FEDERAL SECURITIES LAW—VERSYSS, INC. v. COOPERS & LYBRAND—THE NEW CORPORATE MERGER TRICK: WATCH CLOSELY AS THE TARGET CORPORATION MAKES ITS SECURITIES DISAPPEAR... OR DO THEY???

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Recommended Citation
FEDERAL SECURITIES LAW—VERSYS, INC. v. COOPERS & LYBRAND—THE NEW CORPORATE MERGER TRICK: WATCH CLOSELY AS THE TARGET CORPORATION MAKES ITS SECURITIES DISAPPEAR . . . OR DO THEY???

INTRODUCTION

In 1933, Congress passed the Securities Act of 1933 ("Securities Act" or "Act").1 The purpose of the Securities Act was "to protect the investing public and honest business" from fraud.2 To fulfill this purpose, the Act sought to ensure that potential investors received information relating to securities that might be purchased by the investors in interstate or foreign commerce.3 Since the enactment of the Securities Act, there has been a plethora of litigation on the definition of a security.4 The definition of security seems clear on its face,5 yet in many cases the instrument involved does

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3. Id. The Securities Act focuses on transactions involving securities purchased from issuers, underwriters and dealers, and not on secondary transfers between parties.
5. 15 U.S.C. § 77b(1) (1988). The definition of "security" is as follows: When used in this subchapter, unless the context otherwise requires—
   (1) The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known...
not easily fit within the definition.\textsuperscript{6}

In \textit{Versyss, Inc. v. Coopers & Lybrand},\textsuperscript{7} the United States Court of Appeals for the First Circuit tackled this problem in the context of a merger. Specifically, the question presented in the case was whether stock certificates turned over by the target, or disappearing, corporation in a stock-for-stock merger could still be classified as a “security” for purposes of finding liability under section 11 of the Securities Act.\textsuperscript{8}

The majority and dissent disagreed regarding the effect that the merger had on the stock in question. The majority held that the stock that was turned over to the surviving corporation was no longer a security because the effect of the merger was that the target corporation ceased to exist, thus extinguishing any interest that was in the stock before the merger.\textsuperscript{9} The dissent agreed that the stock interest was extinguished, but believed that the language of the merger agreement actually gave the surviving corporation the right to extinguish the stock. Therefore, the surviving corporation had acquired the stock before the stock was extinguished.\textsuperscript{10}

The majority’s view, while well established in existing state law precedent, creates a gap in the application of the Securities Act. Section I of this Note looks at the Securities Act and discusses the

\begin{footnotesize}
\begin{enumerate}
\item[6.] See supra note 4 and accompanying text.
\item[7.] 982 F.2d 653 (1st Cir. 1992), \textit{cert. denied}, 113 S. Ct. 2965 (1993).
\item[8.] \textit{Id.} at 654. The relevant portions of 15 U.S.C. § 77k (1988) (section 11 of the Securities Act) read:
\begin{itemize}
\item[(a)] Persons possessing cause of action; persons liable
\begin{itemize}
\item In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, either at law or in equity, in any court of competent jurisdiction sue—
\begin{itemize}
\item[(1)] every person who signed the registration statement;
\item[(2)] every person who was a director of (or person performing similar functions) or partner in the issuer at the time of the filing of the part of the registration statement with respect to which his liability is asserted;
\item[(4)] every accountant . . . who has with his consent been named as having prepared or certified any part of the registration statement . . . .
\end{itemize}
\end{itemize}
\end{itemize}
\item[9.] \textit{Versyss}, 982 F.2d at 655-56.
\item[10.] \textit{Id.} at 659.
\end{enumerate}
\end{footnotesize}
reasons for its enactment. This section also examines merger law and its effect on the securities of a corporation. Section II of this Note discusses the facts of Versyss and explains the competing views held by the majority and the dissent. Section III points out the gap that the majority's decision creates in the law and how the dissent's reasoning would avoid this gap. Section III also recognizes the lack of support for the dissent's argument, and offers two alternatives which future courts can rely on to give strength to the dissent's argument thereby eliminating the gap that the majority created.

I. BACKGROUND

A. Securities Act of 1933

The main purpose of the Securities Act of 1933 is to require full disclosure to investors so they can make prudent buying decisions. President Franklin D. Roosevelt expressed support for the bill in a message to Congress dated March 1933, in which he wrote: "This proposal adds to the ancient rule of caveat emptor, the further doctrine 'let the seller also beware.' It puts the burden of telling the whole truth on the seller. It should give impetus to honest dealing in securities and thereby bring back public confidence." Following World War I, an enormous number of securities were "floated" in the United States. Approximately $25,000,000,000 worth of these securities were later found to be valueless. This loss created great despair in many Americans' lives. Many of those who invested in these securities lost everything including investments, homes, and confidence in the economic system. The Securities Act sought to restore the confidence of the people by requiring the registration of securities sold in interstate commerce. The information required in a disclosure includes "items indispensable to any accurate judgment upon the value of the security."  

12. S. REP. NO. 47, 73d Cong., 1st Sess. 6-7 (1933).
13. H.R. REP. NO. 85 at 2. The number of securities floated was estimated at about 50 billion. Id.
14. Id.
15. Id.
17. H.R. REP. NO. 85 at 3.
B. Merger Law

The Versyss court faced the problem of the effect that a merger has on the stock of the target corporation. The precedent dealing with this type of problem appears to be well settled. The answer to the problem is that the stock of the target corporation ceases to exist at the consummation of the merger.

