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## Securities -- Standing to Sue Under SEC Rule 10b-5 and the Purchaser-Seller Limitation -- Manor Drug Stores v. Blue Chip Stamps

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## CASE NOTES

**Securities—Standing to Sue Under SEC Rule 10b-5 and the Purchaser-Seller Limitation—*Manor Drug Stores v. Blue Chip Stamps*.**<sup>1</sup>—In 1963, the United States filed a complaint under the Sherman Act<sup>2</sup> charging Blue Chip Stamp Company (Blue Chip), Thrifty Drug Stores Co. and eight grocery store chains with conspiring to restrain trade and monopolizing the trading stamp business in California. This litigation was settled when a consent decree was filed with, and accepted by, the United States District Court for the Central District of California.<sup>3</sup> In the decree, Thrifty Drug Stores and the eight grocery store chains, which collectively owned 90 percent of the stock of Blue Chip (the stockholding users) consented to offer to the non-stockholding users of Blue Chip trading stamps, at bargain prices, stock in the contemplated Blue Chip Stamps corporation. The stockholding users were to be divested of 55 percent of their interest in Blue Chip when it was merged into Blue Chip Stamps. Concomitantly, 55 percent of the common stock of the new corporation, consisting of 621,600 shares, was to be offered in units to the non-stockholding users. Each unit was to contain three shares of stock in the new corporation and one \$100 debenture, and was to be offered for \$101 on a pro rata basis determined by the quantity of trading stamps which had been issued to each of the non-stockholding users during a specified period. Each unit had a reasonable market value of \$315. Any shares not purchased by the non-stockholding users were to be sold on the open market.<sup>4</sup>

The plaintiffs in *Manor Drug* were a group of the non-stockholding users who claimed that, because of fraudulent information which the defendants included in the prospectus for the units, they refrained from purchasing the units to which they were entitled, thereby incurring injury to the extent of the difference between the fair market value and the offering price of the units to which they had a right of first refusal. Basing their suit on violations of section 10(b) of the Securities Exchange Act of 1934<sup>5</sup> and Securities

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<sup>1</sup> [1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,191 (9th Cir. 1973), as modified on denial of rehearing en banc, 492 F.2d 136 (9th Cir. 1974). All subsequent citations to *Manor Drug* will refer to the later opinion.

<sup>2</sup> 15 U.S.C. §§ 1, 2 (1970).

<sup>3</sup> *United States v. Blue Chip Stamp Co.*, 272 F. Supp. 432, 433-34 (C.D. Cal. 1967).

<sup>4</sup> *Manor Drug*, 492 F.2d at 139.

<sup>5</sup> 15 U.S.C. § 78j(b) (1970), which provides:

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

(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.

CASE NOTES

and Exchange Commission (SEC) Rule 10b-5<sup>6</sup> promulgated thereunder, the group claimed damages in the neighborhood of \$20,000,000.<sup>7</sup>

Following the "purchaser-seller" rule formulated in *Birnbaum v. Newport Steel Corp.*,<sup>8</sup> and adopted by the Ninth Circuit in *Mount Clemens Industries, Inc. v. Bell*,<sup>9</sup> the district court held that, in order to attain standing, the plaintiffs had to be purchasers of the securities for which they alleged damage caused by the defendants' fraud. Accordingly, it dismissed the plaintiffs' complaint for lack of standing to maintain the suit.<sup>10</sup> Over a vigorous dissent, the court of appeals reversed and HELD: from the plaintiffs' complaint, it did not appear beyond doubt that the plaintiffs could prove no set of facts in support of their claim which would entitle them to relief.<sup>11</sup>

Proceeding from a description of the origins of the implied right of civil action under Rule 10b-5, this note will investigate two important judicial developments affecting a plaintiff's standing to maintain an action under the Rule: the "forced seller" theory, with its emphasis on plaintiff's reliance; and the "aborted" transaction cases which emphasize the plaintiff's status as a party to a contract. Finally, tender offer cases arising under Rule 10b-5 will be used to demonstrate the continuing validity of the purchaser-seller limitation and the crucial roles which reliance and contract play in Rule 10b-5 damage suits. The Ninth Circuit's reasoning in support of its grant of standing in *Manor Drug* will then be analyzed in light of these developments. It will be submitted that the theoretical basis for the court's decision is unsound, and that the decision creates a dangerous breach in the standing requirements for suits under Rule 10b-5 which can only exacerbate an already chaotic situation.

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<sup>6</sup> 17 C.F.R. § 240.10b-5 (1973), provides:

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

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

<sup>7</sup> See 492 F.2d at 146 (dissenting opinion). This figure is arrived at as follows: The total number of shares (621,600) was to be divided into lots of three to be offered together with a \$100 debenture as a unit. Therefore, there would be 207,200 units each having a market value of \$315 but to be offered to the non-stockholding users for \$101. See text at note 4 supra. The difference, \$214, multiplied by the number of units is \$20,927,200. However, not all of the non-stockholding users are suing here; therefore, the total amount sought in damages would be less than the hypothetical maximum.

<sup>8</sup> 193 F.2d 461 (2d Cir.), cert. denied, 343 U.S. 956 (1952).

<sup>9</sup> 464 F.2d 339, 341-42 (9th Cir. 1972).

<sup>10</sup> *Manor Drug Stores v. Blue Chip Stamps*, 339 F. Supp. 35 (C.D. Cal. 1971).

<sup>11</sup> *Id.*, citing *Conley v. Gibson*, 355 U.S. 41, 45-46 (1957).

THE IMPLIED CIVIL REMEDY UNDER RULE 10b-5

Rule 10b-5<sup>12</sup> was promulgated by the SEC in 1942 to implement the protections afforded "investors"<sup>13</sup> under section 10(b) of the Securities Exchange Act of 1934 (the 1934 Act).<sup>14</sup> On its face, Rule 10b-5 provides for no private right of action to enforce its sanctions or to recover for injuries resulting from a violation of the Rule.<sup>15</sup> However, beginning with the seminal decision in *Kardon v. National Gypsum Co.*,<sup>16</sup> every court which has considered the question has found a private right of action implied in the language of section 10(b) and Rule 10b-5.<sup>17</sup> In *Kardon*, the court based the implied right of action on alternative theories: statutory tort and statutory voidability.<sup>18</sup> The statutory tort theory is grounded on section 286 of the Restatement of Torts,<sup>19</sup> which states that the invasion of an interest which the statute in question is intended to protect gives to the individual holder of that interest a cause of action in tort provided that the violation is recognized at law as a

<sup>12</sup> 17 C.F.R. § 240.10b-5 (1973). For the text of the Rule, see note 6 supra.

<sup>13</sup> Rule 10b-5 does not contain the term "investors," see note 6 supra, but the courts have determined that the Rule limits "investors" as used in § 10(b) to "purchasers and sellers" of securities. See, e.g., *Herpich v. Wallace*, 430 F.2d 792, 805-06 (5th Cir. 1970). Contra, *Eason v. General Motors Acceptance Corp.*, 490 F.2d 654 (7th Cir. 1973), cert. denied, 42 U.S.L.W. 3595 (U.S. April 24, 1974).

<sup>14</sup> 15 U.S.C. § 78j(b) (1970). Rule 10b-5 was promulgated to protect *sellors* as well as purchasers from fraud in connection with the sale of securities. See *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461, 463-64 (2d Cir. 1952).

<sup>15</sup> For the text of the Rule, see note 6 supra. One commentator maintains that a private right of action under § 10(b) and Rule 10b-5 is contrary to congressional intent, whether the right be express or implied. Ruder, *Civil Liability Under Rule 10b-5: Judicial Revision of Legislative Intent?*, 57 Nw. L. Rev. 627 (1963).

