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Securities Regulation—Supreme Court Acceptance of the Birnbaum Rule

Although other sections of the Securities Act of 1933¹ and the Securities Exchange Act of 1934² provide expressly for private civil actions,³ the civil actions implied under section 10(b) of the 1934 Act⁴ have long been favorites of plaintiffs in federal courts.⁵ In 1952, however, a limitation was placed on plaintiffs' access to section 10(b) actions. In that year the Second Circuit, in *Birnbaum v. Newport Steel Corp.*,⁶ ruled that a plaintiff who alleged injury suffered "in connection with the purchase or sale of securities" under section 10(b) and SEC rule 10b-5⁷ could not maintain an action if he himself had not bought or sold the securities involved. In subsequent years the *Birnbaum* doctrine was variously adopted,⁸ restricted,⁹ and rejected¹⁰ by lower federal

1. 15 U.S.C. § 77a et. seq. (1971).

2. *Id.* § 78a et. seq.

3. See note 43 *infra*.

4. 15 U.S.C. § 78j(b) (1971) provides:

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

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

5. See *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 13-14 n.10 (1971); *SEC v. National Sec., Inc.*, 393 U.S. 453, 465 (1969).

In recent years, rule 10b-5 has become a significant weapon against corporate mismanagement. See Note, *The Controlling Influence Standard in Rule 10b-5 Corporate Mismanagement Cases*, 86 HARV. L. REV. 1007 (1973); Note, *Limiting the Plaintiff Class: Rule 10b-5 and the Federal Securities Code*, 72 MICH. L. REV. 1398 (1974). The trend in federal courts has been toward expansion of civil liability under rule 10b-5. See, e.g., *Rekant v. Desser*, 425 F.2d 872, 877 (5th Cir. 1970); N. LATTIN, R. JENNINGS, & R. BUXBAUM, *CORPORATIONS* iii (4th ed. 1968).

6. 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952).

7. 17 C.F.R. § 240.10b-5 (1973) 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.

8. See, e.g., *Sargent v. Genesco, Inc.*, 492 F.2d 750 (5th Cir. 1974); *Landy v. FDIC*, 486 F.2d 139 (3d Cir. 1973), *cert. denied*, 416 U.S. 960 (1974); *Mount Clemens Indus., Inc. v. Bell*, 464 F.2d 339 (9th Cir. 1972); *Simmons v. Wolfson*, 428 F.2d 455

courts. It was not until twenty-three years after its original pronouncement that the United States Supreme Court ruled on the doctrine directly. In *Blue Chip Stamps v. Manor Drug Stores*¹¹ a divided Court approved *Birnbaum*, holding that only purchasers and sellers of securities have the privilege¹² of bringing suit for money damages under section 10(b) and rule 10b-5. In consecrating this obstacle, the Court left plaintiffs to pursue state rather than federal remedies for violation of section 10(b) of the Act.

Blue Chip Stamps arose out of an offering of securities that defendant Blue Chip Stamps, a trading-stamp firm, was required to make pursuant to a federal antitrust consent decree.¹³ Retailers like plaintiff who had used the stamp service of Blue Chip's predecessor¹⁴ were entitled to purchase quantities of securities¹⁵ in Blue Chip proportional to their past stamp usage. Plaintiff Manor Drug Stores, which was not a party to the consent decree, brought suit under section 10(b). The complaint alleged that defendants intentionally made their prospectus overly pessimistic, so that plaintiff and others¹⁶ would reject the offer, thereby enabling defendants to sell the securities to the public later at a far higher price. Plaintiff alleged that its reliance on misleading statements in the prospectus caused its failure to accept the offer within the period of its duration.¹⁷

The district court dismissed the action because plaintiff failed to meet the requirements of *Birnbaum*: it had neither bought nor sold securities.¹⁸ While purportedly adhering to *Birnbaum* the Ninth Circuit reversed, finding that the consent decree satisfied the reasons for the

(6th Cir. 1970), *cert. denied*, 400 U.S. 999 (1971); *Jensen v. Voyles*, 393 F.2d 131 (10th Cir. 1968).

9. See text accompanying notes 29-32 *infra*.

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

11. 95 S. Ct. 1917 (1975).

