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THE PURCHASER-SELLER LIMITATION TO SEC RULE 10b-5

Section 10(b) of the Securities Exchange Act of 1934¹ and Securities Exchange and Commission Rule 10b-5² provide a private cause of action to persons who have been fraudulently induced to purchase or sell securities.³ When a corporation is fraudulently induced to issue, purchase, or sell securities, it has a cause of action under rule 10b-5 that may be asserted directly by the corporation or derivatively by its shareholders.⁴ Early in the development of rule 10b-5 the requirement emerged that a plaintiff seeking damages resulting from a fraudulent

¹ 48 Stat. 891 (1934), 15 U.S.C. § 78j(b) (1964):

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.

² 17 C.F.R. § 240.10b-5 (1967):

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 an 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.

³ The leading case recognizing civil liability under rule 10b-5 is *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946), *modified*, 73 F. Supp. 798 (E.D. Pa.), *modified*, 83 F. Supp. 613 (E.D. Pa. 1947). Since *Kardon*, civil liability under rule 10b-5 has been upheld by a majority of the circuits of the court of appeals. *E.g.*, *Dasho v. Susquehanna Corp.*, 380 F.2d 262 (7th Cir.), *cert. denied*, 389 U.S. 977 (1967); *Janigan v. Taylor*, 344 F.2d 781 (1st Cir. 1965); *Stevens v. Vowell*, 343 F.2d 374 (10th Cir. 1965); *Hooper v. Mountain States Sec. Corp.*, 282 F.2d 195 (5th Cir. 1960), *cert. denied*, 365 U.S. 814 (1961); *Errion v. Connell*, 236 F.2d 447 (9th Cir. 1956); *Speed v. Transamerica Corp.*, 235 F.2d 369 (3d Cir. 1956); *Fischman v. Raytheon Mfg. Co.*, 188 F.2d 783 (2d Cir. 1951). Civil liability under rule 10b-5 is implied by the decisions of a number of other circuits. *See, e.g.*, *Boone v. Baugh*, 308 F.2d 711 (8th Cir. 1962); *Texas Continental Life Ins. Co. v. Dunne*, 307 F.2d 242 (6th Cir. 1962).

⁴ *Dasho v. Susquehanna Corp.*, 380 F.2d 262 (7th Cir.), *cert. denied*, 389 U.S. 977 (1967) (issuance of shares attending a statutory merger subjects transaction to derivative action under § 10(b)); *Hooper v. Mountain States Sec. Corp.*, 282 F.2d 195 (5th Cir. 1960), *cert. denied*, 365 U.S. 814 (1961) (issuance of shares in return for allegedly spurious assets actionable by corporate trustee in bankruptcy); *see Comment, Securities Regulation: Shareholder Derivative Actions Against Insiders Under Rule 10b-5*, 1966 DUKE L.J. 166; *Note, Shareholders' Derivative Suit To Enforce a Corporate Right of Action Against Directors Under SEC Rule 10b-5*, 114 U. PA. L. REV. 578 (1966).

securities transaction must occupy the position of a purchaser or seller with regard to that transaction.⁵ This restriction has been invoked to deny plaintiffs the benefits⁶ of a 10b-5 action in a growing number of cases.

Arguably, because the Supreme Court has endorsed private enforcement of the proxy rules under section 14a,⁷ it would also endorse similar private enforcement of rule 10b-5. This possibility, together with the recent marked judicial expansion of the scope of rule 10b-5 makes appropriate the reexamination of the need for the purchaser-seller limitation.

I

THE *Birnbaum* DOCTRINE

The purchaser-seller restriction was first imposed upon rule 10b-5 in *Birnbaum v. Newport Steel Corp.*⁸ Newport's minority shareholders

⁵ The requirement that a rule 10b-5 plaintiff must be either a purchaser or seller in the fraudulent transaction should be distinguished from the privity requirement once thought to exist. Some earlier cases established the rule that a plaintiff claiming a violation of rule 10b-5 in a transaction to which he was a party had to show that the transaction was negotiated directly or indirectly with the defendant, rather than, for example, across a national securities exchange. *Joseph v. Farnsworth Radio & Television Corp.*, 99 F. Supp. 701 (S.D.N.Y. 1951), *aff'd per curiam*, 198 F.2d 883 (2d Cir. 1952) (there must be a "semblance of privity"); see *Donovan v. Taylor*, 136 F. Supp. 552 (N.D. Cal. 1955); 3 L. LOSS, *SECURITIES REGULATION 1767* (2d ed. 1961). More recently the privity requirement has been relaxed to the point of extinction. *Cochran v. Channing Corp.*, 211 F. Supp. 239 (S.D.N.Y. 1962); *Freed v. Szabo Food Serv., Inc.*, [1961-1964 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,317 (N.D. Ill. 1964).

By contrast, the purchaser-seller limitation arises when the defendant claims that the plaintiff has not transacted in securities at any time contemporaneous with defendant's alleged fraudulent conduct. The case usually cited as establishing the purchaser-seller limitation is *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952), discussed at pp. 685-87 *infra*. But see *McManus v. Jessup & Moore Paper Co.*, 5 SEC. JUD. DEC. 810 (E.D. Pa. 1948) (under allegations similar to those in *Birnbaum* a motion to dismiss was denied without opinion).

