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Securities Regulation - Purchaser-Seller Requirement under Rule 10b-5 Abandoned by the Seventh Circuit, Standing to Sue Granted to a Non-Purchasing or Selling Plaintiff

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coupled with the resolution of the instant case, does result in a greater range of conduct exposing an attorney to potential liability, but is consistent with an expressed intent to protect the investing public.⁸⁶

It must be emphasized that the instant case was remanded for an evidentiary hearing, an injunction to be granted if negligence is found. The resolution of the conflicting affidavits presented in this case⁸⁷ should set for the future the parameters for culpable conduct by attorneys in similar situations. Even were the facts to be resolved in Schiffman's favor, the SEC requirement that an attorney reasonably investigate⁸⁸ clearly has not been satisfied here. Responsible counsel should not take affirmative action solely in reliance upon the letters of another attorney, if, because of insufficient knowledge of the underlying facts, he is hesitant to rely upon a client's representation. The established practice of responsible counsel should be to use due diligence to resolve for himself any factual as well as legal matters that may be in question. The action taken by the Second Circuit in the instant case fits well with prevailing practice and, as a preface to the *NSMC* litigation, was a necessary step in holding the legal profession to the degree of responsibility long requested and now required.

Marina P. Bartley

SECURITIES REGULATION — PURCHASER-SELLER REQUIREMENT
UNDER RULE 10b-5 ABANDONED BY THE SEVENTH CIRCUIT, STAND-
ING TO SUE GRANTED TO A NON-PURCHASING OR SELLING PLAINTIFF.

Eason v. General Motors Acceptance Corp. (7th Cir. 1973)

Bank Service Corporation (Bank Service) purchased an automobile leasing business from Dave Waite Pontiac, Inc. (defendant seller).¹ As consideration for the business, Bank Service issued stock to defendant seller and assumed its liabilities, among which were certain notes payable to defendant General Motors Acceptance Corporation (GMAC).² The notes were individually guaranteed by plaintiffs, shareholders in Bank Service.³ Due to alleged misrepresentation as to the value of the assets

to do so, he *shall* reveal the fraud to the affected person or tribunal.

(2) A person other than his client has perpetrated a fraud upon a tribunal shall promptly reveal the fraud to the tribunal.

Id. D.R. 7-102(B). Of course, a question would always exist as to how "clearly" the fraud would have to be established before the duty would arise.

86. See notes 56-60 and accompanying text *supra*.

87. 489 F.2d at 538-39.

88. See note 31 *supra*.

1. *Eason v. General Motors Acceptance Corp.*, 490 F.2d 654, 655 (7th Cir. 1973), *cert. denied*, 416 U.S. 960 (1974).

2. 490 F.2d at 655. GMAC financed the cars purchased by the leasing busi-

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3. *Id.*

acquired by Bank Service,⁴ the leasing business failed, causing Bank Service to become insolvent and default on the notes.⁵ Defendant GMAC commenced suit in state court, seeking to hold plaintiffs liable on their individual guarantees.⁶ Plaintiffs countered with a suit in federal district court seeking rescission of the guarantees, alleging violations of section 10-b of the Securities Exchange Act of 1934,⁷ and Securities and Exchange Commission (SEC) rule 10b-5⁸ by both defendants. The district court dismissed the complaint, holding that plaintiffs were neither purchasers nor sellers of securities, and therefore, failed to meet the purchaser-seller requirement⁹ of *Birnbaum v. Newport Steel Corp.*, applicable in suits for private relief under rule 10b-5.¹⁰ The United States Court of Appeals

4. *Id.* at 656. It is immaterial that the fraud involved related to the value of the assets acquired rather than the value of the securities issued by Bank Service. The rule only requires that the fraud be "in connection with" the sale of a security. See note 7 *infra*. But see Fleischer, "Federal Corporation Law": An Assessment, 78 HARV. L. REV. 1146, 1161-62 (1965). The "in connection with" clause has been interpreted to require only that the fraud "touch" a securities transaction. Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 12-13 (1971).

5. 490 F.2d at 656.

6. *Id.*

7. 15 U.S.C. § 78j(b) (1970). The statute provides:

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

(b) To use or employ, in connection with the purchase or sale of any security registered on a national security 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.

Id.

8. 17 C.F.R. § 240.10b-5 (1973). The rule states that:

It shall be unlawful for any person, directly or indirectly, by 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.

9. 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952). In *Birnbaum*, plaintiffs, minority shareholders, sued derivatively on behalf of the corporation and as representatives of all other similarly situated shareholders, alleging that the president, the controlling shareholder of Newport, had abruptly broken off merger talks with Follansbee Steel Corp. and instead sold his stock to Willport Company at a substantial premium. Plaintiffs alleged fraud in violation of rule 10b-5 in that the president misrepresented the reason for suspension of the merger talks in letters to Newports' shareholders. 193 F.2d at 462. The Second Circuit upheld dismissal of plaintiffs' claim holding that plaintiffs had neither purchased nor sold securities and that rule 10b-5 extended protection only to the defrauded purchaser or seller. *Id.* at 464.

