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# Comments

## THE BIRNBAUM DOCTRINE REVISITED: STANDING TO SUE UNDER RULE 10B-5 ANALYZED

It is now a well established principle of federal corporate common law that an implied civil cause of action exists<sup>1</sup> under section 10 of the Securities Exchange Act of 1934<sup>2</sup> [hereinafter referred to as the 1934 Act], and Securities and Exchange Commission (SEC) rule 10b-5<sup>3</sup> enacted thereunder. In essence, it is a 10b-5 violation for any person to use "in connection with the purchase or sale" of any security "any manipulative or deceptive device or contrivance."<sup>4</sup> There has been much speculation as to the breadth of rule 10b-5. At the extreme, it has been suggested that it is unlawful "that someone 'do something bad' . . . in connection with a purchase or sale of securities,"<sup>5</sup> and that the buyer can sue the seller if the price goes down; the seller can sue the buyer if the price goes up; and

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1. Superintendent of Ins. v. Bankers Life & Cas. Co., 92 S. Ct. 165, 169 n.9 (1971). See also the major work in the area of rule 10b-5, A. BROMBERG, SECURITIES LAW: FRAUD §§ 2.4(1)-(2), 8.1 (1971) [hereinafter cited as BROMBERG]. There has been much debate as to the validity of the implied cause of action. Compare Ruder, *Civil Liability Under Rule 10b-5: Judicial Revision of Legislative Intent?* 57 Nw. U.L. Rev. 627 (1963), with Joseph, *Civil Liability under Rule 10-5—A Reply*, 59 Nw. U.L. Rev. 171 (1964). See also Ruder, *Current Developments in the Federal Law of Corporate Fiduciary Relations—Standing To Sue Under Rule 10-5*, 26 Bus. Law. 1289 n.4 (1971).

2. Securities Exchange Act of 1934 § 10 (b), 15 U.S.C. § 78 (j) (1970) provides: It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange

.....  
(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors (emphasis added).

3. SEC rule 10b-5, 17 C.F.R. § 240.10b-5 (1970) 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 as a fraud or deceit upon any person, in connection with the purchase or sale of any security (emphasis added).

4. Superintendent of Ins. v. Bankers Life & Cas. Co., 92 S. Ct. 165, 168 (1971).

5. Herpich v. Wallace, 430 F.2d 792, 804 (5th Cir. 1970), citing R. JENNINGS & H. MARSH, SECURITIES REGULATION 961 (2d ed. 1968).

either can sue the other for interest if the price stays the same.<sup>6</sup> Rule 10b-5 is the most highly litigated<sup>7</sup> and chaotic<sup>8</sup> area in corporate securities law because of its potential scope and the advantages of bringing a cause of action under the 1934 Act.<sup>9</sup>

Because of the great potential for litigation under rule 10b-5, courts have searched for methods to limit its breadth.<sup>10</sup> Judge Kaufman, in the landmark case of *Birnbaum v. Newport Steel Corp.*,<sup>11</sup> enunciated the limitation that only purchasers and sellers of securities have standing to sue under rule 10b-5. Therefore, many possible claimants (*i.e.*, nonselling stockholders and prospective investors) have found the federal courthouse door closed to them. Because the purchaser-seller limitation is the "only substantial impediment" to recovery under 10b-5,<sup>12</sup> a favorable determination on this threshold question is essential.

The purchaser-seller limitation, however, has been construed liberally by most courts,<sup>13</sup> and, moreover, it is inapplicable when the remedy sought is an injunction.<sup>14</sup> Also, the SEC has argued as *amicus curiae*<sup>15</sup> that the purchaser-seller limitation is too narrow.<sup>16</sup> This trend to expand the ambit of protection under 10b-5 has been viewed as an "erosion" or the "demise" of the *Birnbaum* Doctrine.<sup>17</sup> Still, the courts generally have reaffirmed it.<sup>18</sup> In light of this controversy, it is the purpose of this comment to summarize the current law of standing and, more importantly, to offer a framework for an analysis of standing to sue under rule 10b-5.<sup>19</sup>

6. Marsh, *What Lies Ahead Under Rule 10b-5?*, 24 BUS. LAW. 69 (1968).

7. BROMBERG § 2.5 (5), at 45.

8. Marsh, *supra* note 6, at 73.

9. BROMBERG § 4.7 (1), at 83. Once in federal court under rule 10b-5 certain benefits may accrue (*e.g.*, procedural advantages, application to broader classes of persons, and easier standards of proof) that are not available in an action brought in state court.

10. See Bradford, *Rule 10b-5: The Search For A Limiting Doctrine*, 19 BUFF. L. REV. 205 (1970). Some doctrines which have been used to limit the scope of rule 10b-5 are privity, causation, reliance and foreseeability. *Mutual Shares Corp. v. Genesco, Inc.*, 384 F.2d 540, 544 & n.9 (2d Cir. 1967); BROMBERG § 8.9, at 223.

11. 98 F. Supp. 506, 508 (S.D.N.Y. 1951), *aff'd*, 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952).

12. 1967 DUKE L. REV. 894, 895. See also De Lancey, *Rule 10b-5—A Recent Profile*, 25 BUS. LAW. 1355, 1369 (1970).

