Rule 10b-5: The Disclosure of Finder's Fees in Connection with the Purchase or Sale of Securities

David L. Cocanower
Indiana University School of Law
RULE 10b-5: THE DISCLOSURE OF FINDER’S FEES IN CONNECTION WITH THE PURCHASE OR SALE OF SECURITIES

In SEC v. Great American Industries, Inc., the United States Court of Appeals for the Second Circuit reversed a district court's denial of a preliminary injunction for alleged violations of the Securities Exchange Act (SEA) disclosure provisions. The Securities and Exchange Commission (SEC) alleged Great American Industries, Inc. (GAI) had issued press releases and filed 8-K reports which contained untrue statements of material facts or omitted material information necessary to prevent the statements made from being misleading, in violation of rule 10b-5 as to the press releases and rule 13a-11 as to the 8-K reports.


2. The Securities Act of 1933 (SA), 15 U.S.C. §§ 77a-77z (1964), the Securities Exchange Act of 1934 (SEA), 15 U.S.C. §§ 78a-78hh (1964), and the rules promulgated thereunder, attempt to control fraudulent schemes, misstatements or nondisclosures, and business practices in a variety of ways. [Hereinafter all citations will be to the relevant sections of the 1933 and 1934 Acts and to 17 C.F.R. § 240.] The 1933 Act prohibits fraudulent schemes and courses of business in section 17(a) and imposes liability for misrepresentations of material facts in sections 11(a) and 12(2). The 1934 Act regulates all three types of fraudulent practices in section 10(b) and rule 10b-5, and fraudulent courses of business in section 15(a)(1) and rule 15c1-2. The various provisions differ as to the acts and persons regulated, the jurisdictional means involved, and the available sanctions. For a helpful tabular comparison of the five provisions, see A. Bromberg, Securities Law: Fraud: SEC Rule 10b-5 16-17 (1967) [hereinafter cited as Bromberg].

3. Rule 13a-11 provides that companies subject to the jurisdiction of the SEA must file 8-K reports for those months in which one or more of the events enumerated in the 8-K report have occurred. The enumerated events include transactions in securities exceeding five per cent of the amount of securities of the class outstanding prior to the transactions; material changes in shareholder rights or the underlying security of registered securities; material defaults upon the senior securities; changes in the control of the company; material revaluation of assets or restatement of the capital share account; submission of matters to a vote of security holders; material extraordinary legal proceedings; and acquisition or disposition of a significant amount of assets. CHH Fed. Sec. L. Rep. ¶ 31,003. The present case involved disclosure of this latter item.

4. Rule 10b-5 provides:
   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 a 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 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, in connection with the purchase or sale of any security.

Rule 10b-5 was originally intended to apply to fraud by purchasers since such fraud was left unregulated by other disclosure provisions of the federal securities laws. See
DISCLOSURE OF FINDER'S FEES

Secondly, the SEC alleged that GAI and three of its officers, in violation of rule 10b-5 and rule 13a-11, had failed to disclose the material fact that substantial finder's fees were to be paid in connection with the acquisition

Note 2 supra. However, its coverage has been expanded to allow purchasers recovery against fraudulent sellers as well. E.g., Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961). See Fleischer, Securities Trading and Corporate Information Practices: The Implications of the Texas Gulf Sulphur Proceeding, 51 VA. L. Rev. 1271, 1276 (1965). The purposes underlying rule 10b-5 have been interpreted variously as equalization of bargaining positions in securities transactions, disclosure of material facts, regulation of action by corporate insiders dealing with their own stock, insurance of adequate market information, and codification of notions of fundamental fairness in securities transactions. Bromberg 265-77.

The general anti-fraud provisions of rule 10b-5 overlap other provisions of the SEA; e.g., the regulatory scheme covering proxy solicitations under section 14. J.I. Case v. Borak, 377 U.S. 426 (1964). "The fact that there may well be some overlap is neither unusual nor unfortunate." SEC v. National Sec., Inc., 89 S. Ct. 564, 573 (1969). Thus, conduct may be violative of one or both of rules 13a-11 and 10b-5. For example, failure to disclose acquisitions or disposition of less than "a significant amount of assets" (see note 5 infra) would not be violative of rule 13a-11 but could, where a duty of full disclosure exists, constitute a violation of rule 10b-5. Failure to disclose transactions which are required to be disclosed by rule 13a-11 would constitute a violation of that provision but would not constitute a violation of rule 10b-5 if the required information could be found to be immaterial. The third situation, a violation of both rules 10b-5 and 13a-11, was present in the principal case.

Although GAI was found to have made misleading statements in its press releases as to the consideration involved in property acquisitions, in the absence of such misleading press releases the nondisclosure of material finder's fees in GAI's 8-K report coupled with the full disclosure requirements of rule 10b-5 would suffice to impose a duty of full disclosure on GAI.

5. For transactions concerning physical property other than a business, the 8-K report defines a "significant amount of assets" as assets whose net book value, or the amount paid or received therefor, exceeds fifteen per cent of the total assets of the disclosing company and its consolidated subsidiaries. For those transactions which must be disclosed, the information given must include "the nature and amount of consideration given or received therefor, the principle followed in determining the amount of such consideration, the identity of the persons from whom the assets were acquired or to whom they were sold and the nature of any material relationship between such persons and the registrant or any of its affiliates. . . ." CCH Fed. Sec. L. Rep. ¶ 31,003 at 21,992.