10. 490 F.2d at 655. The district court opinion is unreported. The plaintiffs advanced three arguments seeking to avoid the purchaser-seller limitation: (1) that the guarantees were securities which they sold to GMAC; (2) that the notes payable were securities which they were forced to purchase; and (3) that they were indirect sellers of the shares issued by the corporation. *Id.* The court of appeals, in order to reach the issue of the validity of the purchaser-seller requirement rejected the arguments without discussion. *Id.* at 656.

for the Seventh Circuit reversed, *holding* that *Birnbaum* was no longer part of the law of the circuit, and that plaintiffs, *as investors*,¹¹ had alleged injury which could be redressed by a federal court under rule 10b-5. *Eason v. General Motors Acceptance Corp.*, 490 F.2d 654 (7th Cir. 1973), *cert. denied*, 416 U.S. 960 (1974).

Both the Securities Act of 1933 (1933 Act)¹² and the Securities Exchange Act of 1934 (Exchange Act)¹³ were enacted in response to the stock market collapse of 1929 and the resulting decline in investor confidence.¹⁴ Within the legislative scheme, Congress enacted section 10(b) of the Exchange Act, which forbids "any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."¹⁵ In 1942, in a seemingly innocuous exercise of the rulemaking authority of this section, the SEC announced the adoption of rule 10b-5,¹⁶ which essentially prohibited fraud by any person in connection with the purchase or sale of securities. Four years later, the rule acquired the basis for its immeasurable present import¹⁷ when a federal district court held that there existed an implied private right of action for violation of the rule.¹⁸ However, the availability

11. For a discussion of the significance of this term, *see* text accompanying notes 41-45 *infra*.

12. 15 U.S.C. §§ 77a *et seq.* (1970).

13. 15 U.S.C. §§ 78a *et seq.* (1970). The Exchange Act also created the Securities and Exchange Commission. *Id.* § 78d (1970).

14. *See generally* 25 SEC ANN. REP. 215 (1959).

15. 15 U.S.C. § 78j(b) (1970). *See* note 7 *supra*.

16. SEC Securities Exchange Act Release No. 3230 (May 21, 1942). For the text of the rule, *see* note 8 *supra*.

17. The Fifth Circuit recently remarked that "the rule has been applied in such a variety of situations that one can scarcely find an issue of the advance sheets of the Federal Supplement and Federal Reporter that does not contain an opinion on § 10(b)." *Rekant v. Desser*, 425 F.2d 872, 877 (5th Cir. 1970).

18. *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946). The Supreme Court has now explicitly recognized the existence of an implied private right of action for a violation of section 10(b). *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 13 n.9 (1971). In *Kardon* the court relied primarily upon the statutory-tort theory in order to imply a private right of action. To explain the statutory-tort theory, the court cited RESTATEMENT OF TORTS § 286 (1934), 69 F. Supp. at 513, which provides:

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

(a) The intent of the enactment is exclusively or in part to protect an interest of the other as an individual; and,

(b) The interest invaded is one which the enactment is intended to protect; and,

(c) Where the enactment is intended to protect an interest from a particular hazard, the invasion of the interest results from that hazard; and,

(d) The violation is a legal cause of the invasion, and the other has not conducted himself so as to disable himself from maintaining an action.

RESTATEMENT OF TORTS § 286 (1934). For a general discussion of the statutory-tort theory, *see* 1 A. BROMBERG, SECURITIES LAW: FRAUD § 2.4(1)(a) (1973) [hereinafter cited as BROMBERG].

A second theory upon which an implied right of action may be based, is that of statutory voidability. This theory is based upon section 29(b) of the Exchange Act, which provides that a contract in violation of the Exchange Act or any rule or regulation promulgated thereunder shall be void. 15 U.S.C. § 78cc(b) (1970). The

void, the injured party should have a remedy with respect to the void contract. The

of the private remedy was later limited by the Second Circuit's pronouncement in *Birnbaum* that the rule's "umbrella" of protection extended only to those who purchased or sold securities.¹⁹ The life, death, and resurrection of the so-called *Birnbaum* doctrine has been one of the more controversial issues in a rapidly expanding area of the law.²⁰

Eason marks the first time any circuit court of appeals has expressly rejected²¹ the purchaser-seller requirement in a suit for other than prospective injunctive relief.²² The opinion is essentially a tripartite analysis of plaintiffs' claims, the various parts of which merit separate consideration: First, did the plaintiffs have "standing" in its traditional sense? Second, did the protection of rule 10b-5 extend to a party in the plaintiffs' position? And third, were there overriding policy considerations which should have defeated the plaintiffs' claim?²³

Although the term "standing" was not mentioned in the *Birnbaum* decision, it is that label which courts often have attached to the purchaser-

court in *Kardon* listed this theory as an alternative basis for its decision. 69 F. Supp. at 514.

Other theories upon which an implied right of action may be based include those of statutory implication and statutory policy. See generally BROMBERG, *supra*, at §§ 2.4(1)(b)-(d). It has also been argued that Congress did not in fact intend section 10(b) to apply to private causes of action. See Ruder, *Civil Liability Under Rule 10b-5: Judicial Revision of Legislative Intent?*, 57 Nw. U.L. Rev. 627 (1963).

19. See note 9 *supra*.

20. The *Birnbaum* debate has produced an abundance of law review material. See, e.g., Boone & McGowan, *Standing to Sue Under SEC Rule 10b-5*, 49 TEXAS L. REV. 617 (1971); Kellogg, *The Inability to Obtain Analytical Precision Where Standing to Sue Under Rule 10b-5 is Involved*, 20 BUFFALO L. REV. 93 (1970); Lowenfels, *The Demise of the Birnbaum Doctrine: A New Era for Rule 10b-5*, 54 VA. L. REV. 268 (1968); Comment, *10b-5 Standing Under Birnbaum: The Case of the Missing Remedy*, 24 HASTINGS L.J. 1007 (1973); Comment, *The Decline of the Purchaser-Seller Requirement of Rule 10b-5*, 14 VILL. L. REV. 499 (1969).