12. The question is not one of constitutional standing, but of statutory interpretation. See Note, *Securities Law—Rule 10b-5—They Had So Many Plaintiffs They Didn't Know What To Do*, 53 N.C.L. Rev. 150, 155-57 (1974).

13. 95 S. Ct. at 1920-21.

14. Blue Chip Stamp Company was the name of the predecessor firm. It was merged into Blue Chip Stamps pursuant to the consent decree, and was also a defendant, along with eight of its nine controlling shareholders. *Id.*

15. The offering was required to be made in units consisting of debentures and shares of common stock. *Id.* at 1921.

16. Plaintiff claimed to represent the class of offerees who rejected defendants' offer. *Id.*

17. *Id.*

18. *Manor Drug Stores v. Blue Chip Stamps*, 339 F. Supp. 35, 40 (C.D. Cal. 1971), *rev'd*, 492 F.2d 136 (9th Cir. 1973), *rev'd*, 95 S. Ct. 1917 (1975).

Birnbaum rule:¹⁹ the court reasoned that the consent decree limited the potential liability of defendants, provided a precise measure of damages, and even offered an "objective basis" for establishing that plaintiff's intention to buy was thwarted by defendants' misrepresentation.

In reversing the Ninth Circuit and approving the *Birnbaum* doctrine, the Supreme Court split evenly three ways. While three justices found that section 10(b) did not require a plaintiff to be a purchaser or seller of securities,²⁰ three others found such a requirement in the statute;²¹ their remaining colleagues, in the opinion of the Court by Justice Rehnquist, found the statute inconclusive.²² The Court's opinion concluded, for reasons of policy, that plaintiff's failure to sell or buy securities should bar it from federal court.

Before examining the *Blue Chip Stamps* decision, it is helpful to consider briefly the genesis and evolution of the seller-purchaser requirement first iterated in *Birnbaum*²³ for rule 10b-5 actions. In *Birnbaum* the Second Circuit based its dismissal of plaintiff's action on an interpretation of rule 10b-5, holding that "Rule X-10B-5 extended protection only to the defrauded purchaser or seller," and that section 10(b) was directed at the kind of fraud "usually associated with the sale or purchase of securities" rather than at corporate mismanagement.²⁴

The *Birnbaum* doctrine suffered serious erosion before its affirmation by the Supreme Court in *Blue Chip Stamps*. One of the reasons for this erosion was the Supreme Court's 1963 mandate that section 10(b) be construed "not technically and restrictively, but flexibly to effectuate

19. *Manor Drug Stores v. Blue Chip Stamps*, 492 F.2d 136 (9th Cir. 1973), *rev'd*, 95 S. Ct. 1917 (1975).

20. Justice Blackmun, joined by Justices Douglas and Brennan, dissented. 95 S. Ct. at 1937.

21. Justice Powell wrote a concurring opinion, in which he was joined by Justices Stewart and Marshall. *Id.* at 1935.

22. He was joined by Justice White and Chief Justice Burger.

23. *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952). When the controlling shareholder of the corporation in which plaintiffs owned stock sold control to a third party, the value of plaintiffs' stock fell. The court found that, since plaintiffs had neither bought nor sold shares, rule 10b-5 did not apply. Judge Augustus Hand, writing for himself, Judge Learned Hand, and Chief Judge Thomas Swan, cited the press release with which the SEC had explained its adoption of rule 10b-5: the rule was intended to close a loophole in the Commission's anti-fraud powers by "prohibiting individuals or companies from buying securities if they engage in fraud in their purchase." *Id.* at 463. The unanimous panel concluded that the rule should apply no further. Later decisions upholding *Birnbaum* were based at least in part on construction of section 10(b), however. *See, e.g.*, *A.T. Brod & Co. v. Perlow*, 375 F.2d 393 (2d Cir. 1967); *Vine v. Beneficial Fin. Co.*, 252 F. Supp. 212 (S.D.N.Y. 1966); *Stockwell v. Reynolds & Co.*, 252 F. Supp. 215 (S.D.N.Y. 1965).

