

# Washington Law Review

---

Volume 51 | Number 4

---

10-1-1976

## Federal Securities Law—Fraud—Supreme Court Affirmation of the Birnbaum Rule—Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975)

Douglass A. North

Follow this and additional works at: <https://digitalcommons.law.uw.edu/wlr>



Part of the [Securities Law Commons](#)

---

### Recommended Citation

Douglass A. North, Recent Developments, *Federal Securities Law—Fraud—Supreme Court Affirmation of the Birnbaum Rule—Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), 51 Wash. L. Rev. 1025 (1976).

Available at: <https://digitalcommons.law.uw.edu/wlr/vol51/iss4/8>

This Recent Developments is brought to you for free and open access by the Law Reviews and Journals at UW Law Digital Commons. It has been accepted for inclusion in Washington Law Review by an authorized editor of UW Law Digital Commons. For more information, please contact [cnyberg@uw.edu](mailto:cnyberg@uw.edu).

FEDERAL SECURITIES LAW—FRAUD—SUPREME COURT AFFIRMATION OF THE *BIRNBAUM* RULE—*Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975).

Pursuant to an antitrust consent decree,<sup>1</sup> control of defendant Blue Chip Stamp Company was to be distributed more equitably among companies that used its stamps through a special securities offering whereby retail users could purchase the company's stock on a pro rata basis. Many of the retailers, however, declined to purchase such shares. Two years later, plaintiff retailer, which had been an offeree in the special sale but had not purchased, filed a class action under Section 10(b)<sup>2</sup> of the Securities Exchange Act of 1934<sup>3</sup> and Securities and Exchange Commission rule 10b-5.<sup>4</sup> Plaintiff claimed that defendant, through use of a misleading prospectus,<sup>5</sup> had fraudulently dissuaded it from purchasing its entitlement of the stock in what was to have been a bargain offering. Defendant had subsequently changed the prospectus and sold the stock to the public at a price greatly in excess of the price under the special offering. The federal district court dismissed the claim, finding under the rule of *Birnbaum v. Newport Steel Corp.*<sup>6</sup> that plaintiff was neither a purchaser nor a seller of securities and thus did not have standing to bring the action.<sup>7</sup> The Court of Appeals for the Ninth Circuit reversed, concluding that an exception

---

1. *United States v. Blue Chip Stamp Co.*, 272 F. Supp. 432 (C.D. Cal. 1967), *aff'd sub nom. Thrifty Shoppers Scrip Co. v. United States*, 389 U.S. 580 (1968) (mem.) Defendant Blue Chip Stamps had a virtual monopoly in the distribution of "bonus" stamps incidental to retail purchases in California. The United States Government sued to diversify control of the company. Neither plaintiff nor any other member of its class was a party to the antitrust consent decree.

2. 15 U.S.C. § 78j(b) (1970).

3. Ch. 404, tit. I, 48 Stat. 881 (codified in scattered sections of 15 U.S.C.).

4. 17 C.F.R. § 240.10b-5 (1974). *See* note 12 and accompanying text *infra*.

5. The prospectus included under the heading "Items of Special Interest" the statements that (1) suits claiming a total of \$29 million were presently pending against the company; (2) the company expected an unprecedented 97.5% of all stamps issued to be ultimately redeemed; and (3) the company expected net earnings to be considerably down due to the sale of a third of the company's business in southern California. The outstanding claims were later settled for less than \$1 million, and only 90% of the stamps were redeemed (approximately the percentage of stamps which had usually been redeemed in previous years). One year later, when the defendants sold stock in a public offering, these new facts were noted, and no mention was made of other adverse considerations which had been listed in the prospectus issued to plaintiff. Brief for Petitioner at 56, *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975).

6. 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952).

7. *Manor Drug Stores v. Blue Chip Stamps*, 339 F. Supp. 35 (C.D. Cal. 1971).

to that rule should be made in this case since the offer of stock had been mandated by an antitrust consent decree.<sup>8</sup> On writ of certiorari to the United States Supreme Court, the judgment of the court of appeals was reversed. *Held*: The purchaser-seller requirement of rule 10b-5 announced in *Birnbaum* is justified both on grounds of statutory interpretation and policy; since plaintiff did not come within the ambit of the rule, it had no standing to maintain the action. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975).

This note will examine the historical background and development of the *Birnbaum* rule and will consider the Supreme Court's reasoning in its first examination of that rule. Taking the position that the *Birnbaum* rule is generally a useful one, this note nevertheless suggests that the rule should be applied more flexibly in the future in order to achieve its twin objectives of admitting valid claims and excluding nuisance suits. Particularly questioned will be the Court's failure to delineate and consider separately the validity of the substantive portion of the *Birnbaum* rule; the Court's wholehearted acceptance of the rule, which casts doubt upon most of its exceptions; and the fact that many deserving plaintiffs will be foreclosed from maintaining 10b-5 actions by the Court's position in *Blue Chip*.

## I. THE DEVELOPMENT OF *BIRNBAUM*

### A. *The Rule 10b-5 Action*

Following the 1929 stock market crash, the New Deal Congress passed the Securities Act of 1933<sup>9</sup> and the Securities Exchange Act of 1934<sup>10</sup> in an attempt to curb some of the fraudulent and misleading practices that had ruined many investors. Section 10(b) of the Act of 1934 makes it unlawful to use, in connection with the purchase or sale of any security, a manipulative or deceptive device, in contravention of such rules and regulations as the Securities and Exchange Commission (SEC) may prescribe.<sup>11</sup> In 1942, acting under the au-

8. *Manor Drug Stores v. Blue Chip Stamps*, 492 F.2d 136 (9th Cir. 1973).

9. Ch. 38, tit. I, 48 Stat. 74 (codified in scattered sections of 15 U.S.C.).

10. Ch. 404, tit. I, 48 Stat. 881 (codified in scattered sections of 15 U.S.C.).

11. Section 10(b) of the Act of 1934 states:

It shall be unlawful for any person . . . .

. . . .

[t]o use or employ, in connection with the purchase or sale of any security

## Affirmation of the *Birnbaum* Rule

thority of Section 10(b) of the 1934 Act, the SEC promulgated rule 10b-5. The rule makes it unlawful for any person (a) to employ any device to defraud, (b) to make any untrue statement of material fact or omit any material fact, or (c) to engage in any act which operates as a fraud or deceit in connection with the purchase or sale of any security.<sup>12</sup>

There is no indication that Congress had any intention of creating a private civil remedy by the passage of Section 10(b) of the Act of 1934.<sup>13</sup> Nor is there any indication that the SEC intended to create a

---

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).

12. 17 C.F.R. § 240.10b-5 (1974) provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate [*sic*] 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.

13. Virtually the only comment on enforcement of the 1934 Act by the reporting committee was: "The committee considers that the act could be administered effectively by a Commission of five, to be appointed by the President with the advice and consent of the Senate, specifically for that purpose." S. REP. No. 792, 73d Cong., 2d Sess. 5 (1934). The commentators have been unable to find any explicit authorization of such action by Congress and have only been able to argue the implications which can be drawn from other parts of the Act. *See, e.g.*, 1 A. BROMBERG, SECURITIES LAW: FRAUD §§ 2.2(330)-(340) (1975); Note, 61 HARV. L. REV. 858, 860 (1948).

Since *Blue Chip*, the Court has held that the private cause of action is well-established. *Ernst & Ernst v. Hochfelder*, 96 S. Ct. 1375, 1382 (1976). *Ernst & Ernst* was an accounting firm which had audited the records of a Chicago brokerage firm and prepared the annual reports of the brokerage for the Securities Exchange Commission (SEC) as required by 15 U.S.C. § 78q(a) (1970). The president of the firm defrauded plaintiffs by inducing them to invest in some "escrow accounts," the funds of which he appropriated for his own use. The scheme was made possible, at least in part, by the president's mail rule which forbade any employee of the brokerage from opening the president's mail (plaintiffs invested directly with the president and addressed their mail to him). The president committed suicide and the brokerage was bankrupt, so plaintiffs sued *Ernst & Ernst* under rule 10b-5 for negligently aiding and abetting the fraudulent scheme by failing to question the president's mail rule in the course of its audits. The Court of Appeals for the Seventh Circuit reversed the trial court's grant of summary judgment to defendants, holding that plaintiffs stated a cause of action under rule 10b-5. The Supreme Court, in a 6-2 opinion by Justice Powell, reversed, holding that plaintiffs must plead and prove scienter on the part of defendants to prevail under rule 10b-5. Justices Blackmun and Brennan dissented, finding negligence to be a sufficient basis for a claim under 10b-5.