13. See, *e.g.*, *Mader v. Armel*, 402 F.2d 158 (6th Cir. 1968), *cert. denied*, 394 U.S. 930 (1969); *Vine v. Beneficial Fin. Co.*, 374 F.2d 627 (2d Cir.), *cert. denied*, 389 U.S. 970 (1967).

14. *Mutual Shares Corp. v. Genesco, Inc.*, 384 F.2d 540 (2d Cir. 1967).

15. For a general discussion of *amicus curiae* participation by the SEC, see Cohen, *The Development of Rule 10b-5*, 23 BUS. LAW. 593, 597 (1968).

16. See, *e.g.*, *A.T. Brod & Co. v. Perlow*, 375 F.2d 393, 397 n.3 (2d Cir. 1967); *Vine v. Beneficial Fin. Co.*, 374 F.2d 627, 636 (2d Cir.), *cert. denied*, 389 U.S. 970 (1967). See also *Iroquois Indus., Inc. v. Syracuse China Corp.*, 417 F.2d 963 (2d Cir. 1969), *cert. denied*, 399 U.S. 909 (1970).

17. Lowenfels, *The Demise of the Birnbaum Doctrine: A New Era for Rule 10b-5*, 54 VA. L. REV. 268 (1968). But see 6 L. LOSS, *SECURITIES REGULATION* 3620 (Supp. 2d ed. 1969); referring to Lowenfels' article, the author states: "[T]he word 'demise' in this context does nevertheless invoke memories of Mark Twain."

18. See, *e.g.*, *Crane Co. v. Westinghouse Air Brake Co.*, 419 F.2d 787, 797 (2d Cir. 1969), *cert. denied*, 400 U.S. 822 (1970).

19. There have been numerous analyses of the *Birnbaum* Doctrine. Another exhaustive treatment of the cases would be superfluous. Consequently, after a

Before summarizing the current status of the *Birnbaum* Doctrine, it is important to note that the purchaser-seller requirement and the fraud requirement are two different prerequisites to a 10b-5 cause of action.<sup>20</sup> Only the purchaser-seller limitation goes to the question of standing. Failure to understand this distinction will cause an inaccurate analysis of the standing question.<sup>21</sup>

In *Birnbaum*,<sup>22</sup> Feldman sold his controlling stock in Newport Steel at a premium (twice its fair market value), instead of seizing a corporate opportunity to merge with Follansbee Steel. Minority shareholders alleged that Feldman had violated rule 10b-5 by failing to disclose the sale of stock at a premium. The Second Circuit, through Judge Augustus N. Hand, affirmed the dismissal of the cause of action based, among other things, on the purchaser-seller limitation.<sup>23</sup> Judge Hand rationalized the purchaser-seller limitation by stating that the SEC did not intend for all investors to be protected by rule 10b-5:

Section 17 (a) of the 1933 Act only made it unlawful to defraud or deceive *purchasers* of securities, and Section 15 (c) of the 1934 Act dealt only with fraudulent practices by security brokers or dealers in over-the-counter markets. No prohibition existed against fraud on a seller of securities by the purchaser if the latter was not a broker or a dealer. Consequently, on 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."<sup>24</sup>

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summary of the important cases, this comment will concern itself with how to determine standing more accurately. The following is a list of articles which treat the issue of standing; since this is a constantly changing area, the articles are listed in reverse chronological order: Boone & McGowan, *Standing To Sue Under SEC Rule 10b-5*, 49 TEXAS L. REV. 617 (1971); Painter, *Rule 10b-5: The Recodification Thicket*, 45 ST. JOHNS L. REV. 699, 727-32 (1971); Ruder, *Current Developments in the Federal Law of Corporate Fiduciary Relations—Standing to Sue Under Rule 10b-5*, 26 BUS. LAW. 1289 (1971); De Lancey, *Rule 10b-5—A Recent Profile*, 25 BUS. LAW. 1355, 1369-70 (1970); Comment, *Another Demise of the Birnbaum Doctrine: "Tolls the Knell of Parting Day?"*, 25 U. MIAMI L. REV. 131 (1970); Kellogg, *The Inability to Obtain Analytical Precision Where Standing to Sue Under Rule 10b-5 Is Involved*, 20 BUFF. L. REV. 93 (1970); Lowenfels, *The Demise of the Birnbaum Doctrine: A New Era for Rule 10b-5*, 54 VA. L. REV. 268 (1968); Note, *The Purchaser-Seller Limitation to SEC Rule 10b-5*, 53 CORNELL L. REV. 684 (1968); Comment, *The Purchaser-Seller Rule: An Archaic Tool for Determining Standing Under Rule 10b-5*, 56 GEO. L.J. 1177 (1968); 1967 DUKE L.J. 898; 1967 DUKE L.J. 894; Comment, *Securities—Rule 10b-5—Purchaser-Seller and Deception Elements Held Not Strict Prerequisites to Liability in Civil Action Under SEC Rule 10b-5*, 42 N.Y.U.L. REV. 978 (1967); Sommer, *Rule 10b-5: Notes for Legislation*, 17 WEST RES. L. REV. 1029 (1966); Leech, *Transactions in Corporate Control*, 104 U. PA. L. REV. 725, 832-35 (1956).

