CADWALADER

Cadwalader, Wickersham & Taft LLP
www.cadwalader.com

Clients&FriendsMemo

Securities Litigation Alert

Second Circuit Adopts Restrictive View of Purchaser-Seller Rule, Limiting Section 10(b) Standing to Transactions in Securities of Company "About Which" Alleged Misstatements Were Made

January 23, 2023

Looking back, 2022 was light on groundbreaking appellate-level securities decisions. The U.S. Court of Appeals for the Second Circuit, however, closed out the year with a notable decision in *Menora Mivtachim Insurance Ltd. v. Frutarom Industries Ltd.*,[1] articulating a new, restrictive conception of the purchaser-seller rule that limits the class of plaintiffs with standing to recover under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. Rejecting a test that would require only a "direct relationship" between the alleged misrepresentation and the price of a security bought or sold, the Second Circuit limited Section 10(b) standing to plaintiffs "who purchased or sold the securities about which a material misstatement was made."[2] The decision closes the door, at least in the Second Circuit, on claims by purchasers or sellers of the securities of one company, based on alleged misstatements about another, even if the two companies are merging and their prospects (and share prices) are inherently linked. The influence of the decision in other circuits, where case law on the purchaser-seller rule is sparse, remains to be seen.

Background

Endorsed by the Supreme Court nearly 50 years ago in *Blue Chip Stamps v. Manor Drug Stores*, the purchaser-seller rule limits "the plaintiff class for purposes of a private damage action under § 10(b) and Rule 10b-5 . . . to actual purchasers and sellers of securities."[3] The Supreme Court found support for the rule in the text of the Securities Exchange Act of 1934 and the Securities Act of 1933, widespread acceptance of the rule in lower courts, and Congress's repeated rejection of attempts to expand the scope of the judicially created cause of action under Section 10(b) and

---

[1] 54 F.4th 82 (2d Cir. 2022).

[2] *Id.* at 85, 88.

[3] 421 U.S. 723, 730-31 (1975).

Rule 10b-5.[4] The Court also expressed concern about "the danger of vexatious litigation which could result from a widely expanded class of plaintiffs under Rule 10b-5."[5] Applying the rule, the Court denied Section 10(b) standing to plaintiffs who allegedly refrained from buying a company's stock, and thus missed the opportunity to profit from a rise in share price, due to defendants' unduly pessimistic statements about the company's prospects.[6]

While *Blue Chip Stamps* clearly required a purchase or sale of a security for Section 10(b) standing, it did not define precisely what that security must be, other than the statement that plaintiffs must "at least [have] dealt in the security to which the prospectus, representation, or omission *relates*."[7] That was the issue in *Frutarom*. There, the plaintiffs were a putative class of investors who acquired shares of International Flavors & Fragrances Inc. (IFF), a publicly traded U.S.-based seller of flavoring and fragrance products, between May 2018 and August 2019. In May 2018, IFF announced its agreement to acquire Frutarom Industries Ltd., an Israel-based company in the same industry. Plaintiffs alleged that following the announcement, Frutarom made materially misleading statements about its compliance with anti-bribery laws and the sources of its business growth, which IFF incorporated into its public filings. The merger closed in October 2018, and Frutarom became a wholly owned subsidiary of IFF. Almost a year later, IFF publicly acknowledged that in advance of the merger, Frutarom had made "improper payments"—*i.e.*, bribes—"to representatives of a number of customers." IFF's share price dropped by nearly 16% after the announcement.

Plaintiffs filed suit in the Southern District of New York, asserting violations of Section 10(b) and 20(a) of the Exchange Act and Rule 10b-5 against two sets of defendants: IFF and two of its officers, and Frutarom and five of its officers. The district court (Hon. Naomi Reice Buchwald) dismissed all of plaintiffs' claims, ruling that plaintiffs did not adequately allege that Frutarom's misconduct continued into the class period, and that the alleged misrepresentations were neither actionable nor material.[8] The district court also held that "plaintiffs lack[ed] statutory standing under Section 10(b) to bring claims against the Frutarom defendants for statements made about Frutarom."[9] Plaintiffs appealed the dismissal order to the Second Circuit, but only with respect to their claims against Frutarom and its officers.

