Securities - Blue Chip Stamps v. Manor Drug Stores - An Affirmation of the Birnbaum Doctrine

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SECURITIES—Blue Chip Stamps v. Manor Drug Stores—An Affirmation of the Birnbaum Doctrine

INTRODUCTION

The longstanding acceptance by the courts, coupled with Congress’ failure to reject Birnbaum’s reasonable interpretation of the wording of Section 10(b), wording which is directed towards injury suffered “in connection with the purchase or sale” of securities, argues significantly in favor of acceptance of the Birnbaum rule by this Court.¹

With these words the Supreme Court in Blue Chip Stamps v. Manor Drug Stores,² finally determined that the private remedy for fraud “in connection with the purchase or sale of securities” under section 10b of the 1934 Securities and Exchange Act³ and rule 10b-5 of the Securities and Exchange Commission⁴ is limited to a plaintiff class of purchasers and sellers of securities. Accordingly, the judicially imposed Birnbaum doctrine, a product of the lower courts since its conception in 1952,⁵ need no longer battle for its continued existence.⁶ Nevertheless questions remain as to how the doctrine will be applied in light of the Supreme Court opinion in Blue Chip,

2. Id.
   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.
4. Rule 10b-5, 17 C.F.R. § 240.10b-5 (1975) 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.
and as to the effects of this decision on civil liability for securities transactions. This article will discuss the impact of the Blue Chip decision on 10b-5 litigation, with emphasis on the implications for the Seventh Circuit.

STATEMENT OF THE CASE

The Facts

A consent decree in 1967 terminated an action by the United States against Blue Chip Stamp Co., a corporation in the business of providing trading stamps to retailers, and nine retailers holding 90 percent of its shares.7 Pursuant to the decree, a reorganization plan was carried out whereby “old Blue Chip” merged into Blue Chip, a newly formed corporation. In addition, the holdings of the majority shareholders of “old Blue Chip” were to be reduced by offering a substantial number of their shares in the newly formed corporation to non-shareholder users of the trading stamps on a pro-rata basis. In an offering registered pursuant to the 1933 Securities Act,8 a prospectus offering shares in units significantly below fair market value was distributed to the specified stamp users. More than 50 percent of these shares were sold, and the remaining shares were offered to the public a year later.

Manor Drug Stores, a former user of the stamp service, brought suit against old Blue Chip, new Blue Chip, eight majority shareholders of old Blue Chip, and the directors of new Blue Chip (hereinafter collectively referred to as Blue Chip).9 The plaintiffs claimed that Blue Chip, lacking good faith intentions to comply with the consent decree, prepared a prospectus that was materially misleading and overly pessimistic in order to discourage former stamp users from accepting what was intended to be a bargain offer. Allegedly the defendant’s purpose was to later offer the rejected shares to the public at a higher price.10 Asserting that class members failed to purchase the bargain units in reliance on the false and misleading prospectus, plaintiffs sought damages and the right to purchase shares at the original offering price.

The district court dismissed plaintiffs’ claims of violations of sec-

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10. 95 S. Ct. 1917, 1938-39 (1975). The prospectus contained a section entitled “Items of Special Interest” containing the allegedly false and misleading statements. A prospectus issued a year later offering the remaining shares for sale to the public made no reference to those same items, although they were equally relevant or irrelevant at that time.
tion 12 of the 1933 Securities Act,11 section 10b of the 1934 Securities Exchange Act and SEC rule 10b-5 promulgated thereunder. The plaintiffs' claim for rights as the third party beneficiary of the consent decree was also rejected.12 In refusing to allow a remedy under rule 10b-5, the court reaffirmed the Birnbaum doctrine and explained that any party who has not in fact entered into a transaction having the effect of a purchase or sale does not come within the provisions of that rule.

The Ninth Circuit Court of Appeals reversed and remanded.13 The court held that the consent decree was the functional equivalent of a contract and found the plaintiffs' status to be that of investors with a contract to purchase securities. Through this rationale the court succeeded in avoiding the Birnbaum limitation.14

The Supreme Court Opinion

The Supreme Court reversed, and affirmed the Birnbaum doctrine requiring that a plaintiff be a purchaser or seller of securities to have standing to sue under rule 10b-5.15 It was held that the plaintiff-offerees in Blue Chip did not fall within this classification. The Court looked to extrinsic evidence of the 1930's securities legislation and concluded that Congress intended a restrictive application of rule 10b-5. It was noted, for example, that the parallel anti-fraud provision of the 1933 Act16 reaches fraud "in the offer or sale of securities." Thus, by negative implication, congressional failure to so provide under section 10b indicated a contrary intention.17

14. For a discussion of the aborted seller exception, see text accompanying notes 88 through 91 infra.
15. 95 S. Ct. 1917 (1975).

(a) 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.

17. 95 S. Ct. at 1924-25. The concurring opinion refers to section 5b of the 1933 Act, 15 U.S.C. § 77e(b), requiring that offers to sell registered securities be made by means of an effective prospectus; accordingly, it was acknowledged that the Blue Chip plaintiff-offerees were members of the limitless class of plaintiffs protected by that provision. However, it was
the Court's opinion this textual analysis was supported by Congress’ refusal to reject the Birnbaum doctrine, as well as by the long-standing acceptance of the purchaser-seller rule throughout the lower courts. Moreover, the Court cited provisions for express civil liability in the 1933 and 1934 Acts, and stated that the plaintiff class for the judicially implied cause of action under 10b-5 should not be expanded beyond those defined limits of express liability.

Acknowledging that any analysis of congressional intent was inconclusive, the Court focused heavily on policy considerations. Because the threat of extensive discovery procedures and business interruptions increases settlement value in securities litigation and provides the opportunity for nuisance suits, the Court feared the danger of vexatious litigation which could result from the abandonment of Birnbaum. In addition, there was concern that a limitless class of plaintiffs with claims based only on oral testimony would result in problems of proof. The Court concluded that these policy considerations outweigh the SEC argument that Birnbaum is an arbitrary restriction preventing worthy plaintiffs from recovery for violations of 10b-5.

