

Second Circuit: Acquirer Shareholders Lacked Standing to Sue a Merger Target Under Section 10(b) Because They Never Bought or Sold the Target's Shares (Securities Law Alert)

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On September 30, 2022, the Second Circuit affirmed a district court's dismissal of a putative securities fraud class action brought by shareholders of a U.S. company that acquired a non-U.S. target company, alleging that the target made misstatements about itself in advance of the merger in violation of Section 10(b). *Menora Mivtachim Ins. v. Frutarom Indus.*, 2022 WL 4587488 (2d Cir. 2022) (Park, J.). Creating a bright-line rule, the Second Circuit held that plaintiffs lacked standing under Section 10(b) to sue the target because plaintiffs had bought shares of the acquirer, not shares of the target.

Background and Procedural History

Plaintiffs alleged that for several years before the merger, executives at the target bribed key employees of important clients to generate business and bribed foreign import officials. Plaintiffs alleged that in the lead up to the merger, the target made materially misleading statements about the sources of its business growth and its compliance with anti-bribery laws. After the acquisition closed the target became a wholly-owned subsidiary of the acquirer. Several months later, the acquirer acknowledged that the target had "made improper payments to representatives of a number of customers" and the acknowledgment was followed by a stock drop.

Plaintiffs sued the acquirer, two of its officers, the target, and five of its officers, alleging that they made materially misleading misstatements in violation of Section 10(b). The Southern District of New York granted defendants' motion to dismiss, finding that the complaint failed to allege with the requisite particularity that the target's misconduct continued into the class period.^[1] The district court concluded that, "in any case, the allegedly false statements and omissions of material fact were not actionable or material" and that "plaintiffs lack statutory standing under Section 10(b) to bring claims against the [target] defendants for statements made about [the target]." Plaintiffs appealed the decision only against the target and certain of its officers.

Acquirer Shareholders Lack Standing to Sue a Target Company Under Section 10(b)

The Second Circuit began its analysis by discussing *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), where the Supreme Court adopted the “purchaser-seller rule” from *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir. 1952). The rule “requires plaintiffs to have bought or sold a security of the issuer about which a misstatement was made in order to have standing to sue under Section 10(b).” In *Blue Chip Stamps*, the Court expressed concern that to hold otherwise would lead to vexatious litigation and warned against permitting “endless case-by-case erosion” of the rule in the future.

Plaintiffs argued that as acquirer shareholders, they had standing because there was a “sufficiently direct relationship” between the target’s misstatements about itself and the price of the acquirer’s shares. However, the Second Circuit rejected this argument as meritless, explaining that judicially created private rights of action should be narrowly construed. The Second Circuit refused to adopt plaintiffs’ “direct relationship” test stating that doing so would begin the erosion of the purchaser-seller rule. Further, the Second Circuit observed that such a test would cause courts to engage in a “shifting and highly fact-oriented” inquiry requiring them to determine whether there was a sufficiently direct link between one company’s misstatements and another company’s stock price. The Second Circuit concluded that, in this case, plaintiffs lacked statutory standing to sue the target because they bought shares of the acquirer not the target.

[1] The class period ran from the time of the merger announcement to approximately one week after the acquirer’s stock price drop.

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