REVISITING *BIRNBAUM*: CHANGED CONDITIONS AND THE PROVIDENCE OF THE PURCHASER-SELLER RULE

Scott Jones*

I. INTRODUCTION

The long-simmering dispute over exploitation of the private securities litigation system boiled over in the mid

* J.D. Candidate 2007, Columbia University School of Law; B.A. Political Science 2004, University of North Carolina at Chapel Hill; B.A. Afro-American Studies 2004, University of North Carolina at Chapel Hill. The author wishes to thank the *Columbia Business Law Review* for their substantial assistance in editing this Note.

1990s.[1] Fueled by concerns that opportunistic plaintiffs' lawyers filed class actions on news of any substantial decrease in share prices[2] and that the resultant settlements rarely reflected the merits of the underlying suit,[3] the corporate lobby looked to Washington for relief.[4]

Despite inconclusive findings to support such pervasive fears,[5] courts had already begun the process of incorporating the concern for strike suits into their holdings.[6] Two key contemporary cases, *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*[7] and *Gustafson v. Alloyd Co.*[8] reflected emerging judicial preferences for stricter limitations on the scope of Rule 10b-5 liability,[9] in part as a means for limiting vexatious litigation. And nationwide, the

[1] John W. Avery, *Securities Litigation Reform: The Long and Winding Road to the Private Securities Litigation Reform Act of 1995*, 51 BUS. LAW. 335, 338 (1996).

[2] 140 Cong. Rec. S3695, 3706 (daily ed. Mar. 24, 1994) (statements of Sen. Dodd and Sen. Domenici).

[3] *Id.*

[4] David M. Levine & Adam C. Pritchard, *The Securities Litigation Uniform Standards Act of 1998: The Sun Sets on California's Blue Sky Laws*, 54 BUS. LAW. 1, 1 (1998).

[5] Avery, *supra* note 1, at 340.

[6] Consider, for example, the Second Circuit's heightened pleading standard for scienter. *See* Acito v. IMCERA Group, 47 F.3d 47 (2d Cir. 1995).

[7] Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164 (1994). In *Central Bank of Denver*, the Supreme Court ruled that there is no private right of action for aiding and abetting a violation of 10b-5. In scaling back more than two decades of litigation saying otherwise, the Court reasoned in a close five to four decision that absent express intent in the language of 10b-5, there could be no aiding and abetting liability. Notably, prior to the Supreme Court decision, all federal courts of appeal had found aiding and abetting liability when the issue came before them.

[8] Gustafson v. Alloyd Co., 513 U.S. 561 (1995) (restricting application of Section 12(2) of the Securities Act of 1933 to public offerings, excising all private sales of securities and "secondary market" trading; the holding was influenced by the court's concern for strike suits).

[9] 17 C.F.R. § 240.10b-5 (1998).

judicial branch drifted towards more exacting pleading standards for 10b-5 plaintiffs.[10]

With anecdotal evidence of abuse as the impetus for reform[11] and various court holdings as the blueprint,[12] Congress responded in 1995 with the Private Securities Litigation Reform Act.[13] Enacted over President Clinton's veto,[14] the Reform Act promised to "stem... [the] tide of meritless securities litigation"[15] by ushering in heightened pleading standards,[16] carving out a safe harbor for forward-looking statements,[17] requiring stays of discovery during the

[10] *See* Joel Seligman, *The Merits Do Matter: A Comment on Professor Grundfest's "Disimplying Private Rights of Action Under the Federal Securities Laws; the Commission's Authority,"* 108 HARV. L. REV. 438, 446 (1994) (noting that "in 1992 a substantial percentage of all federal securities class actions filed were dismissed on motions before trial"); Julie Triedman, *Class Warfare*, AM. LAW., July/Aug. 1994, 51, 55 (arguing that "[t]he trend is toward more dismissals and more summary judgments") (quoting Leonard Simon of Milberg Weiss).

[11] *See* Private Litigation Under the Federal Securities Laws: Hearings Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs, 103d Cong. 1-3 (1993) (opening statement of Sen. Dodd, Chairman of Subcomm. on Securities).

[12] *See, e.g.*, Ross v. A.H. Robins Co., 607 F.2d 545, 558 (2d Cir. 1979), *cert. denied*, 446 U.S. 946 (1980) (the Second Circuit's heightened pleading standard for *mens rea* would be adopted in part in the Reform Act).

[13] Private Securities Litigation Reform Act of 1995, PUB.L.NO. 104-67, 109 STAT. 737 [hereinafter "Reform Act"].

[14] 141 CONG. REC. S19180 (daily ed. Dec. 22, 1995).

[15] Avery, *supra* note 1, at 353.

[16] *Id.* at 357-58. Perhaps the most important heightened pleading standard adopted requires plaintiffs to state with particularity facts giving rise to a "strong inference" that the defendant party acted with the required scienter. *See also* 141 CONG. REC. H13702 (daily ed. Nov. 28, 1995).

[17] Carl W. Schneider & Jay A. Dubow, *Forward-Looking Information —Navigating in the Safe Harbor*, 51 BUS. LAW. 1070, 1071 (1996). The purpose of the safe harbor protection was, among others, to promote disclosure of generally-desirable forward-looking information. *See* H.R. REP. NO. 104-369 at 31 (1995) (Conf. Rep.).

pendency of various motions,[18] and mandating sanctions for certain frivolous lawsuits.[19]

The Reform Act, however, soon proved insufficient. Rather than forcing weak cases out of court altogether, the plaintiffs' bar simply evaded the Reform Act by filing substitute state claims in state court.[20] There, parallel litigation circumvented the Reform Act's stay-of-discovery protections and undercut the safe harbor for forward-looking statements.[21] Recognizing the need for still further protection, the corporate lobby soon returned to Congress.[22]

Congress responded in 1998 with the Securities Litigation Uniform Standards Act.[23] The Uniform Standards Act preempted certain state law securities class actions.[24] By preempting these causes of action, Congress ensured that the Reform Act's chosen set of rules and remedies, rather than those of the states, would be applied to covered securities class actions.[25]

Perhaps unsurprisingly, plaintiffs responded by testing the bounds of Uniform Standards Act preemption.[26] If

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[18] 15 U.S.C.A. §§ 77z-1(b)(1), 78u-4(b)3(B) (West. Supp. 1998); *see, e.g.*, 15 U.S.C.A. §§ 77z-2(f), 78u-5(f) (staying discovery on unrelated issues while any motion to dismiss by defendant based on the fact that the complaint relates to forward-looking statements is pending).

[19] Avery, *supra* note 1, at 359-60. *See also* Reform Act, 109 STAT. 737 at 741-42, 747-48 (requiring mandatory sanctions when there is a violation of Rule 11).

[20] Amanda M. Rose, *Life After SLUSA: What is the Fate of Holding Claims?*, 69 DEF. COUNS. J. 455, 455 (2002); *see also* Michael A. Perino, *Fraud and Federalism: Preempting Private State Securities Fraud Causes of Action*, 50 STAN. L. REV. 273 (1998).

[21] Rose, *supra* note 20, at 456.

[22] *Id.* at 455.

[23] Securities Litigation Uniform Standards Act, Pub. L. No. 105-353, 112 Stat. 3227 (codified as amended in scattered subsections of 15 U.S.C. §§ 77-78) [hereinafter "Uniform Standards Act"].

[24] Rose, *supra* note 20, at 456.

[25] *Id.*

[26] *See, e.g.*, Newby v. Enron Corp., 338 F.3d 467 (5th Cir. 2003) (employing the All Writs Act to stay proceedings in various state actions filed with just forty-nine class members, one beneath the requisite for "covered" class status under the Uniform Standards Act).

plaintiffs could avoid preemption, they could avoid the Reform Act's strict standards. Of the myriad techniques attempted, the pleading of "holding claims" proved particularly resistant to Uniform Standards Act preemption.[27] Holding claims are those in which plaintiffs assert that they have been fraudulently induced to hold onto their shares. Since the Supreme Court's landmark adoption of the *Birnbaum* doctrine in 1975,[28] plaintiffs who allege fraud due to induced holding have had no standing to bring Rule 10b-5 civil suits. Thus, those who can only allege that they were induced to forebear the sale of their securities have no standing to seek civil damages under 10b-5.