Both the majority and concurring opinions refuted the appellate court's holding that the antitrust decree in Blue Chip was the functional equivalent of a contract between the parties and that this "contract" satisfied the purchaser-seller requirement. Although a party with a contractual right or duty to purchase would be deemed a purchaser as defined by the terms of the 1934 Act, the Court held

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20. 95 S. Ct. at 1926.


22. SEC has regularly called for the abandonment of Birnbaum in numerous amicus curiae briefs. See Superintendent of Ins. of New York v. Bankers Life & Casualty Co., 404 U.S. 6 (1971); Mt. Clemens Industries v. O.M. Bell, 464 F.2d 339 (9th Cir. 1972); Levine v. Seilon Inc., 439 F.2d 328 (2d Cir. 1971); Rekant v. Desser, 425 F.2d 872 (5th Cir. 1970); Pappas v. Moss, 393 F.2d 865 (3d Cir. 1968); Dasho v. Susquehanna, 380 F.2d 262 (7th Cir. 1967).

23. The court noted that the disadvantage of excluding worthy plaintiffs is mitigated to the extent remedies are available under state law. See 95 S. Ct. at 1927 n.9.

24. 1934 Securities and Exchange Act, § 3a (13), 15 U.S.C. § 78c(a)(13) (1970) provides that the terms "buy" and "purchase" each include any contract to buy, purchase, or other-
that the Blue Chip offerees did not have a contractual relationship under the antitrust decree and would not therefore be granted purchaser status as required by Birnbaum.

Policy Considerations of the Dissent

In a dissent concurred in by Justices Douglas and Brennan, Justice Blackmun accused the Court of exhibiting "a preternatural solicitousness for corporate well-being and a seeming callousness toward the investing public quite out of keeping . . . with our own traditions and the intent of the securities laws."25 The dissenting Justices looked to legislative and administrative history of the 1930's securities legislation and rule 10b-5, focusing on the broad general purpose to prohibit fraud in the public interest and to protect the investing public.28 Justice Blackmun interpreted "sale" within section 10b and rule 10b-5 to refer not only to an individualized transaction, but also to a generalized public selling, including the court-ordered special offering of securities in Blue Chip. Plaintiffs that could show a nexus between asserted fraud and that "sale" of securities should not be denied a remedy merely because they were not formal "purchasers" or "sellers." Following this reasoning Justice Blackmun proposed abandoning the purchaser-seller limitation and advocated the adoption of the general nexus test suggested in Eason v. General Motors Acceptance Corp.27

SECTION 10B AND RULE 10B-5

Legislative History of Section 10b

The Securities Act of 193328 and the Securities Exchange Act of 193429 were part of a broad legislative program30 in response to the...
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stock market frauds of the 1920's and the great crash of 1929. The 1933 Act, which included a general antifraud provision, was aimed principally at full disclosure in the sale of new issues of securities or distribution of outstanding securities. The 1934 Act also promoted disclosure by the regulation of the exchanges themselves and regulation of speculative practices carried on by corporate insiders.

Much of the law of securities fraud has evolved from the general antifraud provision on the 1934 Act, section 10b. Thomas Cocoran, a principal spokesman of the Roosevelt administration and drafter of the Act, described section 9c, an earlier version of 10b:

Subsection (c) says "Thou shall not devise any other cunning devices"... Of course subsection (c) is a catch-all clause to prevent manipulative devices[.] I do not think there is any objection to that kind of a clause. The Commission should have the authority to deal with new manipulative devices.

Although a number of witnesses did object to the breadth of the section, there was no indication that Congress responded to such criticism in the enactment of section 10b. Courts have utilized Cocoran's semi-official language to support the significant judicial expansion of the law under 10b-5.

Despite the years of controversy over the scope of 10b-5, section 10b on which the rule was promulgated was one of the least contro-

31. *See Hearings on S. Res. 84 and S. Res. 56 Before the Senate Committee on Banking and Currency, 73d Cong., 1st Sess., & 2d Sess. (1933-34) (Pecora Investigation).*
34. *S. Rep. No. 792, 73d Cong., 2d Sess. 3 (1934); H.R. Rep. No. 1383, 73d Cong., 2d Sess. 5, 6, 11 (1934). Although technically not part of the legislative history of the section, it should be noted that the 1957 and 1959 legislative programs proposed amendments to 10b so that the section would include "any attempt to purchase or sell." According to Professor Loss:*  
   "The purpose was to make it entirely clear that the section applies to the so-called "front money racket," whereby a person obtains money from a prospective issuer by misrepresenting his intention or ability to arrange an underwriting or financing for the issuer, and also to place non-broker-dealers on an equal plane with broker-dealers under Sec. 15(c)(2). ... 103 Cong. Rec. 11, 636 (1957); SEC Legislation, *Hearings before Subcom. of Senate Com. on Banking & Currency on S. 1178-82, 86th Cong., 1st Sess. (1959) 367-68.*
35. *L. Loss, SECURITIES REGULATION 1424 n.6 (2d ed. 1961).*
36. *Hearings on Stock Exchange Regulation Before the House Committee on Interstate and Foreign Commerce, 73d Cong., 2d Sess. 115 (1934).*
37. *Id. at 209.*
38. *1 A. Bromberg, SECURITIES LAW: FRAUD SEC RULE 10b-5 § 2.2 (1974).*
versial sections of the 1934 Act. The committee reports and floor debates that mention section 10b merely paraphrase the language and give minimal insight as to congressional intent. The legislative history of section 10b is so meager that little can be drawn from it to interpret the scope of 10b-5.