The Court's holding in *Ernst* was much broader than was necessary to decide the

right of private action under its rule.<sup>14</sup> Nevertheless, four years after the promulgation of the rule, in *Kardon v. National Gypsum Co.*,<sup>15</sup> a district court held that there was an implied private right of action under the rule. The Supreme Court finally confirmed the existence of such an action in 1971, when it adopted the view expressed by the overwhelming number of federal courts in *Superintendent of Insurance v. Bankers Life & Casualty Co.*<sup>16</sup>

### B. *The Purchaser-Seller Limitation*

Since both Section 10(b) and rule 10b-5 proscribe fraudulent practices only "in connection with the purchase or sale of any security," the Court of Appeals for the Second Circuit in *Birnbaum v. Newport Steel Corp.*<sup>17</sup> concluded that procedurally a plaintiff has standing to sue only if he has actually purchased or sold securities; and that substantively the essence of the claim must be securities fraud and not internal corporate mismanagement.<sup>18</sup> In *Birnbaum* plaintiff was a

---

case. The Court was presented only with the issue of whether negligence is a sufficient basis for liability for *aiding and abetting* 10b-5 fraud. The majority, however, held that scienter was a requirement for *all* 10b-5 actions for damages. The Court did, however, reserve the questions of whether recklessness is sufficient to constitute scienter and whether scienter is a requirement for injunctive relief. 96 S. Ct. at 1381 n.12.

14. The news release distributed by the SEC at the time of the promulgation of rule 10b-5 merely indicates that the rule was designed to plug a loophole in the SEC's enforcement powers. See SEC Securities Exchange Act of 1934 Release No. 3230 (May 21, 1942), in 3 A. BROMBERG, *SECURITIES LAW: FRAUD* app. B (1975). Some of the SEC participants in the promulgation of the rule later described the almost haphazard way in which it came about. Comments by Milton Freeman to Conference on Codification of the Federal Securities Laws, Nov. 18-19, 1966, in 22 *BUS. LAW.* 793, 922 (1967). Courts and commentators have been unable to find any explicit indication that the SEC contemplated the creation of a private remedy. See, e.g., *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461, 463 (2d Cir. 1952); 3 L. LOSS, *SECURITIES REGULATION* 1469 n.87 (1961).

15. 69 F. Supp. 512 (E.D. Pa. 1946).

16. 404 U.S. 6, 13 n.9 (1971).

17. 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952).

18. The basis of the substantive rule in *Birnbaum* was the court's belief that Congress' only intent in passing the securities acts was to provide relief from fraud growing out of misrepresentation in the issuance and exchange of securities. The *Birnbaum* court did not believe that Congress meant to reach breach of fiduciary duties by directors and officers of the corporation. Adequate relief for breach of fiduciary duty was considered available to shareholders under state law. Breach of fiduciary duty and misrepresentation in a securities transaction are not mutually exclusive categories. The *Birnbaum* court, however, understood § 10(b) to require that the essence of plaintiff's claim be misrepresentation in a securities transaction.

A recent case demonstrating such a concern with the nature of the fraud alleged in *Popkin v. Bishop*, 464 F.2d 714 (2d Cir. 1972), where the Court of Appeals for the Second Circuit upheld the dismissal of plaintiff's 10b-5 claim because plaintiff admit-

## Affirmation of the *Birnbaum* Rule

minority stockholder in the Newport Steel Corporation. The president of Newport had rejected an attractive merger plan with another steel company in order to sell his controlling shares of Newport stock at double their market value to a group of manufacturers who wanted Newport as a captive source of steel during a temporary steel shortage. Plaintiff's shares declined sharply in value as the result of the president's questionable action, and he brought suit to recover his losses. The court concluded 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 fraudulent mismanagement of corporate affairs, and that Rule X-10B-5 [rule 10b-5] extended protection only to the defrauded purchaser or seller."<sup>19</sup>

The procedural requirements of the *Birnbaum* rule have subsequently been adopted by most of the circuit courts;<sup>20</sup> it has only recently been rejected by a court of appeals.<sup>21</sup> The substantive requirement of the rule has rarely been specifically addressed,<sup>22</sup> but where it

---

ted that defendants had made a full and fair disclosure of the facts. The court found that the remedy for plaintiff's claim that the directors had breached their fiduciary duty to the minority shareholders in arranging a merger lay in state court. The court did note that relief would not be denied under 10b-5 where plaintiff merely alleges that the misconduct complained of "really amounts to just corporate mismanagement," 464 F.2d at 718, but it found that rule 10b-5 was designed to impose a duty to disclose and inform and that no action would lie under the rule absent a violation of that duty. *But see* *Marshel v. AFW Fabric Corp.*, 533 F.2d 1277 (2d Cir. 1976) (Section 10(b) and rule 10b-5 held to prevent merger where all facts were disclosed to minority shareholders). *Marshel* was distinguished from *Popkin* in that corporate funds were used to finance the merger in *Marshel*. This distinction, however, fails to explain plaintiffs' failure to allege the nondisclosure needed to state a 10b-5 claim.

19. 193 F.2d at 464.

20. The Court of Appeals for the Second Circuit has been joined by the courts for the Third, Fifth, Sixth, Eighth, Ninth, and Tenth Circuits. *See, e.g.*, *Landy v. Federal Deposit Ins. Corp.*, 486 F.2d 139, 156-57 (3d Cir. 1973), *cert. denied*, 416 U.S. 960 (1974); *Rekant v. Desser*, 425 F.2d 872, 879 (5th Cir. 1970); *Simmons v. Wolfson*, 428 F.2d 455, 456 (6th Cir. 1970), *cert. denied*, 400 U.S. 999 (1971); *City Nat'l Bank v. Vanderboom*, 422 F.2d 221, 227-28 (8th Cir.), *cert. denied*, 399 U.S. 905 (1970); *Mount Clemens Indus., Inc. v. Bell*, 464 F.2d 339 (9th Cir. 1972); *Jensen v. Voyles*, 393 F.2d 131, 133 (10th Cir. 1967). The First, Fourth, and District of Columbia circuit courts have not been presented with the issue.

21. *Eason v. General Motors Acceptance Corp.*, 490 F.2d 654 (7th Cir. 1973), *cert. denied*, 416 U.S. 960 (1974). The court accepted the substantive aspect of the rule but rejected the procedural standing requirement. Plaintiffs guaranteed notes assumed by corporation when it bought a business by issuing 7,000 shares of its stock to the previous owners. Although such a transfer of stock amounted to a sale under the Act, plaintiffs were neither purchasers nor sellers; but Judge (now Justice) Stevens found that the claim was for securities fraud covered by the Act and remanded for trial.

22. *See* text accompanying notes 70-77 *infra*.

has, it has been greatly liberalized.<sup>23</sup> Such liberalization seems to have been the intent of the New Deal Congress, which desired that the broadest possible scope be given the law in order to make the stock exchanges calm, serious, and honest marketplaces for securities. This intention is manifest in the records of the hearings and debates on the acts.<sup>24</sup>

Similarly, many exceptions to the standing rule have been fashioned by the courts over the past 23 years.<sup>25</sup> For example, where plaintiff has been injured by a fraudulent practice connected with use of the securities market, and he is at least arguably a purchaser or seller, the courts have often been willing to find that he is within the *Birnbaum rule*.<sup>26</sup> Thus, in some cases plaintiffs have been deemed

23. See Whitaker, *The Birnbaum Doctrine: An Assessment*, 23 ALA. L. REV. 543 (1971); Note, *Standing To Sue in 10b-5 Actions: Eason v. GMAC and Its Impact on the Birnbaum Doctrine*, 49 NOTRE DAME LAW. 1131 (1974). Several writers have taken the view that the substantive holding has been liberalized out of existence. In their view, the courts will require only the most tenuous showing of the use of securities in the fraud, in order to bring a 10b-5 action, regardless of whether the essence of the scheme amounts to breach of a corporate fiduciary duty or misrepresentation in a securities transaction. See note 18 *supra*. Thus, they reject the idea that misrepresentation in a securities transaction is still a significant requirement of such an action. I A. BROMBERG, *SECURITIES LAW: FRAUD* § 4.7 (1975); Comment, *Dumping Birnbaum To Force Analysis Of The Standing Requirement Under Rule 10b-5*, 6 LOYOLA U. CHI. L.J. 230 (1975).

