Theories of Liability Under Convertible Debenture Redemption Notice Requirements

Andrew Macdonald

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Recommended Citation
Andrew Macdonald, Theories of Liability Under Convertible Debenture Redemption Notice Requirements, 44 Fordham L. Rev. 817 (1976).
Available at: https://ir.lawnet.fordham.edu/flr/vol44/iss4/4
I. INTRODUCTION

When an investor\(^1\) purchases a debenture\(^2\) he obtains a security\(^3\) which entitles him to receive a fixed interest on the face amount of the debenture until it matures and if the corporation calls in its debenture prior to maturity, the investor also receives a premium.\(^4\) If the debenture is also convertible, it affords the investor the additional option, at some date prior to redemption, of converting his debenture for a certain number of shares in the issuing corporation.\(^5\) In order to take advantage of this conversion privilege the investor must be informed if the corporation calls in its debentures for redemption. Since the redemption period is relatively short, extending for only thirty days in some instances,\(^6\) there is a danger that notice will not be received so as to enable the holder to convert before the expiration of the conversion privilege (which may precede the date of redemption). If this occurs, the investor loses his right of conversion,\(^7\) as well as the associated potential financial gain.\(^8\) Failure to convert because of the lack of notice of the

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\(^1\) For a discussion of the types of investors who are attracted to convertible securities and why, see 1 A. Dewing, The Financial Policy of Corporations 270-71 (5th ed. 1953).

\(^2\) A debenture differs from a bond in that a debenture is a debt secured by the general credit of the corporation while a bond is secured by specific property of the debtor corporation. H. Guthmann \& H. Dougall, Corporate Financial Policy 204 (4th ed. 1962).


\(^5\) See, e.g., Van Gemert v. Boeing Co., 520 F.2d 1373, 1375 (2d Cir.), cert. denied, 96 S. Ct. 364 (1975) ("The debentures were to pay interest of 4½ per cent per annum and were to be convertible by the debenture-holder into common stock at a rate (subject to adjustment) of two shares per $100 principal amount of debentures."); Abramson v. Burroughs Corp., [1971-1972 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 93,456, at 92,253 (S.D.N.Y. 1972); Kaplan v. Vornado, Inc., 341 F. Supp. 212, 213 (N.D. Ill. 1971). Although there may be instances when debentures are made convertible at the option of the issuer, W. Cary, Corporations 978 (4th ed. 1970), litigation discussed in this Note arises when the option to convert is preempted by the issuers right to redeem.

\(^6\) E.g., Van Gemert v. Boeing Co., 520 F.2d 1373, 1376 (2d Cir.), cert. denied, 96 S. Ct. 364 (1975) (30 days); Abramson v. Burroughs Corp., [1971-1972 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 93,456, at 92,253 (S.D.N.Y. 1972) (33 days); Kaplan v. Vornado, Inc., 341 F. Supp. 212, 213 (N.D. Ill. 1971) (30 days). The length of the redemption period is measured from the date on which the first notice concerning redemption is published to the date on which the debentures are to be redeemed.


\(^8\) Id. at 271. "During a four-month period in 1967, the conversion rights of holders of convertible securities having a face value of $1,313,000 were terminated by redemptions. Since the stock into which these securities could have been converted had a market value of well over three million dollars, the holders suffered a loss in excess of $1,700,000." Id. In Van Gemert v.
redemption call, destroys the advantageous qualities of the debentures for the investor and as a result, litigation instituted by aggrieved investors has often focused upon the adequacy of the notice provided by the issuing corporation.

In addition to a cause of action arising from breach of the covenants of the issuing corporation contained in the indenture, corporate liability for failure to give sufficient notice of an impending redemption may be predicated on three theories. First, the plaintiff may allege that the redemption notice did not meet the standards set forth in the listing agreement entered into by the issuing corporation and the stock exchange. A cause of action may thus be implied under federal law on the theory that the exchange rule, qua listing agreement, violated was an extension of the Securities Exchange Act of 1934 and an integral part of the statutory scheme under which exchanges are required to adopt rules. Second, it may be alleged that, not-

Boeing Co., 520 F.2d 1373, 1375 (2d Cir.), cert. denied, 96 S. Ct. 364 (1975), the total loss alleged by fifty-six investors was over $2,000,000.

On a smaller scale, one court was faced with a suit brought by an individual investor to recover $35,049. In that case the selling price of the stock he would have received upon conversion was $45,424 while the amount he actually did receive was only $10,375—paid by the company for the bonds at their redemption. Abramson v. Burroughs Corp., [1971-1972 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 93,456, at 92,253 (S.D.N.Y. 1972).


10. Perhaps the most attractive quality is the possibility of financial gain through the exercise of the conversion privilege. See note 8 supra and accompanying text.


12. It has been suggested that there might possibly be another claim for liability based upon the Trust Indenture Act of 1939, 15 U.S.C. §§ 77 aaa-bbbb (1970). Van Gemert v. Boeing Co., 520 F.2d 1373, 1385 (2d Cir.), cert. denied, 96 S. Ct. 364 (1975). The appellants in Van Gemert also contended that the indenture was an adhesion contract because of the disparate bargaining powers of the parties involved. Id. at 1380. This theory was advanced in Cornell Note, supra note 7, at 272-73.

13. A company that wishes its securities to be traded on a national stock exchange must file a listing application with both the exchange and the SEC. As a result of this application process, a Listing Agreement is formulated between the exchange and the company. See H. Guthmann & H. Dougall, Corporate Financial Policy 390 (4th ed. 1962).

14. But see note 79 infra and accompanying text.

withstanding the indenture or the listing agreement, the notice of the redemption call was neither proper nor sufficient. Finally, the plaintiff may allege that he, as an investor who purchased debentures from the issuing corporation, is a third party beneficiary of the listing agreement between the corporation and the exchange.