20. BROMBERG § 4.7 (3), at 88.1.

21. See *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 300 F. Supp. 1083, 1096 nn.12 & 13 (S.D.N.Y. 1969), *aff'd*, 430 F.2d 355 (2d Cir. 1970), *rev'd*, 92 S. Ct. 165 (1971).

22. *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952).

23. *Id.* at 464.

24. *Id.* at 463, quoting SEC Securities Act Release No. 3230 (May 21, 1942).

A second ground for dismissal was that the alleged fraud, *i.e.*, corporate mismanagement, was not cognizable under rule 10b-5.<sup>25</sup> It has been suggested that the court overreacted to the presence of corporate mismanagement, and thus accepted the purchaser-seller limitation as further assurance against expansion of federal corporate law,<sup>26</sup> because traditionally, state court was the proper place to seek relief from corporate mismanagement.<sup>27</sup>

In practice, the apparently simple task of identifying who is a "purchaser" or "seller" within the meaning of section 10 of the 1934 Act and rule 10b-5 is difficult. As will be seen, the common law definition of "purchaser" and "seller" is not sufficient for this task<sup>28</sup> because of the broader statutory definition of "purchase" and "sale" in the 1934 Act,<sup>29</sup> and the subsequent liberal interpretations of the terms, based on the Act's policy to protect investors, which have resulted. The discussion that follows illustrates the expansive way in which "purchase" and "sell" have been defined.

The issuance of corporate securities was held to be a "sale" in *Hooper v. Mountain States Securities Corp.*<sup>30</sup> Consequently, the issuing corporation was a "seller" with standing to sue under rule 10b-5. Thus, it follows that nonselling or nonpurchasing shareholders have standing to bring a shareholder's derivative action on behalf of a "seller" (or "purchaser" in an appropriate case) corporation.<sup>31</sup>

The Supreme Court, in *SEC v. National Securities, Inc.*,<sup>32</sup> held the exchange of securities to effect a merger constituted a "purchase" of securities. There, shareholders who approved the merger on the basis of material misrepresentations in the proxy statements were "purchasers" when they exchanged their securities for the new company's securities. In *Dasho v. Susquehanna Corp.*,<sup>33</sup> the surviving corporation was a "purchaser" and "seller" when it exchanged its securities for assets, including stock, of the disappearing corporation, thus effecting a merger. The same result occurs when a sale of assets for securities is followed by a corporate liquidation.<sup>34</sup>

In *Vine v. Beneficial Finance Co.*,<sup>35</sup> the plaintiff was characterized as

25. *Id.* at 464.

26. Leech, *Transactions In Corporate Control*, 104 U. PA. L. REV. 725, 834 (1956).

27. *See, e.g.*, *Perlman v. Feldmann*, 219 F.2d 173 (2d Cir.), *cert. denied*, 349 U.S. 952 (1955), *on remand*, 154 F. Supp. 436 (D. Conn. 1957). After the dismissal of *Birnbaum* was affirmed, the minority shareholders of Newport Steel brought this derivative action (based on Indiana law) for Feldmann's breach of his fiduciary obligation to the corporation. The plaintiffs were successful in recovering the control premium Feldmann received.

28. *See, e.g.*, *Herpich v. Wallace*, 430 F.2d 792, 806-07 (5th Cir. 1970).

29. Securities Exchange Act of 1934 §§ 3 (13)-(14), 15 U.S.C. §§ 78 (c) (13)-(14) (1970) provides:

(13) The terms "buy" and "purchase" each include any contract to buy, purchase, or otherwise acquire.

(14) The terms "sale" and "sell" each include any contract to sell or otherwise dispose of.

30. 282 F.2d 195 (5th Cir. 1960), *cert. denied*, 365 U.S. 814 (1961).

31. BROMBERG § 4.7 (3), at 88.2.

32. 393 U.S. 453 (1969).

33. 380 F.2d 262 (7th Cir.), *cert. denied*, 389 U.S. 977 (1967).

34. *See Swanson v. American Consumer Indus.*, 415 F.2d 1326 (7th Cir. 1969).

35. 374 F.2d 627 (2d Cir.), *cert. denied*, 389 U.S. 970 (1967).

a seller so as to satisfy the *Birnbaum* rule even though no actual purchase or sale ever took place. A short form merger left the plaintiff holding worthless securities. Because his only alternative was to exercise his appraisal right, he was called a "forced seller" by the Second Circuit Court of Appeals and was given standing to sue before actually exercising his option.<sup>36</sup>

In 1969, the Second Circuit Court of Appeals decided two cases which illustrate both that court's allegiance to *Birnbaum* and the expansion of *Birnbaum*. Both cases involved tender offers which were fraudulently thwarted by the management of the target corporations. In the first case, *Iroquois Industries, Inc. v. Syracuse China Corp.*,<sup>37</sup> the tender offer was held not to have standing to sue because none of the target corporation's stock was ever purchased,<sup>38</sup> even though the defendants' fraud induced the offerees not to sell. The second case, *Crane Co. v. Westinghouse Air Brake Co.*,<sup>39</sup> involved a similar situation except that the defendants also threatened the plaintiff with an anti-trust suit if it did not divest itself of Air Brake stock which had been acquired prior and incidental to the tender offer. Succumbing to the threat, plaintiff did sell the stock (at a profit) and, as a result of this "forced sale," was given standing to sue.<sup>40</sup> For the court to have been true to the *Birnbaum* Doctrine, *Crane*, like *Iroquois*, should have been dismissed because *Crane's* "forced sale" bore no relationship to the scheme which thwarted the tender offer.<sup>41</sup>

