The Decline of the Purchaser-Seller Requirement of Rule 10b-5

Edward J. Ciechon Jr.
THE DECLINE OF THE PURCHASER-SELLER REQUIREMENT OF RULE 10b-5

I. INTRODUCTION

Section 10(b) of the Securities Exchange Act of 1934 and rule 10b-5 promulgated thereunder proscribe fraud by any person "in connection with the purchase or sale of any security."¹ In 1946 the District Court for the Eastern District of Pennsylvania in the case of Karden v. National Gypsum Co.² interpreted rule 10b-5 to provide a private cause of action for defrauded sellers and, 5 years later, the Second Circuit recognized a similar right of purchasers.³ The determination of what activities and persons are within the proscription of 10b-5 became and continues to be a perplexing judicial problem. The operative language which has given rise to the confusion in this area is the phrase "in connection with the sale or purchase of any security." This language is found in both section 10(b) and rule 10b-5,⁴ and was first read to limit private actions under 10b-5 to actual purchasers or sellers.⁵ This interpretation, however, is

1. Section 10 provides in part:
   It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

   (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.


Rule 10b-5 provides:

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

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

   (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.


4. Karden and the many decisions following it have used as the basis for the private cause of action the theory that a private right of enforcement is permitted absent clear congressional intent to the contrary. The courts have relied upon RESTATEMENT OF TORTS § 286 (1934). See Comment, Private Rights From Federal Statutes: Toward A Rational Use of Borak, 63 U. L. Rev. 454, 456-59 (1968).

4. See note 1 supra.


---

Ciechon: The Decline of the Purchaser-Seller Requirement of Rule 10b-5

SPRING 1969] COMMENTS 499

Published by Villanova University Charles Widger School of Law Digital Repository, 1969
presently under attack, and the exact meaning of the phrase is unclear. This Comment will explore the development of judicial construction of this phrase.

II. THE PURCHASER-SELLER REQUIREMENT

The strict purchaser-seller limitation was first enunciated by the Second Circuit in Birnbaum v. Newport Steel Corp. The plaintiffs, minority shareholders of Newport Steel Corporation, brought a combined derivative suit and class action alleging that defendants, members of the corporation's board of directors, breached their fiduciary duty to the corporation when the defendant president of Newport caused the directors to reject a merger which would have been profitable to all Newport shareholders. Subsequently, the president sold his controlling interest in the corporation at a substantial premium. The purchaser, a corporation, intended to use Newport as a "captive" source of steel during a market shortage. Immediately after the sale, Newport's board of directors resigned and were replaced by men controlled by the purchaser. The plaintiffs also alleged other specific acts of fraud consisting of misrepresentative letters sent by the board of directors to the shareholders informing them of the transaction. Plaintiffs argued that the president's action of causing the board of directors to reject the initial offer of purchase and the subsequent sale by the president of his stock to the purchaser constituted a violation of rule 10b-5 since that rule's protection may be exercised by persons other than defrauded purchasers or sellers and "the general proscription of fraud 'upon any person' includes and supplements the common law liability of those who abuse the trust of their corporate posi-


7. All of the cases discussed in this Note are similar in their factual situations to the case of the purchasers who are the subject of this Note. The courts have held that the plaintiffs were entitled to recovery on the grounds that the plaintiffs were third-party beneficiaries of the contract between Newport Steel and the defendant corporation. See supra note 5.

8. 193 F.2d 461 (2d Cir. 1952), cert. denied, 343 U.S. 956 (1953).
tions."  Furthermore, plaintiffs contended that the words "in connection with" the purchase or sale of securities supports their position since that phrase would be superfluous if only actual purchasers could obtain a 10b-5 remedy.  

The court, looking to legislative history, rejected plaintiffs' argument on two grounds. First, it found that the SEC promulgated rule 10b-5 merely to close a loophole in section 17(a) of the Securities Act of 1933, which only declared as unlawful fraud or deceit on purchasers of securities and, secondly, that Congress did not intend section 10(b) to be used to proscribe a breach of fiduciary duty. The court held that section 10(b) "was directed solely at that type of misrepresentation or fraudulent practice usually associated with the sale or purchase of securities rather than at fraudulent mismanagement of corporate affairs, and that Rule X-10B-5 extended protection only to the defrauded purchaser or seller."  

Birnbaum's reliance on legislative and administrative history to determine that only defrauded purchasers or sellers have private remedies under 10b-5 appears misplaced. In the Supreme Court decision of J. I. Case Co. v. Borak, the Court was confronted with the question whether a cause of action was available to protect private interests under the Exchange Act's proxy regulation section, 14(a). As with section 10(b), there was no legislative history to directly support a private cause of action under section 14(a), yet the Court determined that such a remedy existed. For support the Supreme Court stressed the congressional purpose of the section, determining that while the language of 14(a) "makes no specific reference to a private right of action, among its chief purposes is 'the protection of investors,' which certainly implies the availability of judicial relief where necessary to achieve that result." It was added that courts have a duty "to be alert to provide such remedies as are necessary to make effective the congressional purpose." Since section 10(b), like