Two cases, Frandsen v. Jensen-Sundquist Agency,18 and Shields v. Shields,19 shed some light on this question. Both cases deal with the same type of problem: a right of first refusal. The phrase “right of first refusal” refers to a restriction on the ability of shareholders to transfer their stock.20 The restriction requires shareholders who wish to sell their shares in a corporation first to offer their stock to other shareholders of the corporation or to the corporation itself before selling to a third party.21

In Frandsen, the plaintiff claimed that the corporation’s majority stockholders had violated the stockholders’ agreement, which provided that in the event the “majority bloc” offered to sell its stock in the company, it would first offer the stock at the same price to Frandsen and any other of the minority stockholders.22 Jensen-Sundquist (“Jensen”) negotiated a deal with First Wisconsin Corporation (“First Wisconsin”) in which First Wisconsin would acquire First Bank of Grantsburg (“First Bank”), Jensen’s principal property.23 During the course of negotiations, Jensen and First Wisconsin structured the deal in two different ways. The second is irrelevant to this discussion except that it was done only to avoid triggering Frandsen’s right of first refusal, which he tried to assert after the first deal was proposed.24 The first deal consisted of First Wisconsin purchasing Jensen for cash and then merging First Bank into a subsidiary of First Wisconsin.25

The court found that the majority stockholders never offered to sell “their” stock; they were, instead, offering to sell their largest holding, the bank, and not their majority interest in Jensen.

18. 802 F.2d 941 (7th Cir. 1986).
21. Id.
22. Frandsen, 802 F.2d at 943.
23. Id.
24. Id.
25. Id.
26. Id. at 944.
First Wisconsin was not interested in becoming a majority stockholder in Jensen, it simply wanted to acquire the bank.\textsuperscript{27}

The court also held that the transaction originally contemplated by the two corporations constituted a merger.\textsuperscript{28} Merger law in Wisconsin is similar to Delaware law in that it also states that the acquired corporation ceases to exist at the time of merger.\textsuperscript{29} With that in mind, the court stated, “[the majority shareholders’] shares would have disappeared but not by sale, for in a merger the shares of the acquired firm are not bought, they are extinguished.”\textsuperscript{30}

\textit{Shields}\textsuperscript{31} involved a family business.\textsuperscript{32} The family members wanted to keep the business in the family, so they wrote a “right of first refusal” requirement into an agreement.\textsuperscript{33} The dispute in \textit{Shields} arose when the business relationship between two brothers became strained.\textsuperscript{34} In order to circumvent the agreement, one brother merged the corporation with a newly established corporation through a stock-for-stock merger.\textsuperscript{35} At this point, the other brother attempted to exercise his right of first refusal.\textsuperscript{36} This case arose from this attempt to circumvent the right of first refusal.\textsuperscript{37}

The court came to a similar conclusion as reached in \textit{Frandsen}, holding that the statutory conversion of stock of the acquired company in a merger did not comprise a “sale, transfer or exchange of that stock for purposes of an agreement among shareholders restricting their power to transfer their stock.”\textsuperscript{38} The court also concluded that, at the time a merger is consummated, the stock in the

\begin{itemize}
  \item \textsuperscript{27} \textit{Id.}
  \item \textsuperscript{28} \textit{Id.}
  \item \textsuperscript{29} \textit{Wis. Stat. Ann.} § 180.1106 (West 1992). The Delaware statute will be the main focus of this Note because the court in \textit{Versyss} focused on the Delaware statute in its analysis.
  \item \textsuperscript{30} \textit{Frandsen}, 802 F.2d at 944.
  \item \textsuperscript{32} \textit{Id. at} 163.
  \item \textsuperscript{33} \textit{Id.}
  \item \textsuperscript{34} \textit{Id. at} 163-65.
  \item \textsuperscript{35} \textit{Id. at} 165-66.
  \item \textsuperscript{36} \textit{Id. at} 166.
  \item \textsuperscript{37} \textit{Id.}
  \item \textsuperscript{38} \textit{Id. at} 167. In support of this proposition, the court cited \textit{Union Chem. & Materials Corp. v. Cannon}, 148 A.2d 348 (Del. 1959). The \textit{Union Chemical} court wrote that “conversion of shares by merger is not a transfer or assignment.” \textit{Id.} at 352.

The court also cited \textit{Silversmiths Co. v. Reed & Barton Corp.}, 85 N.E. 433 (Mass. 1908). The \textit{Silversmiths} court stated that “there was no ‘sale’ of these shares of the old corporation to the new corporation.” \textit{Id. at} 434.
acquired corporation ceases to exist. 39

The Delaware statute authorizing mergers expressly requires that the merger agreement state “the manner of converting the shares of each of the constituent corporations into shares or other securities of the corporation surviving.” 40 The definition of the term “convert” in this context can be traced back to the Delaware case of Federal United Corp. v. Havender. 41 This case dealt with the issue of whether the dividend rights of preferred stockholders could be extinguished by a merger. 42 The court concluded that the dividend rights, as well as other rights, could be extinguished in the event the corporation was merged. 43

In deciding this issue, the Havender court defined “convert” to mean “alter in form, substance or quality.” 44 The court viewed the conversion not as an exchange of one security for another security, but as an alteration of the stockholder’s interest. 45 The conversion did not occur at the time the stockholders turned in their old stock; the conversion took place upon consummation of the merger. The stockholder, therefore, immediately held an interest in the surviving company. 46