At the time of the decision, the *Birnbaum* doctrine appeared to be a resounding loss for holding plaintiffs and other non-purchaser-sellers, resigning them to state court where common law fraud theories, derivative litigation, Blue Sky laws, and various other state causes of action would be their only relief.[29] But in an ironic reversal of fortunes, the Uniform Standards Act turned the holding claim into a sword for plaintiffs to wield. According to some courts, since holding claims were not legitimate 10b-5 claims, they were left unpreempted by the Uniform Standards Act.[30] By construing their claims as holding actions or other non-purchaser-seller frauds, plaintiffs could evade the Reform Act's strict standards and keep their claims in state court. And most importantly, typical purchaser-seller securities claims could often be asserted as holding claims.[31] Thus, purchaser-turned-holding claims and other non-purchaser-

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[27] Rose, *supra* note 20, at 455.

[28] Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).

[29] *See, e.g,*. Small v. Fritz, 65 P.3d 1255 (Cal. 2003) (recognizing a holder action under the state's common law of fraud).

[30] *See, e.g.* Dabit v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 395 F.3d 25 (2d Cir. 2005), *rev'd*, 126 S. Ct. 1503 (2006).

[31] Merrill Lynch, Pierce, Fenner and Smith v. Dabit, 126 S. Ct. 1503, 1514 (2006) [hereinafter Dabit II] ("Facts supporting an action by purchasers under Rule 10b-5 (which must proceed in federal court if at all) typically support an action by holders as well, at least in those states that recognize holder claims").

seller claims soon flocked to state court, sheltered from federal preemption and primed to make use of more liberal rules of procedure for what would otherwise be 10b-5 claims.[32]

Scholarship discussing this troubling migration of securities claims to state court has focused on whether the scope of Uniform Standards Act preemption should be broad enough to rein in holding and other non-purchaser-seller claims.[33] Courts have had equal trouble interpreting the Uniform Standards Act in a manner that best resolves the complex policy issues arising out of the preemption question. Little effort, however, has been spent reflecting on the impact of the Uniform Standards Act and the Reform Act on the providence of the *Birnbaum* rule itself. This Note suggests that the recent statutory reforms have significantly altered the balance of equitable considerations weighed by the Supreme Court in its original treatment of non-purchaser-seller securities fraud claims. Unsurprisingly, the difficulties posed by the Uniform Standards Act and the Reform Act arise because *Birnbaum*'s conclusions were drawn in a different legal context, and thus the issue may be best treated by revising the *Birnbaum* rule with an eye to the post-Uniform Standards Act securities law landscape.

Section I addresses the development of the law, drawing out the most substantial arguments for maintaining the long-standing *Birnbaum* rule. Section II unpacks these arguments through a historical review of securities litigation reform. Section III compares the options available for interpretation of the "in connection with" language in Section 10(b), Rule 10b-5, and the Uniform Standards Act. Finally, Section IV analyzes the probable consequences of a broader interpretation of the "in connection with" language, drawing conclusions as to the providence of the *Birnbaum* doctrine.

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[32] Rose, *supra* note 20, at 460.

[33] *See, e.g.*, Rose, *supra* note 20, at 460 (arguing that the current dichotomy should be kept largely intact); Joshua Ratner, *Stockholder's Holding Claim Class Actions Under State Law after the Uniform Standards Act of 1998*, 68 U. CHI. L. REV. 1035, 1036 (2001) (arguing for field preemption).

II. DEVELOPMENT OF THE LAW

A. *Birnbaum* and *Blue Chip Stamps*: The Specter of the Strike Suit

While there is no express private right of action for fraud under Section 10(b) of the Securities Exchange Act, courts have long recognized an implied right of action under securities laws.[34] These implied private actions supplement the SEC's enforcement of federal securities laws, act as substantial deterrents against 10b-5 violations, and serve to compensate defrauded investors.[35]

In determining the reach of this implied right of action, the courts have considered often conflicting policy interests. Generally, though, they have given special weight to concerns about frivolous claims.[36] Certainly, evolving standards of statutory interpretation have also contributed to the reining in of 10b-5 liability,[37] but fear of extortion through the court system has had particular resonance in the field of securities fraud litigation.[38]

Early on, federal courts responded to the specter of the strike suit in construing the private right of action under Rule 10b-5.[39] In 1952, the Second Circuit Court of Appeals faced a novel question of law when it heard *Birnbaum v.*

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[34] *See* Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 (1971); J.I. Case Co. v. Borak, 377 U.S. 426, 432 (1964) (stating that an implied right of action provides a necessary supplement to Commission action).

[35] *See* Avery, *supra* note 1, at 335.

[36] *See, e.g.*, Birnbaum v. Newport Steel Corp., 193 F.2d 461, 464 (2d Cir. 1952) (affirming the lower court decision that Rule 10b-5 protected the defrauded purchaser or seller and did not extend to fraudulent corporate management).

[37] *See, e.g.*, Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 191 (1994) (holding that there is no private right of action for aiding and abetting a 10b-5 violation).

[38] *See* H.R. REP. No. 104-369, at 31-32 (1995) (Conf. Rep.), *as reprinted in* 1995 U.S.C.C.A.N. 730, 730-31.

[39] *See, e.g.*, *Birnbaum*, 193 F.2d at 464 (holding that Rule 10b-5 provided protection to a defrauded purchaser or seller).

Newport Steel Corp.[40] The private civil action alleged that the controlling shareholder violated Section 10(b) of the Securities Exchange Act of 1934 when he, acting as majority shareholder, made misrepresentations regarding his rejection of favorable merger terms in order to conceal his true purpose—to open the door for the sale of his controlling share at a premium that otherwise would have been spread among the plaintiff shareholders had the merger gone through.[41]

The plaintiffs in the action were non-sellers; that is to say, they alleged that they were defrauded by the sale of another's stock, not their own.[42] The court deliberated whether the language of 10b-5, "in connection with the purchase or sale"[43] of securities, was broad enough to incorporate those who had only attempted to exchange shares.[44] Using the statutory text as evidence, the Circuit Court credited Congress's desire to regulate the securities market without encroaching on the state law province of corporate management in determining here that a proper plaintiff under Section 10(b) is an *actual* purchaser or seller of securities.[45]

More than twenty years later, the Supreme Court first had the opportunity to address the *Birnbaum* holding in *Blue Chip Stamps v. Manor Drug Stores.*[46] The plaintiffs in *Blue Chip Stamps* complained that unreasonably gloomy forecasts by the defendants caused them to forego the purchase of shares offered pursuant to an antitrust consent decree. Accordingly, the misrepresentations defrauded them

[40] *Id.*

[41] *Id.* at 462.

[42] *Id.*

[43] 17 C.F.R. § 240.10b-5 (2006).

[44] *Birnbaum*, 193 F.2d at 463.

[45] *Birnbaum*, 193 F.2d at 464 (as opposed to including fraudulent corporate management).

[46] Blue Chip Stamps v. Manor Drug Stores, Inc. 421 U.S. 723, 754-55 (1975) (holding that rule 10b-5 applies only to actual purchasers or sellers).

of profits they would have realized had they purchased the shares.[47]

In affirming the *Birnbaum* doctrine and dismissing the claims, the Supreme Court relied on two classic modus operandi: (1) implied Congressional intent[48] and (2) public policy considerations.[49]

The *Blue Chip Stamps* Court divined Congressional intent for the *Birnbaum* rule from two sources. First, the Court gave significant weight to Congressional silence in the wake of two decades of application of the rule.[50] Rehnquist reasoned that "[t]he longstanding acceptance by the courts, coupled with Congress' failure to reject Birnbaum's reasonable interpretation... argues significantly in favor of acceptance of the Birnbaum rule by this Court."[51] Presumably, had the *Birnbaum* rule been misconceived, Congress would have redressed the issue through legislative amendment clarifying the language of Section 10(b).

Second, the majority noted that elsewhere in the securities laws, Congress had chosen different wording for express causes of action that clearly pertained to non-purchaser-sellers. For example, under Section 17(a) of the parallel antifraud provision of the 1933 Act, frauds "in the offer of sale" were covered.[52] Presumably, Congress chose to eschew this language when drafting Section 10(b).[53]

Still, the Court found the statutory interpretation and legislative intent arguments unsatisfying. Indeed, if the language were so compelling, why had it been interpreted to include non-purchaser-seller frauds in the civil, administrative, and criminal contexts? Thus, the majority

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[47] *Id.* at 726-27.

