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IS A SELLER’S RULE 10b-5 CAUSE OF ACTION AUTOMATICALLY TRANSFERRED TO THE BUYER?

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INTRODUCTION

Suppose a securities buyer has a private cause of action under rule 10b-5 against someone who perpetrated a fraud relating to the purchase. Further assume that the buyer subsequently sells the security involved. A question arises as to whether the claim is automatically transferred to the new owner of the security. In other words, does the rule 10b-5 claim follow the security?

The issue of automatic assignment is less important in face-to-face transactions than in anonymous stock market trades. With face-to-face transactions, the parties can expressly provide for assignment or non-assignment. With anonymous stock market trades,

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2 For authority that section 10(b) or rule 10b-5 claims can be expressly assigned, see Lowry v. Baltimore & O.R.R., 707 F.2d 721, 739-40 (3d Cir.) (Gibbons, J., dissenting) (“The first question is whether section 10(b) claims are assignable at all. It has been held repeatedly that they are.”), petition for modification denied, 711 F.2d 1207 (3d Cir.), cert. denied, 464 U.S. 893 (1983); id. at 746 (Seitz, C.J., and Becker, J., concurring in part and dissenting in part) (“[T]he section 10(b) claim is [expressly] assignable as a matter of federal law, and both relevant case law and commentary indicate that this is so.”); Gardner v. Surnamer, 608 F. Supp. 1385, 1390 (E.D. Pa. 1985) (relying on Lowry); International Ladies’ Garment Workers’ Union v. Shields & Co., 209 F. Supp. 145, 149-50 (S.D.N.Y. 1962). See also Note, Express Versus Automatic Assignment of Section 10(b) Causes of Action, 1985 Duke L.J. 813, 818.

Lowry was decided by eight judges of the Third Circuit sitting en banc. Three judges held that an assignment of a section 10(b) and rule 10b-5 claim occurred auto-
on the other hand, the issue of automatic assignment is more important, because the parties cannot easily contract out of any rule. Whether a rule 10b-5 claim should be automatically transferred depends on whether the assignment will create an unfair windfall for the new owner. The existence of any windfall is determined in turn by whether the price paid by the new owner reflects the corrective disclosure, if any, or the possibility of a lawsuit by the new owner against the alleged defrauder, or both.

This article makes several recommendations as to the law of automatic assignment. First, federal, not state law, should govern automatic assignment of rule 10b-5 claims. Second, a distinction should be made between new owners who buy before corrective disclosure and those who buy after disclosure. In the first case, a rule of automatic assignment is appropriate. When the new owner purchases after disclosure, a secondary distinction should be made between the unusual situation when all the holders of a class of securities can sue at the time of the fraud (and, consequently, at disclosure), and the typical situation when only some of the holders can sue at the time of the fraud (and, consequently, at the time of the disclosure). In the former situation, automatic assignment is appropriate; in the latter, it is not.

matically upon sale of a security. Lowry, 707 F.2d at 739-43 (Gibbons, J., dissenting); id. at 746-47 (Seitz, C.J., and Becker, J., concurring in part and dissenting in part); id. at 723 (per curiam). Three judges concluded that an assignment of such a claim must be express. Id. at 724, 729 (Garth, J. and Sloviter, J., concurring in the judgment); id. at 723 (per curiam)("Three... judges... conclude that the rights... are assignable only if there is an express provision to that effect."). Therefore, a majority of the eight judges in Lowry would allow an express assignment of a section 10(b) or rule 10b-5 claim. See Gardner, 608 F. Supp. at 1390 ("In the present case... an express assignment took place...[T]he Lowry majority would presumably find a valid assignment of... rights under § 10(b) and Rule 10b-5... "). For additional discussion of Lowry, see notes 30-39 infra and accompanying text.

For opinions upholding an express assignment of a federal antitrust claim under federal law, see Martin v. Morgan Drive Away, Inc., 665 F.2d 598, 603-04 & n.3 (5th Cir.), cert. dismissed, 458 U.S. 1122 (1982); id. at 603 n.3 ("It is well settled in the federal courts that antitrust claims are [expressly] assignable") (citations omitted); Sampiner v. Motion Picture Patents Co., 255 Fed. 2d 242, 245 (2d Cir. 1918), rev'd on other grounds, 254 U.S. 233 (1920); Health Care Equalization Comm. of the Iowa Chiropractic Soc. v. Iowa Medical Soc., 501 F. Supp. 970, 977-78 (S.D. Iowa 1980); id. at 977 ("The Court is confident that at this time treble damages claims are [expressly] assignable") (citations omitted); Fischer Bros. Aviation v. NWA, Inc., 117 F.R.D. 144, 146 (D. Minn. 1987) ("As a matter of federal law, assuming a valid assignment, an antitrust claim may be assigned"). Fischer Bros. Aviation also held that the assignment was valid under state law. Id. at 146-47.
I. LAW GOVERNING AUTOMATIC ASSIGNMENT OF RULE 10b-5 CLAIMS

The Securities Exchange Act of 1934 (the "Securities Exchange Act") contains no provision governing the automatic assignment of federal securities law claims. For at least two reasons, however, some judges and commentators have concluded that federal law, not state law, should govern the automatic assignment of such claims. First, remedies for violations of federal law should be uniform across the nation. Second, automatic assignment has strong policy implications. Indeed, in 1985 the Ninth Circuit stated: "[F]ederal law has been relied upon by all of the federal district courts which have considered the possibility of an automatic transfer of a cause of action under securities law." Although some other circuit judges have

