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## Statutory Merger Involves a Purchase or Sale of Securities for Purposes of Rule 10b-5

Robert M. Bandy

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be extended to misdemeanants.<sup>71</sup>

Seemingly, right to counsel should be expanded. A defendant faces before, during, and after trial a bewildering variety of rules. He is ill-equipped to face, on equal terms, his well-trained adversaries. These factors arise in important cases as well as in not so important ones. Providing the needed counsel presents a serious challenge to American legal resources and ingenuity. Shall the needed counsel be provided through private defender systems, public defender system, legal clinics staffed by law school students, or some combination of the three? The answer will lie in some balance of the desirability of providing counsel for all and the practicality of a limited number of competent practitioners. The answer can be a flexible standard which inherently is vague or a fixed standard which may seem arbitrary. The Minnesota Supreme Court has opted for a fixed standard, which in view of the problems created by the vague *Betts* holding, is probably for the best. The *Borst* approach, especially if modified along the lines suggested by Mr. Justice Peterson, is a logical approach. It has the advantage of affording a clear-cut rule which can be applied by even the usually non-legally-educated local magistrates. It is not the best of all answers, but, given the state of legal services in the United States, it represents a logical compromise. But though *Borst* represents a logical, justifiable resting place, only the United States Supreme Court can decide just how permanent this resting place will be.

Gary R. Rice

### Statutory Merger Involves a Purchase or Sale of Securities for Purposes of Rule 10b-5

The defendants, a group of officers and directors of the Susquehanna Corporation (the "Lannan Group"), conspired with one Korholz to defraud Susquehanna. Initially, the Lannan Group sold 435,000 shares of Susquehanna to Korholz at a price \$1,740,000 in excess of fair market value. The group then resigned, vesting control of Susquehanna in Korholz and his nominees. Korholz, who was also chairman of the board of another corporation, American Gypsum, sold the Susquehanna shares to Gypsum, which obtained a bank loan for substantially all of the purchase price. Finally, Korholz caused the boards of directors of Gypsum and Susquehanna to recommend to their stockholders a statutory merger<sup>1</sup> of Gypsum into Susquehanna. The terms of the merger provided for an exchange of 1.9 shares of Gypsum for one share of Susquehanna, a ratio which represented a gross over-valuation of Gypsum. These fraudulent manipulations prompted a derivative suit by several minority shareholders of Susquehan-

<sup>71</sup> On this subject in general, see Note, *Right to Aid in Addition to Counsel for Indigent Criminal Defendants*, 47 MINN. L. REV. 1054 (1963).

<sup>1</sup> INT. REV. CODE of 1954, § 368(a)(1)(A).

na, who alleged a violation of rule 10b-5<sup>2</sup> on the ground that the Lannan Group had fraudulently caused Susquehanna to acquire 435,000 shares of its own stock at a price \$1,740,000 in excess of fair market value.<sup>3</sup> The district court dismissed the derivative action because of the plaintiffs' failure to state a claim for which relief could be granted, stating that a statutory merger does not involve a "purchase or sale" of securities for purposes of rule 10b-5.<sup>4</sup> An alternative ground for the dismissal was that the district court lacked jurisdiction of the subject matter, since corporate management and the fiduciary duty of directors to their corporations is primarily regulated by state law.<sup>5</sup> *Held, reversed*: The issuance of shares by a corporation in exchange for shares of another corporation pursuant to a statutory merger involves a purchase or sale of securities under the anti-fraud provisions of the securities laws. *Dasbo v. Susquehanna Corp.*, 380 F.2d 262 (7th Cir.), *cert. denied*, 389 U.S. 977 (1967).

### I. RULE 10b-5

While rule 10b-5 is but one of several anti-fraud provisions in the federal securities laws, it is by far the broadest in coverage. Promulgated in 1942 pursuant to section 10(b) of the Securities Exchange Act of 1934,<sup>6</sup> the rule closed a previously-existing loophole in the anti-fraud provisions by providing protection against fraud by both purchasers and sellers of securities.<sup>7</sup> One of the elements that a plaintiff seeking to bring a rule

<sup>2</sup> 17 C.F.R. § 240.10b-5 (1968), which provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

- (a) To employ any device, scheme, or artifice to defraud,
- (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
- (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

<sup>3</sup> Susquehanna acquired Gypsum's assets, which included the 435,000 Susquehanna shares, and obligations, including the bank loan for the purchase of the shares at the inflated price.

