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Bankers Life: Birnbaum Reconsidered

John Michael Ryan*

Two recent decisions typify the varying interpretations given to Superintendent of Insurance of New York v. Bankers Life and Casualty Co.\(^1\)

In citing this decision, the court in *Tully v. Mott*\(^2\) commented that "[t]he thrust of defendants' jurisdictional argument seeks to revive the spectre of the *Birnbaum* buyer-seller doctrine at a point in time when both courts and legal scholars are seeking to bury it. . . . To imply such a requirement ignores the recent edict by the Supreme Court mandating a flexible as opposed to a technical or restrictive construction of the Rule."

On the other hand, in *Mount Clemens Industries, Inc., et al. v. Bell*,\(^3\) the court concluded, "[t]hroughout the Bankers Life opinion, Mr. Justice Douglas repeatedly emphasized that Manhattan, the claimant there, was to be afforded standing under the Act because of its status as a defrauded seller of securities. Of more significance is the fact that the Court explicitly declined to rule on the purchaser-seller question. . . . This express reservation, taken in conjunction with the principle set forth above . . . provides very solid additional support for our adoption of the *Birnbaum* doctrine."

Not since *Erie v. Tompkins* has a single case dominated an area of federal law the way *Bankers Life* has that of litigation under the Securities and Exchange Act of 1934. Courts and litigators have felt compelled to deal with the case, almost to a fault, in this practitioner's viewpoint. This highlights the problem in commenting on *Supt. of Ins. of

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3. CCH Fed. Sec. L. Rep. § 93, 552 (9th Cir. 1972).
N.Y. v. Bankers Life and Casualty Co. and its effect on Birnbaum v. Newport Steel and other Second Circuit cases. The volume of § 10(b) cases and extensions of its applicability, which Bankers Life may have further expanded, are common knowledge. No moratorium on such actions began on November 8, 1971, the date of the decision in Bankers Life, so that circuit and district court interpretations have followed like seagulls in the wake of an ocean liner.

The holding of Birnbaum was two-fold: (1) a purchase or sale requirement must be met before there is standing under § 10(b); (2) a suit under § 10(b) will be dismissed if the fraud alleged is simply corporate mismanagement or a breach of fiduciary duty for which there is an adequate state remedy. This note seeks to analyze what changes this case may have worked in the conceptualization of the corporate entity in the federal courts and whether, as was declared in the recent case, Tully v. Mott, supported by an invitation of the Second Circuit in Drachman v. Harvey, and prompted by the Securities and Exchange

5. Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir. 1952), cert. denied, 343 U.S. 956 (1952) [hereinafter cited as Birnbaum].
6. Iroquois Industries, Inc. v. Syracuse China Corporation, 417 F.2d 963 (2d Cir. 1969), cert. denied, 399 U.S. 909 (1970); A.T. Brod v. Perlow, 375 F.2d 393 (2d Cir. 1967); Mutual Shares Corp. v. Genesco Inc., 384 F.2d 540 (2d Cir. 1967); to name but a few cases in which the Second Circuit has considered its original holdings in Birnbaum.
7. Securities Exchange Act of 1934 [hereinafter cited as the 1934 Act] § 10(b), as amended, 15 U.S.C.A. § 78j(b) (1964) [hereinafter cited as § 10(b)]. Section 10(b) 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 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.

9. This comment does not attempt to explore what effect this case has on the development of a body of federal common law for corporations, see Folk, Does State Corporation Law Have a Future? 8 GA. A.B.J. 311 (1972).
11. Drachman v. Harvey, 453 F.2d 722 (2d Cir. 1972). Here the court refused to overrule Birnbaum at that time but specifically left the possibility open pending, it can be inferred, a settling of the dust following Bankers Life.
Commission\textsuperscript{12} and numerous commentators,\textsuperscript{13} \textit{Birnbaum} has been overruled in either of its two holdings by \textit{Bankers Life}.

One comment \textit{Bankers Life} has noted that it has aroused interest not only for its law but also for the intriguing complexity of its alleged facts.\textsuperscript{14} While nothing short of the six page statement of facts presented by Judge Herlands in the district court\textsuperscript{15} could put forth the intricacies of the alleged scheme, it can be reduced to its essentials. Bankers Life and Casualty Company owned all the stock of Manhattan Casualty Company and agreed to sell this interest to two other defendants for $5,000,000.\textsuperscript{16} The hopeful purchasers, with others, induced Irving Trust to issue a check for that amount although apparently no collateral was put up. This check was turned over to the representatives of Bankers Life in exchange for the stock of the Manhattan Company. This done, the new owners caused Manhattan Casualty to sell its U.S. Treasury bonds, a maneuver that netted close to $5,000,000, which was turned over to Irving Trust as payment for the advance of that amount earlier the same day. It was also alleged that in furtherance of the scheme a $5,000,000 certificate of deposit was obtained so that it would appear on the books of Manhattan, and to its directors, that the proceeds from the sale of the U.S. Treasury bonds were used to purchase the certificate of deposit. In fact, the certificate

\textsuperscript{12} See, e.g., Brief for SEC at 7, n.6, Supt. of Insurance of N.Y. v. Bankers Life, 404 U.S. 6 (1970); Drachman v. Harvey, 453 F.2d 722, 738 (2d Cir. 1972), where the court relates that it has been requested by the SEC to abandon \textit{Birnbaum} in Levine v. Seilon, Inc., 439 F.2d 328 (2d Cir. 1971); in G.A.F. v. Milstein, 433 F.2d 721 (2d Cir. 1971); in Iroquois Industries, Inc. v. Syracuse China Corporation, 417 F.2d 963 (2d Cir. 1969), cert. denied, 399 U.S. 909 (1970); see also Vine v. Beneficial Finance Co., 374 F.2d 627, 636 (2d Cir. 1967), cert. denied, 389 U.S. 970; Brod v. Perlow, 375 F.2d 393, 397, n.3 (2d Cir. 1967).


