

A Perspective on Federal Corporation Law

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A Perspective on Federal Corporation Law

IN THINKING ABOUT THE TITLE OF THIS SYMPOSIUM, "The Fall and Rise of Federal Corporation Law," I was reminded of the curriculum at the University of Colorado Law School when I arrived there as a teacher in 1979. Our curriculum included a course called "Federal Corporation Law." I recall being mystified as to what that was. I graduated from law school only five years before and never heard of the concept of federal corporate law, much less envisioned a course on it. As it turned out, 1979 was the last year that course was taught at Colorado. Indeed, by that time the United States Supreme Court had already decided *Santa Fe Industries v. Green*,¹ which seriously undercut the concept of federal corporation law,² at least the way it was taught in that particular course.

If one looks back from 1979, say to 1964, one might describe the history of federal corporation law as characterized by a rise and then a fall followed by a second rise. In other words, we might have added a third phase to the title of this symposium because federal corporation law was validated by the Supreme Court in its 1964 decision of *J. I. Case v. Borak*.³ In *Borak*, the Court recognized a private cause of action under the Securities and Exchange Act of 1934⁴ for false and misleading proxy statements, even though the '34 Act itself did not provide such a private cause of action and state law did.⁵ Several years later, the Court decided *Superintendent of Insurance v. Bankers Life*,⁶ which established a broad "in connection with" test for private damage actions under Rule 10b-5.⁷ With the decisions in *J. I. Case*, which validated the federal courts' recognition of implied causes of action under the federal securities laws,⁸ and *Superintendent of Insurance*, which made it easier for plaintiffs to state a cause of action under Rule 10b-5,⁹ the era of federal corporation law was approaching its zenith. The meaning of the concept was that

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1. 430 U.S. 462 (1977).

2. Stephen M. Bainbridge, *The Short Life and Resurrection of S.E.C. Rule 19c-4*, 69 WASH. U. L.Q. 565, 614 (1991).

3. 377 U.S. 426 (1964).

4. Securities Exchange Act of 1934, 15 U.S.C. § 78(n) (2002).

5. *Borak*, 377 U.S. at 434-35.

6. 404 U.S. 6 (1971).

7. *Id.* at 10.

8. See *Borak*, 377 U.S. at 433.

9. See *Bankers Life*, 404 U.S. at 12.

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the federal courts could use the federal securities laws to address deficiencies in corporate governance, a matter traditionally thought to rest within the province of state law. This encroachment was undertaken without so much as a mention of the fact that recognizing a federal cause of action might displace state law.

This period, dating back to approximately 1947, and marked by two important Supreme Court decisions, constitutes the first rise of federal corporation law. The fall began in 1975 with *Blue Chip Stamps v. Manor Drug Stores*,¹⁰ where the Court announced that private litigation under Rule 10b-5 had to be trimmed back.¹¹ While foreshadowing future prunings, the Court limited standing by holding that a private party¹² had to be either a purchaser or a seller of securities to maintain a damage action under Rule 10b-5.¹³ It was not enough that a fraudulent prospectus dissuaded one from purchasing a security, even if the issuer of those securities fraudulently intended to dissuade purchases, as was alleged in *Blue Chip Stamps*. Nor was it enough, as future cases decided, if one was fraudulently induced not to sell a security that one held.¹⁴ Two years later, the Court decided *Santa Fe Industries v. Green*,¹⁵ holding that Rule 10b-5 would not support a cause of action for breach of fiduciary duty.¹⁶ Federal corporation law was now in a serious tailspin. More importantly, in *Santa Fe* the Court acknowledged the traditional role of state law and the potential encroachment created by an expansive application of the federal securities laws.¹⁷

The low point, or high point, depending on your perspective, during this second phase came in 1995 in *Central Bank, N.A. v. First Interstate Bank, N.A.*,¹⁸ where the Court denied a cause of action for aiding and abetting a violation of Rule 10b-5.¹⁹ This case was decided against a background of numerous lower court decisions that recognized an aiding and abetting claim.²⁰ One interesting side note about *Central Bank* is that no federalism concerns were mentioned in the decision. The Court did not talk about the probability or the possibility that the existence of a state law cause of action could justify not recognizing a federal cause of action. *Central Bank* marked the fall of federal corporation law.