21. Several courts and commentators have expressed the opinion that *Birnbaum* has been implicitly overruled by some of the expansive readings of the terms "purchaser" and "seller." See e.g., *Entel v. Allen*, 270 F. Supp. 60, 69 (S.D.N.Y. 1967); and Lowenfels, *supra* note 22. Subsequent decisions in the Second Circuit, however, reaffirmed the vitality of *Birnbaum*. See, e.g., *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 430 F.2d 355, 360-61 (2d Cir. 1970), *rev'd on other grounds*, 404 U.S. 6 (1971); *Iroquois Indus., Inc. v. Syracuse China Corp.*, 417 F.2d 963, 968-69 (2d Cir. 1969), *cert. denied*, 399 U.S. 909 (1970).

22. A number of courts have held that, in suits for prospective injunctive relief, a plaintiff need not allege that he is a purchaser or seller of securities. *Kahan v. Rosenstiel*, 424 F.2d 161, 170-73 (3rd Cir.) (dictum), *cert. denied*, 398 U.S. 950 (1970); *Mutual Shares Corp. v. Genesco*, 384 F.2d 540 (2d Cir. 1967). *But see* *Greater Iowa Corp. v. McLendon*, 378 F.2d 783 (8th Cir. 1967); *Jachimiec v. Schenley Indus., Inc.*, Civil No. 51024 (7th Cir.), *cert. denied*, 382 U.S. 841 (1965). The rationale of *Genesco* is that since one purpose of section 10(b) is to prevent the use of manipulative devices, a party who may be subsequently injured by the device or scheme is a "logical plaintiff" to aid the SEC in its enforcement of the Act. 384 F.2d at 547. Moreover, in a suit for injunctive relief the issues of proof of loss and causation are avoided. *Id.* Presumably, a plaintiff who has purchased or sold securities in reliance upon some alleged fraudulent conduct or statement by defendant is in a better position to prove the above elements, and for this reason it has been suggested that courts retain *Birnbaum* when dealing with completed transactions. *Manor Drug Stores v. Blue Chip Stamps*, 492 F.2d 136, 141 (9th Cir. 1973), *cert. granted*, 95 S. Ct. 302 (1974). See also *Kahan v. Rosenstiel*, 424 F.2d 161, 173 (3d Cir.), *cert. denied*, 398 U.S. 950 (1970); BROMBERG, *supra* note 18, § 4.7, at 565-66.

23. 490 F.2d at 656.

seller requirement. Thus, where a complaint fails to allege that the plaintiff was a purchaser or seller of securities, a motion to dismiss is frequently granted because of "a lack of standing."²⁴ In the first segment of its analysis, the *Eason* court noted two possible interpretations of the "standing" requirement: standing in a constitutional sense, as mandated by article III, section 2, of the United States Constitution,²⁵ and standing in a non-constitutional sense, dependent upon an analysis of plaintiffs' status as persons protected by the rule or statute in question.²⁶

The doctrine of constitutional standing concerns whether a particular plaintiff is an appropriate person to maintain the cause of action,²⁷ the crucial question being whether "the dispute sought to be adjudicated will be presented in an adversary context and in a form historically viewed as capable of judicial resolution."²⁸ Presently the law of standing and the precise tests to be applied in a particular situation are in a state of flux.²⁹

24. See, e.g., *Manor Drug Stores v. Blue Chip Stamps*, 492 F.2d 136, 141 (9th Cir. 1973), cert. granted, 95 S. Ct. 302 (1974).

25. 490 F.2d at 656. The federal judicial power is limited by article III of the United States Constitution to "cases" and "controversies." U.S. CONST. art. III, § 2. The Constitution provides:

The Judicial Power shall extend to all *Cases*, in Law and Equity, arising under this Constitution, the Laws of the United States, and Treaties made, or which shall be made, under their Authority; — to all *Cases* affecting Ambassadors, other Public Ministers and Consuls; — to all *Cases* of Admiralty and maritime Jurisdiction; — to *Controversies* to which the United States shall be a Party; — to *Controversies* between two or more States; — between a State and Citizens of another State; — between Citizens of different States; — between Citizens of the same State claiming Lands under Grants of different States, and between a State, or the Citizens thereof, and foreign States, Citizens or Subjects.

Id. (emphasis added).

According to the Supreme Court:

A case arises, within the meaning of the Constitution, when any question respecting the Constitution, treatise or laws of the United States has assumed "such a form that the judicial power is capable of acting on it." . . . A declaration on rights as they stand must be sought, not on rights which may arise in the future, and there must be an actual controversy over an issue, not a desire for an abstract declaration of the law. The form of the proceeding is not significant. It is the nature and effect which is controlling.

In re *Summers*, 325 U.S. 561, 566-67 (1945) (citations omitted).

In addition, the Court has noted:

[A] controversy must be definite and concrete, touching the legal relations of parties having adverse legal interests. It must be a real and substantial controversy admitting of specific relief through a decree of a conclusive character, as distinguished from an opinion advising what the law would be upon a hypothetical state of facts.