⁶ A plaintiff suing under § 10(b) is not required to comply with the security-for-expenses requirements that some states impose on a person bringing a derivative action. *McClure v. Borne Chem. Co.*, 292 F.2d 824 (3d Cir.), *cert. denied*, 368 U.S. 939 (1961). A plaintiff in federal court by virtue of diversity of citizenship, however, is subject to the state statute. *Cohen v. Beneficial Indus. Loan Corp.*, 337 U.S. 541 (1949). Another advantage in proceeding under the 1934 Act is the availability of its liberal service of process and venue provisions. Securities Exchange Act § 27, 15 U.S.C. § 78aa (1964).

⁷ The proxy rules are contained in the Securities Exchange Act § 14(a), 15 U.S.C. § 78n(a) (1964), and SEC rules promulgated thereunder. The Supreme Court has stated: Private enforcement of the proxy rules provides a necessary supplement to Commission action. As in antitrust treble damage litigation, the possibility of civil damages or injunctive relief serves as a most effective weapon in the enforcement of the proxy requirements.

J.I. Case Co. v. Borak, 377 U.S. 426, 432 (1964).

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

brought a derivative action under rule 10b-5 against the former controlling shareholder, claiming that he had sold his stock to certain steel users and received a high premium allegedly paid for the valuable right to control the distribution of Newport's products during the Korean War steel shortage.⁹ The shareholders sought an accounting for the misappropriated asset. Dismissing the action, the court viewed rule 10b-5 as extending "protection only to the defrauded purchaser or seller."¹⁰ The corporation, not a party to the actual sale of control, failed to qualify.¹¹ The court further interpreted rule 10b-5 as having no relation to "fraudulent mismanagement of corporate affairs."¹² The case therefore has a dual aspect. It has been cited as authority for the distinct but related propositions that the rule does not permit redress of breaches of fiduciary duty,¹³ and that an action under the rule is not available to a party who is neither a purchaser nor a seller.¹⁴ The Second Circuit's

⁹ The complaint also charged defendants with misrepresentations and nondisclosures in the announcement of the rejection of a proposed profitable merger of Newport, and in reporting the sale of stock. *Id.* at 462.

¹⁰ 193 F.2d at 464.

¹¹ This limitation was highlighted when the same plaintiffs were later able to bring their action in federal court using diversity of citizenship as the jurisdictional base. The Second Circuit, in *Perlman v. Feldmann*, 219 F.2d 173 (2d Cir.), *cert. denied*, 349 U.S. 952 (1955), applied the substantive law of Indiana to permit plaintiffs to recover the control premium from the selling shareholder. Although the action was derivative, the court directed that any recovery should go only to the shareholders who did not participate in the sale of control. *Id.* at 178. The case was finally settled, and plaintiffs' counsel fees and disbursements were awarded from the settlement. *Perlman v. Feldmann*, 160 F. Supp. 310 (D. Conn. 1958). The case has received a good deal of criticism. *E.g.*, 40 CORNELL L.Q. 786 (1955), 71 HARV. L. REV. 1559 (1959), 68 HARV. L. REV. 1274 (1955).

¹² 193 F.2d at 464.

¹³ *E.g.*, *O'Neill v. Maytag*, 339 F.2d 764, 768 (2d Cir. 1964) (acts of waste by management not actionable where no deception was alleged); *Schoenbaum v. Firstbrook*, 268 F. Supp. 385, 395-96 (S.D.N.Y. 1967) (purchase of stock from corporation by controlling shareholder only gave rise to breach of fiduciary duty where all parties knew all material facts). *But cf.* *Pettit v. American Stock Exch.*, 217 F. Supp. 21 (S.D.N.Y. 1963), in which the court stated: "that the fraud was perpetrated by insiders does not render Section 10(b) inapplicable, if the transaction represents an abuse of the securities trading process, and should properly be subject to SEC regulations for an adequate remedy." *Id.* at 25 (emphasis added).

¹⁴ *Pacific Ins. Co. v. Blot*, 267 F. Supp. 956 (S.D.N.Y. 1967) (plaintiff barred from seeking an injunction against party who was attempting to compel disclosure of shareholder records through use of shares alleged to have been fraudulently acquired); *Studebaker Corp. v. Allied Prods. Corp.*, 256 F. Supp. 173 (W.D. Mich. 1966), *appeal dismissed*, *New York Times*, Dec. 31, 1966, at 27, col. 3 (corporation denied standing to enjoin manipulation of its stock); *Chashin v. Mencher*, 255 F. Supp. 545 (S.D.N.Y. 1965) (plaintiff unable to show she was a defrauded seller since her sale occurred prior to alleged misconduct); *Defiance Industries, Inc. v. Galdi*, 256 F. Supp. 170 (S.D.N.Y. 1964) (corporation has no standing to recover damages for stock manipulations that allegedly caused its shareholders to sell at depressed prices); *Keers & Co. v. American Steel & Pump Corp.*, 234 F. Supp. 201 (S.D.N.Y. 1964) (no damage action allowed where sale of controlling block of

primary concern may have been that application of rule 10b-5 to a breach of fiduciary duty—as distinguished from the type of fraudulent practice “usually associated with the sale or purchase of securities”¹⁵—would call into being federal rights not required by the objectives of the securities legislation. The decision may therefore be viewed as an avoidance of a field traditionally reserved to the states. This interpretation gains strength from the plain language of the rule, which does not seem to impose a purchaser-seller requirement.¹⁶

The language of Section 10(b) of the Securities Exchange Act condemns “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.*”¹⁷ Under this phrase, the Commission presumably could adopt rules specifically encompassing the *Birnbaum* situation.¹⁸ Alternatively, courts might allow an action by a non-purchaser or a non-seller under the present rule. Broadly speaking, rule 10b-5 prohibits fraudulent schemes, false or misleading statements of material facts, and fraudulent or deceitful practices “in connection with the purchase or sale of any security.”¹⁹ Arguably, a private remedy should be available to any person harmed, provided only that there has been a purchase or sale of securities at some time in connection with the allegedly fraudulent activity. Whether such person was a party to the transaction need not be determinative.