Contrary to this view is *Popkin v. Bishop*, 464 F.2d 714 (2d Cir. 1972), in which the court held that rule 10b-5 still requires an allegation of misrepresentation. For fuller discussion, see note 18 *supra*.

24. As noted in H.R. REP. NO. 85, 73d Cong., 1st Sess. 8 (1933):

Any objection that the compulsory incorporation in selling literature and sales argument of substantially all information concerning the issue, will frighten the buyer with the intricacy of the transaction, states one of the best arguments for the provision.

Senator Fletcher, Chairman of the Senate Committee on Banking and Currency, described the function of the section which became § 10(b) of the Act: "The Commission is also given power to forbid any other devices in connection with security transactions which it finds detrimental to the public interest or to the proper protection of investors." 78 CONG. REC. 2271 (1934).

Such a wide role for 10b-5 was not found by the Court, however, in *Ernst & Ernst v. Hochfelder*, 96 S. Ct. 1375 (1976). See note 13 *supra*. Justice Powell refuted the argument of the SEC in its amicus brief that the securities laws were remedial legislation and therefore should be broadly and liberally interpreted, by reading each section of the acts as carefully drafted by Congress to remedy specific injuries. He found that each section also included specific procedural and substantive limitations upon the actions which should be closely observed as part of the overall congressional scheme. 96 S. Ct. at 1384, 1388-89.

25. See I A. BROMBERG, *SECURITIES LAW: FRAUD* § 4.7 (1975); Boone & McGowan, *Standing To Sue Under SEC Rule 10b-5*, 49 TEX. L. REV. 617 (1971); Whitaker, *The Birnbaum Doctrine: An Assessment*, 23 ALA. L. REV. 543 (1971).

26. The courts have never declared that any of their holdings constitute exceptions to the *Birnbaum* rule. Nevertheless, they have so tortured the rule so as to find plaintiffs' cases within it, that the holdings are perhaps best regarded as exceptions. I A. BROMBERG, *SECURITIES LAW: FRAUD* § 4.7 (1975); Fuller, *Another Demise of the Birnbaum Doctrine: "Tolls the Knell of Parting Day?"*, 25 MIAMI L. REV. 131 (1970);

## Affirmation of the *Birnbaum* Rule

“forced sellers.”<sup>27</sup> In other cases where several purchases and sales (either actual or contemplated) were involved, courts have held that plaintiffs could assert standing to challenge as fraudulent transactions other than those that actually caused their injuries,<sup>28</sup> while suits in equity have been exempted from the standing requirement altogether.<sup>29</sup> Additionally, through the use of a stockholder’s derivative action, a plaintiff who has merely held shares in a corporation may claim relief on behalf of all those stockholders who have been adversely affected by fraud in any transaction in which the corporation has bought or sold securities.<sup>30</sup>

---

Note, *Standing To Sue in 10b-5 Actions: Eason v. GMAC and Its Impact on the Birnbaum Doctrine*, 49 NOTRE DAME LAW. 1131 (1974); Note, 7 ST. MARY’S L.J. 602 (1975).

27. See, e.g., *Vine v. Beneficial Fin. Co.*, 374 F.2d 627 (2d Cir.), cert. denied, 389 U.S. 970 (1967). Plaintiff owned some class A stock, which made up over 90% of the stock issued but elected only a third of the board of directors of Crown Finance Co. Defendant purchased all the class B stock, which elected the remaining directors, at a premium and used its control of the board to force a short form merger of Crown into Beneficial. This presented plaintiff with the option of either selling his shares at a discount or continuing to hold shares in a nonexistent corporation. The court found that plaintiff was a “forced seller,” though at the time of the filing of his action, he had not sold his stock. The court also found that he could not be a seller by bringing a stockholder’s derivative action because Crown Finance no longer existed. See also *Crane Co. v. Westinghouse Air Brake Co.*, 419 F.2d 787 (2d Cir. 1969) (Crane’s tender offer for Westinghouse was defeated through market manipulation, leaving Crane with 32% of the shares in Westinghouse which it had to sell for antitrust reasons).

28. See, e.g., *Stockwell v. Reynolds & Co.*, 252 F. Supp. 215 (S.D.N.Y. 1965). Plaintiffs were dissuaded by the misrepresentations of defendant broker from selling their stock. After discovering the fraud, they sold the stocks at a loss and brought suit. The court found that they had standing to sue as sellers, despite the fact that their true injury arose from their earlier failure to sell. See also *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 405 U.S. 6, 12 (1971), the broad language of the Supreme Court suggesting that it, too, would allow the standing requirement to be met by a transaction other than the one which caused plaintiff’s damages.

29. See, e.g., *Mutual Shares Corp. v. Genesco, Inc.*, 384 F.2d 540 (2d Cir. 1967). Controlling shareholders manipulated the price of stock and kept dividends to a minimum in order to induce the minority shareholders to sell at a reduced price. Nonselling minority stockholders did not have standing under *Birnbaum* to bring an action for damages, but the court held that they could seek injunctive relief against further market manipulation. The court, quoting from *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 193 (1963), stated: “It is not necessary in a suit for equitable or prophylactic relief to establish all the elements required in a suit for monetary damages.” 384 F.2d at 547. In *Capital Gains*, the Supreme Court had further noted that to require proof of intent to injure and actual injury to clients would defeat the intent of Congress by empowering the courts to enjoin any practice that operates as a fraud or deceit. 375 U.S. at 195. But see *Greater Iowa Corp. v. McLendon*, 378 F.2d 783 (8th Cir. 1967) (court dismissed claim because plaintiffs had not purchased or sold the securities involved in the alleged fraud); *Tully v. Mott Supermarkets, Inc.*, No. 75-2253 (3d Cir., Aug. 13, 1976) (exception limited to prevention of future fraud, inapplicable to actions seeking mere rescission of an allegedly fraudulent transaction).

30. In such an action plaintiff stands in the shoes of the corporation, and thus it is the corporation which must be a purchaser or a seller. Plaintiff shareholder generally



Since the inception of the *Birnbaum* rule, the SEC has repeatedly attempted its overthrow. Regarding *Birnbaum* as unduly restrictive of valid private actions, the SEC has twice attempted to have Congress change the wording of the statute<sup>31</sup> and has often filed amicus briefs urging the demise of *Birnbaum* in cases challenging the rule.<sup>32</sup> Most commentators, too, have disapproved of the purchaser-seller limitation as an extremely arbitrary rule which bars many plaintiffs who deserve relief.<sup>33</sup> In fact, several have viewed some of the circuit courts' opinions broadening *Birnbaum* as effecting a complete elimination of the rule.<sup>34</sup> Some writers, however, have deemed the creation of exceptions to the standing rule as a natural part of its growth and development.<sup>35</sup> The substantive requirement has drawn little criticism, as its early liberal interpretation has made it an obstacle to few, if any, actions.<sup>36</sup> Despite the exceptions and regardless of comments, *Birnbaum* has remained the nearly universal rule for 23 years.<sup>37</sup>

---

obtains no individual recovery; damages go to the defrauded corporation. See *Zahn v. Transamerica Corp.*, 162 F.2d 36 (3d Cir. 1947); Berger, "Disregarding the Corporate Entity" for Stockholders' Benefit, 55 COLUM. L. REV. 808 (1955). See also H. HENN, HANDBOOK OF THE LAW OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES §§ 358-373 (2d ed. 1970); 1 A. BROMBERG, SECURITIES LAW: FRAUD § 4.7 (1975).