\textsuperscript{15} Superintendent of Ins. of St. of N.Y. v. Bankers Life and Casualty Co., 300 F. Supp. 1083, 1086-1092 (S.D.N.Y. 1969); note that the Second Circuit devoted five and a half pages (450 F.2d 355, 356-361) (2d Cir. 1970) but J. Douglas needed less than two. In the corresponding criminal proceeding, People v. Sweeney, 27 N.Y.2d 138, 313 N.Y.S.2d 744 (1970), nearly eight pages were needed to outline the scheme.

\textsuperscript{16} See infra p. 52 for a discussion of the defense that there can be no fraud when perpetrated on yourself. See also Ruckle v. Roto American Corp., 339 F.2d 24, 29 (2d Cir. 1964), where the court said: "When it is practical as well as just to do so, courts have experienced no difficulty in rejecting such cliches as the directors constitute the corporation and a corporation, like any other person cannot defraud itself." But see O'Neill v. Maytag, 339 F.2d 764 (2d Cir. 1964), where the same court held there could be no fraud without deception, and a corporation cannot be deceived if all of its directors are informed.
was worthless to Manhattan since it had been pledged as collateral for a loan to another corporation, which loan the other corporation had used to purchase the certificate of deposit. When all was said and done, the assets had been used to finance the purchase of the Manhattan stock. Fifteen months after the sale by Bankers Life, the New York Insurance Department discovered the inadequacy of Manhattan's assets and placed it in liquidation during April, 1963. The gist of the plaintiff's allegations was that the defendants conspired to use the assets of Manhattan Casualty to pay for a transfer of ownership, that this was accomplished by means of a fraud on the corporation as an entity, and some of its directors, and that consequently, a solvent corporation was rendered insolvent to the detriment of its policy holders and creditors.

The Superintendant of Insurance of New York, liquidator of Manhattan, sued the previous owners of Manhattan, Bankers Life, those individuals who ended up with the stock, and those financial institutions whose advances made the scheme possible. The district court dismissed the action as one not cognizable under the 1934 Act. With respect to the standing requirement, the court said, "... this entire transaction was a 'wash' and had no economic reality. As such, Manhattan was not a 'purchaser' of a 'security' but was merely participating as a conduit for the sole purpose of having its name appear as payee which enabled the fraud to become further camouflaged."17 Regarding the question of whether the fraud alleged fell within the ambit of §10(b) or was merely actionable in the state court proceeding, the district court determined that "The complaint ... alleges no more than a common law action for misappropriation of corporate funds by a fiduciary, embezzlement or fraudulent conveyance perhaps, or the distribution of an illegal dividend. None of these actions, in the absence of diversity of citizenship, can be maintained in a federal court."18 The Second Circuit affirmed both these holdings, commenting that although there was "no doubt the deception was successful ... that deception did not infect the subsequent sales transaction. With respect to the terms of the sale itself neither the purchaser nor the seller of the bonds was deceived or defrauded."19

The decision in Bankers Life follows 38 years of regulation by the Securities and Exchange Commission, and state regulation beginning in 1852.20 In the Securities Act of 1933,21 § 17(a) was a general

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17. 300 F. Supp. at 1099.
18. Id. at 1102.
19. 430 F.2d 355, 360.
20. For a complete history of the beginnings of governmental regulation of the se-
proscription of fraud in the sale of securities via interstate commerce. Consistent with its statutory pattern of regulating only sales, the Commission never attempted to extend this language to frauds by purchasers. In 1942 acting under § 10b of the Securities Exchange Act of 1934, the Commission adopted Rule 10b-5. This rule is identical to § 17 of the 1933 Act except for the requirement that under 10b-5, the complained-of action must be "in connection with the purchase or sale of any security," and an abbreviation of clause 2 of § 17(a).

Before considering the effect, if any, Bankers Life had on Birnbaum's standing and substantive holdings, two points of great significance, despite their almost casual treatment by the Court, should be noted.

First, Justice Douglas, speaking for the Court, at last explicitly recognizes (by footnote) that there is an implied private right of action under § 10(b). The Court had on at least two previous occasions upheld private actions under the section without discussion of this point, and ten Circuits had specifically done so.

Securities Act of 1933 § 17(a):
It shall be unlawful for any person in the . . . 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.
This section was later amended in 1954 to include a prohibition of fraud in the offer of securities as well.

Rule 10b-5 provides:
It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange
(1) to employ any device, scheme, or artifice to defraud,
(2) 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 are made, not misleading or
(3) 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.


Another area that deserves consideration, potentially as expansive as any modification of Birnbaum, is the Court's decision that the fact that the fraud was perpetrated on the corporation by its sole stockholder, did not deprive the corporation of a right of action. The potential result is to invite another class of plaintiffs, i.e., creditors, to litigate in federal court via § 10(b) in any situation where corporate assets are depleted. But, as we shall see, the result is not to say that whoever suffers harm has a cause of action under the securities acts, since the cause of action is limited to the corporation that is involved in a transaction even though the benefit is for creditors.

On this point Irving Trust in its brief before the Supreme Court argued:

A corporation which sells securities cannot be injured, in its capacity as a seller, when its sole shareholder authorizes, and is aware of all circumstances surrounding, the sale transaction. All of the shareholders of a corporation constitute the corporation and consequently cannot defraud themselves by any corporate action which is ratified by them. See Cunningham v. Jaffe, 251 F. Supp. 143 (D.C.S.C. 1966). In Schoenbaum v. Firstbrook, 405 F.2d 215 (2d Cir. 1968) en banc, cert. denied sub nom. Manley v. Schoenbaum, 395 U.S. 906 (1969), where a corporation was alleged to have issued stock to its controlling shareholder for an inadequate consideration, the Court of Appeals for the Second Circuit recognized that Section 10(b) action could be brought on behalf of the corporation only because minority shareholders of the issuer had been deceived in connection with that sale. See 405 F.2d at 220; see also the opinion of Hays, J., dissenting to the decision of the panel in that case, at 405 F.2d 200, 215.29

This argument is plainly inapplicable to the facts in Bankers Life. It is true enough that one may be unable to defraud oneself but it is quite another thing to equate corporate identity and interests with those of its shareholders. Schoenbaum v. Firstbrook cited by Respond-

(1969), the dissenting opinion of J. Harlan.


ent, Irving Trust, merely says that neither a majority shareholder, nor the board of directors can perpetrate a fraud on the corporation without the minority shareholders having the right to sue on the corporation's behalf. The minority shareholders are merely illustrative of the type of interest that is damaged when a corporation is defrauded. It is inappropriate to say that the Second Circuit in Schoenbaum held that minority shareholders were the only interested parties who could bring an action on behalf of the corporation.