24. 193 F.2d at 464.

its remedial purposes."²⁵ By 1968, the continuing vitality of *Birnbaum* was doubted by a leading district court judge,²⁶ discounted by commentators,²⁷ and apparently left open by the court that had created it.²⁸ It became generally accepted that plaintiffs who had neither purchased nor sold securities could sue under rule 10b-5 in four categories of cases. First, shareholders in a corporation which sold or purchased in a fraudulent transaction were allowed to bring derivative actions.²⁹ Secondly, "forced sellers," that is, persons who had not sold securities, but who would be obliged to do so eventually, either practically or by operation of law, could maintain 10b-5 actions.³⁰ Thirdly, "aborted purchaser-sellers," plaintiffs who failed to purchase or sell because their agreements to do so had been breached, withstood *Birnbaum*-based motions to dismiss.³¹ Lastly, plaintiffs seeking injunctive relief to prevent the sale of securities did not need to show that they were purchasers or sellers.³²

The most serious attacks on the *Birnbaum* requirement occurred in 1973. In *Eason v. General Motors Acceptance Corp.*³³ the Seventh

25. *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963).

26. *Entel v. Allen*, 270 F. Supp. 60, 70 (S.D.N.Y. 1967) (Bonsal, J.).

27. See, e.g., Lowenfels, *The Demise of the Birnbaum Doctrine: A New Era for Rule 10b-5*, 54 VA. L. REV. 268 (1968); Comment, *The Purchaser-Seller Rule: An Archaic Tool for Determining Standing Under Rule 10b-5*, 56 GEO. L.J. 1177 (1968).

28. *Vine v. Beneficial Fin. Co.*, 374 F.2d 627, 634 (2d Cir.), cert. denied, 389 U.S. 970 (1967). The Second Circuit later dispelled the confusion by stating that *Birnbaum* was "still the rule" at least in actions for damages. *Greenstein v. Paul*, 400 F.2d 580, 581 (2d Cir. 1968).

29. See, e.g., *Rekant v. Desser*, 425 F.2d 872 (5th Cir. 1970); *Schoenbaum v. Firstbrook*, 405 F.2d 215 (2d Cir. 1968), cert. denied, 395 U.S. 906 (1969); *Ruckle v. Roto American Corp.*, 339 F.2d 24 (2d Cir. 1964).

30. See, e.g., *Dudley v. Southeastern Factor & Fin. Co.*, 446 F.2d 303 (5th Cir.), cert. denied, 404 U.S. 858 (1971) (plaintiff's stock was converted into a speculative right to payment of money); *Coffee v. Permian Corp.*, 434 F.2d 383, 386 (5th Cir. 1970) (liquidation of corporation would cause minority shareholder to sell "as a practical matter"); *Crane Co. v. Westinghouse Air Brake Co.*, 419 F.2d 787 (2d Cir. 1969), cert. denied, 400 U.S. 822 (1970) (plaintiff would be forced to sell shares or be faced with an antitrust divestiture decree at a later time); *Vine v. Beneficial Fin. Co.*, 374 F.2d 627 (2d Cir.), cert. denied, 389 U.S. 970 (1967) (plaintiff would have to sell because statute provided for short-form merger when some other shareholders acquired a certain percentage of outstanding stock).

31. See, e.g., *A.T. Brod & Co. v. Perlow*, 375 F.2d 393 (2d Cir. 1967); *Opper v. Hancock Sec. Corp.*, 367 F.2d 157 (2d Cir. 1966); *Goodman v. H. Hentz & Co.*, 265 F. Supp. 440 (N.D. Ill. 1967). This situation does not constitute a true exception, because it is covered by the language of the statute. Section 3(a)(13) of the 1934 Act, 15 U.S.C. § 78c(a)(13) (1971) provides: "The terms 'buy' and 'purchase' each include any contract to buy, purchase, or otherwise acquire." Section 3(a)(14) of the 1934 Act, 15 U.S.C. § 78c(a)(14) (1971) provides: "The terms 'sale' and 'sell' each include any contract to sell or otherwise dispose of."