Aetna Life Ins. Co. v. Haworth, 300 U.S. 227, 240-41 (1937) (citations omitted).

The "case and controversy" requirement of Article III is satisfied by an allegation that the plaintiff has suffered "injury in fact, economic or otherwise." *Association of Data Processing Serv. Orgs., Inc. v. Camp*, 397 U.S. 150, 151-52 (1970).

26. 490 F.2d at 657.

27. *Flast v. Cohen*, 392 U.S. 83, 99-100 (1968).

28. *Id.* at 101.

29. In a recent decision involving a challenge to an action of an administrative agency, *Association of Data Processing Serv. Orgs., Inc. v. Camp*, 397 U.S. 150, 152-54 (1970), the Supreme Court articulated a two-pronged test for standing. The initial test mandated by *Data Processing* was that of determining whether plaintiff has alleged an "injury in fact, economic or otherwise." *Id.* at 152. Next, it had to be determined whether the interest sought to be protected is arguably within the zone of interests to be protected or regulated by the statute or constitutional guarantee

Nevertheless, the test for constitutional standing is generally formulated as one which requires plaintiff to allege "injury in fact, economic or otherwise."³⁰ The *Eason* court stated that the purchaser-seller requirement was not *constitutionally* mandated³¹ under this test since plaintiffs who were neither purchasers nor sellers could nonetheless demonstrate the requisite injury. In the instant case, for example, the plaintiffs were potentially liable as guarantors of notes worth \$300,000 as a result of the transaction with defendants.

The court, therefore, turned to the second interpretation of the standing requirement — whether plaintiffs were among the class of persons intended to be protected by the rule. Perhaps mindful of Mr. Justice Douglas' admonition that "[g]eneralizations about standing to sue are largely worthless as such,"³² the *Eason* court concluded that the issue should *not* be phrased in terms of "standing,"³³ and, with that as its predicate, initiated the discussion contained in the second part of its analysis.

Any resolution of the problem of who is protected by rule 10b-5 necessarily turns upon an interpretation of the legislative intent behind the provision. In reaching its more restrictive interpretation, the *Birnbaum* court chose to look to the SEC release accompanying rule 10b-5³⁴ as a vehicle for determining legislative intent. Using the premise of the release — that rule 10b-5 was designed to close a "loophole" in section 17(a)

in question. *Id.* at 153. For a discussion of the foregoing, see Davis, *The Liberalized Law of Standing*, 37 U. CHI. L. REV. 450 (1970); Jaffe, *Standing Again*, 84 HARV. L. REV. 633 (1971).

The courts of appeals have split on the issue of whether the *Data Processing* test is limited to suits involving administrative agency action — as in *Data Processing* — or extends also to suits between private parties. Compare *American Postal Workers Union v. Independent Postal System of America, Inc.*, 481 F.2d 90 (6th Cir. 1973), *petition for cert. dismissed*, 415 U.S. 901 (1974) (*Data Processing* applicable only to challenges to governmental action) with *National Ass'n of Letter Carriers v. Independent Postal System of America, Inc.*, 470 F.2d 265 (10th Cir. 1972) (*Data Processing* test applied in an action between private parties). In the foregoing cases, the courts dealt with the questions of standing and implied right of action under various postal statutes. See 19 VILL. L. REV. 507 (1974).

30. *Association of Data Processing Serv. Orgs., Inc. v. Camp*, 397 U.S. 150, 167-68 (1970) (Brennan & White, JJ., concurring and dissenting); *Landy v. FDIC*, 486 F.2d 139, 158 (3d Cir. 1973), *cert. denied*, 416 U.S. 960 (1974).

The *Eason* court cited *Frothingham v. Mellon*, 262 U.S. 447 (1923), as an example where a plaintiff lacked standing in the constitutional sense. 490 F.2d at 657.

31. 490 F.2d at 657. The Ninth Circuit has stated that the purchaser-seller limitation is required "as a matter of constitutional necessity." *Mount Clemens Indus., Inc. v. Bell*, 464 F.2d 339, 343 (9th Cir. 1972).

32. *Association of Data Processing Serv. Orgs., Inc. v. Camp*, 397 U.S. 150, 151 (1970).

33. 490 F.2d at 657-58. At least two circuits have attempted to resolve the standing issue by an application of the two-pronged test of *Data Processing*. *Landy v. FDIC*, 486 F.2d 139 (3d Cir. 1973), *cert. denied*, 416 U.S. 960 (1974); *Herpich v. Wallace*, 430 F.2d 792 (5th Cir. 1970). Both courts concluded that those who were neither purchasers nor sellers were not within the statute's zone of protected interests. 486 F.2d at 158; 430 F.2d at 806. In light of the sweeping intent of Congress in enacting the securities laws, the conclusion that all plaintiffs who have neither purchased nor sold securities are not even *arguably* within the zone of protected interests seems unwarranted. See text accompanying notes 57-58 *infra*.