A recent Second Circuit Court of Appeals decision, *Van Gemert v. Boeing Co.*,\(^{16}\) illustrates the problems raised by the notification procedure. In 1958, Boeing offered its shareholders one hundred dollar convertible debentures that matured July 1, 1980. The indenture provided that if the debenture was called by the corporation prior to maturity, the holder was entitled to convert up to and including the tenth day prior to the redemption date. The indenture further provided that the corporation furnish the holder of a called security with "'not less than 30 nor more than 90 days' prior notice.'"\(^{17}\) Publication in an authorized newspaper constituted sufficient notice. On the other hand, Boeing's listing agreement with the NYSE provided that the company would publish immediately "any action taken . . . with respect to . . . any rights or benefits pertaining to the ownership of its securities listed on the Exchange . . . and will afford the holders of its securities . . . a proper period within which . . . to exercise their rights.'"\(^{18}\)

In 1966, Boeing decided to recall the debentures, setting April 8th as the redemption date with the conversion privilege expiring ten days earlier, on March 29th. On February 28, 1966 a press release was given to the financial editors of the New York Times, New York Herald Tribune, Wall Street Journal and other national newspapers, in addition to the major wire services. However, this press release did not contain the dates of redemption or of the expiration of the conversion privilege. On March 8th and 18th, notice, in the form of advertisements, appeared in the Wall Street Journal. Still, on March 25th, four days before the end of the conversion period, over one-half of the outstanding debentures remained unconverted. At that time a second press release was issued containing the redemption date and the conversion expiration date which the first had lacked. On March 28th, the company republished its earlier advertisements in all the editions of the Wall Street Journal and the New York Times. Fifty-six investors, holding debentures worth one and one-half million dollars on their face and four million dollars upon conversion, failed to convert their debentures by the redemption date. Following the loss of their option, plaintiff investors instituted a class action against Boeing, alleging that the corporation had provided them with insufficient notice. Boeing had, in fact, complied with the notice requirements of the indenture\(^{19}\) but had failed to do so with regard to the applicable provisions of the listing agreement.\(^{20}\)

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17. Id. at 1376 (emphasis deleted).
18. Id. (emphasis deleted).
19. The Indenture, a 113 page booklet, provided in part: "'In case the Company shall desire to exercise the right to redeem all or any part of the debentures . . . it shall publish prior to the date fixed for redemption a notice of such redemption at least twice in an Authorized Newspaper, the first such publication to be not less than 30 days and not more than 90 days before the date fixed for redemption. Such publication shall be in successive weeks but on any day of the week.'"
II. IMPLIED FEDERAL CIVIL LIABILITY

The Securities Exchange Act of 1934\(^\text{21}\) imposed a broad self-regulatory scheme upon registered stock exchanges under which such exchanges could, subject to the supervisory and limited coercive control of the SEC, make and enforce their own rules.\(^\text{22}\) The rules so promulgated provide for disciplinary measures for members\(^\text{23}\) who do not abide by "just and equitable principles of trade."\(^\text{24}\) The Act provides further that the federal district courts "shall have

Id. "An 'Authorized Newspaper' is defined as one published at least five days a week and of general circulation in the borough of Manhattan, N.Y." Id. at 1376 n.6.

20. See note 128 infra. The NYSE Company Manual specifically defines what is meant by publicity in the listing agreement: "Publicity: the term 'publicity' . . . as used in the listing agreement in respect of redemption action, refers to a general news release, and not to the formal notice or advertisement of redemption sometimes required by provisions of an indenture or charter.

"Such news release shall be made as soon as possible after taking corporate action which will lead to, or which looks toward redemption, or as soon as possible after the company acquires knowledge of any such action taken by others, and shall be made by the fastest available means. The 'fastest available means' may vary in individual cases and according to the time of day. Ordinarily, this requires a release to the public press by telephone, telegraph, or hand delivery, or some combination thereof. Transmittal of such a release to the press solely by mail is not considered satisfactory. Similarly, release of such news exclusively to the local press outside of New York City would not be sufficient for adequate and prompt disclosure to the investing public.

"To insure adequate coverage, releases requiring immediate publicity should be given to Dow Jones & Company, Inc., to Reuters Economic Services, and to Associated Press and United Press International. These releases should also be given to one or more of the newspapers of general circulation in New York City which regularly publish financial news." NYSE Company Manual § A-10, at A-170 (1971). In Van Gemert, the defendant did not notify the NYSE as soon as it knew it was going to make a redemption call, nor did it publish a general news release. 520 F.2d at 1377. But Boeing did publish notices of the dates of the call and the expiration of the redemption option in, "NYSE ticker on March 8, 23, 24, 25, 26 and 28, 1966; NYSE Bulletin on March 11, 18 and 25, 1966; The Commercial and Financial Chronicle on March 14, 21 and 28, 1966; Standard & Poor's Bond Outlook on March 19, 1966; Standard & Poor's Called Bond Record on March 9, 11, 18 and 25, 1966; Moody's Industrials on March 11, 1966. Articles about these dates were also carried in the Seattle Post Intelligencer on March 25, 1966; the Seattle Times on March 27, 1966; and the Financial World on March 23, 1966; and the notice was also carried in the Associated Press Bond Tables published . . . in major cities across the United States." Id. at 1378-79. Yet most of these notices were in fine print and buried in the midst of a multitude of information and financial markets, "scarcely of a kind to attract the eye of the average lay investor or debenture holder." Id. at 1379.


23. A member of the exchange is "any person who is permitted either to effect transactions on the exchange without the services of another person acting as broker, or to make use of the facilities of an exchange for transactions thereon without payment of a commission or fee or with the payment of a commission or fee which is less than that charged the general public . . . ." 15 U.S.C. § 78c(a)(3) (1970).