<sup>4</sup> *Dasbo v. Susquehanna Corp.*, 267 F. Supp. 508 (N.D. Ill. 1966).

<sup>5</sup> *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir. 1951), *cert. denied*, 343 U.S. 956 (1952) (insider's sale of control to third persons at premium). The court denied relief to the plaintiff, suing derivatively, and stated that section 10(b) "was directed solely at that type of misrepresentation or fraudulent practice usually associated with the sale or purchase of securities rather than at the fraudulent mismanagement of corporate affairs . . ." *Id.* at 464. Actually, *Birnbaum* is frail support for this proposition, since the oft-quoted statement was merely dictum; furthermore, the actual ground for dismissal was that the corporation was neither seller nor purchaser and was not a party to the transaction and therefore had no right enforceable under rule 10b-5.

<sup>6</sup> 15 U.S.C. § 78j(b) (1964). Section 10(b) did not by its terms make unlawful any conduct or activity, but conferred rule-making power upon the Commission to condemn deceptive practices in the sale or purchase of securities.

<sup>7</sup> A. BROMBERG, *SECURITIES LAW—FRAUD—SEC RULE 10b-5*, at 19-20 (1967); SEC Securities Act Release No. 3230 (May 21, 1942):

The Securities and Exchange Commission today announced the adoption of a rule prohibiting fraud by any person in connection with the purchase of securities. The previously existing rules against fraud in the purchase of securities applied only to brokers and dealers. The new rule closes a loophole in the protections against fraud administered by the Commission by prohibiting individuals or companies from buying securities if they engage in fraud in their purchase. The text of the Commission's action follows: "The Securities and Exchange Commission, deeming it necessary for

10b-5 action must establish is that the transaction he is attacking constituted a "purchase or sale" of a security.<sup>8</sup> Unfortunately, the meaning and scope of this phrase have been the subjects of controversy. One particularly important question has been whether a statutory merger involves a "purchase or sale" of securities. This question has been answered both affirmatively and negatively by the administrative agencies and courts.

## II. ADMINISTRATIVE CONSTRUCTION OF "PURCHASE OR SALE"

When considering whether a statutory merger is a "purchase or sale" for purposes of the anti-fraud provisions, the administrative agencies have paid particular attention to their construction of "sale" for purposes of the registration provision of the Securities Act of 1933.<sup>9</sup> In this connection, the Commission's interpretation of the phrase has changed at least four times. In early 1934 the Federal Trade Commission took the position that a merger was a "sale" for registration purposes.<sup>10</sup> This interpretation was premised on the expressly stated legislative purpose that "sale" was to be "defined broadly."<sup>11</sup> After the Securities and Exchange Commission was created by the Securities Exchange Act of 1934,<sup>12</sup> the Commission reversed this initial interpretation and held that a merger was not a "sale" and did not require registration.<sup>13</sup> Ultimately, the Commission incorporated this so-called "no-sale theory" in a note to rule 5 of form E-1, the form for most registrations in 1935.<sup>14</sup> In 1941 the Commission apparently again changed its position and expressed concern to Congress because mer-

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the exercise of the functions vested in it and necessary and appropriate in the public interest and for the protection of investors so to do, pursuant to authority conferred upon it by the Securities Exchange Act of 1934, particularly Sections 10(b) and 23(a) thereof, hereby adopts the following Rule X-10B-5:

See note 2 *supra* for text of the rule. The designation X-10B-5 remained until the general renumbering in 1956-1957, when it became 10b-5.

<sup>8</sup> The basic elements of a cause of action under rule 10b-5 are (1) a purchase or sale of a security; (2) an interstate contact; (3) a deception in connection with the purchase or sale, usually in the form of a material misrepresentation or omission; (4) reliance upon the deception; and (5) injury to the purchaser or seller as a result of this reliance.