34. SEC Securities Exchange Act Release No. 3230 (May 21, 1942), reproduced in *Bluebook*, 1974 note 18, appendix B, at 295.

of the 1933 Act³⁵ resulting from the fact that that section only prohibited fraud upon *buyers* of securities³⁶ — the *Birnbaum* court concluded that the rule extended protection only to purchasers and sellers of securities.³⁷ Conversely, the *Eason* court, relying upon the rule's expansive language,³⁸ Supreme Court statements advocating a broad and flexible reading of the rule,³⁹ and the ongoing expansion of the *Birnbaum* test since its inception,⁴⁰ determined that the class of persons which the rule was intended to protect was broader than that comprised only of purchasers and sellers of securities.⁴¹ The court focused upon the literal breadth of the rule, with particular regard to the words "fraud upon any person."⁴² It reasoned that to construe this language flexibly as urged by the Supreme Court⁴³ required protection of a class of persons broader than that which *Birnbaum* had permitted.⁴⁴ Consequently, according to the instant court, any plaintiff who could establish his status as an "investor" and who

35. 15 U.S.C. § 77(q)(a) (1970). Section 17(a) provides:

It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission 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

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the *purchaser*.

Id. (emphasis added).

36. See note 35 *supra*.

37. 193 F.2d at 464, citing SEC Securities Exchange Act Release No. 3230 (May 21, 1942).

38. For the text of the rule, see note 8 *supra*.

39. See *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 151 (1972) quoting *SEC v. Capital Gains Res. Bureau*, 375 U.S. 180, 186 (1963).

40. There have been several judicially created "exceptions" to the *Birnbaum* rule. The term "exception" is actually a misnomer, since expansion has been from within by classification of the plaintiff as a purchaser or seller rather than from without by allowing a non-purchaser or non-seller to maintain the cause of action. Nevertheless, the courts have created categories of plaintiffs who are deemed to be purchasers or sellers for purposes of maintaining a cause of action under rule 10b-5, although they would not be considered as such according to the traditional use of the terms. See, e.g., *Travis v. Anthes Imp. Ltd.*, 473 F.2d 515 (8th Cir. 1973) ("delayed seller" — one who plans to sell at a certain point but delays because of defendant's fraud, suffering a loss as a consequence); *Vine v. Beneficial Fin. Co.*, 374 F.2d 627 (2d Cir.), cert. denied, 389 U.S. 970 (1967) ("forced seller" — one who, as a result of defendant's fraud, is left with the alternative of retaining worthless securities or selling at a depressed price); *Commerce Rep. Co. v. Puretec, Inc.*, 290 F. Supp. 715 (S.D.N.Y. 1968) (the "aborted purchaser" — one who has entered into a contract to buy securities which is frustrated because of defendant's fraud). Recent additions to this list include those in *Manor Drug Stores v. Blue Chip Stamps*, 492 F.2d 136 (9th Cir. 1973), cert. granted, 95 S. Ct. 302 (1974) (plaintiffs, entitled to purchase securities under antitrust consent decree, granted standing since consent decree is functional equivalent of a contract to buy); and *Heyman v. Heyman*, 356 F. Supp. 958 (S.D.N.Y. 1973) (holders of beneficial interest in securities bought or sold granted standing to sue although they neither purchased nor sold securities). For an excellent summary of the various "exceptions," see Comment, *supra* note 20.

41. 490 F.2d at 659.

42. 490 F.2d at 659, quoting SEC rule 10b-5.

43. See note 38 and accompanying text *supra*.

suffered injury as a direct consequence of fraud in connection with a securities transaction⁴⁵ could invoke the protection of the rule.⁴⁶ The plaintiffs, notwithstanding the fact that they had neither purchased nor sold securities in the particular transaction, fulfilled this criterion by reason of their statuses as shareholders and guarantors of the notes. They could, therefore, sue in a federal court.⁴⁷

The *Eason* court's approach to this issue recognized that both the non-constitutional interpretation of standing and the determination of the class of persons to whom an implied right of action extends involve similar, if not identical, considerations.⁴⁸ Each of these questions involves an analysis of statutory language in an attempt to determine the class of persons Congress intended to protect.⁴⁹

When dealing with an implied right of action,⁵⁰ as in *Eason* and *Birnbaum*, judicial interpretations of Congressional intent are readily subject to varying and conflicting results.⁵¹ However, it is submitted that *Birnbaum's* restrictive reading of rule 10b-5 and the subsequent narrow construction of its holding are unwarranted in light of the statutory language⁵² and congressional intent.⁵³ Indeed, largely as a result of the infinite varieties of fraud present in complex factual situations,⁵⁴ those

45. See note 4 *supra*.

46. 490 F.2d at 659.

47. *Id.* at 659-60.

48. See 3A H. BLOOMENTHAL, SECURITIES AND FEDERAL CORPORATE LAW § 11.09. Cf. *Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 480 F.2d 341, 359 n.11 (2d Cir.), *cert. denied*, 414 U.S. 910 (1973). See also *National R.R. Pass. Corp. v. National Ass'n of R.R. Pass.*, 414 U.S. 453 (1974).

It may be argued that the court in *Eason* rejected the applicability of a non-constitutional test for standing to the facts of the case and was stating that the only question to be answered was whether plaintiffs were protected by rule 10b-5. Such an argument, however, would mean that the Seventh Circuit *sub silentio* has denied the applicability of the Supreme Court's decision in the *Data Processing* case to suits by plaintiffs under rule 10b-5. See note 28 *supra*.

49. *National R.R. Pass. Corp. v. National Ass'n of R.R. Pass.*, 414 U.S. 453, 455-56 (1973).