9. Id. at 463.
10. Id.
12. 193 F.2d at 463. The court said: "[O]n May 21, 1942, the SEC adopted Rule X-10B-5 to close this *** loophole in the protections against fraud administered by the Commission by prohibiting individuals or companies from buying securities if they engage in fraud in their purchase. SEC Release No. 3230, May 21, 1942."
13. Id.
14. Id. at 464 (emphasis added).
15. Birnbaum's reliance on the legislative history has been severely criticized by commentators. See, e.g., Leech, Transactions in Corporate Control, 104 U. Pa. L. Rev. 725, 833 (1956); Comment, Private Enforcement Under Rule 10b-5: An Injunction For a Corporate Issuer?, supra note 6, at 622-23.
18. 377 U.S. at 432. See generally Comment, supra note 3, at 454.
19. 377 U.S. at 433. It has been argued that the development of a private action under 10b-5 is not justified by the legislative history of section 10(b). See Cohen, Federal Legislation Affecting the Public Offering of Securities, 28 Geo. Wash. L. Rev. 119, 124 n.17 (1959); Ruder, Texas Gulf Sulphur — The Second Round: Privity and State of Mind in Rule 10b-5 Purchase and Sale Cases, 63 Nw. U. L. Rev. 423, 430 (1968); Ruder, Lost Equities: The Supreme Court and Legislative
14(a), was passed for the protection of investors and, as the following discussion will indicate, there are many situations in which an investor may be injured in the course of transactions "in connection with the purchase or sale of any security," before he actually sold or purchased such a security, it would appear to be within the congressional purpose of 10(b) to allow private parties injured by fraud which was connected with a securities transaction to use rule 10b-5 as a remedy. In line with this reasoning the Seventh Circuit in Jordan Bldg. Corp. v. Doyle, has recently applied the Borak reasoning to a 10b-5 case, thus indicating that the purpose of section 10(b) would be served by allowing a private action under rule 10b-5.

Birnbaum's finding that the SEC only intended 10b-5 to close a loophole in section 17(a) is also misplaced. An indication of this may be gleaned from the amicus curiae briefs submitted by the Commission. The SEC has maintained that a strict purchaser-seller requirement is too narrow and argued in Birnbaum that a party can obtain 10b-5 relief whenever the rule is violated and plaintiff's stock loses value as a result of the violation. The decline of Birnbaum's actual purchaser-seller limitation, should not, however, expand rule 10b-5 to cover the traditional state common law liability for fraudulent mismanagement of corporate affairs. Indeed, it has been suggested that the plaintiff's broad allegations that 10b-5 supplements the common law liability of corporate fiduciary responsibility was the reason for the Second Circuit's narrow interpretation of 10b-5. Thus, it is possible that in the court's zeal to show its disfavor with this broad interpretation it established the purchaser-seller requirement without fully realizing the implications of such a result. Nonetheless, it has been said that the decisions in the decline of the Birnbaum doctrine indicate that at the present time liability for any fraud by a corporate fiduciary may be litigated under 10b-5. The adoption of such an all-encompassing result would be unfortunate and would justify the criticism made of the judicial expansion of private actions under 10b-5 that this development lacks the careful debate and limitations which congressional enactment would give it, particularly in an area such as corporate law which has been traditionally regulated by the states. Since there is a

Intent?, 57 Nw. U.L. Rev. 627 (1963). The Borak case should, however, put an end to this criticism. See R. Jennings & H. Marsh, Jr., Securities Regulation Cases and Materials 847 n.3 (2d ed. 1968).

20. See note 1 supra.


23. See p. 503 infra.


25. Bahlman, supra note 7, at 761 n.151.

danger of usurping a state interest without justification, the courts, as indicated by Birnbaum, have a responsibility for limiting 10b-5 actions to securities transactions covered by the statute.

In Borak, the Supreme Court found that the congressional purpose justifying a private cause of action under 14(a) was manifested in the language of the section.\(^\text{27}\) Since it appears proper to look to the purpose of section 10(b) to find justification for a private cause of action under rule 10b-5,\(^\text{28}\) the language of the section should be respected by the courts. This can be accomplished by reading the phrase “in connection with the purchase or sale of any security” to require that the fraud which a private party may litigate under rule 10b-5 have a connection with a securities transaction, rather than to automatically include all illicit corporategressions under the rule. Since rule 10b-5 applies to both direct and indirect means used to defraud, almost any fraudulent device arguably could be “in connection with the purchase or sale of any security.” Although a shareholder should be given legal rights of redress for all breaches of fiduciary duty and fraud, it is doubtful that the congressional purpose in exacting section 10(b) was to cover these situations.\(^\text{29}\) Although it is true that investors and shareholders are one and the same, and that which affects a person as a shareholder necessarily affects him as an investor, nevertheless the Exchange Act was passed to protect security investors. Thus, with the decline of a strict purchaser-seller requirement the “in connection with” language becomes more important as a limitation.

The decisions which have modified Birnbaum have done so in two ways. First, the cases have expanded the concept of purchaser or seller. Since these decisions rest on a finding that an actual or constructive purchaser or seller is involved, they are easily justified by reliance on the congressional purpose. Second, and more controversial, is the recent tendency to read the “in connection with” phrase to provide a rule 10b-5 remedy when the fraudulent practice merely affects the purchase or sale of a security. Discussion of this later development will follow an analysis of the cases expanding the purchaser-seller doctrine.