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4 Lowry, 707 F.2d at 738-39 (Garth, J., joined by Sloviter, J., concurring).
5 Id. at 727-28; id. at 732 (Adams, J., concurring in the judgment) ("For the reasons advanced by Judge Garth, I agree that federal law governs the assignability of causes of action arising under the federal securities laws . . . .").
6 See In re Nucorp Energy Sec. Litig., 772 F.2d 1486, 1489 (9th Cir. 1985) ("Because of the case law and the strong federal policies surrounding assignment of a federal securities claim, we hold that federal law governs the assignment of claims under the Trust Indenture Act."); In re Saxon Sec. Litig., 644 F. Supp. 465, 474 n.16 (S.D.N.Y. 1985) ("[F]ederal law dictates the rule of law to be applied to federal rights. The state statutes have no applicability [to the issue of automatic assignment of rule 10b-5 claims]."); Gardner, 608 F. Supp. at 1390 ("[I]n satisfaction that in order to best effectuate the policies behind the federal securities laws I should look to principles of federal law [to determine whether section 10(b) rights are assignable]."); see also 3 L. Loss, Securities Regulation 1817 (2d ed. 1961); cf. id. at 739 (Gibbons, J., dissenting) (assignability of a section 10(b) claim is "undoubtedly a federal law question.").
7 Nucorp, 772 F.2d at 1489. See also Puma v. Marriott, 294 F. Supp. 1116, 1119 (D. Del. 1969) ("It is well established that, in the absence of a statutory pronouncement regarding the survivability [after death] of an action [under the federal securities laws], the federal common law will be applied."); accord Wogahn v. Stevens, 294 N.W. 503, 505 (Wis. 1940). See generally Annotation, Assignability or Survivability of Cause of Action to Enforce Civil Liability Under Securities Acts, 133 A.L.R. 1038 (1941). In Western Auto Supply v. Gamble-Skogmo, 348 F.2d 736, 739-41 (8th Cir. 1965), cert. denied, 382 U.S. 987 (1966), a case dealing with the express assignability of a cause of action under section 16(b) of the Securities Exchange Act, the court viewed assignability and survivability as analogous and commented: "[R]esign of a cause of action as of a nature and substance which has traditionally survived." Id. at 740.

After stating that federal law has been relied on by all the district courts dealing with automatic assignment of federal securities law claims, the Nucorp court cited Rose v. Arkansas Valley Envtl. & Util. Auth., 562 F. Supp. 1180, 1188-89 (W.D. Mo. 1983); Independent Investor Protective League v. Saunders, 64 F.R.D. 564, 572 (E.D. Pa. 1974); International Ladies' Garment Workers' Union v. Shields & Co., 209 F.
assumed that the question is still open, federal law, and not state law, should govern the automatic assignment of a rule 10b-5 claim.


When discussing the automatic assignment of section 10(b) claims, a more recent district court opinion cited only federal decisions and apparently assumed that federal law governed. Soderberg v. Gens, 652 F. Supp. 560, 563-64 (N.D. Ill. 1987). The court also apparently assumed that federal law governs the express assignability of the right to sue for rescission under federal securities law: “We have no reason to think that federal securities fraud actions should be an exception to that general rule [excluding express assignment of the right to sue for rescission].” Id. at 565. For additional discussion of Soderberg, see infra notes 46-48 and accompanying text.

Cf. Phelan v. Middle States Oil Corp., 154 F.2d 978, 999-1001 (2d Cir. 1946)(plaintiff bought bonds after alleged wrong by bankruptcy receiver appointed by federal court; federal law, not state law, governs the issue of whether selling bondholders’ claim against a federal court appointee was automatically assigned to buyer). For discussion of Phelan, see infra notes 20-21 and accompanying text.

* In his dissent in Lowry, 707 F.2d at 740, Judge Gibbons wrote, “There is certainly no clear consensus that federal law decides the fact of assignment of interests created by federal law. Indeed the general rule has long been assumed to be otherwise.” (citations omitted). In the same case, Chief Judge Seitz, joined by Judge Becker, stated in a concurring and dissenting opinion: “I would save for a subsequent case the question whether assignment of federal securities claims is controlled by federal or state law.” Id. at 747 (dissenting portion).

* If state law did govern the issue, automatic assignment might result from section 8-301(1) of the Uniform Commercial Code, which provides: “Upon transfer of a security to a purchaser . . . the purchaser acquires the rights in the security which his transferor had or had actual authority to convey . . . .” See Lowry, 707 F.2d at 742 (Gibbons, J., dissenting); id. at 747 (Seitz, C.J., joined by Becker, J., concurring in part and dissenting in part).

The district court in Lowry, however, rejected the argument that U.C.C. § 8-301 leads to automatic assignment and held that under New York law, despite New York’s adoption of section 8-301, state law claims are not automatically transferred when the underlying security is sold. See Lowry v. Baltimore & O.R.R., 629 F. Supp. 532 (W.D. Pa. 1986). The district court in In re Nucorp Energy Sec. Litig., [1983-84] Fed. Sec. L. Rep. (CCH) ¶ 99,577 (S.D. Cal. 1983), aff’d, 772 F.2d 1486 (9th Cir. 1985), came to the same conclusion. See also In re Saxon Sec. Litig., 644 F. Supp. 465, 474 n.16 (S.D.N.Y. 1985)(section 8-301 “applies to the contract rights in the security and cannot be read to have any relevance to claims of fraudulent inducement to purchase [or their assignment]”). The district court in Lowry and both of the Nucorp decisions relied on Licht v. Donaldson, LuFkin & Jenrette Sec. Corp., No. 24560/82 (S. Ct. N.Y. County, Sept. 1, 1983), aff’d mem., 100 A.D.2d 987, 474 N.Y.S.2d 1004, appeal denied, 63 N.Y.2d 608, 472 N.E.2d 1044 (1984), which held that state law claims were not automatically transferred when the underlying security was sold.
Unfortunately, the federal law on automatic assignment of rule 10b-5 claims is unclear. The discussion below argues what the law should be and analyzes the federal case law.

II. PRE-DISCLOSURE PURCHASE AND AUTOMATIC ASSIGNMENT

A crucial distinction should be whether the new owner bought before or bought after disclosure of the fraud. A new owner who

For a general discussion of the assignment of causes of action at state common law, see Phelan, 154 F.2d at 1000 (“In several . . . jurisdictions it has been held that a right of action for a tort to property . . . including a tort resulting from fraud . . . passes with the sale of the property . . . . These decisions are at odds with the apparent rationale of the New York decisions announcing the New York rule, i.e., that a mere assignment of a contract usually does not carry with it a claim for a breach occurring before the assignment . . . . We have found no other jurisdiction in which that doctrine prevails . . . .”); Note, supra note 2, at 815-21.

