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SECOND CIRCUIT REVIEW

Expert Analysis

Statutory Standing Under §10(b) And SEC Rule 10b-5

By **Martin Flumenbaum** And **Brad S. Karp**

In *Menora Mivtachim Insurance Ltd. v. Frutarom Industries Ltd.*, the U.S. Court of Appeals for the Second Circuit considered whether, under §10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5, a putative class of investors in an acquiring company had statutory standing to sue the acquirer's target company based on alleged misstatements that the target made about itself before the merger. In a decision authored by Circuit Judge Michael Park, the court held that the putative class lacked statutory standing to sue the target company because, under Circuit precedent, investors cannot sue a company whose stock they did not purchase for misstatements the defendant company made about itself. In so holding, the Second Circuit articulated a new categorical application of the "purchaser-seller" rule, furthering a 70-year-long trend toward a narrower class of Rule 10b-5 plaintiffs. Circuit Judge William Nardini joined in the majority opinion; Circuit Judge Myrna Pérez concurred in the judgment in a separate opinion.

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Evolution of the 'Purchaser-Seller' Rule

In *Birnbaum v. Newport Steel*, 193 F.2d 461 (1952), the Second Circuit held that in a Rule 10b-5 class action, the plaintiff class may consist of only purchasers and sellers of securities. Id. at 464. The Supreme Court adopted this "purchaser-seller" rule in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), where it held that stock offerees—who did not purchase or sell the stock—lacked statutory standing to sue the offeror. In an opinion authored by Justice William Rehnquist, the Supreme Court explained that the private right of action under §10(b) was not express in the statute, but

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rather judicially implied. Absent express guidance from Congress as to the contours of that right, the court reasoned that policy considerations militated in favor of the purchaser-seller rule since it would curtail vexatious litigation, avoid the need for highly fact-specific adjudication of statutory standing, and was conducive to objective documentary proof.

The Second Circuit applied *Blue Chip Stamps* in *Ontario Public Service Employees Union Pension Trust Fund v. Nortel Networks*, 369 F.3d 27 (2004). There, JDS Uniphase Corporation had sold a business unit to Nortel in exchange for Nortel stock. Plaintiffs—JDS shareholders—sued Nortel for alleged misrepresentations that Nortel made about itself before the sale. The Second Circuit held that the plaintiffs lacked statutory standing because, under *Blue Chip Stamps*, stockholders "do not have standing to sue under §10(b) and Rule 10b-5 when the company whose stock they purchased is negatively impacted by the material misstatement of another company, whose stock they do not purchase." Id. at 34. In dicta, however, the court posited that a case involving a merger might require a "different outcome" because "a merger creates a far more significant relationship between two companies than does the sale of a business unit." Id. The court left the resolution of that issue "for another day." Id.

Factual Background In 'Frutarom'

In May 2018, International Flavors & Fragrances (IFF) announced that it would acquire Frutarom Industries Ltd., another flavoring and fragrance company. Plaintiffs—a putative class of investors who acquired IFF securities after the merger announcement—alleged that between 2002 and 2018, Frutarom executives perpetrated a bribery scheme; and that leading up to the consummation of the 2018 merger, Frutarom made materially misleading statements related to that scheme. Almost a year after the merger closed, IFF acknowledged that Frutarom had made improper payments, and IFF's share price dropped.

The decision demonstrates the Second Circuit's reluctance to expand standing where the private right of action at issue was judicially created.

Plaintiffs sued IFF, Frutarom, and officers of both entities, alleging in relevant part that Frutarom's materially misleading statements violated §10(b) and Rule 10b-5, among other securities laws.

The District Court's Ruling

In a 2021 opinion authored by Judge Naomi Buchwald, the U.S. District Court for the Southern District of New York granted the defendants' motion to dismiss for failure to state a claim. The court held that plaintiffs lacked statutory standing to sue Frutarom and its officers for statements made about Frutarom. The district court relied on a series of U.S. Supreme Court and Second Circuit cases standing for the proposition that under §10(b), a plaintiff does not have standing to sue a company for making a material misstatement when the plaintiff had purchased the securities of a company other than the one that made the misstatement. The district court reasoned that because the plaintiffs alleged misstatements by Frutarom, about Frutarom—but had purchased IFF securities, not Frutarom securities—precedent mandated dismissal.

The Second Circuit's Decision

In *Frutarom*, the Second Circuit addressed the question that *Nortel* left unanswered. First citing *Blue Chip Stamps*, the court reasoned that "judicially created private rights of action should be construed narrowly." 49 F.4th 790, 794 (2022). The court then rejected the plaintiffs' proposed test—which would have held that a sufficiently "direct relationship" between the target company's misstatements and the acquiring company's share price could confer standing—because it would have implicated the highly fact-specific inquiry against which *Blue Chip Stamps* had cautioned.

The court then turned to *Nortel*'s observation that statutory standing in the event of a merger might require a different analysis. Stressing that *Nortel*'s observation was dicta, the court expressly answered the question raised therein and held that purchasers of an acquiring company's securities lacked standing under §10(b) to sue the target company for that company's alleged pre-merger misstatements about itself. According to the court, the dispositive question was "whether the plaintiff bought or sold shares of the company about which the misstatements were made." Id. at 796. Notwithstanding that this case involved a merger instead of the sale of a business unit as in *Nortel*, plaintiffs lacked standing because they did not purchase shares of Frutarom, the entity about which the misstatements were made.

In a separate opinion concurring in the judgment, Judge Pérez wrote that a straightforward application of *Nortel* to the facts of this case justified dismissal, but that the majority went too far in creating a new categorical rule for mergers. Judge Pérez reasoned that, like the misrepresentations in *Nortel*, Frutarom's alleged misrepresentations had only a remote relationship to the plaintiffs' purchase of IFF stock, and that plaintiffs had failed to demonstrate how the simple fact that the IFF-Frutarom transaction was a merger should change the outcome.

Judge Pérez criticized the majority's holding as "an example of judicial policymaking." Id. at 801. Open acknowledgement of the "value judgments" motivating the court's decision, Judge Pérez opined, would benefit lawmakers and the public. Id. at 802. Judge Pérez indicated that by categorically excluding certain plaintiffs—some of whom may well have been damaged—the majority had struck the wrong balance.

Conclusion

In the absence of any express guidance from Congress, the Second Circuit has announced a new categorical application of the purchaser-seller rule that further narrows the class of plaintiffs cognizable under §10(b) and Rule 10b-5. The decision demonstrates the Second Circuit's reluctance to expand standing where the private right of action at issue was judicially created. As Judge Pérez observed, it is now up to Congress to either ratify the holding or amend the Exchange Act to expand standing to include those in similar circumstances to the *Frutarom* plaintiffs.