Judicial acceptance of this argument would require repudiation of *Birnbaum*, and no federal circuit court appears to have gone this far. At least one district judge, however, believes that *Birnbaum* has been overruled,²⁰ and the Second Circuit itself has greatly weakened the effect of *Birnbaum* in injunction cases.²¹ Two recent decisions side-stepped the limitation by enlarging the categories of “purchaser” and “seller” of securities.²²

stock was allegedly made in violation of promise to include minority plaintiffs); *New Park Mining Co. v. Cranmer*, 225 F. Supp. 261 (S.D.N.Y. 1963) (dictum).

¹⁵ 193 F.2d at 464.

¹⁶ See Leech, *Transactions in Corporate Control*, 104 U. PA. L. REV. 725, 832-35 (1956).

¹⁷ 48 Stat. 891 (1934), 15 U.S.C. § 78j(b) (1964) (emphasis added), quoted fully in note 1 *supra*.

¹⁸ 3 L. LOSS, *SECURITIES REGULATION* 1469 n.87 (2d ed. 1961).

¹⁹ 17 C.F.R. § 240.10b-5 (1967), quoted in note 2 *supra*.

²⁰ See *Entel v. Allen*, 270 F. Supp. 60 (S.D.N.Y. 1967), discussed at pp. 691-93 *infra*.

²¹ See *Mutual Shares Corp. v. Genesco, Inc.*, 384 F.2d 540 (2d Cir. 1967), discussed at pp. 696-97 *infra*.

²² In many 10b-5 cases plaintiffs assert grounds for relief other than violation of

II

EXPANSION OF THE "SELLER" CONCEPT—*Vine* AND *Dasho*

In *Vine v. Beneficial Finance Co.*,²³ a minority shareholder of Crown Finance Company alleged that Beneficial, acting in concert with Crown's officers, fraudulently caused the merger of Crown into Beneficial for an inadequate consideration. Beneficial allegedly accomplished the acquisition by obtaining ninety-five percent of the outstanding Crown stock in a tender offer and then effecting a short merger of Crown into a Beneficial subsidiary.²⁴ The plaintiff, who refused to surrender his shares, claimed that the transactions violated rule 10b-5 and demanded extensive damages for Crown and all those stockholders who had not sold. The district court dismissed the action on the narrow ground that, since Vine neither accepted the offer to purchase his stock nor surrendered his stock pursuant to the statutory short-form merger, he was not a "seller" of securities and thus could not invoke rule 10b-5.²⁵

On appeal the Second Circuit addressed itself specifically to whether Vine was a seller. The court noted that the applicable corporation law gave the shareholders who did not agree to the merger an opportunity to obtain the fair value of their shares, either by agreement with the parent corporation or by an appraisal proceeding. The court held for the plaintiff, stating:

Since, in order to realize any value for his stock, appellant must exchange the shares for money from appellee, as a practical matter appellant must eventually become a party to a "sale," as that term has always been used. . . . 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.²⁶

Defendant had pressed the further argument that, since any deception related only to those shareholders who tendered their stock,

rule 10b-5. Reference to such other causes of action will not be made unless necessary to the discussion.

²³ 374 F.2d 627 (2d Cir.), cert. denied, 389 U.S. 977 (1967).

²⁴ Where a short-form merger statute is in effect, a corporation that owns 90-95% of the outstanding shares of each class of stock of another corporation may merge the subsidiary corporation into itself without the approval of the former's shareholders. Whether the merger had been carried out under Delaware or New York law was unclear. N.Y. BUS. CORP. LAW § 905(a) (McKinney 1963, Supp. 1967) requires 95% ownership. DEL. CODE ANN. tit. 8, § 253(a) (Supp. 1966), requires only 90% ownership.

²⁵ 252 F. Supp. 212, 214 (S.D.N.Y. 1966).

²⁶ 374 F.2d at 634 (citations omitted).

plaintiff could not be considered a defrauded seller. Recognizing that there might be a requirement of reliance in other situations,²⁷ the court held that it was unnecessary

when no volitional act is required and the result of a forced sale is exactly that intended by the wrongdoer. . . . What must be shown is that there was deception which misled Class A stockholders and that this was in fact the cause of plaintiff's claimed injury.²⁸

The Securities and Exchange Commission, as *amicus curiae*, suggested an alternative basis for the decision—that the plaintiff need not even have been a selling shareholder so long as there was conduct condemned by the rule and the plaintiff's stock lost value as a result.²⁹ The court expressly declined to reach this point, basing its decision on the narrower ground that plaintiff, by virtue of the position defendants placed him in, was a "seller" of securities.

The court distinguished *Vine's* position—that of a shareholder without a corporation—from that of a shareholder who refuses to accept a fraudulent offer to purchase, but remains a shareholder in an *existing* corporation.³⁰ This casts doubt on the position recently taken by a district court judge that *Vine* has practically overruled *Birnbaum*.³¹ *Vine* does, however, demonstrate a judicial propensity to expand the permissible scope of damage actions under rule 10b-5, when necessary to achieve a result that accords with the broad policy behind the rule, *i.e.*, protection of the investing public.