The circuit court found that GAI's failure to make full disclosure in its press releases and 8-K reports of all material facts concerning the commercial potentialities of the various mining properties was "something more" than mere negligence which justified granting injunctive relief. GAI at 97,539.

6. Given the complexity of the litigation and the number of parties involved, it will be helpful to study the following playbill:

Corporations: Great American Industries, Inc. (GAI)—Principal corporate defendant previously engaged in the manufacture and sale of various confections; Consolidated Sulphur Corporation (CSC)—Owner of California sulphur property; Basin Mining Company (BMC)—Owner of Arizona copper property; and Pacific Sulphur Company (PSC)—Owner of Nevada sulphur property.

Corporate Officer Defendants: Walter S. Mack—Chairman of GAI; Bernard D. Marren—Financial vice president and a director of GAI; and Irving Stolz—General counsel and a director of GAI.

Finder Defendants: Jerome Matusow—The finder who approached Mack concerning the California, Arizona, and Nevada mining properties; William T. Beard—Driller and mining engineer who apparently owned all the shares in BMC; and Frederick J. Pagnani—Legal counsel for Matusow and Beard in the Arizona and Nevada transactions.
of three mining properties by GAI. Finally, the SEC alleged that the


The three separate transactions involved in the events leading up to the action in Great American Industries were:

**California transaction**

GAI acquired a ninety-day option upon sulphur property, the exercise of which would have resulted in the payment by GAI of 250,000 dollars and the issuance of 1,600,000 shares of GAI stock to CSC. CSC had made a prior agreement to distribute 600,000 or 37.5 per cent of the 1,600,000 shares as follows: Matusow 200,000; Lester 200,000; and Howard 200,000.

**Arizona transaction**

GAI acquired an option on a copper property which was exercisable by the payment of 50,000 dollars and the issuance of 200,000 shares of GAI stock to Beard as sole stockholder of BMC. Beard, however, had made a prior agreement to distribute 167,000 of the 200,000 shares to Matusow, Lester, Seagraves, and Pagnani. 259 F. Supp. at 106.

**Nevada transaction**

April 22, 1966 contract: In return for sulphur property GAI was to pay Crofoot Lumber Company 4,500,000 dollars in royalties and to issue 300,000 shares to be distributed under the contract as follows: Crofoot Lumber Company 17,340; Canyon State Mining Company 41,330; and Commonwealth Silver Company 41,330 (total thirty-three per cent); Matusow, 134,000; Pagnani 33,000; and Beard 33,000 (total sixty-seven per cent).

This contract was never closed, either due to the suspension of trading in GAI stock on the American Stock Exchange on April 29, 1966, (GAI at 97,540) or to a lawsuit against the sellers to enjoin the sale (GAI at 97,549), but was subsequently renegotiated to provide for the distribution of shares as follows: Crofoot Lumber Company 44,232; Canyon State Mining Company 105,384; and Commonwealth Silver Company 105,384 (total eighty-five per cent); Matusow, 15,000; Pagnani 15,000; and Beard 15,000 (fifteen per cent).

The very fact of the existence of finder's fees was itself an issue in the principal case. In the Arizona transaction, Beard, as sole owner of BMC, had previously entered into a joint venture agreement with Pagnani and Matusow which provided for their sharing in mining properties owned by Beard on a basis of four-sixths to Matusow and one-sixth each to Pagnani and Beard. GAI at 97,550.

In the Nevada transaction, Beard and Matusow brought the property to the attention of GAI. They, along with Pagnani, asserted that the shares of stock which they were to receive were not finder's fees at all but proceeds paid out under a joint venture agreement between themselves whereby Matusow and Beard contributed sales services
sellers and those who acted as finders in the property transactions violated rule 10b-5 by failing to disclose to GAI the amount of fees to be paid the finders.

The circuit court held that the failure of GAI and its corporate officers to disclose the division of consideration of which they were aware rendered misleading their prior statements as to the consideration in both their press releases and their 8-K reports. The court also held that the failure of the sellers and finders to respond fully to questions concerning the division of consideration constituted common law fraud and thus violated rule 10b-5.

The district court had denied the SEC’s request for a preliminary injunction on the grounds that the SEC had failed to establish that the undisclosed finder’s fees were a material fact. Relying on the failure of the SEC to charge that nondisclosure of the finder’s fees indicated that the property received was overvalued or that GAI would not have issued the stock had it known of the division between the owners and

and Pagnani his legal services. GAI at 97,552. For various views as to whether to disregard the existence of these alleged joint ventures, compare 259 F. Supp. at 108 with GAI at 97,543, 97,547, 97,550, and 97,552.

8. That the duty of disclosure is limited to those situations where there is knowledge of both the existence of finders and the amount of their fees is clearly demonstrated by the factual differences in the three transactions involved. In the California transaction, neither GAI nor its officers knew of the existence of the finders or of the amount of their fees. GAI at 97,539. In the Arizona transaction, the corporation and its officers knew of the existence of the finders but not the amount of their fees. Id. In the Nevada transaction, the corporation and its officers knew of both the existence of the finders and the amount of their fees. GAI at 97,540. It was only in the latter transaction that the court found a duty of disclosure.