24. Id. § 78f(b) (1970). In addition, the exchange may adopt and enforce any rules not inconsistent with the Act, as long as the rules are adequate to "insure fair dealing and to protect investors." Id. § 78f(c),(d) (1970).
exclusive jurisdiction of violations of this chapter or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this chapter or the rules and regulations thereunder.25

The Act raises two questions with respect to a rules violation of a stock exchange duly registered under the Act.26 The first, and perhaps the most important, is whether a violation of an exchange rule comes within the jurisdictional provisions of the Act. Traditionally, courts have treated such rules violations as giving rise to federal jurisdiction by implication.27 Since there is no reference to exchange rules in the grant of jurisdiction under the 1934 Act, congressional intent is hard to decipher. One view has been that a violation of stock exchange rules is covered by the "arising under" provisions of the jurisdictional grant of the Act.28 Another view relies upon the words "a duty created by this chapter" to imply jurisdiction.29 Both views stretch the language of section 27 of the Act30 and both have met with criticism.31 Yet, most actions alleging a claim based upon a violation of stock exchange or dealer association rules32 have sought to imply civil liability from the jurisdictional provisions of the 1934 Act.33

25. Id. § 78aa (1970).
30. See text accompanying note 25 supra.
31. Wolfson & Russo, The Stock Exchange Member: Liability for Violation of Stock Exchange Rules, 58 Calif. L. Rev. 1120, 1128 (1970); Note, Private Actions as a Remedy for Violations of Stock Exchange Rules, 83 Harv. L. Rev. 825, 834-35 (1970). The author of the Harvard Note believed that section 27, which grants jurisdiction to the federal courts, does not support federal jurisdiction based upon a violation of stock exchange rules. Id. at 833-34. "Because there is no federal duty on members to obey exchange rules, a rule violation does not entail a violation of the Act or a duty created by it. While an exchange rule might abstractly be thought a 'rule . . . thereunder,' other provisions of the Act expressly distinguish exchange rules from 'rules thereunder.' Thus, in order to find jurisdiction under section 27, 'created by' must be read to mean 'having its ultimate origin in.' While this reading is possible, it is a stretch of the language." Id. at 834 (footnotes omitted). On the other hand, the authors of the California article believed that it is not clear that the interpretation of "arising under" is any less strained than that of "created by." 58 Calif. L. Rev. at 1128. "Moreover, although a member's liability for violation of a stock exchange rule is created by implication, it is so closely related to the purpose of the 1934 Act that it would be anomalous to hold that such liability is not 'created by' the Act . . . [If] the action is considered to arise under the 1934 Act, it is also 'created by' that Act since in either case the genesis of the action is found in the 1934 Act. This conclusion is clearly the most sensible interpretation." Id. at 1128-29 (footnote omitted).
33. See, e.g., Landy v. FDIC, 486 F.2d 139, 164 (3d Cir. 1973), cert. denied, 416 U.S. 960
The court in Van Gemert avoided this issue, however, and accepted jurisdiction over a similar claim on the basis of pendent jurisdiction. Implicit in the court's consideration was the finding of a common nucleus of operative facts between the federal claim, which was based on alleged violations of the 1934 Act, the Securities Act of 1933, and the Trust Indenture Act of 1939, and the state claim, which was based upon violation of the rules of the NYSE. This was a novel approach for a case involving an alleged violation of stock exchange rules. It is also preferable to implying jurisdiction from the 1934 Act since a federal court does not have to stretch the language of the 1934 Act in order to assume jurisdiction. Yet a litigant proceeding on a theory of pendent jurisdiction should not be guaranteed access to federal court merely by alleging failure to abide by or to enforce stock exchange or dealer association rules. The decision rests upon the discretion of court that must consider "judicial economy, convenience and fairness to litigants" and should avoid needless decisions of state law.

The second question raised by the 1934 Act is whether, having found jurisdiction, violations of certain rules of a stock exchange or dealer association are, of themselves, so tied to the statutory scheme of the 1934 Act as to enable a court to grant relief based upon a theory of implied federal civil liability. The difficulty with this theory of liability is that "the effect and significance of particular [stock exchange] rules may vary with the manner of their adoption and their relationship to provisions and purposes of the [1934 Act]." Difficulties arise in determining the scope of the unique statutory scheme of " 'supervised self-regulation' " promulgated by stock exchange and dealer association rules.
Two tests have been applied to determine whether a violation of certain stock exchange or dealer association rules will give rise to implied federal civil liability.\textsuperscript{41} The first, set forth in \textit{Colonial Realty Co. v. Bache & Co.},\textsuperscript{42} emphasizes the nature of the particular stock exchange rule and its place in the federal regulatory scheme.\textsuperscript{43} In that case, a customer brought an action against a securities broker for alleged violations of the 1934 Act and of the rules of the NYSE requiring that members of the exchange not engage in conduct inconsistent with fair and equitable principles of trade. The court reasoned that in order to find implied federal civil liability based upon a violation of a stock exchange rule, the regulation in question would have to be an extension of the design of the 1934 Act. The implication that a particular rule is such an extension will be strongest under this test when the rule violated imposes an explicit duty unknown to common law. For example, NYSE rule 452 prohibits, in certain instances, members "from voting stock held in a street name without specific instructions from the beneficial owner."\textsuperscript{44} Such a rule "could thus play an integral part in SEC regulation notwithstanding the Commission's decision to take a back-seat role in its promulgation and enforcement . . . ." and is not merely an exchange housekeeping rule.\textsuperscript{45}

The second test, as announced in \textit{Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc.},\textsuperscript{46} is whether the particular stock exchange rule violated was designed "for the direct protection of investors."\textsuperscript{47} In that case, a trustee in

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\bibitem{42} 358 F.2d 178 (2d Cir.), cert. denied, 385 U.S. 817 (1966).
\bibitem{43} Id. at 182. The court held that in the particular fact pattern presented to it—member violating a stock exchange rule—violations of stock exchange rules should not give rise to implied federal civil liability. Id. at 183. Yet the court, in dicta, stated that "[o]n the other hand, we cannot ignore that the concept of supervised self-regulation is broad enough to encompass a rule which provides what amounts to a substitute for regulation by the SEC itself. . . . A particular stock exchange rule could thus play an integral part in SEC regulation notwithstanding the Commission's decision to take a back-seat role in its promulgation and enforcement . . . ." Id. at 182.
\bibitem{45} 358 F.2d at 182 (dictum). The Colonial court also found that the party seeking implication of federal civil liability should bear a heavier burden of persuasion than when a federal statute or SEC regulation is violated. Id. Moreover, it seems that a major concern in Judge Friendly's opinion is that the implication of federal civil liability would in the case of most rule violations merely duplicate state negligence law. See id. at 182-83.
\bibitem{46} 410 F.2d 135 (7th Cir.), cert. denied, 396 U.S. 838 (1969).
\bibitem{47} Id. at 142; see \textit{Lowenfels, Implied Liabilities Based Upon Stock Exchange Rules}, 66
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bankruptcy sued the brokerage firm that allegedly permitted the bankrupt, through its office, to participate in large-scale speculations with customers' funds when the firm knew or should have known of the bankrupt's scheme to defraud.\footnote{48} This conduct by the brokerage firm allegedly violated the "Know Your Customer Rule" of the NYSE.\footnote{49} The court held that the rule had been violated and since rule 405 was aimed at protecting investors, a cause of action would arise. While the court indicated that mere errors in judgment would not amount to a violation of the rule, it held that the "callous disregard" for the rule was tantamount to fraud and thus a private civil damage action could exist.\footnote{50} The 
\textit{Buttrey} requirement seems to allow the implication of liability even if the rule violated was very broad, i.e. "something of a catch-all," so long as the rule was specifically designed to protect investors. Although the court in 
\textit{Buttrey} found for the first time that a violation of a stock exchange rule could create an implied civil liability on the part of a member, it also decided that such a violation does not per se create a cause of action.\footnote{51} Consequently, courts have been forced to decide on a case by case basis whether a particular rule violation will create a cause of action.\footnote{52}