[48] *Id.* at 729-30.

[49] *Id.* at 749.

[50] *Id.* at 733.

[51] *Id.* at 733. *See also* Blau v. Lehman, 368 U.S. 403, 413 (1962) (applying reasoning similar to that of rule 16(b)).

[52] 15 U.S.C. s 77e (2001).

[53] *Blue Chip Stamps*, 421 U.S. at 734-35.

looked to policy considerations for guidance.[54] Appropriately, the Court began by identifying distinct claims falling under the umbrella of non-purchaser-seller securities frauds.[55] It identified three such categories: (1) where potential purchasers are induced to forebear purchase of a security, (2) where holders are induced to forebear the sale of their shares, and (3) where shareholders and third parties allege losses resulting from corporate or insider trading.[56]

The Court began by dismissing as irrelevant the second and third sets of non-purchaser-seller claims because they may often be treated in derivative and other state causes of action.[57] If such facts were already fully cognizable as state law causes of action, little sleep would be lost over the unavailability of this alternate avenue for redress. The majority then zeroed in on the first category—non-purchaser claims—where would-be plaintiffs had no possible derivative remedy.[58] Looking to the public policy issues at stake, the Supreme Court still favored the *Birnbaum* rule.

Principally, the Court relied on two substantial policy concerns in deciding the merit of the *Birnbaum* rule. First, the Court noted the "widespread recognition that litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general."[59] Indeed, this fear of inequitable settlements, frustrated business activity, and chilled disclosure already permeated the language of the Securities Acts.[60] For the majority, non-purchaser-seller actions

[54] *Id.* at 737 (stating that the court will consider policy considerations where congressional enactments and administrative regulations offer little guidance).

[55] *Id.*

[56] *Id.* at 737-38.

[57] *Id.* at 738.

[58] *Blue Chip Stamps*, 421 U.S. at 738 n.9 (undercutting the strength of the complaint by recognizing that the damage done by the *Birnbaum* rule "is attenuated to the extent that remedies are available to nonpurchasers and nonsellers under state law").

[59] *Id.* at 739.

[60] *Id.* at 740.

appeared especially fertile ground for opportunistic litigation, making the *Birnbaum* rule a natural and important prophylactic against strike suits.

Second, the majority credited the plaintiff's argument that non-purchaser-seller causes of action are simply difficult to handle. The Court feared that "the abolition of the *Birnbaum* rule would throw open to the trier of fact many rather hazy issues of historical fact the proof of which depended almost entirely on oral testimony."[61] While requisite reliance on oral testimony would not prove an impossible hurdle for a court and jury, the majority highlighted difficulties peculiar to the oral testimony presented in the typical securities fraud scenario.[62] It clarified these difficulties by juxtaposing the common 10b-5 fraud against a kindred fraud cause of action—the common law tort of deceit and misrepresentation.[63]

Admitting that the *Birnbaum* rule represented a step opposite the evolution of the common law tort of deceit,[64] the Court compellingly distinguished between deceit and the classic 10b-5 fraud.[65] Typically, securities fraud occurs in an impersonal setting, effected through advertisements in major newspapers and trading on international financial exchanges.[66] The tort of misrepresentation and deceit, in

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[61] *Id.* at 743.

[62] *Id.* at 744.

[63] *Id.* at 744-45.

[64] *Id.* at 744 (noting that "[t]hese aspects of the evolution of the tort of deceit and misrepresentation suggest a direction away from rules such as *Birnbaum*"). According to the Court, "it has long been established . . . that a misrepresentation which leads to a refusal to purchase or to sell is actionable in just the same way as a misrepresentation which leads to the consummation of a purchase or sale." *Id.*

[65] *Blue Chip Stamps*, 421 U.S. at 744.

[66] *Id.* at 745; Avery, *supra* note 1, at 338.

> Most large securities fraud cases, particularly fraud-on-the-market cases, are not simple cases of investors who bought newly issued shares on the basis of misleading statements and who are suing the promoters to get their money back. Instead, these cases involve investors who bought their shares in the market from other investors at a

contrast, evolved under significantly different circumstances—where lengthy interpersonal dealings often resulted in a factual record on causation, reliance, and damages that could be substantially developed, especially through adversarial testimony.[67] Convincingly for the Court, in a 10b-5 claim, "[p]laintiff's entire testimony could be dependent upon uncorroborated oral evidence of many of the crucial elements of his claim, and still be sufficient to go to the jury."[68]

The *Blue Chip Stamps* majority thus resolved to take the lesser of two evils. In response to SEC and scholarly denunciations of the rule as "an arbitrary restriction which unreasonably prevents some deserving plaintiffs" from recovery for 10b-5 frauds, the majority offered only the counterbalancing argument that non-purchaser-seller frauds were more costly than beneficial.[69] Finding the statutory language and legislative history incomplete, the Court

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> time when the price was allegedly artificially high due to misstatements by the company. The injured investors cannot sue the sellers . . . because the sellers were not responsible for the misleading statements. Instead, the injured investors sue the company and, usually, various officers who were responsible for the misleading statements.

Id. at 338.

[67] *Blue Chip Stamps*, 421 U.S. at 746.

[68] *Id.* (stressing that, in some securities fraud claims, "[t]he jury would not even have the benefit of weighing the plaintiff's version against the defendant's version, since the elements to which the plaintiff would testify would be in many cases totally unknown and unknowable to the defendant").

[69] *Id.* at 738-39.

> We have no doubt that this is indeed a disadvantage of the *Birnbaum* rule, and if it had no countervailing advantages it would be undesirable as a matter of policy, however much it might be supported by precedent and legislative history. But we are of the opinion that there are countervailing advantages to the *Birnbaum* rule, purely as a matter of policy.

Id.

ultimately relied on a policy calculation to support its affirmation of *Birnbaum*. The majority quantified the various costs imposed by non-purchaser-seller claims—noting in particular the threat of strike suits and the judicial expense of painfully tedious legitimate claims associated with non-purchaser-seller claims.[70] And the Court found solace in the usual availability of alternative state remedies for otherwise aggrieved plaintiffs.[71] According to the Court, then, the securities fraud landscape demanded the purchaser-seller rule in 1975. But have recent changes in that landscape called *Birnbaum* into question?

B. Private Securities Litigation Reform Act of 1995: The Strike Suit Revisited

In 1995, Congress enacted the Reform Act—a broad device containing a "diverse assortment of measures reflecting concerns raised by a number of different constituencies."[72] While the Reform Act was not solely a response to the allegations of strike suits run amok, certainly the abuse of the private securities litigation system was a focal point. Congress perceived the securities laws to be unnecessarily tolerant of frivolous litigation.[73] At stake was the careful balance between the interests of the parties to the corporate market—corporations, directors, officers, security holders, and third parties.[74]

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[70] *Id.* at 746.

[71] *Id.* at 738 (recognizing that would-be holding plaintiffs may often avail themselves of state law remedies).

[72] Avery, *supra* note 1, at 336.

[73] *Id.* at 337. The act addressed several important constituencies with three independent concerns. First were corporations concerned with frivolous litigation. Second were third parties, such as accounting firms and other professional advisors, worried about the effects of securities litigation on their own liability calculus. Third were generalized concerns regarding whether securities class actions fairly represented the "best interests of the investor class." *Id.*

[74] *Id.* at 338. Often these parties themselves have competing interests with regard to each change to securities laws considered by Congress. For example, further protections of forward-looking statements by issuers present distinct advantages and disadvantages to shareholders.