Promulgation of Rule 10b-5

In answer to the question "are we against fraud, aren't we?" the SEC promulgated rule 10b-5 pursuant to its authority in sections 23a and 10b of the 1934 Act. The purpose of the rule was to fill the gap in the otherwise extensive antifraud provisions of the Act by prohibiting fraudulent practices by the purchasers of securities. The general antifraud language of the rule was taken principally from section 17(a) of the 1933 Securities Act.

The initial description of 10b-5 by the SEC was brief:

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39. See, e.g., S. REP. No. 792, 73d Cong., 2d Sess., 18 (1934); H.R. REP. No. 1838, 73d Cong., 2d Sess., 32-33 (1934); 78 CONG. REC. 10261 (1934); 78 CONG. REC. 8164 (1934).

40. 1 A. Bromberg, Securities Law: Fraud-SEC Rule 10b-5 § 2.2 (1974); 5 A. S. Jacobs, Securities Law Series: The Impact of Rule 10b-5 § 5 (1974). See also Ruder, Civil Liability under Rule 10b-5: Judicial Revision of Legislative Intent?, 47 Nw. U.L. Rev. 627 (1963). Professor Ruder argues further that there is no indication that Congress even intended to create a private remedy under 10b-5, although courts have held to the contrary.

41. The story of the casual origin of the rule is related by Milton Freeman, SEC attorney at the time:

It was one day in the year 1943 [1942], I believe, I was sitting in my office in the S.E.C. building in Philadelphia and I received a call from Jim Treanor who was then the Director of the Trading and Exchange Division. He said, "I have just been on the telephone with Paul Rowen," who was then the S.E.C. Regional Administrator in Boston, "and he has told me about the president of some company in Boston who is going around buying up the stock of his company from his own shareholders at $4.00 a share, and he has been telling them that the company is doing very badly, whereas, in fact, the earnings are going to be quadrupled and will be $2.00 a share for this coming year. Is there anything we can do about it?" So he came upstairs and I called in my secretary and I looked at Section 10(b) and I looked at [SA] Section 17, and I put them together, and the only discussion we had there was whether "in connection with the purchase or sale" should be, and we decided it should be at the end.

We called the Commission and we got on the calendar, and I don't remember whether we got there that morning or after lunch. We passed a piece of paper around to all the commissioners. All the commissioners read the rule and they tossed it on the table, indicating approval. Nobody said anything except Sumner Pike who said, "Well," he said, "we are against fraud, aren't we?" That is how it happened.


The Securities and Exchange Commission today announced the adoption of a rule prohibiting fraud by any person in connection with the purchase 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.44

From this uneventful origin, rule 10b-5 has become "the focal point for spectacular growth in the law governing civil liability for transactions in securities."45 It appears at the outset that the SEC was concerned with its enforcement of the rule and not with private litigation.46 Nor did the Commission anticipate the vast amount of securities litigation that the rule has generated. Milton Freeman, an attorney for the SEC in 1942, said in retrospect about the rule: "I never thought that twenty-odd years later it would be the biggest thing that had ever happened."47

Implied Civil Liability

Four years after the promulgation of the rule, the court in Kardon v. National Gypsum Co.48 implied the existence of civil liability under 10b-5. The shareholder-plaintiff in that case alleged that he was induced to sell shares of stock below true value by the fraud of the corporate-defendant. The court allowed relief under rule 10b-5, holding that, although there was no express liability in the statute, plaintiff was within the class for whose benefit the statute was enacted.

In other words, in view of the general purpose of the Act, the mere omission of an express provision for civil liability is not sufficient to negative what the general law implies.49

While this interpretation has not been devoid of criticism,50 the

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46. See note 41 supra. See also 1 A. Bromberg, Securities Law: Fraud—SEC Rule 10b-5 § 2.2 (420) (1974).
49. Id. at 514. The general law to which the court refers is the civil tort remedy provided in 2 Restatement of Torts § 286 (1934): 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.
50. See Ruder, Pitfalls in the Development of a Federal Law of Corporations by Implica-
weight of authority recognizes this private remedy as a necessary supplement to enforcement of the rule by the SEC. The Supreme Court in Superintendent of Insurance v. Bankers Life and Casualty Co. needed only a footnote to approve the implied private right of action under 10b-5, by then firmly established within the lower courts.

**Birnbaum and Its Progeny**

*The Birnbaum Doctrine*

This extraordinary expansion of subject-matter coverage by § 10(b) and rule 10b-5, coupled with the possibility of extraordinarily great liability, has moved courts to limit the class of persons who may recover to purchasers or sellers of securities.

The Birnbaum purchaser-seller rule is the most significant policy developed by the judiciary to restrain the class of persons eligible to bring civil actions under rule 10b-5. The doctrine originated in 1952 with Birnbaum v. Newport Steel Corp. In that case, minority shareholders brought suit, individually and as a class, against the controlling shareholder who had rejected an attractive merger offer in order to sell his shares at a premium price to a third party. Plaintiff-shareholders alleged breach of fiduciary duty and fraud in connection with this sale of securities. The Second Circuit Court of Appeals dismissed the claim holding, first, that rule 10b-5 provided a cause of action for misrepresentation usually associated with the sale or purchase of securities rather than for corporate mismanagement or breach of fiduciary duty; and second, that rule 10b-5 extends protection only to a defrauded purchaser or seller. Focusing on the articulated administrative intent of the SEC in promulgating rule 10b-5, to extend protection from fraud to sellers as well as purchasers of securities, the Birnbaum court denied relief to the plaintiff who was neither a purchaser nor seller of securities. Although the holding has been substantially expanded by allowing

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51. J. I. Case Co. v. Borak, 377 U.S. 426, 432 (1964); see Fischman v. Raytheon Mfg. Co., 188 F.2d 783 (2d Cir. 1951); Fratt v. Robinson, 203 F.2d 627 (9th Cir. 1953); Hooper v. Mountain States Securities Corp., 282 F.2d 195 (5th Cir. 1960); Ellis v. Carter, 291 F.2d 270 (9th Cir. 1971).

