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AT&T

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March 6, 2000

Ms. Magalie Roman Salas
Secretary
Federal Communications Commission
445 Twelfth Street
Washington, DC 20554

RECEIVED
MAR 06 2000
FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

RE: Notice of Oral Ex Parte
In the Matter of GTE Corporation ("GTE") Transferor,
and Bell Atlantic Corporation ("BA") Transferee,
For Consent to Transfer of Control
CC Docket No. 98-184

Dear Ms. Salas:

On March 3, 2000 Peter Keisler and Rick Beckner of Sidley & Austin and the undersigned met with Paula Silbarthau of the FCC's General Counsel's Office, Michelle Cary and Johanna Mikes of the FCC's Common Carrier Bureau and Darryl Cooper of the Cable Service Bureau. The purpose of the meeting was to discuss AT&T's opposition to BA's and GTEs' proposal regarding GTE's Interlata operations as detailed in the pleading filed by AT&T on February 15. In addition to discussing the filed opposition, AT&T also discussed in detail the authorities attached to this submission.

Two copies of this Notice are being submitted to the Secretary of the FCC in accordance with Section 1.1206 of the Commission's rules.

Sincerely,

Joan Marsh

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Attachments

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	RECEIVED
	)	
GTE CORPORATION,	)	MAR 06 2000
	)	
Transferor,	)	FEDERAL COMMUNICATIONS COMMISSION OFFICE OF THE SECRETARY
	)	
and	)	CC Docket No. 98-184
	)	
BELL ATLANTIC CORPORATION,	)	
	)	
Transferee,	)	
	)	
For Consent to Transfer of Control	)	

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January 27, 2000

or other non-voting interests with rights of conversion to voting interests" do not count as equity interests "unless and until conversion is effected." *Id.* § 8 (quotation marks omitted).[22]

In all other contexts where (as with section 271) the Commission enforces ownership attribution limits in order to safeguard competition, the Commission has consistently ruled that options and other convertible interests do not count as ownership:

- In its broadcasting and cable attribution rules, the Commission has concluded that call options and convertible rights are not cognizable ownership interests. *E.g., Review of the Commission's Regulations Governing Attribution of Broadcast and Cable/MDS Interests*, MM Docket No. 94-150, at ¶ 2 n.4 (1999) ("The following corporate interests are not currently attributable: minority stockholdings in corporations with a single majority shareholder; nonvoting stock; other nonvoting instruments such as options or warrants; and debt."); *Attribution of Ownership Interest*, 97 F.C.C. 2d 997 (1984) (adopting 47 C.F.R. § 73.3555) ("Holders of debt and instruments such as warrants, convertible debentures, options or other non-voting interests with rights of conversion to voting interests shall not be attributed unless and until conversion is effected."); *In re Implementation of 1992 Cable Act*, CS Docket No. 98-82, at ¶ 129 n.329 (1999) ("We disagree . . . that options, warrants, and convertible debentures should generally be treated as beneficial interests under our rules creating an attribution . . . . We do not believe that these types of securities demonstrate . . . current, active participation.") The Commission adopted these attribution rules to ensure that competition is not impaired through undue concentration of ownership. Specifically, the cable attribution rules, like section 271's limitations on affiliated ownership, "are designed to promote competition by ascertaining the minimum interest necessary for one entity to potentially influence another." *Id.* ¶ 128. Nevertheless, the Commission concluded that options, convertible rights and other such future interests "exist outside the concerns and constraints of the multiple ownership rules." 97 F.C.C. 2d 997, at ¶ 48.

- In applying the CMRS spectrum aggregation cap, the Commission has concluded that "securities affording potential future equity interests," such as options, warrants and conversion rights, are not deemed attributable until exercised. 47 C.F.R. § 20.6(d)(5); *see also 1998 Biennial Regulatory Review, Spectrum Aggregation Limits for Wireless Telecommunications Carriers*, WT Docket No.

[22] Whatever its precise meaning, the phrase "(or the equivalent thereof)" in section 3(1) certainly does not expand the plain terms of the statute to encompass potential future equity interests. This phrase must be interpreted in a way that preserves the substantive distinction between current and future equity ownership.

common control with such carrier, or (4) any carrier to which clause (2) or clause (3) would be applicable except for furnishing interstate mobile radio communication service or radio communication service to mobile stations on land vehicles in Canada or Mexico; except that Sections 201 through 205 of this Act, both inclusive, shall, except as otherwise provided therein, apply to carriers described in clauses (2), (3) and (4).

Section 3 Definitions. - For the purposes of this Act, unless the context otherwise requires.--

(1) Affiliate.--The term "affiliate" means a person that (directly or indirectly) owns or controls, is owned or controlled by, or is under common ownership or control with, another person. For purposes of this paragraph, the term "own" means to own an equity interest (or the equivalent thereof) of more than 10 percent.

(2) Amateur station.--The term "amateur station" means a radio station operated by a duly authorized person interested in radio technique solely with a personal aim and without pecuniary interest.

(3) AT&T consent decree.--The term "AT&T Consent Decree" means the order entered August 24, 1982, in the antitrust action styled United States v. Western Electric, Civil Action No. 82-0192, in the United States District Court for the District of Columbia, and includes any judgment or order with respect to such action entered on or after August 24, 1982.

(4) Bell operating company.--The term "Bell operating company"--

(A) means any of the following companies: Bell Telephone Company of Nevada, Illinois Bell Telephone Company, Indiana Bell Telephone Company, Incorporated, Michigan Bell Telephone Company, New England Telephone and Telegraph Company, New Jersey Bell Telephone Company, New York Telephone Company, U S West Communications Company, South Central Bell Telephone Company, Southern Bell Telephone and Telegraph Company, Southwestern Bell Telephone Company, The Bell Telephone Company of Pennsylvania, The Chesapeake and Potomac Telephone Company, The Chesapeake and Potomac Telephone Company of Maryland, The Chesapeake and Potomac Telephone Company of Virginia, The Chesapeake and Potomac Telephone Company of West Virginia, The Diamond State Telephone Company, The Ohio Bell Telephone Company, The Pacific Telephone and Telegraph Company, or Wisconsin Telephone Company; and

(B) includes any successor or assign of any such company that provides wireline telephone exchange service; but

(C) does not include an affiliate of any such company, other than an affiliate described in subparagraph (A) or (B).

(5) Broadcast station.--The term "broadcast station," "broadcasting station," or "radio broadcast station" means a radio station equipped to engage in broadcasting as herein defined.

(6) Broadcasting.--The term "broadcasting" means the dissemination of radio communications intended to be received by the public, directly or by the intermediary of relay stations.

(7) Cable service.--The term "cable service" has the meaning given such term in Section 602.

(8) Cable system.--The term "cable system" has the meaning given such term in Section 602.

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TITLE VI - CABLE COMMUNICATIONS

Part I - General Provisions

Section 601 Purposes. - The purposes of this title are to--

(1) establish a national policy concerning cable communications;

(2) establish franchise procedures and standards which encourage the growth and development of cable systems and which assure that cable systems are responsive to the needs and interests of the local community;

(3) establish guidelines for the exercise of Federal, State, and local authority with respect to the regulation of cable systems;

(4) assure that cable communications provide and are encouraged to provide the widest possible diversity of information sources and services to the public;

(5) establish an orderly process for franchise renewal which protects cable operators against unfair denials of renewal where the operator's past performance and proposal for future performance meet the standards established by this title; and

(6) promote competition in cable communications and minimize unnecessary regulation that would impose an undue economic burden on cable systems.

Section 602 Definitions. - For purposes of this title--

(1) the term "activated channels" means those channels engineered at the headend of a cable system for the provision of services generally available to residential subscribers of the cable system, regardless of whether such services actually are provided, including any channel designated for public, educational, or governmental use;

(2) the term "affiliate," when used in relation to any person, means another person who owns or controls, is owned or controlled by, or is under common ownership or control with, such person;

(3) the term "basic cable service" means any service tier which includes the retransmission of local television broadcast signals;

(4) the term "cable channel" or "channel" means a portion of the electromagnetic frequency spectrum which is used in a cable system and which is capable of delivering a television channel (as television channel is defined by the Commission by regulation);

(5) the term "cable operator" means any person or group of persons (A) who provides cable service over a cable system and directly or through one or more affiliates owns a significant interest in such cable system, or (B) who otherwise controls or is responsible for, through any arrangement, the management and operation of such a cable systems;

(6) the term "cable service" means--

(A) the one-way transmission to subscribers of (i) video programming, or (ii) other programming service, and

(11) The term "equity security" means any stock or similar security; or any security convertible, with or without consideration, into such a security, or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right; or any other security which the Commission shall deem to be of similar nature and consider necessary or appropriate, by such rules and regulations as it may prescribe in the public interest or for the protection of investors, to treat as an equity security.

(12)(A) The term "exempted security" or "exempted securities" includes—

(i) government securities, as defined in paragraph (42) of this subsection;

(ii) municipal securities, as defined in paragraph (29) of this subsection;

(iii) any interest or participation in any common trust fund or similar fund maintained by a bank exclusively for the collective investment and reinvestment of assets contributed thereto by such bank in its capacity as trustee, executor, administrator, or guardian;

(iv) any interest or participation in a single trust fund, or a collective trust fund maintained by a bank, or any security arising out of a contract issued by an insurance company, which interest, participation, or security is issued in connection with a qualified plan as defined in subparagraph (C) of this paragraph;

(v) any security issued by or any interest or participation in any pooled income fund, collective trust fund, collective investment fund, or similar fund that is excluded from the definition of an investment company under section 3(c)(10)(B) of the Investment Company Act of 1940 [15 U.S.C.A. § 80a-3(c)(10)(B)];

(vi) solely for purposes of sections 78*l*, 78m, 78n, and, 78p of this title, any security issued by or any interest or participation in any church plan, company, or account that is excluded from the definition of an investment company under section 80a-3(c)(14) of this title; and

(vii) such other securities (which may include, among others, unregistered securities, the market in which is predominantly intrastate) as the Commission may, by such rules and regulations as it deems consistent with the public interest and the protection of investors, either unconditionally or upon specified terms and conditions or for stated periods, exempt from the operation of any one or more provisions of

Before the
Federal Communications Commission
Washington, D.C. 20554

In the Matter of	)	
	)	
Implementation of Section 11(c)	)	
of the Cable Television Consumer Protection	)	
and Competition Act of 1992	)	MM Docket No. 92-264
	)	
	)	
Horizontal Ownership Limits	)	

THIRD REPORT AND ORDER

Adopted: October 8, 1999 **Released: October 20, 1999**

By the Commission: Commissioner Furchtgott-Roth concurring in part, dissenting in part and issuing a statement; Commissioner Tristani approving in part, dissenting in part and issuing a statement.

Table of Contents

I. INTRODUCTION

1. This *Third Report and Order* resolves the issues regarding Section 76.503 of our rules (the

[1] 47 C.F.R. § 76.503.

and partnership interests. The 10% threshold will apply only to active LEC investors. An MVPD competitor cannot be effectively a LEC competitor by virtue of its affiliation with a LEC that is a passive investor only, unless the LEC has an ED interest in the MVPD. We believe that an ED investment, given its size, by a LEC gives an MVPD significant access to the resources of a LEC such that it can be presumed that there is effective LEC competition.[329] The LEC effective competition test presumes, without any market share or market penetration test, that the presence of a LEC competitor or use of a LEC's facilities, given the LEC's identity, resources, and functions, has significance beyond that of other competitors. Consistent with this rationale we will not treat positional interests (officers and directors) or insulated limited partnership interests as creating attributable interests that would result in a finding of LEC effective competition because these interests would not give the MVPD access to the LEC's significant resources. Given that we have not adopted the Title I definition of affiliate, we need not determine what constitutes an interest "equivalent" to an equity interest.

162. We also decline to adopt Time Warner's proposal that we require wireless cable licensees to certify with the Commission whether they are LEC-affiliates and whether any entity offering services over their facilities is LEC affiliated. In the *Cable Reform Report and Order*, we adopted a mechanism for cable operators to obtain evidence from their competitors in order to establish effective competition.[330]

ii. Competing Provider Test

163. As discussed above, in reviewing the effective competition rules, we ascertained that the "competing provider test" does not have its own specific definition of the term "affiliate."[331] The competing provider test provides that there is effective competition in certain circumstances where there are at least two "unaffiliated multichannel video programming distributors" in the franchise area.[332] Because the competing provider test provides the same function as our cross-ownership prohibitions, we will apply cable/SMATV cross-ownership attribution rules to determine whether two MVPDs serving the same market are "affiliated."

[329] We disagree with Time Warner that options, warrants, and convertible debentures should generally be treated as beneficial interests under our rules creating an attribution simply because the SEC defines them to be beneficial interests if their owner can obtain voting stock through these securities within 60 days. *See* Time Warner CR Comments at 8-9 (*citing* 17 C.F.R. § 240.13d-3; 15 U.S.C. § 78(l)-(n)). We do not believe that these types of securities demonstrate the type of current, active participation by a LEC envisioned by the LEC test, unless the amount of these securities that an investor holds is more than 33% of the total assets of a company. Therefore, subject to the ED rule, we will exclude these types of securities as well as any other types of nonvoting interests from attribution for purposes of the LEC test.

[330] *Cable Reform Report and Order* at para. 30; *see* 47 C.F.R. § 76.911(c) ("If the evidence establishing effective competition is not otherwise available[, when considering] petitions filed seeking to demonstrate the presence of effective competition pursuant to § 76.905(b)(4) [the LEC test], the Commission may issue an order directing one or more persons to produce information relevant to the petition's disposition.").

[331] 47 C.F.R. § 76.905(b)(2).

[332] *Id.*

[4] In granting Anthony's fee request in its entirety, the District Court implicitly relied upon the attorney's fee provision of Title VII: it based the award on a rate of $150.00 per hour and discussed the Supreme Court's opinion in *Hanrahan.* Because we find that Anthony has not prevailed on the merits within the purview of the applicable statutory provision, 42 U.S.C. § 2000e-5(k) (1982), we must vacate the District Court's judgment.

The record contains no mention of the final disposition of Anthony's actual Title VII claims. We can only assume that investigation and resolution of those claims are not yet final. It was for that reason that the EEOC held that Anthony's appeal was premature under 29 C.F.R. § 1613.233(a), and that both the District Court and this Court held that Anthony's claims did not arise under Title VII. Instead, we held that Anthony was entitled to relief pursuant to the Mandamus Act, 28 U.S.C. § 1361 (1982). The District Court's final order directed the agency to pursue its *investigation* of Anthony's civil rights claims regarding certain issues and not to investigate others.

Having chosen to invoke the Federal Court's mandamus jurisdiction, Anthony cannot at this time present himself as having prevailed on the merits of his Title VII claim. As is made clear by *Hanrahan* and *Grubbs,* the claimant's proof of a civil rights violation is a prerequisite to an attorney's fee award under 42 U.S.C. § 2000e-5(k).

Anthony's argument that he won everything he sought in this litigation confuses the "prevailing party" requirement of the Title VII provision with that of the Equal Access to Justice Act. The kind of victory Anthony won comports with an award under the Equal Access to Justice Act. *Hirschey v. Federal Energy Regulatory Commission, supra,* 760 F.2d at 309 n. 20. No matter how successful he was in litigating the issues he came to court to redress, he cannot come within the Title VII provision without having established a Title VII violation. *Hanrahan, supra; Grubbs, supra.*

Anthony attempts to avoid this requirement by arguing that the Mandamus Act is merely a jurisdictional vessel, and that since he furthered the substantive goals of Title VII, he should be entitled to an award under the Title VII provision. The clear import of *Hanrahan* and *Grubbs* leaves no room for that argument. The plaintiffs in *Hanrahan* surely furthered the substantive goals of the civil rights laws by obtaining a reversal on appeal of the directed verdicts that had been erroneously rendered against them. *See Hanrahan, supra,* 446 U.S. at 755, 100 S.Ct. at 1988. Despite that fact, the Court said that "it seems clearly to have been the intent of Congress to permit [the award of fees *pendente lite*] only to a party who has established his entitlement to some relief on the merits of his [civil rights] claims, either in the trial court or on appeal." *Id.* at 757, 100 S.Ct. at 1989. Just as the plaintiffs in *Hanrahan* had not yet established the validity of their civil rights claims, Anthony has not yet established the validity of his. He has won the right to have his STRIDE claims investigated. He has won the right to preclude further investigation of his special leave procedures claim. Those victories, without more, cannot establish his success on the merits of either claim. No final disposition at any administrative level of any of his Title VII claims appears in the record. At a minimum, the remaining administrative investigation and hearing must take place first. Anthony is not, therefore, entitled to an award under the Title VII provision.

However, for purposes of the Equal Access to Justice Act, Anthony is a prevailing party in this litigation. *Hirschey v. Federal Energy Regulatory Commission, supra,* 760 F.2d at 309 n. 20. He came to court seeking interlocutory supervision of the administrative processing of his discrimination claims. He sought to prevent further investigation of one claim, and won. He sought to force investigation of other claims, and won.

Basing its award upon the Title VII provision, the District Court did not reach the issue whether the government's position was "substantially justified" as is required

under the Equal Access to Justice Act. *See, e.g., Federal Election Commission v. Rose,* 806 F.2d 1081, 1086-92 (D.C.Cir. 1986).

We therefore vacate the judgment of the District Court and remand for determination of Anthony's entitlement to an attorney's fee award under the Equal Access to Justice Act, and for entry of an appropriate order.

ONE-O-ONE ENTERPRISES, INC., et al., Plaintiffs-Appellants,

v.

Richard E. CARUSO, et al., Defendants-Appellees.

No. 87-7195.

United States Court of Appeals, District of Columbia Circuit.

Argued April 26, 1988.

Decided June 7, 1988.

Appeal was taken from order of the United States District Court for the District of Columbia, Charles R. Richey, J., 668 F.Supp. 693, entered in action for securities fraud and breach of contract. The Court of Appeals, Ruth Bader Ginsburg, Circuit Judge, held that: (1) integration clause in stock option contract precluded securities fraud claim, and (2) marketing clause in contract did not require option holder to maintain the same level of advertising for its restaurants that was being provided on date agreement was entered into.

Affirmed.

1. Securities Regulation ⇐60.53

To state claim of fraud or securities fraud upon which relief can be granted, plaintiffs' allegations must indicate that their reliance on allegedly fraudulent representations was reasonable. Securities Exchange Act of 1934, § 10(b), 15 U.S.C.A. § 78j(b).

2. Securities Regulation ⇐60.27(1)

Integration clause in stock option contract precluded securities fraud claim based on representations made by option holder before contract was entered into; clause provided that agreement superseded any and all previous understandings and agreements and made any reliance by corporation's owners on option holders' prior representations concerning holders' long-term commitment to corporations' operations unreasonable and any failure of holders to disclose negotiations with competitor immaterial. Securities Exchange Act of 1934, § 10(b), 15 U.S.C.A. § 78j(b).

3. Securities Regulation ⇐5.25(3)

Option to purchase corporation's stock was a "security" for purposes of securities fraud claim. Securities Exchange Act of 1934, § 3(a)(10), 15 U.S.C.A. § 78c(a)(10).

See publication Words and Phrases for other judicial constructions and definitions.

4. Corporations ⇐116

Marketing clause in contract granting option to purchase stock of corporation which owned restaurant franchises did not require option holder to maintain the same level of advertising for its restaurants that was being provided on date agreement was entered into, but only required option holder to advertise corporation's restaurants, which were converted to restaurants with same franchise as option holder's restaurants, at same level as option holder's restaurants.

Appeal from the United States District Court for the District of Columbia.

Allan S. Hoffman, with whom Samuel H. Seymour, Washington, D.C., was on the brief for plaintiffs-appellants.

Michael A. Schlanger, with whom Stephen R. Mysliwiec, Washington, D.C., was on the brief, for defendants-appellees.

Before RUTH BADER GINSBURG and SENTELLE, Circuit Judges and PALMIERI *, Senior District Judge.

Opinion for the court filed by Circuit Judge RUTH BADER GINSBURG.

RUTH BADER GINSBURG, Circuit Judge:

Plaintiffs-appellants One–O–One Enterprises, Inc., Guld, Inc., and Ulysses G. Auger, Sr. (hereafter referred to jointly as One–O–One) appeal from an order of the district court dismissing their complaint against defendants-appellees Richard E. Caruso, James M. Sullivan, and For Trish Co., Inc., for failure to state a claim upon which relief can be granted. *One–O–One Enters., Inc. v. Caruso*, 668 F.Supp. 693 (D.D.C.1987). Appellants' complaint tendered securities fraud claims under section 10(b) of the Securities Exchange Act of 1934 (SEA) and Rule 10b–5 promulgated thereunder, pendent state common law fraud and breach of contract claims, and a RICO claim. Appellants are not appealing dismissal of the RICO claims.

Because One–O–One failed to identify any fraudulent representations upon which it reasonably could have relied or any plausible interpretation of the contract upon which a claim of breach could be stated, we affirm the decision of the district court. Nevertheless, although it does not affect the outcome of this appeal, we indicate why we do not approve the portion of the district court's opinion, 668 F.Supp. at 699–701, concerning the existence of a security.

I.

This case arises out of an agreement between defendants and plaintiffs concerning the disposition of 39 debt-ridden Ponderosa Steak Houses in Maryland and Virginia owned by plaintiffs. At the time the complaint was filed, Auger, Sr. and his wife owned 100% of the capital stock in Guld, Inc., a D.C. corporation that in turn owned 100% of the capital stock in One–O–One Enterprises, Inc., a Maryland corporation engaged in the business of owning and operating the 39 Ponderosa Steak Houses. Defendants Caruso and Sullivan own all the capital stock in For Trish Co. (Trish), a Delaware shell corporation "without financial substance or sufficient capital to enable it to engage in any business activities without access to the financial resources of its stockholder/principals." Complaint ¶ 6. Caruso and Sullivan were, until June 1985, also controlling stockholders in Tenly Enterprises, Inc. (Tenly), a Pennsylvania corporation engaged in the business of owning and operating more than 70 Rustler Steak Houses in the Mid–Atlantic states.