Conceivably, a defendant might argue that even if the assignment of a rule 10b-5 claim is valid under federal law, the assignment offends the state law against champerty. At least one court has been willing to entertain this argument against an express assignment of a rule 10b-5 claim. After adopting and applying the state law of Pennsylvania, however, the court concluded that the express assignment was not champertous. One element of champerty is that the assignee have no legitimate interest in the litigation. That element was lacking because the assignees were a general partner and a limited partner of the assignor, which was a limited partnership. Gardiner v. Surnamer, 608 F. Supp. 1385, 1390 (E.D. Pa. 1985).

In Lowry, the parties agreed that if federal law governs the issue of automatic assignment of a rule 10b-5 claim, the federal law will adopt and apply state law to determine whether the assignment of the federal claim is champertous. See Lowry, 707 F.2d at 747 (Seitz, C.J., and Becker, J., concurring in part and dissenting in part). Two judges of the Lowry court mentioned this view of the law and did not disagree. See id. (citing Martin v. Morgan Drive Away, Inc., 665 F.2d 598, 604-05 (5th Cir.), cert. dismissed, 458 U.S. 1122 (1982)). Martin held that, as a matter of federal law, courts should look to state law to determine whether an express assignment of a federal antitrust claim is champertous. After looking to the law of Louisiana, the court concluded that the express assignment was not champertous because Louisiana prohibits only purchases of claims by “officers of the court.” Martin also concluded that the express assignment was not champertous under general common law principles because the assignment was for a bona fide, substantial consideration and because the assignee apparently had an interest in the litigation. Martin, 665 F.2d at 604-05 & n.6.

If federal law provides for automatic assignment of a rule 10b-5 claim from seller to buyer of a security, federal policy should override state champerty law. Furthermore, the state law policy against champerty relates to purchases of causes of action. This state law policy should not apply to an automatic assignment from a seller to a buyer of a security. In such a transaction, the buyer normally will be interested primarily in the security and not the associated lawsuit.

10 See Saxon, 644 F. Supp. at 473 (distinguishing between purchasers who bought without knowledge of the fraud and those who bought after public disclosure of the
bought before corrective disclosure should be allowed to pursue the seller's claim. Two transactions are involved: the original purchase and the subsequent sale by the innocent buyer to another investor. At the time of both transactions, the securities price reflected the fraud — either overly optimistic misrepresentation or non-disclosure of adverse information. In other words, the price was too high. The original purchaser, who avoided injury, has passed the harm to the fraud); *Gardner*, 608 F. Supp. at 1394 n.8 (distinguishing the *Lowry* plaintiffs because they had purchased after the fraud became public, while in *Gardner* the new owner bought without knowledge of the fraud). For additional discussion of *Saxon*, see infra notes 54-64 and accompanying text. For a discussion of *Lowry*, see infra notes 50-59 and accompanying text.

11 "[I]f a buyer of securities purchases securities which are inflated in price because of fraud and sells those securities later at a price which is still inflated by the same fraud, he or she has suffered no actual damages all other things being equal." *Gardner*, 608 F. Supp. at 1388. *See also* *Beissinger* v. *Rockwood Computer Corp.*, 529 F. Supp. 770, 788-89 (E.D. Pa. 1981)("Those members of the class who both purchased and sold during the class period suffered no loss as a consequence of defendants' alleged illegal activities. This conclusion follows from the fact that such purchases and re-sales would have both occurred at prices allegedly inflated by false statements and omissions . . . ") (emphais in original)(footnotes omitted).

In another case, where the plaintiff was a market-maker in options on Texasgulf stock, the defendants allegedly did not reveal negotiations which resulted in a tender offer for Texasgulf stock. By the time of the public announcement of the tender offer, the plaintiff had accumulated a net gain in inventory, and therefore incurred no compensable damages. *Etshokin* v. *Texasgulf*, 612 F. Supp. 1220, 1231-34 (N.D. Ill. 1985). In a class action against an issuer for concealing material information about its potential tax liability, the proposed class representative sold more stock during the proposed class period at an allegedly inflated price than he bought. Because his proceeds from sales of stock during the period exceeded his expenditures, the court held that he lacked the typicality of a class representative. *Katz* v. *Comdisco*, Inc., 117 F.R.D. 403, 407-08 (N.D. Ill. 1987).

In *Wool* v. *Tandem Computers*, 818 F.2d 1433 (9th Cir. 1987), however, the plaintiff bought after the issuer's alleged misrepresentations about earnings and sold before corrective disclosure. The court noted that under some circumstances such a plaintiff can still suffer harm. For example, between the purchase and the sale (a) the issuer may make a disclosure which partially mitigates the effect of the misrepresentation, (b) third parties may predict lower earnings for the issuer, or (c) independent events may reduce the value of the misrepresented news. *Id.* at 1437-38. *See also* *Green* v. *Occidental Petroleum Corp.*, 541 F.2d 1335, 1345-46 (9th Cir. 1976)(Sneed, J., concurring)(Independent events may affect the value of misrepresented news, e.g. the value of a fabricated oil discovery might be affected by a general rise or general decline in the price of oil); *Blackie* v. *Barrack*, 524 F.2d 891, 908-09 (9th Cir. 1976)("If the stock is resold at an inflated price, the purchaser-seller's damages . . . must be diminished by the inflation he recovers from this purchaser. Thus, he is interested in proving that some intervening event, such as a corrective release, had diminished the inflation persisting in the stock price when he sold.") (footnote omitted), *cert. denied*, 429 U.S. 816 (1976). For a discussion of *Tandem*, see *Brodsky*, *Damages Under the Securities Laws*, N.Y.L.J., Jan. 6, 1988, at 1, col. 1.
new owner, who holds the security when disclosure causes a fall in price. As between the unharmed original purchaser and the injured new owner, the latter is obviously the more appropriate plaintiff.\footnote{12}

One possible problem with a rule of automatic assignment is a plaintiff/buyer's ability to identify the seller after an anonymous transaction on the securities market. If, at the time of the fraud, all of the holders of a class of security can sue,\footnote{13} such tracing is unnecessary. All sellers have a cause of action to be automatically assigned. Usually, however, only some of the holders of a class of security at the time of the fraud can sue.\footnote{14} In that situation, a plaintiff/buyer would have to discover the seller, and indeed may even be forced to trace a chain of transactions back to a buyer with standing to sue at the time of the fraud.