<sup>9</sup> 15 U.S.C. § 77b(3) (1964). See 1 L. LOSS, *SECURITIES REGULATION* 518 (2d ed. 1961); Purcell, *A Consideration of the No-Sale Theory Under the Securities Act of 1933*, 24 BROOKLYN L. REV. 254 (1958); Sargent, *A Review of the "No-Sale" Theory of Rule 133*, 13 BUS. LAW. 78 (1957); Sommer, *Mergers, Consolidations, Sales of Assets—Rule 133*, 16 W. RES. L. REV. 11 (1964); Comment, *Rule 133 and the No Sale Theory: Interpretation or Legislation?*, 13 J. PUB. L. 520 (1964); Note, *Securities Regulation—Statutory Merger Involves a "Purchase" or "Sale" Under Section 10(b)*, 36 FORDHAM L. REV. 362 (1967); Note, *The SEC's No-Sale Rule and Exchanges of Securities Pursuant to Voluntary Reorganizations*, 67 HARV. L. REV. 1237 (1954).

<sup>10</sup> The Securities Act of 1933 was administered for some months in its infancy by the Federal Trade Commission until the SEC was created by the Securities Exchange Act of 1934, 15 U.S.C. § 78(d)(a) (1964). See SEC Securities Act Release No. 3698 (Oct. 2, 1956); Sargent, *supra* note 9, at 79.

<sup>11</sup> Sargent, *supra* note 9, at 79. H.R. REP. 85, 73d Cong., 1st Sess. 11 (1933) stated: "The term 'sale' or 'sell' is defined broadly to include every attempt or offer to dispose of a security for value." (Emphasis added.)

<sup>12</sup> 15 U.S.C. § 78(d)(a) (1964).

<sup>13</sup> L. LOSS, *supra* note 9, at 520; Sargent, *supra* note 9, at 79; Comment, *supra* note 9, at 521; letter of SEC Chairman, p. 3, made public as part of SEC Securities Act Release No. 3762 (March 15, 1967).

<sup>14</sup> L. LOSS, *supra* note 9, at 520; Comment, *supra* note 9, at 521; SEC Securities Act Release No. 493(c) (Sept. 20, 1935). The Commissioner deemed no "sale" to be involved when "there is submitted to the vote of such stockholders a proposal for the transfer of assets of such corporation to another person in consideration of the issuance of securities of such other person, or a plan or agreement for a statutory merger or consolidation."

gers and consolidations were not subject to registration. However, when the Commission failed to make any specific proposal, Congress took no action.<sup>15</sup> By 1943 the Commission had again changed its mind, contending vigorously that consolidations did not involve a "sale" of securities for the purposes of registration.<sup>16</sup> Although the Commission abolished form E-1 in 1947, it continued to follow the "no-sale theory" administratively by excluding mergers, consolidations, and sales of assets from the scope of the registration provision of the Securities Act of 1933.<sup>17</sup> In 1951 the Commission officially codified the "no-sale theory" in rule 133,<sup>18</sup> which provides that statutory mergers and consolidations do not involve "sales."<sup>19</sup> However, the Commission expressly limited rule 133 to the registration provision of the Securities Act of 1933 and stated that it was inapplicable to the anti-fraud provisions of the federal securities laws.<sup>20</sup> Thus, as far as the Commission was concerned, a statutory merger was a "purchase or sale" for purposes of the anti-fraud provisions. The Commission has continued to take this position and is now firmly in favor of applying section 10(b) and rule 10b-5 to statutory mergers.<sup>21</sup>

On the surface it appears that the Commission's inconsistency in defining "sale" as it applies to mergers, consolidations, and sales of assets in the registration provision and in the anti-fraud provisions is not justified. However, one explanation for the inconsistency is that requiring registration of these transactions unnecessarily burdens companies which presently disclose through proxy solicitations the essential facts of the merger or consolidation.<sup>22</sup> The proxies covering a merger or consolidation accomplish the same result as a registration—full disclosure in the issuance of the securities. On the other hand, since mergers and consolidations provide opportunities for fraud, the Commission has deemed it wise to make them subject to the anti-fraud provisions. Such a treatment of mergers and consolidations appears to be in accord with the legislative intent of section 10(b) of the 1934 Act, under which rule 10b-5 was promulgated.