31. In 1957 and again in 1959 the SEC sought to add the words "or any attempt to purchase or sell" to the statute. See *Blue Chip*, 421 U.S. at 732, citing 103 CONG. REC. 11636 (1957), *Hearings on S. 1178-1182 Before a Subcomm. of the Senate Comm. on Banking & Currency*, 86th Cong., 1st Sess. 367-68 (1959), S. 2545, 85th Cong., 1st Sess. (1957), and S. 1179, 86th Cong., 1st Sess. (1959).

32. See, e.g., *Vine v. Beneficial Fin. Co.*, 374 F.2d 627, 630, 636 (2d Cir.), cert. denied, 389 U.S. 970 (1967); *A.T. Brod & Co. v. Perlow*, 375 F.2d 393, 395 (2d Cir. 1967). The SEC filed such briefs in all stages of *Blue Chip* as well.

33. 1 A. BROMBERG, SECURITIES LAW: FRAUD § 4.7 (1975); Lowenfels, *The Demise of the Birnbaum doctrine: A New Era for Rule 10b-5*, 54 VA. L. REV. 268 (1968); Comment, *The Purchaser-Seller Requirement of Rule 10b-5 Reevaluated*, 44 COLO. L. REV. 151 (1972).

34. The demise of the purchaser-seller limitation has been viewed as desirable in order to achieve the flexible enforcement of the securities acts necessary to deal with the ingenuity of potential wrongdoers in today's complicated securities markets. See, e.g., Lowenfels, *The Demise of the Birnbaum Doctrine: A New Era for Rule 10b-5*, 54 VA. L. REV. 268 (1968). Lowenfels based his conclusion on the opinions in *Vine v. Beneficial Fin. Co.*, 374 F.2d 627 (2d Cir.), cert. denied, 389 U.S. 970 (1967), see note 27 *supra*, and *A.T. Brod & Co. v. Perlow*, 375 F.2d 393 (2d Cir. 1967), see note 90 *infra*. See also Fuller, *Another Demise of the Birnbaum Doctrine: "Tolls the Knell of Parting Day?"*, 25 MIAMI L. REV. 131 (1970); Comment, *Dumping Birnbaum To Force Analysis Of The Standing Requirement Under Rule 10b-5*, 6 LOYOLA U. CHI. L.J. 230 (1975).

35. For a particularly illuminating discussion along these lines, see Boone & McGowan, *Standing To Sue Under SEC Rule 10b-5*, 49 TEX. L. REV. 617 (1971); Whitaker, *The Birnbaum Doctrine: An Assessment*, 23 ALA. L. REV. 543 (1971).

36. See note 23 *supra*.

37. "*Birnbaum* has been shot at by expert marksmen. . . . Bloody but unbowed. *Birnbaum* still stands." *Rekant v. Desser*, 425 F.2d 872, 877 (5th Cir. 1970).

## II. THE DECISION IN *BLUE CHIP*

### A. *The Majority's Position: Plain Meaning Revived*

*Blue Chip Stamps v. Manor Drug Stores* was the first case to present the issue of the validity of the *Birnbaum* rule to the Supreme Court. Justice Rehnquist's majority opinion upheld the rule both upon legislative history and intent as well as upon policy grounds. He found that "[t]he longstanding acceptance [of the rule] by the courts, coupled with Congress' failure to reject *Birnbaum's* reasonable interpretation of the wording of § 10 (b) . . . argues significantly in favor of acceptance of the *Birnbaum* rule by this Court."<sup>38</sup>

The opinion considered the plain meaning of the statute<sup>39</sup> to require that plaintiff be a purchaser or a seller of securities. It further noted that when Congress wished to provide a private remedy it had no difficulty in finding language to make its wishes clear, citing Section 16(b) of the 1934 Act<sup>40</sup> as an example.<sup>41</sup> Implicit in this observation seems to be the idea that since it is not even clear that Congress intended a private remedy in the first place, the Court is under no compulsion to extend standing to a broader class of plaintiffs.<sup>42</sup> Further support for the *Birnbaum* rule was found in Section 28(a) of the 1934 Act,<sup>43</sup> which limits recovery in any private action brought under the 1934 Act to "actual damages." The Court noted that while such damages are easily determined where plaintiff has actually purchased or sold securities, they become largely conjectural and speculative where he has not.<sup>44</sup> Finally the opinion observes that the principal express nonderivative private civil remedies in the acts of 1933 and 1934 created by Congress contemporaneously with Section 10(b) are by their terms expressly limited to the purchasers or sellers of securities.<sup>45</sup>

38. 421 U.S. at 733.

39. See text accompanying note 11 *supra*.

40. 15 U.S.C. § 78p(b) (1970).

41. 421 U.S. at 734.

42. The continued validity of the argument against a private remedy is doubtful in light of the Court's recent flat statement that "[a]lthough § 10(b) does not by its terms create an express civil remedy for its violation, . . . the existence of a private cause of action for violations of the statute and the rule is now well established." *Ernst & Ernst v. Hochfelder*, 96 S. Ct. 1375, 1382 (1976).

43. 15 U.S.C. § 78bb(a) (1970).

44. *Accord*, 2 A. BROMBERG, SECURITIES LAW: FRAUD § 8.8 (1975).

45. Section 11(a) of the 1933 Act, 15 U.S.C. § 77k(a) (1970), limits the right to "any person acquiring [the] security," while § 12, 15 U.S.C. § 77l (1970), limits the

The Court conceded, however, that the growth of the law in this area has been so great that it is impossible to determine completely the contours of Section 10(b) by the actions of Congress.<sup>46</sup> Consequently, Justice Rehnquist turned to the policy questions involved.<sup>47</sup> Recognizing that the purchaser-seller limitation sometimes excludes plaintiffs with valid claims, the Court found that this disadvantage was outweighed by the advantages of the rule.

First, Justice Rehnquist found that even a complaint which by objective standards has very little chance of prevailing upon the merits has a settlement value out of proportion to its chances of success, if the plaintiff can avoid dismissal or summary judgment. Since the very pendency of a lawsuit can make credit difficult to obtain or halt normal business operations, settlements are virtually compelled in order for the defendant to survive financially.<sup>48</sup> The possibility for abuse of the liberal federal discovery rules exists as well. The threat of extensive depositions and discovery of defendant's business records can have considerable settlement value. The Court found that the elimination of the *Birnbaum* rule would lead to substantially more such nuisance, or "strike," suits, by which money would be extorted from corporations which had done nothing more than be too gloomy in their prospectuses.<sup>49</sup>

Secondly, the majority feared that the elimination of *Birnbaum* would allow the maintenance of many actions which would turn upon hazy issues of fact, resolvable solely by the testimony of the allegedly injured party. If *Birnbaum* were followed, the majority observed, the plaintiffs would at least have dealt in the security involved

---

remedy to the "person purchasing [the] security." Section 9(e) of the 1934 Act, 15 U.S.C. § 78i(e) (1970), confines the remedy for its violation to "any person who shall purchase or sell any security." Section 18(a) of the 1934 Act, 15 U.S.C. § 78r(a) (1970), limits its remedy to "any person . . . who . . . shall have purchased or sold a security at a price which was affected by such statement."

46. In notable contrast with Justice Rehnquist's *Blue Chip* opinion, Justice Powell's majority opinion in *Ernst & Ernst v. Hochfelder*, 96 S. Ct. 1375, 1385-89 (1976), was well able to determine the limits of the section in light of the overall congressional scheme.

47. 421 U.S. at 737.

48. Bromberg suggests that once a case in this area has survived all motions for dismissal and for summary judgment, it is almost always settled before trial. 3 A. BROMBERG, SECURITIES LAW: FRAUD § 9.1 (1975).