Although stock market traders may not know the party on the other side of the transaction \textit{in advance}, tracing that party's identity \textit{after} the transaction is not as difficult as many commentators believe.\footnote{15} Even if tracing proves difficult, it is nevertheless appropriate to have a rule of automatic assignment for transactions before corrective disclosure. Without such a rule, the right to sue would remain with the seller, who has avoided injury.

In \textit{Gardner v. Surname},\footnote{16} a district court squarely confronted the issue of the automatic assignment of a rule 10b-5 claim to a new owner who purchased before discovery of the fraud. Although the court could locate no cases directly on point, it held that the new

\textit{The first two situations mentioned in Tandem actually involve a sale after a kind of corrective disclosure (although the corrective disclosure is only partial and may be by a third party). The last situation mentioned in Tandem is extremely rare, and recognizing it would involve difficult problems of proof. In any event, even in that rare situation, the original purchaser would pass most of the harm on to the new owner.}

\footnote{12} In \textit{Saxon}, the plaintiffs cited \textit{Phelan v. Middle States Oil Corp.}, 154 F.2d 978 (2d Cir. 1946) in support of their argument that rule 10b-5 rights are automatically assigned. The \textit{Saxon} opinion noted that \textit{Phelan} assumed that the purchasers bought without knowledge of the fraud, and distinguished \textit{Phelan} because the transferee in that case "actually suffered an injury." The \textit{Saxon} plaintiffs, on the other hand, "acquired their bonds at a fraction of their pre[bankruptcy]-petition price after public disclosure of the alleged frauds." \textit{Saxon}, 644 F. Supp. at 473. \textit{See also Note, supra note 2, at 827 n.91 ("Perhaps, in such a case [fraud unknown to the public], a rule of automatic assignment would better effect congressional intent.")}.

\footnote{13} \textit{See infra} note 29 and accompanying text.

\footnote{14} \textit{See infra} notes 27-28 and accompanying text.

\footnote{15} \textit{See Wang, The "Contemporaneous" Traders Who Can Sue an Inside Trader, 38 Hastings L.J. 1175, 1179 n.20 (1987).}

owner automatically acquired the seller’s claim: 17

There are compelling policy arguments in favor of this conclusion. If a subsequent buyer could not bring suit against a fraudulent seller “once removed” for damages suffered as a result of that fraud, the remedial purposes of the act would be compromised . . . . Fraudulent sellers could insulate themselves from liability by concealing a fraud and then ensuring that the purchasers transferred the securities to another party. 18

Another opinion mentioned a different argument in favor of automatic assignment when a security is sold before disclosure of the fraud:

[I]nvestors . . . [who] sell their securities before any fraud or deception is discovered . . . . have little incentive to keep abreast of developments . . . and thus may never learn of any fraud or deceit. Assignment of a 10(b) claim places the claim with the person most likely to learn of its existence, thus increasing the remedial purposes of the statute and furthering its deterrence goals. 19

When a security is sold prior to corrective disclosure, the seller is probably unaware of the cause of action. This fact supports two opposing arguments. A defendant may argue that the seller (the original purchaser) cannot have intended to assign a cause of action of which he was unaware. The plaintiff/buyer’s more persuasive counter-argument is that the seller cannot have intended to retain a cause of action of which he was unaware. In Phelan v. Middle

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17 Id. at 1393-94.
18 Id. at 1394. Cf. Texas Continental Life Ins. Co. v. Dunne, 307 F.2d 242, 249 (6th Cir. 1962), where the court stated “It was not necessary that there be privity between plaintiff and the defendants in the sale of the bonds . . . . If this were not so the issuers and brokers could easily evade liability under the law because it is well known that the original purchasers of the securities do not always retain them as permanent investments and that the public trades in securities.”

Another case apparently involved the right of new owners of securities to sue a defendant under rule 10b-5 for fraud perpetrated on previous owners. Mallis v. Federal Deposit Ins. Corp., 568 F.2d 824 (2d Cir. 1977), cert. dismissed sub nom. Bankers Trust Co. v. Mallis, 435 U.S. 381 (1978). The defendant had apparently made the misrepresentation to the previous owners and not to the new owners, who bought the securities before the fraud was discovered. The Second Circuit held that, as pledgees of the previous owners, the new owners were “purchasers” and allowed the action to proceed. Id. at 828-30. If the defendant had in fact made no misrepresentation to the new owners, the court may have assumed that the previous owners’ rule 10b-5 claims were automatically assigned to the new owners. Unfortunately, the court failed to address the issue of assignment.

19 Lowry, 707 F.2d at 746 (Seitz, C.J., joined by Becker, J., concurring in part and dissenting in part).
States Oil Corp., which was a suit against a federal bankruptcy receiver for breach of fiduciary duty, one issue was whether a buyer of bonds automatically acquired the seller's cause of action against the receiver. The Second Circuit held that the cause of action was automatically assigned. The court assumed that the seller did not know of the cause of the action: "The seller of such bonds — ex hypothesi unaware, at the time of the sale, of the wrong done by the trustee — in actual fact can have no notion of retaining any cause of action against the trustee." In a case involving the automatic assignment of rule 10b-5 claims, a district court distinguished Phelan as "clearly [resting] . . . on the assumption that the purchasers bought without knowledge of the fraud."

In summary, the original buyer avoids injury by selling to a new owner before corrective disclosure. Therefore, the new owner should be able to sue the fraud-perpetrator under rule 10b-5. This conclusion is compelled both by logic and precedent.

III. POST-DISCLOSURE PURCHASE AND AUTOMATIC ASSIGNMENT

A different analysis applies to automatic assignment of a rule 10b-5 claim when a new owner buys after corrective disclosure. Because of the lower price, the seller, not the new owner, is harmed by the fraud. In such a situation, automatic assignment may result in an unfair windfall to the buyer and an inequitable loss of rights on the seller's part. Nevertheless, a distinction should be drawn between the situations where, at the time of the fraud (and consequently, at corrective disclosure), (1) all the holders of a particular class of security can sue under rule 10b-5, and (2) only some of the holders can sue. Unfortunately, the importance of this distinction has not yet been recognized by the courts.

