this requirement of deception is meaningless in the case of directors' misconduct against their corporation, the contention that it need not be alleged in such a situation was rejected in *O'Neill v. Maytag*.<sup>20</sup> Plaintiff there argued that the expressions "scheme to defraud" and "course of business which operates or would operate to defraud" in the rule were broad enough to comprehend the exchange at issue without an allegation of any particular facts amounting to deception. This reliance on clauses (1) and (3) as meaning some kind of fraud without deception is misplaced. The words used in those subsections, "fraud," "defraud," and "deceit," have an ordinary and historic meaning which encompasses deception.<sup>21</sup> Furthermore, section 10(b) of the Securities Exchange Act authorizes the Commission to prescribe rules to control only manipulative and deceptive devices and contrivances.<sup>22</sup> Plaintiff did not argue that the exchange of stock for a premium was in any way manipulative. If, on the other hand, he was arguing that fraud under the rule could be found without either deception or manipulation, then he was arguing that the rule went beyond the SEC's statutory authority. No matter which of the three subsections is relied upon, the complaint must allege some facts amounting to deception in order to state a claim under the rule; the case of the defrauded corporation is no exception to this requirement.

Where the fraudulent act is committed by an outsider, finding deception of the corporation is relatively easy. In that case, deception of the directors, who act for the corporation, is deception of the injured corporation itself. The *Ruckle* court overcame the objection that a majority of the board could not defraud the corporation by analogizing fraud cases to those involving conflicts of interest and embezzlement where, the court said, "a majority or even the entire board of directors may be held to have defrauded their [*sic*] corporation. When it is practical as well as just to do so, courts have experienced no difficulty in rejecting such cliches as [*sic*] the directors constitute the corporation and a corporation, like any other person, cannot defraud itself."<sup>23</sup> A different line of reasoning was applied in *Barnett v. Anaconda Co.*<sup>24</sup> There the court held that when directors have the naked power to carry out an act in the name of the corporation,

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<sup>20</sup> 339 F.2d 764, 768 (2d Cir. 1964).

<sup>21</sup> The common legal meaning of these words is discussed in PROSSER, TORTS §§ 100-01 (1964).

<sup>22</sup> 48 Stat. 891 (1934), 15 U.S.C. § 78j (1964):

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 security 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.

<sup>23</sup> *Ruckle v. Roto Am. Corp.*, 339 F.2d 24, 29 (2d Cir. 1964).

<sup>24</sup> 238 F. Supp. 766 (S.D.N.Y. 1965).

and no internal corporate procedures exist to prevent it, any deception used in pursuance of the act cannot be held causative of the injury.<sup>25</sup> *Ruckle* was distinguished on the ground that there, but for the deception, intracorporate means could have been used to stop the action by the directors.<sup>26</sup>

The use of conflict of interest and embezzlement analogies in *Ruckle*<sup>27</sup> to illustrate when directors are liable to the corporation is inappropriate. Neither of those actions, even if it is assumed that they can generically be termed "frauds," would require a showing that anyone had been deceived. The *Ruckle* view of the deception element sidesteps the requirement of proving that the deception by the majority injured the corporation by taking that fact for granted. But another reading of *Ruckle* does take causation into account: that deception of a minority of the board is causative of the corporate injury when, but for that deception, the majority's transaction could have been prevented. *Barnett* adds a caveat to this. In order for deception of a minority by a majority to be causative, the transaction must have been preventable by "internal corporate procedures."<sup>28</sup> If the act by the majority could have been prevented, but for the deception, only by extracorporate means such as a derivative suit, then the deception will not be considered causative. The *Barnett* distinction seems unsupportable. It is probable that the reason the defendant directors in *Barnett* tried to deceive the minority, whose votes they did not need, was to keep them from contesting their acts, which the court assumed to be illegal under state law.<sup>29</sup> Since the plan could not have been successful but for this ancillary deception of the minority shareholders, that deception can be considered one of the causes in fact of the corporate injury. There seems no rational basis for holding the cause any less real in *Barnett* than in *Ruckle* merely because in the latter the fraudulent acts could have been prevented by intracorporate means and resort to a derivative suit would not have been necessary.