This tendency was again exhibited in *Dasho v. Susquehanna Corp.*,³² a derivative suit in which the Seventh Circuit held that a corporation fraudulently induced to issue its own shares in a merger, and

²⁷ See, *e.g.*, *List v. Fashion Park, Inc.*, 340 F.2d 457, 462-64 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965).

²⁸ 374 F.2d at 635. *Voegel v. American Sumatra Tobacco Corp.*, 241 F. Supp. 369 (D. Del. 1965), involved a virtually identical situation. A short-form merger was challenged by a plaintiff who had neither sold her stock nor fully prosecuted an appraisal proceeding. The court found that a "sale" includes a "contract to sell" under § 3(a)(14) of the 1934 Act, 48 Stat. 884 (1934), 15 U.S.C. § 78c(a)(14) (1964), and that under Delaware law when plaintiff initially purchased her shares she agreed to surrender them in event of a merger. The reliance element was supplied by plaintiff's belief in the honesty and fair dealing of the insiders when she bought her stock. The court found an element of deception, noting that plaintiff's initial belief in the insiders' honesty was undercut by the fraudulent terms of the merger. Although both courts reached the same result, the rationale employed in *Vine* is decidedly more credible.

²⁹ 374 F.2d at 636.

³⁰ *Id.* at 634.

³¹ See *Entel v. Allen*, 270 F. Supp. 60 (S.D.N.Y. 1967), discussed at pp. 691-93 *infra*.

³² 380 F.2d 262 (7th Cir.), *cert. denied*, 389 U.S. 977 (1967).

in turn to receive the shares of another corporation, was effectively both a "seller" and a "purchaser" for purposes of rule 10b-5. The case is significant, not so much for the manner in which the court satisfied the purchaser-seller requirement,³³ but for the substantial resemblance between the transactions involved and the scheme undertaken by the defendant in *Birnbaum*. Like *Birnbaum*, *Dasho* involved a transfer of control, allegedly for an excessive premium. In contrast to *Birnbaum*, however, the defendant directors in *Dasho* sold their stock to a corporation about to merge with their own. The purchasing corporation financed the transaction with borrowed funds. The sale was accompanied by a substitution of directors and allegedly false and misleading statements. Upon consummation of the merger, the liability created for the stock purchase inured to the surviving corporation. In other words, the defendants in *Dasho* sold their shares indirectly to their own corporation, allegedly for a substantial premium, whereas in *Birnbaum* the premium was paid by outside purchasers. In both cases there was a misappropriation of a corporate asset by the departing directors, but in *Dasho* the action was allowed to proceed because the corporation had been a party to the various exchanges of stock. By dictum the court accepted the theory that the complex nature of a merger resulted in greater possibilities for fraud and thus increased the need for protection of the investing public.³⁴ Though *Vine* and *Dasho* have not done away with the requirement that a 10b-5 plaintiff must be able to show either purchaser or seller status, the cases do demonstrate a judicial willingness to turn a more sympathetic ear toward plaintiffs who can achieve the status of a "constructive seller."³⁵ Moreover, *Dasho* may indicate that the more complex the allegedly fraudulent securities transaction, the more intense will be the judicial scrutiny.

³³ The idea that the exchange of shares attending a statutory merger could constitute the surviving corporation both a "purchaser" and a "seller" does not seem particularly novel in view of such earlier cases as *Ruckle v. Roto Am. Corp.*, 339 F.2d 24 (2d Cir. 1964), and *Hooper v. Mountain States Sec. Corp.*, 282 F.2d 195 (5th Cir. 1960), *cert. denied*, 365 U.S. 814 (1961), which had held that the issuance by a corporation of its own shares is a "sale" for purposes of rule 10b-5. *See also* *Simon v. New Haven Board & Carton Co.*, 250 F. Supp. 297 (D. Conn. 1966) (shareholders entitled to maintain a derivative action on behalf of a corporation whose acquisition of other corporations for excessive consideration had allegedly been fraudulently caused). The subject is discussed in greater detail in 36 *FORDHAM L. REV.* 362 (1967).

³⁴ 380 F.2d at 267.

³⁵ *See also* *Goodman v. H. Hentz & Co.*, 265 F. Supp. 440 (N.D. Ill. 1967), holding that rule 10b-5 permitted a damage recovery where plaintiffs were parties to intended sales that were never accomplished because of the alleged fraud of a registered securities representative. Plaintiffs were told that securities were being sold for them when in fact they were not, and in some cases plaintiffs were "sold" nonexistent securities.

III

DEMISE OF THE PURCHASER-SELLER LIMITATION IN A
DAMAGE ACTION—*Entel v. Allen*

The continuing pressure on the courts to expand the reach of rule 10b-5 will likely force them to venture into the forbidden area carved out by *Birnbaum*. There are two basic considerations that are helpful in evaluating the utility of the purchaser-seller limitation. Procedurally, the requirement can arise in a direct suit by a private shareholder, in a direct suit by a corporation, or in a derivative action brought on behalf of the corporation. The considerations that warrant relaxing the requirement to allow a derivative action or a direct corporate action will not always apply to the direct individual action. To allow all shareholders, regardless of purchaser or seller status, access to federal courts under rule 10b-5 may invite a multitude of suits brought merely for their nuisance value. The legitimate reluctance of courts to enter the dismal swamp of intracorporate politics is perhaps well served by the purchaser-seller limitation. The judiciary will be more inclined, however, to permit a recovery in a derivative action, because all shareholders would benefit.