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20 154 F.2d 978 (2d Cir. 1946).
21 Id. at 1001. Another reason for the decision was that "the seller of a bearer bond is exceedingly hard to trace. The practical consequence of the [rule against automatic assignment] therefore is that most of the claims against a trustee for wrong done, especially to holders of bearer bonds, will never be prosecuted . . . ." Id.
22 Saxon, 644 F. Supp. at 473. For additional discussion of Saxon, see infra notes 54-64 and accompanying text.
A. Situations in Which, At The Time of the Fraud (And, Consequently, at Disclosure), All Holders of a Class of Securities Can Sue

After corrective disclosure, a strong argument for automatic assignment exists when, at the time of the fraud, all the holders of a particular class of securities could sue under rule 10b-5. As argued earlier, if one of these holders sold between the time of the fraud and corrective disclosure, the claim should automatically have been transferred to the new owner. Thus, at the time of corrective disclosure, all holders should have a rule 10b-5 claim.

When corrective disclosure occurs, the investing public becomes aware of the possibility of a rule 10b-5 lawsuit. Because all holders can sue, a rule of automatic assignment would augment the price of the security by the expected value of any recovery. The fraud victim who sells his shares does so at an enhanced price. The subsequent purchaser is not unjustly enriched. In the words of one circuit judge: "[There will be one] holder of a security who wants, and perhaps even needs, to sell it. Some investors can afford to speculate on the incremental market value which may be added to a security as a result of litigation, and can even afford to finance such litigation."

Even with a rule of automatic assignment of rule 10b-5 claims prior to corrective disclosure, all holders of a class of security will be able to sue at disclosure only if all holders at the time of the fraud could sue. Rarely will that condition be satisfied, especially in light

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23 See supra notes 10-12 and accompanying text.

24 Because all holders have claims, the new owner would not need to trace the identity of the seller. See supra text accompanying note 13.

25 Cf. Flamm v. Eberstadt, 814 F.2d 1169, 1177 (7th Cir. 1987)("Even the unlucky investors . . . who sell their stock in a particular firm too soon [before the announcement of a bid by a "white knight"] can take comfort in knowing that they do not lose the whole gain. To the extent that appearance of White Knights is predictable, the probability of a White Knight appearing in this contest will be reflected in the price of the stock."). For a discussion of the expected value of a derivative suit, see Joy v. North, 692 F.2d 880, 892 (2d Cir. 1982), cert. denied, 460 U.S. 1051 (1983).

Many academics accept the semi-strong form of the efficient market hypothesis. Under this theory, stock prices "fully reflect" all publicly available information. See Wang, Some Arguments That the Stock Market is Not Efficient, 19 U.C. DAVIS L. REV. 341, 341-44 (1986). Compare Gordon & Kornhauser, Efficient Markets, Costly Information, and Securities Research, 60 N.Y.U. L. REV. 761 (1985)(questioning the efficient market hypothesis) and Wang, supra, at 349-94 (noting theoretical problems with the efficient market hypothesis and discussing studies and phenomena contradicting the hypothesis).

26 Lowry, 707 F.2d at 741 (Gibbons, J., dissenting).
of *Blue Chip Stamps v. Manor Drug Stores,*\(^2^7\) which restricted standing in rule 10b-5 damage suits to purchasers, sellers, and those with contracts to purchase or sell.\(^2^8\) One rare example when all the holders would be able to sue is if there is fraud in the initial offering of a class of securities.\(^2^9\) Another instance might be if an issuer deprives holders of convertible securities of information which would induce all of them to convert (assuming that the issuer has a duty to disclose and that the conversion option is a contract to buy meeting the *Blue Chip* standing requirement). These two examples are the fact situations of two federal appellate opinions and one district court opinion dealing with automatic assignment of claims under federal securities law. The opinions in these three cases do not distinguish between situations in which all holders can sue and those in which only some can sue.

*Lowry v. Baltimore & Ohio Railroad Co.*\(^3^0\) involved automatic assignment from holders of convertible securities who were defrauded into not converting. Despite the appropriateness of automatic assignment even after corrective disclosure, the Third Circuit *en banc* panel was divided on the issue. The case arose when Baltimore & Ohio declared an in-kind dividend in favor of the common shareholders. The dividend took the form of stock in a subsidiary corporation. No notice was given to the holders of Baltimore & Ohio's convertible debentures. If these holders had converted prior to the declaration of the dividend, they would have been better off. In an earlier case arising from the same conduct,\(^3^1\) the Third Circuit had held that Baltimore & Ohio had a duty under rule 10b-17\(^3^2\) to provide debenture holders with advance notice of such a dividend dec-

\(^2^7\) 421 U.S. 723 (1975).

\(^2^8\) Id. For a general discussion of this *Blue Chip* standing requirement, see T. Hazen, *The Law of Securities Regulation* 450-57 (1985).

\(^2^9\) For an example of such a fact situation, see *In re Nucorp Sec. Litig.*, 772 F.2d 1486 (9th Cir. 1985), which is discussed *infra* at notes 40-45.

\(^3^0\) 707 F.2d 721 (3d Cir.) (*en banc*), *petition for modification denied*, 711 F.2d 1207 (3d Cir.), *cert. denied*, 464 U.S. 893 (1983).


\(^3^2\) The rule provides, in part:

It shall constitute a "manipulative or deceptive device or contrivance" as used in section 10(b) of the Act for any issuer of a class of securities publicly traded . . . to fail to give notice in accordance with paragraph (b) of this section of the following actions relating to such class of securities: (I) a dividend or other distribution in cash or in kind . . . .

Securities Exchange Act rule 10b-17(a), 17 C.F.R. § 240.10b-17(a) (1987).
laration so that they could exercise their right to convert. Failure to give notice as required by rule 10b-17 gave rise to a violation of rule 10b-5.

Lowry was a class action by purchasers who bought convertible debentures after the declaration of the dividend. These purchasers claimed that although they had full knowledge of the dividend, the sellers automatically transferred their rule 10b-5 claims as a result of the sale of the debentures.