### III. JUDICIAL CONSTRUCTION OF "PURCHASE OR SALE"

Despite the Commission's struggles, the question of whether a statutory

<sup>15</sup> Comment, *supra* note 9, at 522; *Hearings Before the Comm. on Interstate and Foreign Commerce on H.R. 4344, 5065, 5832, 77th Cong., 1st Sess., 843, 845 (1941).*

<sup>16</sup> In *National Supply Co. v. Leland Stanford Jr. Univ.*, 134 F.2d 689, 694 (9th Cir.), *cert. denied*, 320 U.S. 773 (1943), the SEC filed an *amicus curiae* brief stating that a consolidation did not involve a sale.

<sup>17</sup> L. Loss, *supra* note 9, at 521; Sargent, *supra* note 9, at 80; Sommer, *supra* note 9, at 15; Comment, *supra* note 9, at 523; SEC Securities Act Release No. 3211 (April 14, 1947).

<sup>18</sup> Sargent, *supra* note 9, at 80; Comment, *supra* note 9, at 523; SEC Securities Act Release No. 3420 (Aug. 2, 1951).

<sup>19</sup> Rule 133, 17 C.F.R. § 230.133 (1968).

<sup>20</sup> Comment, *supra* note 9, at 524; SEC Securities Act Release No. 3420 (Aug. 2, 1951) provided that "[a]s a matter of statutory construction the Commission does not deem the 'no sale theory' which is described in the rule as being applicable for purposes of any of the anti-fraud provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934."

<sup>21</sup> Brief for SEC as *amicus curiae* at 6-28, *Dasho v. Susquehanna Corp.*, 380 F.2d 262 (7th Cir. 1967); Brief for SEC as *amicus curiae* at 5, *Vine v. Beneficial Fin. Co.*, 374 F.2d 627 (2d Cir. 1967); Note, *Securities Regulation—Statutory Merger Involves a "Purchase" or "Sale" Under Section 10(b)*, 36 FORDHAM L. REV. 362, 366 (1967).

<sup>22</sup> Sargent, *supra* note 9, at 80; see Brief for SEC as *amicus curiae* at 15-20, *Dasho v. Susquehanna Corp.*, 380 F.2d 262 (7th Cir. 1967); Note, *supra* note 21, at 366.

merger amounts to a "purchase or sale" for purposes of the anti-fraud provisions has not often come before the courts. In 1943 in *National Supply Co. v. Leland Stanford Junior University*<sup>23</sup> the Ninth Circuit dealt with the closely related question of whether a consolidation, as opposed to a statutory merger, was a "purchase or sale" of securities. The court agreed with the then current position of the Securities Exchange Commission that a consolidation was not a "sale" for purposes of the anti-fraud provisions, although this was not the principal basis of the decision.<sup>24</sup>

However, in the relatively few cases which have been decided since *Leland Stanford*, the courts have trended toward a broader definition of "purchase or sale" for purposes of the anti-fraud provisions. In the 1960 case of *H.L. Green Co. v. Childree*,<sup>25</sup> Green Co. instituted a section 10(b) action after it had issued its stock in exchange for the stock of another corporation pursuant to a merger. Defendants were certified public accountants who allegedly prepared false financial statements and made other misrepresentations with intent to induce plaintiff to enter into the merger. Defendants moved to dismiss on the ground that plaintiff had failed to state a claim within section 10(b) because the transaction was a merger and not a "purchase or sale" of securities. In denying the defendants' motion, the New York district court noted that a merger "may or may not involve a purchase and sale within the meaning of Section 10(b) of the Act," but that the transaction before the court appeared to be a purchase and sale.<sup>26</sup>

Recently, in *Simon v. New Haven Board & Carton Co.*<sup>27</sup> a Connecticut district court apparently considered a statutory merger a "purchase or sale" within rule 10b-5, but the issue was not raised and the court did not discuss it. In denying the defendants' motion to dismiss for failure to state a claim, the court held that corporate issuance of stock is a sale within the meaning of rule 10b-5.<sup>28</sup> Thus, the court never reached the question of whether a statutory merger was a "sale" for purposes of the anti-fraud provisions of the federal securities laws.