Even if Schoenbaum could be read to support that proposition, it is readily distinguishable from the situation in Bankers Life. In Bankers Life, there were no minority stockholders, so if the corporation as an entity apart from its owners (which is, of course, the justification for corporations being a separate tax entity and for the doctrine of limitation of liabilities) was to be protected, it necessarily fell to other interests to act on its behalf.

The Court's decision, as we shall see, is not limited to corporations where there is no minority equity interest. Situations will arise where the fraud benefits minority stockholders as well as the majority, and enforcement of the securities laws by other interests in the corporation will serve both the corporation's interest and the policy of the securities laws.

The Securities and Exchange Commission in its argument on this point, focusing on the particular situation presented to the Court under the facts of Bankers Life and the nature of the insurance industry, appeared to go so far as to say that creditors, when injured by a securities transaction to which they are not a party, have a cause of action under § 10(b), a position that would have been consistent with the Commission's continuing effort to have the courts extinguish the Birnbaum standing requirement. But, they did not argue that in any fraud perpetrated on any corporation, any group holding a legal interest in the corporation may sue on behalf of the corporation or themselves. Instead, they argued that the peculiar nature of the insurance industry, as detailed in Congressional Hearings, necessitated maintenance of actions by such groups on public policy grounds.30

30. Brief of SEC at 27, n. 35, Supt. of N.Y. v. Bankers Life, 404 U.S. 6 (1971): See H.R. Rep. No. 1383, 73d Cong., 2d Sess. 3-4 (1934), where the House Committee, after first cataloguing the impact that frauds and improper exchange practices then prevalent had, noted that "Over 15,000,000 individuals hold insurance policies, the value of which is dependent upon the security holdings of insurance companies." See also, 78 Cong. Rec. 7867, 7869 (1934) (Remarks of Rep. Maloney); S. Rep. No. 1455, 73d Cong., 2d Sess. 5 (1934): Transactions in securities on organized exchanges and over-the-counter markets are affected with a national public interest. * * *
The Court took a broader view in saying:

And the fact that creditors of the defrauded corporate buyer or seller of securities may be the ultimate victims does not warrant disregard of the corporate entity. The controlling stockholder owes the corporation a fiduciary obligation—one designed for the protection of the entire community of interests in the corporation—creditors as well as stockholders."\(^{31}\)

Thus, the Court did not attempt to limit its holding because of peculiarities in the insurance industry, but did ratify the *Birnbaum* standing rule in requiring that lesser interest-holders can only bring an action if it is on behalf of a purchasing or selling corporation.

In *Bankers Life*, some directors were deceived, but what now would be the result if creditors, or even customers who have a vested interest in a continued corporate existence, as did policyholders in Manhattan, are deceived about a transaction, but the board of directors and stockholders of the corporation buying or selling are not? Are the creditors able only to step into the shoes of the corporation and so have no \(\S\) 10(b) action? On the other hand, are creditors to be seen as one of a community of corporate interests in which deception of any element is tantamount to a fraud on the whole and, therefore, actionable by any part actually injured? Is there now an affirmative duty to inform creditors of all corporate securities transactions even if the indenture doesn't require it? What is to be the measure of damages; is the corporation to be made whole even if that only means that the defrauders recompense themselves, or is it enough to make whole only those elements that although not buyers or sellers are injured?

The best answer to these questions is that the fiduciary duty owed by the controlling stockholder or board of directors to the corporation is the sum of the duties owed to each component. A failure to meet this duty owed to any part is a breach of the fiduciary obligation owed to the corporation and subject to \(\S\) 10(b) if in connection with a purchase or sale. The fiduciary duty need not be the same as the re-

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quirements of disclosure contained in § 10(b) and Rule 10b-5. Consequently, a failure to inform creditors of a proposed stock sale, for example, is not actionable under the Securities Act of 1934, if there is no fiduciary breach. There would be no fiduciary breach unless the right to be informed is contracted for, or the transaction would jeopardize the corporation, and consequently, the creditors' investment.

In regard to damages, it is more consistent with the Court's opinion that the interest of the corporate entity is apart from the interests of its components, to say that the corporation is to be made whole even if that means that the wrongdoers in some sense will be paying themselves. Any interest damaged can, after all, only sue on behalf of the corporation. Moreover, taking Bankers Life as an example, the creditors would not be made truly whole unless the same capital cushion was restored.32

Having considered these two points, it is now appropriate to meet the questions of whether and how Bankers Life has affected the dual holdings of Birnbaum.