Of the eight judges who heard the case, two believed that Baltimore & Ohio had no duty under federal law to provide advance notice, and did not reach the issue of assignment because they felt that there were no claims to assign. Three judges held that the rule 10b-5 claim was assignable only by express provision. Because of the lack of an express assignment, their opinion was that the claim was not transferred. The other three judges held that the claim was automatically assigned upon sale of the debentures. Although the plaintiffs lost five to three, the six judges who considered the issue of automatic assignment split evenly. Thus, the diverse opinions do not resolve the issue, even in the Third Circuit.

33 Judge Gibbons found a number of sources for the duty to provide notice. Pittsburgh Terminal, 680 F.2d at 940-42. Nevertheless, Judge Garth's concurrence based the duty of notice solely on rule 10b-17. Id. at 943-44 (Garth, J., concurring). See Lowry, 707 F.2d at 723 n.1 (per curiam). Judge Adams dissented in Pittsburgh Terminal.

34 Pittsburgh Terminal, 680 F.2d at 941-42 (Gibbons, J., announcing the judgment of the court); id. at 943-45 (Garth, J., concurring). In the opinion announcing the judgment of the court, Judge Gibbons held that because the holders of the convertible debentures had a contract to buy the underlying common, they met the Blue Chip standing requirement. Id. at 939-40.

35 Lowry, 707 F.2d at 722 (per curiam).

36 Id. at 732-34 (Aldisert, J., joined by Hunter, J., concurring in part and dissenting in part). For a summary of the divergent opinions in the case, see id. at 723 (per curiam); Note, supra note 2, at 815.

37 Lowry, 707 F.2d at 729-30 (Garth, J., joined by Sloviter, J., concurring); id. at 732 (Adams, J., concurring). For related discussion, see supra note 2.

38 Id. at 739-41 (Gibbons, J., dissenting); id. at 746-47 (Seitz, C.J., joined by Becker, J., concurring in part and dissenting in part). For related discussion, see supra note 2.

39 To recapitulate, a five-judge majority of the panel affirmed the district court's dismissal of the plaintiffs' federal claims. Three judges felt that the federal claims were not automatically assigned to the plaintiffs, and two judges felt that there were no federal claims to assign. Judge Gibbons, dissenting, excoriated the court's opinion: "[The] judgment . . . has accomplished nothing except to bring . . . appellate process into disrepute [and] . . . is a disgrace to the judicial process." Lowry, 707 F.2d at 739, 743. See also In re Saxon Sec. Litig., 644 F. Supp. 465, 471 n.12 (S.D.N.Y. 1985)("The five opinions [in Lowry] reach a clear holding on no single issue.").

After Lowry, the court in Pittsburgh Terminal Corp. v. Baltimore & O.R.R., 586 F.
In re Nucorp Energy Securities Litigation, the other circuit court decision, involved not rule 10b-5 but the Trust Indenture Act of 1939. The Trust Indenture Act provides a federal cause of action for those who rely on omissions (or misleading statements) when buying securities issued under an indenture. The alleged fraud involved Nucorp Energy convertible debentures offered on October 1, 1981. Because that was the initial public offering of the debentures, the alleged fraud gave a cause of action to all the initial buyers of the debentures.

A three-judge panel of the Ninth Circuit unanimously held that when a security is sold, federal law governs the automatic assignment of Trust Indenture Act claims to the buyer. The court then held that when a security is sold after corrective disclosure, the seller's Trust Indenture Act claim is not automatically assigned to subsequent purchasers:

The statute provides nothing for subsequent purchasers to whom no misrepresentations were made directly or indirectly and to whom no statutorily provided cause of action was expressly assigned. We find no more reason to provide a remedy to these subsequent purchasers than we could find to provide a remedy for individuals who had purchased stock directly from an issuer before a misleading disclosure is made.

A cause of action arising from reliance on misrepresentation is personal to those persons who relied; it does not follow the security to remote purchasers who had no basis for reliance. If we held otherwise, we would remove the remedy from those to whom the statute provides it, i.e., those who were defrauded, by gratuitously giving it to


772 F.2d 1486 (9th Cir. 1985).
See Nucorp, 772 F.2d at 1489-90.
See id. at 1488.
Id. at 1489.
those who were not defrauded and have suffered no injury under the securities law.\textsuperscript{45}

The Ninth Circuit's broad rationale should apply equally to rule 10b-5 claims.

In \textit{Soderberg v. Gens},\textsuperscript{46} the Constitutional Casualty Co. was allegedly defrauded into buying all the initial stock of several companies which were created specifically for the purpose of purchase by Constitutional.\textsuperscript{47} After the disclosure of the alleged fraud, Constitutional sold all the stock in question to the plaintiff and expressly assigned to the plaintiff all causes of action arising out of Constitutional's negotiation and purchase of the stock. The plaintiff then sued the original sellers for rescission of the original purchases based on alleged violations of section 10(b), other provisions of the federal securities law, and state law. The court dealt first with the issue of whether federal causes of action are automatically assigned to a purchaser. The court ruled against automatic assignment and stated: "Recent case law interpreting § 10(b) is virtually unanimous in concluding that the federal cause of action does not attach automatically to the security itself and pass to the next purchaser."\textsuperscript{48}

\textit{Lowry, Nucorp} and \textit{Soderberg} all involved the rare situation where, at the time of the fraud, all of the holders of a class of security can sue. This is a situation in which a rule of automatic assignment of the claim has a strong appeal even when the new owner buys after corrective disclosure.\textsuperscript{49} Nevertheless, the \textit{Lowry} opinions evenly divided on the issue of automatic assignment, the \textit{Nucorp} court unanimously rejected it, and the district court in \textit{Soderberg} also ruled that automatic assignment never occurs.

\section*{B. Situations in Which, At the Time of the Fraud (And, Consequently, at Disclosure), Only Some of the Holders of a Class of Securities Can Sue}

Typically, at the time of the rule 10b-5 violation, only some holders of the class of securities — those plaintiffs who bought or sold — can sue for damages.\textsuperscript{50} Therefore, even with a rule of automatic as-

\textsuperscript{45} Id. at 1490.

\textsuperscript{46} 652 F. Supp. 560 (N.D. Ill. 1987).

\textsuperscript{47} Id. at 662-63.