A consideration of the structure of corporate power supports this resolution of the threshold issue of causation. In the normal situation the corporation is defrauded when its directors or managers are deceived. This is because it is in that group that the corporate power to act and make decisions resides.<sup>30</sup> But there is one situation in which the corporate power to act and make decisions shifts. When the board engages in actual misconduct or merely refuses to seek a remedy for a wrong committed by a third party, a shareholder is permitted to bring a suit on behalf of the

<sup>25</sup> *Id.* at 776.

<sup>26</sup> *Id.* at 776 n.7: "[P]laintiff [in *Ruckle*] represented a majority of the shares and in all probability was deprived by the alleged deception of an opportunity to block the transaction by appropriate corporate action."

<sup>27</sup> 339 F.2d 24 (2d Cir. 1964).

<sup>28</sup> *Barnett v. Anaconda Co.*, 238 F. Supp. 766 (S.D.N.Y. 1965); see note 26 *supra* and accompanying text.

<sup>29</sup> 238 F. Supp. at 769.

<sup>30</sup> See BALLANTINE, CORPORATIONS § 42 (1946).

corporation.<sup>31</sup> The board then is no longer the focus of the corporate entity for these purposes; the shareholder represents the effective decision making power of the corporation. In the normal case, deceiving the managers is deceiving the corporation, because such deception interferes with the rational decision making processes by which corporate actions are taken. When this decision making power shifts to even a minority of the stockholders, it should be sufficient that *they* have been deceived<sup>32</sup> and prevented from making a decision which would protect the corporation. In *Barnett*, minority shareholders were the only ones who would vindicate the rights of the corporation in that situation; therefore the corporate identity was theirs with reference to the particular injury. In *Ruckle* it was the minority directors and a shareholder representing a majority of the stock who were deceived. If these parties had the power to stop majority action, by either intracorporate means *or* by a derivative suit, then the management function was theirs for this purpose. Misleading them and preventing them from exercising this function was deceiving the corporation.<sup>33</sup>

The *O'Neill* plaintiff failed to develop the argument that the facts could have been taken to show deception by an omission—that the directors deceived the stockholders by concealing the fact that the exchange was transacted for personal reasons and not for the corporate good, as their silence would have led the shareholders to believe.<sup>34</sup> Had these shareholders been aware of the true facts, they could have prevented the transaction by a derivative suit in the state court, so the deception was causative of the corporate injury. It has been suggested that rule 10b-5 was not aimed at a deception such as this one involving improper motive, but only at nondisclosure relating “essentially to factors bearing on investment judgment, that is, the valuation of shares involved. . . .”<sup>35</sup> But it may not always be clear which of these practices is present. Allowing a buyer to think that a stock is worth *x*, when in fact it is worth *x* plus *y*, may relate to both value and improper purpose. The heart of the matter is the misuse of information pertaining to value, known to the director by reason of his position and withheld from the minority. For instance, in *Barnett* it was claimed that “audited balance sheets for relevant final periods of Anaconda Wire and Cable were omitted from the proxy statement, earnings and book value comparisons were distorted in favor of Anaconda and other facts were distorted or omitted. . . .”<sup>36</sup> In other words, the directors kept facts bearing on value from minority shareholders. In *O'Neill*, on the other hand, there was no misuse of inside information. The

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<sup>31</sup> *Id.* § 145.

<sup>32</sup> See Fleischer, “*Federal Corporation Law*”: *An Assessment*, 78 HARV. L. REV. 1146, 1163-64 (1965).

<sup>33</sup> See *id.* at 1164.

<sup>34</sup> *Id.* at 1165.