When compared to the current popularity actions under Rule 10b-5 enjoy, litigation began at a leisurely pace. The Commission's first action under the Rule came in 1943,33 but the initial court test had to wait until 1946.34 In the course of this case, Karden v. National Gypsum Co., it was held, on the basis of the Restatement of Torts,35 that there was a civil remedy for violation of § 10(b) and Rule 10b-5.36

While courts have conceded that 10b-5 does not extend to all situations which the Commission could have reached under § 10(b),37 they have, nevertheless attempted to restrict applicability of the rule in several ways.38 Defendants have tried to limit the Rule to cases where investors sought relief;39 a privity requirement rose40 and fell.41 Other

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32. See J.I. Case Co. v. Borak, 377 U.S. 426 (1964), where a flexible approach to remedies was mandated in an action brought under § 14 of the 1934 Act.
35. RESTATEMENT OF TORTS Vol. 2 § 286.
36. See generally Loss, SECURITIES REGULATION, p. 1763; infra, n. 16 for a history of the Supreme Court's considerations of this point.
37. Birnbaum, 193 F.2d 461, 463 (2d Cir. 1952); Loss, SECURITIES REGULATION at 1469, n. 87; Whitaker, The Birnbaum Doctrine: An Assessment, 23 ALA. L. REV. 543 at 546.
38. For a history of the restrictive attempts on § 10(b), see Herpich v. Wallace, 430 F.2d 792 (5th Cir. 1970) at 805, n. 12.
courts have on occasion reintroduced some of the various elements of common law fraud such as foreseeability. A showing of some type of deception was deemed necessary, but only briefly so. Other than casualty or damage which are warranted, the most enduring limitation, if only for the fact that most courts have felt it necessary to deal with it, has been the requirement, first imposed in Birnbaum v. Newport Steel Corporation, that the plaintiff is without recourse unless he is a buyer or seller.

Actually Birnbaum placed two impediments on future 10b-5 claims. To avoid dismissal it must not only have been alleged that the plaintiff was a purchaser or seller, but also that the fraud was not simply corporate mismanagement or a breach of duty by those in a fiduciary position for which there were adequate state remedies. The first requirement has been subsequently relaxed in prophylactic actions, and has been broadened to include exchange via mergers, but it has continued to be an effective restriction on federal court jurisdiction.

44. Vine v. Beneficial Finance Co., 374 F.2d 627 (2d Cir. 1967), cert. denied, 389 U.S. 970 (1967) where the court held that there was fraud, even though the board of directors was not deceived, in misdirecting proceeds of a sale of stock to only one class in which the directors held the predominant interest; Schoenbaum v. Firstbrook, 405 F.2d 215, 220 (2d Cir. 1968), cert. denied Manley v. Schoenbaum, 395 U.S. 906 (1969); cf. Pappas v. Moss, 393 F.2d 865 (3rd Cir. 1968).
45. Birnbaum, 193 F.2d 461, 464 (2d Cir. 1952):
Thus Section 16(b) of the Act of 1934, 15 U.S.C.A. § 78j(b), expressly gave the corporate issuer or its stockholders a right of action against corporate insiders using their position to profit in the sale or exchange of corporate securities. The absence of a similar provision in Section 10(b) strengthens the conclusion that that section was directed solely at that type of misrepresentation or fraudulent practice usually associated with the sale or purchase of securities rather than at fraudulent mismanagement of corporate affairs, and that Rule X-10B-5 extended protection only to the defrauded purchaser or seller;

46. Birnbaum, 193 F.2d 461, 464 (2d Cir. 1952), made the point that regardless of some oblique reference to a Congressional intent to include corporate mismanagement (Hearing before Senate Comm. on Banking and Currency on S. Res. 84 (72d Cong.) and S. Res. 56 and 97, 73d Cong., 1st and 2d Sess. 6624, 6899, 6910, 6936-38, 6988 (1933-1934)), it was not the intent of Congress to proscribe such in § 10(b). Further Congress plainly knew how to outlaw such actions as it did in § 16(b) of the '34 Act, and its failure to clearly do so here must have meaning. See generally Whitaker, The Birnbaum Doctrine: An Assessment, 23 Ala. L. Rev. 543 (1971).
Despite the possibility of finding differences in the scope of various cases and pressure from the Securities and Exchange Commission, the circuit courts have uniformly, albeit sometimes tacitly, recognized and dealt with the *Birnbaum* holdings that a purchase or sale is necessary, and that § 10(b) and Rule 10(b)-5 are not applicable to cases where it is alleged that there is merely a breach of a corporate fiduciary duty having an adequate state remedy.

Dealing first with the standing requirement of *Birnbaum*, it was arguable that the proscription of § 10(b), which speaks only of improper activities by a purchaser or seller, did not require a plaintiff to have been a party to a transaction as *Birnbaum* said. The Securities and Exchange Commission, at least since *Vine* and *Brod*, has requested that the buyer-seller requirement be abolished. In its brief before the Supreme Court in *Bankers Life*, the Commission did not push for a decision on the standing requirement of *Birnbaum*, but did call to the court's attention the Commission's view.

The Commission did make reference to the “in connection with” language of the statute when it said, “The ‘in connection with’ clause is plainly and—one must assume—intentionally the loosest linkage in any of the federal antifraud provisions, between a proscribed act and a security transaction.” This language is relevant to the relationship between the fraud and a transaction, not to the type of fraud, or whether mismanagement is § 10(b) fraud. Despite the Commission's disclaimer *Birnbaum's* standing requirement is called into question.

The Commission has not argued that a purchase or sale is not required under the 1934 Act, but only that when parties other than those who traded in a security are harmed by fraud, they should be allowed to sue.

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49. *See, e.g.*, Herpich v. Wallace, 430 F.2d 792 (5th Cir. 1970), at 808; Dasho v. Susquehanna Corp., 380 F.2d 262 (7th Cir. 1967), at 269-70; Mutual Shares Corp. v. Genesco Inc., 384 F.2d 540 (2d Cir. 1967), at 546.
51. SEC, amicus brief, p. 7, n. 6, Supt. of Ins. of N.Y. v. Bankers Life, 404 U.S. 6 (1970): *Birnbaum* held that only an actual purchaser or seller of securities may maintain an action for damages under Section 10(b). The Commission disagrees with this principle, and other courts of appeals have questioned or limited it. ... The Commission believes, however, that this Court need not reach the question. Petitioner seeks only a single recovery and if the complaint states a cause of action with respect to the Treasury bonds (as to which Manhattan concededly was the seller), petitioner can recover all he is seeking under that theory. Conversely, if this claim is legally insufficient or if petitioner cannot prove fraud with respect to sale of those bonds, he also could not recover under his two other theories.
For policy reasons, they argue, private enforcement should be encouraged to reduce the incidence of fraud, thus effectuating the purpose of the Act.