Beginning in June 1984, Caruso and Sullivan expressed interest in purchasing One–O–One's heavily leveraged Ponderosa restaurants and converting them to Rustlers. On July 31, 1984 Caruso submitted an initial written proposal for the purchase of the Ponderosas. Plaintiffs rejected that proposal, but negotiations continued and eventually yielded a preliminary letter agreement, dated October 8, 1984, among Tenly, Auger, Sr., his son Auger, Jr., One–O–One, and Guld. According to plaintiffs' complaint, which we take to be true for purposes of this appeal, the October 8 preliminary agreement reflected prior oral representations made by defendants that they intended to maintain and expand the Rustler Steak House business "for the long-term future" and that they did not intend "to sell or dispose of their ownership interest in Tenly in the near or foreseeable future." Complaint ¶ 20.

In an endeavor to implement the October 8 preliminary agreement, defendants drafted a detailed formal agreement. This formal agreement—between One–O–One and Tenly—included provisions incorporating defendants' prior representations regarding their long-term commitment to the Rustler business. Ultimately, however, the parties were unable to conclude a final agreement based on the October 8 preliminary plan.

* Of the United States District Court for the Southern District of New York, sitting by designation pursuant to 28 U.S.C. § 294(d).

Negotiations resumed among the parties until they reached a new preliminary letter agreement on January 14, 1985. The new agreement, which substituted Trish for Tenly as a corporate party, contained these essential features:

(a) One–O–One would permanently convey ten of its restaurant units to Trish Co., for no cash consideration;

(b) One–O–One would convert 25 of its remaining 27 restaurant units to Rustler Steak Houses, at its own expense, and would dispose of its other two units;

(c) One–O–One would be authorized to operate the units it converted as Rustler Steak Houses for a period of up to seven years, without payment of any fees or royalties, and Trish Co. would provide advertising and promotional support for One–O–One's units at no cost to One–O–One;

(d) Auger would grant to Trish Co. an option to purchase all of the capital stock of Guld (and with it all of the capital stock of One–O–One) for the nominal sum of $100;

(e) During the six-year option period, One–O–One and Guld would apply all available revenues generated by One–O–One's Rustler Operations to reduce their outstanding indebtedness;

(f) Auger personally would service all existing Guld and One–O–One interest-bearing debt in excess of $10,200,000 in total liabilities as of the date of the final agreement, as well as any additional interest-bearing debt incurred thereafter; and

(g) Upon exercise of its option, Trish Co. would assume the liabilities of Guld and One–O–One up to a maximum amount of $10,200,000, less the amount by which their outstanding indebtedness had been reduced during the option period, and Auger would assume responsibility for the remainder of One–O–One's and Guld's obligations.

Complaint ¶ 26. A Final Agreement dated February 4, 1985 embodying these terms was executed by the parties and delivered on March 8, 1985; One–O–One thereupon conveyed to Tenly, as Trish's assignee, nine of its ten specified restaurant properties and began to convert 25 of its remaining Ponderosas to Rustlers. This 1985 Final Agreement, in contrast to the previous formal agreement based on the understandings reflected in the October 8, 1984 letter agreement, contained no statement regarding Tenly's long-term commitment to the Rustlers. The Agreement did, on the other hand, conclude with an integration clause in which the parties agreed that the Final Agreement "supercede[d] any and all previous understandings and agreements." Joint Appendix (J.A.) at 194.

Beginning in November 1984, continuing through June 1985, and unknown to plaintiffs, Caruso and Sullivan entered into negotiations to sell Tenly to Sizzler Restaurants, Inc. (Sizzler), a California corporation that owns, operates, and franchises steak houses under the Sizzler name. Sizzler intended to phase out the Rustler system after acquiring Tenly. In late June of 1985 Sizzler purchased Tenly and obtained an option to purchase all of Trish's stock.

By the time One–O–One learned that Sizzler had purchased Tenly, One–O–One had converted a number of its restaurants to Rustlers and was in the process of converting the rest. As Sizzler began converting Tenly's Rustlers to Sizzlers, the level of promotional effort devoted to Rustlers diminished markedly, "causing One–O–One's Rustler units economically to perform far more poorly than if the Rustler chain were aggressively promoted, supported with an adequate advertising and marketing effort and, generally, managed and operated with a view towards the perpetuation and expansion of the Rustler Steak House system." Complaint ¶ 36. By the end of 1985, One–O–One could no longer sustain the continuing losses on its remaining Rustlers. On May 2, 1986, One–O–One sold all but one of its Rustlers to Sizzler, having already sold the 25th Rustler to another buyer in February 1986.

On July 15, 1986, more than one year after One–O–One learned of the sale of Tenly to Sizzler, plaintiffs filed the present action seeking to recover approximately $7,600,000 in damages (or thrice that under the now-abandoned RICO claim) that they allegedly sustained because defendants fraudulently induced them to enter into a contract granting Trish an option to purchase the stock of One-O-One.

The defendants moved to dismiss the complaint for failure to state a claim, and the district court granted the motion, finding *inter alia:* (1) the representations upon which plaintiffs based their fraud, securities fraud, and RICO claims were not reasonably relied upon because the contract at issue was fully integrated; (2) the provision of the contract upon which plaintiffs based their breach of contract claim unambiguously precluded such a claim; and (3) the stock option for which the contract provided did not qualify as a security for purposes of stating a securities fraud claim under the SEA. Plaintiffs-appellants timely appealed the district court's dismissal order; we affirm the judgment of that court but correct its misstep with respect to the definition of a security.

II.

A. *Fraud*

[1] To state a claim of fraud or securities fraud upon which relief can be granted, plaintiffs' allegations must indicate that their reliance on the allegedly fraudulent representations was reasonable. *See Kennedy v. Josephthal & Co.*, 814 F.2d 798, 804 (1st Cir.1987) ("To establish a claim under section 10(b) of the Securities Exchange Act, a plaintiff must prove, in connection with the purchase [or sale] of a security ... that [its] reliance [upon false representations or omissions] was justifiable."); *Feinman v. Schulman Berlin & Davis*, 677 F.Supp. 168, 170 (S.D.N.Y.1988) (same); *Call Carl, Inc. v. BP Oil Corp.*, 554 F.2d 623, 629 (4th Cir.) (applying Maryland common law of fraud), *cert. denied*, 434 U.S. 923, 98 S.Ct. 400, 54 L.Ed.2d 280 (1977); *Isen v. Calvert Corp.*, 379 F.2d 126, 130 (D.C.Cir.1967) (applying District of Columbia common law of fraud).[1]

Plaintiffs base their fraud claims on defendants' representations, made orally in the October 8 letter agreement and in the follow-up, but unexecuted, formal agreement, that defendants would retain a controlling interest in Tenly and that Tenly would undertake a long-term commitment to maintain and expand the Rustlers; plaintiffs also assert that defendants' failure to disclose the negotiations between Tenly and Sizzler for the sale of Tenly's Rustlers constituted a fraudulent nondisclosure of material information. These false representations and omissions, plaintiffs maintain, fraudulently induced them to enter into a contract with defendants.

[2] Defendants assert here, as they did successfully before the district court, that the integration clause of the 1985 Final Agreement providing that that Agreement "supercede[d] any and all previous understandings and agreements," J.A. at 194, made any reliance by plaintiffs on prior representations concerning Tenly's long-term commitment to the Rustler operation unreasonable and any failure by defendants to disclose the existence of negotiations with Sizzler immaterial. We agree. As the district court cogently observed:

> After eight months of vigorous negotiations, the parties reached a final agreement that was lengthy, detailed and comprehensive. During these eight months many offers, promises and representations were made.... To avoid a misunderstanding and to make clear that the only understanding between the parties was that expressed in the Agreement, the parties agreed that the Agreement *"supersede[d] any and all previous understandings and agreements."* ... Even if Sullivan and Caruso had previously agreed not to divest their interest in Tenly, the Agreement explicitly superseded the previous representations. Therefore, when the representations were superseded by the Agreement there was no representation upon which plaintiffs could [reasonably] base a fraud claim.

668 F.Supp. at 698 (emphasis in original). Were we to permit plaintiffs' use of the defendants' prior representations (and defendants' nondisclosure of negotiations inconsistent with those representations) to defeat the clear words and purpose of the Final Agreement's integration clause, "contracts would not be worth the paper on which they are written." *Tonn v. Philco Corp.*, 241 A.2d 442, 445 (D.C.1968), quoting *Toledo Computing Scale Co. v. Garrison*, 28 App.D.C. 243, 249 (1906). On a matter of such large significance to the parties' bargain, silence in a final agreement containing an integration clause—in the face of prior explicit representations—must be deemed an abandonment or excision of those earlier representations. *See, e.g., Kardios Sys. Corp. v. Perkin-Elmer Corp.*, 645 F.Supp. 506, 509-10 (D.Md.1986) (removal of "best efforts" provision from final agreement constituted affirmative excision of this term).

Plaintiffs cannot overcome the written instrument here, and, particularly, the integration clause, by invoking the fraud-in-the-inducement exception to the parol evidence rule. The exception for a party who "has been induced by a fraudulent misrepresentation to enter the contract," *Giotis v. Lampkin*, 145 A.2d 779, 781 (D.C.1958); *Standard Motor Co. v. Peltzer*, 147 Md. 509, 128 A. 451 (1925), must not be stretched or inflated in a way that "would severely undermine the policy of the parol evidence rule, which is grounded in the inherent reliability of a writing as opposed to the memories of contracting parties." *Call Carl*, 554 F.2d at 630; *accord Tonn v. Philco Corp.*, 241 A.2d at 445. We need not belabor the point. We have here the case of "a party with the capacity and opportunity to read a written contract, who [has] execute[d] it, not under any emergency, and whose signature was not obtained by trick or artifice"; such a party, if the parol evidence rule is to retain vitality, "cannot later claim fraud in the inducement." *Management Assistance, Inc. v. Computer Dimensions, Inc.*, 546 F.Supp. 666, 671-72 (N.D.Ga.1982), *aff'd mem. sub nom. Computer Dimensions, Inc. v. Basic Four*, 747 F.2d 708 (11th Cir.1984).

B. *"Security"*

[3] The district court need not have reached beyond the "unreasonable reliance" ruling to dismiss the common law and securities fraud claims. That court ventured further, however, to announce an alternative ground for dismissing the securities claim. Relying on the test for the existence of a security in *SEC v. W.J. Howey Co.*, 328 U.S. 293, 301, 66 S.Ct. 1100, 1104, 90 L.Ed. 1244 (1946), the district court held that the option granted Trish in the 1985 Final Agreement to purchase all of the capital stock in Guld, Inc. was not a "security" within the meaning of section 3(a)(10) of the SEA, 15 U.S.C. § 78c(a)(10).

To be a security transaction under the *Howey* test a transaction must involve (1) "an investment of money"; (2) "in a common enterprise"; (3) "with profits to come solely from the efforts of others." *Howey*, 328 U.S. at 301, 66 S.Ct. at 1104. The district court found, correctly, that because of Trish's commitment to provide marketing and promotional services, training, and ongoing advice and training, the profits from the transaction would not come "solely from the efforts of others" but would, in a not insignificant way, come from defendants' efforts as well. The stock option, therefore, was not a security under the *Howey* test.

The district court, we believe, applied the wrong test. In *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 105 S.Ct. 2297, 85 L.Ed.2d 692 (1985), and *Gould v. Ruefenacht*, 471 U.S. 701, 105 S.Ct. 2308, 85 L.Ed.2d 708 (1985), the Supreme Court indicated that the *Howey* test does not apply across-the-board; in relation to the sale of stock, the Court announced a simpler test: the adjudicator must first determine whether the instrument denominated "stock" possesses " 'some of the significant characteristics typically associated with' stock." *Landreth*, 471 U.S. at 686, 105 S.Ct. at 2302, quoting *United Housing Found., Inc. v. Forman*, 421 U.S. 837, 851, 95 S.Ct.

1. Maryland and District of Columbia law agree on this basic requirement for stating a claim of fraudulent misrepresentation; therefore we need not decide which body of law, Maryland's or D.C.'s, governs the pendent claims in this case.

2051, 2060, 44 L.Ed.2d 621 (1975). If "the instrument involved is traditional stock ... [t]here is no need ... to look beyond the characteristics of the instruments to determine whether the [Securities] Acts apply." *Landreth,* 471 U.S. at 690, 105 S.Ct. at 2304.

The *Landreth* Court, it is true, "expressly [left] until another day the question whether 'notes' or 'bonds' or some other category of instrument listed in the [Acts'] definition [of 'security'] might be shown 'by proving [only] the document itself[,]' ... [and held] only that 'stock' may be viewed as being in a category by itself for purposes of interpreting the scope of the Acts' definition of 'security.'" *Id.* at 694, 105 S.Ct. at 2306. Nevertheless, *Landreth* heavily emphasizes a differentiation of traditional from non-traditional "securities" instruments. *See id.* at 690, 105 S.Ct. at 2304 ("All of the cases on which respondents [who supported the *Howey* test] rely involved unusual instruments not easily characterized as 'securities.'"); *id.* at 691, 105 S.Ct. at 2304 ("[T]he *Howey* economic reality test was designed to determine whether a particular instrument is an 'investment contract,' not whether it fits within *any* of the examples listed in the statutory definition of 'security.'") (emphasis in original).

The option to purchase stock, it seems to us, is such a traditional securities instrument that its existence may be shown "by proving the document itself" without any need "to look beyond the characteristics of the instruments" and, specifically, without any need to apply the *Howey* test. *See Penturelli v. Spector, Cohen, Gadon & Rosen,* 779 F.2d 160, 164–65 (3d Cir.1985) (applying *Landreth* rather than *Howey* to a "fractional undivided interest" in coal mining rights). In reaching this conclusion, we have attended to the presence in the SEA definition of "security" not only of the term "option" but also of the phrase "any ... right to ... purchase, any of the foregoing," where "the foregoing" includes "stock." 15 U.S.C. § 78c(a)(10). The contractual option to buy all of Guld's stock established defendants' "right to purchase" that stock. The *right to purchase* an instrument denominated "stock" that possesses "some of the significant characteristics typically associated with stock," we think, should be subject to the same test for application of the securities laws as the instrument itself. *Cf. Blue Chip Stamps v. Manor Drug Stores,* 421 U.S. 723, 750–51, 95 S.Ct. 1917, 1932, 44 L.Ed.2d 539 (1975) ("A contract to purchase or sell securities is expressly defined by § 3(a) of the 1934 Act, 15 U.S.C. § 78c(a), as a purchase or sale of securities for the purpose of that Act.") (footnote omitted).

Had the district court applied the test indicated in *Landreth,* as we conclude it should have, that court would have determined that the option to purchase Guld's stock was a security. The error of the district court in applying *Howey* to declare the stock option in question not a "security," however, does not alter the outcome of this appeal. Plaintiffs cannot prevail, as we earlier explained, because they failed to allege any fraudulent representations upon which they, as commercial entrepreneurs, *reasonably* could have relied.

C. *Breach of Contract*

[4] Finally, One–O–One asserts a breach of contract claim: they allege that defendants breached the Final Agreement's marketing clause by failing "to provide advertising and promotional support for [plaintiffs'] Rustler units of the kind, quantity or quality that the agreement requires." Complaint ¶ 66. The marketing clause of the Agreement states, in part:

> Trish Co. shall be responsible for providing the marketing and promotion programs of the 25 Restaurant Properties, which shall be conducted in a manner essentially consistent with the marketing and promotion programs of the current or then existing Rustler Steak Houses in the Baltimore and Washington, D.C. markets.

J.A. at 169.

The terms "shall be ... consistent with ... the current or then existing [Rustlers]," the district court held, "make clear that the level of future advertising for plaintiffs' Rustlers must be consistent with the level of advertising for the other Rustlers. Therefore, because plaintiffs do not allege that any disparity exists between the level of advertising for plaintiff's [sic] Rustlers and the other Rustlers, plaintiffs have not stated a claim for breach of contract." 668 F.Supp. at 702.

One–O–One counters that "shall be ... consistent with ... the current or then existing [Rustlers]" refers to the level of advertising obtaining during the February 1985 negotiations and not to a continuing consistency in the level of advertising between plaintiffs' and defendants' Rustlers without regard to any baseline level. Alternately, appellants argue that if the marketing clause is ambiguous as between these two constructions, summary dismissal is precluded.

In common with the district court, we see no ambiguity. *See Horn & Hardart Co. v. National R.R. Passenger Corp.,* 793 F.2d 356, 359 (D.C.Cir.1986) ("the construction of *unambiguous* contractual language is a matter of law entrusted to the court") (emphasis in original). The marketing clause uses explicitly relative terms to identify the required level of advertising; it pegs the level of advertising for One–O–One's newly converted Rustlers to the level for all other Rustlers in the Baltimore–D.C. area. The phrase "current or then existing" simply recognizes the possibility that new Rustlers might be established or old ones abandoned after execution of the Final Agreement. The only requirement is that there be no disparity in the level of advertising between One–O–One's Rustlers and all other Rustlers in the relevant market. As the district court observed, "[i]f [the parties] intended to say that the level of advertising may not fall below the level being provided on February 4, 1985, when the Agreement was executed, they could have clearly said so." 668 F.Supp. at 702. Because plaintiffs' complaint alleged no disparity in advertising, the district court correctly dismissed the breach of contract claim.

Conclusion

Having corrected the district court's misstep with respect to the existence of a security, we affirm that court's dismissal of appellants' securities fraud claim and the properly adjudicated pendent state law claims of fraud and breach of contract. Accordingly, we instruct the district court to dismiss plaintiffs' complaint with prejudice.

It is so ordered.

NATIONAL BROADCASTING COMPANY, INC., Petitioner,

v.

COPYRIGHT ROYALTY TRIBUNAL, Respondent,

Worldvision Enterprises, Inc., Old Time Gospel Hour, Warner Communications, Inc., et al., Multimedia Entertainment, Inc., Intervenors.

No. 87–1157.

United States Court of Appeals, District of Columbia Circuit.

Argued Feb. 1, 1988.

Decided June 7, 1988.

As Amended June 7 and June 21, 1988.

Television network, creator of syndicated television series and distribution company which owned domestic distribution rights to same series both claimed royalties generated by cable television fees from Copyright Royalty Tribunal. The Tribunal awarded fees to owner of distribution rights. Network sought review. The Court of Appeals, Silberman, J., held that: (1) resolution of dispute between the owners set forth general rule for distribution of cash royalties, rather than adjudicated contractual rights between claimants, and (2) owner of distribution rights was initially entitled to royalties, but network was entitled to review of contract.

Appendix A

Rule Changes

Part 76 of Title 47 of the Code of Federal Regulations is amended to read as follows:

PART 76 – MULTICHANNEL VIDEO AND CABLE TELEVISION SERVICE

1. The authority citation for Part 76 continues to read as follows:
AUTHORITY: 47 U.S.C. 151, 152, 153, 154, 301, 302, 303, 303a, 307, 308, 309, 312, 315, 317, 325, 503, 521, 522, 531, 532, 533, 534, 535, 536, 537, 543, 544, 544a, 545, 548, 549, 552, 554, 556, 558, 560, 561, 571, 572, 573.

Section 76.501 Cross-Ownership

1. Section 76.501 is amended by revising Notes 1, 2, 5 and 6 as follows:

Note 1: Actual working control, in whatever manner exercised, shall be deemed a cognizable interest.

Note 2: In applying the provisions of this section, ownership and other interests in an entity or entities covered by this rule will be attributed to their holders and deemed cognizable pursuant to the following criteria:

(a) Except as otherwise provided herein, partnership and direct ownership interests and any voting stock interest amounting to 5% or more of the outstanding voting stock of a corporation will be cognizable;

(b) Investment companies, as defined in 15 U.S.C. 80a-3, insurance companies and banks holding stock through their trust departments in trust accounts will be considered to have a cognizable interest only if they hold 20% or more of the outstanding voting stock of a corporation, or if any of the officers or directors of the corporation are representatives of the investment company, insurance company or bank concerned. Holdings by a bank or insurance company will be aggregated if the bank or insurance company has any right to determine how the stock will be voted. Holdings by investment companies will be aggregated if under common management.

(c) Attribution of ownership interests in an entity covered by this rule that are held indirectly by any party through one or more intervening corporations will be determined by successive multiplication of the ownership percentages for each link in the vertical ownership chain and application of the relevant attribution benchmark to the resulting product, except that wherever the ownership percentage for any link in the chain exceeds 50%, it shall not be included for purposes of this multiplication. [For example, if A owns 10% of company X, which owns 60% of company Y, which owns 25% of "Licensee," then X's interest in "Licensee" would be 25% (the same as Y's interest since X's interest in Y exceeds 50%), and A's interest in "Licensee" would be 2.5% (0.1 x 0.25). Under the 5% attribution benchmark, X's interest in "Licensee" would be cognizable, while A's interest would not be cognizable.]

(d) Voting stock interests held in trust shall be attributed to any person who holds or shares the power to vote such stock, to any person who has the sole power to sell such stock, and to any person who has the right to revoke the trust at will or to replace the trustee at will. If the trustee has a familial, personal or extra-trust business relationship to the grantor or the beneficiary, the grantor or beneficiary, as appropriate, will be attributed with the stock interests held in trust. An otherwise qualified trust will be ineffective to insulate the grantor or beneficiary from attribution with the trust's assets unless all voting stock interests held by the grantor or beneficiary in the relevant entity covered by this rule are subject to said trust.

(e) Subject to paragraph (i) of this Note, holders of non-voting stock shall not be attributed an interest in the issuing entity. Subject to paragraph (i) of this Note, holders of debt and instruments such as warrants, convertible debentures, options or other non-voting interests with rights of conversion to voting interests shall not be attributed unless and until conversion is effected.

(f)(1) Subject to paragraph (i) of this Note, a limited partnership interest shall be attributed to a limited partner unless that partner is not materially involved, directly or indirectly, in the management or operation of the media-related activities of the partnership and the relevant entity so certifies. An interest in a Limited Liability Company ("LLC") or Registered Limited Liability Partnership ("RLLP") shall be attributed to the interest holder unless that interest holder is not materially involved, directly or indirectly, in the management or operation of the media-related activities of the partnership and the relevant entity so certifies.