The second consideration concerns the relief sought. Because *Birnbaum* was an action for an accounting, it is arguably inapplicable when an injunction is requested. The desirable objective of policing securities transactions is most effectively served when an injunction can be issued to prevent the threatened conduct, and this factor should at least mitigate the *Birnbaum* requirement. On the other hand, *Birnbaum* poses a much greater obstacle to a damage action, where the allegedly fraudulent conduct has already occurred. The decision in *Entel v. Allen*,³⁶ however, purports to lay to rest the purchaser-seller limitation in a damage suit.

The plaintiffs were shareholders of the Atlas Corporation suing the directors and officers in a direct class action and in a derivative action. Atlas, which owned a substantial interest in Northeast Airlines, entered negotiations for the sale of that interest to Hughes Tool Company. Plaintiffs claimed that, in obtaining approval of various stages of the transaction from the Civil Aeronautics Board, the SEC, and the shareholders of Atlas, the defendants failed to disclose that the sale was not at arm's length, that the value of Atlas's interest in Northeast was greater than the purchase price, and that Atlas actually received less than the agreed price.³⁷

³⁶ 270 F. Supp. 60 (S.D.N.Y. 1967).

³⁷ *Id.* at 64.

On the first argument, prior to the *Vine* decision, Judge Bonsal granted summary judgment for the defendants on the 10b-5 claims.³⁸ Because the plaintiffs in their individual capacities neither bought nor sold securities, the direct action failed. Although the corporation itself had sold securities and thereby fulfilled the *Birnbaum* requirement, the derivative action likewise failed, because essential allegations that the corporation had been deceived were lacking.³⁹ The defendants had aimed their deception at the shareholders and the government agencies involved, not at the corporation itself.

Entel came up for reargument shortly after the Second Circuit had decided *Vine* and *A.T. Brod & Co. v. Berlow*.⁴⁰ In *Brod*, a stockbroker alleged that the defendants had ordered securities intending to pay for them only if their value increased by the settlement date. The 10b-5 claim was dismissed on the ground that the rule protected investors only from frauds "usually associated with the sale or purchase of securities" and relating to the investment value of the securities.⁴¹ The Second Circuit reversed, saying:

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.⁴²

Judge Bonsal interpreted *Vine* as all but overruling *Birnbaum*, so that there was no longer any obstacle to the direct action, and *Brod* as sufficiently undercutting the deception requirement of *O'Neill v. Maytag*⁴³ to allow the derivative action to proceed.

It is not at all clear that *Vine* provides a justification for concluding that the purchaser-seller limitation has been even seriously challenged. The court there very pointedly avoided overruling *Birnbaum*. The reasoning with respect to *Brod* is nearly as tenuous. Since *Brod* had condemned an undisclosed scheme to breach state contract law, Judge Bonsal concluded that "an undisclosed scheme to breach State corporate fiduciary law must also be covered."⁴⁴ He felt bound to view rule 10b-5 as requiring not "deception," but merely an undisclosed breach of

³⁸ [1966-1967 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,886 (S.D.N.Y. 1967).

³⁹ See *O'Neill v. Maytag*, 339 F.2d 764 (2d Cir. 1964), holding that a breach of general fiduciary duties, not involving deception, does not give rise to a cause of action under rule 10b-5.

⁴⁰ 375 F.2d 393 (2d Cir. 1967); see 1967 DUKE L.J. 894.

⁴¹ 375 F.2d at 396 (quoting Judge Bonsal).

⁴² *Id.* at 397 (emphasis in original).

⁴³ 339 F.2d 764 (2d Cir. 1964).

⁴⁴ 270 F. Supp. at 70.

fiduciary duty. *Brod*, however, did involve "deception," albeit in a rather novel form.

Entel v. Allen arguably stands for two propositions. First, shareholders who neither purchase nor sell in the allegedly fraudulent transaction are entitled to damages under rule 10b-5 when corporate insiders withhold material information in order to gain shareholder approval of a securities transaction that is against the best interests of the corporation. This is more than a breach of fiduciary duty to the corporation and its shareholders; the shareholders have been lulled into a false sense of security by the silence of the directors and officers, and the vehicle for the maneuver has been a securities transaction. The proposition is questionable, however, in view of *Birnbaum*, which apparently remains intact despite the decision in *Vine*.

Second, a derivative action may be brought under 10b-5 without an allegation that the corporation was "deceived." This assertion is directly in conflict with *O'Neill*. The result, however, is in accord with much of the criticism that has been leveled at *O'Neill*. When the entire board of directors acts in concert to harm the corporation, the need for protection seems greater than when a majority of the directors deceives the minority.⁴⁵ In the former situation, deception of the shareholders should be sufficient to allow an action on behalf of the corporation.⁴⁶

⁴⁵ The latter situation gave rise to a cause of action in *Ruckle v. Roto Am. Corp.*, 339 F.2d 24 (2d Cir. 1964). The apparent distinction between *Ruckle* and *O'Neill*, viz.; that when some members of the board deceive others there is a cause of action, but when all the members act in concert there is none has recently prompted one circuit judge to remark:

The only possible material difference I can perceive between *Ruckle* and *O'Neill* is that in *Ruckle* there were directors who were not participants in the transaction and thus could be deceived in the ordinary sense. In either case, however, the failure of the defendant directors to perform their duty presumably injured the corporation, and I do not believe it is sound to differentiate between situations where the directors were unanimous in wrongdoing and those where less than all were involved.