10. One of the more puzzling elements of the decision is the role which the question of valuation played. The SEC stated that “... the true value of the mining properties in question is not an issue before this court. ...” Id. at 102. The district court stressed the fact that valuation was not an issue: “Most important, it is not charged that the property acquired in exchange for the shares issued was not worth the value of the shares which were issued in payment therefore.” Id.

By the time the case had reached the circuit court, however, the scent of overvaluation grew stronger. Judge Friendly, author of the majority opinion, felt that the undisclosed finder’s fees were “so unusual as to raise legitimate question in the mind of a prospective purchaser of GAI stock whether GAI had not been ‘taken’ and whether the Nevada mine was worth anything like what GAI was paying for it.” GAI at 97,540 (emphasis added). Judge Kaufman, in his concurring opinion, felt that the finders “... were awarded such a disproportionate percentage of the total consideration paid for the property that, were this arrangement disclosed, it would clearly have indicated the property could not be worth the price paid. Id. at 97,543 (emphasis added). Judge Hays, in a concurring opinion, felt that the amount of finder’s fees was a material factor to the buyer in determining the price to be paid. Id. at 97,544. These exercises of judicial notice outside the scope of the pleadings are severely criticized by Judge Moore in his dissent: “[T]he majority confuse the question of value and the fairness of the purchase price with the question of distribution of the purchase price.” Id. at 97,549.

Given the intimate relation between valuation and the issue of materiality, it is clear that interjection of the valuation question might have been dispositive of the case, or at least highly prejudicial to the defendant’s interests.
the finders, the district court held that there was no duty of disclosure under rule 10b-5 for any of the defendants.\textsuperscript{11} Granting that the trial judge might have been within the bounds of his discretion in denying injunctive relief for nondisclosure of the finder's fees alone, the circuit court held that the nondisclosure of the finder's fees in conjunction with the misleading press releases and 8-K reports warranted the issuance of an injunction for the nondisclosure of finder's fees.\textsuperscript{12}

The uncertainty of the sufficiency of nondisclosure of finder's fees standing alone as a proper basis for the issuance of a preliminary injunction, the phenomenal amount of litigation under rule 10b-5,\textsuperscript{13} the impact which this decision could have on buyers, sellers, and finders engaged in transactions within the scope of rules 10b-5 and 13a-11, and the potential application of the decision to private damage actions provide the impetus for this comment.\textsuperscript{14} Although the decision dealt with disclosure of other material facts, consideration will be limited to the effect of the decision on the disclosure of finder's fees.

I. Duty of Disclosure

Under common law, a party to a transaction need make no factual disclosures so long as he refrains from making any representations whatsoever.\textsuperscript{15} If, however, a party elects to break his total silence, he is then under a duty to disclose whatever additional facts are necessary to prevent his partial disclosure from being misleading.\textsuperscript{16} Under rule 10b-5 disclosure is also required in such situations. In addition, rule 10b-5 has been interpreted in certain limited circumstances as requiring affirmative disclosure by those having access to material inside information.\textsuperscript{17}

\textsuperscript{12} GAI at 97,541.
\textsuperscript{13} As the Supreme Court recently noted, "... section 10(b) and rule 10b-5 may well be the most litigated provisions in the federal securities laws. . . ." SEC v. National Sec., Inc., 89 S. Ct. 564, 571 (1969).
\textsuperscript{14} In addition, Indiana's adoption of a provision in its state securities law closely patterned after rule 10b-5 renders judicial construction of the federal rule of additional significance. See Ind. Ann. Stat. § 25-866 (Burns Supp. 1968).
\textsuperscript{15} W. PROSSER, THE LAW OF TORTS § 101 (3d ed. 1964).
\textsuperscript{16} Id. This duty of disclosure has been applied to information received subsequent to the partial disclosure and extends to those persons whom the party knows are acting on the basis of the original partial disclosure. Affirmative duties of disclosure may exist when parties are in a fiduciary relationship or when one party possesses special knowledge unobtainable by the other party. Id. at 711-12.
\textsuperscript{17} Total silence may violate rule 10b-5 when a party has access to material inside information not available to the investing public (SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968), cert. denied sub. nom., Coates v. SEC, 37 U.S.L.W. 3399 (U.S. April 22, 1969); see Fleischer, Securities Trading and Corporate Information Practices: The Implications of the Texas Gulf Sulphur Proceeding, 51 VA. L. REV. 1271, 1277-80 (1965)), or where a party utilizes his position as a controlling stockholder to engage in fraudulent deception. Cochran v. Channing Corp., 211 F. Supp. 239 (S.D.N.Y. 1962).
DISCLOSURE OF FINDER'S FEES

Underlying rule 10b-5 is a policy of protecting the investing public from practices which produce inequality between individual investors by requiring full disclosure of information which is not available to the public. If this policy is to be effectuated the rule must assure that factual representations made available to the public are accurate. Judicial approval of these policies has been evinced by the relaxation of evidentiary requirements and the elimination of some elements necessary for a cause of action in common law fraud.