50. See note 18 *supra*.

51. Compare *Mount Clemens Indus., Inc. v. Bell*, 464 F.2d 339, 341 (9th Cir. 1972), with *Tully v. Mott Supermks., Inc.*, 337 F. Supp. 834, 839 (D.N.J. 1972). Both courts claimed to be construing 10b-5 flexibly, and not technically or restrictively, as mandated by the Supreme Court in *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 12 (1971). However, the *Mount Clemens* court concluded that such a construction compelled retention of *Birnbaum* while the *Tully* court condemned its retention. 464 F.2d at 341; 337 F. Supp. at 839.

52. See notes 7 & 8 *supra*.

53. See text accompanying notes 56-58 *infra*.

54. That fraudulent schemes can be very complex in nature is demonstrated by the facts of *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6 (1971). The scheme in *Bankers Life* resulted in the purchase of a corporation with its own assets. Defendant purchasers paid for the stock of the corporation with a \$5,000,000 check issued by a bank in which defendants had no funds deposited. This was accomplished by the intervention of a note brokerage firm. Once in control, defendants deceived the board of directors into authorizing a sale of approximately \$5,000,000 of Treasury bonds held by the corporation. The proceeds of this sale were used to cover the initial purchase of stock. Once again through the bank, defendants acquired a \$5,000,000 check and used it to purchase a certificate of deposit. They used this as collateral to a \$5,000,000 loan to cover the second check. The books of the corpora-

courts which follow *Birnbaum* have been forced to construe the definitions of "purchaser" and "seller" expansively to effectuate the purpose of the rule.⁵⁵ On the other hand, a completely unrestricted application of the rule seems equally undesirable, since it is unlikely that Congress intended to provide a federal remedy for *all* injuries in *any* way connected with a securities fraud.⁵⁶

Though a distillation of congressional intent from an analysis of the legislative history of § 10(b) admittedly is inconclusive,⁵⁷ some general objectives may be ascertained. Essentially, Congress was concerned with the purity of the securities transaction and the securities trading process, so as to allow investors a reasonable opportunity to make "knowing, intelligent decisions regarding their purchases and sales of securities in unmanipulated markets."⁵⁸ Arguably, therefore, Congress was concerned not only with one who has been fraudulently induced to buy or sell securities, but also one who has been induced to take some other action which does not culminate in or amount to a purchase or sale, yet ultimately results in injury. This analysis dictates the rejection of either of the polar views expressed above, and suggests that the rule should be applied in a manner which is flexible enough as not to deny an appropriate plaintiff access to a federal forum, yet restrictive enough so as not to allow a 10b-5 action every time "someone does something bad."⁵⁹

Although the *Eason* court advocated this intermediate approach, it declined to formulate a rule embodying its principles.⁶⁰ The court pre-

tion were then falsified to reflect merely an exchange of the Treasury bonds for the certificate of deposit. *Id.* at 7-10.

In *Birnbaum*, the court stated that section 10(b) was "directed *solely* at that type of misrepresentation or fraudulent practice usually associated with the sale or purchase of securities." 193 F.2d at 464 (emphasis added). In later years, however, novel, fraudulent schemes forced the Second Circuit to retreat from this position as indicated in the following statement:

We believe that § 10(b) and rule 10b-5 prohibit all fraudulent schemes in connection with the purchases or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception. *A.T. Brod & Co. v. Perlow*, 375 F.2d 393, 397 (2d Cir. 1967).

It should be noted, however, that the Second Circuit denied standing to the plaintiffs in *Bankers Life* because they were not purchasers or sellers. *Superintendent of Life Ins. v. Bankers Life & Cas. Co.*, 430 F.2d 355, 359-60 (2d Cir. 1970), *rev'd on other grounds*, 404 U.S. 6 (1971).

55. The Fifth Circuit, though affirming *Birnbaum*, recently remarked:

The definitions of purchase and sale have sagged under the weight of courts' attempts to prevent ingenious minds from deflecting the statutory purposes of section 10(b). . . . To prevent the *Birnbaum* doctrine from limiting too severely the ability of rule 10b-5 to meet the broad purposes of the Act, "seller" has been stretched beyond its common law sense.

Smallwood v. Pearl Brewing Co., 489 F.2d 579, 590 (5th Cir.), *cert. denied*, 43 U.S.L.W. 3202 (U.S. Oct. 10, 1974) (No. 73-1671).

56. *Landy v. FDIC*, 486 F.2d 139, 157 (3d Cir. 1973), *cert. denied*, 416 U.S. 960 (1974); *Herpich v. Wallace*, 430 F.2d 792, 804-06 (5th Cir. 1970). See *Marsh, What Lies Ahead Under Rule 10b-5?*, 24 BUS. LAW. 69 (1968).

57. 1 BROMBERG, *supra* note 18, § 2.2, at 331.