(2) In the case of a limited partnership, in order for an entity to make the certification set forth in paragraph (g)(1) of this section, it must verify that the partnership agreement or certificate of limited partnership, with respect to the particular limited partner exempt from attribution, establishes that the exempt limited partner has no material involvement, directly or indirectly, in the management or operation of the media activities of the partnership. In the case of an LLC or RLLP, in order for an entity to make the certification set forth in paragraph (g)(1) of this section, it must verify that the organizational document, with respect to the particular interest holder exempt from attribution, establishes that the exempt interest holder has no material involvement, directly or indirectly, in the management or operation of the media activities of the LLC or RLLP. The criteria which would assume adequate insulation for purposes of these certifications are described in the Memorandum Opinion and Order in MM Docket No. 83-46, FCC 85-252 (released June 24, 1985), as modified on reconsideration in the Memorandum Opinion and Order in MM Docket No. 83-46, FCC 86-410 (released November 28, 1986). Irrespective of the terms of the certificate of limited partnership or partnership agreement, or other organizational document in the case of an LLC or RLLP, however, no such certification shall be made if the individual or entity making the certification has actual knowledge of any material involvement of the limited partners, or other interest holders in the case of an LLC or RLLP, in the management or operation of the media businesses of the partnership or LLC or RLLP.

(3) In the case of an LLC or RLLP, the entity seeking insulation shall certify, in addition, that the relevant state statute authorizing LLCs permits an LLC member to insulate itself as required by our criteria.

(g) Officers and directors of an entity covered by this rule are considered to have a cognizable interest in the entity with which they are so associated. If any such entity engages in businesses in addition to its primary media business, it may request the Commission to waive attribution for any officer or director whose duties and responsibilities are wholly unrelated to its primary business. The officers and directors of a parent company of a media entity, with an attributable interest in any such subsidiary entity, shall be deemed to have a cognizable interest in the subsidiary unless the duties and responsibilities of the officer or director involved are wholly unrelated to the media subsidiary, and a certification properly documenting this fact is submitted to the Commission. The officers and directors of a sister corporation of a media entity shall not be attributed with ownership of that entity by virtue of such status.

(h) Discrete ownership interests held by the same individual or entity will be aggregated in determining whether or not an interest is cognizable under this section. An individual or entity will be deemed to have a cognizable investment if:

(1) The sum of the interests held by or through "passive investors" is equal to or exceeds 20 percent; or

(2) The sum of the interests other than those held by or through "passive investors" is equal to or exceeds 5 percent; or

(3) The sum of the interests computed under paragraph (i)(1) of this section plus the sum of the interests computed under paragraph (i)(2) of this section is equal to or exceeds 20 percent.

(i) Notwithstanding paragraphs (e) and (f) of this Note, the holder of an equity or debt interest or interests in an entity covered by this rule shall have that interest attributed if the equity (including all stockholdings, whether voting or nonvoting, common or preferred, and partnership interests) and debt interest or interests, in the aggregate, exceed 33 percent of the total asset value (all equity plus all debt) of that entity, provided however that:

(1) in applying the provisions of paragraph (i) of this note to § 76.501, § 76.505 and § 76.905(b)(2), the holder of an equity or debt interest or interests in a broadcast station, cable system, SMATV or multiple video distribution provider subject to § 76.501, § 76.505, or § 76.905(b)(2) ("interest holder") shall have that interest attributed if the equity (including all stockholdings, whether voting or nonvoting, common or preferred, and partnership interests) and debt interest or interests, in the aggregate, exceed 33 percent of the total asset value (defined as the aggregate of all equity plus all debt) of that entity; and

(i) the interest holder also holds an interest in a broadcast station, cable system, SMATV, or multiple video distribution provider that operates in the same market, is subject to § 76.501, § 76.505, or § 76.905(b)(2) and is attributable without reference to this paragraph (i); or

(ii) the interest holder supplies over fifteen percent of the total weekly broadcast programming hours of the station in which the interest is held.

(2) For purposes of applying subparagraph (i)(1), the term "market" will be defined as it is defined under the rule that is being applied.

Note 5: Certifications pursuant to this section and these notes shall be sent to the attention of the Cable Services Bureau, Federal Communications Commission, 445 12th Street, N.W. Washington, D.C. 20554.

Note 6: In applying paragraph (a) of § 76.501, no minority voting stock interest will be cognizable if there is a single holder of more than 50% of the outstanding voting stock of the corporation in which the minority interest is held, provided however, that an investor that has an interest under the terms of Note 2(i) of this section shall have that interest attributed.

* * * * *

Section 76.503 National subscriber limits

2. Section 76.503 is amended by adding Note 2 as follows:

Note 1: *Attributable Interest* shall be defined by reference to the criteria set forth in Notes 1-5 to § 76.501 provided however, that:

World Brilliance Corp. v. Bethlehem Steel Co., 342 F.2d 362, 366 (2d Cir.1965).

Every circuit to consider the issue has determined that the "hearing" requirements of Rule 12 and Rule 56 do not mean that an oral hearing is necessary, but only require that a party be given the opportunity to present its views to the court. See *Lujan v. National Wildlife Fed'n*, 497 U.S. 871, 910, 110 S.Ct. 3177, 3200, 111 L.Ed.2d 695 (1990) (Blackmun, J., dissenting) (noting that "[t]he Courts of Appeals consistently have recognized ... that Rule 56 does not necessarily contemplate an oral hearing") (internal quotation marks and citation omitted); see, e.g., *Cray Communications, Inc. v. Novatel Computer Sys.*, 33 F.3d 390, 396 (4th Cir.1994) (oral hearing on summary judgment at discretion of trial court); *Chrysler Credit Corp. v. Cathey*, 977 F.2d 447, 449 (8th Cir.1992) ("hearing" on summary judgment motion may consist of written rather than oral argument); *Arrieta–Gimenez v. Arrieta–Negron*, 859 F.2d 1033, 1042 (1st Cir.1988) (same); *Geear v. Boulder Community Hosp.*, 844 F.2d 764, 766 (10th Cir.1988) (same); *Moore v. Florida*, 703 F.2d 516, 519 (11th Cir.1983) (same); *Allied Chem. Corp. v. Mackay*, 695 F.2d 854, 856 (5th Cir.1983) (per curiam) (same); *Dougherty v. Harper's Magazine Co.*, 537 F.2d 758, 761 (3d Cir.1976) (plaintiff must be given opportunity to be heard, either orally or in writing, prior to Rule 12(b)(6) dismissal); *Dayco Corp. v. Goodyear Tire & Rubber Co.*, 523 F.2d 389, 391 (6th Cir.1975) (Federal Rules do not require oral hearing on motion to dismiss).

[4] Similarly, we find no merit in Greene's claim that a dismissal of a complaint without an oral hearing violates due process. The Supreme Court has held that "the right of oral argument as a matter of procedural due process varies from case to case in accordance with differing circumstances, as do other procedural regulations." *Federal Communications Comm'n v. WJR, The Goodwill Station, Inc.*, 337 U.S. 265, 276, 69 S.Ct. 1097, 1103, 93 L.Ed. 1353 (1949). And the circuit courts that have addressed the question of whether an oral hearing is required on motions to dismiss in civil cases have uniformly held that no oral hearing is required by the Due Process Clause. See, e.g., *United States v. One 1974 Porsche 911–S*, 682 F.2d 283, 286 (1st Cir.1982) ("There is no constitutional right to oral argument on a summary judgment motion."); *Dayco*, 523 F.2d at 391 (denial of an oral hearing before granting a motion to dismiss does not violate "fundamental notions of fairness and due process of law"); *Spark v. Catholic Univ.*, 510 F.2d 1277, 1280 (D.C.Cir.1975) ("due process does not include the right to oral argument on a motion"); *Dredge Corp. v. Penny*, 338 F.2d 456, 464 n. 14 (9th Cir.1964) ("The opportunity to be heard orally on questions of law is not an inherent element of procedural due process, even where substantial questions of law are involved.").

[5] We note that Greene has not shown that he was denied the right to be heard and or the opportunity to present his case in a meaningful way. He filed extensive written arguments with the district court, which allowed him to address the specific issues of law with which the district court was concerned. Under the circumstances, we hold that the decision whether or not to hold an oral hearing on a motion to dismiss lies in the sound discretion of the trial court. And the district court did not abuse its discretion in denying oral argument in the case before us.

* * *

Having considered all of Greene's arguments and found them to be without merit, we affirm the judgment of the district court.

MAGMA POWER COMPANY, Plaintiff–Appellant,

v.

The DOW CHEMICAL COMPANY, Defendant–Appellee.

No. 545, Docket 97–7407.

United States Court of Appeals, Second Circuit.

Argued Oct. 16, 1997.

Decided Feb. 9, 1998.

Corporation brought action against statutory insider, seeking disgorgement of short-swing profits allegedly earned by insider when it satisfied exchange demands pursuant to subordinated exchangeable notes it had issued. The United States District Court for the Southern District of New York, John F. Keenan, J., denied corporation's motion for summary judgment and granted insider's cross-motion for judgment on the pleadings, and corporation appealed. The Court of Appeals, Jacobs, Circuit Judge, held that: (1) insider's decision not to repurchase corporation's securities at market price under subordinated exchangeable notes giving noteholder option to exchange note for fixed number of corporation's shares but permitting insider to satisfy exchange demand by paying market price of shares as of exercise date, was purchase, rather than sale of securities, and (2) even if insider's decision not to repurchase corporation's securities at market price was sale of securities, such sale was exempt from statute requiring disgorgement of short-swing profits.

Affirmed.

1. Securities Regulation ⟹150.1

No showing of actual misuse of inside information or of unlawful intent is necessary to compel disgorgement of short-swing profits under statute compelling statutory insiders to disgorge profits earned on any purchase and sale of securities made within six months of each other. Securities Exchange Act of 1934, § 16(b), 15 U.S.C.A. § 78p(b).

2. Securities Regulation ⟹5.11

"Derivative securities" are financial instruments that derive their value from an underlying security or index.

See publication Words and Phrases for other judicial constructions and definitions.

3. Securities Regulation ⟹5.25(3)

"Option" is purchased right to buy or sell property at fixed or floating price; if not exercised within contractually-specified period, option expires and buyer of option loses acquisition price.

See publication Words and Phrases for other judicial constructions and definitions.

4. Securities Regulation ⟹5.25(3)

"Call option" gives option holder right to buy shares of underlying security at particular price; thus, "call equivalent position" is derivative security position that increases in value as value of underlying equity increases.

See publication Words and Phrases for other judicial constructions and definitions.

5. Securities Regulation ⟹5.25(3)

"Put option" is right to sell security at specified price; thus, value of put option increases as price of underlying security falls.

See publication Words and Phrases for other judicial constructions and definitions.

6. Securities Regulation ⟹5.25(3)

"Put equivalent position" means derivative security position that increases in value as value of underlying equity security decreases.

See publication Words and Phrases for other judicial constructions and definitions.

7. Securities Regulation ⟹53.16(2, 11)

Statutory insider's acquisition of option giving it right to obtain shares of corporation at predetermined price was "purchase" of shares of corporation's common stock for purposes of statute compelling statutory insiders to disgorge profits earned on any purchase and sale of securities made within six months of each other; option was "derivative security" and put insider in a "call equivalent position" because it gave insider right to acquire corporation's shares at fixed price. Securities Exchange Act of 1934, § 16(b), 15 U.S.C.A. § 78p(b); 17 C.F.R. §§ 240.16a–1(b, c), 240.16b–6(a).

See publication Words and Phrases for other judicial constructions and definitions.

8. Securities Regulation ⟹53.16(11)

Component options granted by subordinated exchangeable notes issued by statutory insider, giving noteholder option to exchange note for fixed number of corporation's shares, but permitting insider to satisfy exchange demand by paying market price of shares as of exercise date, were required to be analyzed separately in determining whether insider sold corporation's stock for purposes of statute requiring disgorgement of short-swing profits when insider delivered shares to its noteholders in exchange for their notes and declined to exercise its option to pay market value of corporation's shares. Securities Exchange Act of 1934, § 16(b), 15 U.S.C.A. § 78p(b).

9. Securities Regulation ⟹53.16(2)

Statutory insider's issuance of subordinated exchangeable notes, giving noteholder option to exchange note for fixed number of corporation's shares, amounted to "sale" of corporation's shares for purposes of statute requiring disgorgement of short-swing profits; issuance of notes established "put equivalent position" that was deemed sale under applicable regulations. Securities Exchange Act of 1934, § 16(b), 15 U.S.C.A. § 78p(b); 17 C.F.R. § 240.16b–6(a).

See publication Words and Phrases for other judicial constructions and definitions.

10. Securities Regulation ⟹53.16(2)

Statutory insider's decision not to repurchase corporation's securities at market price under subordinated exchangeable notes giving noteholder option to exchange note for fixed number of corporation's shares but permitting insider to satisfy exchange demand by paying market price of shares as of exercise date, was purchase, rather than sale of securities for purposes of statute requiring disgorgement of short-swing profits. Securities Exchange Act of 1934, § 16(b), 15 U.S.C.A. § 78p(b).

11. Securities Regulation ⟹53.16(1)

Insider's inactivity cannot give rise to liability under statute requiring disgorgement of short-swing profits. Securities Exchange Act of 1934, § 16(b), 15 U.S.C.A. § 78p(b).

12. Securities Regulation ⟹53.17(1)

Even if statutory insider's decision not to repurchase corporation's securities at market price under subordinated exchangeable notes giving noteholder option to exchange note for fixed number of corporation's shares but permitting insider to satisfy exchange demand by paying market price of shares as of exercise date, was sale of securities, such sale was exempt from statute requiring disgorgement of short-swing profits; regulation exempting offsetting transactions when date price is fixed is not known in advance applied, since date exchange demand became fixed was entirely in control of third parties. Securities Exchange Act of 1934, § 16(b), 15 U.S.C.A. § 78p(b); 17 C.F.R. § 240.16b–6(a).

Jeanne M. Luboja, New York City (Joanne M. Chormanski, Michael McIlwrath, Willkie Farr & Gallagher, on the brief), for Plaintiff–Appellant.

Jonathan C. Medow, New York City (Bennett W. Lasko, Richard A. Spehr, Mayer, Brown & Spehr, on the brief), for Defendant–Appellee.

Before: JACOBS and LEVAL, Circuit Judges and RESTANI, Judge.*

JACOBS, Circuit Judge.

Magma Power Company ("Magma") sues under Section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78p(b) ("Section 16(b)"), to capture short-swing profits allegedly earned on trading in Magma stock by The Dow Chemical Co. ("Dow"), which was a statutory insider at the relevant times. The task of matching transactions for the purpose of detecting profits subject to disgorgement under Section 16(b) is ordinarily mechanical; here, because the underlying transactions include a derivative security, the analysis is less straightforward.

At issue are various Dow transactions involving Magma stock. In one transaction, Dow issued subordinated exchangeable Notes with an option in the noteholder to exchange the Notes at any time prior to maturity for a fixed number of Magma shares, *i.e.*, a call equivalent option. The Notes also permitted Dow to satisfy an exchange demand by paying the market price of those shares as of the exercise date rather than delivering the shares themselves. In November and December 1994, many noteholders tendered their Notes in exchange for Magma shares. Dow delivered Magma shares rather than their purchase price. The other set of transactions—an accounting-driven sale of Magma shares with an option in Dow to re-purchase the same shares at the same price—took place in September, 1994. That was more than six months after the issuance of the subordinated exchangeable Notes, and within six months before the time that Dow elected to satisfy the noteholders' exchange demands in stock rather than cash. Magma alleges that for Section 16(b) purposes, Dow's election to satisfy the exchange demands by transfer of Magma stock in the one transaction amounted to a sale that should be matched against Dow's purchase (within six months) of the option to re-purchase Magma shares in the other transaction.

The United States District Court for the Southern District of New York (Keenan, J.) granted judgment on the pleadings in favor of Dow. We affirm.

BACKGROUND

At all pertinent times, Dow owned at least 10% of the common stock of Magma and was the largest minority shareholder.

A. The Issuance of the Notes.

In April 1991, Dow sold to the public $150 million in subordinated exchangeable Notes, which were exchangeable at any time prior to maturity (in the year 2001), at the noteholder's option, for a fixed number of shares of Magma (the "Notes"). Under the terms of the Indenture, each $1000 Note was exchangeable for 26–2/3 Magma shares, meaning that each noteholder had an option to acquire Magma stock at the fixed price of $37.50 per share ($1000 divided by 26–2/3 shares). Simultaneously with the issuance of the Notes, Dow deposited approximately 4,000,000 shares of Magma stock into escrow ($150 million divided by $37.50). In the event of an exchange, the Indenture afforded Dow the option of paying the noteholders (in lieu of the shares) cash equal to the market value of the 26–2/3 shares on the date that the escrow agent received the noteholder's notice of exchange. In other words, to the extent that Dow is viewed as having sold Magma stock when it issued the Notes exchangeable into Magma shares, it might be viewed as having retained the option of reacquiring the shares that were subject to the exchange by paying the noteholders the market price prevailing at the time of exchange.[1]

B. The Garantia Option: Purchase and Sale.

On September 12, 1994—in an unrelated transaction—Dow sold 857,143 shares of Magma common stock to Garantia Banking Limited at the then-current market price of $28.25 per share; Dow simultaneously purchased from Garantia (for $150,000) an option to reacquire those same shares at the same price ("the Garantia Option"). Within three weeks, on September 30, 1994, Dow exercised its option and reacquired the 857,143 shares. This maneuver was apparently undertaken in order to reconcile a mismatch between the book basis and tax basis for these shares.

C. The Exchange of the Notes.

The value of the noteholders' exchange rights rose with the share price of Magma stock. In late 1994, California Energy Company, Inc., n/k/a CalEnergy Company, Inc. ("California Energy"), made an unsolicited tender offer for Magma shares at $38.50 per share—one dollar above the fixed per-share exchange price. Between November 21, 1994 and December 29, 1994, many holders of the Notes reacted by serving demands of exchange pursuant to their option to exchange the Notes for the (appreciated) Magma shares. In response, Dow delivered 882,259 shares of Magma to tendering noteholders. It did not exercise its option to retain the Magma stock and pay its market value to the tendering noteholders. It is these transactions that Magma seeks to match against Dow's purchase pursuant to the Garantia Option; therefore, Magma is entitled to a recovery under Section 16(b) only if it can demonstrate that these transac-

* Hon. Jane A. Restani, of the United States Court of International Trade, sitting by designation.

1. Magma has coined the term "embedded option" to describe Dow's right to satisfy the exchange via cash rather than stock; it is not a term of art in law or finance.

tions constituted a sale within the meaning of the statute.

D. The Take–Over of Magma.

Through its tender offer, California Energy succeeded in acquiring a controlling interest in Magma. On February 24, 1995, California Energy completed its takeover by merging Magma into a wholly-owned subsidiary of California Energy. The merger extinguished all minority interests in Magma, including Dow's. The merger terms obligated Magma (as wholly owned subsidiary of California Energy) to compensate Dow for its minority interest. Magma sought to avoid the multi-million dollar payment, however, on the ground that Dow owed Magma a disgorgement under Section 16(b), and Magma unilaterally proceeded to "withhold and segregate in a separate escrow account that portion of the cash merger consideration which constitutes the ... 'short-swing' profits." Magma's Complaint for Declaratory Relief and Damages, at ¶ 10.

E. The Litigation.

Magma thereafter sued Dow, seeking a declaration endorsing its interpretation of Section 16(b), and Dow counterclaimed for the escrowed funds. Magma later released the funds, and the parties stipulated to a dismissal of Dow's counterclaim and to the recasting of Magma's claim for declaratory relief as a claim for money damages. Magma moved for partial summary judgment on its first cause of action, which sets forth the theory of liability that forms the subject of this appeal; Dow cross-moved for judgment on the pleadings.

On January 21, 1997, the district court entered an order denying Magma's motion and granting judgment on the pleadings in favor of Dow. Recognizing that further amendment could not cure the defects in Magma's complaint, the district court dismissed the first cause of action with prejudice. Following the parties' stipulation to dismissal with prejudice of the remaining causes of action, the district court entered final judgment in Dow's favor on March 3, 1997. We affirm on some of the same grounds adopted by the district court.

DISCUSSION

A. Section 16(b).

As a "beneficial owner" of more than ten percent of the common stock of Magma, *see* 15 U.S.C. § 78p(a) (1994), Dow was an insider subject to Section 16(b) of the Exchange Act:

> For the purpose of preventing the unfair use of information which may have been obtained by *such beneficial owner*, director, or officer by reason of his relationship to the issuer, *any profit realized* by him from any purchase and sale, or *any sale and purchase*, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be *recoverable by the issuer*, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months.

15 U.S.C. § 78p(b) (1994) (emphasis added). Section 16(b) thus compels statutory insiders to disgorge profits earned on any purchase and sale (or sale and purchase) made within six months of each other. Congress intended this strict liability provision to remove any temptation for insiders to engage in transactions which "may serve as a vehicle for the evil which Congress sought to prevent—the realization of short-swing profits based upon access to inside information." *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582, 594, 93 S.Ct. 1736, 1744, 36 L.Ed.2d 503 (1973).

[1] No showing of actual misuse of inside information or of unlawful intent is necessary to compel disgorgement. *See Foremost–McKesson, Inc. v. Provident Sec. Co.*, 423 U.S. 232, 251, 96 S.Ct. 508, 519, 46 L.Ed.2d 464 (1976); *Reliance Elec. Co. v. Emerson Elec. Co.*, 404 U.S. 418, 424 n. 4, 92 S.Ct. 596, 600 n. 4, 30 L.Ed.2d 575 (1972). Section 16(b) operates mechanically, and makes no moral distinctions, penalizing technical violators of pure heart, and bypassing corrupt

insiders who skirt the letter of the prohibition. "Such is the price of easy administration." Robert Charles Clark, *Corporate Law* 295–96 (1986). Congress believed that such a blunt instrument was the only way to control insider trading:

> [T]he only remedy which [Section 16(b)'s] framers deemed effective for this reform was the imposition of a liability based upon an objective measure of proof.... "You hold the director, irrespective of any intention or expectation to sell the security within six months after, because it will be absolutely impossible to prove the existence of such intention or expectation, and you have to have this crude rule of thumb, because you cannot undertake the burden of having to prove that the director intended, at the time he bought, to get out on a short swing."

Smolowe v. Delendo Corp., 136 F.2d 231, 235–36 (2d Cir.1943) (quoting Rep. Corcoran, chief spokesman for the drafters and proponents of the Act). "In short, this statute imposes liability without fault [but only] within its narrowly drawn limits." *Foremost–McKesson*, 423 U.S. at 251, 96 S.Ct. at 519.