<sup>16</sup> 69 F. Supp. 512 (E.D. Pa. 1946).

<sup>17</sup> See, e.g., *Mutual Shares Corp. v. Genesco, Inc.*, 384 F.2d 540, 543 (2d Cir. 1967); *Ellis v. Carter*, 291 F.2d 270, 272-73 (9th Cir. 1961).

<sup>18</sup> 69 F. Supp. at 513-14.

<sup>19</sup> Restatement of Torts § 286 (1934) provides in pertinent part:

The violation of a legislative enactment by doing a prohibited act, or by failing to do a required act, makes the actor liable for an invasion of an interest of another if:

- (a) the intent of the enactment is exclusively or in part to protect an interest of the other as an individual; and
- (b) the interest invaded is one which the enactment is intended to protect; and,
- (c) where the enactment is intended to protect an interest from a particular hazard, the invasion of the interests results from that hazard; and,
- (d) the violation is a legal cause of the invasion . . . .

Compare this 1934 statement of the implied liability arising from a statutory tort with Restatement (Second) of Torts § 286 (1965), especially comment *d*. The emphasis in the more recent Restatement is upon deriving a standard of conduct from the terms of a statute rather than explicitly creating a basis for liability when the terms of a statute are transgressed, as in the original Restatement § 286. It is of interest to observe that the implied liability for violations of Rule 10b-5 is derived from the section of the Restatement dealing with negligence. Another continuing controversy in the 10b-5 area is whether or not scienter is required to establish liability for fraud where the plaintiff is seeking damages. See Comment, *Lansa v. Drexel & Co.* and Rule 10b-5: Approaching the Scienter Controversy in Private Actions, 15 B.C. Ind. & Com. L. Rev. 526 (1974), and cases cited therein.

cause of the invasion. Under this theory, a person injured by any fraudulent activity employed in connection with the purchase or sale of any security would have standing to establish a claim for relief under Rule 10b-5.

The statutory voidability theory is based on section 29(b) of the 1934 Act.<sup>20</sup> The reasoning here is that, if a violation of Rule 10b-5 renders a contract void, the injured party to the contract must have a remedy with respect to that contract. As stated by the court in *Kardon*:

The statute would be of little value unless a party to the contract could apply to the Courts to relieve himself of obligations under it or to escape its consequences. . . . [S]uch suits would include not only actions for rescission but also for money damages.<sup>21</sup>

It is crucial at this point to observe that the right to a civil remedy under Rule 10b-5 is implied only from the invasion of a legally protected interest of an individual to whom the law extends a remedy, and/or from a theory grounded in the standard law of contracts. If the plaintiff cannot establish either that he is a member of the class of persons which the statute was designed to protect, or that his rights are based on contract, he has no standing to sue and may not recover under Rule 10b-5. Although the Supreme Court has removed any lingering doubt that an implied right of action does exist under Rule 10b-5,<sup>22</sup> the issue remains as to who has standing to bring such an action.<sup>23</sup>

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<sup>20</sup> 15 U.S.C. § 78cc(b) (1970), which provides in pertinent part: "Every contract made in violation of any provision of this chapter or of any rule or regulation thereunder . . . shall be void."

<sup>21</sup> 69 F. Supp. at 514.

<sup>22</sup> "It is now established that a private right of action is implied under §10(b)." *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 13 n.9 (1971).

<sup>23</sup> A full discussion of standing is beyond the scope of this note; a short outline must suffice. Most of the standing suits which have been decided by the Supreme Court have involved citizen challenges to administrative action. See, e.g., *Association of Data Processing Serv. Organizations, Inc. v. Camp*, 397 U.S. 150 (1970); *Flast v. Cohen*, 392 U.S. 83 (1968). These cases enunciated the premise that, in all suits before a federal court, there is an irreducible constitutional component to standing found in the "case" and "controversy" requirement of Article III of the United States Constitution: the plaintiff must have a "personal stake" in the outcome of the case. *Flast v. Cohen*, supra at 94, 101; *Herpich v. Wallace*, 430 F.2d 792, 805 (5th Cir. 1970). Beyond this constitutional requirement, however, the Supreme Court has stated that the plaintiff challenging administrative action must also show that the interest he seeks to protect is arguably within the zone of interests to be protected or regulated by the statute or constitutional guarantee in question. *Data Processing*, supra at 153. But see Justice Brennan's criticism of this non-constitutional requirement in his separate opinion in the companion cases of *Data Processing* and *Barlow v. Collins*, 397 U.S. 159, 167-69 (1970) (separate opinion).

When the plaintiff seeks to gain standing on the basis of the violation of a statute, on the other hand, it seems clear that he must bring himself within the class of persons the interests of which the statute was designed to protect, in addition to showing the requisite personal stake. *Herpich v. Wallace*, supra at 805-06; *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461,

LIMITATIONS ON THE IMPLIED RIGHT OF ACTION

The language of Rule 10b-5 is extremely broad: "It shall be unlawful for any person, directly or indirectly, . . . [t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."<sup>24</sup> If the terms were taken literally, brokers and issuers of securities could be transformed into insurers with respect to the securities which find their way into any investor's hands. This is especially true if liability under Rule 10b-5 is not conditioned upon a finding of scienter.<sup>25</sup> Exposing brokers and issuers (and any other person who purchases or sells securities) to such unlimited liability could have a devastating effect upon the operation of securities markets.<sup>26</sup>

Therefore, beginning with the landmark case of *Birnbaum v. Newport Steel Corp.*,<sup>27</sup> the courts have sought to limit the application of Rule 10b-5.<sup>28</sup> The *Birnbaum* court, after reviewing the legislative history of section 10(b) and the administrative history of Rule 10b-5, formulated a tripartite limitation on the scope of the Rule. The protections of the Rule are aimed at (a) the "defrauded purchaser or seller" of securities who is injured by (b) "that type of misrepresentation or fraudulent practice usually associated with the sale or purchase of securities," (c) "rather than at fraudulent mismanagement of corporate affairs."<sup>29</sup> The two substantive limitations, (b) and (c), have gradually been eroded to the point at which they are virtually eliminated.<sup>30</sup> The procedural limitation, com-

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464 (2d Cir.), cert. denied, 343 U.S. 956 (1952); cf. *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 12-13 (1971). The question is whether the plaintiff, under the pleading, can prove any set of facts which would entitle him to relief under the statute. *Conley v. Gibson*, 355 U.S. 41, 45-46 (1957). The determination of standing is not limited to considerations of financial injury to the plaintiff; indeed, he may have suffered economic loss and still be barred from bringing his suit in federal court. Cf. *Herpich v. Wallace*, supra at 810. Therefore, even though the plaintiff could show that he would have a personal stake in the outcome, he must still bring himself within the terms of the statute in order to establish standing.

The Supreme Court has not ruled on the specific basis for standing in a Rule 10b-5 suit. See *Superintendent of Ins.*, supra at 13 n.10, where the Court expressly declined to rule on standing issues. Cf. *Eason v. General Motors Acceptance Corp.*, 490 F.2d 654, 661 (7th Cir. 1973).

<sup>24</sup> 17 C.F.R. § 240.10b-5 (1973). For the full text of the Rule, see note 6 supra.

<sup>25</sup> See note 19 supra.

<sup>26</sup> See 492 F.2d at 147 n.8 (dissenting opinion).

<sup>27</sup> 193 F.2d 461, 464 (2d Cir.), cert. denied, 343 U.S. 956 (1952).

<sup>28</sup> *Rekant v. Desser*, 425 F.2d 872, 877 (5th Cir. 1970).