58. *Herpich v. Wallace*, 430 F.2d 792, 804-06 (5th Cir. 1970). See *id.* at 800-01, 805-06. See also *Landy v. FDIC*, 486 F.2d 139, 157 (3d Cir. 1973), *cert. denied*, 416 U.S. 960 (1974).

ferred to allow future courts to determine on an ad hoc basis whether a particular plaintiff has demonstrated membership in the "special class" protected by rule 10b-5.⁶¹ In this way, the parameters of the replacement for *Birnbaum* could gradually be developed so as to avoid the need for engrafting exception upon exception to meet new factual situations.⁶² Unlike the purchaser-seller rule, which is tied to and limited by the common law concepts of "purchase" and "sale," the "investor" classification is flexible and susceptible to case-by-case development. The court thus concluded that the plaintiffs qualified as members of the class intended to be protected by the rule by virtue of their shareholder status and the execution of their personal guarantees.⁶³

Having rejected the *Birnbaum* interpretation, the court discussed two possible policy ramifications that had been advocated as justifications for the retention of the doctrine.⁶⁴ The court responded to the contention that elimination of the purchaser-seller requirement would result in an "unmanageable flood of federal litigation"⁶⁵ by noting that such a claim was merely speculative because plaintiffs would still be required to show that they were "investors" — the class of persons protected by rule 10b-5.⁶⁶ Furthermore, the alleged danger was mitigated by the fact that a causal connection between the defendant's fraud and the plaintiff's injury had to be established.⁶⁷ As a final reason for rejecting the defendant's argument, the court cited the Supreme Court's silence on the issue in a recent case which liberally construed the phrase "in connection with."⁶⁸

With respect to the defendant's second contention, that the purchaser-seller requirement was necessary "to preserve national consistency in the interpretation of federal securities regulation,"⁶⁹ the court reasoned that due to the often strained expansion of the terms "purchaser" and "seller" to effectuate the application of the rule to various fact situations,⁷⁰ the unanimity of the circuit courts' adherence to *Birnbaum* was superficial;⁷¹ any effort to preserve this "consistency" should not prevent an "independent appraisal of an important issue" in a developing area of the law.⁷²

61. *Id.* at 660.

62. *See* note 40 *supra*.

63. 490 F.2d at 659-60.

64. Courts frequently justify their support for *Birnbaum* on policy considerations. *See, e.g.*, *Herpich v. Wallace*, 430 F.2d 792 (5th Cir. 1970), wherein the court reasons that limitation of the class of persons who can sue under rule 10b-5 is necessary for the maintenance of a "viable, vigorous business community." *Id.* at 804.

65. 490 F.2d at 660, *citing* *Manor Drug Stores v. Blue Chip Stamps*, 492 F.2d 136, 147 (9th Cir. 1973) (Hufstедler, J., dissenting), *cert. granted*, 95 S. Ct. 302 (1974).

66. 490 F.2d at 660.

67. *Id.* *See* note 22 *supra*.

68. 490 F.2d at 66, *citing* *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6 (1971). *See* note 54 *supra*.

69. 490 F.2d at 660, *citing* *Mount Clemens Indus., Inc. v. Bell*, 464 F.2d 339, 342 (9th Cir. 1972).

70. 490 F.2d at 661 n.30, *citing* 2 BROMBERG, *supra* note 18, § 8.8, at 222.

71. *Id.* *See* note 66 *supra*.

72. *Id.*

Moreover, the court believed that true consistency could be achieved only by a Supreme Court pronouncement on the issue.⁷³

The *Eason* court's recognition that anticipation of an increased workload for federal courts should not compel an incorrect interpretation of the statute and rule is meritorious. If a plaintiff fulfills a "standing requirement" and consequently is an appropriate party to maintain a cause of action,⁷⁴ and that party falls within the class of persons Congress intended to protect,⁷⁵ a court should not arbitrarily refuse to hear his claim. No court should sanction a rule which simply seeks to limit the number of actions brought, while leaving an injured plaintiff without a remedy. Further, under the *Eason* "ad hoc" test, the number of potential plaintiffs may not, in fact, be greatly increased. The shareholders in *Eason*, while not having bought or sold securities, had played a substantial role in the transaction in question by their issuance of their personal guarantees. The case may thus be interpreted to mean that in order to prove that one is in fact an "investor" protected by the rule, a plaintiff will have to show some action on his part in addition to the fact that he relied on defendant's actions and that the value of his stock decreased, or that he chose to forego an investment opportunity which subsequently proved profitable. (Indeed, some of the circuits which adhere to *Birnbaum*⁷⁶ have so liberally interpreted its requirements that arguably they would have classified the *Eason* plaintiffs as "sellers" of securities or otherwise permitted them to maintain their action.⁷⁷) Additionally, a potential plaintiff must allege the necessary elements of a 10b-5 cause of action, including a causal connection between defendant's fraud and plaintiff's injury.⁷⁸ This latter requirement has often been urged⁷⁹ and at times accepted⁸⁰ as a substitute for *Birnbaum*,

73. *Id.*

74. See note 28 and accompanying text *supra*.

75. See text accompanying notes 58-59 *supra*.

76. The courts of appeals are nearly unanimous in their adoption of *Birnbaum* in one form or another. See, e.g., *Iroquois Indus., Inc. v. Syracuse China Corp.*, 417 F.2d 963 (2d Cir. 1969), *cert. denied*, 399 U.S. 909 (1970); *Landy v. FDIC*, 486 F.2d 139 (3d Cir. 1973), *cert. denied*, 416 U.S. 960 (1974); *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579 (5th Cir. 1974), *cert. denied*, 43 U.S.L.W. 3202 (U.S. Oct. 10, 1974) (No. 73-1671); *Simmons v. Wolfson*, 428 F.2d 455 (6th Cir. 1970), *cert. denied*, 400 U.S. 999 (1971); *Travis v. Anthes Imp. Ltd.*, 473 F.2d 515 (8th Cir. 1973); *Manor Drug Stores v. Blue Chip Stamps*, 492 F.2d 136 (9th Cir. 1973), *cert. granted*, 95 S. Ct. 302 (1974); *Jenson v. Voyles*, 393 F.2d 131 (10th Cir. 1968).