These subsequent decisions have narrowed the scope of implied federal civil liability.\footnote{53} Because the 
\textit{Buttrey} court had placed emphasis on the fraudulent aspect of the rule 405 violation in that case,\footnote{54} later courts reasoned that if a violation of stock exchange or dealer association rules\footnote{55} were to be

actionable on an implied liability theory then such violations must involve some evidence of fraud. In *Buttrey*, however, while a finding of fraud was necessary for a violation of Rule 405, it was not the essential element for a finding of implied civil liability. Thus, in *Van Gemert* even though the rule allegedly violated did not involve fraud, the court, unlike prior cases, did not address the presence or lack of fraud in its discussion of implied civil liability. It appears, therefore, that the Second Circuit, at least, may not consider fraud an essential element of implied federal civil liability.

Although it may constitute dicta, the court in *Van Gemert* also reinforced

denied, 397 U.S. 963 (1970); Piper, Jaffray & Hopwood, Inc. v. Ladin, 399 F. Supp. 292 (S.D. Iowa 1975); Wells v. Blythe & Co., 351 F. Supp. 999 (N.D. Cal. 1972); Mercury Inv. Co. v. A.G. Edwards & Sons, 295 F. Supp. 1160 (S.D. Tex. 1969); Hecht v. Harris, Upham & Co., 283 F. Supp. 417 (N.D. Cal. 1968), modified on other grounds, 430 F.2d 1202 (9th Cir. 1970). This rule, which parallels NYSE rule 405, provides that: "In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs." CCH NASD Manual ¶ 2152 (1968).


57. 410 F.2d at 142-43; accord SEC v. First Sec. Co., 463 F.2d 981, 988 (7th Cir.), cert. denied, 409 U.S. 880 (1972) (Brokerage firm failed to adequately supervise its president's activities in violation of NASD Rule 27. "We have no doubt that the enforcement [by the firm] of [President] Nay's rule regarding the opening of mail is sufficient without more to constitute violation of Rule 27. Such violations provide a basis for private damage actions where the rule violated serves to protect the public . . . ."); see Avern Trust v. Clarke, 415 F.2d 1238 (7th Cir. 1969). Some commentators have also viewed fraud as essential only to the finding of a rule violation, and not as to implied federal civil liability. Hoblin, A Stock Broker's Implied Liability to its Customer for Violation of a Rule of a Registered Stock Exchange, 39 Fordham L Rev. 253, 267 (1970); Wolfson & Russo, The Stock Exchange Member: Liability for Violation of Stock Exchange Rules, 58 Calif. L. Rev. 1120, 1131 (1970). Wolfson and Russo also suggested that if fraud is actually present, then there might be a cause of action arising out of section 17 of the Securities Act of 1933 and SEC rule 10b-5. Id.

58. The allegation evolves from a failure to comply with section A10 of the NYSE Company Manual as it relates to the listing agreement.


60. The Second Circuit, in *Colonial*, did not consider whether fraud is an essential element. See notes 42-45 and accompanying text.

61. The analysis is dicta because the court in *Van Gemert* did not pass directly upon the issue of implied federal civil liability. Id. at 1382.
previous holdings granting civil liability in certain situations. The court found two considerations to weigh against the position taken by the lower court and advanced by the appellees that "a violation of an exchange rule cannot under any circumstances give rise to civil liability under the federal acts." First, the court noted that three recent decisions supported its statement. One decision, in the Southern District of New York, found that a cause of action arose from a violation of rule 345.17 of the NYSE. The second, a Seventh Circuit decision, allowed recovery by customers of a brokerage firm for the firms' violation of the NASD suitability rule that was designed to protect investors from fraudulent brokerage practices. The third, a Third Circuit case, while not finding liability for violation of a stock exchange rule, did acknowledge that under certain circumstances liability would be appropriate. While these are not statements of the Second Circuit, they are part of a developing case law that permits, rather than prohibits, implied causes of action to arise for violations of stock exchange and dealer association rules. As such they lend support to the Van Gemert courts' refusal to agree with the lower courts' belief on the issue of implied civil liability.

Second, the court found it an "inviting" position that to the investing public, listing on the NYSE carried with it "implicit guarantees of trustworthiness." From this finding it may be inferred that since the listing company benefited from its listing agreement with the NYSE, it should accept the responsibility that a violation of exchange rules may give rise to civil liability because of the guarantees of trustworthiness of the listing agreement. This reflects the shingle theory of broker dealer liability. Moreover, the

62. The fact that the court examined an alleged violation of a stock exchange rule not previously considered in any other judicial proceeding also seems to expand the area in which implied federal civil liability can be applied.


64. Starkman v. Seroussi, 377 F. Supp. 518 (S.D.N.Y. 1974). Rule 345.17 provides in pertinent part that "each registered representative, in consideration of the Exchange's approving his application, shall sign the following statements: (A) That I will not guarantee to my employer or to any other creditor carrying a customer's account, the payment of the debit balance in such account, without the prior written consent of the Exchange. (B) That I will not guarantee any customer against loss in his account or in any way represent to any customer that I or my employer will guarantee the customer against such losses. (C) That I will not take or receive, directly or indirectly, a share in the profits of any customer's account, or share in any losses sustained in any such account." 2 CCH NYSE Guide ¶ 2345.17, at 3595 (1975).