The conversion occurs because the stock certificate is only a representation of the interest that the stockholder owns; it is not the actual interest itself. 47 Theoretically, and assuming that statutes did not require shares to be issued, corporations would not have to issue stock certificates in order for an individual to hold an interest in it. The certificates simply make identifying the stockholders easier. This allows the conversion of stock in a stock-for-stock merger to occur as a matter of law, without any action by the stockholder. At the moment the merger takes place, the stockholder’s interest is in the new corporation. 48

41. 11 A.2d 331, 338 (Del. 1940).
42. Id. at 333-37.
43. Id. at 342-43.
44. Id. at 338.
45. See id.
46. See id.
47. See Balotti & Finkelstein, supra note 20, § 6.4, at 6-7.
THE NEW CORPORATE MERGER TRICK

II. VERSYSS, INC. v. COOPERS & LYBRAND

A. Facts

In May 1985, Continental Telecom, Inc. ("Contel"), a Delaware corporation and Northern Data Systems ("NDS"), a Massachusetts corporation, consummated a contract in which NDS would be merged into a new subsidiary of Contel (also a Delaware corporation). As consideration for the merger, NDS stockholders received Contel stock. At the time the parties entered into the agreement, NDS stock was available for public trading. In August 1984, as part of a public offering of stock, NDS had filed a registration statement with the Securities and Exchange Commission ("SEC") in accordance with the Securities Act of 1933.

On July 16, 1985, after the NDS stockholders ratified the agreement, NDS merged into the subsidiary of Contel. Contel acquired ownership of the assets and the liabilities of NDS. Pursuant to the agreement, NDS stockholders turned in their NDS stock in exchange for Contel stock. The agreement between the parties stipulated that "the 'separate corporate existence of NDS shall terminate.'"

Following the merger, Contel realized that some of the financial information contained in the registration statement of the NDS stock was "materially misleading." The accounting firm of Coopers and Lybrand had certified this information. Section 11 of the Securities Act "imposes . . . continuing liability for misstatements or material omissions in registration statements." This statute provides that a civil action may be brought by anyone "acquiring such security" and the action may be brought against a certain list of persons and entities including an accounting firm.

Contel assigned the suit against Coopers and Lybrand to Versyss Incorporated ("Versyss"). Versyss brought the suit in the
United States District Court for the District of Massachusetts. Coopers and Lybrand argued in its motion for summary judgment that Conte did not "acquire" NDS securities and, therefore, did not qualify as a plaintiff under section 11. The district court and the court of appeals acknowledged that Contel received something in exchange for the shares it gave out to NDS stockholders. Versyss argued that Contel had acquired the NDS stock. Coopers and Lybrand, on the other hand, maintained that the stock, as a result of the merger, was nothing more than an "empty shell" and thus did not qualify as securities under section 11 of the Securities Act. The district court, following the latter view, granted Coopers and Lybrand's summary judgment motion. The Court of Appeals for the First Circuit agreed with the district court's view that the stock was not "acquired" as required by the statute because, upon consummation of the merger, there was no stock left to "acquire." Thus, the court of appeals affirmed the district court's summary judgment in favor of Coopers and Lybrand.

B. The Majority's View of the Case

The majority began its analysis by examining the language of section 11 of the Securities Act of 1933. The language of the statute seems very straightforward in that it creates a cause of action in a person who acquires a security. Thus, the question the majority examined was whether Contel had acquired NDS' stock. To answer this question, the court looked to state merger law.

The majority stated that, under state law, the moment the merger went into effect, "NDS ceased to exist as a corporation." The district court opinion is unpublished.

61. Versyss, 982 F.2d at 654.
62. Id. at 654-55.
63. Id. at 655.
64. Id. at 655.
65. Id. at 655-56.
66. Id. at 655-56.
67. The majority opinion was written by Judge Boudin, and was joined by Judge Cyr.
68. Id. at 655; see supra note 8 for the text of section 11 of the Securities Act, 15 U.S.C. § 77k(a).
69. Versyss, 982 F.2d at 655. The definition of "security" is found in the Securities Act at 15 U.S.C. § 77b(1) (1988); see supra note 5 for the text of the definition. The majority in Versyss found that the definition was not particularly helpful in the case at hand except that the definition called for a broad interpretation of the term "security." Versyss, 982 F.2d at 655. The court concluded that even when utilizing a broad construction, the term "security" had "outer limits, and those limits are strained badly by describing what Contel acquired through the merger as a 'security.'" Id.
70. Id.
The court inferred from this that the shares of NDS stock ceased to exist at the same moment. The court also stated that the Delaware and Massachusetts statutes supported this view. The majority went on to state that:

It follows that, when the merger became effective, NDS stock underwent a considerable transformation. At that point, the NDS stock certificates ceased to represent an investment interest in the separate assets of NDS (since it no longer existed), ceased to reflect voting rights in the management of NDS (since NDS ceased to have a management), and ceased to comprise a claim to dividends declared from NDS earnings (since no such dividends could be issued). In sum, for the NDS stock the essential characteristics of securities ceased to pertain. "[A]t the moment a stock-for-stock merger is effective, the stock in a constituent corporation (other than the surviving corporation) ceases to exist legally."  

The court then concluded that the NDS stock certificates which the NDS stockholders held after the merger were evidence that the stockholders were prior owners of NDS securities and were entitled

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71. Id. The court wrote, "in a merger the shares of the acquired firm are not bought, they are extinguished." Id. (quoting Frandsen v. Jensen-Sundquist Agency, 802 F.2d 941, 944 (7th Cir. 1986)).