III. Expansion of the Purchaser-Seller Concept

A. Corporate Issuer

The finding that a corporate issuer is a seller of stock and therefore entitled to relief under rule 10b-5 is not, in itself, significant. The transfer of shares for a valuable consideration is in fact a sale and logically should be included in 10b-5.\(^\text{30}\) However, the analysis used by the courts to de-

\(^{27}\) 377 U.S. 426, 432 (1964).
\(^{28}\) See pp. 501-02 supra.
\(^{30}\) The terms “sale” and “sell” are broadly defined in the Act: “The terms sale and sell include any act or use of influence to effect, induce or促成 a purchase or sale” Securities Exchange...
termine that a corporate issuer is a seller is an indication of their dis-
content with a literal reading of the rule.

In Hooper v. Mountain Sec. Corp.,\textsuperscript{31} plaintiff, trustee in bankruptcy,
sought relief on behalf of a corporation which was allegedly misled by
fraud into issuing stock for worthless assets. Determining that the cor-
porate issuer had standing to sue under rule 10b-5, the court dismissed
a possible implied limitation that an investor status is required. Arguably
such a limitation could exist since the section states that it is for the pro-
tection of investors; thus, only investors injured by fraud in a purchase or
sale context could use the rule for a remedy. The court, however, looked
to the congressional grant of authority to the SEC contained in section
10(b) and found that Commission rules could be promulgated to foster
"the public interest" as well as for the "protection of investors."\textsuperscript{32} It
was reasoned that 10(b) was passed to protect both of these interests,
and that prevention of the abuses of corporate issuers came within the
purpose of protecting the public interest, which interest by judicial inter-
pretation is limited to those persons specifically injured, \textit{i.e.}, in a manner
other than as a member of the general public.\textsuperscript{33} Thus, 10b-5 protects
"persons who would be engaged in buying and selling and trading in
corporate securities," and this group necessarily includes the corporate
issuer.\textsuperscript{34} The court then determined that regulation of the issuance of
securities under 10b-5 would foster the legislative purpose of 10(b).\textsuperscript{35}
Thus, the court did not feel that a strict reading of the statute was required,
but instead stressed the legislative purpose to read expansively the terms
purchaser and seller. Although the court was not concerned specifically
with the "in connection with" language of section 10(b), its holding is
a departure from Birnbaum's strict reading. Also, since an issuance of
securities was the basis of the fraud the court is not subject to criticism
for expanding 10b-5 beyond its intended purpose, \textit{i.e.}, the protection of
those connected with a securities transaction.

Hooper was relied upon by the Second Circuit in the more significant
case of Ruckle v. Roto American Corp.\textsuperscript{36} In Ruckle, plaintiff, the owner
of over 50 percent of the voting stock of defendant corporation, brought
a derivative suit to restrain defendant directors from consummating a
plan whereby the latter would retain control of defendant corporation by
fraudulently causing the corporation to issue 75,000 shares of treasury

\begin{footnotes}
\footnote{Act \textsuperscript{3} 3(a)(14), 15 U.S.C. \textsuperscript{4} § 78(a)(14) (1964). Equally broad are the terms "buy" and "purchase." "The terms 'buy' and 'purchase' each include any contract to buy, purchase, or otherwise acquire." Securities Exchange Act \textsuperscript{5} 3(a)(13), 15 U.S.C. \textsuperscript{6} § 78c(a)(13) (1964).}
\footnote{31. 282 F.2d 195 (5th Cir. 1960); \textit{accord}, Brammer v. Rosenberg, CCH Fed. Sec. L. Rep. \textsuperscript{7} ¶ 92,341 (S.D.N.Y., Jan. 29, 1969); Pappas v. Moss, 393 F.2d 865 (3d Cir. 1968).}
\footnote{32. See note 1 supra.}
\footnote{33. The court referred to the tort theory of determining a private cause of action from a federal statute. 282 F.2d at 202. See note 3 supra.}
\footnote{34. 282 F.2d at 202.}
\footnote{35. \textit{Id.} at 203}
\footnote{36. 339 F.2d 24 (2d Cir. 1964).}
\end{footnotes}
stock to defendant director. The fraud alleged was a refusal by the directors to disclose certain material facts regarding the financial condition of the corporation. In adopting Hooper's finding that an issuing corporation may be a seller the court distinguished Birnbaum on the facts. It said that Birnbaum involved an action against a director for fraud injuring stockholders and thereby precluding a derivative suit on behalf of the corporation, whereas in the present situation the corporation was actually being defrauded into issuing shares. It continued, "absent statutory language to the contrary, a corporation that has not been the victim of fraud cannot sue." Birnbaum, it said, does not stand for the proposition that a corporation which is actually defrauded into issuing securities is barred from a 10b-5 remedy. Concerning the problem before it, the court added:

"A"s a result of the fraud perpetrated upon the issuing corporation, overvalued stock may reach the market. Of course, it was precisely the fear that such securities would be publicly distributed which prompted Congress to enact the federal securities laws.