This interpretation, that the statute and rule do not require the plaintiff to be a buyer or seller, is supported by C. Whitaker in his article, The Birnbaum Doctrine: An Assessment. Despite this, he argues that there are at least three good reasons for judicial imposition of the requirement that the plaintiff be a buyer or seller. First, he says, since tort law formed the basis of the decision, which found a private right of action, tort law can impose a causation criterion that can only be met if the complainant bought or sold. The second reason is that such a requirement assures that the plaintiff's asserted interest is within the purview of the Rule. Both these reasons suffer from the resultant overkill. Such a requirement helps to insure causation and protected interest (assuming both were intended to be required) but they also exclude plaintiffs who do not buy and sell, but who can none-the-less satisfy a causation and the intended protected interest requirement. The third reason given, that without such a standing rule it will be difficult to limit the rule to transactions intended to be regulated by Congress, assumes without proving that Congress didn't intend to regulate situations where a plaintiff who is not a purchaser or seller is harmed in connection with a securities transaction.

Whatever the merits for doing away with the requirement on the basis of the language of the rule and statute, no circuit has imposed liability where the plaintiff was not, at least, constructively, a buyer or seller. The Supreme Court in Bankers Life not only has done nothing to change this, it in fact can be seen as ratifying Birnbaum in this respect. That is, the Birnbaum holding that the corporation had no standing to sue because it was not a purchaser or seller, is given some support by the Supreme Court, even though the SEC pointed out that in its opinion, it was not necessary to decide the point.

The decision of the Second Circuit was to dismiss the cause of action based on the purchase of Manhattan's stock because Manhattan

53. 23 ALA. L. REV. 543, 583-86 (1971); see Note, Inroads on the Necessity for a Consummated Purchase or Sale Under Rule 10b-5, 1969 DUKE L. J. 349.
56. Supra p. 56 note 51.
did not have standing, since it was not the purchaser or seller as required by § 10(b) in the view of the court. The sale of the Treasury bonds by Manhattan, as well as the purchase and sale by it of the certificate of deposit, were dismissed correctly in the view of the appellate court because the mismanagement was either not fraud or not the type of fraud that the statute sought to protect.

The Supreme Court cannot be thought of as even inferentially lessening the requirement that any plaintiff must be a purchaser or seller, since it ruled only on the second transaction in the scheme, the sale of the U.S. Treasury bonds, where the corporation was unassailably the seller of a security, the proceeds from which were denied it by fraud. In fact, the Court can be seen as lending some support to the standing requirement when it says, "The Act protects corporations as well as individuals who are sellers of a security."\(^57\) It goes on to say, "Manhattan was the seller of Treasury bonds and, it seems to us, clearly protected . . . ."\(^58\) and "The Crux of the present case is that Manhattan suffered an injury as a result of deceptive practice touching its sale of securities as an investor."\(^59\)

It is possible to see support for Birnbaum even though the Court says it intimates no opinion on other aspects of the case and even though any of these statements standing alone might be only a reference to a particular factual situation where there was a sale. But, as here, when the term is repeated, it seems probable to conclude the need for a purchase or sale by the plaintiff was accepted as a given by the Court, and formed part of the framework in which this decision was formulated. This can fairly be interpreted as more than assuming without deciding, the need for such standing.\(^60\)

It is submitted that the Second Circuit was reversed in this case, not for what it said in reference to Birnbaum requiring the plaintiff to be a buyer or seller. Rather, it was reversed for its holding that even if the corporation is a buyer or seller, it has no recourse to the federal courts if it is a victim of mismanagement, unless the mismanagement affected the value of the security or threatened the public interest by jeopardizing the credibility of public markets.\(^61\) The Supreme Court

\(^{58}\) Id. at 9, emphasis added.
\(^{59}\) Id. at 12-13, emphasis added.
\(^{61}\) Supt. of Ins. of N.Y. v. Bankers Life, 430 F.2d at 360, 361.
held to the contrary since § 10(b) "... is not limited to preserving the integrity of the securities markets,"\textsuperscript{62} and since even purely internal fraud can be "in connection with" a purchase or sale and so within the protection of § 10(b).

Looking more at this issue it should be noted that the second holding of Birnbaum, viz. that § 10(b) does not extend to actions traditionally litigated in state courts, \textit{i.e.}, corporate mismanagement, has been by far the more controversial of its two holdings and the one to which the Supreme Court primarily directed its attention in \textit{Bankers Life}.\textsuperscript{63}

Where the line falls between fraud actionable only in state courts and fraud given a federal forum by § 10(b) has long been unclear. The Second Circuit has held that § 10(b) fraud is not limited to actions that affect the value of the security,\textsuperscript{64} that it can be present when a corporation is compelled to issue shares so that management can maintain control,\textsuperscript{65} or when a shareholder is forced to sell and the proceeds are partially misdirected to other classes by the board of directors.\textsuperscript{66} But emphatically, the court has said that not all actions for corporate mismanagement fall within the ambit of §10b-5,\textsuperscript{67} presumably because not all mismanagement is "in connection with" a purchase or sale. Even after \textit{Bankers Life} some kinds of fraud are outside § 10(b).\textsuperscript{68}