The relevant portion of the Delaware statute is as follows:

(a) When any merger or consolidation shall have become effective under this chapter, for all purposes of the laws of this State the separate existence of all the constituent corporations, or of all such constituent corporations except the one into which the other or others of such constituent corporations have been merged, as the case may be, shall cease and the constituent corporations shall become a new corporation, or be merged into [one] of such corporations, as the case may be, possessing all the rights, privileges, powers and franchises as well of a public as of a private nature, and being subject to all the restrictions, disabilities and duties of each of such corporations so merged or consolidated; and all and singular, the rights, privileges, powers and franchises of each of said corporations, and all property, real, personal and mixed, and all debts due to any of said constituent corporations on whatever account, as well for stock subscriptions as all other things in action or belonging to each of such corporations shall be vested in the corporation surviving or resulting from such merger or consolidation; and all property, rights, privileges, powers and franchises, and all and every other interest shall be thereafter as effectually the property of the surviving or resulting corporation as they were of the several and respective constituent corporations . . . .


73. Versyss, 982 F.2d at 655 (emphasis added) (quoting Shields v. Shields, 498 A.2d 161, 168 (Del. Ch.), appeal denied, 497 A.2d 791 (Del. 1985)).
to receive Contel stock.\textsuperscript{74}

The court sought to prove that Versyss' claim was not covered by the Securities Act by looking at another piece of evidence in the statutory language.\textsuperscript{75} It examined the damages provision of section 11\textsuperscript{76} to establish that Congress did not intend to cover the merger transaction involved in Versyss.\textsuperscript{77} The statute provides that the measure of damages is to be the difference between the price of the security at the time the plaintiff acquired the security and either of the three following figures: "\textsuperscript{78}‘(1) the value ... [of the security] as of the time such suit was brought, or (2) the price at which such security shall have been disposed of in the market before suit, or (3) the price at which such security shall have been disposed of after suit but before judgment.'"

The majority concluded that in calculating the damages for a section 11 violation, the securities must still be in the hands of the plaintiff-buyer.\textsuperscript{79} The buyer must purchase the securities and then realize the value paid was much greater than the actual value. Only then could the buyer bring an action for damages for the loss in value of the securities.\textsuperscript{80} In the transaction between Contel and NDS, however, the securities ceased to exist. "It would be fantasy to speak of the non-existent NDS securities as suffering a post-merger decline in value or being resold for less than the purchase price."\textsuperscript{81}

The court conceded, however, that some formula could be devised to satisfy a damages requirement in the case of a merger.\textsuperscript{82} The United States Court of Appeals for the First Circuit further realized that if Contel first acquired the NDS stock and then merged NDS into its subsidiary, there arguably could have been a claim under section 11.\textsuperscript{83} The same problem with the damage formula would have existed nonetheless because, under the majority's analysis, the stock would still have ceased to exist at the time the merger was consummated.\textsuperscript{84}

\textsuperscript{74} Id. at 656.
\textsuperscript{75} Id.
\textsuperscript{77} Versyss, 982 F.2d at 656.
\textsuperscript{78} Id. (quoting 15 U.S.C. § 77k(e)).
\textsuperscript{79} Id.
\textsuperscript{80} Id.
\textsuperscript{81} Id.
\textsuperscript{82} Id.
\textsuperscript{83} Id.
\textsuperscript{84} See id.
The court concluded its analysis of the statutory language by giving its own reflection of the complainant's real underlying problem with the transaction. The majority concluded "that effective upon the merger [Contel] acquired a package of assets and liabilities formerly pertaining to NDS that was worth less than Contel had been led to believe." 85

The court next turned to the legislative history of the Securities Act to see if it would shed some light on the dispute. 86 Its analysis of the legislative history led the court to believe that the Securities Act was intended to protect "ill-informed small investors," and not an experienced corporation which involved itself in a transaction that was simply not covered by the Securities Act. 87 If Contel had undertaken a transaction that deserved section 11 protection, the court stated that it would not deny recovery. 88 However, the court was not willing to stretch the language of the statute to allow Contel to recover. The court wrote as follows: "As the Supreme Court has reminded us, the federal securities laws were not designed to provide 'a broad federal remedy for all fraud.'" 89

The majority then addressed what it felt was the plaintiff's strongest authority, the United States Supreme Court case of SEC v. National Securities, Inc. 90 The plaintiff offered the case "for the proposition that the transfer of stock in a merger is a purchase or sale of securities under section 10(b) of the 1934 Act, 15 U.S.C. § 78j(b)." 91 The court agreed that for purposes of section 10(b), NOS did "sell" their NOS stock and "purchase" Contel stock. 92 The court then went on to say, however, that there was nothing in National Securities that suggests that Contel acquired the NDS securities. 93

The key to the anomaly—that a sale of securities may occur without a purchaser of securities—is that the securities, although relinquished by the seller are never acquired by anyone because they cease to exist as securities (by operation of merger law) at

85. Id.
86. Id. at 656-57. See supra notes 11-17 and accompanying text for a discussion of the legislative history of the Securities Act.
87. Versyss, 982 F.2d at 657.
88. Id.
89. Id. (quoting Marine Bank v. Weaver, 455 U.S. 551, 556 (1982)).
91. Versyss, 982 F.2d at 657.
92. Id. at 657-58.
93. Id. at 658.
the same time as they are relinquished.94