65. SEC v. First Sec. Co., 463 F.2d 981 (7th Cir.), cert. denied, 409 U.S. 880 (1972); see note 55 supra.


68. 520 F.2d at 1381.

69. 3 L. Loss, Securities Regulation 1483 (2d ed. 1961) ("The theory is that even a dealer at arm's length impliedly represents when he hangs out his shingle that he will deal fairly with the public.")
The defendants in Van Gemert argued that violations of an exchange rule did not give rise to implied civil liability for two reasons. First, they argued that the self-regulatory scheme of the NYSE applied only to members of the Exchange rather than to issuers because Congressional intent so declared. The court rejected this argument noting that Congress did not adopt a proposed extension of the 1934 Act requiring listing companies to comply with exchange rules. The legislative history was "at most equivocal on the question" because debate on the proposed amendment had centered on whether such a provision was necessary at all since listing companies might have to "comply with the law regardless of any such agreement." Second, defendants argued that the Exchange's remedies are limited to delisting. The court rejected this argument because no authority has held that delisting of a company is the exclusive remedy available for violation of stock exchange rules. It is arguable, however, that the listing agreement binding issuers is not a rule binding members. The court did not establish the nexus between the listing agreement and the NYSE rules. The court's decision seems to expand the theory of implied federal civil liability to include violations of exchange rules by issuers as well as members.

III. NOTICE TO DEBENTURE-HOLDERS CONCERNING REDEMPTION

The Securities Exchange Act of 1934 does not set forth the duty of an issuing company to notify the holder of the security when it redeems its

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70. See note 47 supra and accompanying text.
71. 520 F.2d at 1382; Brief for Appellees at 40-44, Van Gemert v. Boeing Co., 520 F.2d 1373 (2d Cir.), cert. denied, 96 S. Ct. 364 (1975).
72. See note 23 supra.
73. An issuer is "any person who issues or proposes to issue any security . . . [T]he term 'issuer' means the person or persons performing the acts and assuming the duties of depositor or manager pursuant to the provisions of the trust or other agreement or instrument under which such securities are issued . . . ." 15 U.S.C. § 78c(a)(8) (1970).
74. 520 F.2d at 1382; Brief for Appellees at 44, Van Gemert v. Boeing Co., 520 F.2d 1373 (2d Cir.), cert. denied, 96 S. Ct. 364 (1975).
75. 520 F.2d at 1382.
76. Id.; see 78 Cong. Rec. 8584-86 (1934).
78. 520 F.2d at 1382.
convertible debentures. Thus the duty must arise from the contract between the holder and the issuing company, formulated pursuant to the indenture, the listing agreement, or from some other source that courts find reasonable.

If the issuing company fails to comply with the notice requirements contained in the indenture, then it is liable for breach of contract. But even if the issuing company does provide the investor with such notice, there might be implied federal civil liability based upon the company's failure to provide the requisite notice pursuant to its listing agreement with the stock exchange. Where, however, a court as in Van Gemert, does not pass directly on the question of implied civil liability, it may still reach a decision on the reasonableness of the notice given without regard to the requirements of the indenture.

In one case, a New York court held that publication of a redemption notice in a daily financial newspaper, i.e., the Wall Street Journal, met the requirement that the notice be published in a newspaper of general circulation. The court, reasoning by analogy, believed that since the information to be published was of a financial nature, then publication of the redemption notice in the Wall Street Journal was proper because it was used more than any other newspaper for the publication of such notices.

In Kaplan v. Vornado, Inc., plaintiff failed to convert his debentures within the time allotted for redemption. Notices of the redemption call were mailed only to those holders who had registered their securities when purchasing them. Plaintiff had not so registered. Following a press release, defendant's redemption call had been published in several sources. But the plaintiff did not see these notices. He contended that the debenture itself was misleading and deceptive because it failed to mention the issuer's right to redeem its holdings in the same large size print that was used to write the words "convertible." Yet the court concluded that the key factor in the plaintiff's failure to convert was not the differing sizes of print, but rather the plaintiff's unreasonable behavior in not investigating those aspects of the debenture which he did not understand. The information the plaintiff sought

81. See note 61 supra and accompanying text.
82. 520 F.2d at 1383-86.
83. Gampel v. Burlington Indus., Inc., 43 Misc. 2d 846, 252 N.Y.S.2d 500 (Sup. Ct. 1964) (all other newspapers in New York City were on strike at the time notice was published).
84. Id. at 848, 252 N.Y.S.2d at 502.
85. 341 F. Supp. 212 (N.D. Ill. 1971). Plaintiff purchaser occasionally invested in common stock prior to his purchase of the debentures. He was advised by a broker that the debentures were a good investment, but at no time did he see the prospectus or the trust indenture. Nor did the plaintiff investigate any aspect of the debentures, their ratings or the defendant company. In a superficial examination of the debentures he discovered that he was not sure of the meaning of "convertible," and while he did not understand the terms "redeemable" or "callable," he did not search out the meaning. Id. at 213.
86. Of over five million dollars worth of debentures only $155,800 were not converted. Id.
87. The sources were the Wall Street Journal, Women's Wear Daily, Daily News Record, Homes Furnishings Daily, and the Reuters and Dow-Jones Wire Services. Id.
was on the face of the debenture. The court, employing the reasonable man test, denied the plaintiff's claim.

The court in Abramson v. Burroughs Corp., considered a similar claim by an investor who failed to convert within the redemption period. Notice to registered debenture holders was also made by mail. Plaintiff claimed that the notice provisions of the prospectus were misleading because they omitted the nature and the frequency of the notice which the investors would receive, "thus leading [them] to buy the bonds in the belief that [they] would receive sufficient notice prior to redemption to allow [them] to convert [their] bonds . . . ." However, the court disagreed, pointing out that the prospectus specifically stated that both bonds were redeemable on thirty days notice. The court found further that the information contained in the prospectus was incomplete. But the factor fatal to the plaintiff's claim was that he debentures contained all the information which an investor needed on their face. Defendant, Burroughs Corp., had a right to believe that bond purchasers familiarize themselves with the conditions of issuance by reading the "few short paragraphs on the face of the bond." Thus, Burroughs' notice to the investor was reasonable.