49. In most circumstances this fear is unjustified, as the issuer does not stand to profit by discouraging purchase of its securities. Thus, gloominess is generally good faith conservatism in the prospectus. In *Blue Chip*, however, where the sale was pursuant to an antitrust consent decree, defendants stood to gain by discouraging purchases.

and therefore would have a record of the transaction. This would present far less of an evidentiary problem than where plaintiffs had no record of a transaction. Such a record would at least demonstrate the timing and the quantity of securities involved in the purchase or sale at issue.

The Court noted that the court of appeals had not overruled *Birnbaum* but had found only that plaintiff's status as an offeree pursuant to an antitrust decree served the same function, by limiting the class of plaintiffs, as is normally served by a contractual relationship.<sup>50</sup> There is a clear line of authority, however, holding that a consent decree is not enforceable by those not parties to it, even though they may be beneficiaries of the decree.<sup>51</sup> Thus, Manor Drugs could not enforce the consent decree and had no contractual right to the securities. The Court found this to be in sharp contrast with the situation where plaintiff has such contractual rights, as "contract rights" are expressly included in "purchase" and "sale" under Section 3(a) of the 1934 Act.<sup>52</sup>

### B. *The Dissent: Relief to Deserving Plaintiffs Denied*

Justice Blackmun, joined by Justices Douglas and Brennan, dissented,<sup>53</sup> believing that the *Birnbaum* rule should be eliminated. Finding the rule to be arbitrary and accusing the Court of a "preternatural solicitousness for corporate well-being and a seeming callousness toward the investing public quite out of keeping . . . [with the

---

50. The definitions of "purchase" and "sale" in §§ 3(a)(13)–(14) of the 1934 Act explicitly include contracts to buy and sell. 15 U.S.C. §§ 78c(a)(13)–(14) (1970).

51. In *United States v. Armour & Co.*, 402 U.S. 673 (1971), the Court held that the Government could not enforce what it regarded as the "purpose" of an antitrust consent decree upon a nonparty, because such a decree has no binding force except as to issues settled in it between the parties, and that parties give up their due process right to a trial in return for such limitation of the effect of the decree. *See* *Buckeye Coal & Ry. v. Hocking Valley Ry.*, 269 U.S. 42 (1925) (outsider Buckeye was unable to sue to enforce an antitrust consent decree between Hocking and the federal government in order to separate ownership of railroads and coalfields).

52. 15 U.S.C. § 78c(a)(13)–(14) (1970).

53. Justice Powell, joined by Justices Stewart and Marshall, filed a concurring opinion emphasizing the significance of the acts of 1933 and 1934 and particularly the language of § 10(b) and rule 10b–5. He specifically noted the absence of "offer to sell" from the definitions of "purchase" and "sale" in §§ 3(a)(13)–(14) of the 1934 Act. Justice Powell also stated that when Congress did wish to include offers, it did so expressly, as in § 17(a), 15 U.S.C. § 77q(a) (1970), the antifraud provision of the 1933 Act.

Court's] traditions and the intent of the securities laws,"<sup>54</sup> Justice Blackmun stated that the proper test for a valid rule 10b-5 claim should be the showing of a logical nexus between the alleged fraud and the sale or purchase of a security. Understanding the word "sale" to mean a generalized event of public disposal of property, the dissent reasoned that a plaintiff need not be an actual purchaser or seller in order to have standing under Section 10(b) and rule 10b-5. Justice Blackmun found support for such an interpretation in the legislative history of the Act, particularly that of Section 10(b).<sup>55</sup> He distinguished the factual situation in *Birnbaum* from that in *Blue Chip* and found the practical difficulties cited by the majority<sup>56</sup> as requiring the application of *Birnbaum* to be an insufficient reason for denying relief to many deserving plaintiffs.<sup>57</sup>

54. 421 U.S. at 762. In addition, he cited five previous opinions of the Court which contain liberal interpretations of various provisions of the securities laws. Such interpretations intimated that the Supreme Court would not follow *Birnbaum*. See *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 151 (1972) (Court interpreted rule 10b-5 broadly to impose liability upon persons who had profited by acting as brokers to sell Indians' stock without full disclosure to sellers); *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 12 (1971) (Court held that rule 10b-5 prohibited fraud upon a corporation as well as upon individuals and in face-to-face transactions as well as in organized securities markets); *SEC v. National Sec., Inc.*, 393 U.S. 453, 463 (1969) (merger preventing stockholder from being able to sell his stock in old corporation constituted a sale for purposes of rule 10b-5); *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967) (in defining "security," the Court held that the securities acts constituted remedial legislation and should be construed broadly); *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963) (Congress intended the statute to be construed like other securities legislation enacted for the purpose of avoiding frauds, not technically and restrictively but flexibly to effectuate its remedial purposes). Justices Blackmun and Brennan also dissented in *Ernst & Ernst v. Hochfelder*, 96 S. Ct. 1375 (1976) (Justice Douglas had retired). The basis of the dissent in *Ernst* was again that the securities acts constitute remedial legislation and should be broadly interpreted. See 96 S. Ct. at 1392.

55. One of the principal draftsmen of the House version of the bill (which is substantially the same as the final Act) said of § 9(c) (which became § 10):

Subsection (c) says, "Thou shalt not devise any other cunning devices."

. . . Of course subsection (c) is a catch-all clause to prevent manipulative devices . . .

*Hearing on H.R. 7852 and H.R. 8720 Before the House Comm. on Interstate and Foreign Commerce*, 73d Cong., 2d Sess. 115 (1934).

56. See text accompanying notes 47-50 *supra*.

57. Justice Blackmun made no attempt to define "deserving plaintiff." In *Blue Chip*, plaintiff's case had more credibility than would be the situation in most actions for fraudulent dissuasion, as plaintiff was a member of a well-defined group to which the stock offering was made.

### III. THE TRIUMPH OF *BIRNBAUM*

Although most of the actions brought under rule 10b-5 could be brought under state corporation law, the 10b-5 action is extremely attractive to plaintiffs for two reasons. First, since the action is brought in federal court, the liberal federal rules of procedure apply. Discovery, jurisdiction, venue, and service of process are thus facilitated. A plaintiff can, of course, file his claim in federal court and make use of federal procedure in a diversity action, but it is often difficult to attain complete diversity, particularly as the corporation is a citizen of both the state of its incorporation and the state of its principal place of business.<sup>58</sup> Secondly, the use of federal procedure will not avoid the application of substantive state law in a diversity action.<sup>59</sup> Most state corporation acts require the proof of common law fraud as opposed to the fraud encompassed in rule 10b-5, which until recently amounted to little more than "unfairness."<sup>60</sup> Further, the Supreme Court has held that plaintiff need not prove that he relied on defendant's statements.<sup>61</sup> Perhaps most importantly, most states require the posting of a security bond, which is often prohibitive in amount, as a condition of maintaining a derivative suit.<sup>62</sup> Such suits make up a great portion of the litigation in this area.

These differences in both substantive and procedural law have led to an understandable desire on the part of plaintiffs to bring their actions under rule 10b-5.<sup>63</sup> Two policy considerations, however, support the *Birnbaum* court's desire to prevent a broad class of plaintiffs from taking advantage of 10b-5. First, the substantive part of the

---

58. 28 U.S.C. § 1332(c) (1970).

59. *Erie R. Co. v. Tompkins*, 304 U.S. 64 (1938).

60. See 1 A. BROMBERG, *SECURITIES LAW: FRAUD* § 1.1 (1975), for the view that rule 10b-5 requires little more than "unfairness." This has been substantially altered, however, by the Supreme Court's recent decision in *Ernst & Ernst v. Hochfelder*, 96 S. Ct. 1375 (1976), which held that plaintiff must establish the defendant's scienter in order to prevail under rule 10b-5. The Court did, however, reserve the question as to whether recklessness would be sufficient to state a claim. See note 13 *supra*.

61. *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153 (1972).

62. See 1 A. BROMBERG, *SECURITIES LAW: FRAUD* § 4.7 (1975). See, e.g., WASH. REV. CODE § 23A.08.460 (1974), providing that where plaintiff holds less than 5% of the outstanding shares of any class of stock, unless such shares held have value in excess of \$25,000, the corporation is entitled to have plaintiff give security for reasonable expenses, including attorney's fees, that may be incurred by it in connection with such action.

