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STANDING OF FEDERAL SECURITIES PLAINTIFFS—WHICH WAY THE TREND

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The question of who is a proper party to seek recovery under Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934 has been a topic of controversy and active debate for more than twenty years. In this Article the authors reexamine this controversy in light of several recent decisions and suggest that the courts adopt a flexible, transactional standing analysis to properly limit 10b-5 plaintiffs in a manner which is consistent with the statutory purpose and more clearly reflects changing economic conditions.

DESPITE the passing of more than twenty-five years since the landmark decision in *Kardon v. National Gypsum Co.*[1] created a private right of action to enforce Section 10(b)[2] of the Securities Exchange Act of 1934,[3] and Rule 10b-5[4] adopted thereunder,

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1. 69 F. Supp. 512 (E.D. Pa. 1946).

2. Section 10 provides in part:

> 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—
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> . . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b) (1970).

3. 15 U.S.C. § 78 (1970) [hereinafter referred to as the 1934 Act].

4. Rule 10b-5 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
>
> (a) to employ any device, scheme, or artifice to defraud,

the question of who is the proper party to seek recovery continues to be the subject of active debate among the courts[5] and in commentary.[6] At issue is the so-called *Birnbaum*[7] rule, requiring the plaintiff to be either the purchaser or seller of securities in order to maintain standing in actions brought under the general anti-fraud provisions of Section 10(b) and Rule 10b-5.

Recognizing that a strict application of the *Birnbaum* rule precludes significant numbers of investors, who are neither purchasers nor sellers, but, who incur damages as a result of fraud in connection with a purchase or sale of securities, from pursuing a federal remedy, the courts have attempted to fashion a doctrine of standing which is consistent with the broad remedial language of Rule 10b-5,[8] while ostensibly adhering to *Birnbaum* for fear that failure to do so would

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(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.

17 C.F.R. § 240-10b-5 (1974).

5. There have been at least twenty federal circuit court opinions since 1969 dealing with the issue of standing to sue. Among the more recent cases which are representative of the issue are the following: Smallwood v. Pearl Brewing Co., 489 F.2d 579 (5th Cir. 1974); Eason v. General Motors Accept. Corp., 490 F.2d 654 (7th Cir. 1973), *cert. denied*, 416 U.S. 960 (1974); Landy v. Federal Deposit Ins. Corp., 486 F.2d 139 (3rd Cir. 1973), *cert. denied*, 416 U.S. 960 (1974); Manor Drug Stores v. Blue Chip Stamps, 492 F.2d 136 (9th Cir. 1973), *cert. granted*, 43 U.S.L.W. 3279 (Nov. 12, 1974); Mount Clements Indus., Inc. v. Bell, 464 F.2d 339 (9th Cir. 1972).

6. Commentary on the issue of standing has been extensive. *See, e.g.*, Boone & McGowan, *Standing to Sue Under SEC Rule 10b-5*, 49 TEXAS L. REV. 617 (1971); Kellogg, *The Inability to Obtain Analytical Precision Where Standing to Sue Under Rule 10b-5 Is Involved*, 20 BUFF. L. REV. 93 (1970); Lowenfels, *The Demise of the Birnbaum Doctrine: A New Era for 10b-5*, 54 VA. L. REV. 268 (1968); Ruder, *Current Developments in the Federal Law of Corporate Fiduciary Relations—Standing to Sue Under Rule 10b-5*, 26 BUS. LAW. 1289 (1971); Sommer, *Rule 10b-5: Notes for Legislation*, 17 WEST. RES. L. REV. 1029 (1966); Comment, *Securities-Rule 10b-5—Purchaser-Seller and Deception Elements Held not Strict Prerequisites to Liability in Civil Action under SEC Rule 10b-5*, 42 N.Y.U. L. REV. 978 (1967); Note, *Securities-Rule 10b-5—Non-Purchaser-Seller with a Vital Stake in the Outcome of a Dispute Involving Fraud in Connection with the Purchase or Sale of Securities Has Standing to Sue*, 42 FORDHAM L. REV. 688 (1974); Note, *10b-5 Standing Under Birnbaum: The Case of the Missing Remedy*, 24 HASTINGS L. J. 1007 (1973).