52. 404 U.S. 6, 13 n.9 (1971).


54. 193 F.2d 461 (2d Cir. 1952), cert. denied, 343 U.S. 956 (1952).

55. Id. at 463. See text accompanying note 44 supra for the SEC Securities Act Release No. 3230 and 6 L. Loss, SECURITIES REGULATION 3617 (1969 Supp.) stating that Birnbaum's version of the "legislative history" of the rule is accurate.
claims for corporate mismanagement, the Birnbaum doctrine as a purchaser-seller limitation has received widespread judicial support and has even been hailed as "the progenitor of much of the law and conventional wisdom in the 10b-5 area."

The Second Circuit reaffirmed Birnbaum in Iroquois Industries, Inc. v. Syracuse China Corp. In that case an unsuccessful tender offeror alleged that its take-over attempt had been defeated by defendant's fraud. The court found plaintiff lacked standing to sue, holding that the alleged fraud went to plaintiff's failure to purchase stock and plaintiff was therefore not a purchaser of securities as required under rule 10b-5. The court explained: (1) the purpose of rule 10b-5 was to provide a remedy to sellers as well as buyers of securities; (2) the Birnbaum doctrine had not been relaxed through subsequent decisions; and (3) if the purchaser-seller limitation on standing were to be abandoned, it would be up to Congress to do so.

Illustrative of further judicial construction of Birnbaum is the Ninth Circuit opinion in Mount Clemens Industries, Inc. v. Bell. Plaintiffs in that case argued not only that Birnbaum had been so eroded that it was no longer the law, but also that it had been incorrectly decided and should be disavowed, a theory espoused by the SEC as amicus curiae. The Ninth Circuit rejected both arguments:

56. See Superintendent of Insurance v. Bankers Life and Casualty Co., 404 U.S. 6 (1971). In that case, the Court allowed a cause of action for corporate mismanagement so long as the fraud touched loosely on the purchase or sale of securities. Any question whether the purchaser-seller requirement was also eliminated by that opinion has been settled by the Supreme Court opinion in Blue Chip.

57. See Haberman v. Murchison, 468 F.2d 1305 (2d Cir. 1972) (derivative action against corporate officers who withheld material inside information in selling stock to a third party; the court, following Birnbaum, did not grant standing); Landy v. FDIC, 486 F.2d 139 (3rd Cir. 1973), cert. denied, 416 U.S. 960 (1974) (derivative and shareholder actions against a bank president who had used assets of the bank in personal speculative investments; the claim was dismissed under Birnbaum); City National Bank v. Vanderboom, 422 F.2d 221 (8th Cir. 1970), cert. denied, 399 U.S. 905 (1970) (counterclaim by corporate shareholders based upon misrepresentations made to their corporation; the counterclaim was dismissed following Birnbaum); Simmons v. Wolfson, 428 F.2d 455 (6th Cir. 1970), cert. denied, 400 U.S. 999 (1971) (class suit by holders of stock alleging impairment in value of their stock through manipulation; dismissal of the claim was affirmed pursuant to Birnbaum); Sargent v. Genesco, 492 F.2d 750 (5th Cir. 1974) (direct and derivative action by stockholders alleging nondisclosure of material information concerning a refinancing plan resulting in dilution of stocks' value; the court held plaintiff had no standing because not a purchaser or seller in refinancing plan).


60. See Blau v. Lehman, 368 U.S. 403 (1962).

61. 464 F.2d 339 (9th Cir. 1972).
When examined quite carefully, however, there has been no erosion of Birnbaum. Rather, the doctrine formulated therein has been interpreted and applied flexibly, not technically and restrictively . . . thus promoting the congressional purpose in the enactment of this remedial legislation.\textsuperscript{62}

In affirming the doctrine, the Mount Clemens court rejected the Birnbaum court's reliance on administrative intent in the promulgation of rule 10b-5.\textsuperscript{63} The Ninth Circuit preferred the historical and constitutional approach to the doctrine, as articulated in Herpich\textsuperscript{64} v. Wallace,\textsuperscript{65} an earlier Fifth Circuit decision.\textsuperscript{66}

Without accounting for variant judicial construction of the purchaser-seller rule, the Supreme Court supported its own affirmation of the Birnbaum doctrine by such lower court holdings:\textsuperscript{67}

\begin{flushleft}
\textbf{Birnbaum as a Standing Requirement}
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Although standing was never mentioned in the original opinion, the Birnbaum doctrine has developed into a standing requirement that has been considered of constitutional dimensions.\textsuperscript{68} The Fifth Circuit in Herpich discussed the purchaser-seller limitation in relation to the two-pronged standing test set out by the Supreme Court in Association of Data Processing Service Organizations, Inc.\textsuperscript{69} v. Camp.\textsuperscript{70} The first part of the test is predicated on the case or controversy requirement of article III of the Constitution: the plaintiff