B. The Application of Section 16(b) to Derivative Securities.

[2–6] One feature of the Notes is functionally the equivalent of a call option in the noteholder, the value of which is pegged to the price of Magma stock; the Notes are therefore derivative securities, *i.e.*, financial instruments that derive their value (hence the name) from an underlying security or index. In 1991, the SEC adopted comprehensive amendments to its rules and forms under Section 16(b) in order to clear up uncertainties as to how that section applies to derivative securities, including options.[2] *See* Ownership Reports and Trading by Officers, Directors and Principal Security Holders, Exchange Act Release No. 28,869, [1990–1991 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 84,709, at 81,258 (Feb. 8, 1991) ("Release No. 28869"). The amendments reflect the SEC's "recogni[tion] that holding derivative securities is functionally equivalent to holding the underlying equity securities for purposes of Section 16, since the value of the derivative securities is a function of or related to the value of the underlying equity security." *Id.* The SEC was concerned that unless this functional equivalence were recognized and accounted for, insiders could "evade disgorgement of short-swing profits simply by buying call options and selling the underlying stock, or buying underlying stock and buying put options." *Id.*

Rule 16a–1(c), as revised, defines "derivative securities" as "any option, warrant, convertible security, stock appreciation right, or similar right with an exercise or conversion privilege at a price related to an equity security, or similar securities with a value derived from the value of an equity security." 17 C.F.R. § 240.16a–1(c) (1997). The definition expressly excludes "[r]ights with an exercise or conversion privilege at a price that is not fixed." 17 C.F.R. § 240.16a–1(c)(6) (1997). The exclusion ends when the exercise or conversion price becomes fixed. *See* Release No. 28869, at 81,265 ("[A] right with a floating exercise price ... will not be deemed to be acquired or purchased, for Section 16 purposes, until the purchase price of the underlying securities becomes fixed or established, which commonly occurs at exercise.").

The equivalence drawn by the SEC between derivative securities and the underlying equity securities is reflected in a parallel revision made by the SEC to its Rule 16b–6, so that the *acquisition* of a fixed-price option—rather than its *exercise*—is the trigger-

2. An option, the type of derivative at issue here, is a purchased right to buy or sell property at a fixed or floating price. John Downes and John Elliot Goodman, *Dictionary of Financial and Investment Terms* at 390 (1995). If not exercised within the contractually-specified period, an option expires and the buyer of the option loses the acquisition price. A call option gives the option holder the right to buy shares of an underlying security at a particular price; thus, "[a] 'call equivalent position' is a derivative security position that increases in value as the value of the underlying equity increases." 3C Harold S. Bloomenthal and Samuel Wolff, *Securities and Federal Corporate Law* § 10.11 at 10.73 (1997). A put option is the right to sell a security at a specified price; thus, the value of a put option increases as the price of the underlying security falls. "[A] 'put equivalent position,' ... means a derivative security position that increases in value as the value of the underlying equity security decreases." *Id.* at 10.74.

ing event for Section 16(b) purposes. Rule 16b–6(a) provides that

> [t]he establishment of or increase in a call equivalent position [which includes an option to purchase at a fixed price] or liquidation of or decrease in a put equivalent option [which includes an option to sell a security at a fixed price] shall be deemed a purchase of the underlying security for purposes of section 16(b) of the Act, and the establishment of or increase in a put equivalent position or liquidation of or decrease in a call equivalent position shall be deemed a sale of the underlying securities for purposes of section 16(b) of the Act.

17 C.F.R. § 240.16b–6(a) (1997). Under this rule, the acquisition or disposition of a derivative security with a fixed exercise price is treated just as if the insider had traded the underlying security itself. The prophylactic purposes of Section 16(b) are thus served because the "insider's opportunity to profit" by access to nonpublic information "commences ... when the insider engages in options or other derivative securities that provide an opportunity to obtain or dispose of the stock at a fixed price." Release No. 28869, at 81,258. In essence, an insider who takes an option position is making a bet on the future movement of the price of the underlying securities; the odds in the insider's favor are foreshortened if the wager is backed by inside information. Because the acquisition or disposition of the option is the point at which the inside information may be advantageous, the SEC's regime regards it as the triggering event under Section 16(b).

By the same token, the exercise of a fixed-price option is a non-event for 16(b) purposes. Rule 16b–6(b) provides that

> [t]he closing of a derivative security position as a result of its exercise or conversion shall be exempt from the operation of section 16(b) of the Act, and the acquisition of underlying securities at a fixed exercise price due to the exercise or conversion of a call equivalent position or the disposition of underlying securities at a fixed exercise price due to the exercise of a put equivalent position shall be exempt from the operation of section 16(b) of the Act.

17 C.F.R. § 240.16b–6(b) (1997). The SEC thus treats the exercise of a fixed-price option as nothing more than a change from an indirect form of beneficial ownership of the underlying securities to a more direct one; because the insider by then is already bound by the terms of the option, the potential for abuse of inside information is minimal.

One other revised provision is potentially implicated: Rule 16b–6(a) provides that "the fixing of the exercise price of a right initially issued without a fixed price, where the date the price is fixed is not known in advance and is outside the control of the recipient ... shall be exempt from section 16(b) of the Act with respect to any offsetting transaction within the six months prior to the date the price is fixed." 17 C.F.R. § 240.16b–6(a) (1997). This exemption avoids the unfairness of subjecting insiders to liability under Section 16(b) who engage in a purchase or sale and then have an offsetting sale or purchase thrust upon them thereafter by events "not known in advance" and "outside the[ir] control." *Id.; see* Release No. 28869, at 81,265.

C. *The Application of Section 16(b) to the Dow Transactions.*

In order to recover any short-swing profits realized by Dow, Magma must prove (1) that Dow was a statutory insider; (2) that Dow made a purchase; and (3) that within six months Dow made an offsetting sale. The first two elements are not in dispute. Dow concedes that it was a statutory insider because as of September 12, 1994, it beneficially owned 20.9% of Magma's outstanding shares and, at all times between September 12 and December 29, 1994, it beneficially owned more than 10% of the outstanding shares.

[7] Dow further agrees that its acquisition of the Garantia Option on September 12, 1994 constituted a "purchase" of 857,143 shares of Magma common stock. The Garantia Option came within the definition of a "derivative security" and put Dow in a "call equivalent position" because it gave Dow the right to acquire the Magma shares at the fixed price of $28.25 per share. *See* 17 C.F.R. 240.16a–1(b) and (c). The establishment of a "call equivalent position" constitutes a purchase of the underlying security for purposes of Section 16(b). *See* 17 C.F.R. § 240.16b–6(a). Because Dow had the right to obtain 857,143 shares of Magma at a predetermined price, Dow purchased those shares within the meaning of Section 16(b) when it entered into the option contract on September 12, 1994.

The crucial issue in this appeal relates to the third element of the alleged 16(b) offense—whether Dow sold Magma shares within six months at a profit in a transaction that can be matched against its purchase (through the Garantia option) on September 12, 1994. Magma contends that the transactions in November and December 1994—when Dow delivered Magma shares to its noteholders in exchange for their Notes and declined to exercise its option to pay the market value of the Magma shares instead of delivering them—constituted a sale within six months of the Garantia purchase by which Dow realized an illegal short-swing profit.

Were it not for the feature that gave Dow the option to deliver either Magma stock or its market value in cash—in other words, if the exchangeability feature of the Dow Notes required Dow simply to deliver 26–2/3 shares of Magma stock for every $1000 face amount of Notes—Dow's delivery of the Magma stock obviously would not constitute a sale under Section 16(b). That is because Rule 16b–6(b) provides that "the closing of a derivative security position as a result of its exercise or conversion shall be exempt from the operation of Section 16(b)." 17 C.F.R. § 240.16b–6(b). Instead, it is the "establishment of ... a put equivalent position ... [that] shall be deemed a sale of the underlying securities for purposes of Section 16(b)." 17 C.F.R. § 240.16b–6(a). Under these regulations, Dow's delivery of Magma stock would simply close out its put-equivalent position created at the time of the issuance of the exchangeable Notes, and would not constitute a sale under Section 16(b).

[8] Magma argues that the option feature permitting Dow to retain the Magma stock and instead pay its noteholders the market price prevailing at the time of the exchange transforms the exchange with the noteholders into a sale by Dow at a price higher than its Garantia purchase. Magma expresses this argument on appeal in tripartite form: (1) that the Notes must be treated as a single instrument, the sale of which can only occur at a single point in time; (2) that no sale took place in 1991 because the presence of the floating price option retained by Dow took the Notes outside the category of derivative securities; and (3) that the "sale" therefore took place in November and December of 1994 when (after the noteholders exercised their exchange rights) Dow exercised the option to provide the shares instead of cash. According to Magma, Dow had the opportunity to abuse its insider status at this time because Dow could retain the Magma shares if it anticipated a further rise in stock prices or release the shares to converting noteholders if it anticipated that prices were likely to fall. Without adducing authority for its precise position,[3] Magma construes Rule 16b–6 to mean that *all* options arising out of the same instrument must have a fixed exercise price before the creation of any of the constituent options can be deemed a sale. This approach—treating the instrument rather than the component options as the relevant unit for 16(b) purposes—is problematic.

The recent amendments demonstrate the SEC's efforts to foreclose the use of transactions in derivatives as vehicles for evading Section 16(b) liability by avoiding transactions in the underlying equity securities themselves. Adoption of Magma's proposed interpretation would open a wide loophole for insiders who wish to hold onto their short-swing gains. An insider holding recently purchased shares with confidential knowledge of imminent bad news could, under Magma's analysis, obtain a fixed price put option, coupled with an option to satisfy the buyer of the securities by providing, at the insider's sole election, cash equivalent to the market value at the time of exercise, instead of the shares. Under Magma's analysis, the option to deliver cash—even if inserted with

3. Magma points to a no-action letter issued by the SEC as supportive of its position in an analogous context. *See* Midlantic Corp., SEC No-Action Letter, [1990–1991 Transfer Binder] Fed. Sec.L.Rep. (CCH) ¶ 79,674 (Apr. 19, 1991).

no intent to exercise it, but simply to avoid a sale under 16(b)—means that a subsequent purchase within six months, at a lower price, can lock in a profit (i.e., the difference between the terms of the put option and the purchase price of the shares) that escapes Section 16(b) because no sale is available to match against this purchase. The creation of the put option, in Magma's view, is not a sale because of the presence of the floating price call option. Thus, as long as the insider holds out beyond six months from his last purchase of shares to exercise his put option, he is home free.

No rule is impregnable; but we decline to offer insiders an opportunity to avoid Section 16(b) that poses so little challenge to ingenuity. The better approach is to treat as analytically distinct each option contained in the kind of complex instrument at issue here. Here, the Notes contained two options: a fixed price option granted to the noteholders, and a floating price option retained by Dow that enabled Dow effectively to reacquire the shares in question by paying cash equal to their market value at the time of the exchange. We analyze each component of the instrument in turn.

1. *The Option Granted to the Noteholders.*

[9] Dow's issuance of the Notes in 1991 amounted to the "sale" (at that time) of the corresponding shares of Magma. The establishment of a "put equivalent position" is deemed a sale for Section 16(b) purposes under Rule 16b-6(a). The Notes issued in 1991 placed Dow in a "put equivalent position," because Dow's position moved inversely with Magma's stock price: the higher the market price of the stock, the more costly Dow's obligations would be in the event of an exchange demand, and vice versa. If the price of Magma stock rose above $37.50 per share, the noteholders could compel Dow to retire the $1000 Notes with assets worth more than $1,000.

Midlantic Corp., SEC No-Action Letter, [1990-1991 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 79,674 (Apr. 19, 1991), is not to the contrary. The SEC concluded in *Midlantic* that the Notes in question there were not derivative securities because their conversion price was not fixed. Like the Notes here, the Midlantic Notes were exchangeable for stock or cash, at the issuer's sole discretion. But the instrument in *Midlantic* did not specify in advance the number of shares that each noteholder would receive upon conversion; so the Midlantic option was a genuinely floating option, and as such it was outside the SEC's definition of derivative securities. *See* 17 C.F.R. § 240.16a-1(c)(6) (1997). Here, each $1,000 Note was exchangeable for 26-2/3 shares of Magma stock, so that Dow granted the noteholders a fixed-price option to acquire Magma shares at $37.50 each and, for Section 16(b) purposes, "sold" the shares at that price, as the district court correctly determined, *in 1991*. The noteholders' exercise of their fixed-price options *in 1994* was a non-event for Section 16(b) purposes, *see* 17 C.F.R. § 240.16b-6(b) (1997), because at that time the parties were bound by the contractual terms of the option.

2. *The Option Retained by Dow.*

[10] A separate examination of the nature of the option retained by Dow and Dow's actions (or, more accurately, inactivity) pursuant to the terms of that option reveals no basis for the imposition of Section 16(b) liability. No offsetting sale of Magma shares took place within six months of the Garantia transaction.

(a) *The Nature of Dow's Option.*

The option that Dow retained for itself when it issued the Notes in 1991 was not an option to sell the shares at a floating price; rather, it was only the right to (as it were) repurchase the shares that it was otherwise obligated to deliver by paying the noteholders *the market price prevailing at the time of receipt of the exchange demand.* Magma emphasizes the (conceded) floating nature of this option; undoubtedly it was a floating price option, but it was a floating price *call* option. In other words, Magma's claim under Section 16(b) mismatches a purchase against a purchase. Putting this purchase at a price exceeding $37.50 per share together with Dow's September purchase at the price of $28.25 per share would not create a liability under 16(b), because a pair of purchases are not offsetting transactions within Section 16(b). *See* Clark, *supra,* at 295-95 ("16(b) requires at least *two* transactions within six months: a purchase followed by a sale or a sale followed by a purchase."); *see also* 15 U.S.C. § 78p(b) (compelling disgorgement of profits from "any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months").

(b) *The Decision Not to Purchase.*

[11] Further, Dow in fact never exercised its option to buy back the Magma shares. Magma characterizes the decision by Dow to deliver the shares instead of the cash—*i.e.,* its decision not to exercise its option to repurchase the shares—as a sale. A failure to purchase, however, is not a sale. Were this not the case, virtually every insider transaction could give rise to liability. Every day, an insider has the opportunity to buy shares at the market price. If the foregoing of that opportunity constitutes a sale, then every occasion upon which the market for the stock exceeds the purchase price within six months of an insider purchase, the insider would be deemed to have sold at such higher prices, creating illegal profit. The settled rule is that an insider's inactivity cannot give rise to Section 16(b) liability. *See Blue Chip Stamps v. Manor Drug Stores,* 421 U.S. 723, 737-38, 95 S.Ct. 1917, 1926, 44 L.Ed.2d 539 (1975) (holding that the failure to enter into a voluntary securities transaction is neither a purchase nor a sale under the federal securities laws). Many times every trading day, an insider may decide *not* to purchase further shares in light of inside information that the share price is likely to decline, or decide *not* to sell portfolio shares in light of inside information that the share price is likely to rise. But such passivity is not a transaction for purposes of Section 16(b), which restricts insiders' trading, not their forbearance.

(c) *The Regulations Exempting the Transaction.*

[12] Even if Magma succeeded in convincing us that what occurred in November and December, 1994 was a sale, Magma still could not compel Dow to disgorge any profits arising from that "sale," because, as the district court correctly held, such a sale would be exempt from the operation of Section 16(b).

The SEC has settled the issue in its Rule 16b-6(a), which provides that "the fixing of the exercise price of a right initially issued without a fixed price, where the date the price is fixed is not known in advance and is outside the control of the recipient ... shall be exempt from section 16(b) of the Act with respect to any offsetting transaction within the six months prior to the date the price is fixed." 17 C.F.R. § 240.16b-6(a) (1997). This case fits within that exemption.

Magma argues that "[w]hile the timing of Noteholders' requests to convert their Notes certainly required Dow to give consideration to how it would exercise its rights under the embedded option, Dow completely retained control over the time at which the price of that option would cease to float by retaining absolute and sole control over the decision of whether to provide converting Noteholders with cash or Magma shares." Brief of Plaintiff-Appellant Magma Power Co., at 28. Under the Indenture, however, the value of Dow's retained option became fixed on the date the noteholder's demand was received, and Dow had fourteen days to provide the shares or the cash. The noteholders were entitled under the Indenture to demand exchange *at any time* up to 2001, a decision over which Dow had no control. (They did so within six months of the Garantia purchase, evidently because California Energy's tender offer had run up the price of Magma's stock to a level that made exercise of their exchange rights worthwhile.) Because the value of Dow's option to satisfy the exchange demands became fixed on the date that the exchange demand was received, *see* Section 13.14 of Indenture, an event entirely in the control of third parties, we agree with the district court that the exemption prevents the imposition of Section 16(b) liability.

CONCLUSION

For the foregoing reasons, Dow did not violate Section 16(b). The district court's denial of Magma's motion for summary judgment and its grant of Dow's cross-motion for judgment on the pleadings are therefore affirmed.

Donald GALLO, Plaintiff–Appellee,

v.

Thomas MADERA, Anthony Napolitano, Maurice Foley, Alfred Gerosa, Michael Melnick and Fred C. Stoll, Trustees of the Cement and Concrete Workers District Council of New York Pension Fund, Defendants–Appellants.

No. 1006, Docket 97–7815.

United States Court of Appeals,
Second Circuit.

Argued Jan. 30, 1998.

Decided Feb. 10, 1998.

Retirement plan participant brought action for benefits against trustees of Employee Retirement Income Security Act (ERISA) plan. The District Court, Denis R. Hurley, J., entered summary judgment for participant. Trustees appealed. The Court of Appeals, Calabresi, Circuit Judge, held that: (1) trustees abused their discretion in concluding that plan section outlining calculation of enhanced retirement benefits imported break-in-service provision from another plan section, and (2) trustees acted arbitrarily and capriciously in interpreting plan section governing deferred pension status as providing that participant's benefits for period prior to break in service should be calculated under formula applicable to deferred pension status even though participant rejoined employer after break.

Affirmed.

1. Pensions ⇐122

ERISA plan trustees abused their discretion in concluding that retirement plan section outlining calculation of enhanced retirement benefits imported break-in-service provision from plan section providing that participant electing to retire after 25 years of "current" service was entitled to early retirement benefits only if participant had not incurred two-year break in service; neither latter section nor explanatory note contained any reference to break in service. Employee Retirement Income Security Act of 1974, § 502(a)(1)(B), 29 U.S.C.A. § 1132(a)(1)(B).

2. Pensions ⇐139

ERISA plan trustees are entitled to deference as to grant or denial of benefits when terms of plan afford them discretionary authority over benefits. Employee Retirement Income Security Act of 1974, § 502(a)(1)(B), 29 U.S.C.A. § 1132(a)(1)(B).

3. Pensions ⇐122

ERISA plan trustees acted arbitrarily and capriciously in interpreting plan section, providing that participant with break in service would be deemed to be on deferred pension status and would retain vested interest in accrued benefit, but that participant upon returning to work would be deemed active employee and continue to increase accrued benefit, as providing that participant's benefits for period prior to break should be calculated under formula applicable to deferred pension status even though participant rejoined employer after break; section's plain language allowed participant to rejoin plan and end deferred status upon returning to work. Employee Retirement Income Security Act of 1974, § 502(a)(1)(B), 29 U.S.C.A. § 1132(a)(1)(B).

4. Federal Civil Procedure ⇐928

On ERISA plan trustees' motion for reconsideration, district court was not required to address argument that enhancement of participant's pension benefits was barred by plan section governing deferred pension status; although trustees maintained in moving for reconsideration that such argument was "linchpin" of their case, they had previously mentioned such section only in some supporting affidavits to their motion papers. Employee Retirement Income Security Act of 1974, § 502(a)(1)(B), 29 U.S.C.A. § 1132(a)(1)(B).

5. Federal Courts ⇐753

Although district court did not err in refusing to consider on motion for reconsideration ERISA plan trustees' argument that enhancement of participant's pension benefits was barred by plan section governing deferred pension status, Court of Appeals would consider such argument on appeal of grant of summary judgment in favor of participant, as part of its duty to consider record as a whole in determining presence of genuine issues of material fact; trustees maintained that such argument was "linchpin" of their case, and district courts were split on the issue. Employee Retirement Income Security Act of 1974, § 502(a)(1)(B), 29 U.S.C.A. § 1132(a)(1)(B); Fed.Rules Civ.Proc.Rule 56(c), 28 U.S.C.A.

6. Pensions ⇐139

Even when trustees of pension plan are entitled to deference in interpreting terms of plan, deference cannot be so broad as to permit them to graft additional requirements onto unambiguous plan definitions. Employee Retirement Income Security Act of 1974, § 2 et seq., 29 U.S.C.A. § 1001 et seq.

7. Pensions ⇐139

ERISA plan participant did not convert his action for benefits into action for breach of fiduciary duty merely by mentioning breach of fiduciary duty in one of his counts. Employee Retirement Income Security Act of 1974, §§ 404(a), 502(a)(1)(B), (a)(2), 29 U.S.C.A. §§ 1104(a), 1132(a)(1)(B), (a)(2).

K. Dean Hubbard, Jr., Eisner & Hubbard, P.C., New York City, for Plaintiff-Appellee.

Angelo R. Bisceglie, Bisceglie & Friedman, P.C., Newark, NJ, for Defendants–Appellants.

Before: CALABRESI, CABRANES, and HEANEY,* Circuit Judges.

CALABRESI, Circuit Judge:

Defendants-appellants, various officials overseeing an employees' retirement fund under ERISA, appeal from the denial of their motion for summary judgment, the denial of their post-trial motion for reconsideration, and the grant of summary judgment for plaintiff-appellee Donald Gallo. Because we find no error in the district court's analysis, we affirm substantially for the reasons stated by the District Court (Denis R. Hurley, *Judge*). We write, however, to address a conflict between two district courts within our circuit concerning interpretation of the very same pension plan. We are not unmindful of the fact that the specific argument relied upon in the conflicting case, *Meagher v. Cement and Concrete Workers District Council Pension and Welfare Fund,* 1992 WL 75128 (S.D.N.Y. Mar. 30, 1992), was not directly passed on by the court below. But on appellants' insistence—since they claim that the district court abused its discretion in not addressing that argument—and to resolve the inter-court split, we reach, and ultimately reject, the *Meagher* theory.

1.

The opinion below offers a succinct summary of the terms of the plan. Article Two, "Eligibility for Pensions," provides for three different types of pension: regular (§ 201), disability (§ 206), and early (§ 207). (An employee opting for early retirement, depending on her length of service, may have to take a reduced pension. § 208.) Article Three, "Amount of Pension Benefits," essentially provides for two levels of pension benefits, which, for convenience, we will call "basic" and "enhanced." Eligibility for the different levels of benefits under Article Three are outlined in the first and second paragraphs, respectively, of § 302(a).[1]

Under § 207, there are three ways an employee can take early retirement, *i.e.* re-

* The Honorable Gerald W. Heaney, Circuit Judge of the United States Court of Appeals for the Eighth Circuit, sitting by designation.