\textsuperscript{62} Supt. of Ins. of N.Y. v. Bankers Life, 404 U.S. at 12, \textit{citing} 430 F.2d at 361.
\textsuperscript{63} It is interesting to note that J. Douglas in the \textit{per curiam} decision made no reference to the Birnbaum decision except to direct our attention to an article dealing with it at 404 U.S. 6, 14, n. 10.
\textsuperscript{64} A.T. Brod v. Perlow, 375 F.2d 393, 396 (2d Cir. 1967).
\textsuperscript{65} Ruckle v. Roto American Corp., 339 F.2d 24 (2d Cir. 1964), but this was a suit for injunctive relief as was Mutual Shores Corp. v. Genesco, Inc., 384 F.2d 540 (2d Cir. 1967), in which the court said a more relaxed standard may be applied in such actions.
\textsuperscript{66} Vine v. Beneficial Finance Co., 374 F.2d 627 (2d Cir. 1967), \textit{cert. denied}, 389 U.S. 970 (1967). This case is particularly hard to reconcile with Birnbaum and the Second Circuit's decision in \textit{Bankers Life}. It held that there could be a fraud by the board of directors when they misdirect proceeds from a securities transaction. It resembles a Seventh Circuit case decided shortly after Vine: Dasho v. Susquehanna Corp., 380 F.2d 262 (7th Cir. 1967), where it was held that there was fraud when in effect old stockholders were paid for their shares by the corporation via a loan to the purchasing stockholders.
\textsuperscript{67} Drachman v. Harvey, 453 F.2d 722 (2d Cir. 1972); Mutual Shares Corp. v. Genesco Inc., 384 F.2d 540 (2d Cir. 1967), at 546 where the court said that corporate abuse and diversion of funds are proper for state courts but ordinarily not enough for § 10(b) claims. \textit{But see} Herpich v. Wallace, 430 F.2d 792 (5th Cir. 1970), at 808 where the court said that the only bar to a state law mismanagement claim being transformed into a 10b-5 claim would be if the plaintiff was not a buyer or seller; McClure v. Bourne Chemical Co., 292 F.2d 824 (3d Cir. 1961), \textit{cert. denied}, 368 U.S. 939 (1961), at 834 where the court said 10b-5 "... imposes broad fiduciary duties on management vis-a-vis the corporation and its individual stockholders."
\textsuperscript{68} Supt. of Ins. of N.Y. v. Bankers Life, 404 U.S. 6, 12 (1971).
In *Bankers Life*, the Second Circuit held that while the corporation sold securities, value was received for the securities sold, and only subsequent mismanagement deprived the corporation of the proceeds. While the mismanagement may have been fraud, it was separate from the sale. As a result, the corporation's only recourse was in the state courts since there was no federal jurisdiction on which to base pendant jurisdiction of this issue. It is apparent that the court gave a very restrictive reading to the phrase, "in connection with" in holding that 10b-5 only applied to situations where the fraud was sufficiently close to the transaction so that the integrity of the securities market was affected. Only in those instances is the public interest or the protection of investors involved. The reasoning concludes that since § 10(b) restricts the Commission's rule making power to where it is "appropriate in the public interest or for the protection of investors," the rule does not extend to where "... the securities transaction and the purity of the trading process were unsullied." The alleged fraud did not affect stockholders or other security holders, and since all transactions were for value, the integrity of the market place was preserved.

The court concludes, "Thus, we do not decide that the creditors of Manhattan do not have any remedy under general state tort law for the fraud practiced on their debtors, but only that the federal Securities

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69. Both the Second Circuit and the Supreme Court limited their discussions of these points to the corporation's sale of its U.S. Treasury bonds.
70. Specifically the court said that Manhattan satisfied the requirement of Birnbaum, that it be a buyer or seller, in its sale of the Treasury bonds, and in its purchase and sale of the certificates of deposit. The court also held that the sale of control by Bankers Life to the other defendants was not federally actionable, except by pendant jurisdiction, because the corporation was not a buyer or seller in that separate transaction.
71. *See SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (1968), cert. denied, Coates v. SEC, 394 U.S. 976 (1969),* where it was held that 10b-5 was applicable and market integrity was injured even when the perpetrators were not involved in the damaging transaction so long as the plaintiffs were harmed by the device.
72. Supt. of Ins. of N.Y. v. Bankers Life, 430 F.2d 355, 360 (2d Cir. 1970); Heysich v. Wallace, 430 F.2d 792, 806 (5th Cir. 1970): "The objectives of section 10(b) are purity of the securities transaction and the securities trading process.
74. We are never told what kind of creditors Manhattan had, *i.e.*, unsecured or bondholders. If the latter, the sale of control could have been construed as a forced sale of the bondholder's securities since the purchase price was financed by them, and so could fit within the forced sale doctrine of *Vine v. Beneficial Finance, 374 F.2d 627 (2d Cir. 1967).* Such a construction would bring the fraud much closer to the transaction than could be done with the sale of Treasury bonds.
75. This construction seems strange in light of *Crane Co. v. Westinghouse Air Brake Co., 419 F.2d 787, 798, n.14 (2d Cir. 1969)*, where the court said "... the courts, as they would have broadly construed the statutory phrase, 'in connection with the purchase or sale of any security.' *See also Hooper v. Mountain State Securities Corp., 282 F.2d 195, 201 (5th Cir. 1960).*
Acts have not provided a federal forum for its enforcement."^76

This is at least in accord with the Birnbaum holding that frauds that were the product of a breach of fiduciary duty were not frauds that could be in connection with a purchase or sale. In fact there appear to be two separate criteria, based on the purposes of the 1934 Act, for determining the appropriateness of a 10b-5 action accords to the Second Circuit's opinion in Bankers Life. If the public interest is the justification for a claim, then the integrity of the market must have been adversely affected. On the other hand, if protection of investors is the premise, then there is fraud "in connection with" a purchase or sale only if the value is affected.^77 The court held, in light of its view of the facts in Bankers Life, that the value of the security was not misrepresented and the credibility of the market was not jeopardized. So neither the market nor the investor, as such, was damaged by the fraud.