<sup>35</sup> *Ibid.*

<sup>36</sup> 238 F. Supp. at 769.

directors knew no more about the value of the securities than did the minority. The minority shareholders were not foreclosed from finding out the actual market value of the stock; they could simply have checked the prices on the exchange to learn that something was amiss. In *Barnett* and in *Ruckle* there was no independent source of information on value available to the minority shareholders; they had to rely on the directors' version of the facts. One of the central purposes of rule 10b-5 was to prevent knowledgeable insiders from taking advantage of investors who were at a bargaining disadvantage because the information that the insider had was unavailable to them.<sup>37</sup> The type of deception that is arguably present in *O'Neill* is not of the type that Congress intended to deal with; the deception in *Ruckle* and *Barnett* is.

The most frequently cited case for the proposition that rule 10b-5 will not support a private action where the misconduct alleged in connection with the sale or purchase of securities is a form of corporate mismanagement is *Birnbaum v. Newport Steel Corp.*<sup>38</sup> In that case the president and controlling stockholder of Newport passed up a merger which would have been beneficial to the minority and instead sold his stock at a premium to another company. The court, in denying relief to the plaintiff, suing derivatively held that section 10(b) "was directed solely at that type of misrepresentation or fraudulent practice usually associated with the sale or purchase of securities rather than at the fraudulent mismanagement of corporate affairs . . . ." <sup>39</sup> It is apparent that in *Birnbaum*, unlike the three cases here discussed, the corporation was not a party to the transaction, and the case can certainly be distinguished on that basis.<sup>40</sup> But the objection to which it gives voice is more fundamental.

At this point it will be helpful to distinguish between two possible 10b-5 situations involving corporate directors. In the more common case the insider holding stock in the corporation is charged with buying it from or selling it to an outsider, withholding or misrepresenting facts pertinent to the value of the security which he knows by virtue of his corporate position.<sup>41</sup> He acts in an individual capacity and not for the corporation. In such cases, where an instrumentality of interstate commerce was em-

<sup>37</sup> See *Speed v. Transamerica Corp.*, 99 F. Supp. 808, 828-29 (D. Del. 1951); cf. *Cady, Roberts & Co.*, 40 S.E.C. 907, 911-12 (1961).

<sup>38</sup> 193 F.2d 461 (2d Cir. 1952).

<sup>39</sup> *Id.* at 464.

<sup>40</sup> [T]here can be nothing to preclude resort to Rule 10b-5 as the basis of a shareholder's derivative action complaining that the corporation sold shares to dominating insiders at a wrongfully low price or . . . bought shares from them at a wrongfully high price. Since the gist of such a complaint would be injury to the corporation as buyer or seller and there would be no question about the corporation's "privity," the dictum in *Birnbaum* that Rule 10b-5 was not intended to redress the fraudulent management of corporate affairs seems irrelevant in such a context.

Loss, *op. cit. supra* note 3, at 1770-71; see Leech, *Transactions in Corporate Control*, 104 U. PA. L. REV. 725, 834-35 (1956).

<sup>41</sup> See, e.g., *List v. Fashion Park, Inc.*, 340 F.2d 457 (2d Cir. 1965); *Ellis v. Carter*, 291 F.2d 270 (9th Cir. 1961); *Taylor v. Janigan*, 212 F. Supp. 794 (D. Mass. 1962), *modified*, 344 F.2d 781 (1st Cir. 1965).

ployed by the defendant, the federal courts have allowed private recoveries and used rule 10b-5 as the basis for a federal standard of disclosure.<sup>42</sup> While the states do have policies against fraudulent sales and purchases of securities, the interstate nature of the transactions provided Congress with the power to regulate them and the federal courts with power to effectuate that congressional policy by allowing private recoveries.<sup>43</sup> The second group of cases includes those like *Ruckle*, *Barnett* and *O'Neill*. In these cases the directors were acting in a corporate capacity and were making management decisions in the course of the transaction. If the transaction were fraudulent and employed interstate instrumentalities, certainly the federal interest was no less present than in the former class of case. But a significant problem arises here: corporate management has traditionally been a subject for state, not federal regulation. If a federal law of corporate management supersedes state law on that subject, as the federal law on disclosure in interstate securities transactions between an insider and the person he deals with has preempted state control of such relations, the result could be a substantial disruption of the state's policy, not to speak of the difficulties that would be created for insiders ruled by two possibly conflicting standards of conduct.