<sup>29</sup> 193 F.2d at 464.

<sup>30</sup> The Supreme Court and the Second Circuit have definitely rejected the idea that the type of fraud covered by Rule 10b-5 is limited to that usually associated with the sale or purchase of securities. The Supreme Court quoted the Second Circuit with approval:

"We believe that § 10(b) and Rule 10b-5 prohibit *all* fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception. Novel or atypical methods should not provide immunity from the securities laws."

monly known as the "purchaser-seller limitation," has come under severe attack<sup>31</sup> since its introduction, but has been retained in various forms.<sup>32</sup> Thus far, only one court of appeals has totally rejected it;<sup>33</sup> the other courts of appeals have adopted and retained it probably from fear that not to do so would flood the federal courts with litigation.<sup>34</sup> Although not discarded, the purchaser-seller limitation has undergone considerable evolution since its original formulation in 1952.<sup>35</sup> Two modifications which have had a great impact on the standing issue under Rule 10b-5 are the "forced seller" cases and the "aborted" purchase or sale situations.

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Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 11 n.7 (1971), quoting A.T. Brod & Co. v. Perlow, 375 F.2d 393, 397 (2d Cir. 1967).

The nucleus of the other substantive limitation, namely, that Rule 10b-5 does not encompass internal corporate mismanagement, has survived but has been severely circumscribed. The Supreme Court has indicated that only where the sole issue is corporate mismanagement does the case fall outside the scope of Rule 10b-5. *Superintendent of Ins.*, supra at 12. See *Dyer v. Eastern Trust & Banking Co.*, 336 F. Supp. 890, 913 (D. Me. 1971). See generally A. Bromberg, *Securities Law: Fraud—SEC Rule 10b-5*, § 4.7(522) (1973).

<sup>31</sup> Only the Seventh Circuit has flatly rejected the *Birnbaum* purchaser-seller limitation. *Eason v. General Motors Acceptance Corp.*, 490 F.2d 654, 661 (7th Cir. 1973). The Supreme Court, by a 5-3 vote, declined, however, to grant certiorari. 42 U.S.L.W. 3595 (U.S. April 22, 1974). The *Eason* court treated standing as a pure jurisdictional question divorced from any inquiry into the plaintiff's status as a member of a class which the statute is designed to protect. *Id.* at 657. But see note 23 supra. However, the court then proceeded to investigate whether the plaintiffs there, who were neither purchasers nor sellers, "were members of the class for whose special benefit Rule 10b-5 was adopted." *Id.* at 658. In the final analysis, it seems that the court substituted the status of "investor" for "purchaser-seller" as a standing limitation on 10b-5. *Id.* at 659-60. It furthermore appears that the court was explicitly inviting the Supreme Court to define the scope of the class entitled to relief under 10b-5 by creating this stark conflict among the circuits. *Id.* at 661.

<sup>32</sup> See *Rekant v. Desser*, 425 F.2d 872, 877 (5th Cir. 1970). The SEC has repeatedly requested that the courts overrule *Birnbaum* and discard the purchaser-seller limitation. See, e.g., *Mount Clemens Indus., Inc. v. Bell*, 464 F.2d 339, 341 (9th Cir. 1972); *Iroquois Indus., Inc. v. Syracuse China Corp.*, 417 F.2d 963, 967 (2d Cir. 1969), cert. denied, 399 U.S. 909 (1970).

<sup>33</sup> *Eason v. General Motors Acceptance Corp.*, 490 F.2d 654 (7th Cir. 1973). See note 31 supra. One district court thought that the *Birnbaum* purchaser-seller limitation had been totally eliminated, *Entel v. Allen*, 270 F. Supp. 60, 69-70 (S.D.N.Y. 1967), but the Second Circuit rejected this view and reaffirmed the authority of *Birnbaum* in damage actions, *Greenstein v. Paul*, 400 F.2d 580, 581 (2d Cir. 1968).

<sup>34</sup> *Bound Brook Water Co. v. Jaffe*, 284 F. Supp. 702, 708 (D.N.J.), amended complaint dismissed, [1967-69 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 92,243, at 97,140 (D.N.J. 1968); but see *Eason*, 490 F.2d at 660-61.

<sup>35</sup> Cf. *Mutual Shares Corp. v. Genesco, Inc.*, 384 F.2d 540, 543-44 (2d Cir. 1967). The purchaser-seller limitation has been eliminated in suits seeking injunctive relief. See, e.g., *Kahan v. Rosenstiel*, 424 F.2d 161, 173 (3d Cir.), cert. denied, 398 U.S. 950 (1970); *Tully v. Mott Supermarkets, Inc.*, 337 F. Supp. 834, 841 (D.N.J. 1972). Contra, *Greater Iowa Corp. v. McLendon*, 378 F.2d 783, 791 (8th Cir. 1967).

In *Manor Drug*, the majority's implied assertion that the plaintiffs could have obtained injunctive relief under the facts presented is completely irrelevant to the issues in the case. Even in the majority's development of its line of reasoning, it is a non sequitur; and the inappropriateness of the point is highlighted by the statement in which the majority concedes that requirements for maintaining an action are more stringent in a damage suit (which is the case in *Manor Drug*) than in an action for prophylactic relief.

THE "FORCED SELLER"—RELIANCE

The "forced seller" doctrine emerged from the Second Circuit's decision in *Vine v. Beneficial Finance Co.*<sup>36</sup> In that case, the plaintiff (Vine) sued Beneficial Finance Company for damages he allegedly sustained when Beneficial fraudulently accomplished a short form merger with Crown Finance Company in which Vine was a Class A stock minority shareholder. Vine claimed that the board of directors of Crown conspired with Beneficial, with the result that most of the money which Beneficial was to pay to acquire the Crown stock reached the hands of the Crown directors, who owned Class B stock. Beneficial made a tender offer to the Class A shareholders and succeeded in obtaining 95 percent of the outstanding shares although Beneficial paid the shareholders barely half of what the stock was worth. Vine, who had refused to sell, brought suit to recover damages for the defrauded Class A shareholders. The defendants claimed that Vine had no standing since he had not sold his shares. The Second Circuit rejected this argument and stated that, because of Beneficial's fraud, Vine had been placed in the position of a forced seller.<sup>37</sup> Once the merger was completed, the only options remaining to Vine were to hold onto stock in a non-existent corporation, or exchange his shares for money from Beneficial and thereby become a party to a "sale." Concerning the absence of an actual sale, the court said:

It is true that appellant still has his stock; if he turned it in for the price of \$3.29 a share, it would be clearer that appellant is a seller. Assuming that this would not otherwise affect his right to sue under the Act and the Rule, requiring him to do so as a condition to suit seems a needless formality.<sup>38</sup>

The court made it clear that the essential factor in finding Vine to be a "seller" within the meaning of Rule 10b-5 was the *involuntary* nature of the alternatives imposed upon him.<sup>39</sup>

We do not have here a stockholder who refuses to accept a fraudulent offer to purchase his stock but remains a stockholder in an existing corporation; whether to label this . . . person a "seller" under the Rule is a much different question. Due to defendant's acts, Crown has now disappeared

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<sup>36</sup> 374 F.2d 627 (2d Cir.), cert. denied, 389 U.S. 970 (1967).

<sup>37</sup> 374 F.2d at 635.

<sup>38</sup> *Id.* at 634.