The circuit court in *Great American Industries* found partial disclosures by all defendants concerning the consideration which was to be given by GAI in various transactions. Although the court avoided creating an affirmative duty of disclosure by limiting the violations to those situations involving partial disclosure, the opinion does represent a significant extension of a duty of disclosure to facts not previously judicially required to be disclosed.

Rule 10b-5 imposes liability only for nondisclosure of material facts. The district court applied a test of materiality turning on whether "... the fact concealed or omitted influenced or should have influenced the

In the case of corporate officers, this statutory requirement is similar to the common law fiduciary duty of such an officer to his corporation. However, the requirement of rule 10b-5 has been extended beyond directors or management officers to include "anyone in possession of material inside information." 401 F.2d at 848. The opinion reserved judgment, however, on the question of whether "tippees" are included within the scope of this language. 401 F.2d at 852-53.

18. See note 4 *supra*.

19. See text accompanying notes 53 to 56 *infra*. At least one scholar in the area views this expansive attitude as a reflection of judicial impatience with statutory gaps in protection and disapproval of restrictive procedural obstacles placed in the way of recovery under other provisions of the SEA. BROMBERG 281. The propriety of the judicial role in removing "procedural obstacles" which the legislature thought appropriate is open to question on policy grounds.

20. The court specifically withheld consideration of the advisability of placing an affirmative duty of disclosure on persons who do not occupy a special relationship to a seller or buyer of securities like that of insiders or broker-dealers. GAI at 97,541. Thus the question of an affirmative duty of finders or sellers to disclose material finder's fees remains to be resolved.

Although his concurring opinion is not unambiguous, Judge Kaufman would appear to support an affirmative duty of disclosure by sellers and finders in the absence of inquiry by the purchaser. *Id.* at 97,543. Judge Hays, on the other hand, clearly opts for a broader "basis of liability" by placing an affirmative duty on the corporate officers to inquire of the sellers as to the amount of the finder's fees and to report the same to the SEC and the investing public. *Id.* He also would place an affirmative duty on the finders to inform the purchasers of the amount of their fees, but curiously remains silent as to any duty on the part of the sellers themselves to make disclosure. *Id.* at 97,544. This bifurcation of the duties of sellers and finders could have great significance, particularly in a situation such as the instant case where a question exists whether certain parties are really finders or owners (sellers). See note 7 *supra*.

It is also noteworthy in light of Judge Hays' employment of the term "liability" that both Judge Friendly and Judge Kaufman expressly reserved comment on the question of damages. *Id.* at 97,541 and 97,543.
issuer in its decision to issue the stock in question, or would under the circumstances influence a buyer in the market." 21 The circuit court rejected this test and substituted the test of whether "... a reasonable man would attach importance [to the fact in question] ... in determining his choice of action in the transaction in question." 22

An understanding of the difference between the two tests requires identification of the "fact in question" and the "transaction in question." To determine the "transaction in question," the nature of the "fact in question" must be clearly understood. The district court based its denial of injunctive relief upon the failure of the SEC to establish that the finder's fees were material in amount. The circuit court, however, did not look at the finder's fees alone, but rather found a material fact in "the variation of finder's fees from conventional norms." 23 One difference between these approaches lies in the inferences which may be raised by the fact which is required to be disclosed. By focusing on the variation the circuit court required a disclosure which could serve as a reflection on management's ability. The district court, however, would have required disclosure of material amounts which may have no bearing on management's ability so long as the amounts represent the normal fee in such situations.

With this analysis of the "fact in question" the relevant "transaction in question" is apparent. Although there were three types of transactions—the agreement between the sellers and finders, 24 the contract between GAI and the seller, and any transactions in the market place with respect to GAI stock—it is the latter type which is germane. It is the effect of the fact in question upon a reasonable investor which is decisive. 25

In contrast, the district court's test looked not only to the effect of the fact in question upon an investor but also to the effect upon the issuer. 26 This focus results in an application of the materiality test to a


22. GAI at 97,540. This test was adopted in List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir. 1965), cert. denied sub nom., List v. Lerner, 382 U.S. 811 (1965), and was subsequently quoted with approval and applied in SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968).

23. GAI at 97,540 (emphasis added).

24. See note 7 supra.

25. This conclusion is supported by the prior applications of the same test in List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir. 1965), and Texas Gulf Sulphur. In both cases the "transaction in question" was a purchase of stock by insiders who had access to material information not known to those who sold the stock. In both cases the "reasonable man" was an unassociated investor and the "choice of action" was whether to enter the securities market either to buy or sell stock.

26. Judge Kaufman, in his concurring opinion, seems to adopt the same test in stating that the finder-defendants failed to disclose a material fact since GAI might have
DISCLOSURE OF FINDER'S FEES

The second transaction—the acquisition of property. Although this transaction gives rise to the duty of disclosure, under the test it is not the transaction of foremost importance. In addition, the SEC argued that the district court substituted a mixed subjective-objective test for the objective reasonable man test of the second circuit and thereby required them to establish reliance in addition to materiality. The circuit court did not answer the allegation directly, but held that the seller's willingness to pay two-thirds of the sale price to finders was a material variation from conventional norms.