---

[4] *Id.* at 731-35.

[5] *Id.* at 740.

[6] *Id.* at 754-55.

[7] *Id.* at 747 (emphasis added).

[8] *Menora Mivtachim Ins. Ltd. v. Int'l Flavors & Fragrances Inc.*, 19 Civ. 7536 (NRB), 2021 WL 1199035, at *9-23 (S.D.N.Y. Mar. 30, 2021).

[9] *Id.* at *29.

The Second Circuit's Decision

A Second Circuit panel affirmed, with the majority holding that plaintiffs lacked standing to sue "based on alleged misstatements about Frutarom because they never bought or sold shares of Frutarom."[10] The majority opinion authored by Judge Michael H. Park cited "the advantages of limitations" to a Section 10(b) cause of action recognized in *Blue Chip Stamps*, including "the danger of vexatious litigation that could result from a widely expanded class of plaintiffs."[11] The majority interpreted *Blue Chip Stamps*—in particular, the statement that plaintiffs must have "at least dealt in the security to which the prospectus, representation, or omission relates"—as creating a bright-line rule limiting Section 10(b) standing to plaintiffs "who purchased or sold the securities *about which a material misstatement was made*."[12] Plaintiffs—purchasers of IFF shares only—lacked standing because the alleged misstatements, pertaining only to Frutarom's compliance with anti-bribery laws and the source of its business growth, were "about Frutarom," not about IFF.[13]

The majority also quashed plaintiffs' advocacy for a "direct relationship" test that would confer standing based on the linkage between Frutarom's misstatements and the price of the IFF shares. Construing "narrowly" the judge-made cause of action under Section 10(b), the majority explained that contrary to *Blue Chip Stamps*, a "direct relationship" test would lead to a "case-by-case erosion" of the purchaser-seller rule, and require a "shifting and highly fact-oriented inquiry" to determine standing.[14] The majority disagreed that the Second Circuit had adopted a "direct relationship" test in its 2004 decision *Ontario Public Service Employees Union Pension Trust Fund v. Nortel Networks Corp.*[15] Rather, *Nortel* denied standing for claims by purchasers of shares of one company, JDS Uniphase Corporation, against another company, Nortel Networks Corporation, which had acquired a business unit of JDS. To the extent *Nortel* left open whether a "potential merger," as opposed to the sale of a business unit, "might require a different outcome," the *Frutarom* majority explicitly held that "purchasers of a security of an acquiring company do not have standing under Section 10(b) to sue the target company for alleged misstatements the target company made about itself prior to the merger between the two companies."[16]

Although concurring in judgment, Judge Myrna Pérez criticized the majority's rejection of a "direct relationship" test. According to Judge Pérez, the Second Circuit, in *Nortel* and subsequent

---

[10] *Frutarom*, 54 F.4th at 84. Judge William J. Nardini joined Judge Park in the majority opinion. Judge Myrna Pérez filed a concurring opinion.

[11] *Id.* at 85-86 (quoting *Blue Chip Stamps*, 421 U.S. at 740).

[12] *Id.* at 85 (emphases added).

[13] *Id.* at 86.

[14] *Id.* at 86-87 (quoting *Blue Chip Stamps*, 421 U.S. at 755).

[15] 369 F.3d 27 (2d Cir. 2004).

[16] *Frutarom*, 54 F.4th at 88 (quoting *Nortel*, 368 F.3d at 34).

decisions, had focused on "the significance of the relationship between alleged misstatements and plaintiff's purchase of the securities" in assessing Section 10(b) standing.[17] In Judge Pérez's view, the majority's test—which limits standing to purchasers or sellers "of securities *about which* a misstatement was made"—not only conflicted with Second Circuit precedent, but may be confusing to litigants and difficult to apply in different factual scenarios.[18] The "formalism" of the majority's new test, Judge Pérez worried, could lead to "undesirable" consequences, "exclud[ing] plaintiffs who have in fact been damaged by violations of Rule 10b-5."[19] Judge Pérez believed that the *Frutarom* case could be disposed of simply by applying *Nortel* (the relationship between IFF and Frutarom was no more "direct" than between JDS and Nortel), and she would have stopped there.