<sup>39</sup> *Id.* at 635. Accord, *Crane Co. v. Westinghouse Air Brake Co.*, 419 F.2d 787, 798 (2d Cir. 1969), cert. denied, 400 U.S. 822 (1970). But see Kellogg, *The Inability to Obtain Analytical Precision Where Standing to Sue Under Rule 10b-5 Is Involved*, 20 Buffalo L. Rev. 93, 100-01 (1970-71) (criticizing the court's application of the "forced seller" theory to the facts of *Crane*).



and plaintiff's stock has, in effect, been involuntarily converted into a claim for cash.<sup>40</sup>

Furthermore, the court declared that the plaintiff need not show reliance upon the defendant's fraudulent representations in order to have standing "in the limited instance where no volitional act is required and the result of a forced sale is exactly that intended by the wrongdoer."<sup>41</sup>

However, it is arguably begging the question to concentrate on the question of *plaintiff's* reliance under the "forced seller" concept. The plaintiff in the *Vine* case did not have to do anything to gain standing; the action upon which the court grounded its grant of standing was taken by others. These others arguably did rely: in *Vine*, the selling shareholders relied on Beneficial's fraudulent conduct and tendered their shares. Hence, *someone* relied on the defendant's deception.<sup>42</sup>

<sup>40</sup> 374 F.2d at 634.

<sup>41</sup> Id. at 635. "In essence, because of the distinctive nature of the short form merger procedure, appellee by deceiving A can cause B to become a seller." Id.

The "forced seller" doctrine is a good example of the reasoning processes which courts have pursued in order to expand the classes of plaintiff which may obtain standing under Rule 10b-5 and still adhere to the purchaser-seller limitation which serves to prevent the expansion from becoming an explosion. See *Bound Brook Water Co. v. Jaffe*, 284 F. Supp. 702, 706, 708 (D.N.J. 1968). It is submitted that, if the purchaser-seller limitation is to be retained and such an explosion of litigation is to be avoided, analytical precision and consistency must be the guiding principle when a court considers the facts of a case arising under Rule 10b-5. The confusion surrounding the present state of standing in Rule 10b-5 cases derives largely from a failure by the courts to attain analytical precision. *Kellogg*, supra note 39. See also *Whitaker, The Birnbaum Doctrine: An Assessment*, 23 Ala. L. Rev. 543, 545 (1971). In other words, once a rule of law for standing such as the purchaser-seller limitation has been adopted, a plaintiff should be granted standing only if the facts he alleges logically bring him directly within the purview of the rule. Where a rule depends upon the greatest precision of analysis in order to have any efficacy, it is a dangerously short step from derogation to demise. The problem is further compounded because, every time a broadening of the purchaser-seller limitation is effected, counsel will attempt to bring the facts of his client's case within the holding. See *Mount Clemens Indus., Inc. v. Bell*, 464 F.2d 339, 346-47 (9th Cir. 1972). Therefore, a decision based on imprecise reasoning can create chaos. *Manor Drug*, 492 F.2d at 147 (dissenting opinion).

Logical consistency is lacking in the majority's opinion in *Manor Drug*. The court gave lip service to *Birnbaum* and then proceeded to create an exception to the rule; the opinion is all the more unsettling because the majority apparently thought that it was remaining faithful to *Birnbaum* principles. See text at notes 65-67 *infra*.

<sup>42</sup> See *Boone & McGowan, Standing to Sue Under SEC Rule 10b-5*, 49 Tex. L. Rev. 617, 634 (1971). The Supreme Court stated in *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972), that, "[u]nder the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery." Id. at 153. Furthermore, the Court stated that "[a]ll that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision." Id. at 153-54. Here, the real basis for the plaintiffs' claim may not have been the materiality of the nondisclosure, but reliance. In this case, the plaintiffs may have relied not on any particular conduct of the defendants, but on the *relationship* between themselves and the defendants through which relationship the defendants perpetrated a fraud upon the plaintiffs in connection with their sales of stock. See *A. Bromberg*, supra note 30, § 8.6(2). The Court quoted a finding of the court of appeals that the plaintiffs, who sold their stock,

It is therefore submitted that, even in the "forced seller" situation, it was necessary that someone rely on the defendant's fraudulent conduct and that the plaintiff's injury causally result from that reliance. In other words, the "forced seller" formulation does in fact require that the plaintiff show reliance; it is simply that the reliance need not necessarily be the plaintiff's own. In this case, there was nothing remaining for the plaintiff to do; he could only sell his stock or lose his investment. But, even where the plaintiff had to do nothing, the court's decision is premised upon a showing of reliance by someone. In sum, it may be said that the two crucial factors in the "forced seller" situation are *reliance* by others upon fraudulent representations which places the plaintiff in the position of having to make an *involuntary sale*. Although this case dispensed with the requirement that the plaintiff show individual reliance, an element of reliance is nevertheless central to standing.

In *Manor Drug*, on the other hand, the plaintiffs had a whole host of options open to them; there was no question of involuntary action. The crux of the case was whether the defendants' fraud had actually caused them to act as they did. If the essential requirement of individual reliance<sup>43</sup> is dispensed with in an action for damages in a misrepresentation case where the failure to purchase or sell could have been the result of voluntary choice, the reliance element for Rule 10b-5 standing will be obviated in toto. Although the plaintiffs in *Manor Drug* alleged that they had relied to their detriment upon the defendants' fraudulent representations, they pointed to no affirmative acts taken by them to establish this reliance.<sup>44</sup> Absent any ability to prove such affirmative reliance, or a set of facts which would elevate the plaintiffs to the status of purchasers,<sup>45</sup> the plaintiffs should have been denied standing. The plaintiffs' contention that the magnitude of the bargain of which they failed to take

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"considered these defendants to be familiar with the market for the shares of stock and relied upon them when they desired to sell their shares." 406 U.S. at 152, quoting *Reynos v. United States*, 431 F.2d 1337, 1347 (10th Cir. 1970).

Consideration of cases involving the nondisclosure of a material fact as a violation of Rule 10b-5 is beyond the scope of this note. See, e.g., *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969). However, the quoted passages above from the Supreme Court's opinion in *Affiliated Ute Citizens*, supra, indicate that the standard of proof for causation in nondisclosure cases may be substantially different from causation (as evidenced by reliance) in misrepresentation cases. Perhaps, in addition to the "reasonable investor" test enunciated by the Court, there should be added the requirement that the plaintiff prove that it is reasonable to infer that he *individually* would have considered the nondisclosed fact to be material. This would serve to protect the defendant from unlimited liability by establishing a standard similar to the individual reliance test in misrepresentation cases. See text at notes 51-54 infra.

<sup>43</sup> See *Britt v. Cyril Bath Co.*, 417 F.2d 433, 436 (6th Cir. 1969); *Neuman v. Electronic Specialty Co.*, [1969-70 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 92,591, at 98,704 (N.D. Ill. 1969); 6 L. Loss, *Securities Regulation* 3876-77 (Supp. 1969); A. Bromberg, supra note 30, § 8.6(1).

<sup>44</sup> See 492 F.2d at 140.

<sup>45</sup> See text at notes 60-62 infra.

advantage was "so great as to provide, prima facie, an objective basis for a factual inference that [non-stockholding] users properly informed rather than misled would have accepted the offer"<sup>46</sup> may be accepted arguendo, but it will not serve as a substitute for *individual reliance* which forms the basis for standing in Rule 10b-5 damage actions based upon misrepresentations.