Ruckle apparently read Birnbaum in a limited sense, i.e., as only standing for the proposition that the person seeking 10b-5 redress must, himself, establish a "connection with" a security transaction. In 1964, however, the time of the Ruckle decision, Birnbaum's strict purchaser-seller requirement was still arguably in force. Under such a requirement, it would be possible to find that the corporate issuer in Ruckle did not have standing since it had yet to complete the issuance of securities and was not a seller entitled to 10b-5 relief. However, if this result was required under Birnbaum, its rejection appears proper. The Second Circuit has literally interpreted both the SEC rule and Securities Exchange Act in order to effectuate the congressional purpose of protecting investors rather than relying on a rigid doctrine, and thereby has given "seller status" to a person who has yet to sell shares. Allowing a cor-

37. Id. at 27.
38. Id. at 27-28. The court also discussed Howard v. Furst, 238 F.2d 790 (2d Cir. 1956), cert. denied, 353 U.S. 937 (1957).
39. 339 F.2d at 28.
40. Id. See Comment, The Purchaser-Seller Limitation To SEC Rule 10b-5, supra note 6, at 694.
41. Decisions such as A.T. Brod & Co. v. Perlow, 375 F.2d 393 (1st Cir. 1967), see p. 506 infra, and Vine v. Beneficial Fin. Co., 374 F.2d 627 (2d Cir.), cert. denied, 389 U.S. 970 (1967), see p. 508 infra, which distinguished Birnbaum's strict purchaser-seller requirement in order to allow "abortive" and "constructive" sellers respectively to obtain 10b-5 remedies, had not yet been decided. In both cases, a sale was not completed. Brod involved a fraudulent order to purchase securities and "Vine" a merger. However, since Ruckle was decided before these cases, there was still a question as to whether a 10b-5 remedy could be obtained by a private party without such party being defrauded by an actual and completed purchase or sale.
42. Since Ruckle concerned the ability of a corporation to obtain an injunction to restrain the issuance of its shares by the directors, it could be argued that its distinction of Birnbaum was not significant because of the unique situation involved. When a private party learns of a fraud he may simply refuse to complete the transaction and thereby avoid injury, yet to obtain the same result a corporation, through its shareholders, must seek an injunction, since the party deceiving it is its own
porate issuer an injunction to restrain a fraudulent issuance of shares meets the “in connection with the purchase or sale of any security” test, since there is an actual security transaction which if carried out would cause an injury. This result, furthermore, finds support in the line of cases which have limited Birnbaum by permitting 10b-5 relief to persons who have been injured by fraud in a purchase-sale context, yet have not actually sold or purchased securities.

B. Abortive Seller

In A. T. Brod & Co. v. Perlow,43 a broker brought an action under section 10(b) and rule 10b-5 seeking monetary damages to compensate him for defendant’s fraudulent failure to pay for securities which he had ordered through the plaintiff with the subjective reservation of paying for them only if they reached a certain price. The Court of Appeals for the Second Circuit found that it is not necessary to be an actual purchaser or seller in order to maintain an action under the above provisions and that an aborted seller may therefore properly obtain relief. Although the court did not mention Birnbaum, its analysis evidenced an intent to expand that doctrine. The court found that “10(b) was aimed at manipulative and deceptive devices which were employed ‘in connection with the purchase or sale of any security’ and which contravened the rules and regulations established by the Commission.”44 Furthermore, on the ground that the Act’s protection was not limited to investors, the court used an analysis similar to that in Hooper to find that the non-investor broker had standing to maintain the suit.45 The court said:

Nor do we think it sound to dismiss a complaint merely because the alleged scheme does not involve the type of fraud that is “usually associated with the sale or purchase of securities.” 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.46

In reaching their decision the court mentioned that the SEC filed an amicus curiae brief condemning the plaintiff’s practice and noting its

director presently in power. However, the approach of the court indicated a liberal view toward analyzing the standing problem.

There are two other areas in which the issue is the availability of an injunction under rule 10b-5. One concerns the ability of a private party to restrain a continuing manipulation of corporate stock by insiders. This will be discussed at pp. 512-13 infra. The other concerns the ability of the corporation to obtain an injunction under 10b-5 to restrain a fraud against the corporation by outsiders. See note 67 infra.

44. 375 F.2d at 396.
45. Id.
46. Id. at 397.
adverse effect on the securities market. This indicates the court's concern that the particular activity before it must have a connection with a purchase or sale. Thus, rather than relying on an arbitrary rule limiting standing, the court stressed the connection which this scheme had with the securities market. The *Brod* decision is sound in that it has used the purpose of the Act to extend protection; yet, since it specifically found a connection with the purchase of a security the court has limited itself to matters properly in the federal domain.

*Commerce Reporting Co. v. Puretec, Inc.* represents a case emphasizing the words "in connection with". The facts were similar to *Brod* and the defendant urged the application of the *Birnbaum* doctrine, but the court refused to follow that doctrine because to do so would "fly in the face" of the congressional objective, and would render unnecessary the words "in connection with". Its effect would be to artificially restrict the statute to proscription of fraud "in the purchase or sale" rather than "in connection with" the purchase and sale of a security. The use of the words "in connection with" indicates that Congress intended to protect against fraud in agreements to buy or sell, as well as with respect to completed sales, provided damages could be shown.