Under this view of the facts, certainly the integrity of the market is jeopardized when one is unwittingly forced into a securities transaction. Here the corporation as a constructive purchaser of its own stock unwillingly retracted its capital. Moreover the goal of protection for investors is sacrificed when the ultimate investor, here the corporation, is unable to negotiate the price paid because of its post facto position. It seems that a transaction that deprives a purchaser of the knowledge or opportunity to bargain should be seen as fraudulent.

One is left to wonder what the decision of the Second Circuit might have been, if it had been argued that there was another transaction that could have met this test under these facts. It could have been argued directly that the corporation was a constructive purchaser of its own shares from the defendants with the proceeds it had obtained in the clean transaction involving the Treasury bonds. Under this theory,^76 Supt. of Ins. of N.Y. v. Bankers Life, 430 F.2d 355 at 361. The court quotes from its decision in SEC v. TGS, 401 F.2d 833, 858 (2d Cir. 1968), en banc, cert. denied Coates v. SEC, 394 U.S. 976 (1969). It uses language from that case, where there was reasonable reliance by investors, as support for its conclusion in Bankers Life that the statute and rule only extend to cases where investors, and not creditors, are damaged by fraud. In fact the language used from TGS:

Therefore it seems clear from the legislative purpose Congress expressed in the Act, and the legislative history of Section 10(b) that Congress when it used the phrase "in connection with the purchase or sale of any security" intended only that the device employed, whatever it might be, be of a sort that would cause reasonable investors to rely thereon, and, in connection therewith, so relying, cause them to purchase or sell a corporation's securities. Id., 401 F.2d at 860, while undeniably correct, contributes nothing to the conclusion in Bankers Life that § 10(b) permits regulation by the SEC to protect only investors or the public interest. 77. Supt. of Ins. of N.Y. v. Bankers Life, 430 F.2d 355, 361 (2d Cir. 1970).
the investor corporation was undeniably damaged since the stock, even if bought for value, was deleteriously affected in value by the fact of sale.

Focusing on this necessary relationship between the fraud and the transaction, Professor Folk said in 1970,

Of all the areas of 10b-5 litigation, none is currently more in flux than the status of the Birnbaum doctrine, which interprets a vital phrase in Rule 10b-5: that the fraud must occur “in connection with the purchase or sale” of a security. The reasons for this state of flux seems twofold.

First, 10b-5 is under enormous pressure to give up all limitations upon its potential coverage. The “in connection with” language is still the hardiest of the several restrictions . . . which have been used to contain the inexorable growth of the private cause of action.78

This state of flux is reflected in the fact that other circuits have tended to give 10b-5 and especially the phrase “in connection with” a more expansive reading, as indeed has the Second Circuit sporadically.79 The Fifth Circuit in Hooper v. Mountain States Securities Corporation80 held that when a corporation exchanges stock for worthless assets it has a good action. The Seventh Circuit, Dasho v. Susquehanna,81 in a factual situation similar to Bankers Life stripped of its embellishments, held that where a corporation ends up repurchasing its own shares, it has a 10b-5 claim if deception is established.

Although cited for the proposition that the substantive holding of Birnbaum, i.e., breaches of fiduciary duty are not actionable, has seen its day, both cases can be interpreted as not directly repudiating Birnbaum. In Hooper, there was fraud when the corporation exchanged for nothing while in Bankers Life all the transac-

80. Hooper v. Mountain States Securities Corp., 282 F.2d 195 (5th Cir. 1960), cert. denied, 365 U.S. 814 (1961) (hereinafter Hooper); see also Herpich v. Wallace, 430 F.2d 792, 801 (5th Cir. 1970), where the court said, “We are of the opinion that only purchasers and sellers of securities involved in an alleged Rule 10b-5 violation—that is, securities in connection with which fraud has allegedly been committed—can show injury of the type the rule is meant to overcome.” But the court indicated that it would interpret this requirement loosely so as to effectuate its purpose and would “. . . construe the ‘in connection with the purchase or sale of any security’ clause . . . broadly and flexibly. . . .”
81. Dasho v. Susquehanna Corp., 380 F.2d 262 (7th Cir. 1967); note that the concurring opinion at 270 struggles unsuccessfully to determine from Ruckle v. Roto America Corp., 339 F.2d 24 (2d Cir. 1964), and O’Neill v. Maytag, 339 F.2d 764 (2d Cir. 1964), when the Second Circuit would find a fraud on the corporation by its directors.
tions discussed were for value received in the view of the Second Circuit. In Dasho, it was not held that mismanagement was, per se, fraud but only that there was an action on these facts because the corporation repurchased its shares from insiders at a price that was allegedly $1,740,000 in excess of fair market value. So under the test used by the Second Circuit in Bankers Life, both these cases would sustain a § 10(b) action because the value of the security involved in the transaction was deleteriously affected.82

Recently, the Tenth Circuit in Richardson v. MacArthur83 cited approvingly cases where fraud was a step removed from a clean purchase or sale for value,84 although Richardson itself was not such a case but rather dealt with a corporation’s liability for the fraud of its employee. The principal case cited, Cooper v. North Jersey Trust Co.,85 involved a misappropriation of the stock purchased by plaintiff and it was alleged that to do so had been the defendant’s intent all along. The court said:

The main problem concerning these theories for recovery, not explicitly raised by defendant in its brief or argument, is whether Rule 10b-5 is limited to the situation in which the purchaser receives something less than he paid for directly from the sale. In other words, does the Rule cover the case in which the purchase of stock is a vital aspect of a continuing scheme and plaintiff received his full value for the stock purchased, but ultimately retained nothing as a result of the fraudulent arrangement? The language in Rule 10b-5 makes unlawful a “device, scheme or artifice to defraud” or an “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.) In the face of this broad language and the intent of the Act and Rule to protect investors, I conclude that the outlawed activity is not limited to the portion of the transaction involving an exchange of consideration by the purchaser for the stock. The Rule also covers an entire transaction aimed at extracting money from the purchaser through a loan, which, by hypothesis, violated the Act, to finance a stock purchase with the ultimate intent of converting the stock so purchased.86