In both Abramson and Kaplan the standard adopted by the courts seemed to be that of the reasonable man. In Kaplan, for example, the investor was deemed to have acted unreasonably for his failure to investigate information concerning the debentures which he did not understand. The information that the investor lacked in Abramson and Kaplan appeared on the face of the debentures. Thus those courts ruled that the investor was unreasonable in not being aware of that which was clear. The criterion of reasonableness used in

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88. Id. at 215-16. The title on the debentures read: “5% Convertible Subordinated Debenture Due March 1, 1982.” The remainder of the printing on the debentures was much smaller. It was in the “fine print” that the right to redeem appeared. Id. at 213-14.

89. Id. at 215-16. As a sidelight, the court also found that the words “at least thirty days published notice” did not mean notice published on thirty consecutive days. Id. at 217.


91. Id. at 92,253. The Indenture called for publication by at least four newspapers, two in New York City and two in Detroit. Id.

92. Id. at 92,254.

93. Id.

94. Id.

95. Id. “The bonds specifically state 'Notice of redemption shall be given by publication at least four times, each publication to be made in at least two newspapers printed in the English language and customarily published at least once a day for at least five days in each calendar week and of general circulation, one in the Borough of Manhattan, The City of New York, and one in Detroit, Michigan, the first such publication to be not less than thirty nor more than sixty days prior to the date fixed for redemption, as provided in the Indenture. Notice of redemption shall also be given to the registered holder of Debentures registered as to principal to be redeemed as a whole or in part by mailing a notice of such redemption not less than thirty nor more than sixty days prior to the date fixed for redemption to their last addresses as they shall appear upon the registry books, all as provided in the Indenture, but failure to give such notice by mail, or any defect therein, shall not affect the validity of the proceedings for the redemption of any of the Debentures.'” Id.
these cases to judge investor action could as easily have been applied to the notification standards required of an issuing corporation. This was the case in Van Gemert.

The court in Van Gemert, going beyond the requirements of the listing agreement, found two basic failings in the notice given by Boeing. First, the debenture holders were not adequately appraised of what notice would be provided by the redemption call. Secondly, the newspaper publication was insufficient because it did not give the holders "fair and reasonable notice." The court emphasized that, on their face, the debentures themselves contained no information about the benefits of registration. The 113 page indenture was the only place where Boeing stated that an investor who had registered his debenture was entitled to notice of redemption by mail. The court found that it was not the investor who was unreasonable in failing to read the indenture. Rather it was the issuing corporation which was unreasonable for placing the notice only in the indenture.

What one buys when purchasing a convertible debenture in addition to the debt obligation of the company incurred thereby is principally the expectation that the stock will increase sufficiently in value that the conversion right will make the debenture worth more than the debt. The debenture holder relies on the opportunity to make a proper conversion on due notice. Any loss occurring to him from failure to convert, as here, is not from a risk inherent in his investment but rather from unsatisfactory notification procedures. The debenture holder's expectancy is that he will receive reasonable notice and it is his reliance on this expectancy that the courts will protect. Had there been proper publication, a reasonable investor undoubtedly would have taken action to prevent the loss occurring to him.

Proper notification, as implied in the Van Gemert decision, means personal notice to the investor by mail, or notice of the manner in which he will be notified, or notice of the means by which he can assure himself of receiving written personal notice.

Typically, a company wishing to notify coupon bondholders of an impending redemption call must publish such notice once a week for four weeks in an authorized newspaper. This is necessary since a coupon bond is a bearer bond, as distinguished from a registered bond which has no attached interest coupons, and requires publication rather than mailing since the issuer does not know the name and address of the bearer. The notice

96. 520 F.2d at 1383.
97. Id.
98. Id.; see text accompanying note 19 supra.
99. 520 F.2d at 1383. Compare note 95 supra.
100. 520 F.2d at 1383-84. The court also found that Boeing was unreasonable since it knew of the redemption call at the time it sent out proxy statements to its shareholders, yet made no effort to inform the debenture holders of the redemption. Id. at 1384. However, if the debenture holder was not a shareholder, this notice would not have been helpful.
101. Id. at 1385 (citations omitted).
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usually has to be published from thirty to sixty days prior to the redemption date. However, this procedure has been attacked as being inadequate and unconscionable because of the alleged gross inequality of the parties' bargaining powers. But the part of the procedure which requires those who have registered their bonds to receive notice by mail has not been so criticized.

It would seem, therefore, that the courts may require that an issuing company print, on the face of its debentures, both the procedures for an investor registering his debentures and the benefits for so doing, i.e., mail notice, as well as the manner in which the company will give notice to those who do choose not to register their debentures. One financial analyst believes that "a company that redeems should go out of its way to notify shareholders. As a minimum the company should write a person a letter . . . . They can telephone those security holders who do not respond. We have known many companies that have gone that far." The court in Van Gemert indicated, however, that it would be reluctant to grant relief to an investor who has not read the debenture he purchased. Other demands regarding publication of notice that may be made upon the issuing company will probably be more flexible.

A corporation may be able to avoid the litigation problems encountered by Boeing if when giving notice to its debenture holders, it takes extreme care to include on the face of its debentures more details regarding redemption and conversion. If the corporation has outstanding debentures similar to Boeing's, it may avoid liability in the event of a future redemption call by revising the face of the security to include notice of the benefits of registration and other items essential to the investor. However, this could be expensive since it requires an amendment of the indenture, a reprinting of the debenture, and an offer to exchange existing debentures for the new ones. Moreover, it could be ineffectual since the present holder of the debenture may not be aware of their ability to exchange their securities for the new ones with the adequate notice. The exchange process suffers from the same notice deficiencies as the original notice of redemption. However, this might prompt a court to be more lenient towards a corporation that has made such a good faith effort.