With *Brod* and *Puretec* protecting parties against fraud even though a sale has not been consummated, it appears that the purchaser-seller requirement will not be a bar to plaintiffs who have been defrauded in situations involving an abortive sale or purchase transaction. In such a context a connection with a securities transaction is evident and the only element lacking is the completion of that transaction. It would appear proper, therefore, to allow standing to bring an action under 10b–5 in this situation.

C. Constructive Seller

In the previously discussed cases there has been an actual sale or purchase transaction to which the "in connection with" language could be applied to provide rule 10b–5 protection. The following discussion will concern the extension of 10b–5 to cover parties who have been victims of fraudulent mergers and who received stock in the merged com-

---

47. *Id.*
48. *See* 375 F.2d at 397 n.3, where the court said:

Prior decisions in this Circuit [second] have been, on occasions, interpreted as standing for the rule that only a purchaser or seller may bring a Rule 10b–5 action. . . . [citing Birnbaum]. The Commission, in recent cases, has urged that this interpretation of the Act is too narrow . . . . [see the discussion of *Vine v. Beneficial Fin. Co.*, p. 508 infra.] We need not consider that contention since appellant is clearly a purchaser of securities.
pany in exchange for their old stock. The extension includes situations termed forced or constructive sales. It is forced because the volition normally associated with a sale is absent when a stockholder exchanges his shares for stock in the surviving corporation and it is constructive since the exchange element of a sale is present and the shareholder has disposed of shares, yet there actually has not been a sale.

In *Vine v. Beneficial Fin. Co.*, plaintiff, a minority shareholder of Crown Finance Co., Inc., sought damages under rule 10b-5 alleging that defendant, acting in concert with Crown officers, acquired shares of Crown by a tender offer for an inadequate consideration. Subsequently, defendant completed a short-form merger of Crown into one of its subsidiaries. Although the plaintiff did not tender shares pursuant to defendant’s offer, the court allowed the action. It determined that the harm to plaintiffs was similar to that suffered by a normal seller and found that the 1934 Act’s definition of seller was broad enough to include protection for this type of transaction. A specific determination of a sale was then made. It may be argued that since this situation was labeled a sale, Birnbaum has not been affected. Yet, the result-oriented analysis of the court evidences a departure from Birnbaum’s strict purchaser-seller requirement. By stressing the type of injury which defendant’s fraud caused the plaintiff, it necessarily emphasized the “in connection with” language of the rule and section. Furthermore, the court said:

The amicus brief [of the SEC] points out that the fraud alleged here is properly regarded as in connection with the purchase of the Class A stock, rather than a sale, since the wrongdoing emanates from the purchaser. We accept this characterization and note that it does not change the substance of the legal right involved.

By adopting the SEC’s view, and finding that this characterization does not change the result, the court has indicated that it considers Birnbaum as too restrictive and that the “in connection with” language of 10b-5 should be read more expansively.

Another significant decision allowing a private party to attack a merger under 10b-5 notwithstanding his continuing shareholder status is the Seventh Circuit case of *Dasho v. Susquehanna Corp.* Plaintiffs brought a derivative action against officers and directors of Susquehanna seeking damages under rule 10b-5. It was alleged that the directors devised a plan by which the corporation would indirectly purchase its own stock from the directors at an inflated price. This was accomplished by the directors selling their stock to another corporation, which was sub-

---

52. 374 F.2d 627 (2d Cir.), cert. denied, 389 U.S. 970 (1967).
54. 374 F.2d at 635 (emphasis added).
55. *But see* Greenstein v. Paul, 400 F.2d 580, 581 (2d Cir. 1968), where the court indicated a more narrow reading of *Vine* was required.
56. 380 F.2d 269 (7th Cir. 1967).
Ciechon: The Decline of the Purchaser-Seller Requirement of Rule 10b-5

SPRING 1969] COMMENTS

sequently merged into defendant corporation. Two judges on a three judge panel joined in a concurring opinion which illustrated the court’s concern with the “in connection with” requirement. They first determined that a statutory merger involved a sale of securities within the Securities Exchange Act and that the act’s purpose would be served by a holding to that effect when the anti-fraud provisions are in controversy.57 Having found a sale the court analyzed the facts to determine whether the directors’ activities were proscribed by 10b-5. They distinguished Birnbaum’s holding that 10b-5 was not applicable to a breach of fiduciary duty by a corporate insider by finding that the corporation was specifically suing as a defrauded seller or buyer.58 Thus, the court found a nexus with a security transaction which would render 10b-5 applicable.

Since there was a specific finding of a purchase and sale, Dasho, like Vine, does not appear to be much of a departure from Birnbaum. It is significant, however, in that once again a court has used the congressional purpose to find 10b-5 coverage. Also, the Dasho concurring opinion did not discuss Birnbaum until after it found a “sale”, i.e., when it was making a determination of whether a fraud was perpetrated by directors in violation of 10b-5.