7. Birnbaum v. Newport Steel Corp., 193 F. 2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952).

8. SEC v. Joiner Leasing Corp., 320 U.S. 344 (1943).

subject potential defendants to unlimited liability.[9] The reluctance to overrule *Birnbaum* has unfortunately resulted in several major exceptions to the purchaser-seller requirement, as well as the development of a rule of standing which is neither correct as a matter of law nor capable of consistent application.

It is the purpose of this Article to suggest that recent decisions interpreting *Birnbaum* clearly demonstrate that its rationale no longer exists. Rather, the courts should follow the lead of the Seventh Circuit in *Eason v. General Motors Acceptance Corp.*,[10] and adopt a flexible standing test based upon an analysis of the entire transaction or series of transactions involved, which reflects the statutory purpose and reasonably limits the scope of Rule 10b-5.

On the assumption that a liberal interpretation of the "in connection with" clause, in the context of the expansive statutory language, would result in 10b-5 actions being brought for fraud only remotely connected with securities transactions, the courts, using the doctrine of common law fraud as a guide, have at various times required plaintiffs to prove privity,[11] reliance,[12] and causation.[13] Recent decisions, however, indicate that the primary limitation on private actions brought under Rule 10b-5 is the purchaser-seller requirement first set forth in *Birnbaum v. Newport Steel Corp.*[14]

In *Birnbaum* the plaintiffs were minority shareholders of the Newport Steel Corporation who, in a representative and derivative action, alleged that the directors and the controlling stockholder of Newport had rejected a favorable merger offer from another corporation in order to permit the controlling stockholder to sell his stock to a third corporation at a substantial premium. The complaint alleged specific acts of fraud including misrepresentations in letters to the Newport stockholders at the time of the merger negotiations and again after the sale. It was contended that the sale constituted fraud in

9. Rekant v. Desser, 425 F.2d 872, 877 (5th Cir. 1970).

10. 490 F.2d 654 (7th Cir. 1973), *cert. denied*, 416 U.S. 960 (1974).

11. *See* Joseph v. Farnsworth Radio & Telev. Corp., 99 F. Supp. 701 (S.D.N.Y. 1951), *aff'd per curiam*, 198 F.2d 883 (2d Cir. 1952).

12. *See* List v. Fashion Park, Inc., 340 F.2d 457, 462-63 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965).

13. *See* Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972).

14. 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952).

violation of Section 10(b) and Rule 10b-5, even though neither the plaintiffs nor the company had purchased or sold any securities in reliance upon the misrepresentations.[15]

Affirming a dismissal of the complaint, the Second Circuit relied heavily upon its own interpretation of the legislative and administrative intent behind Rule 10b-5. Of particular significance was the SEC's public release announcing the adoption of Rule 10b-5:

> 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.[16]

Thus, the court reasoned that:

> While the Rule may have been somewhat loosely drawn its meaning and scope are not difficult to ascertain when reference is had to the scheme of SEC Regulation and the purpose underlying the adoption of X—10B—5. Prior to its adoption the only prohibitions against fraud in the sale or purchase of securities were contained in Section 17(a)[17] of the 1933 Act, . . . and Section 15(c)[18] of the 1934 Act. . . . Section 17(a) of the 1933 Act only made it unlawful to defraud or deceive purchasers of securities, and, Section 15(c) of the 1934 Act dealt only with fraudulent practices by security brokers to dealers in the over-the-counter markets. No prohibition existed against fraud on a seller of securities by the purchaser if the latter was not a broker or a dealer. . . . The SEC's press release . . . shows that the Commission was attempting only to make the same prohibitions contained in Section 17(a) of the 1933 Act applicable to purchasers as well as to sellers. That such was the only purpose of Rule X—10B—5 is made abundantly clear when the language of the Rule is compared with the language of Section 17(a); the Commission simply copied Section 17(a), adding the words "any person" in place of "the purchaser" and a final clause "in connection with the purchase or sale of any security."[19]