In drafting the Reform Act, Congress did not act off of a clean slate, but rather considered the various, prior court-supplied solutions to the policy problems posed by frivolous litigation.[75] Particularly, the Reform Act bolstered the defendants' ability—and courts' willingness—to dismiss frivolous claims early in the litigation process.[76]

First, the Reform Act simply elided certain representations from the set of statements that could trigger Section 10(b) liability. In adopting the "bespeaks caution" doctrine,[77] the Reform Act, generally speaking, protected persons making forward-looking statements, so long as their representations were accompanied by meaningful cautionary language.[78] Further, the Reform Act required actual knowledge as to the forward-looking statement's falsity or tendency to mislead in order to lead to liability.[79]

Second, the Reform Act adopted a number of heightened pleading standards. Presumably, this would diminish

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Shareholders themselves profit from increased availability of truthful information. Forward-looking statements contribute further, often providing better information to potential purchasers and sellers regarding their prospects. On the other hand, greater protections perhaps necessarily create greater opportunity for fraud. Shareholders presented with inaccurate forward-looking statements may rely on these statements and, depending on the reach of the law, may be left without a remedy. Shareholder interests rest here in finding an optimal level of efficiency regarding the dissemination of forward-looking information. To the extent that the gain in value to shareholders of the increased quantity and quality of forward looking statements outweighs the costs to the shareholders in terms of meritorious suits left without a remedy, shareholders might favor increased protections for issuers of these statements.

[75] *Id.* at 354.

[76] *Id.* (noting that the Reform Act equips judges with "valuable tools" for weeding out meritless litigation).

[77] *See* Hillson Partners Ltd. P'ship v. Adage, Inc., 42 F.3d 204, 209 (4th Cir. 1994) (holding that "[m]ere allegations of 'fraud by hindsight' will not satisfy the requirements of Rule 9(b)"). Thus, simply alleging that a forward-looking statement had turned out to be incorrect would not alone give rise to liability.

[78] Avery, *supra* note 1, at 355-56.

[79] *Id.* at 356.

weaker claims' possibilities of proceeding past a motion to dismiss, discouraging the filing of frivolous claims.[80] Particularly, the heightened pleading standard for state-of-mind posed an onerous burden on 10b-5 claimants.[81]

Third, and in close combination with the heightened pleading standards and the safe harbor for forward-looking statements, the Reform Act supplied a stay-of-discovery requirement during the pendency of certain motions.[82] This measure presumably prevented frivolous filers from using the threat of discovery costs to extract settlement values. During the pendency of a motion to dismiss, generally, or a motion for summary judgment on the issue of whether safe harbor protections for forward-looking statements were applicable, discovery would be stayed.[83]

A more comprehensive review of the Reform Act, while valuable to a complete understanding of the issue of frivolous lawsuits generally and more particularly to the incentives driving the adoption of the Uniform Standards Act, is beyond the scope of this Note.[84] It is enough to note that the Reform Act was sufficiently exacting to drive 10b-5 class actions out of federal court and into state court.[85] Would-be 10b-5 claimants simply pled their case in state court, seeking state law remedies. There, plaintiffs could avoid the Reform Act's strict standards and accomplish in state court what the Reform Act meant to prevent from occurring under federal law.

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[80] *Id.* at 357-58.

[81] *Id.* at 358. Language from the Second Circuit's pleading standard for mental state, adopted by the Reform Act, requires that complainants state "with particularity facts giving rise to a 'strong inference' that the defendant acted with the required state of mind." At the time, this was generally considered the most stringent pleading standard available.

[82] Reform Act, *supra* note 13.

[83] *Id.*

[84] Much has been written about the Reform Act. For a start, see Avery, *supra* note 1.

[85] Joseph A. Grundfest & Michael A. Perino, *Securities Litigation Reform: The First Year's Experience*, 1015 PLI/CORP 955 (1997).

C. Securities Litigation Uniform Standards Act: The Strike Suit Revisited, Again

The Securities Litigation Uniform Standards Act responded to the unpredicted consequence of plaintiff flight to state courts by hauling class action securities fraud claims back into federal court under federal laws.[86] The Uniform Standards Act intended to prevent plaintiffs from evading "the protections that federal law provides against abusive litigation by filing suit in state, rather than federal, court."[87] By preempting "certain state law securities fraud claims by allowing automatic removal to federal court," the Uniform Standards Act would force such claims to face the stricter standards imposed by the Reform Act.[88]

More immediately, however, courts were confronted with determining the boundaries of Uniform Standards Act preemption. While some prerequisites were easily accounted for,[89] resolving whether certain elements of securities fraud claims should apply to the preemption determination proved more problematic.[90] Thus, "mindful that SLUSA was intended to block artful plaintiffs, courts have gone beyond asking whether the removed complaint contains the talismanic phrase 'in connection with,' and have looked also to whether the allegations, if true, would satisfy the 'in con-

[86] Uniform Standards Act, *supra* note 23.

[87] Burns v. Prudential Secs., 116 F. Supp. 2d 917, 921 (N.D. Ohio 2000).

[88] Rose, *supra* note 20, at 455.

[89] *Id.* at 457. Rose discusses four conditions for pre-emption: (1) the claim must be based on state law, (2) the claim must concern a covered security, (3) the underlying suit must be a covered class action, and (4) the plaintiff must allege untrue, manipulative, or deceptive statements or omissions in connection with the purchase or sale of a covered security. The first two elements are relatively uncomplicated.

[90] *Burns,* 116 F. Supp. 2d at 917 (holding that because the plaintiffs had not alleged the element of deception, the claim did not fit within the scope of Uniform Standards Act preemption).

nection with' requirement."[91] As courts adjusted to carefully pleaded complaints calculated to avoid the exacting standards of the Reform Act, they once again faced the policy issues created by non-purchaser-seller claims.

Two recent cases exemplify the difficulties created by imposing the purchaser-seller rule on the determination of Uniform Standards Act preemption. The Second Circuit confronted a diverse assortment of claims arising out of errors in investment advice in *Dabit v. Merrill Lynch*.[92] Dabit, a former broker with the defendants, alleged holding damages and lost commissions caused by Merrill Lynch's inaccurate investment advice.[93] IJG, a second plaintiff, sued to reclaim fees and commissions lost as a result of the false research.[94] All the claims were initially dismissed as preempted by the Uniform Standards Act; the Second Circuit reviewed the decision *de novo*.[95]

The Second Circuit revisited familiar rationales when it agreed that the scope of Uniform Standards Act preemption was not broad enough to encompass holding claims. As with the *Blue Chip Stamps* rationale, its first method was to investigate the Congressional history to determine whether Congress favored any particular reading of the Uniform Standards Act. Finding little there, the majority noted that the language at issue already "ha[d] been extensively interpreted by the Supreme Court and the lower federal courts in the context of § 10(b) and Rule 10b-5."[96] In imputing Congressional intent much like the Supreme Court did in *Blue Chip Stamps*, the Eleventh Circuit earlier reasoned that "where Congress uses terms that have accumulated settled meaning under either equity or the common law, a court must infer, unless the statute otherwise

[91] Spielman v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 332 F.3d 116, 133 (2d Cir. 2003).

[92] Dabit v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 395 F.3d 25 (2d Cir. 2005), *rev'd*, 126 S. Ct. 1503 (2006).

[93] *Dabit*, 395 F.3d at 29.

[94] *Id.* at 30.

[95] *Id.* at 31.

[96] *Id.* at 34.

dictates, that Congress means to incorporate the established meaning of these terms."[97] The Second Circuit majority had little trouble concluding that, absent express historical evidence to the contrary, the presumption must be that Congress chose the language it ultimately used fully aware of the prior judicial interpretations.[98] Therefore, since the purchaser-seller rule was such a hallmark of private securities litigation, Congress could be presumed to have intended the purchaser-seller rule to also apply as a limit on preemption.

Instead of moving from the intent argument to a public policy discourse as the Supreme Court had in *Blue Chip Stamps*, the Second Circuit reviewed the alternative from the position of holding plaintiffs. The majority reasoned that if the Uniform Standards Act were to preempt non-purchaser-seller causes of action, these "actions might be preempted for meeting all of SLUSA's requirements . . . but not be capable of being brought under federal law for failure to meet the parallel requirement of 10b-5, a result that the legislative history does not suggest Congress intended to produce in enacting SLUSA."[99] In other words, it seemed odd, if not unjust, to steal out of state court claims that would immediately be dismissed for lack of standing under 10b-5, especially with no Congressional statement suggesting such to be the intent of the legislature.

The Second Circuit thus concluded that the meaning of "in connection with" in the Uniform Standards Act was coterminous with that found in Section 10(b) and Rule 10b-

[97] Riley v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 292 F.3d 1334, 1342 (11th Cir. 2002).