10. 421 U.S. 723 (1975).

11. *Id.* at 730-31.

12. This holding was limited to private parties, as opposed to the Securities and Exchange Commission.

13. *Blue Chip Stamps*, 421 U.S. at 730.

14. *Id.* at 731.

15. 430 U.S. 462 (1977).

16. *Id.* at 476.

17. *Id.* at 479.

18. 511 U.S. 164 (1994).

19. *Id.* at 191.

20. See, e.g., *SEC v. Universal Major Indus. Corp.*, 546 F.2d 1044, 1046 (2d Cir. 1976), *cert. denied*, 434 U.S. 834 (1977); *Walck v. Am. Stock Exch., Inc.*, 565 F. Supp. 1051, 1064 (E.D. Pa. 1981), *aff'd*, 687 F.2d 778 (3d Cir. 1982); *Bloor v. Dankser (In re Investors Funding Corp.)*, 523 F. Supp. 533, 542 (S.D.N.Y. 1980), *aff'd*, 752 F.2d 57 (2d Cir. 1985); *In re Caesars Palace Sec. Litig.*, 360 F. Supp. 366, 386 (S.D.N.Y. 1973); *Geo. H. McFadden & Bro., Inc. v. Home-Stake Prod. Co.*, 295 F. Supp. 587, 589 (N.D. Okla. 1968).

The second rise began with *United States v. O'Hagan*²¹ in 1997. This was another Rule 10b-5 case.²² This time, a lawyer for a bidder bought stock in the target company.²³ When the announcement of the tender offer was made, the lawyer cashed out at a handsome profit.²⁴ The issue was the same issue as in *Superintendent of Insurance v. Bankers Life*:²⁵ whether the attorney's action was a fraud in connection with a securities transaction.²⁶ The *O'Hagan* Court held that the lawyer deceived his client, and that this deception occurred in connection with his purchase of securities.²⁷ It is debatable whether the Court was on firm ground in either respect.²⁸ As to the deception, the lawyer did not say to the client "Thanks for this information. I will not trade on it." That would be a deception. Indeed, he said nothing to the client. Nonetheless, and with little discussion, the Court concluded that it is a deception for a lawyer to take such information and use it for his own purposes.²⁹ More controversial was the Court's conclusion that the deception occurred in connection with the purchase of securities.³⁰ The Court was satisfied that there was a sufficient link between this deception and the subsequent transaction, even if the sellers of the stock were not deceived.³¹ Thus, with some creative reasoning, a fact situation that is a classic breach of fiduciary duty, the subject of state law for centuries, was transformed into a criminal charge under the federal securities laws.

The second rise of federal corporation law, which began with *O'Hagan*,³² has resulted in the preemption of state law, either expressly or implicitly. This expansion of Rule 10b-5 and federal power in general has taken place simultaneously with a wide-spread perception that the Court is honoring principles of federalism.³³ This perception is grounded on a few high-profile cases, the first of which is *United States v. Lopez*.³⁴

Decided in 1995, *Lopez* is a case that corporate lawyers never talk about because it involves the Gun-Free School Zones Act.³⁵ The Supreme Court held that federal law cannot regulate the possession of guns in a school area because it is beyond

21. 521 U.S. 642 (1997).

22. *Id.* at 646.

23. *Id.* at 647-48.

24. *Id.* at 648.

25. 404 U.S. 6 (1971).

26. *O'Hagan*, 521 U.S. at 653.

27. *Id.*

28. *See id.* at 679 (Scalia, J., dissenting); *id.* at 680 (Thomas, J., dissenting).

29. *Id.* at 658-59.

30. Elliott J. Weiss, *United States v. O'Hagan: Pragmatism Returns to the Law of Insider Trading*, 23 J. CORP. L. 395, 429 (1998).

31. *O'Hagan*, 521 U.S. at 656-57.

32. *Id.* at 642.