The disclosure requirements of rule 10b-5 extend only to transactions "in connection with the purchase or sale of any security." This language was recently construed in SEC v. Texas Gulf Sulphur Co. as applying to statements "... of a sort that would cause reasonable investors to rely thereon, and, in connection therewith, so relying, cause them to purchase or sell a corporation's securities." Under such an interpretation, rule 10b-5 can be violated in the absence of any associated securities transaction whatsoever since it is the misleading statements which constitute the violation. Thus, the only requirement would appear to be that the representation be of a sort upon which reasonable investors might rely.

Using such an analysis there is no doubt that the misrepresentations of the corporation and its officers were made in connection with the purchase or sale of securities for the statements were made to the investing public through press releases and 8-K reports. Such an analysis may not, however, be applicable to the misrepresentations of the sellers and finders, for their statements were not directed at the general investing public but at the issuer or seller of the securities. Without

---

27. Since the purpose of an action by the SEC is to enforce disclosure and not to recover damages, the SEC need only show materiality and not reliance. However, a private party bringing an action for damages may have to show reliance as well. See text accompanying notes 53 and 54 infra.

28. GAI at 97,540. The percentage referred to was based upon the initial contract in the Nevada transaction which was never closed. The renegotiated contract provided for only fifteen per cent of the consideration to go to the finders. See note 7 supra.

29. For the text of rule 10b-5 see note 4 supra.

30. 401 F.2d 833 (2d Cir. 1968).

31. 401 F.2d at 860. This rule was approved and applied in Heit v. Weitzen, 402 F.2d 909, 913 (2d Cir. 1968). "Purchase or sale" was construed by the Supreme Court to include exchange of stock by shareholders pursuant to a corporate merger. SEC v. National Sec., Inc., 89 S. Ct. 536 (1969). Indicating that "... the relevant definitional sections of the 1934 Act are for the most part unhelpful. ..." the Court derived a functional definition; viz., whether the conduct involved "... is the type of fraudulent behavior which was meant to be forbidden by the statute and the rule. ..." Id. at 572.

analyzing the result the circuit court held that since the sellers' and finders' misrepresentations were made in connection with the purchase of securities rule 10b-5 had been violated. The ramifications of such an application of the rule cannot be fully appreciated without considering the potential liability for nondisclosure.

II. LIABILITY FOR NONDISCLOSURE

Although the circuit court expressly reserved comment on the question of damages, it may have paved the way for private recovery in future actions. The expansion of the coverage of rule 10b-5 to date serves as ample indication that the courts are not loath to provide private remedies to effectuate the legislative purpose of the rule. This expansive

33. GAI at 97,540; contra, Jensen v. Voyles, 393 F.2d 131 (10th Cir. 1968), where the court held in a private damage action that the seller's misrepresentation was not made in connection with the purchase or sale of a corporation's stock within the meaning of rule 10b-5 when the misrepresentations were made to a corporation which acquired the seller's property in exchange for stock.

34. The three concurring judges in GAI were apparently concerned with the implication of the majority's opinion and each indicated that the decision should be limited to acquisitions involving the issuance of stock. GAI at 97,542; 97,543; 97,544. The rationale advanced for the distinction was the "world of difference" between agreements in which the finders are compensated in cash as compared to securities, since "only the buyer and seller are affected" in a cash transaction. GAI at 97,543. This distinction seems to be untenable since whatever depressant effect a material variation in finder's fees would have on the market price of the company's stock should be the same in either case. However, if the purchase of securities supplies the necessary link to rule 10b-5, the effect would be to exclude the second type of representation from the scope of the rule. This result need not follow, however, if the only necessary connection between the statements and a purchase or sale of securities is that the statements become available to the investing public.

35. GAI at 97,541.

36. Private parties may be desirous of private rights of action implied from the terms of rule 10b-5, notwithstanding the express provisions for civil liabilities contained in other anti-fraud sections of the SA and the SEA (see note 2 supra) and the relief available under state securities laws. This preference for action under rule 10b-5 can be explained by advantages of nation-wide jurisdiction, venue, and process (under sections 10 and 27 of the SEA and FED. R. Civ. P. 4) along with the relaxation of evidentiary requirements and the elimination of some elements necessary for a cause of action in common law fraud. See the text accompanying notes 52 to 55 infra.