1. Enhanced benefits are actually calculated in accord with formulae set forth in Paragraphs 2 and 3 of § 302(a). For simplicity, we will refer to enhanced benefits as being calculated under Paragraph 2.

right, nor the additional constitutional grounds raised.

The parties and the court agree that the controlling case, or at least the most relevant United States Supreme Court opinion, is *Kelley v. Johnson,* 425 U.S. 238, 96 S.Ct. 1440, 47 L.Ed.2d 708 (1976). The *Kelley* Court held that a state subdivision could constitutionally restrict facial hair of its male police officers because of its strong interest in having law enforcement personnel present a uniform appearance to the public. Whether the goal of this similarity was ready public recognition or the fostering of an esprit de corps, facial hair prohibitions were a rational means of achieving these legitimate objectives. *Id.* at 248, 96 S.Ct. at 1446. The defendants contend that *Kelley* bars the relief sought by plaintiff in the instant case since Nalley is a county employee.

The Fifth Circuit has held that a public school teacher's liberty interests were not infringed when he was terminated for refusing to shave a beard. *Ball v. Board of Trustees of the Kerrville Independent School Dist.,* 584 F.2d 684 (5th Cir. 1978). The Court of Appeals found in that case that no substantial federal question was present and that the claim was frivolous. Judge Godbold's concurrence to the opinion pointed out that the Supreme Court in *Kelley* had not found for the county government because the policeman's claim was frivolous, but because his liberty and expression interests were outweighed by the state's law enforcement goals. Judge Godbold supported the Kerrville schools because the teacher had already substantially prevailed on his claim in the state courts by an award of full salary for the year in question.[2]

The present case offers few of the justifications for hair and other personal appearance regulations that are found in the cases of policemen and teachers. County road crews need not have an esprit de corps and whether the public instantly recognizes them as road maintenance personnel is of little importance, even assuming that hair length regulations would foster such spirit and recognition.

There is no question that the burden of proving a statute unconstitutional is on the party challenging its validity. *Kelley,* 425 U.S. at 247–48, 96 S.Ct. at 1445–1446. But to set a burden of proof on plaintiffs by presuming legislation constitutional, as the Supreme Court has done, is not to mandate a finding of constitutionality. The instant regulation is so unconnected to any legitimate state goal that it cannot be applied as it was here.

Mr. Justice Powell, concurring in the *Kelley* decision, wrote that he found

> no negative implication in the opinion with respect to a liberty interest within the Fourteenth Amendment as to matters of personal appearance.... When the State has an interest in regulating one's personal appearance, as it certainly does in this case, there must be a weighing of the degree of infringement of the individual's liberty interest against the need for the regulation. This process of analysis justifies the application of a reasonable regulation to a uniformed police force that would be an impermissible intrusion upon liberty in a different context.

425 U.S. at 249, 96 S.Ct. at 1447. *See also East Hartford Educ. Ass'n v. Board of Educ. of Town of Hartford,* 562 F.2d 838, 841 (2d Cir. 1977) ("The right to control one's own body, recognized by Supreme Court decree as constitutionally derived, ... extends in the minds and hearts of many individuals to the body's teguments, be they clothing or hair."), *rev'd en banc,* 562 F.2d 856 (2d Cir. 1977); *Karr v. Schmidt,* 460 F.2d 609, 621 (5th Cir. 1972) (Wisdom, J., dissenting) (en banc, 8–7), *cert. denied,* 409 U.S. 989, 93 S.Ct. 307, 34 L.Ed.2d 256 (1972).

2. The court declines to follow *Jacobs v. Kunes,* 541 F.2d 222 (9th Cir. 1976), relied on by the defendants. In that case the Ninth Circuit Court of Appeals extended the holding in *Kelley* to all public employees, but did not discuss the Supreme Court's reasons for finding that states had particularly strong justifications for regulating the personal appearance of policemen, nor why these applied to clerks in a county assessor's office.

As the instant regulation would be constitutional if applied to policemen and other public servants whose roles are subsumed by the *Kelley* decision the court will not strike it down for facial overbreadth. Rather, it merely holds that as applied to plaintiff Nalley, the regulation impermissibly restricted his protected rights to expression and personal liberty. When his interest is weighed against the county's wish to have its road maintenance crews present a uniformly clean-shaven appearance to taxpayers the constitutional safeguards prevail. It was evident from the transcript of the review hearing that uniforms for road workers are subsidized by the county but not required, indicating that the asserted goals of uniformity are not highly prized even by the enacters of the regulation.

The question of employee safety presents a more difficult question as the goal of preventing injury is less illusory. There is little evidence in the record on this point, the only material concerning it having been submitted by plaintiff. At the review hearing the Superintendent of Roads for Douglas County admitted that he could not recall any instance in which the plaintiff's beard had interfered with his work and that he would not expect any interference. In light of the type of work involved and the fact that the weight of proof favors the plaintiff, the court determines that the slight degree, if any, to which the rule may further safety of road workers is outweighed by the infringement of Nalley's rights. He has met his burden of proving, if not that the regulation is unconstitutional on its face, at least that as applied to him it violates the Bill of Rights.

Summary judgment is therefore GRANTED for the plaintiff, and DENIED for the defendants. Plaintiff is ORDERED to submit to the court in writing, within thirty (30) days of the entry of this order, a calculation of the amount of this judgment. Defendants are ORDERED to respond within an additional fifteen (15) days with any objections which they may have to these calculations. A final judgment will then be entered.

SECURITIES AND EXCHANGE COMMISSION, Plaintiff,

v.

TEXAS INTERNATIONAL COMPANY, Defendant.

No. 78 C 847.

United States District Court, N. D. Illinois, E. D.

Sept. 30, 1980.

In an action brought by the Securities and Exchange Commission growing out of the reorganization of a corporate debtor in bankruptcy proceedings and the making of a tender offer by defendant corporation, the District Court, Marshall, J., held that: (1) under totality of circumstances and in light of purposes of Williams Act, public invitation to well-defined class of creditors of publicly held bankrupt company who had also held shares therein and who anticipated trading their claims for shares in reorganized corporation qualified as "tender offer"; (2) offer to such claimholders which by its terms was for interests in class settlement fund was, in effect, offer made for "equity security"; (3) where the claims were fraud claims against bankrupt corporation arising out of ownership of stock therein and the claimholders anticipated receiving stock in reorganized corporation, their shares in bankrupt corporation having been cancelled or modified under reorganization plan, purchase offer to such class members was tender offer for which informational statement was required to be filed, and same was true though Securities and Exchange Commission after reorganization of bankrupt corporation first directed reorganized corporation to file form for initial registration and later directed filing of form for continuance of registration; and (4) under totality of circumstances, the Commission did not make showing required for injunctive relief, and prayer for rescission would be denied pending final adjudication of fraud issues.

Order in accordance with opinion.

1. Bankruptcy ⟹601

Goal of debtor relief proceeding under Chapter X of Bankruptcy Act is to confirm plan of reorganization that settles rights of creditors and stockholders who will participate in the new company. Bankr.Act, §§ 101-276, 301 et seq., 11 U.S.C.A. §§ 501-676, 701 et seq.

2. Bankruptcy ⟹640.20

General creditors must receive full satisfaction before stockholders may participate in Chapter X reorganization plan. Bankr.Act, §§ 101-276, 11 U.S.C.A. §§ 501-676.

3. Securities Regulation ⟹52

Williams Act amendments to Securities Exchange Act of 1934 were designed to ensure disclosure to investors of material facts concerning identity, background and plans of person or group making cash takeover bid or other acquisition that might cause shift in control of corporation. Securities Exchange Act of 1934, §§ 12(g), 13(d, e), 14(d-f) as amended 15 U.S.C.A. §§ 78*l* (g), 78m(d, e), 78n(d-f).

4. Securities Regulation ⟹52

Meaning of "tender offer" within Williams Act develops on case-by-case basis, but, in conventional understanding, it is public invitation addressed to all shareholders of corporation to tender their shares for specified price, offer typically being open for limited time, with price set at premium above current market price, and offer being conditioned upon receipt of stated number of shares. Securities Exchange Act of 1934, §§ 12(g), 13(d, e), 14(d-f), 16(b) as amended 15 U.S.C.A. §§ 78*l*(g), 78m(d, e), 78n(d-f), 78p(b).

See publication Words and Phrases for other judicial constructions and definitions.

5. Securities Regulation ⟹52

Under totality of circumstances and in light of purposes of Williams Act, public invitation to well-defined class of creditors of publicly held bankrupt company who anticipated trading their fraud claims, arising out of their ownership of shares therein, for shares in reorganized corporation qualified as "tender offer." Securities Exchange Act of 1934, §§ 13(d, e), 14(d) as amended 15 U.S.C.A. §§ 78m(d, e), 78n(d).

6. Securities Regulation ⟹52

Principles of construction which have applied to definition of "security" for Williams Act purposes are equally applicable to definition of "equity security," which definitions embody flexible rather than static principle, and thus form should be disregarded for substance, and emphasis should be on economic reality. Securities Exchange Act of 1934, § 3(a)(10, 11) as amended 15 U.S.C.A. § 78c(a)(10, 11).

See publication Words and Phrases for other judicial constructions and definitions.

7. Securities Regulation ⟹42, 52

Offer to well-defined class of holders of claims against bankrupt corporation, which offer by its terms was for interests in class settlement fund was, in effect, offer made for "equity security" in view of fact that such claimholders anticipated trading their claims for shares in reorganized corporation. Securities Exchange Act of 1934, §§ 3(a)(10, 11), 12(g), (g)(1)(B), 14(d) as amended 15 U.S.C.A. §§ 78c(a)(10, 11), 78*l* (g), (g)(1)(B), 78n(d).

8. Securities Regulation ⟹18

Statutes under which issuance of stock under confirmed plan in exchange for claims against bankrupt corporation would be arguably exempt from registration operate on assumption that judicial scrutiny provided during approval and fairness hearings in reorganization proceedings are adequate substitute for normal Securities and Exchange Commission oversight of such transactions, and, on entry of confirmation order, brokers or dealers became legally entitled to sell new securities on "when, as and if issued" basis. Securities Exchange Act of 1933, §§ 3(a)(10), 5(c) 15 U.S.C.A. §§ 77c(a)(10), 77e(c); Securities Exchange Act of 1934, § 13(a) as amended 15 U.S.C.A. § 78m(a); Bankr.Act, §§ 172, 208, 264(a)(2), 265(a), 11 U.S.C.A. §§ 572, 608, 664(a)(2), 665(a).

9. Securities Regulation ⟹42

Registration under 1964 amendment of Securities Exchange Act registers only particular equity security, not company generally. Securities Exchange Act of 1934, § 12(g) as amended 15 U.S.C.A. § 78*l* (g); Securities Exchange Act of 1933, § 5(c), 15 U.S.C.A. § 77e(c).

10. Securities Regulation ⟹42

Registration requirement of 1964 amendment of Securities Exchange Act was added as means of extending disclosure obligations to wider class of issuers of securities, because growing number of stocks and over-the-counter (OTC) markets had been outside scope of regulations. Securities Exchange Act of 1934, §§ 12, 12(g), 13, 14, 16 as amended 15 U.S.C.A. §§ 78*l*, 78*l* (g), 78m, 78n, 78p; Securities Act of 1933, § 5(c), 15 U.S.C.A. § 77e(c).

11. Securities Regulation ⟹52

Where well-defined class of creditors who held fraud claims against bankrupt corporation arising out of their ownership of stock therein anticipated receiving stock in reorganized corporation, their shares in bankrupt corporation having been cancelled or modified under reorganization plan, purchase offer to such class members was tender offer for which informational statement was required to be filed, and same was true though Securities and Exchange Commission after reorganization of bankrupt corporation first directed reorganized corporation to file form for initial registration and later directed filing of form for continuance of registration. Securities Exchange Act of 1934, §§ 12(g), 13, 14, 16, 26 as amended 15 U.S.C.A. §§ 78*l* (g), 78m, 78n, 78p, 78z; Securities Exchange Act of 1933, §§ 3(a)(10), 5(c), 15 U.S.C.A. §§ 77c(a)(10), 77e(c); Bankr.Act, § 264(a)(2), 11 U.S.C.A. § 664(a)(2).

12. Securities Regulation ⟹173

Elements of action for injunctive relief brought under Securities Exchange Act section relating to omissions of material facts from tender offer announcement are essentially same as those of action brought under Rule 10b-5. Securities Exchange Act of 1934, § 14(e) as amended 15 U.S.C.A. § 78n(e).

13. Securities Regulation ⟹52

Standard of materiality under Securities Exchange Act section relating to omissions of material facts from tender offer announcement contemplates that omitted facts would have significantly altered "total mix" of information made available, and issue of materiality is mixed question of law and fact which is ordinarily inappropriate for summary judgment. Securities Exchange Act of 1934, § 14(e) as amended 15 U.S.C.A. § 78n(e).

14. Securities Regulation ⟹52

Where challenged omissions of information in tender offer announcement concerned data which was either rejected or discredited by reorganization court, challenged omissions failed test of materiality as a matter of law. Securities Exchange Act of 1934, § 14(e) as amended 15 U.S.C.A. § 78n(e); Rules Bankr.Proc. Rule 10-303(e), 11 U.S.C.A.

15. Securities Regulation ⟹52

As matter of law, corporation making tender offer was not obliged to disclose relevant "ask" prices for stock for which offer was being made, "bid" prices being more accurate and meaningful reflection of current market. Securities Exchange Act of 1934, § 14(d)(1), (e) as amended 15 U.S.C.A. § 78n(d)(1), (e).

16. Securities Regulation ⟹52

Tender offer to claimholders was not required to convert per share figures into per claim figures, conversion factor between claims and shares being in a fixed proportion. Securities Exchange Act of 1934, § 14(d)(1), (e) as amended 15 U.S.C.A. § 78n(d)(1), (e).

17. Securities Regulation ⟹52

Standard of materiality of information to be included in tender offer, as such standard applies to prospective events, is that reasonable stockholder, once informed of contingency, can then determine whether to assume risk of occurrence or nonoccurrence in accepting or rejecting tender offer. Securities Exchange Act of 1934, § 14(e) as amended 15 U.S.C.A. § 78n(e).

18. Securities Regulation ⟹52

Where tender offer clearly disclosed that appellate proceedings were pending which had potential impact on plan and could delay its final consummation, it was not necessary that materials with offer attempt to predict specific impact on plan assuming various alternative outcomes on appeal. Securities Exchange Act of 1934, § 14(e) as amended 15 U.S.C.A. § 78n(e).

19. Securities Regulation ⟹52

Disparity in treatment between two classes of shareholders included in tender offer is generally of great importance to disfavored shareholder and should be disclosed, and omission of fact which makes statement concerning value of target company's share misleading is material. Securities Exchange Act of 1934, § 14(e) as amended 15 U.S.C.A. § 78n(e).

20. Securities Regulation ⟹52

Solicitation materials of corporation making tender offer, in giving predominant emphasis to assertion that current offer was worth more than prior offer to other creditors on per share basis, were misleading when viewed in isolation, share distributions to groups of creditors under the plan being unequal. Securities Exchange Act of 1934, § 14(e) as amended 15 U.S.C.A. § 78n(e).

21. Securities Regulation ⟹105, 117

Both Securities Exchange Act section making it unlawful to use or employ any manipulative or deceptive device or contrivance in purchase or sale of stock and section making it unlawful for any person to engage in any fraudulent, deceptive or manipulative acts or practices in connection with tender offer merit same standard of culpability, and scienter must be proved under either section, and mere possession and nondisclosure is not sufficient, without actual knowledge of falsity or of incompleteness. Securities Exchange Act of 1934, §§ 10(b), 14(e) as amended 15 U.S.C.A. §§ 78j(b), 78n(e); Securities Act of 1933, § 17(a), 15 U.S.C.A. § 77q(a).

22. Securities Regulation ⟹171

Under statutory standard, Securities and Exchange Commission is not required to show irreparable harm for injunction but need only show that statutory conditions have been satisfied, and critical question is whether there is reasonable likelihood that wrong will be repeated. Securities Exchange Act of 1934, § 21(d) as amended 15 U.S.C. (1964 Ed.) § 78u(d); Fed.Rules Civ. Proc. Rule 65, 28 U.S.C.A.

23. Securities Regulation ⟹171

For purposes of injunctive relief sought by Securities and Exchange Commission, an appraisal is required of totality of circumstances and factors suggesting that violation may or may not have been isolated occurrence, and relevant factors include character of past violations, effectiveness of discontinuance, bona fides of expressed intent to comply, number and duration of past wrongs, time which has elapsed since last violation, opportunity to commit further illegal acts, novelty of violation, harmful impact of injunction on defendant and willfulness or bad faith in defendant's prior conduct. Securities Exchange Act of 1934, §§ 14(d), 27 as amended 15 U.S.C.A. §§ 78n(d), 78aa; Fed.Rules Civ.Proc. Rule 65, 28 U.S.C.A.

24. Securities Regulation ⟹173

Failure of corporation making tender offer to file offering materials with Securities and Exchange Commission was not to be deemed continuing violation for purpose of determining appropriateness of injunctive relief. Securities Exchange Act of 1934, § 21(d) as amended 15 U.S.C. (1964 Ed.) § 78u(d); Securities Exchange Act of 1934, §§ 12(g), 14(d) as amended 15 U.S.C.A. §§ 78*l*(g), 78n(d); Securities Act of 1933, § 5(c), 15 U.S.C.A. § 77e(c); Fed.Rules Civ.Proc. Rule 65, 28 U.S.C.A.

25. Securities Regulation ⟹173

Securities Exchange Act section, under which action was brought, conferred general equity powers upon district courts, and remedies are available even though no injunctive relief is granted, including such remedies as depriving defendants of gains made through violations, deterring future violations and increasing overall efficiency of private actions. Securities Exchange Act of 1934, §§ 14(d), 27 as amended 15 U.S.C.A. §§ 78n(d), 78aa; Fed.Rules Civ. Proc. Rule 65, 28 U.S.C.A.

26. Securities Regulation ⟹156

Prayer of Securities and Exchange Commission for rescission order, absent any proof that tender offer materials contained any fraudulent misrepresentation or omissions, was denied pending final adjudication of fraud issues. Securities Exchange Act of 1934, §§ 14(d), 27 as amended 15 U.S.C.A. §§ 78n(d), 78aa.

Ronald P. Kane, Dennis B. O'Boyle, Securities and Exchange Commission, Chicago, Ill., for plaintiff.

John J. Enright, Jeffrey R. Liebman, Arvey, Hodes, Costello & Burman, Chicago, Ill., Daniel S. Greenfeld, Marshall, Bratter, Greene, Allison & Tucker, New York City, for defendant.

MEMORANDUM DECISION

MARSHALL, District Judge.

This case involves the application of two complex sets of statutes. The first is Chapter X of the Bankruptcy Act, 11 U.S.C. §§ 501–676, relating to the reorganization of a corporate debtor so that its stockholders and creditors receive fair consideration of their claims and so that it emerges from the bankruptcy proceedings as a revitalized corporation with a sound financial structure; the second is the reporting and antifraud sections of the federal securities acts, which are designed to regulate the issuance and acquisition of securities so that investors can make realistic and informed investment decisions. The interaction between these statutes is created by a rather labyrinthian factual setting.

To give a brief outline, King Resources Corporation (KRC) received approval for a plan of reorganization which offered new securities in settlement of its indebtedness. Under the plan, claims held by certain of KRC's shareholders were exchangeable for new securities in the reorganized corporation. Before the securities were issued, and before the reorganized corporation became fully operational, Texas International Company (TI) made a take-over bid for the reorganized KRC. To effectuate its plan, TI offered to purchase the claims of the KRC shareholders. A large number of shareholders accepted the offer. The Securities and Exchange Commission (SEC) brought this action seeking an injunction against TI, contending that the TI offer violated the reporting and antifraud provisions of the securities laws. Among other things, the action raises the novel legal issue of whether an offer to purchase the claims of creditors in a reorganzation proceeding can qualify as a tender offer within the scope of the Williams Act, 15 U.S.C. §§ 78m(d)–(e), n(d)–(f).

Although KRC is not a party to the present action, an examination of its recent financial history is essential to an understanding of the current litigation.

KRC and its predecessors have been engaged in the exploration for, and production of, oil and gas. Its principal assets are producing and developing properties in the United States and Canada. In early 1971, after attempting a major business expansion, KRC found itself short on working capital and cash. As a result, KRC could not make the payments on $20 million of bank debt, and $40 million of its debentures. (SEC 2d Advis. Report, pp. 3-4).

On August 14, 1971, an involuntary petition for reorganization under Chapter X was filed against KRC in the United States District Court for the District of Colorado (reorganization court). Exercising its bankruptcy powers, that court appointed a trustee to take charge of KRC's assets and manage the business. The trustee soon began the tasks of selling unprofitable operations, and of working on a plan to restructure and revitalize KRC's debt and capital.

A corporate reorganization necessitates a probing examination of broad economic, legal, financial and business issues, including analysis of market conditions, appraisal of the debtor's managerial expertise, prediction of future earnings, and determination of proper financial structures. To resolve these problems, the Bankruptcy Act contemplates frequent resort to the expertise of the SEC. *See* Hooton, *The Role of the Securities and Exchange Commission under Chapter X, Chapter XI and Proposed Amendments to the Bankruptcy Act,* 18 Boston Coll.Ind. & Comm.L.Rev. 427, 428 (1977). Thus, copies of all Chapter X petitions, as well as all notices mailed to creditors, must be sent to the SEC. 11 U.S.C. § 665(a). If the SEC feels the proceedings affect substantial public investor interest, it may ask to intervene in the case. 11 U.S.C. § 608; 40 SEC Ann.Rep. 123 (1974); Hooton, *supra* at 430. The SEC did intervene in the KRC proceedings.