[98] Dabit v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 395 F.3d 25, 36 (2d Cir. 2005), *rev'd*, 126 S. Ct. 1503 (2006). The *Dabit* court goes on to call this the "more natural" reading of the statutory language as it preempts only as much as is needed to shore up the loophole in the PSLRA by which parties can avoid the stringent, uniform standards by filing in state Court. According to the *Dabit* majority, holding claims could never be brought under 10b-5 and thus the Uniform Standards Act, as a correction to the PSLRA, could not be interpreted to cover the claims.

[99] *Dabit*, 395 F.3d at 36.

5.[100] To the majority this meant that the purchaser-seller rule must apply as a limit on the Uniform Standard Act's preemptive scope.[101] Under this reasoning, if the plaintiff were not a purchaser or seller, the plaintiff's claim would fall outside Uniform Standards Act preemption. This conclusion allowed the court to return to the familiar determination regarding whether classes were comprised of purchasers or sellers, only this time the analysis applied to the threshold question of preemption, not of standing.[102]

Despite tracing similar arguments, the Seventh Circuit reached the opposite conclusion in *Kircher v. Putnam Trust*.[103] Easterbrook, writing for the court, began the argument by agreeing with the basic premise that the language of the Uniform Standards Act has a scope co-equal with its antecedent—Rule 10b-5.[104] However, Easterbrook quickly diverged from other circuits when recognizing that the circuits themselves were not in accord regarding the actual meaning of 10b-5.[105] If 10b-5's "in connection with" language had different interpretations in different contexts, which interpretation did Congress choose for the preemption question?

The Seventh Circuit looked more broadly in considering the interplay between Section 10(b) and the Uniform Standards Act. It began by recognizing the role of the "in connection with" phrasing with regards to criminal and administrative enforcement, rather than private enforcement.[106] For the SEC and Department of Justice, "[i]nvocation of [Rule 10b-5] does not depend on proof that the agency or United States purchased or sold securities; instead the 'in connection with' language ensures that the fraud occurs in securities transactions rather than some

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[100] *Id.* at 28.

[101] *Id.*

[102] *Id.* at 44-51.

[103] Kircher v. Putnam Trust, 403 F.3d 478 (7th Cir. 2005), *rev'd on other grounds*, 126 S. Ct. 2145 (2006).

[104] *Kircher*, 403 F.3d at 482.

[105] *Id.*

[106] *Id.* at 483.

other activity."[107] To the majority, the *Blue Chip Stamps* holding arose in the private litigation context because "the Court wanted to confine these actions to situations where litigation is apt to do more good than harm."[108] Here, however, where application of the purchaser-seller rule to the preemptive reach of the Uniform Standards Act is likely to do more harm than good, finding congressional intent to create this perversion seemed to the Seventh Circuit to be "more than a little strange."[109]

Rather, the court found it more acceptable to state that "[b]y depicting their classes as containing entirely non-traders, plaintiffs do not take their claims outside § 10(b) and Rule 10b-5; instead they demonstrate only that the claims must be left to public enforcement."[110] Legitimate holding claims, according to the Seventh Circuit's reasoning, are thus preempted under the language of the Uniform Standards Act, requiring successful claims to be litigated as derivative actions or through public prosecution.[111] The *Kircher* court's reasoning more closely paralleled the *Blue Chip Stamps* Court because it made a fairness determination about policy implications after conceding that the statutory language left the issue unresolved.

Taking *Dabit* on appeal, the Supreme Court attempted to reconcile the conflicting circuit holdings. The Court was visibly troubled by the inconsistencies presented by both conclusions. On one hand, could it be possible that Congress, without so much as mentioning the tort, intended to render extinct the class action holding claim? But on the other hand, could Congress have intended to flip the playing field, making artfully-pled state law holding claims the new rainmaker for securities fraud firms?[112] Given the difficulties

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[107] *Id.*

[108] *Id.*

[109] Kircher v. Putnam Trust, 403 F.3d 478, 484 (7th Cir. 2005) *rev'd on other grounds*, 126 S. Ct. 2145 (2006).

[110] *Id.*

[111] *Id.*

[112] *See* Dabit II, *supra* note 31, at 1514 (2006) (explaining more succinctly that "[i]t would be odd, to say the least, if SLUSA exempted that

presented by each, it would have been reasonable under the circumstances for the Court to reaffirm the interpretation adopted by the *Birnbaum* panel.[113] Yet a unanimous Court ultimately sided with Easterbrook and the Seventh Circuit's sweeping concept of preemption.

The Supreme Court reasoned that because the purchaser-seller rule was adopted for reasons of public policy, its rationale applied only in the context of private litigation.[114] But taking the argument one step further, the unanimous Court stated that *Birnbaum* only applied to the reach of the private remedy itself, and not to the language of the organic law.[115] Unless otherwise advised, the generally broader interpretation of the "in connection with" language would be applied.[116] This construction would better serve Congress's aim to undercut perceived abusive securities litigation; a narrower reading would accomplish the opposite.[117]

Again, however, public policy—and not exceptionally consistent statutory interpretation—carried the day. Indeed, the Supreme Court's cavalier oversight of the conflicting intent arguments that underlie the essential question of statutory interpretation was striking. In contending that Congress intended the broader meaning of 10b-5 to apply, the majority writes:

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particularly troublesome subset of class actions from its pre-emptive sweep").

[113] *See id.* at 1513 ("A narrow construction would not, as a matter of first impression, have been unreasonable; one might have concluded that an alleged fraud is 'in connection with' a purchase or sale of securities only when the plaintiff himself was defrauded into purchasing or selling particular securities.").

[114] *Id.* at 1512 ("The *Blue Chip Stamps* Court purported to define the scope of a private right of action under Rule 10b-5 – not to define the words 'in connection with the purchase or sale.'").

[115] *Id.*

[116] *Id.* at 1513.

[117] *Id.* at 1513. Writing for the Court, Stevens suggested that "the presumption that Congress envisioned a broad construction follows . . . from the particular concerns that culminated in SLUSA's enactment. A narrow reading of the statute would undercut the effectiveness of the 1995 Reform Act and thus run contrary to SLUSA's stated purpose." *Id.*

> Congress can hardly have been unaware of the broad construction by both this Court and the SEC when it imported the key phrase—"in connection with the purchase or sale"—into SLUSA's core provision. And when "judicial interpretations have settled the meaning of an existing statutory provision, repetition of the same language in a new statute indicates, as a general matter, the intent to incorporate its...judicial interpretations as well."[118]

But this ignores the equally plausible assertion that Congress was aware of the long history of the purchaser-seller rule, and that Congress's choice of phrasing indicated its intent to leave untouched those frauds that had never come under the umbrella of federal securities laws—namely non-purchaser-seller frauds. In fact, the Second Circuit earlier invoked the same standard regarding repeated statutory language to decide, in opposition to the Supreme Court, that the purchaser-seller rule must apply to limit Uniform Standards Act preemption.

What each holding missed, however, is that this difficult position results not because of the language of Rule 10b-5, but rather because the *Blue Chip Stamps* Court did not and could not anticipate the Reform Act and the Uniform Standards Act. The *Birnbaum* rule made perfect sense when keeping frivolous and vexatious securities litigation out of federal court was the chief concern. But when Congress insisted through the Uniform Standards Act that it would prefer securities litigation to be brought under the Reform Act rather than under state law, the policy underlying the *Birnbaum* holding was frustrated.

The *Dabit* Court essentially resolved this issue of proper forum by characterizing the *Birnbaum* holding as *sui generis* to the issue of Rule 10b-5 civil suit standing. If the *Birnbaum* construction and its rationale simply did not apply to the issue of preemption, the Court could easily adopt the typically broader interpretation of the "in connection with" language. But does prudence truly

[118] *Id.* at 1513.

countenance the building of an artificial barrier around the *Birnbaum* holding, or does the real answer lie in revisiting the *Birnbaum* rationale altogether? Could reconsideration of the *Birnbaum* rule result in reconciliation of interpretations and a more uniform approach to 10b-5 jurisprudence?