An argument based upon inferential reliance was presented to the United States District Court for the Northern District of Illinois in *Neuman v. Electronic Specialty Co.*,<sup>47</sup> where the plaintiffs claimed that reliance could be inferred from alleged misrepresentations alone, and that they need not show that any particular plaintiff had in fact failed to tender in reliance upon the defendant's statements.<sup>48</sup> The court rejected this inference and maintained that, absent a showing of affirmative reliance, the failure to tender could be imputed to "a reason such as avoidance of capital gains tax, or simply . . . inertia."<sup>49</sup> Accordingly, the court made it clear that only those plaintiffs who could point to an affirmative act constituting actual reliance would be permitted to sue.<sup>50</sup>

Similarly, in *Manor Drug*, there was no showing by the plaintiffs of reliance in fact on the statements in the prospectus. Nor did the plaintiffs' complaint negate the equally plausible inferences that their failure to purchase the units resulted from lack of financial ability, inertia, or actual rejection of the offer (which did not have to be communicated to the defendants). *Manor Drug* vividly reveals the dangers which a relaxation or elimination of the reliance element could entail.<sup>51</sup> Here, the plaintiffs, who may well have failed to take advantage of the bargain because they were financially unable, or had made a positive decision not to avail themselves of it, or had simply let the offer slip by, have now been granted standing to sue for the benefits they previously failed to obtain.<sup>52</sup> The discovery of the defendants' fraud may have been entirely fortuitous; but the plaintiffs may be able to realize a fortune because of it. Concededly, there will be some among the group of plaintiffs who really were deterred from purchasing because of the fraud; but, the fact that the defendants' reprehensible behavior allegedly caused injury to some

<sup>46</sup> 492 F.2d at 142.

<sup>47</sup> [1969-70 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 92,591, at 98,701 (N.D. Ill. 1969).

<sup>48</sup> Id. at 98,705.

<sup>49</sup> Id.

<sup>50</sup> Id. at 98,706.

<sup>51</sup> Cf. Boone & McGowan, *supra* note 45, at 622; Ruder, *supra* note 15, at 679-80.

<sup>52</sup> Such recovery would be in direct contradiction to § 28(a) of the 1934 Act, 15 U.S.C. § 78bb(a) (1970), which limits recovery under the 1934 Act to "actual damages." See note 53 *infra*. See also Restatement of Torts § 549, comment *b* (1938); Restatement (Second) of Torts § 549 (Tent. Draft No. 10, 1964). The new § 549(2) would allow a "benefit of the bargain" recovery as an alternative to "out of pocket" losses caused by the fraud. *Id.* But recovery under the "benefit of the bargain" rule is predicated on the existence of a contract which was not performed.

plaintiffs<sup>53</sup> does not perforce require a federal remedy under Rule 10b-5.<sup>54</sup>

Therefore, where the plaintiff offers no affirmative proof of reliance on the fraudulent conduct, he should be denied standing under Rule 10b-5. However, there may be other circumstances where, even though there has been only a constructive sale or purchase, the plaintiff may nevertheless bring suit—the “aborted” transaction.

#### THE “ABORTED” PURCHASER OR SELLER—CONTRACT

The essential notion underlying the “aborted” transaction rule<sup>55</sup> is that the plaintiff need not be a purchaser or seller to maintain standing, but he must allege facts which could prove that he would have become a purchaser or seller but for the defendant’s fraud.<sup>56</sup> In *Commerce Reporting Co. v. Puretec, Inc.*,<sup>57</sup> Commerce Reporting Company had entered into an agreement with Puretec, Inc. and other defendants whereby Puretec was to sell all of its stock and business to Commerce or its assigns. Commerce then contracted to assign its purchase rights to the Puretec stock to Granite Equipment Leasing Company in exchange for 5000 shares of Granite’s stock. Puretec consented to the assignment; subsequently, however, it found a higher bidder for its stock and announced that it would sell to that person. Commerce sued under Rule 10b-5, claiming that, but for Puretec’s fraud, its purchase of the Puretec stock would have been completed,<sup>58</sup> and that its sale of securities to Granite would have been consummated.<sup>59</sup> The court found standing to sue on both allegations and maintained that the use of the expansive phrase “in connection with” in section 10(b) indicated that Congress sought to protect against fraud affecting agreements to buy or sell, as well as fraud connected with completed sales or purchases, provided that injury could be shown.<sup>60</sup> It may be inferred that the agreement that

<sup>53</sup> The plaintiffs in *Manor Drug* should be permitted to amend their complaint to allege facts which could prove individual reliance and thereby gain standing. It is significant in this connection to observe that § 28(a) of the 1934 Act, 15 U.S.C. § 78bb(a) (1970), does not provide for punitive damages. Therefore, there should be no award of punitive damages under Rule 10b-5. *Green v. Wolf Corp.*, 406 F.2d 291 (2d Cir. 1968), cert. denied, 395 U.S. 977 (1969). See A. Bromberg, supra note 30, § 9.1. Accordingly, where a plaintiff cannot establish the amount of actual damages, the court is powerless to impose liability even though the court believes that the imposition of liability would deter similar frauds in the future. See *Commerce Reporting Co. v. Puretec, Inc.*, 290 F. Supp. 715, 719 (S.D.N.Y. 1968).

<sup>54</sup> *Herpich v. Wallace*, 430 F.2d 792, 809 (5th Cir. 1970); *Iroquois Indus., Inc. v. Syracuse China Corp.*, 417 F.2d 963, 969 (2d Cir. 1969).

<sup>55</sup> See generally 6 L. Loss, supra note 43, at 3614-20.

<sup>56</sup> Whitaker, supra note 41, at 568.

<sup>57</sup> 290 F. Supp. 715 (S.D.N.Y. 1968).

<sup>58</sup> Id. at 718-19.

<sup>59</sup> Id. at 719.

<sup>60</sup> Id. at 718. The court stated that, while a failure to consummate the purchase may sometimes make it impossible for the plaintiff to prove damages and may thus preclude recovery under Rule 10b-5, the plaintiff’s simultaneous agreement to assign the Puretec stock

Commerce entered into with Puretec would elevate Commerce to the status of a statutory purchaser within the meaning of section 3(a)(13) of the 1934 Act.<sup>61</sup> In addition, Commerce's sale and assignment of its contract rights would give Commerce the status of a statutory seller under section 3(a)(14).<sup>62</sup>

The sine qua non of standing in the "aborted" transaction situations is the existence of an *agreement* or *contract* for the sale or purchase of securities coupled with either fraudulent acts of the defendant which prevented the plaintiff from performing according to the contract, or the defendant's fraudulent failure to perform which damaged the plaintiff.<sup>63</sup> The cases which have granted standing on the basis of an "aborted" transaction have not discarded the requirement that the plaintiff be a purchaser or seller.

It is true that the purchaser-seller requirement has been liberalized by expanded definitions of "purchaser" and "seller." . . . In each of [the cited] cases, however, the plaintiff was found to be an actual or constructive "seller" or "purchaser" of shares, and the fraud alleged was in connection with such sale or purchase. The purchaser-seller requirement was not eliminated.<sup>64</sup>

Applying the "aborted" purchase rationale to the facts in *Manor Drug*, it can be seen that the plaintiffs failed to bring themselves

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to Granite indicated the availability of an appropriate measure of the plaintiff's injury. *Id.* at 719. In *Manor Drug*, the court reasoned in the opposite direction. The court used the consent decree to establish the measure of damages and, *a posteriori*, found the functional equivalent of a contract. 492 F.2d at 142. See note 66 *infra*. This reasoning fails on two grounds: (a) the majority's measure was not the true measure of damages, but merely the hypothetical maximum amount of the defendants' liability, see note 7 *supra*; (b) the contract must be found first, from which the measure of damages can be determined, as in *Commerce Reporting*. It was logically inaccurate for the court to reason in, *a posteriori* fashion. One cannot deduce that a contract exists merely because some contract-like elements are present. A contract is a conceptual synthesis of its necessary elements; when all of these elements are present, a contract is deemed to exist. Perhaps the only two elements which are strictly necessary are an offer and an acceptance (both broadly defined)—in any event, at least these two elements *must* be present for a contract to exist. See Restatement of Contracts §§ 20, 22 (1932); Uniform Commercial Code §§ 2-204 to -206. In *Manor Drug*, there was no acceptance (or conduct indicating acceptance, see Uniform Commercial Code § 2-204(1)); therefore, it follows, that there was no contract. In fact, it may be argued that a number of the factors which the court considered to be indicia of a contractual relationship are not essential to a contract, e.g., price and quantity. See Uniform Commercial Code § 2-204(3). Of course, these elements would be necessary to determine damages, but they are not essential for the existence of the contract, for the violation of which the damages are sought. *Manor Drug*, 492 F.2d at 144 (dissenting opinion).