The problem, however, is not so insoluble as these considerations might seem to indicate. There is a way to allow the federal interest in preventing interstate stock frauds to operate with no corresponding disruption of state policy. This approach involves viewing the element of causation as a question of state law. Section 10(b), as implemented by rule 10b-5, reflects a congressional policy decision that the interstate sale and purchase of securities is to be free from fraud. The rule is designed to protect all "persons" which, as the legislation makes clear, includes corporations.<sup>44</sup> This is a federal right to be free from a particular kind of misconduct. One of the chief purposes of federal question jurisdiction is the vindication of federal rights.<sup>45</sup> Since the same right has already been granted federal court protection where a director acts in his private capacity, there is little reason for denying such protection to the corporate victim when he has acted in his managerial capacity.<sup>46</sup> The case belongs

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<sup>42</sup> See *Loss*, *op. cit. supra* note 3, 1450-74; Note, *Purchaser's Duty To Disclose Under Securities and Exchange Commission Rule X-10B-5*, 40 MINN. L. REV. 62 (1955).

<sup>43</sup> See the discussion in *Kardon v. National Gypsum Co.*, 69 F. Supp. 512, 514 (E.D. Pa. 1946), inferring this particular remedy from the general legislative and regulatory scheme. It is surprising that the *Kardon* court and those that followed it never considered the question of federal question jurisdiction. There seems to have been some doubt, at least before *Textile Workers v. Lincoln Mills*, 353 U.S. 448 (1956), whether such a private suit, not provided for in the legislation, arises under federal law. See also *Mishkin, The Federal "Question" in the District Courts*, 53 COLUM. L. REV. 157, 195-96 (1953).

<sup>44</sup> 48 Stat. 883 (1934), 15 U.S.C. § 78c(a) (9) (1964).

<sup>45</sup> See *Mishkin, supra* note 43, at 159.

<sup>46</sup> In this regard see two fairly recent cases from the Southern District of New York which would seem to support this position. In *New Park Mining Co. v. Cranmer*, 225 F. Supp. 261 (S.D.N.Y. 1963), the court said:

It is immaterial whether the purchase or sale was part of a larger scheme of corporate mismanagement if the elements of a claim under Section 10(b) and

in a federal forum and federal law should regulate the theory of the action. This does not mean, however, that in determining whether the misconduct falls under the rule, recognition cannot be given to state policy. Federal law can fix the outer limits of proscribed conduct with reference to the congressional regulatory scheme.<sup>47</sup> This will meet the objective of giving a federal remedy for violation of a federal right. But state law governing corporate management will determine whether a deception, within these outer limits, was causative of the injury. The deception must be causative in order to give rise to a claim. To be causative of the injury it must have been preventable; if plaintiff could not have prevented the transaction even if he were aware of all the facts, the test has not been met. Whether the transaction was preventable will be a question to which the federal courts will look to state law; the state has the primary interest in what directors should or should not be allowed to do vis-à-vis the corporation. The delicate balance of corporate power which the state has established, and which will govern the corporation in most cases anyway, must be respected.

The idea of federal courts using a state standard in federal question cases is not novel.<sup>48</sup> Nor should there be a fear of federal courts' applying state law incorrectly; they are regularly called upon to apply state law in diversity situations.<sup>49</sup> The result will be that violation of a state law on

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Rule 10b-5 are otherwise present. . . . Were this not the rule, corporate officers and directors would possess an immunity from the consequences of their fraud under Section 10(b) and Rule 10b-5 which outsiders who may have collaborated with them in defrauding the corporation would not possess

*Id.* at 266.