A number of standing rules have been developed in cases involving broker-dealers and their clients. Broker-dealers have standing to sue their nonpurchasing clients who, before ordering, plan not to consummate the purchase if the price of the securities falls.<sup>42</sup> Under these circumstances the broker-dealer is characterized as a "purchaser,"<sup>43</sup> based on the fact that a contract for the sale of securities is a "sale" within the meaning of the 1934 Act.<sup>44</sup> On the other hand, clients can sue broker-dealers who sell them non-existent securities because they would have been actual purchasers of securities in a valid transaction.<sup>45</sup> This is another example of the non-purchasing investor being characterized as a "purchaser" under rule 10b-5.<sup>46</sup> Clients were also allowed to sue their broker in *Stockwell v. Reynolds & Co.*,<sup>47</sup> even though the clients did not sell immediately after the alleged fraud. A later sale of securities satisfied the *Birnbaum* Doctrine because the broker's fraud had induced the plaintiffs to defer sale.

36. *Id.* at 634-35.

37. 417 F.2d 963 (2d Cir. 1969), *cert. denied*, 399 U.S. 909 (1970).

38. *Id.* at 970.

39. 419 F.2d 787 (2d Cir. 1969), *cert. denied*, 400 U.S. 822 (1970).

40. *Id.* at 798.

41. Kellogg, *The Inability to Obtain Analytical Precision Where Standing To Sue Under Rule 10b-5 Is Involved*, 20 BUFF. L. REV. 93, 101 (1970). *But see* Boone & McGowan, *Standing To Sue Under SEC Rule 10b-5*, 49 TEXAS L. REV. 617, 629 (1971).

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

43. *Id.* at 397 & n.3.

44. *Cf. Commerce Reporting Co. v. Puretec, Inc.*, 290 F. Supp 715, 719 (S.D.N.Y. 1968).

45. *Goodman v. H. Hentz & Co.*, 265 F. Supp. 440 (N.D. Ill. 1967).

46. *Id.* at 444.

47. 252 F. Supp. 215 (S.D.N.Y. 1965). *Cf. Opper v. Hancock Sec. Corp.*, 250 F. Supp. 668 (S.D.N.Y.), *aff'd*, 367 F.2d 157 (2d Cir. 1966).

In contrast to the above cases, which expanded the *Birnbaum* Doctrine by broadly interpreting the terms "purchase" and "sale," *Mutual Shares Corp. v. Genesco, Inc.*<sup>48</sup> created a true exception to the *Birnbaum* Doctrine. This exception is that no purchase or sale is required for those seeking *injunctive* relief under rule 10b-5:

[W]e do not regard the fact plaintiffs have not sold their stock as controlling on the claim for injunctive relief. The complaint alleges a manipulative scheme which is still continuing. While doubtless the Commission could seek to halt such practices, present stockholders are also logical plaintiffs to play "an important role in enforcement" of the Act . . . .<sup>49</sup>

As a result of these inroads into the purchaser-seller limitation, the demise of the *Birnbaum* Doctrine has been predicted by the commentators.<sup>50</sup> Nevertheless, the doctrine, at least in principle, has been consistently reaffirmed by the courts:<sup>51</sup>

*Birnbaum* has been shot at by expert marksmen. The buyer-seller requirement for standing has been criticized as too strict a reading of the rule. Commentators have said that [the] *Birnbaum* [rule] has been significantly eroded. . . . Bloody but unbowed, *Birnbaum* still stands . . . .<sup>52</sup>

The Supreme Court, in *Superintendent of Insurance v. Bankers Life & Casualty Co.*,<sup>53</sup> could have resolved the above conflict between the lower courts and the writers.<sup>54</sup> In that case, the fraudulent scheme involved three securities transactions—one involving government bonds, one involving common stock, and one involving a certificate of deposit. The scheme was to acquire Manhattan Corporation common stock with Manhattan's own assets. Begole purchased all of Manhattan's stock from Bankers Life with a check from Irving Trust, even though no funds were on deposit at that time. Once in control, the Begole group sold the government bonds owned by Manhattan for the purported purpose of acquiring a certificate of deposit as a substitute investment. However, the proceeds from the sale of the bonds were used to reimburse Irving Trust. In order to conceal this depletion of Manhattan's assets, Irving Trust issued another check to the new president of Manhattan, a cohort of Begole. The president used this check to purchase a certificate of deposit in Manhattan's name from Belgian Trust. Then the certificate was used as collateral on a loan so that the second check from Irving Trust could be paid off. Manhattan's records only reflected the sale of the bonds and the purchase of the certificate of deposit.

48. 384 F.2d 540 (2d Cir. 1967).

49. *Id.* at 546-47: However, the *Birnbaum* Doctrine was reaffirmed as to actions for damages.