III. STARTING FROM SQUARE ONE: TEXTUAL SUPPORT FOR A SEPARATE READING OF § 10(B) AND RULE 10B-5

The dissent in *Blue Chip Stamps* took the opposite position regarding the scope of the "in connection with" language of 10b-5 and its parent statute, Section 10(b). Arguing for a "nexus" approach, Justice Blackmun drew his strongest support from the language of the statute itself—admittedly the weaker premise of the majority's argument. Section 10(b) establishes a crime when a person or persons "use or employ, in connection with *the* purchase or sale of any security... any manipulative or deceptive device."[119] Thus, Blackmun writes, "[t]he question . . . is whether fraud was employed—and the language is critical—by 'any person . . . in connection with the purchase or sale of any security.'"[120] More simply, the purpose of the language is to limit 10b-5 to *securities* fraud, rather than frauds generally. Under the facts of *Blue Chip Stamps*, the connection between the fraud and a sale of securities was manifest.[121] Where the *Blue Chip Stamps* majority went wrong, then, was in reading into

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[119] 15 U.S.C. § 78j(b) (emphasis added).

[120] Blue Chip Stamps v. Manor Drug Stores, Inc., 421 U.S. 723, 768 (1975) (Blackmun, J. dissenting) (citation omitted).

[121] The contrast is best illustrated by the situations posed in *Birnbaum* and in *Blue Chip Stamps*. In *Birnbaum*, the link between a sale and the plaintiffs' complaint was tenuous at best. The fraud, if there was one, was completed before the defendant sold his controlling share. In *Blue Chip Stamps*, however, the link between the fraud and a sale of securities was unmistakable. The fraud existed wholly because of and was completed through the sale of securities pursuant to an antitrust decree. The striking differences between the two cases influenced Blackmun's dissent. "I would avoid the Court's pragmatic solution resting upon a 20-odd-year-old, severely criticized doctrine enunciated for a factually distinct situation." *Id.* at 771 (Blackmun, J., dissenting).

the implied right of action the words "his or her" such that one may sustain a cause of action only when a contrivance has been used "in connection with *his or her* purchase or sale of any security."

The majority's error was in failing to distinguish between mere attempts to purchase or sell and attempts to purchase or sell that are connected to an actual purchase or sale, as was the case in *Blue Chip Stamps*. In doing so, it contravened the purpose of the securities laws—to penalize securities fraud, without regard to whether the fraud was direct or indirect.

The *Blue Chip Stamps* majority's reading of the statute was constraining, given that it only defined the scope of Section 10(b) and Rule 10b-5 private rights of action, while ignoring civil administrative and criminal interpretations of the same language. There, as Blackmun would have it in the private context, "the 'in connection with' language ensures that the fraud occurs in securities transactions rather than some other activity" and little more, just as the language operated in the civil administrative and criminal contexts.[122]

The majority in *Blue Chip Stamps* attempted to reinforce its position by contrasting the language of Section 10(b) with that of Section 17(a) of the 1933 Act which legislates against fraud "in the offer or sale" of securities.[123] Arguably, the different language here implies that Congress had different plans for Section 10(b). But this cannot necessitate the purchaser-seller rule. At best, it can only suggest that courts should be wary of naked attempts at a purchase or sale of securities absent any actual purchase or sale. Ultimately, this legislative intent argument by the majority is limited by "the history of this provision[,]" which does not "provide any indication that Congress considered the problem of private suits under it at the time of its passage."[124]

However, Congress *did* provide guidance through comments that patently describe the aims of the securities

[122] Kircher v. Putnam Trust, 403 F.3d 478, 483 (7th Cir. 2005), *rev'd on other grounds*, 126 S. Ct. 2145 (2006).

[123] *Blue Chip Stamps*, 421 U.S. at 733-34.

[124] *Id.* at 729.

laws as broad and flexible.[125] In recognizing the craftiness of defrauders, Congress ensured the effectiveness of securities laws by empowering the Securities Exchange Commission to promulgate rules that serve the sweeping purpose of the Acts.[126] As an interesting side note, the SEC's amicus brief in *Blue Chip Stamps* denounced the purchaser-seller rule, and historically the SEC has asked for revision of the rule on various other occasions.[127]

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[125] *Id.* at 765 (Blackmun, J., dissenting) (quoting Sen. Fletcher, Chairman of the Subcomm. on Banking and Currency, 78 Cong. Rec. 2271 (1934)).

> Manipulators who have in the past had a comparatively free hand to befuddle and fool the public and to extract from the public millions of dollars through stock-exchange operations are to be curbed and deprived of the opportunity to grow fat on the savings of the average man and woman of America. Under this bill the securities exchanges will not only have the appearance of an open market place for investors but will be truly open to them, free from the hectic operations and dangerous practices which in the past have enabled a handful of men to operate with stacked cards against the general body of the outside investors. For example, besides forbidding fraudulent practices and unwholesome manipulations by professional market operators, the bill seeks to deprive corporate directors, corporate officers, and other corporate insiders of the opportunity to play the stocks of their companies against the interests of the stockholders of their companies.

Id.

[126] *Blue Chip Stamps*, 421 U.S. at 766 (Blackmun, J., dissenting) (quoting Sen. Fletcher, Chairman of the Subcomm. on Banking and Currency, 78 Cong. Rec. 2271 (1934)) ("The Commission is also given power to forbid any other devices in connection with security transactions which it finds detrimental to the public interest or to the proper protection of investors").

[127] "The Commission should have the authority to deal with new manipulative devices." *Hearing on H.R. 7852 and H.R. 8720 Before the H. Comm. on Interstate and Foreign Commerce*, 73d Cong., 2d Sess., 115 (1934) (statement of Thomas G. Corcoran, Counsel with the Reconstruction Finance Corporation) ("There is little reason to believe that non-purchaser-seller causes of action should fall outside of the SEC's scope to handle 'new manipulative devices.'").

A. Confronting the Public Policy Rationale of the *Blue Chip Stamps* Majority

Academics widely questioned the providence of the rule from its inception in *Birnbaum*.[128] While the textual and intent arguments used by the majority stood on shaky ground, the majority's strongest foothold was in the policy considerations proffered by corporate interests. The dissent contested these interests as "mire[d] in speculation and conjecture," but history would suggest that the concerns about frivolous litigation would be ongoing and, at least in Congress's eyes, legitimate.[129] The Court was certainly justified in crediting Congress's stated underlying fears of strike suits as part of its policy interest balancing act.[130]

These policy interests, however, have changed markedly since 1975. While judicial interference began to chip away at the need for the purchaser-seller rule, the Reform Act ultimately tipped the balance. The Reform Act reduces the opportunity for exploitation of federal securities laws by cutting off certain weaker claims at the motion to dismiss stage. One notable result, then, is that the Reform Act reduces the costs associated with any particular subset of securities fraud claims. Weaker claims whose costs exceed their benefits will now be dismissed earlier, with less attendant expenditure of court and defendant resources. Under the Reform Act, the mean cost imposed by a securities fraud claim is greatly reduced while, presumably, the mean benefit created by the filing of the claim is at most marginally reduced.[131]

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[128] *See, e.g.*, Lewis D. Lowenfels, *The Demise of the* Birnbaum *Doctrine: A New Era for Rule 10b-5*, 54 VA. L. REV. 268 (1968).

[129] *Blue Chip Stamps*, 421 U.S. at 769 (Blackmun, J., dissenting).

[130] *Id.* at 740-41.

[131] This assumes that the Reform Act dismisses more claims that are cost-ineffective (as in, claims that would ultimately lose on the merits or that have an unfairly high settlement value) than are cost-effective (as in, claims that would ultimately win on the merits, or would settle at a socially optimal rate). There is good reason to believe that the enforcement of stricter standards at the motion to dismiss state will result

This effect should hold true for non-purchaser-seller claims. The costs universal to securities fraud claims will be reduced in non-purchaser-seller actions under the Reform Act just as they are elsewhere. As explained in the simple formulation below, this has likely led to a significant shift in the balance of policy interests underlying the purchaser-seller rule.

The *social cost* caused by non-purchaser-seller actions can be expressed as such:

Social Cost (SC) = (total costs of purchaser-seller securities frauds, generally) + (total costs unique to non-purchaser-seller frauds).

The *social benefit* caused by a non-purchaser-seller can be similarly expressed as:

Social Benefit (SB) = (total benefits of purchaser-seller securities frauds, generally) + (total benefits unique to non-purchaser-seller frauds).