32. See, e.g., *Kahan v. Rosenstiel*, 424 F.2d 161 (3d Cir.), cert. denied, 398 U.S. 950 (1970); *Mutual Shares Corp. v. Genesco, Inc.*, 384 F.2d 540 (2d Cir. 1967).

33. 490 F.2d 654 (7th Cir. 1973), cert. denied, 416 U.S. 960 (1974). When Bank

Circuit expressly disavowed *Birnbaum*, saying that the purchaser-seller limitation was "not part of the law of this Circuit."³⁴ The court proposed to permit suit by any "investor" in a securities "transaction," since investors were the class of persons that Congress intended section 10 (b) to protect.³⁵

The circuit court opinion in *Blue Chip Stamps* also represented a serious erosion of *Birnbaum*.³⁶ The Ninth Circuit allowed plaintiff's action despite its failure to buy or sell securities. Two members of a three-judge panel, while maintaining their allegiance to the *Birnbaum* rule, found that it did not bar plaintiff. The majority found that the *Birnbaum* rule had its justification in the prevention of unlimited liability of defendants and in its denial of the judicial forum to plaintiffs who could establish neither that defendants' actions had damaged them, nor to what degree they had been damaged.³⁷ The Ninth Circuit saw no such problems in the Blue Chip offer. Since the consent decree offer was made to a limited class of persons, the potential liability of defendants was limited. Because the amount of securities that plaintiff could have bought was prescribed by the decree, damages could easily be determined. The majority found that plaintiff's complaint even solved the problem of proving that it was defendants' misrepresentation that caused the damage: the difference between 101 dollars, the price at which defendants had been obliged to sell blocks of securities, and 315 dollars, their later market value, was so great that it provided "prima facie, an objective basis for a factual inference that users properly informed rather than misled would have accepted the offer."³⁸

The Supreme Court was unpersuaded by the Ninth Circuit's analysis. The first issue it determined was whether the language of section 10(b) controlled.³⁹ Both the prevailing and the concurring opinions

Service Corporation (BSC) traded 7000 shares of stock for a car leasing business, plaintiff shareholders of BSC, as part of the deal, personally guaranteed payment of BSC's liabilities to defendant. When defendant brought suit in state court on the guarantees, plaintiffs sued in federal district court for their rescission.

34. *Id.* at 661.

35. *See* note 4 *supra*.

36. 492 F.2d 136.

37. *Id.* at 141.

38. *Id.* at 142.

39. Justice Rehnquist, writing for the Court, leaned heavily on the legislative history of the 1934 Act in construing section 10(b). He pointed out that Congress rejected language that would have defined "sale" and "purchase" to include attempts, offers, and solicitations. 95 S. Ct. at 1932 n.13. Both his and the concurring opinions emphasized the refusals of later Congresses to amend section 10(b) to include "any attempt to purchase or sell" any security." *Id.* at 1924, 1935. Justice Rehnquist cited Congress' obvious fear that strike suits would result from the private causes of action

contrasted section 10(b)'s "in connection with the purchase or sale" with broader language in section 17(a) of the 1933 Act⁴⁰ that reaches fraud "in the offer or sale" of securities. The concurring opinion found that this contrasting language "indicate[d] clearly that Congress selectively and carefully distinguished between offers, purchases, and sales,"⁴¹ whereas the opinion of the Court found that this difference, along with others, "though not conclusive, support[ed] the result reached by the *Birnbaum* court."⁴²

This argument is not so persuasive as it may appear. Using the reasoning of the *Blue Chip Stamps* concurers, the Court should not have implied private causes of action under the 1934 Act. Its approval of such actions—including those under section 10(b)—came in the face of Congress' express creation of private rights of action in other sections of the 1933 and 1934 Acts.⁴³ In implying those actions, the Court ignored the express actions, basing its decision on the policy ground that "private enforcement . . . provides a necessary supplement to Commission action."⁴⁴

In dissent, Justice Blackmun relied on the statutory language to *support* the plaintiff's action. He argued that *Blue Chip Stamps* came within section 10(b) since the word "sale" could properly be construed to mean "not only a single, individualized act transferring property from one party to another, but also the generalized event of public disposal of property through advertisement, auction, or some other market mechanism."⁴⁵

There being no definition of "contract" in the 1934 Act, a better approach would have been to construe the statutory provision "any contract to sell or otherwise dispose of" as equivalent to a "sale."⁴⁶ As the Ninth Circuit majority pointed out, a decision by Manor to purchase "could not have been thwarted by the intervention of an earlier

that it created expressly, and reasoned that courts should move especially carefully to avoid that danger in administering judicially implied remedies. *Id.* at 1928.