Once it intervenes in a case, the SEC serves primarily an advisory function. It has no authority to hold hearings, decide issues or approve plans of reorganization. The trustee has the primary responsibility for the preparation of a plan, and the judge of the reorganization court has sole responsibility for its ultimate approval. The SEC's main function "is to act as an impartial representative of public investors and to provide expert assistance to the court." Hooton, *supra* at 440, 429. If the corporation's scheduled indebtedness exceeds $3,000,000, the reorganization court must submit the proposed plan of reorganization to the SEC for an advisory report. 11 U.S.C. § 572. However, the SEC is likely to file a formal advisory report "only in a case which involves substantial public investor interest and presents significant problems." 40 SEC Ann.Rep. 127 (1974); Hooton, *supra* at 441. In the present case, the SEC prepared two advisory reports which were submitted to the reorganization court.

[1, 2] The goal of a debtor relief proceeding under Chapter X is to confirm a plan of reorganization that settles the rights of creditors and stockholders who will participate in the new company. Corotto, *SEC Reporting, Proxy and Antifraud Compliance—An Additional Perspective on Bankruptcy Reorganization Proceedings,* 63 Calif.L.Rev. 1563, 1577 (1975). After seven years of proceedings in the reorganization court and the rejection of several proposed plans, the trustee finally secured acceptance for a plan for KRC in 1977. After receiving an advisory report on the plan from the SEC the reorganization court approved the plan in May, 1977. At that time, the court found that KRC was insolvent, i. e., that its liabilities exceeded its assets. Because the general creditors must receive full satisfaction before stockholders may participate in a plan, *see Consolidated Rock Products Co. v. DuBois,* 312 U.S. 510, 61 S.Ct. 675, 85 L.Ed. 982 (1941), this finding of insolvency had the practical effect of eliminating KRC stockholders from the plan, and from voting thereon. All shares of KRC common stock would be cancelled under the plan. After judicial approval, the plan was submitted to KRC creditors for their acceptance. The requisite number of acceptances were received, and the reorganization court confirmed the plan on October 7, 1977.

A partial description of the plan is required so that we may identify two classes of creditors that have a bearing on the present case, and so that we may understand the securities law problems in this case in the context of the capital structure of the reorganized company.

The plan provided for the continuation of KRC's business by an essentially debt-free reorganized company, renamed Phoenix Resources Company. Under the plan, the allowed claims of all creditors of KRC totalled $95.3 million. Of those claims, $7.1 million were to be paid in full in cash. The remaining $88.2 million of claims were to be discharged by the distribution of new stock in the reorganized company. Two classes of Phoenix stock, A and B, were to be issued to the creditors. Class A shares would have certain preferred rights over

Class B shares. Specifically, each Class A share would be convertible into 1½ Class B shares during the first year after confirmation of the plan, and into 1¼ Class B shares during the second year after confirmation. Class B shares would not be convertible.

To recognize the varying priorities of the different classes of KRC creditors, the plan contemplated a distribution of different numbers of shares of Class A and B stock to each group of creditors. Thus, senior creditors would receive 50 shares of Class A stock for each $1,000 of allowed claims. Debenture holders would receive approximately 8 shares of Class A stock and 42 shares of Class B stock for each $1,000 of allowed claims. General unsecured creditors would receive 25 shares of Class A stock and 25 shares of Class B stock for each $1,000 of allowed claims.

Included in the general unsecured creditors were a particular class of KRC shareholders and debenture holders. In September, 1971 these security owners had filed a class action lawsuit against KRC, charging it with having conducted fraudulent securities transactions. (*Dietrich v. King Resources Co.*). The action sought damages of more than $100 million and included more than 20,000 claimants. To avoid a costly and lengthy trial, the reorganization trustee settled these claims for $13 million in 1975. As a result of the settlement, the Dietrich class members were entitled to participate in the plan of reorganization of KRC as general unsecured creditors. It is clear that the basis of their participation was the fraud settlement and not their stock as such; nevertheless their status as stock and debenture holders in KRC was an essential ingredient of their settled fraud claim.

The Dietrich class members and the senior creditors play a prominent role in the financial maneuvers leading to the present litigation. In addition, the value, character and distribution of the new Phoenix stock has important ramifications for the application of the securities laws in this case.

Before reaching those issues, however, we must introduce another corporation into the picture–Texas International Company (TI), which is the defendant in the present action. TI is a Texas-based corporation engaged in the manufacture of oil field equipment, the provision of oil field services and the exploration for and production of crude oil and natural gas. It has adopted a continuing program of acquiring companies in the oil and gas exploration and production industry. In late 1977 TI decided to attempt to obtain control of KRC and to ultimately effect a merger of the two companies. Its preliminary "take–overtures" were directed at two groups of KRC creditors–the senior creditors and the Dietrich class members.

On August 3, 1977, about two months after approval of the plan of reorganization and two months prior to its final confirmation, TI made an offer to purchase for cash the allowed claims of certain "eligible creditors." Eligible creditors were defined to include the $29 million in claims held by about 12 senior creditors, and $4 million in claims held by about 1,300 "trade creditors." Trade creditors were defined as a special group of unsecured general creditors, and did not include the Dietrich class members. The offering price was $0.90 for each $1.00 of allowed claims, but the offer was subsequently raised to $1.02 on the dollar after negotiations between TI and the eligible creditors. The soliciting materials gave detailed information on the terms of the offer, the method of acceptance and payment, information about TI and KRC, and TI's purpose in making the offer. TI's announced objective was ". . . to acquire all Allowed Claims of all Eligible Creditors as a preliminary step to obtaining control of KRC and, perhaps, consummating a merger of KRC into or the combination of KRC with, TI." As a result of its offer, TI acquired $30.8 million of the targeted $33 million of claims of senior and trade creditors.

TI's second "take–overture" was made on or about December 21, 1977, about two months after the confirmation of the plan. At that time, TI made an offer to purchase for cash the $13 million in claims held by the Dietrich class members. The offering price was $0.86 for each $1.00 of allowed claims. As before, the soliciting materials gave detailed information on the terms of the offer, the method of acceptance and payment, information about TI and KRC, and TI's purpose in making the offer. TI repeated its intentions of taking over KRC and effecting a merger of the two companies. In addition, the materials described the status of the reorganization proceedings, the structure and terms of the plan of reorganization, and TI's prior offer to senior and trade creditors. As a result of its offer, TI acquired about $4.4 million of the $13 million of claims of the Dietrich class members.

As a consequence of its two offers, TI acquired about $35.2 million of the $95.3 million in total allowed claims. Under the plan of reorganization, its purchases were convertible into about 44% of the Class B stock to be issued, which is somewhat less than majority ownership.[1] Pursuant to reorganization court authorization, the trustee began issuing Phoenix stock in exchange for claims of creditors on January 27, 1978.

On March 7, 1978, the SEC filed the present action for injunctive and equitable relief against TI. It alleged that TI's offer to the Dietrich class members violated sections 10(b), 14(d) and 14(e) of the Securities Exchange Act, as amended, 15 U.S.C. §§ 78j(b), 78n(d) and 78n(e), and Rules 10b-5 and 14d-1, 17 C.F.R. §§ 240.10b-5 and 240.14d-1, promulgated thereunder. The SEC's charges are separated into three counts, but may be conveniently divided into two broad allegations: 1) that TI failed to file a report with the SEC describing its offer to the Dietrich class, as required by section 14(d) of the Exchange Act (Count 3) and 2) that TI's offering materials to the Dietrich class contained statements and omissions which fall short of the disclosure standards set forth in the anti-fraud sections of the Exchange Act (Counts 1 and 2).

There are pending for decision the SEC's motion for a preliminary injunction pursuant to Rule 65, F.R.Civ.P., the SEC's motion for summary judgment on Counts 1 and 2 pursuant to Rule 56, F.R.Civ.P., TI's motion to dismiss Count 3 and its cross-motion for summary judgment on Counts 1 and 2.

I. *The Section 14(d) Claim*

[3] The SEC's claim which alleges a violation of the filing requirements of the federal securities laws, rests on an unusual construction of the Williams Act, amendments to the Securities Exchange Act of 1934, 15 U.S.C. §§ 78m(d)-(e), n(d)-(f). Those amendments were designed to ensure the disclosure to investors of material facts concerning the identity, background and plans of the person or group which makes a cash take-over bid or other acquisition that may cause a shift in control of a corporation. To implement this objective, section 14(d) of the Act provides that any person making "a tender offer for . . . any class of any equity security which is registered pursuant to" section 12(g) of the Act, 15 U.S.C. § 78l(g), must file a statement with the SEC, if the person would be the beneficial owner of more than 5% of the securities after the tender offer is completed.

The SEC alleges that TI's offer to purchase the reorganization claims of the Dietrich class members satisfied the requirements for 1) a tender offer 2) for a class of equity security 3) which is registered under § 12(g) of the Act and 4) more than 5% of which would be beneficially owned by TI after the offer. Thus the SEC contends that although TI offered to purchase the creditor claims in bankruptcy of the former KRC security holders, those claims should be regarded as the equivalent of an equity security, since the plan of reorganization made the claims readily exchangeable into shares of Phoenix stock which clearly qualify as an equity security. Next, the Phoenix equity security fulfilled the registration requirement of § 14(d) for either of two reasons. First, the Phoenix stock was a "successor security" to the common stock and convertible debentures of KRC, which had been registered under § 12(g) of the Act. Phoenix is essentially the same corporation as KRC; it is the same reorganized business under a new name. Therefore, the Phoenix stock should be "deemed registered" under § 12(g) as of the date of confirmation of the plan of reorganization, which was some two months before TI's tender offer. Alternatively, the SEC contends that the Phoenix stock should be "deemed registered" pursuant to its Rule 12g-3(a) which implements § 12(g). The rule requires a continuity of compliance with § 12(g) when a corporation undergoes certain fundamental business changes. It provides that when securities not previously registered are issued during such fundamental business changes in exchange for registered securities of another issuer, the new securities shall be "deemed registered" under § 12(g). The fundamental business changes are defined as "a succession by merger, consolidation, exchange of securities or acquisition of assets." The SEC contends that the KRC reorganization had the same net effect as a merger or consolidation. It also argues that the Dietrich class members effectively experienced an "exchange of securities," since their ownership rights in KRC securities became creditor claims in the reorganization proceeding and in turn became exchangeable for Phoenix stock under the plan. Finally, to fulfill the "beneficial ownership" requirement of § 14(d), the SEC urges that TI's purchase of the Dietrich members' claims can be equated with beneficial ownership of Phoenix stock, because after TI's offer was accepted the only missing incident of ownership was the actual possession of Phoenix stock certificates. The formula for converting claims to shares was settled when the plan was confirmed, and the issuance of the Phoenix shares under the plan in the very near future was an almost certain eventuality.

TI has moved to dismiss the SEC's § 14(d) claim, contending that none of the prerequisites to a § 14(d) action are present here. The SEC in turn has moved for summary judgment on this claim, since TI admittedly failed to file any statement with the SEC concerning its offer to the Dietrich class members. For the reasons now stated we deny TI's motion to dismiss and grant the SEC's motion for summary judgment on this claim (Count 3).[2]

[4] The first question is whether TI's offer to purchase the claims in bankruptcy held by the Dietrich class members qualifies as a "tender offer" within the meaning of § 14(d) of the Williams Act. Neither Congress nor the SEC has defined the term. Its meaning develops on a case-by-case basis. *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579, 596-98 (5th Cir. 1974). In conventional understanding, a tender offer is a public invitation addressed to all shareholders of a corporation to tender their shares for a specified price. Typically, the offer is open for a limited time, the price is set at a premium above the current market price, and the offer is conditioned upon the receipt of a stated number of shares. Note, *The Developing Meaning of "Tender Offer" under the Securities Exchange Act of 1934*, 86 Harv.L.Rev. 1250, 1251-52 (1973). Most courts and commentators have agreed that the definition should be extended beyond its conventional meaning, and should encompass offers which are likely to pressure shareholders into making uninformed, ill-considered decisions to sell. Note, *supra*; *Nachman Corp. v. Halfred*, CCH Fed.Sec. Rep., ¶ 94,455 (N.D.Ill. July 13, 1973); *Cattlemen's Investment Corp. v. Fears*, 343 F.Supp. 1248 (N.D.Okla.1972). In formulating this definition, courts have applied a method of statutory construction by which borderline or "unorthodox" transactions are included within the broad statutory definition if they may serve as a vehicle for the evil which Congress sought to prevent. *See Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582, 593-94, 93 S.Ct. 1736, 1744, 36 L.Ed.2d 503 (1973) (applying this method to the meaning of "purchase" and "sale" under § 16(b) of the Exchange Act).

1. On March 24, 1978, TI advised Phoenix that it had acquired more than half of Phoenix's stock, apparently as a result of additional stock purchases. (SEC Reply Mem., Exh. 1).

2. In reaching the result we do with respect to this aspect of the case we acknowledge that we differ with the conclusions reached by Hon. Luther E. Eubanks in *Lipper v. Texas International Company*, No. 78 0215E, (D.W.D.Okla. 1979), a private action brought by a member of the Dietrich class alleging, *inter alia*, violations of the Williams Act by TI.

[5] TI's offer had many characteristics of a conventional tender offer, and also had characteristics which satisfy the evolving judicial standard which implements Congressional intent. The method of solicitation used was a public invitation to all members of a well-defined class of claim holders in a publicly-held company. There were no ordinary market transactions where an investor takes the initiative and steps forward to sell on his own. Note, *supra* at 1279; *Kennecott Copper Corp. v. Curtiss-Wright Corp.*, 449 F.Supp. 951, 961-62 (S.D.N.Y.1978). The offer was made by an outside corporation which intended to gain control of KRC. The offer was directed at a large number of solicitees, over 20,000, and therefore had a widespread impact on the investing public. *See* Aranow, Einhorn & Berlstein, *Developments in Tender Offers for Corporate Control*, 4-6 (1977). The Dietrich class members held claims representing about 15% of the corporation's assets. The offer was for a fixed price, specified in advance. The offer was not conditioned upon the tender of a specified number of shares. It is difficult to tell whether the price included a premium above the current market price which might have pressured the Dietrich claim holders into quick selling. The reorganization court valued KRC as a going concern at between $90-100 million, and the total value of claims in reorganization was $95.3 million. The offer was for $0.86 per $1.00 of claim. Assuming these claims were fully converted into Class B stock of Phoenix, the offer was worth $13.77 per share. At the time of the offer, the unissued Phoenix stock was being traded in the over-the-counter market on a "when, as and if issued" basis. The market "bid" price stood at around $17½ per share. No regular market for the stock existed. Despite this uncertainty about the precise value of the TI offer and the absence of a first-come, first-served condition on the offer, the Dietrich claim holders could easily have been pressured into a hasty investment decision by the two-week time limit contained in the offer. Viewed in its totality, and in light of the purposes of the Williams Act, we hold that the TI offer qualifies as a "tender offer" within the meaning of § 14(d).

[6, 7] The second question is whether TI's tender offer was made for an "equity security." By its terms, the TI offer to the Dietrich class claim holders was for "interests in the [Dietrich] class settlement fund." It is undisputed that such "interests," viewed in isolation, could not qualify as an "equity security," as that term is defined in section 3(a)(11) of the Exchange Act. 15 U.S.C. § 78c(a)(11). However, the SEC argues that substance rather than form should control, and that the substance of TI's offer was for the Phoenix stock into which the "interests" were exchangeable. Clearly the Phoenix stock would qualify as an equity security, since the statutory definition covers "any stock or similar security."

We agree with the SEC position. The principles of construction which have been applied to the definition of a "security" under section 3(a)(10) are equally applicable to the definition of an "equity security" under section 3(a)(11). Thus, it is clear that these definitions "embod[y] a flexible rather than a static principle," *SEC v. Howey*, 328 U.S. 293, 299, 66 S.Ct. 1100, 1103, 90 L.Ed. 1244 (1946), and that in searching for the meaning "form should be disregarded for substance and the emphasis should be on economic reality." *Tcherepnin v. Knight*, 389 U.S. 332, 336, 88 S.Ct. 548, 553, 19 L.Ed.2d 564 (1967); *Hirk v. Agri-Research Council, Inc.*, 561 F.2d 96, 99-100 (7th Cir. 1977). In its solicitation materials to the Dietrich class members, TI describes an economic reality which clearly contemplates the issuance of Phoenix stock for the purchased interests. The materials frequently state that if the plan of reorganization is consummated, Phoenix stock would be distributed to the Dietrich class members. Although TI attempts to make much of pending appeals and the complexity of the reorganization proceedings to demonstrate "substantial uncertainty" regarding the actual consummation of the plan, its solicitation materials indicate that issuance of the stock was quite probable:

> "While the distribution of shares of New King Stock pursuant to the Plan is subject to consummation of the Plan and the related motions and appeals described under Section 6 below, *the Trustee has indicated that he intends to consummate the Plan during January 1978*, if the proceedings are not delayed by a stay of consummation by judicial order."

While there were several stay-related motions which were before the reorganization court and which were clustered closely in time around the December 1977 tender offer, they do not seriously weaken the probabilities of imminent issuance of the Phoenix stock. Despite those motions, the reorganization court entered an order authorizing the issuance of the Phoenix stock on January 6, 1978, the day TI's tender offer terminated. The trustee began issuing Phoenix stock some 21 days later. Although our post-tender offer hindsight gives us a clearer picture of the probabilities than may have been apparent in December 1977, the contemporaneous expressions by TI in its tender offer display similar expectations. Indeed, the offer included a clause which provided that if the trustee began issuing stock "during the pendency of the Offer . . . , payment for any Interests tendered will be made only against receipt of certificates evidencing the shares distributed . . ." and "[t]he certificates must be accompanied by duly executed stock powers . . ." Finally, there is no doubt that, in TI's own words, its "objective in making the Offer is to acquire all the [Phoenix] Stock to be issued to the Class Settlement Fund . . ." Given the pragmatic economic reality that the Dietrich claims and the Phoenix stock were wedded in both a temporal and a conceptual sense, we conclude that TI's offer was made for an "equity security" under § 14(d).

The third question under § 14(d) is whether TI's tender offer was made for an equity security which was registered under section 12(g) of the Exchange Act. It is here that TI wages its most vociferous defensive battle. It argues that no targeted security was registered under 12(g) at any time before or during the offering period, and that the SEC effectively admitted this fact by its conduct in early 1978 when it recommended that Phoenix file certain forms for the registration of the Phoenix stock.

At the outset, we set forth the pertinent facts and statutes on this issue in somewhat greater detail. Section 12(g) of the Exchange Act provides that every issuer engaged in interstate commerce or whose securities are traded by use of the mails or any means or instrumentality of interstate commerce, which has total assets exceeding $1,000,000 and a class of "equity security" held of record by 500 or more persons, must register that security with the SEC by filing a registration statement that contains such information and documents as the SEC may specify. 15 U.S.C. § 78*l*(g)(1)(B). This provision applied to KRC when it entered the Chapter X proceedings. As a large, publicly-held corporation with sizeable assets, it had two classes of equity securities registered under § 12(g): common stock and convertible debentures. These securities were section 12(g) securities until at least October 7, 1977 when the plan of reorganization was confirmed. Once KRC's securities were registered under § 12(g), it became a reporting company and thereafter was required by law to file current and periodic reports with the SEC pursuant to § 13(a) of the Exchange Act, 15 U.S.C. § 78m. Those reporting requirements ordinarily remain in force despite the onset of reorganization proceedings, since trading in a debtor's securities usually continues during reorganization. Corotto, *supra* at 1568 n.17, 1574-75. Although public financial reports reveal that KRC's stock was being traded in the over-the-counter market in late 1973 at around 20¢ per share, we have found no information indicating a subsequent market in the securities.

KRC filed a Form 8-K with the SEC on August 8, 1977, reporting the submission of the plan to the creditors for their vote and TI's offer to purchase the claims of the senior creditors. (Ponzio Exh. 3). A Form 8-K is the report form used to keep the § 12(g) registration current. Corotto, *supra* at 1573 n.37.

[8] On October 7, 1977 the reorganization court confirmed the plan of reorganization. Under the plan, all outstanding shares of common stock were to be cancelled. The outstanding KRC convertible debentures were allowed as general unsecured claims against KRC, and were to be satisfied by the issuance of Phoenix stock. All KRC shareholders as shareholders would be excluded from participation in the plan. However, those shareholders who qualified as creditors under the terms of the Dietrich settlement would be entitled to receive shares of the new Phoenix stock to be issued under the plan. Because the Phoenix stock would be issued under a confirmed plan "in exchange for one or more bona fide outstanding securities, claims or property interests, or partly in such exchange and partly for cash," it was arguably exempt from the registration requirement of § 5(c) of the Securities Act of 1933, 15 U.S.C. § 77e(c), by virtue of section 3(a)(10) of that Act, 15 U.S.C. § 77c(a)(10), or by virtue of section 264 of Chapter X of the Bankruptcy Act, 11 U.S.C. § 664(a)(2). Securities Act Release No. 33–3343, May 24, 1949, CCH Sec. Law Rep. ¶ 2,197. Those sections operate on the assumption that the judicial scrutiny provided during the approval and fairness hearings in reorganization proceedings are an adequate substitute for the normal SEC oversight of such transactions. *See* Note, 51 Amer. Bankruptcy Law Journal 99 (1977); 6A *Collier on Bankruptcy* ¶ 15.05 at 1196 (14th ed. 1972). Upon entry of the confirmation order, brokers or dealers became legally entitled to sell the new Phoenix securities on a "when, as and if issued" basis.[3] Securities Act Release No. 33–3343, *supra*. That trading occurred in an over-the-counter market, and was active at the time TI made its tender offer in December, 1977. At that time, under the plan, Phoenix was a company engaged in a business affecting interstate commerce and had assets valued in excess of $1,000,000. In addition, it had more than 500 holders of a previously registered security who had a right to sell the unissued Phoenix securities. Those holders included the Dietrich class members.

Since the reorganization court's confirmation of the plan, KRC has continued to file periodic reports with the SEC under § 13(a) of the Exchange Act, presumably to keep its § 12(g) registration current. It filed a current report on Form 8–K on October 28, 1977 and a quarterly report on Form 10–Q on November 17, 1977. It filed another 8–K under its successor company name of Phoenix Resources on January 12, 1978, some six days after the termination of the TI tender offer. On February 16, 1978, on the SEC's recommendation, Phoenix filed a Form 8–A seeking registration of its Class A and Class B common stock. A Form 8–A is used to obtain initial registration of securities not previously registered or deemed registered under § 12 of the Exchange Act. Some two months later, on March 31, 1978 and again on the SEC's recommendation, Phoenix withdrew the Form 8–A and substituted a Form 8–K in its place. A Form 8–K assumes that the security is already registered or deemed registered. Then on June 16, 1978, Phoenix filed a second Form 8–A application for registration of its common stock, which the SEC deemed as unnecessary because the Phoenix stock was already considered to be registered under § 12(g).