Dasho v. Susquehanna Corp., 380 F.2d 262, 270 (7th Cir.) (concurring opinion), cert. denied, 389 U.S. 977 (1967); see Fleischer, "Federal Corporation Law": An Assessment, 78 HARV. L. REV. 1146, 1160-67 (1965) (pointing out that the motives of the entire board of directors, if disclosed, might prompt a derivative suit to block a proposed transaction); Comment, *Securities Regulation: Shareholder Derivative Actions Against Insiders Under Rule 10b-5*, 1966 DUKE L.J. 166, 186, where the author states:

[W]here the control of exploiting insiders over the corporate mechanism they employ approaches the absolute, as in *O'Neill*, the necessity for the usual type of fraudulent practice decreases. Correlatively, there is an increase in the vulnerability of the minority segment whose protection is the justification for applying rule 10b-5 at all.

⁴⁶ Since *O'Neill* was decided there has been some support for this result at the district court level, particularly when a shareholder vote was necessary to accomplish the trans-

IV

THE PURCHASER-SELLER LIMITATION IN THE
INJUNCTION ACTION

Although the purchaser-seller requirement was born in an action for an accounting, it has been used occasionally to deny standing to plaintiffs seeking injunctive relief. Courts have imposed the requirement with little or no discussion of the underlying reasons, suggesting that its application to injunctions is no more than a mechanical response conditioned by *Birnbaum*. Recent decisions, however, have accorded less weight to the limitation, concentrating on the equitable and policy considerations involved.

Ruckle v. Roto American Corp.,⁴⁷ one of the earlier cases, considered whether a shareholder of a corporation, allegedly fraudulently induced by some of its directors to authorize issuance of treasury stock to its president, could maintain a derivative action to enjoin the issuance. Without considering whether the corporation's lack of "seller" status (the issuance had not yet been consummated) would bar an action, the court granted the injunction. The corporation seems to have been a "constructive seller" and probably satisfied the purchaser-seller requirement in light of subsequent decisions in *Vine* and *Dasho*. *Ruckle* nevertheless supports the proposition that the *Birnbaum* limitation will not apply when an injunction is sought against a fraudulently induced corporate securities transaction. Thus under the *Ruckle* rationale, a fraudulently authorized redemption of stock or an exchange of shares pursuant to a merger are possible situations in which *Birnbaum* will not block an injunction. The utility of *Ruckle* becomes

action in question. Thus, a derivative action has withstood a motion to dismiss where stockholder approval of a corporate acquisition was allegedly obtained by the use of proxy statements known by the directors to be false and misleading. *Simon v. New Haven Board & Carton Co.*, 250 F. Supp. 297 (D. Conn. 1966). More recently, a similar action was allowed to proceed where a stock option agreement was allegedly approved through the use of misleading information accompanying proxy materials. The defendants argued that there had been no deception at the corporate level in contrast to *Ruckle*, but the court replied:

[T]he distinction is at best superficial. . . . In both situations, the corporation is alleged to have been "deceived" in the only sense in which a fictional legal person can be deceived, *i.e.*, through deception practiced upon those real persons through whom it acts.

Globus, Inc. v. Jaroff, 266 F. Supp. 524, 529 (S.D.N.Y. 1967) (footnotes omitted). Where, however, there is no allegation of deception at the corporate level, as where all the directors were aware of the material facts, and, in addition, there was no need for shareholder approval, *O'Neill* apparently still controls. *Schoenbaum v. Firstbrook*, 268 F. Supp. 385 (S.D.N.Y. 1967).

⁴⁷ 339 F.2d 24 (2d Cir. 1964).

more conjectural, however, when the party on whose behalf the injunction is sought is not an expected party to the transaction. *Ruckle* probably fails to reach the facts of *Birnbaum* since the corporation there was not a party to the sale of control.

Other cases demonstrate that the limitation does in fact have greater force when the plaintiff is a stranger to the alleged fraud. In *Studebaker v. Allied Products Corp.*,⁴⁸ the plaintiff corporation alleged that defendant outsiders, following an unsuccessful merger attempt, were seeking to gain control of plaintiff and had made false representations that caused a distortion in the price of its stock, in violation of sections 9(a)⁴⁹ and 10(b). The suit to enjoin the alleged manipulations was dismissed on the ground that the plaintiff, not a purchaser or seller, was not entitled to maintain a private action. On appeal to the Sixth Circuit, the argument was made that an issuer of stock has a duty to prevent manipulations of its stock. Settlement was reached before a decision was handed down.⁵⁰

Appellants in *Allied Products* argued that *J.I. Case Co. v. Borak*⁵¹ and *Studebaker Corp. v. Gittlin*⁵² allow a corporation to enjoin violations of section 10(b). In *Borak* the Supreme Court held that private suits were permissible to remedy violations of section 14(a) and the proxy rules, stating that "[p]rivate enforcement of the proxy rules provides a necessary supplement to Commission action."⁵³ The Second Circuit followed this broad policy in *Gittlin* by upholding an injunction prohibiting the use of shareholder authorizations obtained by solicitations made in violation of section 14(a).

The argument that, if a corporation is permitted to enjoin a violation of the proxy rules, it should also be entitled to enjoin violations of rule 10b-5 was accepted in *Moore v. Greatamerica Corp.*⁵⁴ The court rested its decision squarely on the rationale of *Borak* and *Gittlin* and decided that an injunction could legitimately be granted to a non-purchaser or non-seller against a tender offeror who had made misleading statements in conjunction with the offer.⁵⁵

⁴⁸ 256 F. Supp. 173 (W.D. Mich. 1966), *appeal dismissed*, N.Y. Times, Dec. 31, 1966, at 27, col. 3.