37. The federal circuits have approved, either expressly or by implication, an implied right of action for violation of rule 10b-5; e.g., Jordan Bldg. Corp. v. Doyle, O'Connor & Co., 401 F.2d 47 (7th Cir. 1968); Doelle v. Ireco Chem., 391 F.2d 6 (10th Cir. 1967); Greater Iowa Corp. v. McLendon, 378 F.2d 783 (8th Cir. 1967); A. T. Brod & Co. v. Perlow, 375 F.2d 393 (2d Cir. 1967); Janigan v. Taylor, 344 F.2d 781 (1st Cir. 1965), cert. denied, 383 U.S. 879 (1965); Texas Continental Life Ins. Co. v. Dunne, 307 F.2d 242 (6th Cir. 1962); McClure v. Borne Chem. Co., 292 F.2d 824 (3d Cir. 1962); Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961); Hooper v. Mountain States Sec. Corp., 282 F.2d 195 (5th Cir. 1960), cert. denied, 365 U.S. 814 (1961); Beury v. Beury, 222 F.2d 464 (4th Cir. 1955). For a discussion of the rationale underlying these decisions, see Bromberg 27-34; Ruder, Texas Gulf Sulphur—The Second Round: Privity and State of Mind in Rule 10b-5 Purchase and Sale Cases, 63 NW. U.L. Rev. 423, 430-33 (1968). The Supreme Court has not however, passed upon the existence of private actions. SEC v. National Sec., Inc., 89 S. Ct. 564, 572 n.9 (1969).
attitude is, however, subject to judicial, administrative, and economic limitations. The judicial limitation results from the necessity for adequate standards by which a factual situation may be tested in the adjudicative process; the administrative limitation reflects the need for an adequate method of ensuring compliance with judicially developed standards; and the economic limitation stems from the desirability of an orderly securities market and resultant promotion of the nation’s economic growth.

In considering the relation of these limitations to the disclosure rules established in *Great American Industries*, a distinction should be made between the three types of individual defendants which were involved—corporate officers, sellers, and finders. This distinction was not clearly drawn in the decision since the SEC contended that there was no difference in the nature of the violations by the three types of defendants and the court did not find it necessary to distinguish between the finders and the sellers since their joint conduct constituted common law fraud. If, however, the disclosure rule is to be applied to situations in which common law fraud is not present, or in which private compensatory remedies are sought, failure to distinguish between the different types of defendants may lead to unintended results.

*The Judicial Limitation*

The opinion fails to establish any criteria by which to judge the unusualness of finder’s fees but relies upon the division as being unusual upon its face. In transactions such as these where no “conventional norms” exist, both sellers and finders may be unable to anticipate with any degree of exactitude what a court will consider a “material deviation” from this elusive “norm.” Consequently, in order to ensure compliance with the disclosure duty established by the principal case, future sellers and finders might have to disclose all finder’s fees which they receive if the information is requested. Corporate officers, on the other hand, presumably have a certain expertise in these matters acquired in the

An implied private cause of action for violation of a statutory standard or conduct is normally vested only in the class of persons whom the statute was intended to protect; *e.g.*, Greater Iowa Corp. v. McLendon, 378 F.2d 783 (8th Cir. 1967); Taussig v. Wellington Fund, Inc., 313 F.2d 472 (3d Cir. 1963), *cert. denied*, 374 U.S. 806 (1963). *See* W. PROSSER, *The Law of Torts* § 35 (3d ed. 1964); *Restatement (Second) of Torts* § 286 (1965). Thus the private cause of action implied from the provisions of rule 10b-5 has been limited to purchasers and sellers. *E.g.*, Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir. 1952), *cert. denied*, 343 U.S. 956 (1952). The SEC, however, has taken the position that the class of persons Congress intended to protect under section 10(b) and rule 10b-5 is not restricted to buyers and sellers. A. T. Brod & Co. v. Perlow, 375 F.2d 393 n.3 (2d Cir. 1967). If this interpretation prevails then “an ever-increasing circle of others” may indeed be permitted private recovery. See note 49 *infra*.
course of preparing reports pursuant to section 13 of the SEA and thus may be able to determine what fees should be disclosed. The result of such a disclosure scheme is to give the party who can most advantageously use the information in the negotiating process an effective means of obtaining that information.

An additional problem arises when the lack of conventional norms is coupled with the traditional reluctance of the courts to inquire into discretionary business judgments in the absence of fraud. Since one of the inferences arising from a material deviation in finder's fees from conventional norms is management's inability, it could be argued that the courts have embarked upon a course which could require them to inquire into matters heretofore deemed inappropriate. Such a contention fails to recognize that the courts can remain consistent with their prior position, for the mechanics of the market, through the valuation process, provides the proper forum to determine management's ability. Injunctive proceedings do not impinge upon the business judgment rule but are attempts to assure that the market will have accurate information upon which to make its valuation.

The Administrative Limitation

The problem of enforcing the disclosure rule established by Great American Industries may justify creation of an implied private right of action under rule 10b-5. Although the SEA empowers the SEC to investigate and publish violations of the SEA and to take appropriate legal actions to enforce its provisions, the court in Great American Industries noted that the SEC is already too overburdened to "... have the time, the resources or the material to enable it to police 8-K reports. . . ." which are filed directly with the SEC, as rapidly as is necessary to effectively

40. E.g., United Copper Sec. Co. v. Amalgamated Copper Co., 244 U.S. 261 (1917); Seagrave Corp. v. Mount, 212 F.2d 389 (6th Cir. 1954); Heimann v. American Express Co., 279 N.Y.S. 2d 867, 53 Misc. 2d 749 (Sup. Ct. 1967). There has been a particular reluctance to inquire into the adequacy of consideration in a good-faith transaction arrived at after arms-length negotiations between willing buyers and sellers; e.g., Fielding v. Allen, 99 F. Supp. 137 (S.D.N.Y. 1951); Bayer v. Beran, 49 N.Y.S. 2d 2 (Sup. Ct. 1944). 41. See sections 21 and 32 of the SEA. Since adverse publicity is normally damaging to a corporate defendant, the SEC is sometimes able to secure compliance with the federal securities laws by an informal process of negotiations. Frequently these negotiated settlements include restitution to defrauded private parties. See Bromberg 237-39; L. Loss, SECURITIES REGULATION 1824-29 (2d ed. 1961).