The Reform Act significantly reduces the "total costs of purchaser-seller securities frauds" within the subset of non-purchaser-seller frauds. Previously, as when *Blue Chip Stamps* was decided, it was possible that SC > SB for non-purchaser-seller securities frauds. Now, under the Reform Act, the balance for non-purchaser-seller frauds may very well have shifted such that SC < SB.

The migration of securities fraud plaintiffs from federal court to state court demonstrates just how substantially the Reform Act reduced the prospects of would-be frivolous filers.[132] It significantly limited the ability of marginal claims to extract settlement costs. The Uniform Standards Act reflects Congress's recognition of the costliness of more liberal state rules of procedure. The shift in balance of policy interests resulting from the 1995 Reform Act and the

in such a positive balance. *See, e.g.,* Note, *Risk-Preference Asymmetries in Class Actions*, 119 HARV. L. REV. 587, 604 (2005).

[132] *See* Grundfest & Perino, *supra* note 85, at 958.

Uniform Standards Act provides the impetus for a renewed look at the role the purchaser-seller rule now plays in securities law enforcement.

IV. A SIMPLE FRAMEWORK FOR ANALYSIS

The basic conundrum for those who interpret the scope of private civil securities fraud remedies is determining the proper line between beneficial and harmful causes of action. Meritorious causes of action substantially support the enforcement of securities laws while meretricious ones unduly chill disclosure and prevent the productive growth of the markets. Presumably, the Reform Act is Congress's estimate of where the line should be drawn.

The Uniform Standards Act introduces a second important criterion – whether a case is a class action. With regard to class actions, Congress found the threat caused by avoidance of the Reform Act through the filing of state *class* claims to be particularly invidious, thus it limited the scope of Uniform Act preemption to larger class actions.[133]

A simple framework can put these two criteria—strength of claim and class action status—together in order to better analyze the role played by the purchaser-seller rule and the possibilities available to the Courts as they approach the construction of the Uniform Standards Act and, as I propose, Rule 10b-5 itself.

[133] Securities Litigation Uniform Standards Act, Pub. L. No. 105-353, 112 Stat. 3227 (codified as amended in scattered subsections of 15 U.S.C. § 77p(f)(2)(A)).

	Non-Covered Class Action	Covered Class Action[134]
Meritorious Non-Purchaser-Seller Claims[135]	1	3
Meretricious Non-Purchaser-Seller Claims[136]	2	4

A. The Second Circuit Approach

The Second Circuit held that non-purchaser-seller claims should not be preempted. It also maintained the purchaser-seller rule. The following table categorizes the likely effects of the holding.

	Non-Covered Claims[137]	Covered Class Action
Meritorious Non-Purchaser-Seller Claims	(1) No federal remedy; must rely on state causes of action if available.	(1) No preemption; must rely on state causes of action.
Meretricious Non-Purchaser-Seller Claims	(1) No federal remedy; may rely on state causes of action.	(1) No preemption; may rely on state causes of action.

The above chart paints a clear picture of the glaring pitfalls of the Second Circuit approach. First, as described earlier, the Second Circuit approach would have left un-preempted artfully pled class actions that do not involve the

[134] "Covered Class Action" refers to class actions that, the purchaser-seller issue notwithstanding, would otherwise be preempted by the Uniform Standards Act.

[135] "Meritorious Non-Purchaser-Seller Claims" refers to those claims whose social benefit is greater than their social cost.

[136] "Meretricious Non-Purchaser-Seller Claims" refers to those claims whose social cost outweighs their social benefit.

[137] "Non-Covered Claims" refers to claims otherwise unable to be preempted (*e.g.*, claims filed by single plaintiffs).

actual purchase or sale of securities by the plaintiff class.[138] Under this approach, otherwise covered class actions, including meretricious ones, would not be preempted. Plaintiffs could bring these meretricious cases under more liberal state rules, circumventing the Reform Act. The burdensome costs of meretricious litigation that Congress intended to reduce with the Reform Act and Uniform Standards Act would thus be imposed against defendants in state court.

Second, under the Second Circuit approach, meritorious non-purchaser-seller claims would continue to have no federal remedy. While historically this should give the reader little pause, if the balance of policy considerations has shifted due to the Reform Act as suggested earlier, this is a resounding flaw of the Second Circuit approach. This is especially the case because it is unlikely that plaintiffs with marginal cases will flood into federal court to bring federal non-purchaser-seller claims. Presumably, because of the Reform Act's strict standards, only non-class plaintiffs with the strongest claims or those with no available state remedy would choose to pursue a claim under Rule 10b-5 rather than under state laws.[139] Thus, under the Second Circuit approach, the purchaser-seller rule keeps out only the most meritorious of non-class claims, most insidiously, when sufficient state remedies are not available.

The Second Circuit approach is unsatisfactory. Meretricious, class action non-purchaser-seller claims remain in state court where plaintiffs can take advantage of more liberal procedural rules. On the other hand, plaintiffs with the most meritorious of individual non-purchaser-seller

[138] Dabit v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 395 F.3d 25, 28 (2d Cir. 2005), *rev'd*, 126 S. Ct. 1503 (2006).

[139] It is entirely possible that plaintiffs will use parallel litigation (simultaneous litigation of single plaintiff actions litigated in state court and class actions in federal court) to circumvent the goals of the Uniform Standards Act. This is not unique, however, to non-purchaser-seller claims. It is worth recognizing, however, that successful circumvention of the Reform Act's protection may return the cost-benefit analysis to the pre-Reform Act measure regarding non-purchaser seller claims.

securities claims, facing insufficient state remedies, will be left without a federal cause of action.[140]

B. The Supreme Court Approach:

	Non-Covered Class Action	Covered Class Action
Meritorious Non-Purchaser-Seller Claims	(1) No federal remedy; must rely on state causes of action	(1) Preempted (2) Summarily dismissed
Meretricious Non-Purchaser-Seller Claims	(2) No federal remedy; must rely on state causes of action	(1) Preempted (2) Summarily dismissed

The Supreme Court approach is somewhat less troubling than the Second Circuit approach. First, under the Supreme Court approach, covered class actions alleging non-purchaser-seller securities frauds will be preempted, although they will be dismissed for lack of standing.[141] This at once solves the problem created by the artful pleading of otherwise meretricious, covered class action claims to avoid the Reform Act. These frivolous non-purchaser-seller claims will be preempted but will immediately run afoul of the purchaser-seller standing requirement.

Further, the Supreme Court approach attenuates the indirect notification problem caused by the filing of non-purchaser-seller claims in state court. Non-purchaser-seller class actions brought under state law will be preempted. To the extent that the SEC and DOJ are more likely to take notice of and investigate claims that arise under federal securities laws, the preemption of these private claims bolsters administrative and criminal enforcement of federal

[140] Also, state causes of action are less likely to alert the SEC and DOJ to enforcement opportunities. To the extent that these bodies rely on private litigation to trigger interest in civil administrative and criminal penalties, these alternative forms of enforcement may be undercut by disallowing the filing of 10b-5 non-purchaser-seller securities fraud claims.

[141] Kircher v. Putnam Trust, 403 F.3d 478, 484 (7th Cir. 2005), *rev'd on other grounds*, 126 S. Ct. 2145 (2006).

securities laws. This benefit may be illusory, however. It is entirely possible that many plaintiffs will simply not file the class actions because they are assured of being dismissed after preemption.

On the other hand, the Supreme Court approach results in the automatic dismissal of even meritorious non-purchaser-seller securities fraud class actions. When the Supreme Court heard *Blue Chip Stamps,* it specifically relied on the presence of underlying state claims as part of its public policy rationale for adopting the purchaser-seller rule.[142] Yet the Uniform Standards Act only leaves derivative causes of action untouched.[143] The Court reasoned that the overbreadth of the *Birnbaum* doctrine would be at least somewhat mitigated by state claims that could provide compensation in lieu of the federal securities laws. The Supreme Court approach, however, preempts and dismisses these state class actions for non-purchaser-sellers. Whether the *Blue Chip Stamps* Court would have upheld the purchaser-seller rule knowing that no underlying state claim could save otherwise meritorious class actions is certainly debatable.