Implications

- **A Bright-Line Test for Section 10(b) Standing in the Second Circuit.** *Frutarom* clarifies that, at least in the Second Circuit, courts will assess standing under the purchaser-seller rule by asking whether plaintiffs "bought or sold the securities about which the misstatements were made."[20] Under *Frutarom*, standing does not depend on the "significance or directness of the relationship between two companies."[21] This means that, where two companies have close business dealings with each other, one company cannot face Section 10(b) liability from shareholders of the other, for statements about itself or its own business prospects, regardless of how "direct" the implications are for the price of plaintiffs' shares. Even if the two companies are merging, and one company's optimistic statements about itself inevitably would induce investors to purchase shares in the other, that does not confer Section 10(b) standing to those investors. That is particularly significant in instances, such as *Frutarom*, where the company that is the subject of the misstatements does not trade in the U.S., leaving no recourse under Section 10(b) to investors allegedly harmed by the misstatements.

- **The Subject Matter of the Misstatements Matters, Not Who Made Them.** The crux of *Frutarom* was that the alleged misstatements—concerning Frutarom's compliance with anti-bribery laws and the source of its business growth—were "about Frutarom," not about IFF. The majority did not base its decision on the fact that Frutarom actually made the alleged misstatements. The majority, moreover, reaffirmed a prior Second Circuit holding that the purchaser-seller rule does not preclude suits against "underwriters, brokers, bankers, and non-issuer sellers," as long as the alleged misstatements made by those parties were "about" the securities plaintiffs actually bought or sold.[22] What if IFF had made misstatements about Frutarom? Would the purchaser-seller rule bar claims by IFF shareholders against IFF, as well as Frutarom, based on such misstatements? Under the majority's articulation of the rule, the

[17] *Id.* at 90-91 (Pérez, J., concurring).

[18] *Id.* at 91.

[19] *Id.* at 94-95 (quoting *Blue Chip Stamps*, 421 U.S. at 743).

[20] *Id.* at 88.

[21] *Id.*

[22] *Id.* (quoting *In re NYSE Specialists Sec. Litig.*, 503 F.3d 89, 102 (2d Cir. 2007)).

answer would appear to be yes, as the statements were not technically "about" IFF; it is subject matter, not who makes the statement, that is relevant. The Court, however, did not explicitly decide that issue in *Frutarom*, as the claims at issue were against Frutarom, not against IFF. Thus, some uncertainty remains over the question.

- **No "Direct Relationship" Test in the Second Circuit, but Questions Remain.** *Frutarom* unequivocally rejects a "direct relationship" test for Section 10(b) standing (*i.e.*, a test based on the linkage between a misstatement and the price of a security), opting for a bright-line rule that confers standing only to plaintiffs who acquired securities of the company "about which" alleged misstatements were made. That makes the standing analysis straightforward in cases like *Frutarom* and *Nortel*, in which there are two companies and the misstatements clearly pertain to one or the other. Less clear is how a court would apply the test where there is ambiguity as to which of the two companies the statements are "about." That will have to await further judicial development on a case-by-case basis. Moreover, the "about which" test does not clearly fit with certain scenarios in which other courts previously have assumed standing. For example, in the decision below, Judge Buchwald stated that the purchaser-seller rule is satisfied in "lawsuits against an acquiring company brought by shareholders of the target company whose shares were convertible into stock of the acquiring company,"[23] and for "owners of equity-linked derivative securities directly tied to the value of a company [who] sue that company for misrepresentations by virtue of that direct ownership interest."[24] In Judge Buchwald's view, standing is appropriate in these situations because the would-be plaintiffs have a "direct investment interest" in the company that is the subject of the alleged misrepresentations.[25] By contrast, in *Frutarom*, the plaintiffs "never purchased or sold Frutarom securities, never stood to be contingent direct shareholders in Frutarom . . . , and never owned a derivative security linked to the ownership value of Frutarom," so the rationale supporting standing did not apply.[26] Elimination of a "direct relationship test" would seem to foreclose standing even in the instances cited in Judge Buchwald's hypothetical, but because they were not at issue in *Frutarom*, questions will persist for the time being.