Although in Bankers Life the misappropriation was the result of a fiduciary breach, the Court held that this factor did not remove the ac-

82. Supra, p. 60.
83. Richardson v. MacArthur, 451 F.2d 35 (10th Cir. 1971).
86. Id. at 978 (emphasis added).
tion from a § 10(b) claim. The above quoted language from Cooper is the essence of the Supreme Court's ruling in Bankers Life. Misappropriation of the proceeds from a securities transaction is to be seen as an integral part of the fraud; indeed misappropriation may be seen as the fraud "in connection with" a securities transaction.\footnote{Supt. of Ins. of N.Y. v. Bankers Life, 404 U.S. 6, 10 (1971).}

While the Bankers Life decision most certainly stands for the proposition that 10(b) and 10b-5 are not limited to protecting the integrity of securities markets, and that there is a federally enforceable claim by the purchaser or seller for fraudulent mismanagement in connection with purchase or sale, the decision cannot be read too expansively because of the explicit language of the Court.\footnote{Supt. of Ins. of N.Y. v. Bankers Life, 404 U.S. 6, 16 (1971): "... Congress ... did not seek to regulate transactions which constitute no more than internal . . . mismanagement."} But it is nonetheless an expansion of Birnbaum's substantive holding.

It is submitted that this decision divides the world of corporate mismanagement (even corporate mismanagement accompanied by a securities transaction) into halves. One half contains those instances where the mismanagement even though a part of the securities transaction cannot be said to be "in connection with" the transaction because it didn't directly affect it, wasn't motivated by the transaction, or wasn't the motivation for the purchase or sale. The other half are those cases where the mismanagement is sufficiently tied to the transaction.

It is possible to prevent a § 10(b) action then, when there is a breach of fiduciary duty but no purchase or sale by the plaintiff, or when there is a purchase or sale but the mismanagement is not even remotely connected with a securities transaction. The instant case was not one of simple mismanagement unconnected to the purchase or sale, even if the factual complexity is overlooked. In addition to misappropriation, which the Court finds would have been sufficient,\footnote{Supra, p. 59.} the defendants, it was alleged, intentionally deceived members of the board of directors of Manhattan in regard to the disposition of the bonds and financial position of the corporation. The Supreme Court cited Shell v. Hensley:

When a person who is dealing with a corporation in a securities transaction denies the corporation's directors access to material information known to him, the corporation is disabled from availing itself of an informed judgment on the part of its board regarding the merits of the transaction. In this situation the private
right of action recognized under Rule 10b-5 is available as a remedy for the corporate disability.\textsuperscript{90} This interpretation is in accord with the purpose of § 10(b) in the oft quoted words of one of its spokesmen, which was to communicate to those dealing in securities, “Thou shalt not devise any other cunning devices.”\textsuperscript{91} The Supreme Court, recognizing the remedial intent of securities legislation has held that their provisions should not be construed “... technically and restrictively but flexible to effectuate (their) remedial purposes.”\textsuperscript{92}

The “in connection with” phrase of § 10(b) and Rule 10b-5 prevents action in any case where there is no purchase or sale or where the mismanagement is of such a type that it cannot be said to be “in connection with” a transaction.\textsuperscript{93} Bankers Life does modify Birnbaum, then, not in the latter’s standing requirement, but in holding that some types of corporate mismanagement, even if there is an adequate state remedy, are subject to federal court trials if the fraud is more than tangential to the purchase or sale by the plaintiff. The decision in Bankers Life that corporate mismanagement can be fraud and that any fraud perpetrated with a purchase or sale, albeit removed from it, is within the ambit of 10b-5, is consistent with many prior appellate decisions\textsuperscript{94} and Congressional intent. That the section was intended to include situations involving some types of mismanagement finds support in the statement that speculation, manipulation, investors' ignorance and “disregard of trust relationships by those whom the law should regard as fiduciaries are all a seamless web.”\textsuperscript{95}

\textsuperscript{90} Shell v. Hensley, 430 F.2d 819, 827 (5th Cir. 1970).
\textsuperscript{91} Hearings before the House Committee on Interstate and Foreign Commerce on H.R. 7852 and 8720, 73rd Cong., 2d Sess. 115 (1934).
\textsuperscript{93} Supt. of Ins. of N.Y. v. Bankers Life, 404 U.S. 6, 13-14, n.10 (1971), should be a caution against generalities one way or the other. J. Douglas makes it explicit that the Court has only ruled on Manhattan's standing as a result of the bond sale. See generally City of Greenwood v. Peacock, 384 U.S. 808 (1966), where the Court ruled against opening the federal courts to a feared inundation of cases, absent a very explicit Congressional declaration that such was its intent.
\textsuperscript{95} Supt. of Ins. of N.Y. v. Bankers Life, 404 U.S. 6, 12, n.8, citing H.R. Rep. No. 1383, 73d Cong., 2d Sess., p. 6 (1934) (emphasis added).
While there remains much uncertainty in the area, *Bankers Life* has made some things clearer. It has arguably ratified the standing requirement of *Birnbaum* in much the same way it treated a private right of action under § 10(b), by assuming it without discussing it. The Court otherwise has reaffirmed its intention to read § 10(b) flexibly as evidenced by the inclusion of at least some types of corporate mismanagement in the definition of fraud. Further, the “in connection with” language of both the statute and rule has been clarified to say that the fraud need only be material to, not part of, a sale.

As was noted in the beginning of this comment, development concurrent with and subsequent to this decision has been rapid. The Second Circuit has again been invited but refused to overrule *Birnbaum's* standing requirement in *Drachman v. Harvey*, but has not closed the door to such a rejection. Following the directive of the Supreme Court to take a flexible approach, the “blue sky” promises of another era may be the password for plaintiff lawyers today.

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96. *Drachman v. Harvey*, 453 F.2d 722 (2d Cir. 1972); p. 47 n. 11.