We now must apply to these facts the two theories of successor registration espoused by the SEC. First, the SEC argues that the Phoenix stock should be "deemed registered" under § 12(g) of the Exchange Act because: the KRC securities were registered under that section; after confirmation of the plan, the shareholders, assets and business of KRC were transferred to Phoenix, which is in essence the same corporation under a new name; under the plan, the Dietrich class members simply exchanged their old KRC securities for the new Phoenix securities; the Phoenix stock succeeded to the KRC common stock and convertible debentures which were already registered. To effectuate the Congressional intent to provide a continuous flow of information concerning publicly-held companies, the SEC urges the Phoenix stock must be deemed registered under § 12(g).

3. "Most trading is conducted on the basis of 'regular way contracts' which require settlement and delivery of the certificates no longer than the fifth business day after the transaction. 'When, as and if issued' trading refers to transactions in shares that have not been formally issued, and, accordingly, settlement is contingent on later issuance of the stock." *SEC v. Coven*, 581 F.2d 1020, 1024 n.7 (2d Cir. 1978).

[9] Although this theory has a pragmatic ring to it, there are several gaps in its logic. First, the Dietrich class members could not receive Phoenix stock in exchange for their old KRC securities, since those securities were cancelled or modified under the plan. Instead, they could only receive Phoenix stock in exchange for their creditor claims which arose from the settlement of their action for fraudulent securities transactions. Those fraud claims in turn arose from their ownership of KRC securities, so the conduit of exchange was an indirect one. Second, the similarities in financial structure between KRC and Phoenix are not necessarily probative of the fact that their respective securities are subject to identical registration obligations. Under § 12(g), a registration registers only a particular equity security, not the company generally.[4] Third, the new Phoenix stock was arguably exempt from the registration requirements of § 5(c) of the Securities Act of 1933. Consequently, continuous registration is difficult to accept as an objective fact.

[10, 11] Despite these problems, we agree with the SEC that the securities and bankruptcy laws were intended to provide an accurate and adequate flow of information to investors in large companies such as KRC and Phoenix. Section 12(g) was added by the Congress in 1964 as a means of extending disclosure obligations to a wider class of issuers of securities. Before this amendment, corporations with exchange-listed stock and those which floated new issues were subject to the registration, reporting, proxy solicitation and inside trading controls contained in sections 13, 14 and 16 of the Exchange Act. But the growing number of stocks in the over-the-counter (OTC) markets were outside the scope of these regulations. The purpose of section 12(g) was to extend the protections of sections 13, 14 and 16 of the Exchange Act to this important group of investors in OTC securities. *See* 109 Cong.Rec. 13725–26 (1963); 110 Cong.Rec. 17916, 17921 (1964). At the time of the TI tender offer, Phoenix had all the essential characteristics of companies which fell within the expanded orbit of section 12(g). It was a large company with interstate activities, sizeable assets exceeding $1 million, and many thousand public investors. It had securities which were being traded in an OTC market. And it was voluntarily updating its registration of its superceded KRC securities by filing reports with the SEC in October and November, 1977.

Furthermore, to permit the non-registration of the new Phoenix stock in December, 1977 to work an escape of the protective provisions of the Williams Act would allow TI to fall into the cracks of the securities laws simply because of the unorthodox nature of the issuance of securities in reorganization proceedings. The KRC securities owned by the Dietrich class were § 12(g) securities until at least October 7, 1977, when the KRC plan was confirmed. The replacement Phoenix stock issued in exchange for the claims of the Dietrich class became registered, or were re-registered, sometime in early 1978. Relying on a literal reading of the statute, TI urges that the old KRC securities and the new Phoenix securities lost their § 12(g) status in the interim and that its tender offer during that time escaped scrutiny under the Williams Act. Such a narrow construction of the statute would defeat Congressional objectives in providing full disclosure of corporate acquisitions to public investors. *See* *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582, 593–94, 93 S.Ct.

4. Under the Proposed ALI Federal Securities Code (March 15, 1978), registration of securities would be replaced by registration of companies themselves. See Introduction pp. xxv xxvi, §§ 402 403.

1736, 1744, 36 L.Ed.2d 503 (1973). In addition, assuming an exemption of the Phoenix stock under § 3(a)(10) or § 264(a)(2), the alternative protective eye of the reorganization court was designed only to scrutinize the issuance of the new securities, not to examine the adequacy of disclosure in tender offers for those securities. It therefore fails to provide substitute protection for the Dietrich class.

The SEC's second theory of successor registration also provides support for a liberal construction of § 12(g). The theory is based upon the SEC's Rule 12g–3(a), which was promulgated pursuant to § 12(g). 17 C.F.R. § 240.12g3(a). The rule creates a continuity of registration for securities which are issued by companies undergoing certain fundamental business changes. It provides that:

> Where in connection with a succession by *merger*, consolidation, *exchange of securities* or acquisition of assets, equity securities of an issuer, not previously registered pursuant to Section 12 of the Act, are issued to the holders of any class of equity securities *of another issuer* which is registered pursuant to Section 12(g), the class of securities so issued shall be *deemed to be registered* pursuant to Section 12(g) of the Act unless upon consummation of the succession such class is exempt from such registration or all securities of such class are held of record by less than 300 persons. (emphasis added).

Although the transformation of securities which occurred under the plan does not fit clearly within the literal terms of a "merger" or an "exchange of assets," and Phoenix and KRC are realistically regarded as the same rather than as different "issuers," we do not believe that the unorthodox form of the business metamorphosis should be employed as a shield to evade the purpose and tenor of the rule. The TI tender offer, in its timing, falls within a unique and novel temporal and economic setting, but it is surrounded by the same dangers and need for investor protection which spurred the enactment of the rule. Although we share TI's concern that statutes and rules not be expanded so far beyond their literal terms that companies lose any clear guides for their business decisions, we believe that, in the particular circumstances of this case, TI's tender offer falls within the core concern of the Congress when it enacted the Williams Act. *See* S. Rep. No. 550, 90th Cong., 1st Sess. (1967); H.Rep. No. 1711, 90th Cong., 2d Sess. (1968), U.S.Code Cong. & Admin.News 1968, p. 2811.

As its final defense on the registration issue, TI argues at some length that the SEC effectively admitted the fact that the Phoenix stock was unregistered at the time of the tender offer because of its subsequent conduct in recommending that certain filings be made. Thus, the SEC initially recommended to Phoenix that it file a Form 8–A for its new stock, the form used for previously unregistered stock. Four months later, and three days after filing the present complaint, the SEC advised Phoenix to withdraw the Form 8–A and file a Form 8–K in its place. The latter form is used to keep a previous registration up to date. From this evidence, TI argues that the SEC sought to eliminate evidence which supported TI's position, and to "manufacture" evidence tending to support the SEC's theory of successor registration. TI labels this conduct "a grave abuse of the public trust" and contends that it is an "admission" that the Phoenix stock was not registered or "deemed registered" in January, 1978 when TI's tender offer concluded. In response, the SEC has called its action in this regard "an interpretive mistake," has vigorously denied that any sinister motives were at work, and has moved to strike TI's arguments under Rule 12(f), F.R.Civ.P., as redundant, immaterial, impertinent and scandalous matter.

We agree with the SEC that TI's charges of evidence tampering are totally unsupported by any evidence of deliberate or culpable misconduct and are highly exaggerated. We also find that the incident itself is of dubious relevance, and cannot constitute an "admission," since § 26 of the Exchange Act provides that no action or omission by the SEC shall be construed to mean that it "has in any way passed upon

the merits of, or given approval to, any security or any transaction or transactions herein," or that any statement or report filed with or examined by the SEC is true and accurate on its face. 15 U.S.C. § 78z. Section 23 of the Securities Act of 1933 contains similar language involving registration statements filed with the SEC. 15 U.S.C. § 77w. Both sections make it "unlawful" for the SEC to make such a representation of accuracy or approval. We find these statutes to be an effective negation of TI's arguments, and see no need to strike the pertinent sections of its memoranda.

The final prerequisite for a § 14(d) action is that the tender offeror would own more than 5% of the targeted equity securities after consummation of the proposed offer. TI does not deny that it was the beneficial owner of more than 5% of the claims in bankruptcy held by KRC creditors after its tender offer to the Dietrich class members, but does argue that its ownership of claims in reorganization cannot be equated with the beneficial ownership of Phoenix securities. We disagree. Upon tender of their claims, Dietrich class members were required to execute an assignment giving TI a power of attorney to exercise any and all of their rights. Once TI accepted an assignment, the only impediment to actual ownership of Phoenix equity securities was the trustee's issuance of Phoenix stock according to the predetermined formula set forth in the plan. As we noted earlier, the issuance of those securities appeared imminent, as evidenced by TI's contemporaneous statements in its tender offer. Although the legal uncertainties surrounding the consummation of the plan posed some threat of delay, the eventual issuance of the stock appeared highly probable.

We conclude that TI's offer falls within the scope of § 14(d) of the Exchange Act. As a consequence, TI was obliged to file an appropriate informational statement with the SEC. It is undisputed that it did not do so. Accordingly, TI's motion to dismiss the SEC's § 14(d) claim in Count 3 of the complaint is denied, and the SEC's motion for summary judgment on Count 3 is granted. We defer the question of relief to Part III of this memorandum.

II. *The Claim of Fraudulent Nondisclosure and Misrepresentation*

[12, 13] Counts 1 and 2 of the SEC's complaint charge that TI's tender offer materials which it sent to the Dietrich class members contained numerous fraudulent misrepresentations and omissions, in violation of sections 10(b) and 14(e) of the Exchange Act, 15 U.S.C. §§ 78j(b) and 78n(e), and Rule 10b–5 promulgated thereunder, 17 C.F.R. § 240.10b–5. The elements of an action for injunctive relief are the same under § 14(e) and Rule 10b–5, except that under § 14(e) the plaintiff must establish that the alleged fraud was in connection with a tender offer while under Rule 10b–5 the alleged fraud must be in connection with the purchase or sale of securities. *Gulf & Western Industries, Inc. v. Great Atlantic & Pacific Tea Co., Inc.*, 476 F.2d 687, 695–696 (2d Cir. 1973); *Berman v. Gerber Products Co.*, 454 F.Supp. 1310, 1316 (W.D.Mich.1978). Both sections prohibit untrue or misleading statements and omissions, as well as any fraudulent, deceptive or manipulative acts or practices. The alleged misrepresentations and omissions must be material. The standard of materiality is an objective one, and is identical under both sections. *Berman, supra* at 1322. "An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote." *TSC Industries, Inc. v. Northway*, 426 U.S. 438, 449, 96 S.Ct. 2126, 2132, 48 L.Ed.2d 757 (1976). This standard contemplates that the omitted fact would have significantly altered the "total mix" of information made available. *Id.* The issue of materiality is a mixed question of law and fact. The underlying objective facts are only the starting point for the inquiry, with the ultimate determination resting on "delicate assessments a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him . . ." *Id.* at 450, 96 S.Ct. at 2133. This determination is normally inappropriate for summary judgment, unless reasonable minds could not differ on

the obvious importance or insignificance of an omitted fact to an investor's decision. *Valente v. Pepsico*, 454 F.Supp. 1228, 1238–39 (D.Del.1978).

The SEC alleges that TI's tender offer materials 1) omitted to disclose material financial information about KRC; 2) misrepresented and omitted to disclose material information about the trading market for Phoenix stock at the time of the tender offer; 3) failed to disclose the potential impact on Phoenix stock which could result from the reversal of several rulings by the reorganization court which were on appeal to the Court of Appeals for the Tenth Circuit; 4) misrepresented the comparability between the tender offer to the Dietrich class members and the prior tender offer to the senior and "trade" creditors. Each side has moved for summary judgment on all of the fraud claims, relying on certain affidavits and exhibits. We will examine each of the claims individually.

A. Financial Information about King Resources

TI's solicitation materials to the Dietrich class members reported that the reorganization court had set King's value as a going concern at between $90 million and $100 million. However, they did not include certain underlying financial calculations which were used to arrive at this figure, and did not report the SEC's opinion on the valuation evidence which was adduced at the court hearings on the plan. The SEC claims that these omissions were material and fraudulent. Specifically, the SEC argues that TI should have disclosed the value of KRC's producing and non-producing properties, and the trustee's forecasts of KRC's net income and net cash from its operations during the five-year period between 1975 and 1979. (Ponzio aff. ¶ 18).

In its original advisory report of August, 1975, the SEC agreed with the trustee that KRC was insolvent. It set KRC liabilities at a figure in excess of $100 million and valued KRC's assets at about $70 million. The asset valuation was consistent with the reorganization court's preliminary finding that the value of the assets was between $60 million and $80 million. On July 1, 1977, about a month after the trustee submitted the plan of reorganization which would later receive judicial approval, the SEC submitted a Second Advisory Report in which it cited new valuation evidence which purportedly demonstrated that KRC could no longer be regarded as insolvent. (Order in Response to Second Advisory Report of the SEC, p. 1).

The report stated that KRC's producing properties had undergone a dramatic increase in value between 1973 and 1977, from $30 million to $113 million (p. 18), while KRC's non-producing properties had remained relatively constant at about $35 million (p. 35). Although the *ex parte* character of the new valuation data made the SEC reluctant to conclude that the total estate was worth a combined amount of about $150 million, the SEC was confident enough to conclude that the original valuation figure of $70 million was "hopelessly obsolete" and that there was "very strong evidence" that the estate had sufficient producing reserves to cover all pre-bankruptcy claims (pp. 26, 28). The Second Advisory Report also contained a comparison of the trustee's operating and income forecasts based on the "obsolete" and the new valuation data. The trustee's original projections, for the years 1975–79, showed that net revenues would increase steadily from $7.6 million to $11.1 million, while net cash would decline steadily from $1.9 million to $0.3 million. Based on the new data, the trustee calculated that KRC's pre-tax income from its existing properties would remain close to $11 million for each year between 1977 and 1979. (p. 26).

The Second Advisory Report, containing this financial information, was sent to KRC's creditors in July, 1977 along with other materials designed to provide them with relevant data and analysis upon which they could cast their vote for or against the proposed plan. *See* Chap. X Rule 10–303(e); Corotto, *supra* at 1578. However, these materials were only sent to the Dietrich class representative, not to the individual class members. When TI made its tender offer to the senior creditors in August, 1977, it incorporated these materials by reference into its offer, since the senior creditors already had received them. However, TI made no reference to the materials or the Second Advisory Report when it made its tender offer to the Dietrich class members in December, 1977, and TI did not furnish any of those materials with its offer. The SEC points to TI's ready access to the report, and its unequal disclosure of its contents to the two groups of offerees, as persuasive evidence that TI's omission of the data in the report was a material and misleading one.

In response to the SEC's claim of inadequate disclosure of this financial information, TI argues that the Williams Act does not require it to disclose financial information about a target company, that the Act does not require it to disclose information which, like the report, is publicly available, and that the data in the report is not material since it was rejected by the reorganization court prior to confirmation of the plan.

[14] We question TI's assertion that it is under no obligation to disclose financial information about a target company. *See Weeks Dredging & Contracting v. American Dredging*, 451 F.Supp. 468, 477–78, 481–82 (E.D.Pa.1978) (value of target's stock and equipment); *Valente v. Pepsico*, 454 F.Supp. 1228, 1243 (D.Del.1978) (improvement in target's earnings performance). We also see little merit in its argument that the Second Advisory Report falls within the category of "readily available" financial information which is excused from disclosure. *Valente, supra* at 1243. It is hardly sufficient that the 20,000 Dietrich class members scattered "throughout the world" (Complaint, ¶ 10) could have read the document in regional SEC offices in four major American cities during the two-week period of the tender offer. However, we agree with TI that the challenged omissions concern data which was either rejected or discredited by the reorganization court, and therefore fail the test of materiality as a matter of law.

In its order responding to the SEC's Second Advisory Report, which was filed some five months before TI's tender offer, the reorganization court took issue with the SEC's valuation theories and its income forecasts. It found that "the SEC's suggested higher valuation is conjectural and is not supported by concrete, definite, reliable or competent evidence." With respect to the income forecasts, it noted that over the past three years (1974–76), KRC's actual earnings had averaged about $3 million. By contrast, the SEC projected that KRC's earnings for the next three years (1977–79) would average about $11 million, and opined that $12 million was "a fair representation of the earning power of the existing assets on a going concern basis." The reorganization court found that this fourfold leap in earnings was unrealistic and conjectural, and stated "that the actual earnings record of the past three years is a [more] reliable criterion of future performance."

Given this judicial rejection of the financial information, we see no likelihood that the Dietrich class members would have attached substantial significance to this data in making their tender offer decision. Indeed, to disclose this financial data based upon such conjectural or unreliable evidence might itself have been misleading. TI was completely accurate in disclosing the final valuation figure ($90–100 million) fixed by the reorganization court, and a greater specification of the underlying valuation controversy could have created unnecessary confusion and prolixity in the offering materials. *See Susquehanna Corp. v. Pan American Sulphur Co.*, 423 F.2d 1075, 1085–86 (5th Cir. 1970); *Freedman v. Barrow*, 427 F.Supp. 1129 (S.D.N.Y.1976).

For these reasons we reject, as a matter of law, the SEC's allegation that TI failed to disclose material financial information concerning KRC and grant summary judgment to TI on this allegation of material omission.

B. The Current Market for Phoenix Stock

In its solicitation materials, TI reported that shares of the new Phoenix stock had been trading since mid-November in the over the-counter market on a "when, as and if issued" basis. TI also stated that since trading began, the "bid" price of Class B stock had ranged from $14 to $17 ½ per share, and the "bid" price of Class A stock had a range approximately 1½ times that level, in proportion to its convertibility into 1½ shares of Class B stock. TI's offer of $0.86 for each $1.00 of claims held by the Dietrich class members was equivalent to an offer of $13.77 for each share of Class B stock.[5]

[15] The SEC charges that TI's disclosure was misleading or incomplete in two respects. First, although the SEC does not challenge the accuracy of the range of market "*bid*" prices of Phoenix stock, it contends that TI should also have stated that the range of market "*ask*" prices was from $15¼ to $18 per share, that the lowest "ask" and "bid" prices occurred during the opening week of trading, that the "ask" and "bid" prices steadily increased, and "ask" levelled off at $18 during the week prior to TI's tender offer. Second, the tender offer failed to convert this $18 "ask" price into a figure of $1.12 for each $1.00 of allowed claims, thereby permitting a better comparison of the market and tender offer values. (Ponzio aff. ¶¶ 15, 21).

TI's disclosure of "bid" prices was in complete conformity with the SEC's own published rule on the information to be contained in tender offer statements filed pursuant to § 14(d)(1) of the Exchange Act. That rule requires an offeror to:

> Identify the principal market in which [the] securities [being sought] are traded and state the high and low *sales* prices for such securities in such principal market (or, in absence thereof, *the range of high and low bid quotations*) for each quarterly period during the past two years. (17 C.F.R. § 240.14d-100, Item 1(c), effective Aug. 31, 1977, 42 Fed.Reg. 38341 (July 28, 1977)). (emphasis added).

TI did exactly that. According to the company's executive vice president, TI received its published bid prices from a major brokerage firm, which in turn obtained that information from market makers in Phoenix stock, including Arbitrage Securities. (Gist aff. ¶ 3).

The SEC argues that "ask" as well as "bid" prices should have been disclosed, so that Dietrich class members could have compared TI's tender offer "to what *might* be obtainable by selling in [the OTC] market." (SEC Reply Br. p. 16). The SEC's "might" standard is reminiscent of the now-rejected theory that tender offerors must disclose all information which "might" be considered important by a reasonable shareholder. *TSC Industries v. Northway,* 426 U.S. 438, 96 S.Ct. 2126, 48 L.Ed.2d 757 (1976). That theory has been replaced by a "would" standard, and we believe the same reasoning compels the conclusion that a shareholder need only be told what price he probably *would* receive in the current market. By that standard, the buyer's "bid" prices are a more accurate and meaningful reflection of the current market than the seller's "ask" prices. Therefore, we hold that, as a matter of law, TI was not obliged to disclose the relevant "ask" prices for the Phoenix stock, and we grant summary judgment to TI on this issue of material omission.

[16] The SEC's second objection to the disclosure of the market information was that TI failed to convert the $18 "ask" price into a $1.12 per $1.00 claim figure for easier comparability with the $0.86 tender offer price. Even assuming that the $18 ask price should have been disclosed, this additional mathematical computation is superfluous. TI's materials clearly stated that its offer was equivalent to a price of $13.77 per share and that the OTC market ranged from $14-17 per share. These per share figures yield the same comparative ratio as the SEC's suggested per claim figures, since the conversion factor between claims and shares is a fixed proportion. Therefore, the SEC's suggestion is little more than a drafting comment which creates a qualitative but not a quantitative difference. As a matter of law, it does not constitute a material omission and we grant summary judgment to TI on this issue of material omission.

5. Under the plan of reorganization, the Dietrich class was entitled to receive 25 shares of Class A and 25 shares of Class B stock for each $1,000 of allowed claims. The class owned $13 million in claims, which entitled them to a total of 325,000 shares of Class A and 325,000 shares of Class B stock. Assuming convertibility at the 1.5 A to B ratio, they were entitled to a total of 812,500 shares of Class B stock. Under the terms of TI's offer, it would pay $11.18 million ($13 million of claims × $0.86 per dollar of claim) for these 812,500 shares, or $13.77 per share.

C. The Pending Appeals in the Tenth Circuit

Several of the reorganization court's rulings in conjunction with its confirmation of the plan were appealed to the Court of Appeals for the Tenth Circuit in October and November, 1977, one or two months prior to TI's tender offer. TI's offering materials described the pertinent rulings and the pending appeals in some detail. TI stated that at the time of confirmation, the court reaffirmed its earlier finding that KRC was insolvent, placed KRC's value as a going concern at between $90 million and $100 million, and denied a motion by certain trustees to eliminate that feature of the plan which provided for the conversion of Class A stock into Class B stock. TI also noted that the court's rulings on insolvency, on the fairness and feasibility of the plan, and on the motion attacking the conversion feature had been appealed. Finally, TI stated that "the outcome of the various motions and appeals and their impact on the Plan cannot be determined at this time."