\begin{itemize}
\item \textsuperscript{62} Id. at 341.
\item \textsuperscript{63} Id. at 342 n.6.
\item \textsuperscript{64} 430 F.2d 792 (5th Cir. 1970).
\item \textsuperscript{65} It must be noted that the Ninth Circuit Court of Appeals deemed the plaintiff-offeree in Blue Chip a statutory purchaser pursuant to an antitrust decree, fulfilling this articulated standing requirement.
\item \textsuperscript{66} The Court analogized the acceptance of Birnbaum with the overwhelming judicial affirmation afforded the implied private remedy under rule 10b-5; \textit{but see} note 50 supra.
\item \textsuperscript{67} 95 S. Ct. at 1923. This comment is of particular note to the Seventh Circuit which, in Eason, had abandoned the Birnbaum doctrine.
\item \textsuperscript{68} \textit{See} Herpich\textsuperscript{69} v. Wallace, 430 F.2d 792 (5th Cir. 1970); Mount Clemens Industries, Inc.\textsuperscript{70} v. Bell, 464 F.2d 339 (9th Cir. 1972).
\item \textsuperscript{69} 397 U.S. 150 (1970).
\item \textsuperscript{70} U.S. CONST. art. III, § 2:
\begin{quote}
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
\end{quote}
must allege an injury in fact, economic or otherwise, has been
caused by defendant's conduct. The second part of the test requires
that the interest sought to be protected by the plaintiff is "arguably
within the zone of interests to be protected or regulated by the
statute or constitutional guarantee in question." The Herpich
court construed the "in connection with language" of section 10b as
demonstrating congressional intent to provide open and unmanipu-
lated markets in which investors could make knowing decisions
regarding purchases and sales of securities. Accordingly, any loss in
connection with these purchases or sales is the type of injury prohib-
ited under section 10b and rule 10b-5. Deviating from that inter-
pretation of broad congressional intent, the court drastically nar-
rowed their focus to conclude that only purchasers or sellers could
demonstrate "an invasion of their own federally protected interest
to engage in securities transactions while free from the effects of
deceptive or unfair practices employed in connection therewith, not
merely a wrong done to someone else." Therefore, it was held that
only a purchaser or seller meets the requirements of Data Processing
for standing to sue under rule 10b-5. However, this finding was
tempered by the court's approval of exceptions to Birnbaum,
thereby parties not technically purchasers or sellers may be deemed
such and afforded the protection of the rule.

Exceptions to Birnbaum

While courts have espoused the Birnbaum requirement, many
exceptions to the purchaser-seller limitation have become a recog-
nized part of 10b-5 litigation. These confusing and sometimes inco-
sistent results led some commentators and courts to suggest that the
requirement itself had been abandoned. Although Birnbaum has
been affirmed in Blue Chip, courts may continue to recognize these
exceptions articulated as a flexible construction of rule 10b-5 in
order to "effectuate its remedial purposes."

The most clearly defined of these exceptions is an action for in-
junctive relief as opposed to damages. In Mutual Shares Corp. v.

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71. 397 U.S. at 153.
72. See Herpich v. Wallace, 430 F.2d 792, 806 (5th Cir. 1970).
73. Id.
74. See note 6 supra.
Genesco, Inc.,\textsuperscript{76} plaintiffs alleged that, after they had purchased stock in S. H. Kress Co., defendant Genesco and its chairman manipulated the market price of the Kress stock and decreased stock dividends in order to force minority stockholders to sell out at a depressed price. Damages were denied, but the court allowed injunctive relief to halt the continuing manipulative scheme. Noting that such claims avoid the issue of proof of loss and casual connection, the court did not require the plaintiff to assert purchaser-seller status.\textsuperscript{77}

The "forced" seller or purchaser situation is another recognized exception to Birnbaum. In A. T. Brod & Co. v. Perlow,\textsuperscript{78} a broker-dealer suffered a loss as a direct result of a customer's fraud in ordering stocks with the intent of paying only if the value increased. That court granted the broker-plaintiff the unusual status of "forced purchaser" and allowed standing to sue.

The "forced seller" doctrine is more common. It is typified in Vine v. Beneficial Finance Co.\textsuperscript{79} where the court held a minority stockholder of a corporation to be a "seller" when the corporation was merged in a short-form merger. The holding was based on the fact that, although the shareholder still retained stocks of the non-existent corporation, he would be forced to convert them into cash at the price fixed either by the merger or under the statutory appraisal procedure. The doctrine has also been applied to executory mergers\textsuperscript{80} and liquidation proceedings.\textsuperscript{81} The Supreme Court has looked with approval at this expanded concept of purchase or sale:

Whatever the terms "purchase" and "sale" may mean in other contexts, here an alleged deception has affected individual shareholders' decisions in a way not at all unlike that involved in a typical cash sale or share exchange.\textsuperscript{82}

At the outer limits of the "forced seller" exception are some "hy-
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"forced seller" cases which courts have brought under the protective umbrella of 10b-5. In *Travis v. Imperial Limited*, defendants bought 90 percent of the shares of a corporation, but through alleged fraudulent means induced the remaining ten percent of the shareholders not to tender. When there was no longer an open market for the stock, plaintiffs had no choice but to sell at the artificially low rates. The court held that the sale, though delayed, constituted a forced sale since defendant's fraud had so limited the market that plaintiff was forced in a practical sense to dispose of the stock. 

The "forced seller" doctrine was also applied in *Crane Co. v. Westinghouse Air Brake Co.* In that case, Crane's unsuccessful tender offer was defeated as a result of defendant's fraudulent market manipulations. The court did grant the frustrated tenderer standing to sue as a forced seller under 10b-5, but only because that plaintiff was later forced to dispose of his stocks as a result of a threatened antitrust action. It must be noted that the Second Circuit denied standing to sue under rule 10b-5 in a comparable factual situation. In *Iroquois Industries, Inc. v. Syracuse China Corp.*, the court held that the unsuccessful tenderer had not been defrauded in purchasing stocks but only in being precluded from purchasing and the action was not permitted. The only distinction between the two cases was that the *Crane* court relied upon the subsequent disposal of securities in order to find the plaintiff within the "forced seller" exception to Birnbaum.