77. Plaintiffs might have fallen within one of the well-recognized exceptions to the *Birnbaum* rule. See note 39 *supra*. Some courts have held that in certain situations, a non-purchasing or non-selling plaintiff might be allowed to sue. For example, in *Landy v. FDIC*, 486 F.2d 139 (3d Cir. 1973), *cert. denied*, 416 U.S. 960 (1974), the Third Circuit, though affirming the *Birnbaum* rule, stated that "[e]xceptional circumstances may arise in which a stockholder might have a cause of action due to fraud in connection with the stock he holds and has not sold; that situation is not before us." *Id.* at 158. See also *Travis v. Anthes Imp. Ltd.*, 473 F.2d 515, 521 n.9 (8th Cir. 1973).

78. There is no unanimity as to the precise elements of a 10b-5 cause of action. However, it is generally agreed that they should include scienter, materiality, reliance, and privity. For detailed discussion of each, see 2 BROMBERG, *supra* note 18, §§ 8.1-8.9.

79. The SEC has been the leading proponent of this view. See, e.g., *Vine v. Beneficial Fin. Co.*, 374 F.2d 627, 636 (2d Cir.), *cert. denied*, 389 U.S. 970 (1967).

80. In *Tully v. Mott Supermarkets, Inc.*, 337 F. Supp. 834 (D.N.J. 1972), the court, in rejecting the *Birnbaum* rule, stated that federal jurisdiction hinges on the

though such a test goes to the merits and cannot be classified as a "standing requirement."⁸¹

The *Eason* court also seems correct in its response that the "national consistency" argument presumes a unity which is, in fact, illusory. In an area where complex transactions are commonplace and the opportunities for "novel or atypical"⁸² schemes seems endless, it is perhaps inevitable that still more situations will arise where a non-purchasing or non-selling plaintiff is in fact injured by a defendant's fraud in connection with a securities transaction. Many courts, feeling that the claim should not be foreclosed, will allow the suit via a "broad and flexibl[e]" construction of the statutory language.⁸³ If in fact the courts are to continue to create a "federal corporations law,"⁸⁴ it is questionable whether the continued application of the purchaser-seller doctrine which will further compel a continuing movement away from the common law concepts of purchase and sale, will encourage the development of the necessary "analytical precision."⁸⁵ Viewed in this respect, the Seventh Circuit's decision to "start anew" and eliminate the purchaser-seller requirement is commendable.

However, if the *Eason* approach does in fact result in overcrowded federal dockets, nuisance suits,⁸⁶ and unlimited liability,⁸⁷ plus renewed cries of excessive federalism⁸⁸ and usurpation of legislative function,⁸⁹ several alternatives are available. First, there could always be a retention of or return to the status quo — a *Birnbaum* rule applied "broadly and flexibly" to effectuate the purpose of the rule. The evils of this alternative have already been discussed. Second, Congress could codify rule 10b-5

existence of a causal relationship between fraud in connection with the purchase or sale of securities and plaintiffs' loss." *Id.* at 841 (citation omitted). The *Tully* court was faced with a claim for retroactive rather than prospective injunctive relief. *Id.* Therefore, the case does not fall within the exception created by *Mutual Shares Corp. v. Genesco*, 384 F.2d 540 (2d Cir. 1967). See note 22 *supra*. *Tully* was not appealed and the Third Circuit subsequently reaffirmed *Birnbaum* in *Landy v. FDIC*, 486 F.2d 139 (3d Cir. 1973), *cert. denied*, 416 U.S. 960 (1974).

81. Presumably a challenge to the claim would arise on a motion for summary judgment rather than on a motion to dismiss. Dismissal on the former grounds would be res judicata while a dismissal for lack of standing would allow suit in a state court, if a cause of action were available.

82. See *A.T. Brod & Co. v. Perlow*, 375 F.2d 393, 397 (2d Cir. 1967).

83. See, e.g., *Herpich v. Wallace*, 430 F.2d 792, 806 (5th Cir. 1970). See also *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 12 (1971).

84. See generally *Bradford, Rule 10b-5: The Search for a Limiting Doctrine*, 19 BUFFALO L. REV. 205 (1970); *Fleischer, supra* note 4.

85. See *Kellog, supra* note 20, at 117.

86. According to this argument, defendants, after already having incurred the time and expense of preliminary discovery and motion practice, will, if a motion to dismiss is unsuccessful, simply settle to avoid a complex, lengthy trial with its attendant costs and risks. See *Comment, supra* note 20, at 1030.

87. Conversely, it has been argued that rather than defining a proscribed area of conduct and thereby limiting liability under the rule, the *Birnbaum* requirement instead defines who may be defrauded with impunity. *Id.* at 1032.

88. In response to the argument that an expanded rule 10b-5 would envelop state law (see *Comment, supra* note 20, at 1034), one can point to the lack of protection for shareholders and absence of effective remedies in many states. See *Ruder, Current Developments In The Federal Law Of Corporate Fiduciary Relations — Standing To Sue Under Rule 10b-5*, 26 *BUS. LAW.* 1289 (1971).

89. See *Landy v. FDIC*, 486 F.2d 139, 156-57 (3d Cir. 1973), *cert. denied*, 416 U.S. 960 (1974).