⁴⁹ 48 Stat. 889 (1934), 15 U.S.C. § 78i(a) (1964).

⁵⁰ N.Y. Times, Dec. 31, 1966, at 27, col. 3. There is an enlightening discussion of the case, including a review of the arguments urged on the abortive appeal, in Comment, *Private Enforcement Under Rule 10b-5: An Injunction for a Corporate Issuer?*, 115 U. PA. L. REV. 618 (1967).

⁵¹ 377 U.S. 426 (1964).

⁵² 360 F.2d 692 (2d Cir. 1966).

⁵³ 377 U.S. at 432.

⁵⁴ 274 F. Supp. 490 (N.D. Ohio 1967). See 81 HARV. L. REV. 501 (1967).

⁵⁵ 274 F. Supp. at 492. Cf. *Symington Wayne Corp. v. Dresser Indus., Inc.*, 383

In *Pacific Insurance Co. v. Blot*,⁵⁶ the plaintiff corporation sought to enjoin the defendant's use of shares, which were allegedly acquired through violations of section 10(b), to compel disclosure of its shareholder lists. The court noted that the case had a strong procedural similarity to *Gittlin*, but denied standing because the plaintiff was not a party to the alleged transactions and thus had not been defrauded or damaged. *Gittlin* was distinguished on the ground that the court there had found that "impairment of corporate suffrage by itself was a sufficient injury."⁵⁷ This reasoning suggests that it was unnecessary for the court to use the purchaser-seller limitation to buttress its opinion, since it could have denied the injunction solely on traditional equitable principles. There is, of course, a significant difference between a holding that the plaintiff has no standing to sue and one that it is not entitled to the relief sought.

*Mutual Shares Corp. v. Genesco, Inc.*⁵⁸ presented the purchaser-seller requirement in the context of an action for damages and an injunction. Defendant Genesco, by means of private purchases and a tender offer, acquired control of S.H. Kress & Co., allegedly intending to use Kress's undervalued real estate to finance the acquisition and to appropriate Kress's assets for its own benefit. The plaintiffs bought Kress stock after the tender offer terminated. They claimed that after their purchase the defendants manipulated the price of Kress's stock to encourage the minority shareholders to sell at depressed prices.⁵⁹ The plaintiffs sought a direct pro rata payment for the misused assets, liquidation of Kress, and an injunction prohibiting further manipulation of the stock.

The court dismissed the damage claims, holding that the alleged fraud prior to plaintiff's purchase was outside the ambit of rule 10b-5. At best plaintiffs could claim that in gaining control of Kress, through a tender offer to which plaintiffs were not parties, defendants had failed to disclose their intentions to misuse the corporate assets. The court accepted the SEC's argument that to allow this action would "convert any instance of corporate mismanagement into a Rule 10b-5 case."⁶⁰ This holding illuminates one of the outer limits of the 10b-5 phrase "in connection with the purchase or sale of any security." The alleged

F.2d 840 (2d Cir. 1967), in which an injunction against a tender offer was not granted where there was no showing that the alleged misrepresentations were material or that irreparable injury would result. The court assumed without deciding that plaintiffs had standing.

⁵⁶ 267 F. Supp. 956 (S.D.N.Y. 1967).

⁵⁷ *Id.* at 957.

⁵⁸ 384 F.2d 540 (2d Cir. 1967).

⁵⁹ *Id.* at 542.

⁶⁰ *Id.* at 545.

deception took place before the plaintiffs became shareholders and was directed at a class of persons of which plaintiffs were not members; certainly a buyer has no cause of action when there is no proximate causal relation between the deception and the alleged injury. However, although the plaintiffs were neither purchasers nor sellers in relation to the market manipulations subsequent to their purchase, the court granted the injunction, stating:

[W]e do not regard the fact that plaintiffs have not sold their stock as controlling on the claim for injunctive relief. The complaint alleges a manipulative scheme which is still continuing. While doubtless the Commission could seek to halt such practices, present stockholders are also logical plaintiffs to play "an important role in enforcement" of the Act in this way. . . . Deceitful manipulation of the market price of publicly-owned stock is precisely one of the types of injury to investors at which the Act and the Rule were aimed. . . . [A]s already indicated, the claim for damages . . . founders both on proof of loss and the causal connection with the alleged violation of the Rule; on the other hand, the claim for injunctive relief largely avoids these issues, may cure harm suffered by continuing shareholders and would afford complete relief against the Rule 10b-5 violation for the future.⁶¹

This decision indicates an intent to apply the rationale developed in the cases involving the proxy rules to shareholders seeking to enjoin violations of rule 10b-5.⁶² The decision, however, has no apparent effect on damage actions.

The position of the Second Circuit is healthy, because it will result in a fairer and less arbitrary application of rule 10b-5. The court has recognized that whether the plaintiff is a purchaser or seller is irrelevant to a prayer for injunctive relief. The key issues are whether there is a potential violation of rule 10b-5 and whether the violation threatens harm to the plaintiff. If these elements are present, there is no sound reason to deny a federally-created cause of action, with its attendant procedural advantages, to both corporations and individuals.

V

THE FUTURE OF THE PURCHASER-SELLER LIMITATION

The purchaser-seller limitation created in *Birnbaum* has come under increasing attack. The requirement has been almost entirely eliminated from injunction cases, and its continuing vitality in damage

⁶¹ *Id.* at 546-47 (citations omitted).