The opinion emphasized that the absence of a provision in Section 10(b) expressly intended to protect stockholders against a breach

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15. The plaintiffs argued that the applicability of Rule 10b-5 was not limited to actual purchasers or sellers of securities, but that the general proscription of fraud "upon any person" includes and supplements the common law liability of those who violate their corporate fiduciary obligations. 193 F.2d at 463.

16. SECURITIES ACT RELEASE No. 3230 (May 21, 1942).

17. SECURITIES ACT OF 1933, 15 U.S.C. § 77q(a) (1970).

18. SECURITIES ACT OF 1934, 15 U.S.C. § 78o(c) (1970).

19. Birnbaum v. Newport Steel Corp., 193 F.2d 461, 463 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952).

of fiduciary duty by corporate insiders, similar to the one contained in Section 16(b)[20] of the 1934 Act

> strengthens the conclusion that that section was directed solely at that type of misrepresentation or fraudulent practice usually associated with the sale or purchase of securities rather than at fraudulent mismanagement of corporate affairs, and that Rule X—10B—5 extended protection only to the defrauded purchaser or seller.[21]

While the *Birnbaum* rule may have been a reasonable description of the court's understanding of the class of persons protected by Rule 10b-5 in 1952, the subsequent decline in "face-to-face" dealings between purchasers and sellers, the complexity of securities transactions,[22] and the increasing sophistication of fraudulent schemes[23] have required courts in recent years to expand the definitions of purchase and sale,[24] as well as the class of persons falling into the category of purchasers and sellers.[25] Thus confusion among the various circuits arises from juxtaposing the mechanical application of *Birnbaum's* Rule with attempts to protect investors in a manner consistent with the Supreme Court's admonition that "[S]ection 10(b) must be read flexibly, not technically and restrictively."[26]

Notwithstanding the erosion of the *Birnbaum* rule, many courts still support retention of at least an attenuated purchaser-seller requirement on the incorrect ground that such a prerequisite is constitutionally compelled[27] in order to comply with the "standing" requirements governed by Article III of the United States Constitution. To the contrary, under the correct application of this standing approach, the plaintiff must have a sufficient interest in a real contro-

20. SECURITIES EXCHANGE ACT OF 1934, 15 U.S.C. § 78p(b) (1970).

21. Birnbaum v. Newport Steel Corp., 193 F.2d 461, 464 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952).

22. *See* Herpich v. Wallace, 430 F.2d 792 (5th Cir. 1970).

23. *See* A.T. Brod & Co. v. Perlow, 375 F.2d 393 (2d Cir. 1967).

24. This expansion has been consistent with the definitions used in the 1934 Act. For example § 3(a)(13) provides: [t]he terms "buy" and "purchase" each include any contract to buy, purchase, or otherwise acquire. 15 U.S.C. § 78c(a)(13) (1970). Likewise, § 3(a)(14) provides: [t]he terms "sale" and "sell" each include any contract to sell or otherwise dispose of. 15 U.S.C. § 78c(a)(14) (1970). *See* Tcherepnin v. Knight, 389 U.S. 332, 336 (1967); SEC v. Capital Gains Research Bur., 375 U.S. 180, 186 (1963); Herpich v. Wallace, 430 F.2d 792, 801 (5th Cir. 1970).

25. *See* Herpich v. Wallace, 430 F.2d 792, 806 (5th Cir. 1970).

26. Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 12 (1971).