The court in *Pettit v. American Stock Exch.*, 217 F. Supp. 21 (S.D.N.Y. 1963), put it somewhat differently:

It is of course true that irrespective of the broad language of Rule 10 (b)-5, the courts have been disinclined to allow "innumerable facets of internal corporate affairs" to be included within federal question jurisdiction on the basis of a purchase or sale of securities that is only incidental to a major mismanagement issue. On the other hand, that the fraud was perpetrated by insiders does not render Section 10(b) inapplicable, if the transaction represents an abuse of the securities trading process, and should properly be subject to SEC regulations for an adequate remedy.

*Id.* at 25.

See *Leech*, *supra* note 40, at 834-35; *cf. J. I. Case Co. v. Borak*, 377 U.S. 426, 434 (1964):

[W]e believe that the overriding federal laws applicable here would, where the facts required, control the appropriateness of redress despite the provisions of state corporation law, for it "is not uncommon for federal courts to fashion federal law where federal rights are concerned." . . . In addition, the fact that questions of state law must be decided does not change the character of the right; it remains federal. . . .

<sup>47</sup> A case like *O'Neill* might not be actionable under rule 10b-5 even if there were a violation of state law, because the deception there does not seem to be of the kind which the regulation prohibits. See notes 34-37 *supra* and accompanying text.

<sup>48</sup> *Holmberg v. Armbrrecht*, 327 U.S. 392 (1946); see *Mishkin, The Variousness of Federal Law: Competence and Discretion in the Choice of National and State Rules for Decision*, 105 U. PA. L. REV. 797 (1957).

<sup>49</sup> Indeed, if this type of case is held not to arise under any federal law, the federal courts will probably still be called upon to adjudicate many controversies of this type,

fiduciary duties which is relevant to the purposes of the federal regulatory scheme will give rise to a federal cause of action.<sup>50</sup>

Certain unique problems, then, arise in a derivative action against corporate directors which are absent in other circumstances where rule 10b-5 comes into play. The requirement of deception cannot be dispensed with in such a case, nor can the need to show that the deception was causative of the corporate injury. But the concept of causation must be considered with reference to the actualities of the corporate power structure, and it should suffice that those who are entitled to wield the corporate decision making power over a given transaction be deceived. The kind of deception that should be required to state a claim under the rule is that which involves misuse of inside information pertaining to the value of the securities, which is what Congress intended to prevent. The danger of disruption of state policies on corporate management by federal court intrusion into this area can be minimized by viewing a violation of state law on fiduciary duties as an element of the federal cause of action. This will allow the federal courts to oversee the vindication of federal rights while respecting state rules on a subject where state interests are primary.

using state law as the standard. The benefits of federal procedures governing derivative suits will often motivate claimants to try to establish diverse citizenship. For some of these advantages, see Lowenfels, *Rule 10b-5 and the Stockholder's Derivative Action*, 18 VAND. L. REV. 893, 898-908 (1965).

<sup>50</sup> The problem of the relation of fiduciary duties to the purposes of the act was brought to the attention of the House of Representatives. See House Comm. on Interstate and Foreign Commerce, *Securities Exchange Bill of 1934*, H.R. REP. No. 1383, 73d Cong., 2d Sess. 7701 (1934):

The causes of dangerous speculation in the securities markets go far deeper than defects and abuses in stock-market machinery alone . . . . They include inadequate corporate reporting which keeps in ignorance of necessary factors for intelligent judgment of the values of securities a public continually solicited to buy such securities by the sheer advertising value of listing. They include exploitation of that ignorance by self-perpetuating managements in possession of inside information. Speculation, manipulation, faulty credit control, investors' ignorance, and disregard of trust relationships by those whom the law should regard as fiduciaries, all are a single seamless web. No one of these evils can be isolated for cure of itself alone.

*Id.* at 7703.