The SEC claims that TI's discussion of the appeals were deficient in two respects. First, TI failed to compute the value of Phoenix's stock if the appellate court disagreed with the reorganization court's valuation of KRC's assets, and instead accepted the higher valuation figures proposed by the SEC. Second, it failed to compute the value of TI's tender offer to the Dietrich class members assuming that the challenged conversion feature of the plan were eliminated on appeal.

[17, 18] To evaluate the SEC's claims, we must first outline the general standard of materiality as it applies to prospective events. That standard is succinctly stated in *Sonesta Int'l Hotels Corp. v. Wellington Associates,* 483 F.2d 247, 251 (2d Cir. 1973):

> To be material a statement in a tender offer need not necessarily relate to a past or existing condition or event. It may refer to a prospective event, even though the event may not occur, provided there appears to be a reasonable likelihood of its future occurrence. . . . A reasonable stockholder, once informed of the contingency, can then determine whether to assume the risk of its occurrence or non-occurrence in accepting or rejecting the tender offer. Where the event, if it should occur, could influence the stockholder's decision to tender, the chance thát it might well occur is a factor that should be disclosed to the investor in making his or her decision. (Citations omitted).

In applying these principles, at least one court has held that a tender offeror was obliged to disclose the fact that substantial legal obstacles, perhaps resolvable only through litigation, stood in the way of its stated goal of gaining control of the target company. *Alaska Interstate Co. v. McMillian,* 402 F.Supp. 532, 553, 575 (D.Del.1975); *see* Aranow, Einhorn & Berlstein, *supra* at 69-71.

In the present case, TI clearly disclosed in its materials that appellate proceedings were pending, had a potential impact on the plan, and could delay its final consummation. However, TI did not attempt to predict any specific impact on the plan assuming various alternative outcomes on appeal. The SEC seeks to impose this obligation on TI. We think such a burden is wholly unjustified.

There is a tremendous difference between disclosing the likelihood of litigation and disclosing its probable result. The first is at least partially a function of objectively verifiable factors, such as the stated intentions of the parties, their willingness to compromise, and the requirements imposed by existing contractual agreements. The second is largely a speculative judgment, especially in the complex field of securities and bankruptcy law, where a multitude of factual detail, statutory interconnections and relief options often put even the most skilled lawyers on unsettled or uncertain legal ground. We can think of no method, short of divine inspiration, by which TI could have perceived a "reasonable likelihood" that the appeals would be decided one way or another. The reorganization court recognized that the valuation issues posed "inherent uncertainties." (Order in Response to Second Advisory Report of the SEC, p. 1). Those valuation issues were closely tied to the fairness of the conversion feature in the plan. We think that TI was accurate in limiting its comments to a description of the issues on appeal and a statement that the appeal may affect the plan. It was not required to speculate on potential outcomes. Indeed, such speculations could have confused or misled the shareholders. *See Kohn v. American Metal Climax, Inc.*, 458 F.2d 255, 265 (3d Cir.1972), *cert. denied*, 409 U.S. 974, 93 S.Ct. 120, 34 L.Ed.2d 126. Accordingly we grant summary judgment to TI on this issue of material omission.

D. The Comparability of TI's Two Tender Offers

TI's first move toward acquiring KRC was made in August, 1977, when it offered certain senior and "trade" creditors $1.02 for each $1.00 of their claims. Four months later, TI took a second step by offering the Dietrich class members $0.86 for each $1.00 of their claims. In the second paragraph of its cover letter of the solicitation materials it sent to the Dietrich class members, TI made a statement which compared these two offers. The statement was conspicuously typed in all capital letters, and read as follows:

> THE AMOUNT BEING OFFERED TO YOU IS MORE THAN THE AMOUNT PAID BY TEXAS INTERNATIONAL FOR THE CLAIMS OF SENIOR CREDITORS OF KING, BASED UPON THE NUMBER OF SHARES OF STOCK IN KING TO BE RECEIVED BY YOU. SEE SECTION 6 OF THE OFFER TO PURCHASE, "INFORMATION ABOUT KING–TI'S PURCHASES."

Section 6 of the offering materials elaborated upon this assertion, explaining that TI had paid the senior creditors $26.7 million for the right to receive 1,305,000 shares of Class A stock, which was convertible into 1,958,000 shares of Class B stock. TI stated that this payment converted into a price of $13.64 per share. TI then explained that its offer of $0.86 on the dollar was equivalent to a price of $13.77 per share.[6]

While not disputing the accuracy of TI's mathematical computations, the SEC charges that TI's statement in its cover letter was materially misleading because it highlighted only one aspect of the two offers and failed to provide full information which would have put the offered amounts in their proper perspective. Specifically, TI failed to explain that although the senior creditors received less money per share of Class B stock than the Dietrich class members, they were entitled to receive more shares of Class B stock for each $1,000 of their claims.

Under the plan, senior creditors would receive 50 shares of Class A stock for each $1,000 of claims, or the equivalent of 75 Class B shares after full conversion. Dietrich class members would receive 25 shares of Class A and 25 shares of Class B stock for each $1,000 of claims, or the equivalent of 62.5 Class B shares after full conversion. If we multiply the number of Class B shares per $1,000 of claims times the price per share contained in TI's two offers, we find that senior creditors would receive a total of $1,020 per $1,000 of claims, while Dietrich class members would receive $860 per $1,000 of claims. In other words, the senior creditors would receive more money on a per claim basis, even though their per share take was less. The ratio between these totals is, of course, the same as that provided by a direct comparison of the prices in the two offers–$0.86 and $1.02 per dollar of claim. TI did not provide such a direct comparison in its materials. It did mention the $1.02 figure as the price it paid for claims of the "trade" creditors, and it stated that those claims were purchased simultaneously with the claims of senior creditors, but it nowhere stated that senior creditors were paid $1.02 on the dollar. In fact, the implication of parity between trade and senior creditors was negated by TI's statement that the trade creditors received the equivalent of $16.57 per share of Class B stock, nearly $3.00 more than the senior creditors.

[19, 20] A disparity in the treatment between two classes of shareholders included in a tender offer is generally of great importance to the disfavored shareholder and should be disclosed. *Valente v. Pepsico, Inc.*, 454 F.Supp. 1228, 1244 (D.Del.1978); *Gould v. American–Hawaiian S. S. Co.*, 535 F.2d 761, 771 (3d Cir. 1976). Furthermore, "omission of a fact which makes a statement concerning the value of the target company's share misleading is material, for value of the stock is likely to be an important consideration to the shareholder." *Weeks Dredging & Contracting v. American Dredging*, 451 F.Supp. 468, 477 (E.D.Pa. 1978). In the present case, we hold that the SEC has demonstrated that TI's statement on the comparability of the two offers was materially misleading. In its solicitation materials, TI gave predominant emphasis to its assertion that the Dietrich offer was worth more than the offer to the senior creditors on a per share basis. That per share method of computation when viewed in isolation is inherently misleading since the share distributions to the two groups of creditors under the plan were unequal. A per claim comparison is necessary to give the proper weight to the two offers, because it speaks in a uniform currency which is untainted by the application of the terms of the plan. In other words, a dollar per claim formulation provides a pure comparison of the total amount of money offered to each class. By that standard, the Dietrich class members in fact would receive less than the senior creditors.

TI argues that it preserved the accuracy of its statement by adding the provision that its price comparison was "based upon the number of shares of stock in King to be received by [the Dietrich class members]." However, this statement is only partially curative, since it suggests that the price comparison is limited to a per share basis but does not provide alternative data on a per claim basis. In addition, the qualifying language is ambiguous, and erroneously suggests that the value of the total package is greater for the Dietrich class members.

Accordingly, we grant summary judgment to the SEC on this issue of material misrepresentation and omission.

E. The Scienter Requirement

[21] There is one additional issue we must address. TI contends that in addition to materiality, the SEC must show that TI's alleged omissions or misrepresentations were made with scienter. In its briefs it relied primarily on *Ernst and Ernst v. Hochfelder*, 425 U.S. 185, 96 S.Ct. 1375, 47 L.Ed.2d 668 (1976), where the Supreme Court held that some showing of scienter–"a mental state embracing intent to deceive, manipulate or defraud," 425 U.S. at 193 n.12, 96 S.Ct. at 1381 n.12–is an essential element of a damage claim by a private litigant under § 10(b) of the Exchange Act. The Court left open the question of whether reckless behavior might also be sufficient to impose liability, and whether scienter is a necessary element in SEC injunctive actions. 425 U.S. at 193 n.12, 96 S.Ct. at 1381. Insofar as an action under § 10(b) and Rule 10b–5 is concerned the Court has now resolved the question and imposed a proof of scienter burden on the SEC. *Aaron v. SEC*, — U.S. ——, 100 S.Ct. 1945, 64 L.Ed.2d 611 (1980).

The second question is whether a similar standard of scienter should also apply to SEC actions brought under § 14(e) of the Exchange Act. That issue, too, has been

6. See fn. 5, p. 1248 *supra*.

left open in Supreme Court decisions. *Piper v. Chris-Craft Industries, Inc.*, 430 U.S. 1, 47, 97 S.Ct. 926, 952, 51 L.Ed.2d 124 (1977). Nevertheless, federal courts have consistently held that the similarity in language between the two sections justifies a requirement of some culpability in private actions under § 14(e). *Chris-Craft Industries, Inc. v. Piper Aircraft Corp.*, 480 F.2d 341, 362–63, 397–98 (2d Cir. 1973); *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579, 606 (5th Cir. 1974); *Lowenschuss v. Kane*, 520 F.2d 255, 268 n.10 (2d Cir. 1975); *A & K Railroad Materials v. Green Bay & W. R. Co.*, 437 F.Supp. 636, 641–42 (E.D.Wis.1977). The Seventh Circuit has accepted the reasonableness of this conclusion, short of adopting the conclusion itself. *Indiana Nat'l Bank v. Mobil Oil Corp.*, 578 F.2d 180, 184 n.8 (7th Cir. 1978).

We agree that both sections merit the same standard of culpability. Section 10(b) makes it unlawful to use or employ "any manipulative or deceptive device or contrivance." Section 14(e) makes it unlawful for any person to "engage in any fraudulent, deceptive, or manipulative acts or practices." In *Hochfelder*, the Supreme Court held that the word "manipulative" is "especially significant," manifests an "unmistakable" congressional intent to prohibit something more odious than simple negligent conduct, and "connotes intentional or willful conduct designed to deceive or defraud investors . . ." 425 U.S. at 197–99, 96 S.Ct. at 1384. Moreover, unlike other sections of the Act which prohibit practices which "operate as a fraud or deceit" and therefore focus attention on the effect of potentially misleading conduct on the public, *see* 15 U.S.C. § 77q(a), section 14(e) and 10(b) both focus on the culpability of the person responsible. *SEC v. Coven, supra*, 581 F.2d at 1026; *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 195, 84 S.Ct. 275, 284, 11 L.Ed.2d 237 (1962). We therefore hold that the SEC must prove scienter under either § 10(b) or § 14(e).

The final task before us on the scienter issue is to define the parameters of that concept. In *Aaron* the Court did not elaborate beyond its statements in *Hochfelder*. Accordingly, *Hochfelder* remains our guide.

Although the Court in *Hochfelder* initially defined scienter as a "mental state embracing intent to deceive, manipulate or defraud," it limited that definition to the case before it. 425 U.S. at 193–94 n.12, 96 S.Ct. at 1381. In other parts of the opinion, the Court seems to have recognized that scienter is not a rigid concept encompassing only the specific intent to accomplish a particular purpose. Thus, the Court expressly left open the question of whether reckless conduct could provide a sufficient basis for civil liability under § 10(b). *Id.* At another point, the Court described its holding as a "conclusion that § 10(b) was addressed to practices that involve *some element of scienter* and cannot be read to impose liability *for negligent conduct alone*." 425 U.S. at 201, 96 S.Ct. at 1385 (emphasis added). Finally, Justice Powell stated that the statutory language "strongly suggest[s] that § 10(b) was intended to proscribe *knowing* or intentional misconduct." 425 U.S. at 197, 96 S.Ct. at 1383 (emphasis added).

Since *Hochfelder*, the federal trial and appellate courts have sought to give greater focus to that gray area of misconduct which is more culpable than mere negligence, but less egregious than willful intent to defraud. Noting that "there has not been any inter-Circuit controversy that *scienter* short of specific intent to defraud is sufficient to support liability," the Seventh Circuit has assessed Rule 10b-5 liability for reckless behavior. *Sunstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1044 n.16 (7th Cir.), *cert. denied*, 434 U.S. 875, 98 S.Ct. 225, 54 L.Ed.2d 155 (1977). It defined such conduct as:

> "a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it."

Wright v. Heizer Corp., 560 F.2d 236, 251–52 (7th Cir. 1977); *Sanders v. Nuveen & Co.*, 554 F.2d 790 (7th Cir. 1977). This test is closer to intent than negligence, and is more egregious than "white heart/empty head" good faith. *Sundstrand Corp., supra*, 553 F.2d at 1045. Thus, on the objective side, there must be an actual or obvious danger that the omissions were misleading and, on the subjective side, the nondisclosures must be caused by more than the defendant's simple forgetfulness or inadvertence. *Id.* A few courts have ventured beyond recklessness, and have concluded that § 10(b) also reaches "knowing" conduct. Under this test, actual knowledge of the falsity or incompleteness of the disclosed information, combined with participation in the preparation or dissemination of the informational materials, is sufficient to satisfy the scienter requirement. *Nelson v. Serwold*, 576 F.2d 1332, 1336–38 (9th Cir. 1978); *Weinberger v. Kendrick*, 432 F.Supp. 316, 319 (S.D.N.Y.1977); *In Re Transocean Tender Offer Securities Litigation*, 455 F.Supp. 999, 1009–12 (N.D.Ill.1978).

On the basis of the present record, the SEC has not established, as a matter of law, that TI's misrepresentation of the comparability of the two offers to the senior creditors and the Dietrich class members was either knowingly or recklessly made. Indeed, it has not shown a reasonable likelihood of success on the merits on this issue. SEC contends that its burden is fulfilled because TI at all times possessed the allegedly material information on comparability, yet failed to disclose it. However, mere possession and nondisclosure is not sufficient: there must also be actual knowledge of its falsity or incompleteness. TI has submitted an affidavit from its Executive Vice President, Mr. Gist, which negates such knowledge. Gist states that he closely followed the KRC reorganization proceedings beginning in November, 1976 and believed at the time of the mailing of the Dietrich solicitation that those offering materials contained a full and fair disclosure of all material facts. He also states that he relied on the advice of his counsel that neither the federal securities laws nor the SEC's rules required TI to file its offering materials with the SEC or to make a fuller disclosure. Finally, he quotes a statement from KRC's trustee, made after the Dietrich tender offer, in which the trustee said he found no reason to doubt the accuracy of TI's offering materials. Although Gist's self-serving affidavit untested by cross-examination is not conclusive, the scanty evidence we presently have before us does not convince us that TI knowingly or recklessly violated the statute. In short, a disputed issue of fact exists on the issue of scienter which we decline to resolve without a full evidentiary hearing. Accordingly, the cross-motions for summary judgment are denied on the issue of scienter.

In addition, SEC's motion for a preliminary injunction is denied on the fraud issues.

III. *Relief*

The only remaining issue is whether permanent injunctive relief is appropriate for Count 3 of the complaint, since TI's failure to file the appropriate tender offer statement under § 14(d) of the Act has been established. In part 3 of its prayer, the SEC has requested a permanent injunction to require TI to comply with that statutory obligation, and has also requested an order requiring TI to make an offer of rescission to the Dietrich class members who accepted its tender offer.

A. Injunctive Relief

[22, 23] Section 21(d) of the Exchange Act, 15 U.S.C. § 78u(d), empowers the SEC to bring an action for injunctive relief when it appears that any person "is engaged or about to engage in any acts or practices which constitute or will constitute a violation" of that Act or its implementing regulations. A permanent or temporary injunction or restraining order will be granted "upon a proper showing." Under this standard, the SEC need not show irreparable harm but need only show that the statutory conditions have been satisfied. *SEC v. American Realty Trust*, 429 F.Supp. 1148, 1174 (E.D.Va.1977). This determination involves an evaluation of past, present, and possible future violations. "A simple con-

clusion that illegal activity has occurred, without more, does not provide a basis for relief." *Id.* at 1174. Although past illegal conduct is "highly suggestive of the likelihood of future violations," *SEC v. Keller Corp.*, 323 F.2d 397, 402 (7th Cir. 1963), the critical question is whether there is a reasonable likelihood that the wrong will be repeated. *SEC v. Cenco, Inc.*, 436 F.Supp. 193, 197 (N.D.Ill.1977). That inference requires an appraisal of the totality of the circumstances and factors suggesting that the violation may or may not have been an isolated occurrence. The relevant factors include the character of the past violations, the effectiveness of the discontinuance, the bona fides of the expressed intent to comply, the number and duration of past wrongs, the time which has elapsed since the last violation, the opportunity to commit further illegal acts, the novelty of the violation, the harmful impact of the injunction on the defendant and the willfulness or bad faith in a defendant's prior conduct. *SEC v. National Student Marketing Corp.*, 360 F.Supp. 284, 297 (D.D.C.1973); *SEC v. Koracorp Industries*, 575 F.2d 692, 699 (9th Cir. 1978).

[24] The SEC characterizes TI's failure to file its offering materials with the SEC as a continuing violation since those materials have yet to be filed. However, § 14(d) requires all offering materials to be filed "at the time copies of the offer . . . are first published or sent or given to security holders," and that all subsequent materials shall be filed "not later than the date such materials is first published or sent or given to any security holders." At worst, those time limits expired in late December, 1977. There have been no subsequent events which triggered additional violations of the Act. Therefore, we reject the SEC's continuing violation theory. Thus, no violations of § 14(d) have occurred over the past two years. In addition, since the tender offer in question expired on January 6, 1978, the targeted investors have nothing to gain from a belated filing with the SEC.

The SEC contends that because TI made two tender offers for control of KRC, and has acquired twenty-six companies since 1966, it is an "acquisition-minded" company and will likely be making more purchases in the future. However, this fact is outweighed by the novelty of the circumstances surrounding the Dietrich offer. The offer erupted at the confluence of two uncharted streams of bankruptcy and securities law, where the application of § 14(d) was a legal issue of genuine uncertainty and unique complexity.

Finally, the SEC has failed to demonstrate any willfulness or bad faith in TI's conduct. Although TI, in turn, has failed to express an intention of voluntarily complying with § 14(d), we believe that its reluctance stems from a good faith belief in an erroneous construction of federal statutes. Therefore, we find that, under all the circumstances, the SEC has not made a proper showing for a permanent injunction on Count 3 of its complaint.

B. Rescission

[25, 26] In addition to an injunction enjoining TI from future violations, the SEC also seeks relief in the form of an order requiring TI to make a full rescission offer to all Dietrich class members. Section 27 of the 1934 Act, 15 U.S.C. § 78aa, under which this action is brought, confers general equity powers upon the district courts. *SEC v. Investors Security Corp.*, 560 F.2d 561, 566–67 (3d Cir. 1977). "Once the equity jurisdiction of the district court has been properly invoked by a showing of a securities law violation, the court possesses the necessary power to fashion an appropriate remedy." *SEC v. Manor Nursing Centers, Inc.*, 458 F.2d 1082, 1103 (2d Cir. 1972). The available remedies include a rescission order. *Chris-Craft Industries, Inc. v. Piper Aircraft Corp.*, 480 F.2d 341, 390–91 (2d Cir. 1973). These remedies are available even though no injunctive relief is granted. *SEC v. Penn Central Co.*, 425 F.Supp. 593, 599 (E.D.Pa.1976). In general, the court's equity power is to be exercised when it effectuates the statutory purposes, such as by depriving defendants of gains made through violations, by deterring future violations,

and by increasing the overall efficiency of private actions. *Chris-Craft Industries, supra; SEC v. Penn Central Co., supra.*

Although we have found TI in violation of the federal securities laws by failing to file its tender offer materials with the SEC, this violation in itself does not warrant a rescission order. Noncompliance with the reporting and filing requirements of the Williams Act does not necessarily result in injury or prejudice to investors. The tender offer materials may be unassailable under the anti-fraud provisions of the securities laws even though the SEC has been deprived of an opportunity for supervision over the solicitation. The SEC has not, at least at this stage of the proceedings, proved that TI's tender offer materials contained any fraudulent misrepresentations or omissions. In the absence of such violations, the use of a rescission order for noncompliance with statutory filing requirements strikes us as a disproportionately severe remedy which does not effectuate the statutory purposes. Accordingly, the SEC's prayer for a rescission order is denied pending final adjudication of the fraud issues.

IV. *Conclusion*

To summarize, TI's motion to dismiss Count 3 of the complaint is denied. The SEC's motion for summary judgment on Count 3 is granted. TI's motion for summary judgment on Counts 1 and 2 is granted as to all but the claim set forth in II(D) and the issue of scienter set forth in II(E) of this memorandum. The SEC's motion for summary judgment on Counts 1 and 2, its motion to strike, its motion for a preliminary injunction and its motion for a permanent injunction are denied in their entirety. Cause set for report on status November 14, 1980 at 11:00 a. m.

UNITED STATES of America,

v.

VELSICOL CHEMICAL CORPORATION, a corporation, formerly Michigan Chemical Corporation, Charles L. Touzeau, and William Thorne, Defendants.

Crim. No. 79–492.

United States District Court, District of Columbia.

Sept. 30, 1980.

Corporation and two of its employees were charged with concealing, falsifying, and covering up material facts relating to contamination and adulteration of food and drug products and with conspiring among themselves and with others to defraud the Food and Drug Administration in performance of its functions. On defendants' motions to dismiss, the District Court, Parker, J., held that the indictment, which was returned after corporation pled nolo contendere to misdemeanor feed adulteration charges, was result of prosecutorial vindictiveness and thus was to be dismissed.

Dismissed.

1. Indictment and Information ⇐144.1(1)

Indictment charging corporation and two of its employees with concealing, falsifying, and covering up material facts relating to contamination and adulteration of food and drug products and conspiring among themselves and with others to defraud the Food and Drug Administration in performance of its lawful functions was to be dismissed for prosecutorial vindictiveness due to fact that the charges were filed in retaliation for corporation's nolo contendere plea entered on misdemeanor feed adulteration charges. U.S.C.A.Const. Amend. 5.

2. Criminal Law ⇐986(3)

Under the "vindictive sentencing doctrine," whenever a more severe sentence is imposed after retrial, reasons for the decision must be set forth on record by trial