40. 15 U.S.C. § 77q(a) (1971).

41. 95 S. Ct. at 1935.

42. *Id.* at 1924.

43. *See, e.g.*, 1933 Act, § 11, 15 U.S.C. § 77k (1971); *id.* § 12, 15 U.S.C. § 77i (1971); 1934 Act, § 16, 15 U.S.C. § 78p (1971).

44. *J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964) (allowing an implied private cause of action under section 14(a) of the 1934 Act, 15 U.S.C. § 78n(a) (1971)). When the Court finally authorized a private cause of action under section 10(b), it did so in a footnote, with, by its own admission, "virtually no discussion." 95 S. Ct. at 1923. The decision came in *Superintendent of Ins. v. Bankers Life and Cas. Co.*, 404 U.S. 6, 13 n.9 (1971).

45. 95 S. Ct. at 1939.

46. *See* note 31 *supra*.

or higher bidder”⁴⁷ In effect, what Manor had under the consent decree was more than an offer: it was an option contract, albeit unenforceable because unsupported by consideration. Interpreting “contract” in the 1934 Act to include this kind of obligation would have led to the result that Justice Blackmun urged.⁴⁸ Although, as the Court observed, a consent decree is not enforceable by those who are not parties to it,⁴⁹ allowing plaintiff in *Blue Chip Stamps* recovery under this theory would not be foreclosed. Plaintiff’s action was not to enforce the consent decree, but to recover for fraud.⁵⁰

The three remaining members of the Court, having found no statutory answer to the question of the necessity of the purchaser-seller requirement, turned their attention to policy considerations. Their first concern was avoidance of “liability in an indeterminate amount for an indeterminate time to an indeterminate class.”⁵¹ The Court seemed to view the alternatives as either retaining *Birnbaum* or discarding all “standing” requirements under rule 10b-5. The Court warned that, with the *Birnbaum* barrier removed, “strike suits” under rule 10b-5 would be not only much more frequent, but also peculiarly vexatious. Justice Rehnquist reasoned that vexatiousness would result because oral testimony would be the key to each additionally allowed case, thus making summary judgment unavailable.⁵² In addition, the availability of exten-

47. 492 F.2d at 142 n.15.

48. The majority in the Ninth Circuit alluded to such an interpretation by saying that a consent decree serves the “same function” as a contract. *Id.* at 142. Judge Hufstедler, dissenting in the Ninth Circuit, clearly failed to recognize such an interpretation. She saw no reason to allow a cause of action to one of ten offerees who were offered 10,000 each of a 100,000 share offering, while denying a cause of action to one of eleven offerees of 10,000 shares of the same-sized offering. *Id.* at 147 n.10. But the *Blue Chip* situation involved more than just a limited offering: it involved an *obligation*, albeit unenforceable by the offeree, to sell a given amount to a given person at a given price.

49. *Buckeye Coal & Ry. Co. v. Hocking Valley Ry.*, 269 U.S. 42, 49 (1925).

50. See 492 F.2d at 142 n.14. This situation is quite similar to the one in which *A* has an unenforceable contract with *B*, and *C* fraudulently induces *B* not to perform. If *B* would have performed, *A* can sue *C* for fraud at common law. *Rice v. Manley*, 66 N.Y. 82 (1876) (Plaintiffs contracted orally to buy cheese from Stebbins. Although the contract was unenforceable by the statute of frauds, both plaintiffs and Stebbins would have performed. Defendant, knowing of the contract, signed plaintiffs’ names to a telegram to Stebbins cancelling the order, then proceeded to buy the cheese himself. Allowing plaintiffs to recover, the court said, “What difference can it make that plaintiffs could not enforce their agreement against Stebbins?” *Id.* at 84.); *Benton v. Pratt*, 2 Wend. 385 (N.Y. Sup. Ct. 1829). See generally 37 C.J.S. *Fraud* § 41d (1943). In *Blue Chip Stamps*, *Blue Chip* occupies in some way the positions of both *B* and *C* in the example. Like *B*, *Blue Chip* would have performed had Manor Drug sought performance. Like *C*, *Blue Chip* caused the deal not to go through. *Blue Chip*’s actions, if fraudulent, should subject it to liability.