\textsuperscript{48} Id. at 563. The court went on to hold that, regardless of whether section 10(b) claims for damages could be expressly assigned, the right to sue for section 10(b) rescission could not be expressly assigned. Id. at 565.

\textsuperscript{49} See supra notes 23-26 and accompanying text.

\textsuperscript{50} See supra notes 27-28 and accompanying text.
assignment of claims prior to corrective disclosure, only some of the holders could sue at the time of disclosure. In this situation, a new owner who buys after corrective disclosure has a poorer case for automatic assignment.

With a face-to-face transaction, a rule of automatic assignment might not be that harmful. A seller with a rule 10b-5 claim who was aware of an automatic assignment rule can ask the buyer either to waive the assignment or to pay a premium based on the expected value of any recovery. On the other hand, automatic assignment would not be particularly beneficial either. Even without such a rule, a seller could easily provide an express assignment.

If the parties deal anonymously on the stock market, on the other hand, the buyer normally would not know in advance if the seller is one of the few holders who had a rule 10b-5 claim. Therefore, even with a rule of automatic assignment, the stock market price of the security would not adequately reflect the possibility of recovery against the defendant. 61

Corrective disclosure causes a drop in the price of the security. When selling in the market after disclosure, the original buyer suffers a loss. Even with a rule of automatic assignment, this loss would not be mitigated by adequate augmentation in the market price reflecting the possibility of a lawsuit. Automatic assignment would deprive the original buyer of the opportunity to recoup part or all of his loss and would give the subsequent purchaser an undeserved windfall. 62 Therefore, the original buyer is the appropriate

61 In re Saxon Sec. Litig., 644 F. Supp. 465 (S.D.N.Y. 1985), involved bondholders who bought during a period of allegedly fraudulent behavior by the issuer. After this period, the market did not differentiate in price between bonds sold by the defrauded bondholders and by those with no claim against the issuer. Id. at 469.

62 "[I]t would be unjust and inconsistent with the remedial purposes of the securities laws to strip the right to recover from the convertible debenture holders who were actually injured, and grant it instead to subsequent purchasers who sustained no injury or loss from the Rule 10b-5 violation." Lowry v. Baltimore & O.R.R., 707 F.2d 721, 729 (Garth, J., joined by Sloviter, J., concurring), petition for modification denied, 711 F.2d 1207 (3d Cir.), cert. denied, 464 U.S. 893 (1983). "Ordinarily, the injury remains with the first purchaser who was actually the victim of the fraud. If he has managed to sell the securities, in most cases they will have sold for far less than he paid for them precisely because of the fraud. If he is to be compensated for his loss, the right of action should ordinarily remain with him as well." Soderberg, 652 F. Supp at 564. Ironically, both Lowry and Soderberg involved the rare situation where a rule of automatic assignment might augment the price of the security by the expected value of the lawsuit. This would benefit the seller (the original buyer) and deprive the buyer of any unjust enrichment. See supra notes 23-39, 46-49 and accompanying text.

In a case involving state law, Bangor Punta Operations v. Bangor & A.R.R., 417
plaintiff.\textsuperscript{53}

In \textit{In re Saxon Securities Litigation},\textsuperscript{54} a district court confronted the issue of automatic assignment of rule 10b-5 claims in a situation where only some of the holders of a class of security had such claims. Saxon Corporation allegedly violated rule 10b-5 through fraudulent misstatements made prior to its bankruptcy petition. These misstatements defrauded those who purchased Saxon debentures during the period between the misstatements and the filing for bankruptcy. The Saxon plaintiffs, however, purchased the debentures after the bankruptcy petition, and argued that the sellers automatically assigned their rule 10b-5 claims. Both plaintiff and defendant agreed that federal law, and not state law, applied; the court concurred.\textsuperscript{55} After an extensive analysis of both federal law\textsuperscript{56} and policy,\textsuperscript{57} the court concluded that the claims were not automatically assigned.\textsuperscript{58}

The court noted that after Saxon's bankruptcy petition the market did not differentiate in price between debentures sold by allegedly defrauded holders and debentures sold by holders who had no claim against the issuer.\textsuperscript{59} Thus, if the plaintiffs were to participate in the settlement fund, they would receive an unfair windfall. In this case, the plaintiffs would obtain a profit of 35.2\% for a two-year investment.\textsuperscript{60}

In analyzing federal law, the Saxon court relied both on \textit{Nucorp} and on a combination of the \textit{Blue Chip} standing requirement\textsuperscript{61} and the reliance requirement of rule 10b-5.\textsuperscript{62} These two requirements to-

\textsuperscript{53} Although not a dispositive consideration, a subsequent purchaser might also sometimes face difficulty in demonstrating that the previous owner was one of the holders with a rule 10b-5 claim. \textit{See supra} text accompanying note 14.


\textsuperscript{55} Id. at 473-74.

\textsuperscript{56} \textit{See id.} at 469-73.

\textsuperscript{57} \textit{See id.} at 474-75.

\textsuperscript{58} \textit{Id.} at 471-73, 474-75.

\textsuperscript{59} \textit{Id.} at 469.

\textsuperscript{60} Id. at 468.

\textsuperscript{61} \textit{See supra} notes 27-28 and accompanying text.

\textsuperscript{62} In a discussion of the reliance requirement, the court cited Titan Group v. Fagggen, 513 F.2d 234 (2d Cir. 1975) and Clegg v. Conk, 507 F.2d 1351 (10th Cir. 1974).
gether meant that the plaintiff must buy or sell with "some minimal form of reliance . . . even if it is simple reliance on a market tainted by fraud." The plaintiffs in *Saxon* were not defrauded at all and therefore could not sue.  

### IV. MISCELLANEOUS CASES

A few cases address the issue of automatic assignment but do not indicate whether the new owner bought before or after corrective disclosure. One example is *International Ladies' Garment Workers Union v. Shields & Co.* which held that a rule 10b-5 cause of action is not automatically assigned upon sale of a security:

Of course by a mere assignment of securities the assignee does not acquire any and all rights of action that the assignor may have had against the person from whom he bought. One who has been defrauded by the sale of goods to him of a value less than they would have had if as represented retains the right of action for the amount of his damage unaffected by his parting with the goods.