⁶² Despite the decision, at least one later case denying a request for injunctive relief for an alleged violation of rule 10b-5 has been based partially on the purchaser-seller limitation, *Colonial Realty Corp. v. Curtis Publishing Co.*, [Current Vol.] CCH FED. SEC. L. REP. ¶ 92,105 (S.D.N.Y. 1967).

actions is at least questionable. Are there persuasive reasons for retaining the requirement either in whole or in part?

Neither the statute nor rule 10b-5 requires such a restriction; each merely defines the area of unlawful conduct. The private civil action and the limitations thereon are solely creatures of judicial interpretation.⁶³ The Supreme Court has given implicit sanction to the private remedy,⁶⁴ and arguably no arbitrary bar such as the purchaser-seller requirement ought to exist. The courts should instead decide whether there is conduct prohibited by rule 10b-5 and whether it has caused the damages claimed.

A simple example illustrates the dilemma that *Birnbaum* creates for potential plaintiffs. The directors of X Corporation, desiring to force shareholders to sell out, drive the market price of the stock down by cutting dividends and issuing falsely pessimistic reports of the corporation's prospects. If a shareholder, S, does in fact sell out in response to this scheme, he can probably bring a 10b-5 action for damages.⁶⁵ But he may have sensible reasons for not wishing to sell his stock. At least in the Second Circuit, S is free to seek an injunction against further manipulation. Injunctive relief will minimize future losses, and the market price of the stock may well recover the lost ground. If he should decide to bring a damage action, however, *Birnbaum* probably stands in his path.⁶⁶

Some may argue that there is no point in allowing S to seek damages, since he, as opposed to his counterpart who has sold his stock at the depressed price, has suffered only paper losses. It is not, however, always true that S's losses are only "paper." Any significant drop in the market price of the stock impairs its value to S as collateral, and he may be denied business opportunities otherwise available to him. Furthermore, if S has purchased the stock on margin, he may be forced to put up additional capital to avoid foreclosure. Under ordinary circumstances this additional capital would be available to produce independent income.

⁶³ See Comment, *The Prospects for Rule X-10B-5: An Emerging Remedy for Defrauded Investors*, 59 YALE L.J. 1120 (1950); cf. Ruder, *Civil Liability Under Rule 10b-5: Judicial Revisions of Legislative Intent?*, 57 Nw. U.L. REV. 627 (1963), in which the author argues that it was not the intent of Congress to create a civil liability under § 10(b).

⁶⁴ See p. 685 & note 7 *supra*.

⁶⁵ Cf. *Cochran v. Channing Corp.*, 211 F. Supp. 239 (S.D.N.Y. 1962).

⁶⁶ See also *Greenstein v. Paul*, [1966-67 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,011 (S.D.N.Y. 1967), where the district court granted summary judgment to defendants in precisely this type of action. The court distinguished *Mutual Shares Corp. v. Genesco, Inc.*, 384 F.2d 540 (2d Cir. 1967), as involving a request for injunctive relief rather than damages, and applied the *Birnbaum* rule. The issue posed in the text was briefly discussed by the court in *Mutual Shares*, 384 F.2d at 546, but does not appear to have received full consideration.

Some might further argue that the speculative nature of *S*'s damages will usually preclude recovery. This should not, however, bar his cause of action. Since *S*'s damages might not be speculative, the issue should be determined upon proof at trial rather than upon the pleadings.⁶⁷

A comparison of *S*'s position with that of the plaintiff in *Vine* further emphasizes the arbitrary effect of *Birnbaum*. Apart from the technicality that *S* is not a "seller" by virtue of his corporation's having ceased to exist, his situation is strikingly similar to that of the plaintiff in *Vine*.

The fraud involved has certainly been the type of manipulation the Securities Exchange Act was meant to curb. Moreover, the fraudulent misrepresentations were aimed at a class of persons of which plaintiff was a member. Finally, under the *Vine* rationale plaintiff is not required to show his reliance if he is a member of a class, some of whose members have relied on the misrepresentations or nondisclosures of material facts by insiders. To allow the plaintiff in *Vine* but not *S* to proceed to trial is difficult to justify.

The complete abolition of the *Birnbaum* requirement would not only eliminate an unwarranted bias against one class of plaintiffs but also would have a salutary effect on 10b-5 litigation by forcing courts to rule on the sufficiency of a greater number of claims and thereby further define the limits of rule 10b-5. *A.T. Brod & Co. v. Perlow*⁶⁸ demonstrates that the rule can find novel application, and, in the absence of more specific legislation, this is probably desirable.

The fear is frequently voiced that any judicial expansion of the scope of the 10b-5 action is a further step in the development of a federal corporation law and amounts to legislative action better left to Congress.⁶⁹ The requirement remains, however, that there must be some form of deception to bring an action under 10b-5. The "breach of fiduciary duty" to corporations and their shareholders, without some element of deception, remains exclusively within the province of state law. The removal of the purchaser-seller limitation would not add to the activities that are actionable under rule 10b-5, but would merely increase the number of potential plaintiffs who could recover for injuries caused by those activities.

Henry P. Massey, Jr.

⁶⁷ Cf. *Defiance Indus., Inc. v. Galdi*, 256 F. Supp. 170 (S.D.N.Y. 1964), in which a corporation brought suit for damages allegedly sustained when defendants manipulated its stock on the American Stock Exchange. The action was dismissed because the corporation had not traded in the stock and the only losses involved were those of its shareholders.

⁶⁸ 375 F.2d 393 (2d Cir. 1967).

⁶⁹ See, e.g., Judge Bonsal in *Entel v. Allen*, 270 F. Supp. 60, 70 (S.D.N.Y. 1967).