*Voege v. American Sumatra Tobacco Corp.*<sup>29</sup> was the first case in which a district court squarely faced the issue of whether a statutory merger involved a "purchase or sale" within the meaning of section 10(b) and rule 10b-5. There, the merger of a subsidiary into the parent company was accomplished under Delaware law without shareholder approval because the

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<sup>23</sup> 134 F.2d 689 (9th Cir.), cert. denied, 320 U.S. 773 (1943).

<sup>24</sup> *Id.* at 694.

<sup>25</sup> 185 F. Supp. 95 (S.D.N.Y. 1960).

<sup>26</sup> *Id.* at 96.

<sup>27</sup> 250 F. Supp. 297 (D. Conn. 1966).

<sup>28</sup> *Id.* at 299. The court followed *Ruckle v. Roto Am. Corp.*, 339 F.2d 24, 27 (2d Cir. 1964), where a majority of the board of directors, withholding the latest financial information from the remaining directors, approved issuance of 75,000 shares, to be sold to the corporation's president at an amount below the real value of the shares. The court stated, "the issuance by a corporation of its own shares is a 'sale' to which the anti-fraud policy expressed in the federal securities laws extends." Similarly, in *Hooper v. Mountain States Sec. Corp.*, 282 F.2d 195, 200-03 (5th Cir. 1960), cert. denied, 365 U.S. 814 (1961), a corporation was misled by fraud in the issuance of stock in return for worthless property. The court held that the issuance by a corporation of its own stock is a sale under the anti-fraud provisions of the federal securities laws.

<sup>29</sup> 241 F. Supp. 369 (D. Del. 1965).

parent owned more than ninety per cent of the subsidiary's stock. Under the terms of the merger agreement, minority shareholders of the subsidiary, including plaintiff Voege, were required to surrender their stock in the subsidiary for a price grossly below its fair market value. Alleging fraud in determining the price at which she was compelled to surrender her shares, Voege sued under rule 10b-5. The court concluded that a statutory merger involved a "sale" within the meaning of that rule.<sup>30</sup> "Any other view of the transaction," the court stated, "would defeat the purpose of Rule 10b-5."<sup>31</sup>

Most recently, the Second Circuit in *Vine v. Beneficial Finance Co.*<sup>32</sup> joined the trend of broadening the definition of "purchase or sale" by holding that a short-form merger<sup>33</sup> involved a "purchase or sale" of securities under section 10(b) and rule 10b-5.<sup>34</sup> In this case the Class A shareholders of Crown Finance Co. were defrauded of approximately \$900,000 by their officers and directors, who were in collusion with Beneficial Finance Co. The allegedly fraudulent scheme was accomplished by a short-form merger of Crown into a wholly-owned New York subsidiary of Beneficial. The merger agreement required the surrender of the Class A shares in return for cash payments. Thus, the plaintiff became a "forced" seller of securities when the merger was consummated without his consent. The court apparently construed the definition of "sale" to include this plaintiff because a sale was inevitable.

#### IV. DASHO V. SUSQUEHANNA CORP.

*Dasbo v. Susquehanna Corp.* is the first case in which an appellate court has decided whether a statutory merger involves a "purchase or sale" for purposes of rule 10b-5.<sup>35</sup> An examination of *Dasbo* is aided by a breakdown of the successive transactions as follows: first, the Lannan-Korholz sale of 435,000 shares of Susquehanna stock at a value in excess of fair market value; second, the Korholz-Gypsum sale of these shares; and third, the Susquehanna-Gypsum statutory merger. The primary controversy was whether a rule 10b-5 cause of action in favor of Susquehanna could be based upon the fraudulent scheme. The stockholders of Susquehanna were not privy to the initial Lannan-Korholz sale, nor were they privy to the Korholz-Gypsum sale. They were, however, privy to the Susquehanna-Gypsum merger. Thus, the issue narrowed to whether the statutory merger involved a "purchase or sale."