Another opinion which does not indicate whether the plaintiff bought before or after corrective disclosure is *Independent Investor*  


63 *Saxon*, 644 F. Supp. at 470.

64 One commentator has made a similar argument:
[...]

65 *But cf.* Gardner v. Surnamer, 608 F. Supp. 1385, 1392-93 (E.D. Pa. 1985) (*Blue Chip*, which dealt with the distinction between real and potential purchasers and sellers, does not preclude a new owner from automatically acquiring a seller's rule 10b-5 claim, and does not require contractual privity between plaintiff and defendant).

*Saxon* also noted one absurd result of a general rule of automatic assignment by both defrauded purchasers and sellers. If an investor were defrauded into selling his securities, his right to sue would go to the buyer. Therefore, someone fraudulently induced to sell on the securities market would never be able to sue under rule 10b-5. Indeed, in some situations, the purchaser receiving the automatic assignment might be the perpetrator of the fraud. Although *Saxon* involved the assignment of claims of defrauded purchasers, the opinion saw "no justification for applying a different rule to purchasers than sellers." *Saxon*, 644 F. Supp. at 475.


66 *Id.* at 149. The opinion went on to hold that a rule 10b-5 cause of action could be expressly assigned. *Id.* at 149-50.
Protective League v. Saunders, a case that did not involve rule 10b-5. The plaintiffs argued that by buying bonds they automatically acquired the sellers’ causes of action under sections 11 and 17 of the Securities Act of 1933, under sections 9 and 14 of the Securities Exchange Act, and under the Trust Indenture Act. The court flatly rejected this theory:

The provisions of the securities acts relied upon here create rights of actions on the part of investors who have been harmed by the misconduct of others. Those rights belong to the persons who have suffered injury. They do not attach for all eternity to the security itself, to pass forever from the person who has been harmed to be asserted by others who have not.

CONCLUSION

It is unclear whether a rule 10b-5 claim is automatically assigned upon the sale of a security. Moreover, whether federal or state law governs has not been completely resolved. Nevertheless, federal law

\footnote{64 F.R.D. 564, 572 (E.D. Pa. 1974).}

\footnote{Id. (emphasis in original). In passing, another district court assumed that rule 10b-5 claims are not automatically assigned. Alameda Oil Co. v. Ideal Basic Indus., 326 F. Supp. 98, 102 (D. Colo. 1971) (“[T]hose who bought after the duty to disclose arose cannot claim inheritance of their sellers’ causes of action . . . . ”)(emphasis in original).

Rose v. Arkansas Valley Envtl. & Util. Auth., 562 F. Supp. 1180 (W.D. Mo. 1983), a class action by certain bondholders against the issuer and others, involved the survivability after death of rule 10b-5 claims, not their automatic assignment. The bonds allegedly were worthless from the outset. The plaintiffs alleged fraud in the original issue of the bonds and sued under rule 10b-5 and state securities law. Some of the plaintiffs had not purchased the bonds but had inherited them. The court dismissed the rule 10b-5 claims of these heirs. One of the court’s reasons for dismissal was that the heirs were not purchasers or sellers and lacked standing to sue under Blue Chip. Id. at 1188-89. Another reason was that “the cause of action itself is entirely separate and distinct from the security which gave rise to it, and does not automatically follow the ownership of that security.” Id. at 1189 (emphasis in original). According to the opinion, the cause of action would survive as an asset of the estate and normally would be brought by the personal representative of the estate. Id.

The appropriateness of the Rose holding depends on the testators’ intent. If a person defrauded into buying a security dies and leaves the security to an heir, one might plausibly assume that the testator also intended to give the heir any cause of action for fraud, regardless of whether the fraud is known at the time of the bequest. Under this assumption, Rose is wrongly decided. In any event, the opinion does not reveal what the testators knew at the time of the bequests about the bonds and the fraud. The judge noted, “Precisely when the present plaintiffs or their predecessors acquired their bonds and when or in what manner difficulties first became apparent is unclear from the materials presently before me . . . . ” Id. at 1187.
should control the automatic assignment of a federal securities claim because of the strong policy implications and the need for uniformity across the nation.

A policy analysis should focus on whether automatic assignment would result in an unfair windfall to the new owner. The existence of any windfall in turn would depend on the price paid by the new owner. If he buys before corrective disclosure, he will pay too high a price and will "inherit" the original purchaser's injury. As between the original buyer and the injured new owner, the latter is the proper plaintiff. Automatic assignment is appropriate, despite any practical problem the new owner may face in ascertaining the identity of his seller (the original purchaser). Tracing the identity of the party on the other side after the transaction is not as difficult as many commentators believe.69

With sales on the stock market after disclosure, however, a second distinction must be made between (1) the unusual situation in which, at the time of the fraud (and, consequently, at disclosure), all the holders of a class of security can sue, and (2) the normal situation in which, at the time of the fraud (and, consequently, at disclosure), only some of the holders can sue. In the first situation (when all the security-holders have claims), a rule of automatic assignment results in an augmentation of the market price based on the expected value of the lawsuit. This augmentation eliminates the buyer's windfall and gives the original buyer the option of selling at a price which reflects the value of his claim. On the other hand, in the second situation, the anonymity of the stock market will generally prevent a buyer from knowing in advance whether the seller is one of the few holders who can sue. Therefore, the price of the security will not adequately reflect the possibility of recovery even with a rule of automatic assignment. The buyer would receive an unfair windfall and the seller would suffer an inequitable loss of rights. In short, after corrective disclosure, automatic assignment is inappropriate, except when all the holders of a class of security can sue.

Unfortunately, the few cases dealing with the automatic assignment of rule 10b-5 claims largely fail to make the crucial distinctions discussed above. In Lowry, the en banc Third Circuit evenly divided on the issue of automatic assignment of a rule 10b-5 claim. The three-judge Ninth Circuit panel in Nucorp flatly rejected automatic assignment of claims under the Trust Indenture Act. Both

69 Wang, supra note 15, at 1179 n.20.
Lowry and Nucorp involved the rare situation when, at the time of fraud, all the holders of a security could sue. These two decisions should have allowed automatic assignment. Because the issue of automatic assignment of rule 10b-5 claims remains unresolved in all the circuits, however, the courts have ample opportunity to adopt the approach urged in this article.