50. Lowenfels, *supra* note 17.

51. *See, e.g.*, Cooper v. Garza, 431 F.2d 578 (5th Cir. 1970); Simmons v. Wolfson, 428 F.2d 455 (6th Cir. 1970); Kahan v. Rosenstiel, 424 F.2d 161 (3d Cir.) *cert. denied*, 398 U.S. 950 (1970); City Nat'l Bank v. Vanderboom, 422 F.2d 221 (8th Cir. 1970); Greenstein v. Paul, 400 F.2d 580 (2d Cir. 1968).

52. Rekant v. Desser, 425 F.2d 872, 877 (5th Cir. 1970).

53. 92 S. Ct. 165 (1971).

54. Boone & McGowan, *supra* note 41, at 649.

Both the district court<sup>55</sup> and the Second Circuit Court of Appeals<sup>56</sup> agreed that because of the sale of Manhattan's bonds, Manhattan had standing to sue under the *Birnbaum* Doctrine. However, both courts also held the company did not have standing on the other two transactions because it was neither a purchaser or seller. Even though plaintiff had standing to sue on one of its theories, the Second Circuit Court of Appeals affirmed the dismissal of the complaint because it determined the fraud forcing the sales of the bonds (corporate mismanagement) was not cognizable under rule 10b-5.<sup>57</sup> Because the lower courts had already found that Manhattan had standing on the treasury bond transaction, Mr. Justice Douglas proceeded to the issue of the cognizability of the fraud. The Supreme Court held that corporate mismanagement was cognizable fraud under rule 10b-5 when it touched a securities transaction.<sup>58</sup> The Court passed up the opportunity to comment upon the question of the standing of nonsellers under rule 10b-5, which was presented by the sale of Manhattan's common stock by Banker's Life:

Petitioner's complaint bases his single claim for recovery alternatively on three different transactions alleged to confer jurisdiction under § 10 (b): Manhattan's sale of the Treasury bonds; the sale of Manhattan stock by Banker's Life to Bourne and Begole; and the transactions involving the certificates of deposit. We only hold that the alleged fraud is cognizable under § 10 (b) and Rule 10b-5 in the bond sale and we express no opinion as to Manhattan's standing under § 10 (b) and Rule 10b-5 on other phases of the complaint.<sup>59</sup>

Because the Court expressed no opinion on standing in the other two transactions, it would appear that the only transaction on which evidence can be presented on remand is Manhattan's sale of the bonds. Query: was the Court's failure to address theories involving the *Birnbaum* Doctrine an implicit affirmation of that doctrine?

The Supreme Court is not alone in avoiding a direct determination of the propriety of *Birnbaum*. On occasion, the Second Circuit Court of Appeals has explicitly avoided such a determination by characterizing plaintiffs as purchasers or sellers, thus avoiding the issue of whether others affected by the fraud have standing to sue under rule 10b-5.<sup>60</sup> Also, the Fifth Circuit Court of Appeals, in *Rekant v. Desser*,<sup>61</sup> sidestepped the SEC's contention (as amicus curiae) that purchasers, sellers and holders of securities have standing to sue, by holding the complaint failed to state a cause of action. The issue of standing was not reached.<sup>62</sup>

55. Superintendent of Ins. v. Bankers Life & Cas., 300 F. Supp. 1083, 1098 (S.D.N.Y. 1969), *aff'd*, 430 F.2d 355 (2d Cir. 1970), *rev'd*, 92 S. Ct. 165 (1971).

56. Superintendent of Ins. v. Bankers Life & Cas. Co., 430 F.2d 355, 360-61 (2d Cir. 1970), *rev'd*, 92 S. Ct. 165 (1971).

57. *Id.*

58. Superintendent of Ins. v. Bankers Life & Cas. Co., 92 S. Ct. 165, 169 (1971).

59. *Id.* at 169 n.10, *citing* Kellogg, *supra* note 41; Lowenfels, *The Demise of The Birnbaum Doctrine: A New Era For Rule 10b-5*, 54 VA. L. REV. 268 (1968).

60. See A.T. Brod & Co. v. Perlow, 375 F.2d 393 (2d Cir. 1967); Vine v. Beneficial Fin. Co., 374 F.2d 627 (2d Cir.), *cert. denied*, 389 U.S. 970 (1967).

61. 425 F.2d 872 (5th Cir. 1970).

62. *Id.* at 879.



As can be seen from the cases discussed, the determination of standing is unpredictable. Resolution of the issue depends upon judicial discretion as to who is a "purchaser" or "seller," or perhaps a fortuitous sale or purchase of securities by the plaintiff. The obvious lack of analytical precision in determining standing to sue under rule 10b-5 should be corrected.<sup>63</sup> Logically, the place to begin is with a definition of standing, although due deference must be given to Mr. Justice Douglas' admonition that "[g]eneralizations about standing to sue are largely worthless as such."<sup>64</sup>

Historically, the issue of standing has been encountered most frequently in cases involving administrative and constitutional law.<sup>65</sup> Its origin is article III, section 2 of the United States Constitution, which limits federal court jurisdiction to "cases" and "controversies."<sup>66</sup> A resolution of the standing issue determines only "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."<sup>67</sup> Justice Brennan has defined standing and its underlying policy this way:

"[T]he gist of the question of standing" is whether the party seeking relief has "alleged such a personal stake in the outcome of the controversy as to assure that concrete adverseness which sharpens the presentation of issues upon which the court so largely depends for illumination of difficult . . . questions." "In other words," we said in *Flast*, "when standing is placed in issue in a case, the question is whether the person whose standing is challenged is a proper party to request an adjudication of a particular issue" and not whether the controversy is otherwise justiciable, or whether, on the merits, the plaintiff has a legally protected interest that the defendant's action invaded. . . . The objectives of the Article III standing requirement are simple: the avoidance of any use of a "federal court as a forum [for the airing of] generalized grievances about the conduct of government," and the creation of a judicial context in which "the questions will be framed with the necessary specificity, . . . the issues . . . contested with the necessary adverseness . . . ."<sup>68</sup>

Consequently, the focus is on the person invoking federal court jurisdiction in making the determination whether he is the appropriate person to maintain the cause of action.<sup>69</sup> The merits of the case are irrelevant<sup>70</sup> and standing is but one of a number of criteria which may be used to determine whether a case is nonjusticiable.<sup>71</sup>

63. Kellogg, *supra* note 41.

64. Association of Data Proc. Serv. Organizations, Inc. v. Camp, 397 U.S. 150, 151 (1970).

65. Herpich v. Wallace, 430 F.2d 792, 805 (5th Cir. 1970).

66. Association of Data Proc. Serv. Organizations, Inc. v. Camp, 397 U.S. 150, 151 (1970).

67. *Id.* at 151-52, citing *Flast v. Cohen*, 392 U.S. 83, 101 (1968).

68. *Barlow v. Collins*, 397 U.S. 159, 170-71 (1970) (citations omitted).

69. *Flast v. Cohen*, 392 U.S. 83, 99 (1968).

70. Association of Data Proc. Serv. Organizations, Inc. v. Camp, 397 U.S. 150, 151 (1970). Previously, the Court had applied a "legal interest" test to determine standing; this test went to the merits, and was abolished on the ground that the question of standing should not be based on the merits.

71. *Echter, The Proper Parameters of Justiciability*, 67 THE BRIEF 25 (1971). The doctrines used by the courts are "rules of self restraint." *Barrows v. Jackson*,

The Supreme Court has developed two tests to determine when standing exists,<sup>72</sup> one constitutional and one non-constitutional. The constitutional test is this threshold question: Has "the plaintiff *alleged* that the challenged action has caused him injury in fact, economic or otherwise?"<sup>73</sup> Once it has been determined that "injury in fact" has been alleged by the plaintiff, the question becomes: "[Is] the interest sought to be protected by the complainant . . . *arguably* within the zone of interests to be protected or regulated by the statute . . . in question?"<sup>74</sup> This non-constitutional test further limits those having standing to persons most immediately involved in the alleged wrong giving rise to the claim.<sup>75</sup> Mr. Justices Brennan and White concur in the minority position that the second test is "wholly unnecessary and inappropriate."<sup>76</sup>

*Herpich v. Wallace*<sup>77</sup> will be used as a vehicle to discuss the two tests for determining standing to sue in the context of rule 10b-5. In this case, the Fifth Circuit Court of Appeals recognized that the plaintiff's right to invoke the jurisdiction of a federal court under rule 10b-5 should be determined by the "injury in fact" and the "zone of interests to be protected" tests.<sup>78</sup> The result was continued support for the *Birnbaum* rule.<sup>79</sup>

The facts were that Wilder had practical control of National American by virtue of his ownership of stock in National American and in a company owning a majority of National American's stock. He sold his stock in both companies to defendant's corporation for a premium (three million dollars in excess of its fair market value). By a number of transfers between corporations controlled by the defendants, the stock came to rest in Alabama National Life Insurance Co. National American was to be merged into Alabama National. Through the merger National American would receive at the premium price the stock sold by Wilder. Consequently, National American would pay the premium out of its own assets. Also, the complaint alleged the new controlling stockholders were wasting corporate assets.

Before the merger was completed the minority shareholders in National American brought class and derivative actions, alleging a violation of rule 10b-5. The class action was dismissed because the plaintiffs were neither buyers or sellers in the securities transaction touched by the fraud.<sup>80</sup> However, because the corporation would have been a seller and a purchaser,

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346 U.S. 249, 255 (1953). One of the problems with standing is that it has been used as a "shorthand" expression for various elements of justiciability. *Flast v. Cohen*, 392 U.S. 83, 97 (1968).

72. *Association of Data Proc. Serv. Organizations, Inc. v. Camp*, 397 U.S. 150, 152-53 (1970).

73. *Id.* at 152.

74. *Id.* at 153 (emphasis added).

75. Jaffe, *Standing Again*, 84 HARV. L. REV. 633, 637 (1971).

76. *Association of Data Proc. Serv. Organizations, Inc. v. Camp*, 397 U.S. 150, 169 (1970). For a debate on the validity of the second test, compare *Davis, The Liberalized Law of Standing*, 37 U. CHI. L. REV. 450 (1970), with Jaffe, *supra* note 75.

77. 430 F.2d 792 (5th Cir. 1970).

78. *Id.* at 805.

79. *Id.* at 810.