33. *See* Mark J. Loewenstein, *The Supreme Court, Rule 10b-5 and the Federalization of Corporate Law*, 39 IND. L. REV. 17, 30-31 (2005).

34. 514 U.S. 549 (1995).

35. Gun-Free School Zones Act of 1990, Pub. L. No. 101-647, § 922(g), 104 Stat. 4884, *invalidated by* *United States v. Lopez*, 514 U.S. 549 (1995).

Congress' power under the Commerce Clause.³⁶ Seven years later, in *United States v. Morrison*,³⁷ the Court stuck another blow in favor of federalism when it held that the federal Violence Against Women Act³⁸ was unconstitutional under the Commerce Clause.³⁹ Commentators look at these two decisions, and several others during that period, and conclude that the Court is indeed committed to a more vigorous concept of federalism.⁴⁰ However, if you look at *O'Hagan* and other business law cases that have not received the notoriety of *Lopez* and *Morrison*, you might reach just the opposite conclusion. Are *O'Hagan*, and other post-*O'Hagan* securities law cases the anomalies, or are *Morrison* and *Lopez* the anomalies? I think that the *Lopez* and *Morrison* cases are anomalies. Indeed, the steady march of greater federal power recognized in the Supreme Court continues pretty much unabated. Perhaps these cases have flown under the radar screen and been overshadowed by the strong reaction to *Morrison* and *Lopez*, both positive and negative. Perhaps, the legal community has taken its eye off what I think is an important trend in Supreme Court jurisprudence.

As I mentioned previously, *O'Hagan* is a case where the Court recognized as a federal criminal violation conduct that could be characterized as a simple breach of fiduciary duty.⁴¹ A lawyer, as a fiduciary for his client, steals his client's information and trades on it.⁴² Such facts also support a state criminal prosecution.⁴³ Indeed, *O'Hagan* was prosecuted under state law,⁴⁴ and the need for federal intervention was minimal in that case.

One additional note about the *O'Hagan* opinion is in order. The majority opinion says that its decision was necessary in order to further the purposes of the federal securities laws—maintaining the integrity of securities markets and so forth.⁴⁵ The Court said this without any real empirical justification that this type of insider trading has any affect on the market.⁴⁶ Moreover, as Justice Thomas pointed out, the Court's job is not to implement the purposes of statutes, but rather its words and the intent.⁴⁷ I think that Justice Thomas was on to something when he stated that "Rule 10b-5 cannot be said to embody this theory"⁴⁸

36. *Lopez*, 514 U.S. at 551.

37. 529 U.S. 598 (2000).

38. Pub. L. No. 103-322, § 13981, 108 Stat. 1902 (1994), *invalidated by* *United States v. Morrison*, 529 U.S. 598 (2000).

39. *Morrison*, 529 U.S. at 607–27.

40. See, e.g., George D. Brown, *Constitutionalizing the Federal Criminal Law Debate: Morrison, Jones and the ABA*, 2001 U. ILL. L. REV. 983, 986–87; Bradley A. Harsch, *Finding a Sound Commerce Clause Doctrine: Time to Evaluate the Structural Necessity of Federal Legislation*, 31 SETON HALL L. REV. 983, 984–85 (2001).

41. See *United States v. O'Hagan*, 521 U.S. 642 (1997).

42. *Id.* at 658–59.

43. *Id.* at 648 n.2.

44. *Id.*

45. *Id.* at 653.

46. See *id.* at 687 (Thomas, J., dissenting).

47. *Id.* at 691–92.

48. *Id.*

One little noticed post-*O'Hagan* case worth considering in this context is *Wharf (Holdings) Ltd. vs. United Int'l Holdings, Inc.*⁴⁹ because it is typical of the way the Supreme Court has acted in this area.⁵⁰ It involved a situation where two companies formed a joint venture to build a cable television system in Hong Kong.⁵¹ The parties orally agreed that if the venture was successful, the defendant would provide the plaintiff with an opportunity to buy stock in the company.⁵² Of course, the defendant refused to honor the oral understanding.⁵³ Instead of bringing a breach of contract claim, however, the plaintiff brought a federal securities fraud claim, alleging that the defendant never intended to honor this option.⁵⁴ The plaintiff argued that this was deceptive conduct in connection with the sale of an option.⁵⁵ The question before the Supreme Court was whether this alleged deception was in connection with the purchase and the sale of a security.⁵⁶ Lo and behold, the Court found a basis for federal jurisdiction⁵⁷ and concluded that this deceptive conduct was in connection with the purchase or sale of a security.⁵⁸ One might have thought that it was a garden-variety breach of contract claim, but no, this falls under Rule 10b-5.