The majority concluded its opinion by questioning why there is such a lack of precedent on this issue. It pondered whether this lack of prior case law was a result of the fact that the acquiring corporation rarely relies on a registration statement put out by the constituent corporation, or simply because no one has ever thought to bring a section 11 action in this situation.95 The court then conceded that it would not infringe upon expectations if it were to hold Coopers and Lybrand liable.96 The court realized that accountants are held to a very high standard, but in this case the language of the statute would be stretched too far if the court held that Contel acquired securities under section 11 of the Securities Act.97 "For us, there is greater conformity to language and less unease in concluding that a defunct security in a non-existent corporation is not a 'security' within the meaning of section 11."98

C. The Dissent’s View of the Case99

Like the majority, the dissent in Versyss began its analysis with the statutory language of section 11 of the Securities Act.100 The dissent particularly focused on the phrase “acquiring [a] security” and analyzed the plain meaning of the phrase.101 “In its plain meaning, ‘acquire’ means ‘to come into possession, control, or power of disposal of often by some uncertain or unspecified means.’”102 The term “security” is defined in the statute103 and the dissent noted that the NDS stock before the merger easily fell into this definition.104

Thus, the dissent defined the issue as whether the plaintiff ever attained “possession, control or power of disposal” over the stock of the NDS shareholders.105 The dissent contended that the merger

94. Id.
95. Id.
96. Id.
97. Id.
98. Id.
99. Id. The dissenting opinion was written by Judge Torruella.
100. Id.
101. Id.
102. Id. (quoting WEBSTER’S THIRD NEW INTERNATIONAL DICTIONARY 18 (1981)). The dissent noted a similar definition of “acquire” in BLACK’S LAW DICTIONARY 41 (4th ed. 1951). Versyss, 982 F.2d at 658.
104. Versyss, 982 F.2d at 658-59.
105. Id. at 659.
agreement offered help in answering this question and quoted the agreement at section 2.2. The agreement provided that "each share of NDS Stock . . . by virtue of the Merger and without any action on the part of the holder thereof, [shall] be converted into and exchanged for' Contel stock." 106

The dissent argued that the words "converted into and exchanged for" signified that Contel had acquired the stock. 107 The dissent posited that each corporation had, by virtue of the agreement, purchased each other's stock. 108 The dissent further contended that it made no difference that the NDS stock ceased to exist following the merger because "Contel acquired the stock prior to such extinction. Indeed, Contel gained its ability to extinguish NDS stock as a result of its acquisition." 109

The dissent then proceeded to argue that such a reading of the statute furthers the purpose of the Securities Act. 110 The main purpose of the statute is to require disclosure so that business practices maintain a high standard of honesty. The dissent argued that whether there was fraud in a simple stock purchase or in a merger, the statute was meant to protect against fraud in both cases. 111 The dissent's final note was one of concern: concern that the majority's ruling would lead to businesses structuring their transactions in the form of a merger simply to evade the liability of section 11 of the Securities Act. 112

III. ANALYSIS

A. The Majority's Decision: Creating the Gap

Section 11 of the Securities Act requires that, in order for there to be liability, a "security" must be "acquired" by the party bringing suit. 113 The majority in Versyss found that immediately upon consummation of a stock-for-stock merger, the stock of the target corporation ceases to exist. 114 Thus, it was impossible for Contel to have acquired NDS' stock because there was nothing left to acquire.

106. Id. (quoting the merger agreement).
107. Id.
108. Id.
109. Id.
110. Id.
111. Id.
112. Id.
114. Versyss, 982 F.2d at 655.
The court's analysis began with the language of the statute. Section 11 of the Securities Act allows any person who "acquired [a] security" that had a misleading registration statement to bring a civil action. Thus, the majority focused on whether Contel had acquired a security. In order to decide this issue, the majority made a very technical analysis of state merger law.

In fact, the decision of the majority in Versyss was almost wholly based on its interpretation of state merger law. Its argument focused on the effect that a merger had on the stock of the acquired company. Under Delaware merger law, the target corporation ceases to exist at the time of the merger. The majority's interpretation of the law is that the stock of the company also ceases to exist immediately upon consummation of the merger.

The majority looked to other evidence in the statutory language to support its case as well. It found this evidence in the damages section of the Securities Act. In doing so, the majority pointed out a serious gap in the scope of the protection of section 11.

The majority contended that the damages section of the Securities Act provides evidence that the merger in Versyss was not intended to be covered by the Securities Act. The court explained that the damages formula assumes the security is in existence at the time the suit is brought. However, it conceded that in order to calculate damages in this case, some formula could no doubt be developed, especially if the case involved Contel purchasing the NDS stock first and then merging NDS out of existence. In that case, the securities would also have ceased to exist, but the majority

115. See supra notes 67-98 and accompanying text for a discussion of the majority's analysis.
117. See supra notes 70-74 and accompanying text for the majority's merger law analysis.
118. Versyss, 982 F.2d at 655-56.
119. This Note for the most part will limit its analysis to Delaware merger law because the majority focuses on the Delaware merger law. This is evident when the court in Versyss quotes Delaware law and in its citation implies that it believes that Massachusetts law would lead to the same outcome. See, e.g., id. at 655.
121. Versyss, 982 F.2d at 655-56.
122. Id. at 656 (citing to 15 U.S.C. § 77k(e)).
123. See supra notes 75-84 and accompanying text.
124. Versyss, 982 F.2d at 656.
125. Id.
pointed out that the "securities would have been 'acquired' and an arguable claim would exist under section 11." This considerably weakens the majority's damage argument because the court acknowledged that in a similar transaction, a damages formula would have to be developed and could, in fact, be developed. Thus, the majority essentially rested its decision on its technical state merger law analysis and, in so doing, created a gap in the law.