63. This desire will be somewhat lessened by the Court's decision in *Ernst & Ernst v. Hochfelder*, 96 S. Ct. 1375 (1976), requiring specific intent as a basis for a 10b-5 action. See note 13 *supra*.

*Birnbaum* rule<sup>64</sup> was motivated by a belief that Congress did not intend to supplant all state law dealing with corporate fiduciary duties when it passed the securities acts.<sup>65</sup> Secondly, the standing portion of the *Birnbaum* rule<sup>66</sup> was motivated by a recognition of the dangers of strike suits, which would have free play if a means of dismissing such suits before trial were not available.<sup>67</sup>

Over the years both parts of the rule have been broadened,<sup>68</sup> but the standing portion of the rule has remained a significant obstacle to many plaintiffs. In the vast majority of cases the standing rule is a good one. It excludes many actions that might be brought where plaintiff complains that he would have bought stock which later increased in value but for defendant's gloomy representations which plaintiff may have seen in a prospectus or through the communications media.<sup>69</sup> There would be little evidence other than plaintiff's oral assertions to show that he had actually been influenced by defendant's representations and to show when and how much he would have purchased. While such a case would likely fail for want of evidence at trial, its nuisance effect would probably be sufficient to give it settlement value; funds for settlement come, of course, out of the corporate earnings. The general validity of the rule, however, should not obscure the fact that it will occasionally result in a dismissal of a valid claim if inflexibly construed. The Supreme Court in *Blue Chip* treated *Birnbaum* in just such an inflexible manner in a factual situation where plaintiff might have been able to establish a valid claim.

#### A. *The Omissions by the Majority*

Three important lines of analysis were either ignored or inadequately considered by the *Blue Chip* Court, thereby resulting in considerable ambiguity as to its holding. First, the Court should have de-

---

64. See text accompanying note 18 *supra*.

65. This belief is supported by § 28(a) of the 1934 Act, 15 U.S.C. § 78bb(a) (1970), which provides that federal remedies supplement state remedies.

66. See text accompanying note 7 *supra*.

67. For a discussion of the settlement value of such "strike suits," see note 48 and accompanying text *supra*.

68. See notes 23 & 25 and accompanying text *supra*.

69. In *SEC v. Texas Gulf Sulfur*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969), a corporation was held liable to all those shareholders who sold their stock after the company had issued a misleading pessimistic press release about its mining exploration in Canada.

lineated and considered the substantive portion of *Birnbaum* apart from its standing aspect. Secondly, the Court should have given serious consideration to the creation of an exception to *Birnbaum* in the case of a securities offering pursuant to an antitrust decree. Thirdly, the Court should have devoted greater analysis to the types of plaintiffs who will be allowed to sue under 10b-5 after *Blue Chip*.

1. *A delineation of the substantive requirement*

There was no allegation of internal corporate mismanagement in *Blue Chip*; therefore, the substantive part of the *Birnbaum* rule was not directly involved. In view of the considerable confusion that has resulted from the mixing of the substantive doctrine and the standing rule, both by the courts<sup>70</sup> and the commentators,<sup>71</sup> the Court should have clearly distinguished the two and addressed them separately. A ruling by the Court upon the present status of the substantive requirement was necessary to eliminate the confusion in the federal courts over the continuing validity of the standing rule. It was due to a belief that the substantive doctrine was the only true holding of *Birnbaum* that the court in *Eason v. General Motors Acceptance Corp.*<sup>72</sup> rejected the standing requirement as being a false interpretation of the case.

The *Eason* court concluded that the purchaser-seller limitation was only a description of the *Birnbaum* court's understanding of the class

---

70. Of particular note are the Second Circuit opinion denying recovery because plaintiff was not a purchaser or seller (the standing doctrine) and the Supreme Court's reversal because 10b-5 extends its protection to private securities transactions as well as to those conducted on the stock exchanges (the substantive doctrine). *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 430 F.2d 355 (2d Cir. 1970), *rev'd*, 404 U.S. 6 (1971).

71. At least four writers have completely failed to make any distinction between the substantive and standing parts of the rule. See Boone & McGowan, *Standing To Sue Under SEC Rule 10b-5*, 49 TEX. L. REV. 617 (1971); Fuller, *Another Demise of the Birnbaum Doctrine: "Tolls the Knell of Parting Day?"*, 25 MIAMI L. REV. 131 (1970); Lowenfels, *The Demise of the Birnbaum Doctrine: A New Era for Rule 10b-5*, 54 VA. L. REV. 268 (1968); Comment, *The Purchaser-Seller Requirement of Rule 10b-5 Reevaluated*, 44 COLO. L. REV. 151 (1972). One other observer has taken the view that the two doctrines have merged. See Note, *Standing To Sue in 10b-5 Actions: Eason v. GMAC and Its Impact on the Birnbaum Doctrine*, 49 NOTRE DAME LAW. 1131 (1974). Bromberg believes that the Supreme Court's decision in *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6 (1971), dealt the death blow to the substantive doctrine, 1 A. BROMBERG, *SECURITIES LAW: FRAUD* § 4.7(522) (1975), but nowhere does the Court explicitly acknowledge this.

72. 490 F.2d 654 (7th Cir. 1973), *cert. denied*, 416 U.S. 960 (1975).



of persons protected by rule 10b-5. Such a position is not unreasonable if one acknowledges the factual distinctions between *Birnbaum* and a typical securities transaction on an exchange.<sup>73</sup> The *Birnbaum* opinion conveys the impression that the principal reason for the court's rejection of the claim in *Birnbaum* was that plaintiffs were not members of the class for whose benefit the statute was passed, since they were asking for damages for corporate mismanagement rather than seeking redress from fraud in a securities transaction. This interpretation was seemingly further buttressed when the Supreme Court said in *Superintendent of Insurance v. Bankers Life & Casualty Co.* that it agreed that Section 10(b) was not directed at internal corporate mismanagement but rather at deceptive devices in the purchase or sale of securities.<sup>74</sup> Due to repeated citation of *Birnbaum* as authority for the purchaser-seller limitation in later cases, however, its rule has become known as a rule of standing,<sup>75</sup> and its substantive holding has been largely ignored. The *Blue Chip* Court continued this policy of sidestepping the substantive requirement. While the Court's holding clearly rejects the *Eason* approach,<sup>76</sup> it is not clear what is the present status of the substantive doctrine. It may have continued validity, though in a more liberalized form,<sup>77</sup> or it may have ceased to exist altogether.

## 2. *An exception to the standing rule*

The Court did not seriously consider the possibility of creating an exception to the standing rule in the case of stock offerings pursuant

---

73. *Birnbaum* involved the corporation president's breach of his fiduciary duty to the minority shareholders in his sale of control of the company. It is not at all clear that Congress intended § 10(b) to reach such activity. See note 18 *supra*. It is clear that Congress intended to provide a remedy for misrepresentation in the sale of securities. Recently the Second Circuit court in *Popkin v. Bishop*, 464 F.2d 714 (2d Cir. 1972), required an allegation of a breach of defendant's duty to inform and disclose in order to state a 10b-5 cause of action.

74. The Court said:

We agree that Congress by § 10(b) did not seek to regulate transactions which constitute no more than internal corporate mismanagement. But we read § 10(b) to mean that Congress meant to bar deceptive devices and contrivances in the purchase or sale of securities whether conducted in the organized markets or face to face.

404 U.S. at 12 (1971).

75. Many commentators fail even to acknowledge the existence of the substantive doctrine. See note 71 *supra*.

76. The *Eason* approach should be rejected, as it does not deal with the problem at which the *Birnbaum* rule is primarily aimed—nuisance suits.