51. 95 S. Ct. at 1931, quoting *Ultramares Corp. v. Touche*, 255 N.Y. 170, 179, 174 N.E. 441, 444 (1931) (Cardozo, C.J.).

52. 95 S. Ct. at 1927. The oral testimony would presumably concern whether

sive and expensive discovery under the federal rules would help make the settlement value of "strike suits" high. Not only would this litigation force corporations to abandon some normal activities in order to defend against litigation, it would also damage the securities markets, and, the Court implied, it would wreak havoc upon the federal trial apparatus.⁵³

In reaching this pessimistic conclusion, Justice Rehnquist failed to analyze the intermediate solution proposed by the Ninth Circuit.⁵⁴ Had he done so, he would have found his policy arguments refuted. The Ninth Circuit's decision would have limited the potential liability of defendants and the problems of proof that the majority identified. The appellate court would have limited suit to cases in which plaintiff alleged a relation sufficiently analogous to a contract to limit the number of suits and to provide prima facie proof of causation.⁵⁵

Furthermore, the Court's claim that rejection of *Birnbaum* would provoke a flood of trials in federal courts is highly speculative. Adoption of an intermediate solution, such as that of the Ninth Circuit, might well cause a substantial increase in the number of 10b-5 complaints filed. Without a definitive Supreme Court standard, plaintiffs would seek to expand yet further the class of persons allowed to sue. But the case-by-case erosion, were it to continue, would cause additional court burdens

plaintiff's loss was caused by his reliance on defendant's misrepresentation.

53. *Id.* at 1928.

54. See text accompanying notes 36-38 *supra*.

55. See text accompanying note 38 *supra*. The Seventh Circuit's formulation, like the Ninth Circuit's, answered the Supreme Court's policy objections. The Seventh Circuit proposed to allow a cause of action only to investors in securities transactions. Attempts further to erode *Birnbaum* would no doubt have continued under its approval, but substantial numbers of additional trials would not necessarily have occurred. The *Eason* rule would have barred plaintiff in *Blue Chip Stamps*. The decision in *Eason* dealt expressly with this problem:

The volume of 10b-5 litigation has already expanded and will no doubt continue to do so whether or not the purchaser-seller limitation is rejected. The extent to which a refusal to adhere to *Birnbaum* will affect that volume is really a matter of speculation. The fact that the purchaser-seller limitation is unacceptable does not mean that there will be no limit of any kind of the availability of private relief. For in each case the plaintiff will have to demonstrate membership in the "special class" protected by Rule 10b-5 and injury as a direct consequence of the alleged violation. The number of parties who may invoke Rule 10b-5 without the purchaser-seller limitation may not differ materially from the number who would recover by persuading a court to interpret the purchaser-seller concept flexibly.

Assuming, however, that a complete abandonment of *Birnbaum* will significantly increase our workload, we may not for that reason reject what we believe to be a correct interpretation of the statute or the rule. Indeed, the volume of future litigation that was more clearly predictable as a consequence of the Supreme Court's holding in [*Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6 (1971)] was not even mentioned in the Court's opinion as a possible objection to its broadened interpretation of Rule 10b-5 as encompassing the misuse of proceeds of sale.

490 F.2d at 660-61 (footnotes omitted).

at the *pleading* stage rather than the trial stage. For instance, many plaintiffs would be unable to allege a causal link so strong as that shown by Manor Drug Stores and would be dismissed pursuant to pre-trial motions. Undoubtedly, upon dismissal, plaintiffs might often appeal, thus creating additional *appellate* work. But the specter of costly and lengthy *trials* and discovery is a faint one indeed.