The gap in the law that the majority has created is that if a corporation purchases all of the acquired corporation's stock first and then merges with the corporation, a section 11 claim exists; but if a corporation simply merges with the constituent corporation, then no section 11 claim exists. The end result is the same, yet in one case there is no section 11 claim under the Securities Act.

The dissent tried to avoid creating this gap in the law with its view that the security of the target corporation in a stock-for-stock merger survives long enough to be "acquired" by the corporation. Then, the security could be extinguished. While this view does not create a gap in the law, the dissent offered no legal justification to support its view. Thus, the question remains: is there any support for the dissent's view?

B. Is There Support for the Dissent's View?

The dissent recognized that the majority had created a gap in the law, stating, "[t]he holding of the majority ... precludes the application of [section] 11 to any merger like the one presented here, and thus allows parties to structure their transactions in the form of such a merger to circumvent the application of [section] 11." While the dissent had the insight to recognize this problem, it did not offer much justification for its solution.

The dissent simply considered the definitions of "acquire" and "security" and looked to the merger agreement to conclude that the merger agreement clearly allowed Contel to "acquire" the NDS stock. As a result, the dissent found that a section 11 claim existed. The dissent was advocating a new view of the effect of a merger on the securities of the target company: the stock is first acquired and then extinguished, as opposed to being extinguished immediately at the time of merger. What follows in this section are

126. Id.
127. Id. at 659.
128. Id. at 658-59.
two alternatives that will strengthen the dissent's view and eliminate the gap created in the securities law.

1. Reconciling the Dissent's Theory with Existing Case Law

The first alternative is to attempt to reconcile the dissent's view with existing law as characterized by the majority. The majority relied on precedent to the effect that the stock of a target corporation is extinguished immediately at the time of merger. The dissent framed the issue as whether Contel ever, even for an instant, "acquired" or "gained possession, control or power of disposal of NDS stock."¹²⁹ To deal with this issue, the dissent looked to the merger agreement.¹³⁰ The dissent believed that the words "converted into and exchanged for" sufficiently indicated that Contel had acquired the NDS stock.¹³¹ Indeed, the dissent believed that Contel had the right to acquire the stock and extinguish it.¹³²

There appear to be two types of cases in which this type of dispute most often arises: (1) a dispute over the extinguishment of stockholders' dividend rights and (2) a dispute involving the right of first refusal. The first class of cases are easily reconcilable with the dissent's argument because the dissent believed that the stock in a merger was extinguished. State merger law says that when stock from the target corporation in a merger is extinguished, the dividend rights of preferred stockholders are also extinguished.¹³³ The dissent in Versyss argued that the stock ceases to exist after the surviving corporation acquires it.¹³⁴ Thus, the dividend rights would still be extinguished, albeit after the stock was acquired by the surviving corporation. Therefore, the life of the stock could be extended by allowing the surviving corporation to first acquire the stock and then extinguish it. The result would then be the same because the shareholders' dividend rights would still cease to exist.

The second class of cases is also reconcilable with the dissent's view. The right of first refusal accomplishes its purpose by requiring shareholders who wish to sell their stock to offer it to other

¹²⁹. Id. at 659.
¹³⁰. See supra note 106 and accompanying text.
¹³¹. Versyss, 982 F.2d at 659 (quoting the merger agreement).
¹³². Id.
¹³³. See supra notes 42-43 and accompanying text.
¹³⁴. Id. "That the NDS stock ceased to exist following the consummation of the merger is of no consequence because Contel acquired the stock prior to such extinction. Indeed, Contel gained its ability to extinguish NDS stock as a result of its acquisition." Id.
shareholders before they can sell it to a third party who is not a shareholder in the corporation.\(^\text{135}\) A merger, on the other hand, results when one corporation is entirely absorbed by another.\(^\text{136}\) In a merger, there is never an offer to sell or to buy one particular shareholder's stock; the offer is to take over the entire corporation which includes acquiring every shareholder's stock.\(^\text{137}\)

The *Shields* court made the argument that if the right of first refusal could be triggered by a merger, then an anomaly would be created because each shareholder would have the right to buy out the other's shares.\(^\text{138}\) Both the *Frandsen* court and the *Shields* court concluded that this did not matter because the stock would cease to exist as a result of the merger.\(^\text{139}\) One could argue, however, that this merger analysis is not relevant to the right of first refusal based on the *Frandsen* decision.\(^\text{140}\)

In a merger, one stockholder is not offering to sell his or her shares and the buyer is not looking to own that individual stockholder's shares. The transaction involved is a merger of a business. As part of the merger, as part of acquiring the whole business, the surviving company "acquires" all of the shares of the target corporation's stock. The right of first refusal would never be triggered because at the time of merger all shareholders are simultaneously giving up their stock to the surviving corporation. The surviving corporation, again, acquires the stock as part of acquiring the whole business. Once the stock is acquired, it is immediately extinguished.

It seems as though the dissent's theory could be reconciled with the law on which the majority relies. The main problem with this alternative is that the law upon which the majority relies is well settled. The court in *Versyss* even characterized this view as "ordinary merger-law jurisprudence."\(^\text{141}\) The second alternative avoids this problem by circumventing state corporation law. Instead, this second solution creates federal corporation law.

