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SECOND CIRCUIT REVIEW

BY MARTIN FLUMENBAUM AND BRAD S. KARP

Limiting Standing in Securities Fraud Cases

IN THE U.S. COURT of Appeals for the Second Circuit's recent decision, *Lawrence v. Cohn*, No. 02-7642, 2003 WL 1594147 (2d Cir. March 28, 2003), the court reinvigorated the standing requirement applicable to securities fraud cases by barring plaintiffs from dressing up common-law claims as federal securities law claims.

Plaintiffs, the surviving beneficiaries of Sylvan Lawrence, filed this lawsuit, "denominated a securities fraud action," individually and on behalf of Mr. Lawrence's estate, seeking relief under §10(b) of the Securities and Exchange Act of 1934. More than 35 years ago, Mr. Lawrence had formed a longstanding oral-agreement partnership with his brother, defendant Seymour Cohn, pursuant to which they engaged in various real estate transactions and ventures. In 1968, Lawrence and Cohn, together acting as the "General Partner," formally entered into a limited partnership with an entity known as the Aron Group (which was comprised of individuals related through familial ties or shared business interests). Mr. Lawrence and Mr. Cohn owned 60 percent of the limited partnership as the General Partner, and the Aron Group owned the remaining 40 percent as "Limited Partners."

The Issues

The dispute between Mr. Lawrence's beneficiaries and his brother arose from the Aron Group's sale of its 40 percent interest in the limited partnership following Mr. Lawrence's death, and centered on two provisions in the limited partnership agreement.

First, the "Assignability of Partnership Interest" provision specified an ordered, progressive right of first refusal applicable to

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any of the Limited Partners' interests that are the subject of a bona fide "Outside Offer." The assignability provision required the recipient of the offer to: (1) notify the other Limited Partners, giving them a right of first refusal to purchase the interest on the same terms as the outside offer; and (2) notify the General Partner — again, granting the same terms — but only in the event that none of the Limited Partners has exercised their refusal rights. If the General Partner passed on the option to purchase, the recipient of the offer could freely sell.

The assignability provision also gave the Limited Partners a congruent right of first refusal, applicable to a bona fide outside offer made to the General Partner. As the court explained, "any member of the Aron Group receiving an 'offer' to sell his interest in the [limited partnership] would first have to offer it proportionately to the other members of the Aron Group." If none of the Aron Group members wanted to purchase the interest, Mr. Lawrence and Mr. Cohn could. Significantly, the assignability provision "[did] not establish a right of first refusal as between [Mr. Lawrence and Mr. Cohn]." Indeed, "the General Partner is, as elsewhere in the [limited partnership agreement], referred to in the singular, and the only right of first refusal that is triggered by an 'Outside Offer' to the General Partner is a right of first refusal among the Limited Partners."

Second, the "Termination of the Partnership" provision specified that in the event either Mr. Lawrence or Mr. Cohn dies (as happened here), his legal representative becomes a Limited Partner with a 30 percent interest in the partnership, leaving the surviving General Partner with a 30 percent interest. "This provision contains the only reference to individual interests held by [Mr. Lawrence and Mr. Cohn] as distinct from their collective identity as the General Partner."

Mr. Cohn negotiated a deal to purchase the entire Aron Group interest, which was finally realized in 1983, after Mr. Lawrence died, "as nominee for himself, for the Estate, and 'for any combination thereof.' " Having become the executor and trustee of Mr. Lawrence's estate, Mr. Cohn "brought an advice and direction proceeding in Surrogate's Court to determine how the Aron Group interest should be allocated between the Estate and [himself]."

Before receiving a determination, however, Mr. Cohn and the plaintiffs entered into a settlement agreement, pursuant to which Mr. Cohn and the Estate "each purchased half of the Aron Group interest" (therefore resulting in each owning exactly half of the limited partnership) and plaintiffs "released any claim to a greater percentage of the Aron Group Interest." Furthermore, plaintiffs released any claim that "might arise out of a diminution in value of the Aron Group Interest and any claim that the investment was otherwise unsound or unwise." Finally, Mr. Cohn represented that "he had not failed to disclose any material information that would 'adversely affect the value of one-half of the Aron interests.' "

Leasing a Building

The limited partnership later leased one of its buildings to Chemical Bank in a lucrative deal that plaintiffs assert had been agreed to in principle without their knowledge and before they signed the settlement agreement. In response, plaintiffs initiated litigation in Surrogate's Court "to obtain an accounting and a winding up of the affairs of the Estate,

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including a dissolution of the partnership," alleging that Mr. Cohn's "failure to disclose the advantageous pending lease constituted a material misrepresentation about the future prospects of the [limited partnership]." Furthermore, plaintiffs filed a federal court action, alleging both §10(b) and Rule 10b-5 claims "on the theory that but for Cohn's failure to disclose the impending Chemical Bank lease, plaintiffs would not have agreed to the settlement equalizing the distribution of the Aron Group Interest, and would instead have purchased the entire interest."