77. See note 18 *supra*.

## Affirmation of the *Birnbaum* Rule

to an antitrust decree. In failing to do so, the Court did not decide the case on the facts before it. The court of appeals had allowed the complaint by fashioning an exception to *Birnbaum* in the case of sales pursuant to an antitrust consent decree. The Supreme Court, however, gave only the most cursory consideration to the possibility of such an exception to the rule.<sup>78</sup> It concluded, based perhaps in part upon a too credulous reading of petitioner's brief,<sup>79</sup> that the circuit court's decision amounted to a complete rejection of *Birnbaum*. The Court's reaction was the imposition of the purchaser-seller limitation in toto.<sup>80</sup>

This result was surprising in light of several of the Court's prior opinions which had liberally interpreted the scope of other provisions of the securities acts. In *Tcherepnin v. Knight*<sup>81</sup> when the Court was called upon to define the word "security" for the purpose of the acts, it observed that the Securities Exchange Act was remedial legislation which should be interpreted broadly to effectuate its purpose.<sup>82</sup> It further noted that form should be disregarded for substance and the

---

78. See text accompanying notes 50-52 *supra*.

79. Petitioners argued that the Ninth Circuit decision effectively overthrew the purchaser-seller doctrine and that it could not be limited to the facts of this case. Brief for Petitioner at 23, *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975). Petitioner based its argument upon the finding of the court of appeals that the principal reason for the purchaser-seller rule was that if plaintiff has neither bought nor sold the securities in question, his claim must fail for want of proof as to loss and causation. Since the court of appeals could find no difficulties of proof where the proposed sale was pursuant to an antitrust consent decree, it allowed the claim. Thus, the circuit court's reasoning is limited to those situations where the only possible purchaser, the price of the proposed sale, the time of the transfer, and most important, the number of shares involved in the proposed sale are clearly ascertainable and not subject to speculation.

80. That the Court should choose to write such an extreme opinion in this case is particularly surprising in light of its denial of certiorari, 416 U.S. 960 (1975), only a few months before to *Eason v. General Motors Acceptance Corp.*, 490 F.2d 654 (7th Cir. 1973), in which the standing doctrine was rejected. Assuming that the Court wished to affirm *Birnbaum* wholeheartedly, a reversal of *Eason* would have been perhaps a more appropriate way to do so rather than reversal of the Ninth Circuit exception to the rule in *Blue Chip*.

81. 389 U.S. 332 (1967).

82. The full text of the Court's statement was as follows:

In addition, we are guided by the familiar canon of statutory construction that remedial legislation should be construed broadly to effectuate its purposes. The Securities Exchange Act quite clearly falls into the category of remedial legislation. One of its central purposes is to protect investors through the requirement of full disclosure by issuers of securities . . . . Finally, we are reminded that, in searching for the meaning and scope of the word "security" in the Act, form should be disregarded for substance and the emphasis should be on economic reality.

*Id.* at 336 (footnote omitted).

The Court, however, rejected the liberal approach suggested by the *Knight* case when *Ernst & Ernst v. Hochfelder*, 96 S. Ct. 1375 (1976), was argued by the SEC. The Court found that each section of the Act was carefully tailored to provide a certain remedy and should not be stretched beyond that role. See note 13 *supra*.

emphasis should be on "economic reality." This language seemed to foreshadow a retreat from an arbitrary interpretation of the *Birnbaum* rule or at least a willingness to make liberal exceptions to the rule when advisable in accordance with equitable considerations. More recently, in *Affiliated Ute Citizens v. United States*,<sup>83</sup> the Court indicated that a broad view of the scope of Section 10 and rule 10b-5 should be taken.<sup>84</sup>

The *Blue Chip* majority, however, found that to agree with the court of appeals would leave the *Birnbaum* rule open to endless case-by-case erosion, depending upon whether or not a particular group of plaintiffs was sufficiently discrete to justify an exception to the rule. The majority concluded that "such a shifting and highly fact-oriented disposition of the issue [was not] a satisfactory basis for a rule of liability imposed on the conduct of business transactions."<sup>85</sup> Consistency in decisionmaking is very important in the area of commercial liability, particularly in interpretation of contracts. One can only write a contract with confidence if he knows how the courts will interpret the language used. This is not true, however, of a rule of standing for bringing a securities fraud action. Any uncertainty created here will only have the salutary effect of deterring fraud. The creation of such a limited exception in an area where the seller is peculiarly likely to engage in fraud to dissuade the buyer from purchasing would not lead to any of the practical difficulties suggested by the Court.<sup>86</sup> Nor is the

---

83. 406 U.S. 128 (1972).

84. The Court particularly emphasized the liberality with which the statute should be construed in order to effect its purpose:

These proscriptions, by statute and rule, are broad and, by repeated use of the word "any," are obviously meant to be inclusive. The Court has said that the 1934 Act and its companion legislative enactments embrace a "fundamental purpose . . . to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry." *SEC v. Capital Gains Research Bureau*, 375 U.S. 180 . . . (1963). In the case just cited the Court noted that Congress intended securities legislation enacted for the purpose of avoiding frauds to be construed "not technically and restrictively, but flexibly to effectuate its remedial purposes." *Id.* at 195 . . . . This was recently said once again in *Superintendent of Insurance v. Bankers Life & Casualty Co.*, 404 U.S. 6, 12 . . . (1971).  
*Id.* at 151 (footnote omitted).

Again, in *Ernst & Ernst v. Hochfelder*, 96 S. Ct. 1375 (1976), the Court rejected the liberality of this approach. *Blue Chip* and *Ernst* taken together suggest that in the future the Court will strictly construe the securities acts.

85. 421 U.S. at 755.

86. Where the parties, time, price, and amount of securities involved in the aborted transaction are beyond dispute, as in *Blue Chip*, plaintiff's chances of prevailing upon

language of the Act or the rule so clear as to force the Court to refuse to hear the case.<sup>87</sup> The primary purpose of the Act was to promote honest disclosure of material facts. That purpose would be well served by allowing such an action under these circumstances.

3. *An analysis of potential plaintiffs*

The majority's analysis of the plaintiffs potentially excluded by the *Birnbaum* rule is inadequate.<sup>88</sup> The Court initially noted that the rule will exclude all potential purchasers who have been dissuaded from purchasing by an allegedly fraudulent prospectus. In general, such exclusion is valid, but in some cases such as *Blue Chip*, where plaintiff can prove his allegations with written documents, the rule becomes overly exclusive. The position of actual shareholders who have been fraudulently dissuaded from selling is endangered as well. Though some potential plaintiffs in this category may be able to obtain relief through stockholder's derivative actions, other stockholders may find a derivative action insufficient to provide a remedy when interests protected by the statute are violated. For instance, derivative action cannot be used where plaintiff holds stock in a corporation which no longer exists due to merger,<sup>89</sup> nor will it operate where the fraud is upon the individual plaintiff and not upon a corporation.<sup>90</sup> Lastly, the

---

the merits are good (and thus any settlement value justified), and there are no "hazy issues of fact" to be resolved by oral testimony. In *Blue Chip*, plaintiff was clearly an offeree of a limited securities offering. This is very different from the case where a plaintiff claims to have been fraudulently dissuaded from purchasing in a general securities offering and can put forward no evidence other than his own statement that he ever really considered buying.

87. The legislative history of the Act and the rule indicates a desire for both a breadth of coverage, *see* notes 24 & 55 *supra*, which is inconsistent with the purchaser-seller limitation, and for a specificity of language in § 10(b) and other sections of the Act, *see* note 53 *supra*, which is consistent with the limitation.

88. 421 U.S. at 737.

89. *See* *Vine v. Beneficial Fin. Co.*, 374 F.2d 627 (2d Cir.), *cert. denied*, 389 U.S. 970 (1967).

90. *See* *A.T. Brod & Co. v. Perlow*, 375 F.2d 393 (2d Cir. 1967), where plaintiff stockbroker purchased securities for defendants, who refused to pay him for the stock when its price went down. The ordering of stock with intent to refuse to pay in the event of a decline in price was found to be a manipulative or deceptive device within the meaning of § 10(b) and rule 10b-5. Under a broad, pre-*Blue Chip* interpretation of *Birnbaum*, the court found that plaintiff broker's subsequent sale of the stock gave him standing to sue under 10b-5, in spite of the fact that his injury was caused not by that sale, but by the previous refusal of defendants to purchase. Note that derivative action would have been useless, as there had been no fraud upon the corporation (which stands as plaintiff in a derivative action) but only upon the individual broker.