41. See sections 21 and 32 of the SEA. Since adverse publicity is normally damaging to a corporate defendant, the SEC is sometimes able to secure compliance with the federal securities laws by an informal process of negotiations. Frequently these negotiated settlements include restitution to defrauded private parties. See Bromberg 237-39; L. Loss, SECURITIES REGULATION 1824-29 (2d ed. 1961).

DISCLOSURE OF FINDER'S FEES

prevent violations of rule 10b-5.\textsuperscript{42} A fortiori, the SEC must lack the time, resources, and materials to roam the countryside searching out and smiting tight-lipped sellers and finders with injunctive swords. Thus, the same necessity for additional enforcement of federal securities laws in the form of private rights of action which served as the basis for the Supreme Court's decision in \textit{J. I. Case v. Borak}\textsuperscript{43}—the inability of the SEC to determine the accuracy of all proxy materials submitted—may warrant the creation of an implied private right of action for violation of rules 10b-5 and 13a-11 in connection with the disclosure of finder's fees.\textsuperscript{44}

There seems to be no reason why the necessity rationale of \textit{Borak} should not apply with equal force to disclosure of finder's fees under rule 10b-5.\textsuperscript{45} In both instances, the congressional purpose is to provide investors with adequate information upon which to base their actions by requiring those who have access to information to disgorge it. With respect to proxy solicitations and 8-K reports, the facilities of the SEC are inadequate to handle the multitudinous instances deserving of investigation primarily because of the temporal factor involved. Thus supplemental enforcement via private damage actions seems necessary to adequately ensure compliance with the new judicial rule of disclosure of finder's fees and clearly should be available under present judicial interpretation of rule 10b-5.\textsuperscript{46}

The dimensions of the new relief available in a private right of action for damages may be extensive in light of the \textit{Texas Gulf Sulphur} deci-

\begin{itemize}
  \item \textsuperscript{42} GAI at 97,538. See Cohen, "Truth in Securities" Revisited, 79 HARV. L. REV. 1340, 1362 (1966).
  \item \textsuperscript{43} 377 U.S. 426 (1964).
  \item \textsuperscript{44} It seems settled that federal courts have the power to create such implied private rights in order to effectuate the purposes underlying federal statutes (e.g., Deckert v. Independence Shares Corp., 311 U.S. 282 (1940) (violation of section 22(a) of the SA); Dann v. Studebaker-Packard Corp., 288 F.2d 201 (6th Cir. 1961) (violation of section 14 of the SEA); Fitzgerald v. Pan American World Airways, Inc., 229 F.2d 499 (2d Cir. 1956) (violation of the Civil Aeronautics Act of 1938, 52 Stat. 993 (1938)). For the scope of such implied private remedies see note 41 \textit{supra}. The \textit{Borak} decision indicates that the Supreme Court will do so in the context of the SEA. The lower federal courts have clearly demonstrated their willingness to create such implied rights under the provisions of the SEA. See note 41 \textit{supra}.
  \item \textsuperscript{46} The addition of a private right of action not only increases the effectiveness of enforcement of the present remedies, but also alters the existing balance between the policies of deterrence and compensation. See Comment, \textit{Private Rights From Federal Statutes: Toward a Rational Use of Borak}, 63 NW. U.L. REV. 454, 466-69 (1968).
\end{itemize}
A concurring opinion in *Great American Industries* asserted that the injury extends to "passive shareholders, potential purchasers, and an ever-increasing circle of others." A right vested only in the purchasing corporation would be insufficient to enforce such a duty of disclosure on finders and sellers, since a seller, or a finder, cannot be compelled by a purchaser to disclose information against his will prior to entering into a consensual relationship. Although a contract subsequently entered into would be voidable if the information had been requested and not given, where the assets acquired were not overvalued and the corporation was satisfied with the acquisition, as was apparently the case in *Great American Industries*, to pursue this course would clearly not be in the best interests of the corporation. In addition to rescission a corporation could have an action for damages. However, since there has been no misrepresentation as to the value of the property received this action should fail for a failure to show any resulting damage. A derivative action by stockholders of the corporation would be similarly inappropriate for the corporation has suffered no harm by acquiring an asset which was correctly valued. A direct action by these shareholders against the purs-
chasing corporation would also fail because of the court’s reluctance to inquire into business judgment.

A direct action by shareholders of the purchasing corporation against the sellers and finders would be appropriate only in those situations where the shareholder could demonstrate damage independent of that of the corporation, i.e., in those situations where they had acted or refrained from acting in any way which could be attributed to the misrepresentations of the sellers and finders; otherwise their action would be basically derivative. A common law action of this type would be effectively delimited by the necessity of proving causation and reliance.

However, it is uncertain as yet which elements of common law deceit need be shown in a private action seeking damages for violation of rule 10b-5. The decisions are split as to the requirements of scienter and privity, but the trend appears to be toward abandonment in private actions. Although reliance appears to be necessary for a private action under rule 10b-5, it is sometimes presumed from materiality and has become so intertwined with causation as to have become partially interchangeable with that requirement. Causation in some form seems to be required, but the nature of the test and the proximity required have not received sufficient judicial attention to warrant any generality.