The Dasho concurring opinion suggests an approach courts should take when deciding a 10b-5 case. A two-step analysis should be used to determine whether the fraud allegedly violative of rule 10b-5 is actionable, considering the rule’s “in connection with” phrase. First, courts should determine whether a securities transaction was affected by the fraud, rather than looking for a completed securities transaction. Second, it should be determined that the fraudulent securities transaction was the basis of the plaintiff’s cause of action. It is possible that a fraud will be concurrent in time with a securities transaction, but instead of being the basis of the plaintiff’s claim, will only be incidental to it. One example is the fraudulent scheme involved in Birnbaum. There, the defendant director had sold his shares to another corporation at an increased price because he knew the latter wished to obtain control of his corporation.59 If he acted in accordance with his fiduciary responsibility, the corporation would have made the profit by selling its assets to the purchaser. This was no doubt a fraudulent scheme, and it involved securities, however, the basis of the fraud was the usurping of the corporate opportunity. The defendant director’s illegal profit was the same that he would have earned if he purchased a profitable real estate tract rightfully belonging to the corporation. Assuming the same monetary amounts, the loss to minority shareholders, the corporate plaintiffs in Birnbaum, would be exactly the same in either the stock or the real estate transaction. The Dasho facts, on the other hand, represent a

58. 380 F.2d at 269-70.
59. See p. 500 supra.
situation which has a securities transaction as the basis of the 10b-5 claim. Although the situation appears similar in both cases in that both decisions involve the transfer of control for an excessive premium, the court in Dasho specifically found a purchase and sale of securities as the basis of the fraud. There was a transfer of shares, albeit indirectly, for an inadequate consideration. Thus, not considering the purchaser-seller status of the plaintiffs, the "in connection with" requirement would not be satisfied under the Birnbaum factual situation, yet can be found in the Dasho situation.

Since the previously discussed cases limiting Birnbaum's strict purchaser-seller requirement have involved an actual, abortive, or constructive sale and were based on the legislative purpose of section 10(b), they appear sound. The constructive seller cases, Vine and Dasho, and to a degree the abortive seller cases, Brod and Puretec, since they all involved interpretation of the purchase and sale terminology involving an actual securities transaction, would probably be approved by the Supreme Court. In the first case dealing with rule 10b-5 to reach the Court, SEC v. National Sec., Inc., it upheld the Commission's use of 10b-5 to attack a merger of two insurance companies which was allegedly achieved through fraudulent misrepresentations sent through the mails. The Court used an expansive definition of seller to allow the SEC's action to proceed under 10b-5. The Court said:

Whatever the terms "purchase" and "sale" may mean in other contexts, here an alleged deception has affected individual shareholder's decisions in ways not at all unlike that involved in a typical cash sale or share exchange. The broad antifraud purposes of the statute and the rule would clearly be furthered by their application to this type of situation.

Although the Court specifically noted that its decision would not affect the question of when a private party may bring an action under 10b-5, as Justice Harlan pointed out in his dissent, determinations concerning the SEC often apply to private parties. Furthermore, since the Court's holding in National Sec., Inc. is only an indication of the manner in which they will read the terms "purchase and sale", it does not appear that the use of its decision in this context is misplaced. It would seem, therefore, that the expansive reading of purchase and sale used by the courts in allowing an abortive or constructive seller to recover under rule 10b-5, has the Supreme Court's approval. When the Court's holding in Borak concerning the use of congressional purpose as a basis for extending private rights of enforcement under federal regula-

60. See generally Schoenbaum v. Firstbrook, 405 F.2d 200 (2d Cir. 1968).
62. 89 S. Ct. 564 (1968).
63. Id. at 572.
64. Id. at 572 n.9.
65. Id. at 574 (dissenting opinion).
tory statutes is considered, the various courts’ reliance on the congressional purpose also appears proper.

As a result of the abortive and constructive seller cases the criteria for bringing a private action under 10b-5 appears to be an injury suffered by a party as a result of an actual securities transaction, whether that transaction is completed or not, as long as the fraud is “in connection with” that transaction. The test, however, has been expanded to allow plaintiffs an injunction under 10b-5 to restrain manipulations of stock which are still continuing i.e., where the securities transaction which is connected with the fraud is in the future rather than in the past.

IV. Expansion of the “In Connection With” Concept

In Mutual Shares Corp. v. Genesco, Inc. plaintiffs, shareholders of S. H. Kress and Company, alleged fraudulent activity by the corporate defendant Genesco and its chairman concerning Kress stock both before and after plaintiffs became shareholders of Kress. The allegations of fraud occurring before plaintiffs became Kress shareholders were that Genesco acquired a substantial percentage of Kress stock by outright purchase and through public tender offers, and by withholding information concerning Kress’ undervalued real estate. It was also alleged that defendants planned to sell this real estate to Genesco’s pension fund for an inadequate consideration to raise funds to pay for the Kress stock acquisitions, and that defendants planned to manage Kress solely for Genesco’s benefit. The allegations of fraud after plaintiffs became Kress shareholders were that defendants financed the Kress acquisition with Kress’ own assets, that Kress was dominated and run for Genesco’s interest rather than Kress’, and the defendants manipulated the market price of Kress’ shares in order to purchase shares from Kress’ minority stockholders at a depressed value.