The district court had ruled that the transaction was not a "sale." That court distinguished a statutory merger from other transactions in which a corporation exchanges its stock for stock of another corporation, reasoning that in a statutory merger the exchange is "involuntary," while in a

<sup>30</sup> *Id.* at 374.

<sup>31</sup> *Id.*

<sup>32</sup> 374 F.2d 627 (2d Cir.), *cert. denied*, 389 U.S. 970 (1967).

<sup>33</sup> In a "short-form" merger approval by the shareholders of both corporations is not required as it is in a statutory "long-form" merger. The "short-form" merger is consummated by a resolution of the board of directors of a parent corporation which owns a certain percentage (set by statute) of the outstanding shares of each class of a subsidiary.

<sup>34</sup> 374 F.2d at 635.

<sup>35</sup> 380 F.2d 262 (7th Cir.), *cert. denied*, 389 U.S. 977 (1967).

sale the exchange is voluntary.<sup>36</sup> Strictly speaking, the district court was correct. Neat corporate theory would dictate that the Susquehanna shares were not "sold" for shares of Gypsum, but upon merger Susquehanna merely converted shareholders' security from one form to another.<sup>37</sup> Once the merger was approved, the exchange was automatic, and the shareholders had no control over it. The court of appeals, however, rejected this line of reasoning, concluding that "the district court was unduly impressed by the semantic and conceptual difficulties arising when the words 'purchase' and 'sale' are applied to merger."<sup>38</sup>

Apparently, the district court's error was failure to recognize that the injured parties were not the Susquehanna shareholders, who, after the merger had been approved, could only surrender their shares for shares of the surviving corporation or receive the appraised value of their shares in cash. Instead, the injured party was the surviving corporation, Susquehanna. Moreover, the injury to Susquehanna occurred under the proposed merger agreement requiring Susquehanna to issue its shares for shares of Gypsum, not in the subsequent physical exchange of the shares in consummation of the merger.

Although the court of appeals seems to have reached the correct result in *Dasbo*, the majority opinion is quite vague as to which transaction constituted the "purchase or sale." Was it the issuance by the acquiring corporation, Susquehanna? Was it the surrender of shares by the holders of the acquired corporation, Gypsum? Or was it the exchange pursuant to the statutory merger? Apparently, all of these are purchases and sales, but the court was not specific on this point.

The majority opinion also fails to deal with the alternative ground of the district court decision, namely, that this was only a case of "corporate mismanagement" and thus, according to *Birnbaum v. Newport Steel Corp.*,<sup>39</sup> not within rule 10b-5. *Birnbaum* was bad law to begin with and is being rapidly discredited, most recently by the Second Circuit, which originally decided it.<sup>40</sup> Apparently, the Seventh Circuit in *Dasbo* is rejecting *Birnbaum* too. Although the majority opinion fails to mention that case, its rejection may be inferred from the undifferentiated reversal of the district court decision and the explicit language of the concurring opinion.<sup>41</sup>

## V. CONCLUSION

The *Dasbo* holding that a statutory merger involves a "purchase or sale" for purposes of rule 10b-5 is consistent with legislative history, administrative construction, and recent judicial decisions. Moreover, the extension of the scope of rule 10b-5 provides defrauded shareholders and corporations with a uniform remedy which may be applied to challenge corporate trans-

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<sup>36</sup> *Dasbo v. Susquehanna Corp.*, 267 F. Supp. 508, 511 (N.D. Ill. 1966).

<sup>37</sup> 380 F.2d at 268.

<sup>38</sup> *Id.* at 267.

<sup>39</sup> 193 F.2d 461 (2d Cir. 1951), *cert. denied*, 343 U.S. 956 (1952).

<sup>40</sup> *A.T. Brod & Co. v. Perlow*, 375 F.2d 393 (2d Cir. 1967); *Vine v. Beneficial Fin. Co.*, 374 F.2d 627 (2d Cir.), *cert. denied*, 389 U.S. 970 (1967).

<sup>41</sup> 380 F.2d at 269.

actions. Currently, the application of this rule to corporate transactions is in a state of flux. *Dasbo* could have brought some order to this unsettled area. But unfortunately, the imprecise language and confusion of the opinion is more likely to lead to judicial battles as to what this case means.

*Robert M. Bandy*