The Economic Limitation


53. E.g., Janigan v. Taylor, 344 F.2d 781 (1st Cir. 1965).


56. The direct practical impact of the economic constraint may be illustrated by the current activity in the District Court for the Southern District of New York follow-
market resulting from the disclosure policy underlying rule 10b-5 must be examined in light of the effect which such disclosure may have on the operation of the economy upon which the securities market depends. In view of the frequent involvement of finders in a wide range of financing transactions, and the broad construction of the phrase "in connection with the purchase or sale of any security" in Texas Gulf Sulphur, the duty to disclose finder's fees could arise in innumerable situations.

In assessing the disclosure duty it is important to distinguish between disclosures by finders and sellers to corporate officers and ultimate disclosure by the latter. Since neither group is normally in a position to enforce disclosure by the other group, the source of the necessary compulsion must be in either the SEC or the public via private damage actions. The economic effect of the duty to disclose finder's fees will vary according to the method of enforcement chosen and the group to which enforcement is applied.

It may be desirable for future courts which pass upon the question of disclosure of finder's fees to reassess the desirability of disclosing finder's fees which are not clearly material, for example, those which are not material under some standard analogous to that provided in section 13 relating to transactions involving a "significant amount of assets." This judicial reexamination of the disclosure duty is appropriate because there

---

57. Those sellers who are subject to the SEA must file an 8-K report with the SEC if the assets sold constitute a "significant amount of assets." See generally Ruder, Texas Gulf Sulphur—The Second Round: Privity and State of Mind In Rule 10b-5 Purchase and Sale Cases, 63 Nw. U.L. Rev. 423, 429 (1968).

58. The distinction between finders and sellers on one hand, and corporate officers on the other, serves as the basis and the justification for the following suggested disclosure scheme. Finders and sellers, upon inquiry, could be required to disclose to the corporate officers with whom they deal any finder's fees which the finders and sellers deem material. If such disclosure is adequate and accurate, any future legal action by the corporation, the SEC, or members of the investing public against the finders or sellers should be precluded. The corporate purchaser would then be required to disclose to the SEC those finder's fees which the corporate officers, in the exercise of their past experience and best judgment, believe material. Adoption of this scheme should serve to minimize the adverse economic effects of disclosure without unduly compromising the flow of adequate market information to the investing public.

59. See note 5 supra.
are frequently legitimate reasons why those selling property to a corporation may not wish to divulge the ultimate division of the proceeds. Sellers might forgo many transactions which would have been advantageous to the corporate purchaser rather than disclose the amount of finder's fees involved. Further, the percentage of the proceeds allocated to finder's fees is an unreliable indicator of the correct value of property acquired by a corporation since the division of the purchase price necessarily reflects extraneous factors such as the financial positions, bargaining skills, and personal relationships of the parties. Disclosure of the amount of finder's fees alone may be misleading to a reasonable investor unaware of such factors and adverse market reactions may result. If such reactions become common, finder's fees may be forced below the level necessary to adequately encourage and reward finders in their performance of a valuable economic function. This effect would be magnified if private damage actions are permitted in circumstances where undisclosed amounts are numerically insignificant. On the other hand, it may be argued that disclosure proceedings by the SEC are both desirable and consistent with the purpose of rule 10b-5 since such proceedings ensure that the market is afforded an opportunity to express investors' opinions that certain finder's fees have varied excessively from established norms.

CONCLUSION

As has already been suggested, finders might avoid the new disclosure provisions in Great American Industries by merely absenting themselves from the negotiations. Since purchasers can avoid imposing a duty to disclose material finder's fees upon sellers by remaining silent as to such fees, and sellers can avoid imposing the same duty on purchasers by failing to question the purchasers as to such fees, then in those instances where each party considers the proposed transaction to be desirable their course of conduct to avoid liability becomes clear—silence. The desirability of this result would seem to be, at best, debatable. However, if the finder's fees involved are justified under the circumstances, the parties should not be overly hesitant to disclose them so long as private parties must express their disapproval through the market mechanism rather than through the judicial system. Therefore, the policy of disclosure underlying rule 10b-5 is best served not by allowing private damage actions, but rather by increasing the effectiveness of administrative enforcement procedures.

61. See the text accompanying notes 40 and 41 supra.
62. See note 7 supra. Finders may run an additional juridical risk of being classified as sellers regardless of pre-existing contractual arrangements to the contrary.
Thus, if the decision in *Great American Industries* is read as simply imposing a duty on finders and sellers to respond to direct questions by purchasers concerning finder’s fees and requiring purchasers to disclose to the SEC those finder’s fees “... which in reasonable and objective contemplation might affect the value of the corporation’s stock or securities. . . ,” then it represents a logical outgrowth of the *Texas Gulf Sulphur* decision. If, however, the variation standard used by the court is strictly applied, and the duty of disclosure is enforced by allowing private damage actions, then extensive liability may be imposed for the failure to disclose comparatively small finder’s fees.

*David L. Cocanower*