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137. *See Frandsen*, 802 F.2d at 945.


139. *Frandsen*, 802 F.2d at 944; *Shields*, 498 A.2d at 168-69.

140. *See supra* notes 26-27 and accompanying text.

2. Federal Common Law or State Law?

The majority in Versys gave great deference to state merger law in deciding whether Conte actually "acquired" a "security."142 Since the inception of the securities laws, however, there has been much debate concerning the need for federal corporation law.143 The United States Supreme Court has recognized that in some instances it may be necessary to disregard state corporation law in the interest of furthering federal policy.144

The first step in the analysis is to determine which law—state or federal—is involved in the dispute.145 If there is a federal statute involved, then courts should focus their efforts on providing a federal remedy. However, this does not preclude courts from looking to state law to fill in any gaps in the federal law.146 There are instances in which the court should try to incorporate state law into federal law. One such instance occurs when the parties have "entered legal relationships with the expectation that their rights and obligations would be governed by state law standards . . . . Corporation law is one such area."147

The Court has recognized corporations to be entities wholly created by state law.148 Thus, there is a strong presumption that disputes involving corporations will be governed by state law.149 "[I]n this field congressional legislation is generally enacted against the background of existing state law; Congress has never indicated that the entire corpus of state corporation law is to be replaced simply because a plaintiff's cause of action is based on a federal statute."150 Therefore, the existence of a federal statute should not impede the use of state corporation laws "unless the state laws permit action prohibited by the Acts, or unless 'their application would be inconsistent with the federal policy underlying the cause of ac-

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142. See supra notes 70-74 and accompanying text.
145. Burks, 441 U.S. at 475.
147. Id. at 98.
148. Id.
149. Id. at 98-99.
150. Burks, 441 U.S. at 478.
This test allows courts to limit the effect of state law where a federal statute is involved "and yet relieves federal courts of the necessity to fashion an entire body of federal corporate[ion] law out of whole cloth." 152

In a 1991 case, Kamen v. Kemper Financial Services,153 the Court utilized this test to decide whether the demand requirement for a stockholder's derivative action brought under the Investment Company Act of 1940154 should be excused.155 The demand requirement dictates that before stockholders can bring a derivative suit, they must make a demand on the board of directors and request that the board obtain redress from the corporation.156 The plaintiff in Kamen argued that under state law, her demand could be excused based on the demand futility exception.157 The court of appeals attempted to establish federal common law by creating a universal demand requirement which required demand to be made to the board of directors in all cases.158

The Supreme Court reversed the lower court's decision. It first reasoned that even though the case involves a federal statute, the demand requirement is closely connected to the distribution of corporate governing power and this power is inherently a product of state law.159 The Court stated that the futility exception dictates the situations in which the shareholder is allowed to bypass the board of directors and make a management decision about whether to bring suit.160 "Superimposing a rule of universal-demand over the corporate doctrine of these States would clearly upset the balance that they have struck between the power of the individual shareholder and the power of the directors to control corporate litigation."161

Having decided that the demand requirement is a product of state law, the Court next had to decide whether the futility excep-

151. Id. at 479 (quoting Johnson v. Railway Express Agency, 421 U.S. 454, 465 (1975)).
152. Id. at 480.
155. Kamen, 500 U.S. at 92.
157. Kamen, 500 U.S. at 94.
158. Id. at 94-95.
159. Id. at 101.
160. Id. at 102.
161. Id. at 103.
tion impedes the purpose of the federal statute involved.\textsuperscript{162} The Court recognized that the Investment Company Act "embodies a congressional expectation that the independent directors would 'loo[k] after the interests of the [investment company]' by 'exercising the authority granted to them \textit{by state law.}"\textsuperscript{163} The Supreme Court could find "no policy in the [Investment Company] Act that would require us to give the independent directors, or the boards of investment companies as a whole, greater power to block shareholder derivative litigation than these actors possess under the law of the State of incorporation."\textsuperscript{164}

Following this analysis, it is easy to see that the rules governing mergers are also a product of state law. Each state has intricate statutes outlining the procedure for the merger of corporations. States include in statutes the effects that a merger will have on the corporations involved in merger transactions. Consequently, as in \textit{Kamen}, it is necessary to consider whether the application of the state law in this case impedes federal policy.

With the creation of the Securities Act, Congress sought to require full disclosure of information which would protect investors from fraud.\textsuperscript{165} The policy behind the Securities Act was to ensure that investors were provided with accurate information necessary to make an investment decision. Moreover, investors would not be misled into investing their money in an unprofitable enterprise.\textsuperscript{166} The majority in \textit{Versysy} took a very narrow view of who should be protected by section 11. The majority asserted that the law was meant to protect private investors against fraud and not to protect sophisticated corporations involved in a complex merger agree-