27. *See* Mount Clements Indus., Inc., v. Bell, 464 F.2d 339, 343 (9th Cir. 1972).

versy with the defendant in order to satisfy the constitutionally mandated jurisdictional requirements of Article III of the United States Constitution, in addition to meeting the non-constitutional requirement that "the interests sought to be protected by the complaint [are] arguably within the zone of interests to be protected or regulated by the statute."[28]

In applying these tests, however, the courts, in addition to often becoming confused as to whether the *Birnbaum* rule was merely a definition of the "zone of protection" aspect of the standing test (which the authors believe it was) or whether it represented an additional limitation on Section 10(b) and Rule 10b-5, have also generally interpreted the legislative and administrative intent behind Section 10(b) and Rule 10b-5 as requiring that sellers of securities be afforded the same protection previously limited to purchasers of securities under Section 17(a) of the 1933 Act.[29] Thus, decisions favoring a strict application of the *Birnbaum* rule have narrowly defined the class of persons protected by Rule 10b-5, thereby denying standing to plaintiffs who were neither purchasers nor sellers.[30]

Although the *Birnbaum* rule has repeatedly been set forth as the sole standing requirement in 10b-5 actions, recent decisions demonstrate that such an application is inconsistent with the traditional constitutional standing rules applied to cases brought in federal courts, and effectively precludes a substantial number of potential plaintiffs from pursuing a remedy to which they otherwise would be entitled. An example of this improper use of the *Birnbaum* rule as the sole standing test is the Third Circuit's decision in *Landy v. Federal Deposit Insurance Corp.*[31]

In *Landy*, the president of the Eatontown National Bank, Schotte, engaged in a scheme involving the misuse of bank funds for the purpose of trading in speculative securities. This scheme, in turn, resulted in the financial collapse of the bank, and left the shareholders with worthless stock.[32]

28. Association of Data Proc. Serv. Org., Inc. v. Camp, 397 U.S. 150, 153 (1970).

29. *See* notes 17-22 and accompanying text *supra*.

30. *See, e.g.*, Landy v. Federal Deposit Ins. Corp., 486 F.2d 139 (3rd Cir. 1973), *cert. denied*, 416 U.S. 960 (1974); Smallwood v. Pearl Brewing Co., 469 F.2d 579 (5th Cir. 1974); Rekant v. Desser, 425 F.2d 872 (5th Cir. 1970).

31. 486 F.2d 139 (3rd Cir. 1973), *cert. denied*, 416 U.S. 960 (1974).

32. *Id.* at 143-44.

Plaintiffs, minority shareholders and purchasers of the bank stock during the period the fraudulent activities of the president took place, brought suit on behalf of themselves as individuals, derivatively on behalf of the defendant bank, and as representatives of all the shareholders in the bank. They claimed that violations of Section 10(b) and Rule 10b-5 occurred when the president concealed the scheme through false statements to the shareholders upon which they relied in making their purchases.[33]

With the *Banker's Life*[34] decision before it, the *Landy* court appeared to recognize that although there was

> some question whether the fraudulent scheme of Schotte . . . was the type "usually associated with the sale or purchase of securities" rather than fraudulent mismanagement of corporate affairs. . . .
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> . . . .
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> [A]ll that is now required is an injury to an investor caused by deceptive practices "touching" on the purchase or the sale of securities by that investor.[35]

Judge Rosenn conceded that this requirement may have been met on the facts of *Landy*, but nevertheless dismissed the action on the ground that since the plaintiffs were neither purchasers nor sellers of the two hundred million dollars in stock traded by Schotte through the bank, the *Birnbaum* purchaser-seller requirement had not been satisfied.[36]

Viewed in the context of traditional standing rules, this continued adherence to *Birnbaum* becomes increasingly difficult to justify. Clearly, the plaintiffs in *Landy* suffered injury in fact "in connection with" a purchase or sale of securities which, under the *Banker's Life* criteria, was sufficient to satisfy the jurisdictional requirements of Article III. Regardless of the fact that plaintiffs never bought or sold the stock subject to the fraud, there was causation of loss arising out of the purchase of the bank's shares which should have been sufficient to sustain an action under Rule 10b-5. In other words, it is at least arguable that plaintiffs were also among the class of persons the statute was intended to protect.[37] Consequently, as a result of

33. *Id.*

34. 404 U.S. 6 (1971).