In *Thompson v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 401 F. Supp. 111

Court noted that the *Birnbaum* rule will exclude actions by shareholders and creditors who have suffered loss due to fraudulent insider activity with respect to securities. If the substantive portion of the rule is still valid, such plaintiffs are properly excluded under rule 10b-5. The Securities Exchange Act was not designed to provide a remedy for corporate mismanagement and even the broadest interpretation of *Birnbaum* would not encompass all such claims.<sup>91</sup>

### B. *The Results of Blue Chip*

In order to establish firmly the *Birnbaum* rule, the Court dealt harshly<sup>92</sup> with plaintiff Manor Drug Stores, which had alleged precisely the type of fraud that Congress intended to prevent in requiring full disclosure in prospectuses. Although the purchaser-seller limitation is generally a good one,<sup>93</sup> no rule should be applied with such rigid formalism that the implication is inescapable that there are no exceptions.<sup>94</sup> A well-developed rule has many exceptions in order to deal with some of the more difficult cases.<sup>95</sup> Such exceptions to the

---

(W.D. Okla. 1975), plaintiff was induced by misrepresentation to hold stock which declined in value. The court, relying on *Blue Chip*, dismissed the claim.

91. See S. REP. NO. 792, 73d Cong., 2d Sess. 1-5 (1934). See also *Popkin v. Bishop*, 464 F.2d 714 (2d Cir. 1972). The Court of Appeals for the Second Circuit has been the leading court in expanding the *Birnbaum* rule. *But see* *Marshel v. AFW Fabric Corp.*, 533 F.2d 1277 (2d Cir. 1976).

92. "There is a 'throw the baby out with the bath water' result—by enshrining the buyer-seller requirement as one of standing rather than a factor bearing on the quantum of proof or the need for . . . other devices to prevent abusive suits." 3 A. BROMBERG, *SECURITIES LAW: FRAUD* § 8.8, at 424 (Supp. 1975).

93. Generally if there has been no purchase or sale, one has only plaintiff's word for what he would have done, "had he known." Such a basis for a claim is too speculative to be taken seriously and has been consistently rejected. See *Mount Clemens Indus., Inc. v. Bell*, 464 F.2d 339 (9th Cir. 1972) (claim dismissed because nonpurchasing plaintiff failed to show that no other purchaser could have bought before he would have, had he not been dissuaded from buying by defendant's fraudulent statements).

94. Bromberg notes that the opinion amounts to "a return to a restrictive tone and mode of reasoning that was common in 10b-5 cases in the 1950s but has almost wholly disappeared since." 3 A. BROMBERG, *SECURITIES LAW: FRAUD* § 8.8, at 424 (Supp. 1975).

95. Kenneth Davis makes an analogous argument in the area of administrative law:

We must reject the false ideal of a government of laws and not of men. What we have and what we have to have is a government of laws and of men. We cannot accomplish the main objectives of modern government without significant discretionary power. No legal system in world history has been without such power. None can be. Discretion is essential for individualized justice, for creative justice, for new programs in which no one yet knows how to formulate rules, and for old

## Affirmation of the *Birnbaum* Rule

*Birnbaum* rule were evolving, but unfortunately these varied in phrasing and underlying policy among the several circuit courts. In *Blue Chip* the Supreme Court had an opportunity to standardize policy and terminology in the area and accept those exceptions to the rule which furthered its objectives.

Instead, the *Blue Chip* Court did not consider any of the cases creating exceptions to the *Birnbaum* rule, leaving the present standing rule quite vague—something the Court claimed to avoid. Its wholehearted acceptance of *Birnbaum* casts doubt upon those cases where the lower courts had modified the purchaser-seller limitation so as to find a deserving plaintiff within the rule.<sup>96</sup> The Supreme Court might be willing to accept those interpretations as none of the courts claimed to be finding an exception to the rule as such.<sup>97</sup> The validity of the “forced seller” doctrine, however, is in considerable doubt.

### C. The “Developed Rule” Alternative

The crucial requirement of a rule of standing in this area is to provide a test which will admit all valid claims and exclude all nuisance or “strike” suits on summary judgment. Although no test would perform this function perfectly, the purchaser-seller limitation could be quite effective if flexibly applied. Exceptions to the rule should be allowed in those cases where plaintiff has some sort of documentary evidence of the time, amount, and price of his proposed purchase or

---

programs in which some aspects cannot be reduced to rules.

K. DAVIS, ADMINISTRATIVE LAW TEXT § 4.02, at 92–93 (3d ed. 1972).

Other examples of well-developed rules which have recognized exceptions are the hearsay rule, see MCCORMICK ON EVIDENCE §§ 244–327 (2d ed. 1972), and the parol evidence rule, which has an exception in the case of fraud. See, e.g., *Lusk Corp. v. Burgess*, 85 Ariz. 90, 332 P.2d 493 (1958); *Sabo v. Delman*, 3 N.Y.2d 155, 143 N.E.2d 906, 164 N.Y.S.2d 714 (1957).

96. Bromberg notes that aborted purchases and sales will not provide a basis upon which to maintain a cause of action but concludes that nothing seems to prevent parties to a contract or forced buyers or sellers from suing. 3 A. BROMBERG, SECURITIES LAW: FRAUD § 8.8 (Supp. 1975). As forced buyers and sellers have not actually purchased or sold under the present meaning of the “forced” concept, their position is quite tenuous. Note, 7 ST. MARY’S L.J. 602 (1975).

97. This seems to have been the mistake of the Court of Appeals for the Ninth Circuit in *Blue Chip*—to actually admit that it was making an exception to the rule. Certainly any future plaintiff should at least claim to fall squarely within *Birnbaum*, no matter how outlandish that claim may be, rather than ask the court to make an exception in his case. Unfortunately this creates a system in which a close case will turn much more on the niceties of language used by counsel in the briefs than upon the substance of the claim.

sale. Such a "developed rule" would recognize exceptions for "forced sellers," suits in equity, and for those transactions which are pursuant to an antitrust decree. As rule 10b-5 is a "catchall" provision,<sup>98</sup> relief should be as broad as possible consistent with avoiding strike suits. Although the substantive requirement has been considerably liberalized in order to allow for federal jurisdiction in all cases where securities are significantly involved, the requirement should prohibit 10b-5 consideration of claims which allege only corporate mismanagement and only incidentally involve securities. Congress never intended that Section 10(b) supersede state law on corporate fiduciary relationships.<sup>99</sup>

#### IV. CONCLUSION

The Supreme Court seemingly did not approach the *Blue Chip* case with a view to establishing the best rule for future cases. The majority and dissent both took extreme stances and engaged in a battle of polemics without ever considering the possibility that the best rule lay in some middle ground. Arguments based upon the language of the statute and the intent of the Congress exist on both sides and are inconclusive. Such an impasse suggests that the Court should look to the policy reasons underlying the statute for guidance in the creation of an equitable rule. The *Blue Chip* Court correctly identified the policy of preventing strike suits as demanding some form of the purchaser-seller limitation, but in failing to give equal recognition to its earlier announced policy of broad relief for fraud involving securities,<sup>100</sup> it erred in announcing an overly restrictive rule.

*Douglass A. North*

---

98. See note 55 *supra*. Section 10(b) and rule 10b-5 are the only provisions of the securities acts and regulations which are not directed at any specific group that plays a role in securities issuance and transfer. The section and rule apply to "any person."

99. Section 28(a) of the 1934 Act, 15 U.S.C. § 78bb(a) (1970), specifically provides that federal remedies are to supplement state remedies. See also S. REP. No. 792, 73d Cong., 2d Sess. 12-13 (1934).

100. In *Ernst & Ernst v. Hochfelder*, 96 S. Ct. 1375 (1976), the Court similarly rejected its earlier policy of broad relief under the securities acts. *Blue Chip* and *Ernst* seem to mark a new departure from liberality in the Court's interpretation of the securities acts.