Had the Court wished truly to determine the validity of its "practical considerations," it could have let the Ninth Circuit's decision in *Blue Chip Stamps* and the Seventh Circuit's total rejection of *Birnbaum* in *Eason* stand for longer than twenty months.⁵⁶ The Court had already waited twenty-three years before ruling on the purchaser-seller limitation. An influx in the Seventh and Ninth Circuits of 10b-5 suits that failed to allege that plaintiff had purchased or sold securities would have given the opinion an empirical rather than a speculative basis.⁵⁷

Despite questionable analysis in both the Court's opinion and the concurring opinion, *Blue Chip Stamps* was correctly decided. In effect, the Court's decision is that the common law rather than the federal securities law will govern cases in which defendant induces plaintiff not to purchase or sell securities. Both the prevailing and the concurring opinions point out the availability of a state remedy for a fraudulent scheme to induce plaintiff to fail to act.⁵⁸ Indeed, Justice Rehnquist specifically noted that Manor Drug Store's fraud action was pending in a California court.⁵⁹

A major difference between the federal securities law and the state fraud remedy is the element of intent that is required under each. In common-law fraud cases in which plaintiff succeeds in establishing defendant's liability for causing him to fail to act, intent by defendant to deceive plaintiff is uniformly present.⁶⁰ The cases do not dwell on that element; however, they do not suggest the possibility of relief when defendant's culpability is less. On the other hand, in federal 10b-5

56. The Seventh Circuit decided *Eason* on December 28, 1973, and the Ninth Circuit decided *Blue Chip Stamps* on October 15, 1973; the Supreme Court rendered its decision in *Blue Chip Stamps* on June 9, 1975.

57. Of course, the number of suits *threatened* is one consideration of the Court for which data would be unobtainable.

58. 95 S. Ct. at 1927 n.9, 1937.

59. *Id.* at 1927 n.9.

60. *See, e.g.,* *Butler v. Watkins*, 80 U.S. (13 Wall.) 456 (1871); *Fottler v. Moseley*, 179 Mass. 295, 60 N.E. 788 (1901); *Rice v. Manley*, 66 N.Y. 82 (1876); *Kaufmann v. Delafield*, 224 App. Div. 29, 229 N.Y.S. 545 (1928) (defendant held liable for inducing plaintiff to retain stock, although plaintiff had not decided to sell); *Snow v. Judson*, 38 Barb. 210 (N.Y. Sup. Ct. 1862). *See generally* 37 AM. JUR. 2d *Fraud and Deceit* §§ 225, 242 (1968).

actions, plaintiff may prevail with a showing of less than intent to deceive. In these cases, plaintiff must ordinarily show "scienter" on defendant's part.⁶¹ The degree of knowledge that defendant must have had is the subject of dispute. No circuit, however, requires so much as a showing of intent to deceive.⁶²

In the typical securities purchase or sale fraud situation, defendant profits in some way from the misrepresentation that damages plaintiff. When defendant is a broker who arranges plaintiff's purchase or sale, he profits by receiving a commission. When there is privity between defendant and plaintiff, a bad deal for plaintiff is *ipso facto* a good deal for defendant. Even when there is no privity between the parties, defendant is ordinarily selling to, purchasing from, or arranging transactions with other persons, and profiting thereby. Indeed, given the potential liability under federal law for statements that induce purchases or sales, people would rarely make statements that tended to induce others to buy or sell without the possibility of profiting in some way. Thus, when a plaintiff purchases or sells securities, a defendant who intentionally caused him to do so ordinarily had a motive to misrepresent. By requiring a low degree of scienter, the federal securities law catches some defendants in whom intent to deceive is present, but impossible of proof. Indeed, a possible profit was present in *Blue Chip Stamps*, where defendants owed plaintiff an unenforceable duty to sell securities below value. Ordinarily, persons do not profit when others refrain from purchasing or selling securities. Thus, there is ordinarily no motive for intentional deception when there is no purchase or sale.

In the *Blue Chip Stamps* situation the state remedy should work greater substantial justice than would a federal 10b-5 remedy: by painting with a less broad brush, the state law can effectively discriminate between defendants who intended to deceive and those who did not.⁶³

61. Note, *Scienter and Rule 10b-5: Development of a New Standard*, 23 CLEV. ST. L. REV. 493 (1974). See, e.g., *White v. Abrams*, 495 F.2d 724 (9th Cir. 1974).