<sup>61</sup> 290 F. Supp. at 719. Section 3(a)(13), 15 U.S.C. § 78c(a)(13) (1970), provides: "The terms 'buy' and 'purchase' each include any contract to buy, purchase, or otherwise acquire."

<sup>62</sup> 290 F. Supp. at 719. Section 3(a)(14), 15 U.S.C. § 78c(a)(14) (1970), provides: "The terms 'sale' and 'sell' each include any contract to sell or otherwise dispose of."

<sup>63</sup> See, e.g., *Mount Clemens Indus., Inc. v. Bell*, 464 F.2d 339, 345 (9th Cir. 1972); *Goodman v. H. Hentz & Co.*, 265 F. Supp. 440, 444-45 (N.D. Ill. 1967).

<sup>64</sup> *Dyer v. Eastern Trust & Banking Co.*, 336 F. Supp. 890, 912 (D. Me. 1971) (citations omitted).

within the ambit of the theory. They did not allege any circumstances that would entitle them to have been considered constructive, or statutory, purchasers. It is submitted that the majority erred in finding otherwise. After reviewing "aborted" transaction cases, including the Ninth Circuit decision in *Mount Clemens Industries, Inc. v. Bell*,<sup>65</sup> the court concluded that "the consent decree involved here serves the same function as the contractual relationship"<sup>66</sup> necessary to confer upon the plaintiffs "statutory purchaser" status within the meaning of Rule 10b-5; and, more specifically, that the alleged facts brought the plaintiffs within the "aborted" purchaser doctrine.<sup>67</sup> However, the reasoning which the *Manor Drug* court advanced to support this finding is spurious.

After noting that the plaintiffs could not have directly enforced the consent decree,<sup>68</sup> the court proceeded to demonstrate the way in which the consent decree was nevertheless sufficiently like a contract to justify the grant of standing. The contractual characteristics were found in that the decree: (a) required the defendants to offer (b) particular securities to (c) a particular group of persons (d) for a fixed price and (e) in a fixed amount.<sup>69</sup> The court furthermore stated that the plaintiffs had "a right to buy those securities at a fixed price and in a fixed amount."<sup>70</sup>

Regardless of all these indicia of a contract, however, the essential elements of a true contract are missing. No promise was made by the defendants to the plaintiffs; although the consent decree presented the plaintiffs with a lucrative opportunity, *i.e.*, a "bargain," there was no bargain in the contractual sense. The "parties" here neither exchanged nor made an agreement to exchange any consideration. Manor Drug had no contract rights which it could enforce; the law provided it no remedy should the defendant fail to fulfill the terms of the decree. There was no duty upon the defendant to perform any promise to Manor Drug—the promise or duty ran between the defendant and the government.<sup>71</sup> If the arrangement is viewed as analogous to a "firm offer"<sup>72</sup> which the

<sup>65</sup> 464 F.2d 339 (9th Cir. 1972).

<sup>66</sup> 492 F.2d at 142. The majority apparently realized the weakness of the comparison between a contractual relationship and the consent decree because, in the original opinion in *Manor Drug*, the majority stated that the consent decree was the "functional equivalent" of a contractual relationship. [1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,191, at 94,820. The weaker language in the modified opinion serves only to vitiate the majority's analogy. Also note the new final paragraph in the modified opinion, 492 F.2d at 142.

<sup>67</sup> 492 F.2d at 142.

<sup>68</sup> *Id.* at 142 n.14.

<sup>69</sup> *Id.* at 142.

<sup>70</sup> *Id.* (emphasis added).

<sup>71</sup> *Id.* at 138-39, 144 (dissenting opinion). Restatement of Contracts § 1 (1932) states: "A contract is a promise or a set of promises for the breach of which the law gives a remedy, or the performance of which the law in some way recognizes as a duty." Restatement (Second) of Contracts § 1 (Tent. Draft No. 1, 1964) contains identical wording.

<sup>72</sup> See generally Uniform Commercial Code § 2-205. Cf. *Eason v. General Motors Acceptance Corp.*, 490 F.2d 654, 658 (7th Cir. 1973).

defendant was required to extend to Manor Drug, still there was no contract formed because there was no acceptance.<sup>73</sup>

It is manifest that the plaintiffs could not claim relief under the consent decree because they were not a party to it. The majority recognized this.<sup>74</sup> But the majority, after effectively admitting that no contract or functional equivalent of one existed, proceeded to say that that fact does not bar the plaintiffs' suit because the suit is not based on a violation of the consent decree but on a violation of Rule 10b-5.<sup>75</sup> The fact that there was a violation of Rule 10b-5, however, is of no avail to the plaintiffs. In order to take advantage of Rule 10b-5 and the "aborted" purchaser doctrine, the plaintiffs must be able to point to some agreement or contract.<sup>76</sup> The consent decree will not serve the same function as a contract, as the majority declared. An arrangement which lacks the most essential ingredient of the offeree's contribution—acceptance—cannot possibly serve the same function as a contract. The criterion which the majority itself states must be present in order for the "aborted" purchaser rule to apply—the prerequisite which is satisfied by the existence of a contract—is entirely absent in *Manor Drug*: "proof . . . that the non-purchaser would in fact have purchased but for the fraud . . ."<sup>77</sup> Only a contract can "furnish objective evidence of the reality of a plaintiff's intention to purchase . . ."<sup>78</sup> The criterion was not established merely by adopting the plaintiffs' contention that the "bargain" was so attractive that any reasonable person who had not been misled would have snapped it up.<sup>79</sup>

The majority in *Manor Drug* fully approved the Ninth Circuit decision in *Mount Clemens Industries, Inc. v. Bell*,<sup>80</sup> which it had decided the previous year. The plaintiffs in *Mount Clemens* claimed that they were prevented from purchasing securities at a sheriff's sale because they had relied on the fraudulent representation that

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<sup>73</sup> "[A]n offeree can 'accept' an offer and form a contract only (1) by making a counter promise and thus entering a 'bilateral contract,' or (2) by doing a requested act, and thus binding the other party to a 'unilateral contract.'" L. Fuller & M. Eisenberg, *Basic Contract Law* 322-23 (3d ed. 1972).

<sup>74</sup> 492 F.2d at 142 n.14.

<sup>75</sup> *Id.*

<sup>76</sup> *Mount Clemens Indus., Inc. v. Bell*, 464 F.2d 339, 345 (9th Cir. 1972).

<sup>77</sup> 492 F.2d at 141.

<sup>78</sup> *Id.* at 142.

<sup>79</sup> See text at note 46 *supra*. An extremely interesting comment made by the court appears near the end of the opinion: "It is also alleged that 60 per cent of those non-stockholding users who did purchase the units offered them had information as to value not made available by the defendant-appellees in the prospectus." *Manor Drug*, 492 F.2d at 142. From this statement, it follows that 40% of those who did purchase had the same information available to them as did the plaintiffs. Why did they purchase while the plaintiffs refrained from doing so? See text at note 49 *supra*. The implication, urged by the plaintiffs, that the fraudulent information supplied by defendants served as an all but absolute bar to purchase seems considerably weakened in light of this action on the part of other non-stockholding users.