80. *Id.*

the plaintiffs were allowed to bring the derivative action for damages and to enjoin the merger.<sup>81</sup>

It seems anomalous that the plaintiff had a sufficient personal stake to bring the action on behalf of the corporation yet not for himself. In both instances it would seem that the plaintiff was sufficiently aggrieved to assure an adversary proceeding. This situation was brought about by the court's misapplication of the two tests used to determine whether a minority shareholder has standing. Instead of analyzing the two tests separately, the court combined them and asked: Was the "injury of the type that the Act seeks to prevent?"<sup>82</sup> As a result, the court focused its attention on the injury rather than the plaintiff-shareholder's status.

The proper threshold question is: Did the plaintiff *allege* injury in fact, economic or otherwise? Because of the defendant's sale of securities, the corporation's assets were being wasted. Not only did this damage the value of the corporation; it also diminished the value of an individual plaintiff's stock. Moreover, the proposed merger was to be entered into on terms disadvantageous not only to National American but to its shareholder as well. Thus, the complaint contained a colorable allegation of personal injury.

Because the pleading contained an allegation of injury in fact, the court should have proceeded to the non-constitutional test of standing as to an individual plaintiff. Though the court did not directly consider this second issue it did identify what it considered to be the zone of interest protected by rule 10b-5. In essence, the court said that the interest to be protected is an unmanipulated market (or trading situation), so as to afford investors a reasonable opportunity to make knowledgeable and intelligent decisions regarding their security investments.<sup>83</sup> But the court concluded that the only investors to be protected were purchasers and sellers of securities. This overlooked the fact that investors may also be induced by fraud *not* to buy or *not* to sell securities. Query: Should not these nonsellers and nonpurchasers be protected from clandestine, fraudulent schemes which significantly affect the price of securities?

The court's decision supporting the *Birnbaum* Doctrine is not surprising. The cases cited in *Herpich* supporting the proposition that only purchasers and sellers have interests to be protected are, for the most part, progeny of the *Birnbaum* Doctrine and *Birnbaum* itself.<sup>84</sup>

Instead, a reexamination of *Birnbaum* should have been undertaken to determine who actually possesses the interests within the zone to be protected by section 10 and rule 10b-5. As stated before, the *Birnbaum* Doctrine rests on administrative history evidencing the SEC's intent in promulgating 10b-5: to close the "loophole" in section 17 (a) of the 1933 Act by providing protection for defrauded sellers.<sup>85</sup> Professor Louis Loss,

81. *Id.* at 809-10.

82. *Id.* at 805.

83. *Id.* at 806.

84. *Id.*

85. SEC Securities Act Release No. 3230 (May 21, 1942), (reprinted in BROMBERG App. B, at 295), reads as follows:

The Securities and Exchange Commission today announced the adoption of a rule prohibiting fraud by any person in connection with the purchase

although agreeing that the above interpretation is correct,<sup>86</sup> points out that the SEC did not exhaust its power under section 10 by the promulgation of rule 10b-5.<sup>87</sup> Even though there is a "dearth of evidence" on this point,<sup>88</sup> the statute itself and its legislative history seem to bear out the proposition that Congress intended to protect all investors—not just purchasers and sellers. The legislative history indicates several attempts to narrow the broad language of section 10,<sup>89</sup> but, as finally amended, it gave the SEC the power to promulgate rules "necessary or appropriate in the public interest or for the protection of investors."<sup>90</sup> Thus, the SEC has power to protect all investors, not just purchasers and sellers of securities.<sup>91</sup> One commentator recently supported this proposition by noting:

*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 . . . 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 14 (a), was passed for the protection of investors . . . there are many situations in which an investor may be injured . . . "in connection with the purchase or sale of any security," before he actually sold or purchased such a security, [and] it would appear to be within the congressional purpose of 10 (b) to allow [such] . . . a remedy.<sup>92</sup>

Even though the *Birnbaum* Doctrine was based on the express administrative history that a loophole in section 17 (a) of the Securities Act of

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of securities. The previously existing rules against fraud in the purchase of securities applied only to brokers and dealers. The new rule closes a 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. The text of the Commission's action follows:

The Securities and Exchange Commission, deeming it necessary for the exercise of the functions vested in it and necessary and appropriate in the public interest and for the protection of investors so to do, pursuant to authority conferred upon it by the Securities Exchange Act of 1934, particularly Sections 10 (b) and 23 (a) thereof, hereby adopts the following Rule X-10B-5 . . . (emphasis added).

For the text of the rule, see note 3 *supra*.

86. 6 L. LOSS, *SECURITIES REGULATION* 3617 (Supp. 2d ed. 1969).

87. *Id.* at 1469 n.8.

88. BROMBERG § 2.2 (331), at 22.2.

89. *Id.*

90. *Id.*

91. *Id.*

92. Clechon, *The Decline of the Purchaser-Seller Requirement of Rule 10b-5*, 14 VILL. L. REV. 499, 501 (1969) (citations omitted).