After resolving questions of whether plaintiffs' §10(b) and Rule 10b-5 claims were time-barred and, thus, ought to be dismissed under *Lampf, Pleva v. Gilbertson*, 501 US 350 (1991), the district court denied Mr. Cohn's motion to dismiss. *Lawrence v. Cohn*, 932 FSupp 564 (SDNY 1996)). The district court found, among other things, that plaintiffs had standing to bring their securities fraud claim. Mr. Cohn then moved successfully for summary judgment (defeating plaintiffs' cross-motion), with the district court concluding that plaintiffs lacked any right of first refusal, whether predicated on the language of the limited partnership agreement or common law.

The Second Circuit Decision

In its decision, the Second Circuit carefully delineated the outer boundary of the standing requirement for claims brought under §10(b) and Rule 10b-5, originally articulated by the Supreme Court in *Blue Chip Stamps v. Manor Drug Stores*, 421 US 723 (1975). *Blue Chip Stamps* limited standing in Rule 10b-5 and related cases to two classes of plaintiffs: (1) actual buyers and sellers of securities; and (2) those who have a contractual right to buy and sell securities — e.g., contractually conferred rights of first refusal, calls, options or puts. Over the past two decades, the Second Circuit has extended the *Blue Chip Stamps* rule to cover, among other transactions, employment contracts providing shares as compensation, *Mills v. Polar Molecular Corp.*, 12 F3d 1170, 1175 (2d Cir. 1993), and employment offers using shares as a method to induce acceptance, *Yoder v. Orthomolecular Nutrition Inst., Inc.*, 751 F2d 555, 558-61 (2d Cir. 1985). Each of these extensions involved contractually conferred — rather than common law — rights.

The *Lawrence* court focused on three factors in affirming the district court's judgment granting summary judgment for Mr. Cohn and dismissing plaintiffs' complaint. First, and most important, the court declined to extend the scope of the *Blue Chip Stamps* rule to permit standing where plaintiffs asserted common law, rather than contractual, rights. Such common-law rights fall outside the definition of a "security" under the 1934 Act, thereby precluding plaintiffs' purported securities fraud claim. Moreover, the court found the two sources for plaintiffs' common-law claims to be specious. The court rejected the theory that Mr. Cohn's fiduciary duties as executor and trustee of Mr. Lawrence's estate gave rise to an obligation for him to offer the entire Aron Group interest to the Estate first, triggering a right of first refusal. The court also rejected plaintiffs' claim that they should have been allowed to purchase the Aron Group interest under the "Best Interest of the Estate" standard, finding that plaintiffs' claim amounted to a noncontractual predicate insufficient to confer standing under *Blue Chip Stamps*. The Second Circuit concluded that "even if plaintiffs have a common-law right to purchase the entire Aron Group Interest, it would not satisfy the standing requirements of §10(b)," because a common-law right of first refusal does not "qualify as a 'security' under §10(b)."

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Second, the court found that plaintiffs did not have a contractual right to purchase all of the Aron Group shares at issue. Therefore, plaintiffs did not 'sell' any securities by voluntarily entering into their settlement agreement with Mr. Cohn. The court adopted a two-step analysis, first, accepting the district court's finding that, as the Estate's beneficiaries, plaintiffs became limited partners upon Mr. Lawrence's death. The court then examined the assignability provision of the limited partnership agreement and found that Mr. Cohn's offer to purchase the Aron Group interest did not trigger the provision creating a proportionate right of first refusal. Consequently, the court affirmed the district court's conclusion that the limited partnership agreement did not grant plaintiffs a right of first refusal with respect to the entire Aron Group interest.

Right of First Refusal

In rejecting plaintiffs' claim that they had such a contractual right of first refusal, the court looked to four sources of authority: (1) the parties' conduct at the time the limited partnership agreement was drafted, which indicated that they wanted to preserve a conventional right of transfer between families, as well as maintain the proportionate ownership interests between Mr. Lawrence and Mr. Cohn; (2) expert testimony and extrinsic evidence indicating that the terms "bona fide offer" and "outside offer" customarily signify offers from nonpartner third parties; (3) New York case law providing that "because a right of first refusal constitutes a restraint on transfer, it should be construed narrowly as applying only to offers from outsiders unless the agreement contains express language to the contrary"; and (4) the district court's own "common sense" reasoning that "it would make no sense to construe [the assignability provision] as applying to anything other than outside offers."

Third, the court rejected plaintiffs' argument that their purchase of one-half of the Aron Group shares satisfied the "in connection with" requirement under §10(b) because plaintiffs failed to prove a causal connection between the purchase and the alleged fraud. The court explained that plaintiffs' "claim here is not that they purchased half of the Aron Group Interest in reliance on alleged misrepresentations about the future prospects of the [limited partnership], but rather that they were fraudulently induced to forgo purchasing the other half." Mr. Cohn's "alleged misrepresentations, then, did not affect or 'touch' the actual purchase made by plaintiffs."

Conclusion

The pragmatic impact of *Lawrence* may prove to be quite significant. Potential securities fraud plaintiffs asserting common-law claims will be unable to establish standing under the rigorous *Lawrence* court analysis. Indeed, standing was denied to plaintiffs in *Lawrence* "who allege[d] that they decided not to purchase because of an unduly gloomy representation or the omission of favorable material which made the issuer appear to be a less favorable investment vehicle than it actually was" — with the Second Circuit finding that such claims were analogous analytically to those raised by plaintiffs in *Blue Chip Stamps*.