\textsuperscript{162} \textit{Id.} at 100.
\textsuperscript{163} \textit{Id.} at 107 (quoting \textit{Burks v. Lasker}, 441 U.S. 471, 485 (1979)).
\textsuperscript{164} \textit{Id.} at 107-08. The Court further wrote, where a gap in the federal securities laws must be bridged by a rule that bears on the allocation of governing powers within the corporation, federal courts should incorporate state law into federal common law unless the particular state law in question is inconsistent with the policies underlying the federal statute. The scope of the demand requirement under state law clearly regulates the allocation of corporate governing powers between the directors and individual shareholders. Because a futility exception to demand does not impede the regulatory objectives of the [Investment Company Act], a court that is entertaining a derivative action under that statute must apply the demand futility exception as it is defined by the law of the State of incorporation.
\textit{Id.} at 108-09.
\textsuperscript{165} See \textit{supra} notes 11-17 and accompanying text for the legislative history of the Securities Act.
\textsuperscript{166} See \textit{supra} notes 11-17 and accompanying text for the legislative history of the Securities Act.
The court stated that "the federal securities laws were not designed to provide 'a broad federal remedy for all fraud.'"168 In making this argument, the majority forgets that even though the party bringing suit is a corporation, that corporation is representing its private investors. In taking on this suit, Versyss Incorporated is attempting to protect the interests of its investors.169 Also, the legislative history indicates that Congress intended mergers of this type to be covered by the Securities Act. In its legislative history, the House of Representatives outlined transactions that should be exempt from the Securities Act writing, "[r]eorganizations carried out without . . . judicial supervision possess all the dangers implicit in the issuance of new securities and are, therefore, not exempt from the act. For the same reason the [exemption] provision is not broad enough to include mergers or consolidations of corporations entered into without judicial supervision."170 Thus, even Congress recognized the dangers inherent in mergers because of the exchange of stock and believed that mergers should not be exempt from coverage by the Securities Act.

Furthermore, the majority's narrow reading of the fraud which Congress intended to cover with the Securities Act does not make logical sense in light of the Versyss court's arguments. The majority argued that section 11 was not intended to cover corporations involved in this type of agreement unless the corporation fit into the language of section 11.171 Thus, a corporation which purchases the stock of another corporation and then merges the acquired corporation into itself fits easily into the language of section 11. This corporation, however, is no more a victim of fraud than the corporation that simply merges another corporation into itself.

This case differs from Kamen. In Kamen, it was not the merits of the plaintiff's claim under the Investment Company Act of 1940 that would have been impeded by state law. The issue of which law to use—state or federal—focused solely on whether the plaintiff must make a demand on the board of directors for redress before filing a derivative action. In Kamen, the Court was not using state law to decide whether the plaintiff would prevail on the merits of

168. Id. (quoting Marine Bank v. Weaver, 455 U.S. 551, 556 (1982)).
169. Versyss, Inc. was not a party to the merger but for whatever reason, it has been assigned the suit and must act in the interest of its shareholders.
171. Versyss, 982 F.2d at 657.
her claim under the federal statute. The Court simply used state law to see if the plaintiff had a right to have the merits of her claim under the federal statute examined in a court of law. There was nothing in the federal statute that directly addressed the issue of demand.

In Versyss, on the other hand, by utilizing state law to interpret the federal statute, the court directly impeded the application of the Securities Act. The majority in Versyss used state law to directly interpret the meaning of the federal statute. In doing so, the policies of the federal statute were thwarted. The Securities Act was enacted to protect against fraud and by using state law to interpret the merits of the plaintiff's claim, the plaintiff was denied protection from exactly the type of fraud the statute was meant to cover.

Even the majority itself acknowledged the possible implications of its decision on the furtherance of federal policy when it wrote that, "applying section 11 to merger acquisitions might not unfairly upset settled expectations; under section 11, accountants are held to demanding standards when they certify registration statements and are liable to remote purchasers well beyond more predictable common law limits." In the final words of its opinion, the majority in Versyss showed even further reluctance to reach its conclusion. The court recognized that Contel would have had a claim if it had acquired NDS stock in a tender offer and then merged NDS out of existence, yet would have clearly had no claim if Contel had simply purchased the assets of NDS. The court went on to note the following:

Faced with a merger transaction that fits neatly into neither category, any construction of the statute will leave discontinuities and a sense of lingering unease. For us, there is greater conformity to language and less unease in concluding that a defunct security in a non-existent corporation is not a "security" within the meaning of section 11.

Confining itself mainly to a technical analysis of state merger law, the court was not able to find that the surviving corporation had "acquired" a "security" within the language of section 11 of the Securities Act. Therefore, the Versyss court could have created federal common law in interpreting the words "acquiring such secur-

172. Id. at 658.
173. Id.
174. Id.
ity”175 and held that, for the purposes of the Securities Act the surviving corporation to a merger “acquires” the target corporation’s securities and then the securities of the target corporation are extinguished.

CONCLUSION

When the United States Court of Appeals for the First Circuit approached the issue in Versyss with a technical analysis, it may have neglected to consider the future effects its decision might create. At the basis of our legal system rests the notion that the courts should build on what has come before, that is, look to precedent, and make a decision, with the hope that the decision will strengthen the law and aid future courts in making decisions. In such a system, inevitably a case will come about in which the decision will create a conflict in the law that endures after it. Therefore, courts must take care to balance efficiency against caution. Courts must take extra precaution to ensure that their decisions will not adversely affect surrounding law.

In Versyss, a gap was created in a federal statute through an interpretation of state law. This Note has offered two alternatives which would eliminate the gap. Whether these alternatives should be followed is also a question of careful balancing. Although the majority’s analysis makes logical sense and is well supported by existing law, the majority seemed hesitant about its own decision.176 Our judiciary possesses a tremendous burden to get the answer right in as little time as possible. But when judges close an opinion doubting their decision and writing as if they are settling for the best alternative available, it may become more important to ask that judge to step back, think a little more, and start all over again.

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