The court held that 10b-5 was not applicable to the period before plaintiffs became shareholders of Kress. It reasoned that at best the basis of this claim was that defendants impliedly represented that they would not mismanage Kress in the future, and that plaintiffs relied on

68. 384 F.2d 540 (2d Cir. 1967).
69. Id. at 542.
70. Id.
this when they acquired Kress stock. Holding that such a basis was insufficient to maintain a 10b-5 action, the court adopted the SEC's view that this "would convert any instance of corporate mismanagement into a rule 10b-5 case." The court distinguished *Vine v. Beneficial Fin. Co.*, relied upon by the plaintiffs, by noting that there the defendants making the alleged fraudulent offer were insiders and the plaintiff was a member of the class deceived. Thus the court has limited "standing" to bring a private cause of action under 10b-5 to persons who were affected by the alleged wrongful conduct. Since plaintiffs were not shareholders at the time of the alleged fraudulent transactions, they were not harmed and, logically, no remedy was available to them.

The more significant aspect of *Mutual Shares*, however, is its holding regarding defendants' misconduct after plaintiffs became Kress stockholders. The court refused to allow damages for this period since a monetary injury had not yet to occur and the only "connection with" a securities transaction was defendants' purchase of stock from other Kress shareholders at depressed prices. Yet, it allowed the injunctive relief sought by plaintiffs since the manipulative scheme was still continuing. The court said: "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 . . . ." It continued:

Deceitful manipulation of the market price of publicly-owned stocks is precisely one of the types of injury to investors at which the Act and Rule were aimed. Since private parties have the right to sue for violation of the Rule, the broad remedial purposes of the Act suggest that the judicial relief available should not be limited to a particular type of remedy.

The court has therefore used the congressional and administrative purpose of the Act and rule to read the phrase "in connection with the purchase or sale of any securities" to allow a private party standing under 10b-5, even though there has yet to be an actual securities sale or purchase. It should be emphasized, however, that in permitting the remedy the court spoke of the continuing manipulation of the security markets. It did not use the plaintiffs' allegations that defendants' operation of Kress solely for Genesco's benefit and use of Kress assets to pay for the Kress acquisitions was a basis for the 10b-5 relief. Thus, the court has appropriately limited its holding to apply only to frauds which affect security transactions.

71. Id. at 545.
73. See Comment, *The Purchaser-Seller Limitation to SEC Rule 10b-5*, supra note 6, at 696-97.
74. 384 F.2d at 546.
75. Id. at 546-47.
76. Id. at 547.
In light of the Mutual Shares rationale in determining that rule 10b-5 would permit a private party the right to obtain an injunction, its refusal to allow a cause of action to proceed for damages appears illogical. Although the lack of actual monetary damages would make more difficult a plaintiff's proof of loss,77 this factor alone should not be a basis for dismissing an action without first permitting a plaintiff an attempt to prove his damages. The court found that the only connections with the purchase or sale of any security on which plaintiff could rely were the purchases by defendants from other shareholders.78 Yet, in allowing the injunction the court looked to the purpose of the Act and determined that continuing manipulations of stock was a sufficient "connection with" the purchase or sale of a security.79 It is submitted that this same connection could be the basis of an action for damages if damages could be proved. Since plaintiffs were members of the group at which defendants' fraud was aimed, they could be injured by the depressed value of the stock even while they still held it. The plaintiffs could prove that the reduced price of the stock dwindled its value as collateral for a loan, thus causing them to lose a business opportunity.80 Moreover, the Mutual Shares court cited Borak for the proposition that relief available to private parties "should not be limited to a particular type of remedy."81 Nonetheless, the court has limited plaintiffs to injunctive relief, when a manipulative device directly affecting the price of securities is continuing, and could cause plaintiffs monetary damage.

The United States District Court for the Southern District of New York case of Entel v. Allen82 represents a successful attempt by a private party to recover damages before he has become a party to an actual securities transaction. However, because of the factual situation involved in the case, the validity of the case may be questioned. In Entel, plaintiffs, stockholders of Atlas Corporation, sued individually and derivatively on behalf of Atlas, alleging a fraudulent sale of Atlas' interest in Northeast Airlines to Hughes Tool Company. The allegations of fraud were that defendants obtained shareholder approval of the sale by failing to disclose that the sale was not at arm's length and that an inadequate consideration was paid for the stock. The court relied upon the Vine83 and Brod84 decisions, concluding that these cases have appeared to overrule Birnbaum's strict purchaser-seller requirement, thereby permitting the 10b-5 remedy.85