105. Cornell Note, supra note 7, at 279; see note 12 supra.
106. Cornell Note, supra note 7, at 279.
108. N.Y. Times, August 3, 1975, § 3 (Business & Finance), at 6, col. 4.
109. 520 F.2d at 1384 n.20.
110. See id. at 1384-85. These requirements deal mainly with the number of times during the redemption period when newspaper notice should be published, the size of the advertisements, their placement in the newspaper itself, the number of newspapers in which the notice will be published and in what other sources will such notice be found. As to press releases, the minimal requirements would seem to be those set forth by the NYSE. See NYSE Company Manual § A10, at A-170 (1971).
IV. Third Party Beneficiary

A third party beneficiary claim is the final theory upon which corporate liability may be predicated. The corporation's failure to abide by the notice provisions set forth in the listing agreement is a breach of its contract with the Stock Exchange. The debenture holder therefore may be able to sue the corporation for its breach of the agreement as a third party beneficiary.

In Weinberger v. New York Stock Exchange, the court held that an investor may recover as a third-party beneficiary of an agreement between the SEC and a registered national securities exchange. Normally, an individual not a party to a contract, who derives benefits from it, may not recover for its breach. However, a third party may recover for a breach of contract if the parties to the contract intended that he benefit from the agreement. Otherwise a third party is only an "incidental" beneficiary of the contract regardless of whether it benefits him and accordingly he cannot recover in the event of a breach. In Weinberger the complainant was an investor seeking damages from the NYSE for the Exchange's alleged failure to supervise its member firms adequately in violation of its agreement with the SEC. The court found that the Exchange's agreement with the SEC made the investor more than just an "incidental" beneficiary of the contract. Since the agreement was aimed at benefiting the investor directly, it conferred upon him the status of "intended" beneficiary and permitted him to sue for the breach of contract.

113. Id. at 144.
115. Seaver v. Ransom, 224 N.Y. 233, 120 N.E. 639 (1918); Lawrence v. Fox, 20 N.Y. 268 (1859); Calamari & Perillo, supra note 114, § 244; Corbin, supra note 114, § 776; Williston, supra note 114, § 356.
117. 335 F. Supp. at 144. "If we apply the Congressional intent found in Baird v. Franklin [141 F.2d 238 (2d Cir.), cert. denied, 323 U.S. 737 (1944)] to the agreement by the Exchange, that agreement must be read as being for the benefit of investors. We come to the conclusion, therefore, that the policy of federal law, as interpreted in the Second Circuit, makes an investor more than an incidental beneficiary of the contract mandated by an Act of Congress. It gives him an independent claim for relief." Id. (footnote omitted). But cf. Cutner v. Fried, 373 F. Supp. 4, 8 (S.D.N.Y. 1974); Hornblower & Weeks-Hemphill, Noyes v. Burchfield, 366 F. Supp. 1364, 1367 (S.D.N.Y. 1973).
118. Originally the term used to describe this type of beneficiary was "donee," and the category of third-parties to which it applied was very limited. Corbin, supra note 114, § 782; Williston, supra note 114, § 357. But through the years the category has expanded, see Calamari & Perillo, supra note 114, § 244; Restatement (Second) of Contracts § 133 (Tent. Drafts Nos. 1-7, 1973); Gould v. Pollack, 68 Misc. 2d 670, 677-78, 327 N.Y.S.2d 808, 816 (N.Y. Civ. Ct. 1971), aff'd per curiam, 71 Misc. 2d 344, 335 N.Y.S.2d 840 (App. Term 1st Dep't 1972), to the point where the Restatement (Second) of Contracts has done away with the word donee because its
The Maryland Court of Appeals in *Mackubin v. Curtiss-Wright Corp.*, 119 found that the provision of a listing agreement that is breached must be designed to benefit the particular person or class of persons who are suing as third party beneficiaries.120 The key factor in determining whether a third party may claim under a contract is the intent of the promisee. Where the promisee manifests a direct intent, either expressly or impliedly, to have a third party benefit from his agreement with the promisor, then the third party may recover for a breach of contract as a result of his "intended" beneficiary status.121 The court in *Mackubin* did not allow the third party beneficiary claim based upon the company's failure to publish prompt notice with respect to dividends on shares as required by the listing agreement because the plaintiff was suing as a prospective purchaser of the company's stock. Plaintiff was not in the class of persons which the listing agreement requirements were designed to protect. In *Weinberger*, the SEC, as promisee of its agreement with the stock exchange, intended to have the investor benefit from the Exchange's promise to regulate its member firms. Here, the stock exchange, as promisee of its agreement with the corporation, did not intend for a prospective purchaser of the corporation's stock to derive the benefit from a provision requiring the company to publish prompt notice with respect to dividends. While the court did not comment on whom the provision was designed to benefit, it seems that current shareholders were the intended recipients.

It has been suggested that a third party beneficiary claim by an investor is possible when a stock exchange member breaches his agreement with the Exchange by violating one of the Exchange rules.122 This conclusion is based upon the belief that the agreement between a stock exchange and its members is made for the benefit of investors.123 By extending this analysis and that of *Weinberger* and *Mackubin*, it would seem reasonable to conclude that the breach of a listing agreement will permit a third party beneficiary claim under certain circumstances, depending upon the requirements of the particular provision violated.124 Generally, the listing agreement is designed to protect

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119. 190 Md. 52, 57 A.2d 318 (1948).
120. Id. at 54, 57 A.2d at 321.
121. Calamari & Perillo, supra note 114, § 244; Corbin, supra note 114, §§ 776-77; Restatement (Second) of Contracts § 133 (Tent. Drafts Nos. 1-7, 1973).
124. Judge Oakes suggested in a footnote to Van Gemert that a debenture holder was a third party beneficiary to the listing agreement. He believed that since the duty of a listed company is to treat its own security holders fairly, and since security holders can be viewed as creditors of the corporation, then they can be deemed creditor beneficiaries of the listing agreement and thus recover for its breach. 520 F.2d at 1382-83 n.19. However, in order to create a creditor
the investor from certain conduct of the issuing company. Listing agreements require timely disclosure, to both the public and the exchange, of all corporate information which may "affect security values or influence investment decisions, and in which stockholders, the public and the Exchange have a warrantable interest . . ." Other requirements made upon the issuing company also reflect the investor protection function of the listing agreement. This is especially true with respect to the notice that the company is requested to provide to the investor in the event of a redemption call. Thus, while an aggrieved investor may not have standing as a creditor beneficiary of the listing agreement, as Judge Oakes suggested in a footnote to the Van Gemert decision, an argument can be made that he has standing as an "intended" beneficiary of such a contract.