<sup>80</sup> 464 F.2d 339 (9th Cir. 1972).

the securities were worthless.<sup>81</sup> The *Mount Clemens* court conceded that the facts of the case were very similar to the "aborted" purchase cases but that one crucial element was missing: "The lack of a prior contractual relationship . . . is fatal to the contention of the appellants here that they should be afforded standing as 'purchasers' under the rationale of the 'aborted purchaser-seller' cases."<sup>82</sup> The plaintiffs simply had not provided any basis upon which a contractual relationship could be found, regardless of how liberally the term "contract" was construed.<sup>83</sup> Furthermore, the court refused to accept the SEC's contention that *Birnbaum* was incorrectly decided and that the purchaser-seller limitation was too restrictive.<sup>84</sup> Instead, the court adopted the *Birnbaum* doctrine for the Ninth Circuit because it found "substantial and compelling reasons why standing to sue for money damages under [section 10(b) and Rule 10b-5] should be so limited."<sup>85</sup>

The majority in *Manor Drug* attempted to distinguish *Mount Clemens* on its facts by stating that, in *Manor Drug*, "[a]n informed decision by plaintiff-appellant to purchase these shares could not have been thwarted by the intervention of an earlier or higher bidder, as in *Mount Clemens* . . ."<sup>86</sup> But it is clear that the plaintiffs in *Mount Clemens* were denied standing not because a higher bidder could have intervened, but because they failed to show any agreement with the defendant to purchase stock.<sup>87</sup> *Manor Drug* is, therefore, factually indistinguishable from *Mount Clemens*, and *Mount Clemens* should have controlled *Manor Drug*.<sup>88</sup>

#### THE TENDER OFFER CASES

Perhaps the most striking testimonial to the continuing vitality of the *Birnbaum* purchaser-seller limitation as found in *Mount Clemens* can be found in the cases dealing with "aborted" tender offers where the plaintiff did not attempt to sell his shares pursuant to the tender offer because he relied on the fraudulent representations of the defendant. In *Iroquois Industries, Inc. v. Syracuse China Corp.*,<sup>89</sup> Iroquois Industries invited shareholders of Syracuse China to tender their shares for purchase. The management of Syracuse resisted the tender offer and fraudulently informed the

<sup>81</sup> Id. at 345.

<sup>82</sup> Id. at 346 (footnote omitted).

<sup>83</sup> Id. at 346 n.12.

<sup>84</sup> Id. at 341. The SEC appeared as amicus curiae. See note 32 supra.

<sup>85</sup> Id. at 342.

<sup>86</sup> 492 F.2d at 142 n.15.

<sup>87</sup> 464 F.2d at 345-46 n.11.

<sup>88</sup> See 492 F.2d at 143 n.1 (dissenting opinion). A possible explanation for this inconsistency is that the panel which decided *Mount Clemens*, 464 F.2d at 340, was different from the panel in *Manor Drug*, 492 F.2d at 138. Two of the judges on the *Mount Clemens* panel voted to rehear *Manor Drug* en banc. 492 F.2d at 136.

<sup>89</sup> 417 F.2d 963 (2d Cir. 1969), cert. denied, 399 U.S. 909 (1970).



shareholders that Syracuse was negotiating a very favorable merger with another company; the shareholders were advised not to tender. As a result, Iroquois' effort failed. When Iroquois discovered the fraud, it brought suit against Syracuse and its directors. The Second Circuit reaffirmed *Birnbaum*<sup>90</sup> and ruled that, since the plaintiff had not accepted tendered shares (*i.e.*, was not a purchaser), it had no standing to sue under Rule 10b-5.<sup>91</sup> In support of its position, the court referred to amendments to the Securities Exchange Act of 1934, enacted by Congress in 1968, which were designed to forbid fraud in tender offers,<sup>92</sup> particularly section 14(e).<sup>93</sup>

That Congress enacted the new Section 14(e) to prohibit fraud by "any person" in respect to tender offers is at least an indication that in tender offer contests such as that at bar there was no standing to sue under Rule 10b-5 by either the tender offeror or by the target corporation.<sup>94</sup>

The plaintiff in *Iroquois* was denied standing because it could point to no affirmative acts which would signify a contractual relationship to make it a constructive purchaser. In *Manor Drug*, the same argument may be applied to the plaintiffs who did nothing affirmative to show their intention to actually purchase stock.<sup>95</sup>

At first sight, *Neuman v. Electronic Specialty Co.*<sup>96</sup> appears to extend standing to non-sellers in a tender offer situation. In *Neuman*, a tender offer was made to the shareholders of Electronic

<sup>90</sup> 417 F.2d at 970.

<sup>91</sup> *Id.* at 965-70. See A. Bromberg, *Securities Law: Fraud—SEC Rule 10b-5*, § 6.3(1022) (1973).

<sup>92</sup> Pub. L. No. 90-439, 82 Stat. 454 (1968).

<sup>93</sup> 15 U.S.C. § 78n(e) (1970), which provides:

It shall be unlawful for any person to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer or request or invitation for tenders, or any solicitation of security holders in opposition to or in favor of any such offer, request, or invitation. The Commission shall, for the purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative.

The House Report on the bill states that its purpose was to fill a gap in the securities laws by requiring full disclosure by tender offerors to ensure that shareholders make their decisions on the basis of adequate information. H. R. Rep. No. 1711, 90th Cong., 2d Sess., reprinted in U.S. Code Cong. & Ad. News 2812-14 (1968). It appears that, until these amendments were enacted, if an investor refrained from selling, in reliance on fraudulent representations by someone resisting the tender offer, neither the shareholder nor the tender offeror would have standing to sue for damages under Rule 10b-5. *Iroquois*, 417 F.2d at 969-70.

<sup>94</sup> 417 F.2d at 969. See *Lanning v. Serwold*, 474 F.2d 716 (9th Cir. 1973) (tender offeror denied standing even though he alleged fraud since he could show "no relationship with anyone either as a purchaser or seller of the securities involved with the alleged rule violation," *id.* at 718).

<sup>95</sup> See text at note 44 *supra*.

<sup>96</sup> [1969-70 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 92,591, at 98,701 (N.D. Ill. 1969).

Specialty Company (ESC) by International Controls Corp. (IC). The directors of ESC, through false statements made to the ESC shareholders, discouraged the shareholders from tendering. However, on the last day of the duration of the tender offer, the director-defendants withdrew their recommendation that the shareholders not tender and indicated that they themselves would tender their own shares to IC. At the same time, the defendants advised the shareholders that a telegraphic tender would be acceptable to IC, although the defendants in fact knew that such a mode would be unacceptable to IC. Certain of the plaintiffs thereupon sent to IC telegraphic tenders which were rejected. The tender offer expired before the plaintiffs could transmit an alternate means of tender.

The court, in granting standing to sue under Rule 10b-5, took great pains to make it clear that, in order to recover damages,<sup>97</sup> a plaintiff must offer proof that he individually relied on the misrepresentations and, so relying, did not tender.<sup>98</sup> The attempt to accept the tender offer created a contractual relationship between the plaintiffs and IC; but for the defendants' fraud, the tender would have been consummated. The court implied that plaintiffs who made no attempt to tender would be denied standing.<sup>99</sup> In addition, the *Neuman* court brought its holding within the purchaser-seller limitation by stating that the "plaintiffs can . . . be regarded as actual sellers of securities."<sup>100</sup>

#### CONCLUSION

In sum, it may be said that, although the three situations examined—the "forced seller," the "aborted" transaction, and the tender offer—appear to represent erosions of the *Birnbaum* purchaser-seller limitation on standing to sue under Rule 10b-5, they are in reality entirely consistent with the limitation. It has not been discarded or eroded; rather, the definitions of "purchaser" and "seller" have been expanded to include within the purview of Rule 10b-5 persons who were not actual purchasers or sellers but constructive (and, therefore, statutory) purchasers or sellers.