The "aborted seller" exception is another means of achieving standing under rule 10b-5. Cases in this category are based on the principle that once a party enters a contractual agreement the status of purchaser or seller, as defined by the 1934 Act, is obtained. For example, a proposed reorganization plan resulted in a 10b-5 action when the exchange of stock was never completed. The Ninth Circuit held that because sufficient contractual relations had been interrupted, the plaintiff had standing to sue as an aborted seller. The contractual requirements for the exception were also considered

83. 473 F.2d 515 (8th Cir. 1973).
84. *Travis* has also been classified within the delayed seller exception. See also Stockwell v. Reynolds, 252 F. Supp. 215 (S.D.N.Y. 1965). In that case, plaintiff alleged that broker-dealer induced him by misrepresentations to retain his stocks. When plaintiff sold the stocks at a loss five months later, the court allowed relief, holding that the purchase or sale does not have to follow immediately the alleged fraud.
86. 417 F.2d 963 (2d Cir. 1969).
87. See note 24 *supra*.
adequate in *Goodman v. H. Hentz & Co.* The defendant-stockbroker misrepresented to the plaintiff-client that purchases and sales of securities were being made. The district court found that *Birnbaum* did not apply since these plaintiffs were parties to the securities transactions and would have been actual purchasers or sellers but for defendant's fraud. The court granted relief, reasoning that rule 10b-5 was clearly intended to prohibit this kind of transaction.

When damages are easily determinable and plaintiff's failure to act is directly caused by defendant's fraud, aborted seller status has been granted. In *Neuman v. Electronic Speciality Co.*, defendants had misled plaintiffs into believing that a telegraphic acceptance of a tender offer would be honored. Because plaintiffs could show that they would have sold their stock but for defendants' fraud, the court found the required causal connection between defendants' fraud and the aborted sale. This case has broader implications than other cases within this exception which rely on contractual relations as the statutory equivalent to purchase or sale. By employing a causation analysis, the Seventh Circuit in *Neuman* expanded the boundaries of the "aborted seller" exception otherwise determined by the existence of these contractual connections.

Subsequent to *Birnbaum*, courts have also recognized the "constructive" purchaser or seller exception. In these cases, plaintiffs are brought within the confines of the rule through a functional equivalent analysis as employed by the Sixth Circuit in *James v. Gerber Products Co.* The court held that the plaintiff as beneficiary of a trust from which securities were sold directly to defendant-corporation had standing to sue under rule 10b-5. The plaintiff was found to have constructive seller status because he was the real party in interest or the functional equivalent of the seller of securities.

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92. 483 F.2d 944 (6th Cir. 1973).
SCOPE OF 10B-5 AFTER BLUE CHIP

Based on policy considerations directed at protection of the business community, the Supreme Court has affirmed the Birnbaum purchaser-seller limitation on standing to sue under rule 10b-5. It is the tradition of 10b-5 litigation for the Court, lacking the benefit of legislative history, to balance the commercial welfare with that of the individual in deciding cases brought under the rule. As the court in Herpich explained:

Protection for investors is a primary importance but it must be kept in mind that the nation's welfare depends upon the maintenance of a viable, vigorous business community.\(^{95}\)

Relying on this theory, the Court in Blue Chip determined that Birnbaum could not be abandoned for fear of encouraging vexatious litigation and forced settlements under rule 10b-5. The restrictive policy appeared to have two goals: the first was to limit liability to an ascertainable class of plaintiffs; the second, which can be inferred, was to prevent claims for corporate mismanagement presently allowable only in state court from reaching the federal forum. Dismissing the viability of alternate methods of achieving these goals for limiting liability, the Court simply concluded that Birnbaum continues to be the most effective judicial restriction on the private remedy for fraud.\(^{96}\)

An essential consideration of the Blue Chip mandate is its effect on the vast body of case law litigated under rule 10b-5. With the exclusion of the Seventh Circuit's recent disavowal in Eason of the doctrine, courts have generally paid homage to the purchaser-seller rule. Nevertheless, judicial construction has been so varied between and within circuits that the expansive Birnbaum decisions have come to include not only the doctrine, but also its many judicially-created exceptions.\(^{97}\) There can only be speculation as to the future

94. See Hearings on H.R. 4314 Before the House Committee on Interstate and Foreign Commerce, 73d Cong., 1st Sess. 12 (1933). As discussed by Huston Thompson, one of the principal drafters of the 1933 act:

The purpose and policy here is to protect, first of all, the purchasers of securities, and second, honest business houses that are selling securities, with as little interference with business as possible.

95. 430 F.2d at 804.


97. For a discussion of the exceptions to Birnbaum, see text accompanying notes 74 through 93 supra.
of such judicial interpretation because the Supreme Court did not specifically address this issue.

The Court did carefully distinguish the *Blue Chip* plaintiff-offerees as a potentially broader class than parties who had been granted purchaser-seller status through recognized judicially-created exceptions:

Even if we were to accept the notion that the *Birnbaum* rule could be circumvented on a case-by-case basis through particularized judicial inquiry into the facts surrounding a complaint, this respondent and the members of his alleged class would be unlikely candidates for such a judicially created exception. While the *Birnbaum* rule has been flexibly interpreted by lower federal courts, we have been unable to locate a single decided case from any court in the 20-odd years of litigation since the *Birnbaum* decision which would support the right of persons who were in the position of respondent here to bring a private suit under Rule 10b-5. Respondent was not only not a buyer or seller of any security but it was not even a shareholder of the corporate petitioners.  

The negative implication drawn from this distinction and from the Court's failure to nullify the *Birnbaum* exceptions is that prior case law has not been overruled. It is likely that those lower courts following a liberal precedent will focus on this vague language to continue their independent construction of the doctrine with broad exceptions. However, courts that have preferred a narrower construction of the doctrine may follow *Blue Chip* more restrictively in delineating the status of purchaser or seller. As a result, much of the chaos and unpredictability surrounding civil liability under 10b-5 has not been eliminated.

Nevertheless, the Supreme Court in *Blue Chip* has provided the outer boundaries for this ill-defined area. *Birnbaum* has been firmly established as the law; the purchaser-seller criteria are essential to the standing test under 10b-5. Moreover, the *Blue Chip* opinion stands as a major policy statement halting further expansion of the plaintiff class under the rule.