V. Conclusion

It appears that the failure of an issuing corporation to provide its convertible debenture holders with proper and sufficient notice of an impending beneficiary the promisee must enter into the contract with the promisor for the purpose of discharging an obligation which the promisee owes, or thinks he owes, to the beneficiary. Consequently, investors in debentures may only recover as creditor beneficiaries if there is an obligation running from the promisee of the listing agreement directly to them. Thus, the issuing company must be the promisee of the particular applicable provisions of the listing agreement. Where the provision of the listing agreement that is allegedly violated is one in which the issuing corporation promises to provide specific types of notice to its security holders, see note infra, then the company is the promisor of the agreement and the exchange is the promisee. Therefore, investors may not be creditor beneficiaries of the listing agreement as it relates to notice because any alleged obligation emanates from the issuing corporation and not from the stock exchange.

125. 78 Cong. Rec. 8586 (1934) (remarks of Sen. Steiwer). Senator Byrnes stated: "I am told that in the State of New York, where most of these agreements will be made . . . a contract made for a consideration for the benefit of a third person is sustained at law. This agreement is made between the issuing corporation and the commission [SEC] and the exchange. In my opinion, [the listing agreement] is made for the benefit of a third person, namely, the investor. Undoubtedly certain remedies inhere in this agreement in favor of that third person." Id.

127. Id. at A-29 to -34.
128. Id. at A-34. "The Corporation will publish immediately to the holders of any of its securities listed on the Exchange any action taken by the Corporation with respect to dividends or to the allotment of rights to subscribe or to any rights or benefits pertaining to the ownership of its securities listed on the Exchange; and will give prompt notice to the Exchange of any such action; and will afford the holders of its securities listed on the Exchange a proper period within which to record their interests and to exercise their rights; and will issue all such rights or benefits in form approved by the Exchange and will make the same transferable, exercisable, payable and deliverable in the Borough of Manhattan in the City of New York." Id.
129. See note supra.
130. This conclusion is made recognizing that the debenture provisions arising out of the holder's purchase of the security from the issuing company are viewed as a specie of contract. Buchman v. American Foam Rubber Corp., 250 F. Supp. 60, 75 (S.D.N.Y. 1965).
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redemption call may give rise to corporate liability on any of three theories: 131 implied federal civil liability, lack of proper and sufficient notice, or third party beneficiary.

Under the first theory, liability may be based upon either the Colonial or Buttrey test. The emphasis of subsequent courts upon fraud as an essential element of implied civil liability under Buttrey seems to have been undermined. If the rule violated can be considered an integral part of SEC regulations and an extension of the federal regulatory scheme, as required by Colonial, or if it is precise and aimed at protecting the customer, as required by Buttrey, then implied federal civil liability can be predicated on such a rule. 132 As between the two tests however, the Van Gemert decision would seem to indicate an implied acceptance of the Buttrey test. This may result in the bifurcation of exchange rules when future courts decide whether to imply a federal civil cause of action for violations of stock exchange or dealer association rules. Rules designed for the direct benefit and protection of the investor may support liability and those that are merely "housekeeping" regulations may not 133 because they do not represent an extension of the investor protection function of the 1934 Act. 134 However, the Achilles heel of the Van Gemert decision may be that it did not establish a nexus between a listing agreement and a NYSE rule. Unless such a relationship is shown, liability under this theory should fail.

Under the second theory, the plaintiff's case will be dependent upon what type of notice is provided to him. Different courts will reach different decisions based upon the various fact patterns. The doctrine of reasonableness will play an important role in the court's evaluation of particular cases. The knowledge and opportunity of an investor to receive his notice of redemption by mail may be the crucial factor upon which a case turns. Yet, in any event, Van Gemert may prompt a modification of corporations' notification procedures. Indeed, one financial commentator has stated that, as a consequence of Van Gemert, "corporate attitudes appear to be changing in favor of the security holder." 135 Pro forma notification may no longer be sufficient.

131. The debentures must be listed on a national securities stock exchange. Otherwise, there would be no statutory scheme from which to imply federal civil liability. See notes 13-15 supra and accompanying text. Neither would there be a listing agreement upon which to predicate third party beneficiary liability. See note 13 supra and text accompanying note 111 supra. Only the second cause of action, reasonableness of notice, may still be maintained.


133. See Lowenfels, Implied Liabilities Based Upon Stock Exchange Rules, 66 Colum. L. Rev. 12, 28-29 (1966). The author distinguishes rules which he feels can be classified as either "housekeeping" or "investor protection" rules.

134. In Baird v. Franklin, 141 F.2d 238 (2d Cir.), cert. denied, 323 U.S. 737 (1944), Judge Clark pointed out that one of the primary purposes of the 1934 Act was to protect the general investing public. Id. at 244 & n.4 (dissenting opinion). In support of this proposition he set forth thirty-six sections of the Act which contained references to the Act's investor protection function. Id.; see Lowenfels, Implied Liabilities Based Upon Stock Exchange Rules, 66 Colum. L. Rev. 12, 24 (1966); MacLean, Broker's Liability for Violation of Exchange and NASD Rules, 47 Denver L.J. 63, 77 (1970).

135. N.Y. Times, August 3, 1975, § 3 (Business & Finance), at 6, col. 4.
The process will now be carried out with care and a considerable degree of foresight.

Under the third theory, recovery will depend upon whether the particular requirement of the listing agreement that is not complied with was designed for the benefit of those security holders suing for its breach. In this sense a third party beneficiary claim will closely parallel one based on implied civil liability. In order to succeed, a third party must bring his action based upon a rule or regulation that will characterize him as an "intended" beneficiary. This can only occur if the rule or regulation was promulgated for the direct benefit and protection of the investor. Otherwise, the investor would be merely an incidental beneficiary, and as such will have no basis for a claim.

Andrew Macdonald