35. 486 F.2d at 153-55.

36. *Id.* at 155.

37. *See* Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 12-13 (1971).

the court's application of *Birnbaum* as the sole standing test, plaintiffs were foreclosed from pursuing a remedy which should have been available.

The most significant case to date deciding the issue of 10b-5 standing under *Birnbaum*, in terms of its impact on the continued viability of the purchaser-seller requirement, is *Eason v. General Motors Acceptance Corp.* (GMAC).[38] The plaintiffs in *Eason* were shareholders of a corporation which purchased an automobile leasing business from one of the defendants. GMAC, one of the other defendants, financed purchases of automobiles for the leasing business. In connection with the transaction, the corporate purchaser issued 7,000 shares of its stock to the seller, while the plaintiffs individually guaranteed the liabilities assumed by the purchaser—including notes payable to GMAC.

When the leasing business subsequently failed, the corporation became insolvent and defaulted on the notes. GMAC brought suit in state court to recover on the guarantees, and the plaintiffs countered with a federal action seeking rescission of the guarantees, accusing the defendants of fraud in connection with the sale of securities. The district court denied the plaintiffs standing, finding that under *Birnbaum*, guarantors of a corporation's indebtedness were neither purchasers nor sellers.

On appeal, the Seventh Circuit reversed the district court, and in so doing expressly overruled the *Birnbaum* purchaser-seller requirement. Arguably, the same result could have been reached under the "forced seller"[39] exception to the *Birnbaum* rule, but the court reasoned that the continuing expansion of the class of purchasers and sellers had diminished the effectiveness of the rule to the extent that its retention was no longer warranted. Specifically rejected were the arguments that: (1) the purchaser-seller requirement is constitutionally compelled; (2) abandonment of the rule would prompt an unmanageable flood of federal litigation; and, (3) retention of the rule is necessary to preserve consistency in the interpretation of federal securities legislation.

38. 490 F.2d 654 (7th Cir. 1973), *cert. denied*, 416 U.S. 960 (1974).

39. *See* Vine v. Beneficial Fin. Co., Inc., 374 F.2d 627 (2d Cir.), *cert. denied*, 389 U.S. 970 (1967). Under the "forced seller" approach, the involuntary conversion of the plaintiff's stock into a claim for cash will be deemed to be a sale for 10b-5 purposes.

Viewing the decisive issue to be "whether, notwithstanding the fact that they were neither purchasers nor sellers of a security, plaintiffs may obtain relief under Rule 10b-5,"[40] the court examined the cases which have interpreted the *Birnbaum* rule as the sole standing requirement in the constitutional and jurisdictional sense, and held: "We are satisfied that such an interpretation of *Birnbaum* is unwarranted and we have no doubt that the plaintiff's interest in the controversy before us is sufficient to satisfy the requirements of Article III."[41]

In addition to overruling *Birnbaum* as the sole "standing" requirement, the court also rejected the contention that the absence of such a limitation would create unlimited access to the federal courts. Noting that the availability of private relief required the plaintiff to demonstrate membership in the class of investors protected by Rule 10b-5 and injury as a direct consequence of the alleged violation, Judge Stevens drew an analogy to Section 4 of the Clayton Act[42] which expressly authorizes "any person injured in his business or property by reason of an antitrust violation" to sue for damages. "Although that broad language opened 'nearly limitless possibilities' for damage recovery, a case by case evaluation of what may be described either as the 'standing' issue or the concept of injury has resulted in a significant limitation on the potential scope of recovery."[43]

Despite the court's reluctance to define the scope of 10b-5 actions other than on an ad hoc basis, Judge Stevens, nevertheless suggested that "[I]nstead of stating the issue in terms of standing, we think it is more useful to ask whether the plaintiffs were members of the class for whose special benefit Rule 10b-5 was adopted."[44]

Unfortunately, the "special class" limitation suggested by the court, as a practical matter, differs little from the "zone of protection" test which has been criticized as being of questionable value

40. 490 F.2d 654, 656 (1973).
41. *Id.* at 657.
42. 15 U.S.C. §§ 12-27 (1970).
43. 490 F.2d 654, 661 n.29.
44. *Id.* at 658.

in screening out frivolous securities fraud allegations.[45] Those tests become ambiguous when used in connection with the expansive language of Rule 10b-5, even though those limitations are fundamentally sound when applied to other statutes.