Unfortunately, the Court left unanswered the most perplexing and difficult question arising from its acceptance of *Birnbaum*: whether the adoption of the purchaser-seller rule as a limiting doctrine is consistent with the standing requirement set out by the Court in *Data Processing*. That test provides that a complainant may be afforded a remedy to sue if the party has suffered an injury

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98. 95 S. Ct. at 1933 (footnote omitted).
in fact and that injury is arguably within the zone of interests sought to be protected under the statute. Certainly such a determination of standing under section 10b and rule 10b-5 is particularly complex due to the vague statutory language, lack of administrative and legislative history, overlapping regulatory provisions, and conflicting judicial construction. Several appellate courts have analytically confronted the problem, attempting to clarify the plaintiff class legitimately deserving a remedy for fraud "in connection with the purchase or sale of securities."100

The Supreme Court in *Blue Chip* ignored the problem. The opinion stated that plaintiffs deserving a remedy under rule 10b-5, impliedly as required by the *Data Processing* test, would arbitrarily be denied standing under the *Birnbaum* restriction. The Court explained that such a result is justified by the policy considerations underlying the enforcement of *Birnbaum*.101 This reasoning brought forth legitimate criticism from the dissent:

We should be wary about heeding the seductive call of expediency and about substituting convenience and ease of processing for the more difficult task of separating the genuine claim from the unfounded one.102

A blatant example of the controversy left unresolved by *Blue Chip* is reflected in the dichotomy between the *Crane* and *Iroquois* cases. In comparable factual situations, each plaintiff alleged the same injury by a defendant in the same manner, but only one plaintiff was granted standing to sue under rule 10b-5. That plaintiff, *Crane*, was allowed a federal forum because of a later sale of securities due to a threatened antitrust action unrelated to the defendant's alleged fraud. In *Crane* the Second Circuit, creator and adherent of *Birnbaum*, employed a fictitious distinction to avoid the purchaser-seller limitation on standing. It appears that the restrictive policy application of the *Birnbaum* doctrine, now mandated by the Supreme Court in *Blue Chip*, propagates such contradictions and continued confusion regarding civil liability under rule 10b-5.

**Impact of Blue Chip on Seventh Circuit Law**

*Eason v. General Motors Acceptance Corp.*

In 1973 the Seventh Circuit in *Eason v. General Motors Accept-

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100. Compare *Eason v. General Motors Acceptance Corp.*, 490 F.2d 654 (7th Cir. 1973) with *Herpich v. Wallace*, 430 F.2d 792 (5th Cir. 1970).

101. For a discussion of the Supreme Court opinion, see text accompanying notes 15 through 24 supra.

102. 95 S. Ct. at 1941-42.
ance Corp.\textsuperscript{103} abolished the Birnbaum limitation on standing to sue under rule 10b-5. In that case, defendant Bank Service Corporation (Bank Service) had purchased the leasing division of Dave Waite Pontiac, Inc. (Waite) and had issued in return 7,000 shares of its own stock to Waite, assuming the liabilities of Waite Leasing including notes payable to General Motors Acceptance Corporation (GMAC). The plaintiff-shareholders of Bank Service had also personally guaranteed those notes and any future obligations. After the leasing business became insolvent and Bank Service defaulted, GMAC brought suit against the plaintiff-shareholders in the state court to recover on the guarantees. Plaintiffs counterclaimed, bringing an action in the federal court under 10b-5 alleging fraudulent misrepresentations and omissions in connection with the purchase or sale of securities.

After the district court dismissed the action for lack of standing under Birnbaum, the appellate court reversed and remanded stating that rule 10b-5 protected investors who "suffer significant injury as a direct consequence of fraud in connection with a securities transaction, even though their participation in the transaction did not involve either the purchase or sale of a security."\textsuperscript{104} The court, although seeming to formulate a new test, carefully pointed out that it was not trying to develop "a succinct substitute" for Birnbaum.\textsuperscript{105} The Seventh Circuit preferred to define the appropriate limits of relief through case-by-case adjudication using a causal-nexus analysis.

The opinion acknowledged that 10b-5 litigation had expanded significantly in recent history and would continue to do so. The court minimized the possibility of a dramatic increase in litigation if Birnbaum were abandoned, but stated that the SEC had the power and expertise to curtail any such increase by appropriate amendments. In any event, the court refused to rely on this consideration to qualify the imposition of what they believed to be "an artificial restriction inconsistent with the intent of the underlying statute."\textsuperscript{106}

In holding that Birnbaum was no longer the law in the Seventh Circuit, the Eason court extended 10b-5 protection to investors who could demonstrate a direct causal connection between their injury and the alleged fraud of the defendant. More specific guidelines as to the definition of "direct causation," "investors" and "special

\textsuperscript{103} Eason v. General Motors Acceptance Corp., 490 F.2d 654 (7th Cir. 1973).
\textsuperscript{104} Id. at 659.
\textsuperscript{105} Id. at 660 n.29.
\textsuperscript{106} Id. at 661.
class" were left to future judicial construction. Although boldly articulated, it is questionable whether this approach varied significantly from pre-Eason law in the Seventh Circuit or other circuits following a liberal interpretation of the Birnbaum doctrine.

Pre-Eason Decisions

In the history of securities law in the Seventh Circuit, it is not certain whether Birnbaum was ever adopted or was adopted but liberally construed. Most decisions involving plaintiffs who were not technically purchasers or sellers, often categorized as Birnbaum exceptions, seem to have been analyzed on a functional equivalent basis or the causation approach, ultimately articulated by the Eason court.