Wharf (Holdings) is remarkable, in part, because it does not cite or discuss *Marine Bank v. Weaver*,⁵⁹ which was decided during the period when the concept of federal corporation law was in decline. In *Weaver*, the Court said that neither a profit-sharing arrangement between two parties nor a certificate of deposit was a security under the federal securities laws.⁶⁰ Instead, to decide whether these things constitute securities, the Court required an examination of the context in which these instruments were issued.⁶¹ Ultimately, the Court found that there was no need to apply the federal securities laws under these circumstances.⁶² This was a sensible way to approach the problem, but one that the Court chose not to consider in deciding *Wharf (Holdings)*.

So, one might ask, what is the harm in applying Rule 10b-5 to the *Wharf (Holdings)* fact pattern? This is, however, a private arrangement between two parties, where a federal interest seems nonexistent. State law, relying on other principles,

49. 532 U.S. 588 (2001).

50. See Loewenstein, *supra* note 33, at 32–34.

51. *Wharf (Holdings)*, 532 U.S. at 591.

52. *Id.*

53. *Id.*

54. *Id.* at 592.

55. *Id.* at 595.

56. *Id.* at 592.

57. *Id.* at 593–97.

58. *Id.*

59. 455 U.S. 551 (1982).

60. *Id.* at 559–60.

61. *Id.* at 556.

62. *Id.* at 560–61.

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may have resolved the dispute differently.⁶³ For instance, state law may have considered the statute of frauds as relevant to the outcome. That is, perhaps a plaintiff's right to acquire stock would not be enforceable at all under state law or perhaps the recoverable damages differ significantly from those available under Rule 10b-5.⁶⁴ These policy questions, resolved under state law, are now federalized under Rule 10b-5.⁶⁵

The third case in this new paradigm, following *O'Hagan* and *Wharf (Holdings)*, is *SEC v. Zandford*,⁶⁶ where a unanimous Supreme Court, in a relatively brief opinion, easily expanded the reach of Rule 10b-5.⁶⁷ This case has a fact pattern that looks eerily like a law school exam question. An elderly man and his mentally disabled daughter opened up a brokerage account.⁶⁸ The broker stole money from the account and, as a result, suffered numerous consequences, including dismissal from his job, revocation of his license, and criminal penalties.⁶⁹ After all of these consequences, the Securities and Exchange Commission (SEC) decided to bring an enforcement action against the broker for violating Rule 10b-5.⁷⁰

The Court of Appeals held that there was no jurisdiction under Rule 10b-5 because this was just a common theft from an account.⁷¹ Thus, there was no fraud in connection with the sale of the security. On appeal, the Supreme Court had little trouble concluding otherwise. The Court found that the broker deceived his clients by failing to tell them that he was going to steal the proceeds when securities were sold in their account.⁷² The Court went so far as to say that he did not even have to misappropriate the funds.⁷³ It was enough that he had a scheme, the sale took place, and the funds were in the account. This was a fairly broad interpretation of the federal securities laws.

It is hard to identify the federal interest involved, or the underlying policy that informed the Court's decision. After all, the federal wire fraud statute applied, the state criminal law applied, NASD discipline applied, the state security administra-

63. See Loewenstein, *supra* note 33, at 34.

64. Francis J. Facciolo & Richard Stone, *Avoiding the Inevitable: The Continuing Viability of State Law Claims in the Face of Primary Jurisdiction and Preemption Challenges Under the Securities Exchange Act of 1934*, 1995 COLUM. BUS. L. REV. 535, 623-24.