1933 existed, this does not justify the use of the legal maxim *expressio unius est exclusio alterius* in the interpretation of rule 10b-5. The rule is much broader than the remarks in the release promulgating the rule indicated. Indeed, in the same release, the SEC emphasized that the rule was adopted to protect "investors."<sup>93</sup> Rule 10b-5 is in substance a repetition of section 10 (b) of the 1934 Act and 17 (a) of the 1933 Act, with one important exception—the substitution of "any person" for "any purchaser." Had the Commission intended to limit the application of the rule to sellers, so that only the loophole in section 17 (a) would be closed, it would have said "any seller" rather than "any person." Judge Hand in *Birnbaum* merely glossed over the "any person" language, however, regarding rule 10b-5 as "loosely drawn" in comparison with section 17 (a), which refers only to "purchasers."<sup>94</sup>

A broad interpretation of rule 10b-5 is justified for at least two reasons. First, it is reasonable to assume that the Commission's exercise of power was co-extensive with the congressional grant of power. The fact that the SEC, as *amicus curiae*, has argued the *Birnbaum* interpretation is too narrow certainly bears this out. Second, section 10 (b) (and therefore rule 10b-5) is a remedial statute, and remedial statutes are traditionally interpreted broadly.<sup>95</sup>

The foregoing discussion illustrates that every investor—not just purchasers and sellers—has interests section 10 and rule 10b-5 should protect (*i.e.*, freedom to make security investment decisions unaffected by fraud). Granting the reasonableness of this argument, the second test of standing is fulfilled, because all it requires is that the interest sought to be protected be "arguably within the zone of interests of the statute."<sup>96</sup>

This does not mean that the protection of rule 10b-5 is unlimited. The clause "in connection with the purchase and sale of securities" indicates that the "purchase" or "sale" of securities (as broadly defined by the 1934 Act) must occur to activate rule 10b-5 protection. Thus, either the effectuation of the scheme of fraud must involve the purchase or sale of securities, or there must be a purchase or sale by *some* investor. Once the trigger has been pulled, any investor who is harmed would have standing to sue. The "in connection with" clause would be a jurisdictional basis, as is the "use of interstate instrumentalities" clause.<sup>97</sup> This result would clearly avoid further inconsistencies in the case law<sup>98</sup> and the creation of fictions to allow recovery.<sup>99</sup>

93. See SEC Securities Act Release No. 3230 (May 21, 1942), quoted note 85 *supra*.

94. *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461, 463 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952).

95. *Herpich v. Wallace*, 430 F.2d 792, 801 (5th Cir. 1970); *cf.* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 195 (1963).

96. For this type of analysis of the "zone of interest" test, see *Barlow v. Collins*, 397 U.S. 159, 164-65 (1970).

97. *Ruder, Current Developments In the Federal Law of Corporate Fiduciary Relations—Standing to Sue Under Rule 10b-5*, 26 BUS. LAW. 1289, 1302-03 (1971).

98. *Leech, Transactions in Corporate Control*, 104 U. PA. L. REV. 725, 834 (1956).

99. See *Voegel v. American Sumarata Tobacco Corp.*, 241 F. Supp. 369 (D.

In sum, standing under rule 10b-5 is an "amorphous" concept, as it is in other areas of the law.<sup>100</sup> This uncertainty is due to direct and result-oriented judicial manipulation of the standing concept. The limitation of standing to buyers and sellers has been motivated by such factors as the potentially broad scope of rule 10b-5 liability,<sup>101</sup> curbing expansion of federal corporate common law,<sup>102</sup> lack of causation,<sup>103</sup> or speculative damages.<sup>104</sup> But standing is not the proper tool to correct such vices.<sup>105</sup> It is a constitutional doctrine for determining who is the proper party to bring the suit to insure that an adversary proceeding will result. As elsewhere, the "alleged injury in fact" and "arguably within the zone of interest" tests should be applied. In cases, for example, where damages are too speculative or causation is not present, these defects should be dispensed with procedurally as they would be in other areas of the law. Nevertheless, the attenuated *Birnbaum* Doctrine still stands.

C. THOMAS WESNER, JR.

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Del. 1965). The authors of R. JENNINGS & H. MARSH, *SECURITIES REGULATION* (2d ed. 1968), in commenting on this case, said:

Judge Steel held that when the plaintiff purchased her stock in the market in 1945 the corporation impliedly represented to her that if and when it ever entered into a merger it would only do so on terms that were "fair" to her; when it did enter into a merger in 1960 on terms which she alleged were "unfair," this made the representation false and gave her a cause of action under Rule 10b-5. One would have to go back at least several hundred years to find such a palpable creation of a fiction by a court to seize jurisdiction not otherwise conferred upon it. *Id.* at 963.

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

101. *Herpich v. Wallace*, 430 F.2d 792, 804 (5th Cir. 1970), citing R. JENNINGS & H. MARSH, *SECURITIES REGULATION* 961 (2d ed. 1968).

102. Leech, *supra* note 98, at 834. Compare Ruder, *Pitfalls in the Development of a Federal Law of Corporations by Implication Through Rule 10b-5*, 59 NW. U.L. REV. 185 (1964), with Felischer, *Federal Corporate Law, an Assessment*, 78 HARV. L. REV. (1965). See also Bollman, *Rule 10b-5: The Case of its Full Acceptance as Federal Corporate Law*, 37 CIN. L. REV. 727 (1968); Ruder, *supra* note 97, at 1290-92; and Note, *Federal Common Law*, 83 HARV. L. REV. 1512 (1969) (discusses growth in other areas of the law).

103. BROMBERG § 8.8, at 221.

104. *Id.*

105. Davis, *The Liberalized Law of Standing*, 37 U. CHI. L. REV. 450, 468 (1970).