The plaintiffs in *Manor Drug* cannot be described as purchasers, actual or constructive, no matter how flexibly "contract" is interpreted. They therefore should have been denied standing in accordance with the purchaser-seller limitation. The court in *Manor Drug* was faced with a dilemma: it sought to extend the opportunity

<sup>97</sup> The plaintiffs sought to recover the difference between the tender offer price and the price at which the plaintiffs and similarly situated persons could have or did sell their shares after the termination of the tender offer. *Id.* at 98,702.

<sup>98</sup> *Id.* at 98,704. "[T]he problem[s] of causation and measure of damages which appear in considering the private damage remedy under 10b-5 . . . are logically overcome only where individual reliance is proved as a condition of recovery." *Id.* at 98,705-06.

<sup>99</sup> *Id.* at 98,704.

<sup>100</sup> *Id.* at 98,705.

for relief to the injured plaintiffs, but it was hampered by the *Birnbaum* doctrine. Such a situation brings to mind the old adage that "hard cases make bad law." It is submitted that *Manor Drug* did make bad law; while claiming to adhere to the *Birnbaum* rule, the court in fact violated it. The majority was probably disturbed by the fact that the defendants would elude the grasp of the law even though they may have caused injury to some of the plaintiffs. But the concept of standing operates to deny access to the courts to otherwise qualifying plaintiffs. The precise function is to limit the classes of persons who may obtain relief under a statute.<sup>101</sup>

If standing is to be extended to plaintiffs such as those in *Manor Drug*, it should be accomplished legislatively and not judicially.<sup>102</sup> In *Mount Clemens*, the Ninth Circuit recognized the "unquestionably sound principle"<sup>103</sup> stated by the Supreme Court in *Blau v. Lehman*:<sup>104</sup>

Congress can and might amend [the Act] if the Commission would present to it the policy arguments it has presented to us, but we think that Congress is the proper agency to change an interpretation of the Act unbroken since its passage, if the change is to be made.<sup>105</sup>

The court in *Mount Clemens* maintained that, although the statement in *Blau* referred to a request to expand the coverage of section 16(b) of the 1934 Act,<sup>106</sup> the argument applied with equal force to a proposed exception to, or elimination of, the purchaser-seller limitation. Even with such a limitation, the volume of litigation under Rule 10b-5 has been spectacular.<sup>107</sup> Removal of this valve could produce an overwhelming flood of litigation;<sup>108</sup> this apprehension is prominently manifested in the dissenting opinion of Judge Hufstедler in *Manor Drug*.<sup>109</sup>

<sup>101</sup> 492 F.2d at 146 (dissenting opinion).

<sup>102</sup> As a matter of fact, it could be changed by the SEC.

Since all of the jurisprudence in this area rests upon the flimsy foundation of this innocuous-looking rule, the S.E.C. could, if it wanted to, codify the entire subject by merely re-writing the rule. . . . I doubt that it has the slightest desire to accomplish this result.

Marsh, What Lies Ahead Under Rule 10b-5?, 24 Bus. Law. 69, 75 (1968).

<sup>103</sup> 464 F.2d 339, 343 (9th Cir. 1972).

<sup>104</sup> 368 U.S. 403 (1962).

<sup>105</sup> Id. at 413, quoted in *Mount Clemens*, 464 F.2d at 343.

<sup>106</sup> 15 U.S.C. § 78p(b) (1970).

<sup>107</sup> *Mutual Shares Corp. v. Genesco, Inc.*, 384 F.2d 540, 543 (2d Cir. 1967). See A. Bromberg, supra note 95, § 2.5(6). From the plaintiff's point of view, Rule 10b-5 possesses many advantages. The extent of this attractiveness is evidenced by the fact that the cases brought under Rule 10b-5 comprise about one-third of all suits brought under all of the SEC statutes. See id. §§ 2.5(6), 2.7(2), 4.7(120).

<sup>108</sup> *Bound Brook Water Co. v. Jaffe*, 284 F. Supp. 702, 708 (D.N.J.), amended complaint dismissed, [1967-69 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 92,243, at 97,140 (D.N.J. 1968). But see *Eason v. General Motors Acceptance Corp.*, 490 F.2d 654, 660-61 (7th Cir. 1973).

<sup>109</sup> 492 F.2d at 147-48 (dissenting opinion).

In conclusion, it is submitted that the court in *Manor Drug* should have followed its analytically more precise decision in *Mount Clemens* and concluded that the non-purchasing plaintiffs had no standing to sue.

LARRY E. BERGMANN

**Securities—Attorney's Opinion Letter in an Unregistered Sale—Standard of Culpability in SEC Injunction Action—*SEC v. Spectrum, Ltd.***<sup>1</sup>—In an action by the Securities and Exchange Commission (SEC) to enjoin twelve defendants from further alleged violations of the federal securities laws in connection with the illegal sale of unregistered securities,<sup>2</sup> the United States Court of Appeals for the Second Circuit reversed the district court's denial of an injunction<sup>3</sup> in the case of defendant-appellee Stuart Schiffman—an attorney who prepared an opinion letter on the basis of which some of the unregistered securities allegedly were sold—and remanded for an evidentiary hearing to determine the extent of his role in the scheme.<sup>4</sup> The Second Circuit further directed that, should Schiffman be found liable as an aider and abettor of the scheme, the standard of culpability to be applied would be that of negligence.<sup>5</sup>

The *Spectrum* case involves a particularly complex fact situation and a large cast of characters; it is therefore necessary to outline in perhaps greater than usual detail the events leading up to the suit. On April 2, 1971 the SEC filed a complaint charging Spectrum, Ltd. (Spectrum), appellee Schiffman, and ten other defendants with participation in a scheme to distribute unregistered shares of Spectrum in violation of the registration provisions of the Securities Act

<sup>1</sup> 489 F.2d 535 (2d Cir. 1973).

<sup>2</sup> The SEC obtained permanent injunctions against at least ten of the defendants, but was unsuccessful in obtaining a preliminary injunction against defendant-appellee Schiffman. *Id.* at 536. The SEC derives its authority to obtain injunctions from section 20(b) of the Securities Act of 1933, 15 U.S.C. § 77t(b) (1970), and section 21(e) of the Securities Exchange Act of 1934, 15 U.S.C. § 78u(e) (1970). The purpose of such injunctive relief is to prevent further violations of the securities laws by defendants.

The typical SEC fraud injunction restrains the defendant from making any untrue statement of a material fact concerning a number of specific matters, or any untrue statement of a material fact similar to those statements specifically set forth or of similar purport or object. And the typical injunction under § 5 of the Securities Act restrains any further offers or sales of any securities in violation of the registration or prospectus requirement, with an explicit exception normally for exempted securities or transactions.

<sup>3</sup> L. Loss, *Securities Regulation* 1978 (2d ed. 1961) (footnote omitted). Such relief does not usually affect defendants' criminal or private civil liability.

<sup>4</sup> [1972-1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 93,631, at 92,868 (S.D.N.Y. 1972).

<sup>5</sup> 489 F.2d at 541, 543.

<sup>5</sup> *Id.* at 541.