65. See generally *Wharf (Holdings) Ltd. v. United Int'l Holdings Inc.*, 532 U.S. 588 (2001) (holding that defendant's conduct in refusing to honor a stock option agreement was deceptive conduct in connection with the sale of a security under Rule 10b-5); *United States v. O'Hagan*, 521 U.S. 642 (1997) (holding that an attorney's action in deceiving his client was in connection with a securities transaction, in violation of Rule 10b-5).

66. 535 U.S. 813 (2002).

67. See generally *id.* (holding that a broker's sale of securities with undisclosed intent to misappropriate the proceeds was fraud in connection with the purchase or sale of securities).

68. *Id.* at 815.

69. *Id.* at 816.

70. *Id.*

71. *Id.* at 818.

72. *Id.* at 822.

73. *Id.*

tor could certainly have disciplined the broker, a private damage action obviously was available under state law, and finally, the guy was fired. Did Congress intend to empower a federal agency to address this conduct as well? What we see here is the SEC motivated to expand its jurisdiction and, with that, a robust role for Rule 10b-5.

A sterling example of other cases that expand the reach of federal law can be found in cases decided by the Court under the Federal Arbitration Act.⁷⁴ These cases have expanded the reach of the Act far beyond anything that Congress intended when it passed the statute in 1925. Another rich area for examination are the preemption cases, where the Court has been very willing to find federal preemption when there are other solutions the Court could have found.⁷⁵ Finally, consider the punitive damages cases, where the Court has disrespected state law by developing a jurisprudence that would define when punitive damages violate the federal constitution.⁷⁶

One can argue whether an expansive role for federal law in corporate governance or antifraud is a good thing or not. But the critical question is whether this expansion should be the result of judicial fiat, as opposed to legislative action. Judicial displacement of state law is not a good thing, at least not in the perfunctory fashion in which it has taken place.⁷⁷ It is time for a bit more dialogue and examination, because this has led to a second “rise in federal corporation law.”

74. 9 U.S.C. §§ 1–14 (1947). *See, e.g.*, *Citizens Bank v. Alafabco, Inc.*, 539 U.S. 52 (2003) (holding that debt-restructuring agreements executed in Alabama by Alabama residents are nonetheless governed by the provisions of the Federal Arbitration Act); *Equal Employment Opportunity Comm’n v. Waffle House, Inc.*, 534 U.S. 279 (2001) (holding that an arbitration agreement does not bar the EEOC from pursuing victim specific judicial relief on behalf of an employee); *Cortex Bird Chips, Inc. v. Bill Harbert Constr. Co.*, 529 U.S. 193 (2000) (holding that the venue provisions of the Federal Arbitration Act are permissive, permitting a motion to confirm, vacate or modify an arbitration award either where the award was made or in any district proper under the general venue statute).

75. *See, e.g.*, *Beneficial Nat’l Bank v. Anderson*, 539 U.S. 1 (2003) (holding that the cause of action at issue arose under federal law and could therefore be removed to federal court); *Entergy La., Inc. v. La. Pub. Serv. Comm’n*, 539 U.S. 39 (2003) (holding that prior cases rest on a foundation broad enough to require preemption of the Public Service Commission’s order); *Buckman Co. v. Plaintiffs’ Legal Comm.*, 531 U.S. 341 (2001) (holding that the plaintiff’s state law fraud claims conflicted with and were therefore impliedly preempted by the Federal Food, Drug and Cosmetic Act).

76. *See, e.g.*, *BMW of North Am., Inc. v. Gore*, 517 U.S. 559 (1996) (holding that the two million dollar punitive damages award was grossly excessive and therefore in excess of the federal constitutional limit); *Honda Motor Co. v. Oberg*, 512 U.S. 415 (1994) (holding that the state high court’s denial of review of the size of the punitive damages award violates the Due Process Clause); *cf. TXO Prod. Corp. v. Alliance Res. Corp.*, 509 U.S. 443 (1993) (holding that the amount of punitive damages was not so grossly excessive as to violate due process).

77. *See* Loewenstein, *supra* note 33, at 48–49.