Prior to Eason, the case of Dasho v. Susquehanna Corp. had been frequently cited for the proposition that Birnbaum was the law in this circuit, sanctioning by implication the forced purchaser-seller exception. In Dasho, the Seventh Circuit allowed a derivative action by shareholders of a surviving corporation which had been fraudulently induced to sell its stock to another corporation at excessive prices, resulting in financial gain to the corporate officers. The issuance of stock was to be followed by a merger into the purchaser corporation, whereby the surviving corporation was to assume the excessive financial obligations of the original sale. The court determined that "when the merger was approved and the exchange of securities occurred, the owner of the stock had in effect purchased a new security and paid for it by turning in his old one." The plaintiffs were therefore deemed either purchasers or sellers of securities entitled to the protection of rule 10b-5. Explaining that a flexible interpretation of sale and purchase was in keeping with the purposes of securities legislation, the court considered the merger the equivalent of a cash sale of corporate stocks for purposes of the rule.

Other Seventh Circuit decisions have advanced this line of reasoning in holding that a "fraudulent substitution of shareholder status in one company for the same status in another" is a cognizable injury under section 10b and rule 10b-5, whether or not the transaction is actually characterized as a forced purchase or sale.

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109. But cf. 490 F.2d at 661 n.30. The Eason court claimed that Dasho merely explained why the Birnbaum limitation would not defeat plaintiff's action.
110. 380 F.2d at 267.
Decisions of the Seventh Circuit have also been categorized within the "aborted seller" exception. In *Goodman v. H. Hentz & Co.*, the plaintiff was granted purchaser status on the basis of the interruption of contractual relations by defendant's fraud. The plaintiff in *Neuman v. Electronic Speciality Co.* was granted relief under rule 10b-5, by proving a direct causal connection between defendant's fraud and plaintiff's aborted sale, and also by proving easily determinable damages. The court employed a causation analysis to determine that plaintiffs would have been actual sellers but for defendant's fraud and granted seller status for purposes of the rule.

**Implications for the Future**

In viewing the case law of the Seventh Circuit, it does not appear that the protection of rule 10b-5 has been extended noticeably beyond that provided in other circuits. As acknowledged by the Supreme Court, liability under the rule has never been extended so far as to afford relief to a party in the position of the plaintiff-offeree in *Blue Chip*. In the future, the Seventh Circuit will have to show deference to the Birnbaum doctrine as mandated by *Blue Chip*, but may well continue to employ the causation approach substantively in accord with prior Seventh Circuit holdings.

The facts of *Eason* provide a framework in which to discuss this hypothesis. Pursuant to Birnbaum, the court might have approached the same factual situation by bringing the plaintiff within the status of constructive purchaser-seller. Just as the beneficiary in *James v. Gerber Products Co.* was allowed standing to sue as the real party in interest, the plaintiff in *Eason* might also have been allowed this status. The *Eason* plaintiff was the real party in interest since he, and not the corporation, had suffered injury from the securities transaction entered into by the corporation. Following

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112. For a discussion of the aborted seller exception, see text accompanying notes 87 through 91 supra.
113. See text accompanying note 89 supra.
114. See text accompanying note 91 supra.
115. The *Neuman* court distinguishes *Jachiemiec v. Schenley Industries, Inc.*, Case No. 15,027 (7th Cir. Feb. 26, 1965) where a plaintiff was barred from injunctive relief by the rule.
116. During the short time that *Eason* was controlling, there was no departure from precedent in factual analysis. See, e.g., *C.N.S. Enterprises, Inc. v. G & G Enterprises, Inc.*, 508 F. 2d 1354 (7th Cir. 1975) where the court paid homage to the *Eason* test but was not dealing with the issue of purchaser-seller status under 10b-5.
117. 483 F.2d 944 (6th Cir. 1973).
this analysis the *Eason* court might have invoked an exception to *Birnbaum* to provide that plaintiff a federal forum. Hopefully the Seventh Circuit will continue its former enlightened approach, legitimized under the name of *Birnbaum* and its exceptions. If this occurs, established precedent will not be drastically affected by the *Blue Chip* requirement.

The significant implications of the *Blue Chip* decision go to the future of securities law in the Seventh Circuit. In disavowing *Birnbaum*, the *Eason* court was attempting to grapple with the difficult issue of standing under rule 10b-5. Through case-by-case adjudication employing the causation approach, the court had sought to effect the definition of the legitimate plaintiff class to be afforded a remedy under the rule even at risk of extending liability to a broader class of deserving complainants, including claims for corporate mismanagement. The ultimate goal appeared to be the evolution of a predictable standing requirement for 10b-5.

However, following the Supreme Court's mandate, the Seventh Circuit must quantitatively restrict standing to sue under 10b-5, and some plaintiffs who might have brought valid claims for fraud in connection with the purchase or sale of securities under the *Eason* causal-nexus approach will be denied a federal forum. Furthermore, the Seventh Circuit must couch its opinions in the language of the purchaser-seller rule, and the fictions propagated therein. As a result, the judicial reform anticipated for securities litigation by the *Eason* court has been nullified.

**CONCLUSION**

The application of rule 10b-5 has been a confusing combination of congressional history, administrative intent, and judicial interpretation. The rule no longer means what it says, and the area needed clarification and reform. Many commentators and the Seventh Circuit looked to the Supreme Court with that hope. But the Court in *Blue Chip*, by simply affirming *Birnbaum* as a limiting doctrine, has made it clear that there will be no judicial reform of the law under 10b-5. If there is to be a systematic and predictable scheme of securities regulation, it must be legislatively initiated.

119. See Jacobs, *Birnbaum in Flux: Significant 10b-5 Developments*, 2 *Sec. Reg. L.J.* 305, 325-329 (1975). The commentator discusses the Seventh Circuit's solution for the most serious objection to its former position: the question of the motion to dismiss. Mr. Jacobs suggests that, in response to a motion to dismiss, the causal nexus was a rebuttable presumption not sufficiently direct without a showing of special facts (such as the affirmative action to trade in *Neuman* or the guaranteed notes in *Eason*).

Unless Congress is willing to take such a step, "bloody, but unbowed Birnbaum still stands."121

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