---

77. See generally Comment, Private Enforcement Under Rule 10b-5: An Injunction For A Corporate Issuer?, supra note 6, at 624-25.
78. 384 F.2d at 546.
79. See p. 512 supra.
80. Comment, The Purchaser-Seller Limitation to SEC Rule 10b-5, supra note 6, at 698.
81. 384 F.2d at 547.
82. 270 F. Supp 60 (S.D.N.Y. 1967).
83. See p. 508 supra.
84. See p. 506 supra.
85. 270 F. Supp. at 70.
This reliance on *Vine* and *Brod* has been criticized on the ground that in both cases it was expressly found that a purchaser or seller was involved. The *Entel* decision warrants criticism but not on this ground. Both *Vine* and *Brod*, it will be recalled, emphasized the congressional purpose and read the "in connection with" language expansively in concluding that the type of fraud involved in those cases was properly within the scope of 10b-5. Once it is established that this method of reading the statute and rule is acceptable, it would appear permissible to determine whether the transaction before the court was the type of transaction which would affect a purchase or sale of securities and, thus, be within the congressional purpose. Thus, the fact that *Vine* and *Brod* eventually made a determination that a purchaser or seller was involved should not be significant. *Entel* may be criticized, however, because it failed to distinguish between the derivative suit and the class action. The decision permitting the derivative suit appears correct. The corporation was a seller and was, therefore, defrauded by a scheme directly pertaining to the sale. There was a securities sale by the corporation which was induced by fraud, and this was the basis of the suit. However, concerning the shareholder class action, the *Entel* decision rests on weaker grounds. The basis of the shareholders' suit was the defendants' scheme of selling the corporation's interest in Northeast Airlines for an inadequate consideration. When the fraud is analyzed, it becomes evident that plaintiffs were relying on a breach of fiduciary duty for their 10b-5 action. The only injury which they suffered was a loss to their corporation of a just price for its Northeast Airline stock. This injury does not affect them as individual investors. Once again, therefore, it is important to distinguish between a fraud which directly affects a securities transaction, and one which is incidently related to the purchase or sale of securities. The plaintiffs, as shareholders, are the parties who must allege a fraud "in connection with" a securities transaction and, in this situation, the plaintiffs are relying on fraud affecting the corporation.

The *Entel* decision represents a danger inherent in an unreflected application of the theory involved in the decline of Birnbaum's strict purchaser-seller requirement. It may appear anomalous to allow private parties relief in a *Mutual Shares* situation when corporate securities are being manipulated, yet deny relief when a fraudulent sale has taken place actually causing harm to the plaintiff's corporation. Nonetheless,
a distinction is present. In the first situation there is a fraud "in connection with" a securities scheme which will harm the shareholder, while in the second, the fraud is "in connection with" a scheme which instead of harming the shareholder harms his corporation.

V. Conclusion

The extension of 10b-5 to cover fraudulent schemes which are similar to a purchase or sale and which will affect a future securities transaction appears proper. Nevertheless, caution must be exercised lest the demise of Birnbaum's strict purchaser-seller requirement open the door to allow any corporate fraud to be remedied under rule 10b-5. It was said in the Third Circuit case of McClure v. Borne Chem. Co.\(^\text{92}\):

Section 10(b) imposes broad fiduciary duties on management vis-à-vis the corporation and its individual stockholders. As implemented by Rule 10b-5 and Section 29(b),\(^\text{93}\) Section 10(b) provides stockholders with a potent weapon for enforcement of many fiduciary duties . . . . It can be said fairly that the Exchange Act, of which Sections 10(b) and 29(b) are parts, constitutes a far reaching federal substantive corporation law.\(^\text{94}\)

This statement together with the trend to read rule 10b-5 expansively could be used as a basis for allowing private parties to seek remedies under 10b-5 for corporate fraud which only indirectly affects market prices. Cases such as Britt v. Cyril Bath Co.\(^\text{95}\) and Lester v. Preco Indus., Inc.,\(^\text{96}\) where plaintiffs attempted to use 10b-5 to obtain redress for various acts of corporate mismanagement and waste, should continue to have legal validity.\(^\text{97}\) In the Britt case plaintiffs attempted to obtain a remedy for defendant's fraudulent entrance into a royalty agreement with its principal shareholder in return for patent assignments by him to the corporation. The only connection with a security transaction was the defendant corporation's purchase of treasury stock apparently in no way connected with the fraudulent patent deal. In dismissing plaintiff's cause of action the court said:

Even the most generous reading of the facts alleged in the amended complaint fails to disclose a causal connection between this conduct and any resultant purchase or sale of a security . . . [A]ny stockholder could plausibly argue that in buying or selling shares he relied on implied representations of management not to mismanage and by such argument convert any instance of corporate mismanagement

\(^{92}\) 292 F.2d 824 (3d Cir. 1961).
\(^{94}\) 292 F.2d at 834.
\(^{95}\) 290 F. Supp. 934 (N.D. Ohio 1968).
\(^{97}\) 290 F. Supp. at 936; 282 F. Supp. at 461-62.
into a Rule 10b–5 case . . . . Allegations of directors' mismanagement coupled only to some ultimate speculative effect on the general market for a corporation's stock is a much too tenuous connection to support a claim under Rule 10b–5.

This statement represents a sensible limitation to the extension of 10b–5. The fraud being proscribed should be limited to that which pertains to a securities transaction and affects the party seeking redress because failure to so limit it will transform 10b–5 into a general federal law of corporate fiduciary duty, a result which is not within the congressional purpose of 10b–5.

Edward J. Ciechon, Jr.