- **Outside the Second Circuit, Much About the Purchaser-Seller Rule, Including the Existence of a "Direct Relationship" Test, Is Unsettled.** *Blue Chip Stamps* was decided nearly 50 years ago, yet outside the Second Circuit, federal circuit courts have issued scant decisions expounding on the scope of the purchaser-seller rule. Over 20 years ago, the Ninth Circuit held that a shareholder of a target, who acquired contingent rights to receive shares of an acquiring company as merger consideration, had standing to sue based on alleged misstatements by the acquiring company about itself.[27] The Third Circuit also has suggested (but not explicitly held) that plaintiffs who acquired securities of a company based on

---

[23] *IFF*, 2021 WL 1199035, at *31 (citing *Semerenko v. Cendant Corp.*, 223 F.3d 165, 169 (3d Cir. 2000), and *Griggs v. Pace Am. Grp., Inc.*, 170 F.3d 877, 878-80 (9th Cir. 1999)).

[24] *Id.* (citing *Zelman v. JDS Uniphase Corp.*, 376 F. Supp. 2d 956 (N.D. Cal. 2005), and *In re WorldCom, Inc. Sec. Litig.*, No. 02 Civ. 3288 (DLC), 2004 WL 1435356 (S.D.N.Y. June 28, 2004)).

[25] *Id.*

[26] *Id.* at *32.

[27] *Griggs*, 170 F.3d at 878-80.

misrepresentations made by a tender offeror may have a Section 10(b) claim against the tender offeror.[28] Those decisions, however, did not address whether there is a "direct relationship" under the purchaser-seller rule—the Ninth Circuit deemed contingent rights as equivalent to actual ownership, and the Third Circuit did not even mention the purchaser-seller rule in its analysis. Indeed, it appears that no federal circuit court outside the Second Circuit has opined on the existence of a "direct relationship" test, or otherwise attempted to define the requisite relationship between a misstatement and a security bought or sold in the context of the purchaser-seller rule. As a result, the questions addressed in *Frutarom* will be open in all other circuits for now, incentivizing plaintiffs with claims clearly barred by *Frutarom* to try their hand in forums outside the Second Circuit.

- **Supreme Court Guidance Unlikely in the Near Term.** After 50 years, one might think it is time for the Supreme Court to provide litigants with further guidance on the purchaser-seller rule. But given the sparse treatment in federal appellate courts, and the absence of a clear circuit split, that is unlikely for now. Until that happens, the only near-certainty in all circuits is that the purchaser-seller rule bars Section 10(b) claims by three sets of plaintiffs specifically identified in *Blue Chip Stamps*: (1) potential purchasers who never actually acquired a security, (2) actual shareholders who merely held onto securities that they previously had acquired, and (3) existing shareholders who may be consequentially harmed by an insider's sale of securities to a third party.[29] In the Second Circuit, *Frutarom* now adds an additional limitation, requiring plaintiffs to have purchased or sold securities "about which" the alleged misstatements were made. Elsewhere, uncertainty will persist on that question, although *Frutarom* may prove to be persuasive authority on the road to achieving judicial consensus.

* * *

If you have any questions, please feel free to contact any of the following Cadwalader attorneys.

Jason Halper	+1 212 504 6300	jason.halper@cwt.com
Ellen Holloman	+1 212 504 6200	ellen.holloman@cwt.com
Philip Khinda	+1 202 862 2262	philip.khinda@cwt.com
Adam Magid	+1 212 504 6314	adam.magid@cwt.com
Jonathan Watkins	+1 212 504 6229	jonathan.watkins@cwt.com
Diane Lee	+1 212 504 6232	diane.lee@cwt.com

[28] *Cendant Corp.*, 223 F.3d at 169.

[29] *Blue Chip Stamps*, 421 U.S. at 737-38.