62. Bucklo, *Scienter and Rule 10b-5*, 67 Nw. U.L. REV. 562, 598-600 (1972). For example, the Second Circuit allows recovery on the basis of "reckless disregard for the truth." *Shemtob v. Shearson, Hammill & Co.*, 448 F.2d 442, 445 (2d Cir. 1971). The Ninth Circuit rejects scienter as a separate element of a 10b-5 action. *White v. Abrams*, 495 F.2d 724 (9th Cir. 1974). However, it allows recovery on the basis of mere negligence, *Ellis v. Carter*, 291 F.2d 270 (9th Cir. 1961), as does the Eighth Circuit. *City Nat'l Bank v. Vanderboom*, 422 F.2d 221 (8th Cir. 1970). The Seventh Circuit requires less than "bad faith intent to mislead." *Kohler v. Kohler Co.*, 319 F.2d 634, 637 (7th Cir. 1963).

63. This difficulty in the federal remedy would be reduced by a sliding-scale approach to the problem of scienter, as advocated in *White v. Abrams*, 495 F.2d 724 (9th Cir. 1974).

Because of *Blue Chip Stamps*, defendants who had no reason to intend deception but who have induced inaction will not be subjected to the lower federal standard of scienter. Plaintiffs will prevail only against defendants who actually intended to deceive them, and they will do so in state courts. On the other hand, defendants who induced a purchase or sale of securities ordinarily had a pecuniary reason to do so. Such defendants may have intended deception but their intent may be impossible to prove. In those cases the federal scienter standard is appropriate. In cases in which defendants caused plaintiffs not to act, extension of a federal remedy would be inappropriate. The Supreme Court's decision not to extend such a remedy not only reduces the burden on the federal courts,⁶⁴ it also works substantial justice.

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64. The decision in *Blue Chip Stamps* puts a halt to further expansion of the class of persons who may sue under rule 10b-5. However, the Supreme Court does not significantly reduce the size to which that class had grown prior to *Eason*. The four categories by which *Birnbaum* was eroded remain capable of federal suit. See text accompanying notes 29-32 *supra*. A shareholder's right to sue derivatively following his corporation's purchase or sale of securities will continue, as he sues on behalf of a purchaser or seller. Although no support can be found in *Blue Chip Stamps* for continuing to allow "forced sellers" a cause of action, this area presents only a minor problem. By fulfilling a mere "needless formality," a requirement that they sell their shares, the forced sellers will comply with the *Birnbaum* rule. Persons in the class of "aborted purchaser-sellers" will clearly be able to sue under 10b-5: their contracts bring them into the operation of the rule. While it does not refer specifically to injunctive relief, the majority limits its holding to actions for damages.

There is thus ample evidence that Congress did not intend to extend a private cause of action for *money damages* to the non-purchasing offeree of a stock offering . . . for loss of the opportunity to purchase due to an overly pessimistic prospectus. . . .

. . . . We do not believe that . . . a shifting and highly fact-oriented disposition of the issue of who may bring a *damage claim* for violation of Rule 10b-5 is a satisfactory basis for a rule of liability imposed on the conduct of business transactions.

95 S. Ct. at 1934 (emphasis supplied). Furthermore, "[i]t is not necessary in a suit for equitable or prophylactic relief to establish all the elements required in a suit for monetary damages." SEC v. Capital Gains Research Bureau, 375 U.S. 180, 195 (1963). In a suit for injunctive relief, the Court's policy concern about strike suits with high settlement values would be irrelevant. Therefore, plaintiffs seeking to prevent an unlawful sale will be able to sue without purchaser or seller status.

Although *Blue Chip Stamps* did not involve corporate mismanagement, its primary significance will be in effectively precluding any further movement in the direction of affording federal relief for corporate mismanagement. Plaintiffs need expect no further erosion in the *Birnbaum* doctrine as to rule 10b-5, and no other federal remedy provides an effective basis for relief for corporate mismanagement. See note 5 *supra*.