Moreover, for decades state courts have been the exclusive province of non-purchaser-seller claims. There seems to be no express Congressional intent to overthrow that division. This Note agrees that Congress failed to pay much attention to the rule in the first place, but the record surely cannot support the suggestion that Congress intended to hale non-purchaser-seller frauds into federal court only to deny them a private remedy.[144]

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[142] Blue Chip Stamps v. Manor Drug Stores, Inc., 421 U.S. 723, 738-39 (1975).

[143] Rose, *supra* note 20, at 456.

[144] Dabit v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 395 F.3d 25, 36 (2d Cir. 2005) *rev'd*, 126 S. Ct. 1503 (2006).

> [A]ctions might be preempted for meeting all of SLUSA's requirements, including the 'in connection with' term, but not be capable of being brought under federal law for failure to meet the parallel requirement of Rule 10b-5, a

Thus, the Supreme Court approach has its own shortcomings. While it more effectively serves the anti-strike suit purposes of the Reform Act, it also appears to overreach. By going further than Congress likely intended, it eliminates the relief once afforded to non-purchaser-sellers under state law. And, most importantly, it ignores the real possibility that non-purchaser-seller claims brought under the Reform Act are more socially beneficial than costly. As such, the current approach remains a suboptimal one.

C. The Abolition Approach

	Non-Covered Class Action	Covered Class Action
Meritorious Non-Purchaser-Seller claims	(1) Federal remedy available; state causes of action usually sought	(1) Preempted; will proceed to merits
Meretricious Non-Purchaser-Seller claims	(1) Federal remedy available; state causes of action always sought	(1) Preempted; likely dismissal

Abolishing the purchaser-seller rule results in a system of securities enforcement that best reflects Congressional intent, coming closest to serving the public policy goals justifying the creation of the doctrine in the first place.

First, with regards to non-purchaser-seller, non-class actions, the effect of abolition of the *Birnbaum* doctrine should be minimal. Ultimately, most individual plaintiffs should continue to pursue state remedies because they provide a more favorable set of procedural rules than can be found under the Reform Act. The Reform Act will continue to set the bar high for non-purchaser-seller claimants; thus, the chance that more frivolous litigation will arise from the abolition of the rule is quite slim. Moreover, because non-class plaintiffs have the ability to choose whether to pursue a

result that the legislative history does not suggest Congress intended to produce in enacting SLUSA.

Id.

10(b) or 10b-5 claim and because, generally speaking, state rules of procedure continue to be more favorable to plaintiffs, it seems unlikely that any but the most convincing of cases will proceed under federal rather than state laws.[145]

Given that only the most confident non-class plaintiffs will pursue a federal remedy, the balance of policy interests for non-purchaser-seller claims clearly tips in favor of abolition. Those non-purchaser-seller claims proceeding under Rule 10b-5 will presumably involve the most egregious conduct, where the social benefits of compensation and enforcement of substantial civil liability are most likely to outweigh the expense of difficult determinations of fact. Unlike the circumstances facing the Supreme Court in *Blue Chip Stamps*, where the *Birnbaum* doctrine clearly would serve as an important prophylactic against frivolous litigation, the effect of the rule under the current securities fraud environment is only to prevent legitimate claims from being remedied under federal laws.

The case for abolition of the rule is even more compelling for class actions. First, abolition of the purchaser-seller rule immediately solves the preemption problems posed by *Dabit* and *Putnam*. Instead of choosing between an option that allows for class claims to escape to state courts (Second Circuit's *Dabit*) and an option that requires an implausible interpretation of Congressional intent (Seventh Circuit's *Putnam*), abolition of the purchaser-seller rule makes for an easy solution. The difficult policy questions may be cast aside, and courts may be permitted to focus on the more

[145] There is certainly the fear that parallel litigation, in which a single plaintiff files in state court functionally the same class claims preempted and heard under federal court, will eviscerate the benefits of the Uniform Standards Act. But, importantly, this is not a problem unique to non-purchaser-sellers, and Congress must have contemplated it in deciding to limit preemption to certain covered class actions. Moreover, parallel litigation in this regard does not create *new* costs. Discovery in these rare cases (non-class, non-purchaser-seller claims), for example, will still only occur in the state court. Discovery will not begin in the federal case until after state court discovery has provided enough material for plaintiffs to emerge successfully from the motion to dismiss and summary judgment stages of the federal case.

pertinent question regarding preemption—simply whether the fraud concerns securities transactions.

Second, meritorious class actions would now proceed under the strictures of the Reform Act. Strong non-purchaser-seller claims surviving early motions to dismiss and the stay on discovery can now be considered on the merits. These cases, which are most likely to be of greater social benefit than cost, should be given their day in court. Continued enforcement of the *Birnbaum* doctrine is no longer a benefit to the securities markets if the balance has indeed swayed; rather, it has become counterproductive.

V. PUTTING NON-PURCHASER-SELLERS IN PLAY: A GLIMPSE AT THE NEXUS APPROACH

The conclusion that the purchaser-seller rule should be abolished is an unremarkable one. It relies on two rather unspectacular propositions: first, that the language and legislative intent regarding the purchaser-seller rule is ambiguous, as admitted by the Supreme Court majority in *Blue Chip Stamps* and as evidenced by Congress's failure to meaningfully discuss the issue while drafting the Uniform Standards Act; and second, that the balance of policy interests originally considered by the *Blue Chip Stamps* Court has dramatically shifted as a result of the Reform Act and the Uniform Standard Act. Without strong statutory support for maintenance of the purchaser-seller rule, there is a compelling argument that policy reasons demand a return to the more natural reading of Section 10(b)—adopting a standard like the nexus approach proposed by Justice Blackmun in the *Blue Chip Stamps* dissent.

This does not mean to suggest that the nexus approach is without its pitfalls. Certainly, as a more flexible standard, it will require marginally greater expense of resources to be determined in the setting of each case. This should cause little worry. The reduction in costs caused by bringing these extra claims under the Reform Act rather than under state laws will more than offset the extra resources used in wielding the flexible nexus standard. And arguably, the social benefit gained by offering a forum for hearing the most

beneficial of non-purchaser-seller claims outweighs these excess costs. It seems likely that the abolition approach will result in more good than harm.

Admittedly, class certification, reliance determinations, and damages considerations will all pose significant costs to the court. Non-purchaser-seller frauds almost universally share these difficult questions of fact. But many of these costs would only arise after the stringent Reform Act guaranteed the claim's legitimacy.

Further, federal courts are not without extra tools to appropriately dispose of non-purchaser-seller claims. Equipping themselves with the rules employed by state courts dealing with non-purchaser-seller securities frauds would be step one.[146] The SEC itself has offered multiple options that the court might employ in sifting through the difficult questions of fact, including a requirement of corroborative evidence and oral testimony regarding the issue of reliance and a limitation on the vicarious liability of corporate issuers to when there has been unjust enrichment from the violation.[147]

While these adjustments would help curtail excess costs caused by non-purchaser-seller frauds, the suggestion stands absent their adoption. Here, the words of Justice Blackmun sound prophetic: "The acceptance of [the *Birnbaum* doctrine] in this case may well come back to haunt us elsewhere before long."[148] The current balance of policy interests already favors the abolition of the *Birnbaum* doctrine and the

[146] *See, e.g.*, Small v. Fritz, 65 P.3d 1255 (Cal. 2003) (employing a rigorous reliance standard that ultimately prevented the case from succeeding, despite accepting that a holding claim states a cause of action under the state's law of fraud and misrepresentation).

[147] *Blue Chip Stamps*, 421 U.S. at 738-39. Note that the *Blue Chip Stamps* Court somewhat unfairly dismissed these two options as inadequate and irrelevant. They are neither. The former significantly limits the class of non-purchaser-sellers to those who can use documentary evidence to show their proximity to the fraud. While somewhat arbitrary, it is certainly less damaging than the purchaser-seller rule itself. The latter helps to cut costs in the damages determination by, arguably, creating a cap on damages equal to the amount of unjust enrichment.

[148] *Id.* at 771 (Blackmun, J., dissenting).

adoption of a more natural reading of Section 10(b) and Rule 10b-5—the nexus approach. Careful statutory reading, legislative intent, a changed litigation environment, and uniformity all press toward the acceptance of a different interpretation of the "in connection with" language of the securities laws.