Rather than suggesting another inflexible rule as an alternative to *Birnbaum*, the authors propose a method of transactional analysis in order to achieve uniform results in complex 10b-5 cases, without arbitrarily limiting the class of potential plaintiffs. Inherent in such a method of analysis is the concept that "form should be disregarded for substance and the emphasis should be on economic reality."[46] A court should be free to extend the Rule's protection to those persons who,

> suffer significant injury as a direct consequence of fraud in connection with a securities transaction, even though their participation in the transaction did not involve either the purchase or sale of a security.[47]

In another 10b-5 action, *Karvelas v. Sellas*,[48] the court acknowledged the repudiation of *Birnbaum* in the *Eason* decision, and found the crux of the issue to be whether the fraudulent conduct occurred in connection with the purchase or sale of a security. In spite of the absence of a purchase or sale by the plaintiff of the securities subject to the fraudulent transaction, the facts did allege a transaction which was a part of a larger scheme to defraud. Thus, the court held that "the degree of 'touching' which is required before the 'in connection with' clause is satisfied . . . is sufficient if a corporate mismanagement scheme includes within it as an essential act a securities transaction, the motive of which is to further the purposes of the scheme."[49]

There can be little doubt that the search for a limiting doctrine in Rule 10b-5 actions has been marked by an increasing reluctance to adhere to inflexible rules which do not reflect changing economic conditions. The vast number of small stockholders, the variety of financial transactions, and the increased potential for fraud have em-

45. *See* Albert, *Standing to Challenge Administrative Action: An Inadequate Surrogate for Claim for Relief*, 83 YALE L. J. 425; Davis, *The Liberalized Law of Standing*, 37 U. CHI. L. REV. 450 (1970).

46. Tcherepnin v. Knight, 389 U.S. 332, 336 (1967).

47. Eason v. General Motors Accept. Corp., 490 F.2d 654, 659 (1973).

48. 376 F. Supp. 1010 (N.D. Ill. 1974).

49. *Id.* at 1014.

phasized the need for effective enforcement of the securities laws. Unfortunately, the absence of legislative or administrative guidance has left the courts to develop a standing doctrine on a case-by-case basis, the result of which has brought about arbitrary limits on the access to federal courts, with little regard for the validity of the plaintiff's claim.

Although both Section 10(b) and Rule 10b-5 are silent with respect to the class of persons protected by the statute, there presently appears to be little correlation between a rule requiring plaintiffs to be purchasers or sellers, and the damages suffered as a result of the prohibited conduct. When viewed in the light of economic reality, the argument that *Birnbaum* is constitutionally compelled becomes difficult to support. For instance, recent decisions have demonstrated that persons incurring damages in connection with prohibited conduct may be denied a federal remedy under *Birnbaum*, while, on the other hand, there is nothing to suggest that plaintiffs who otherwise meet the standing requirements will be able to present an actionable 10b-5 claim. Thus, to the extent that the *Eason* decision minimizes such arbitrary distinctions by shifting the emphasis in 10b-5 actions to the substantive elements, without abandoning the correctly applied standing requirement, it is a correct decision which should be followed by the United States Supreme Court which has recently agreed to review, on *certiorari*, *Manor Drug Stores v. Blue Chip Stamps*.[50]

50. 492 F.2d 136 (9th Cir. 1973), *cert. granted*, 43 U.S.L.W. 3279 (Nov. 12, 1974).