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Birnbaum Rejected: Expansion of the Standing Requirement under Rule 10b-5: *Eason v. General Motors Acceptance Corp.*, 490 F.2d 654 (7th Cir. 1973)

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Birnbaum Rejected: Expansion of the Standing Requirement Under Rule 10b-5

Eason v. General Motors Acceptance Corp.,
490 F.2d 654 (7th Cir. 1973).

As a general rule, only purchasers or sellers of securities have standing to sue under Rule 10b-5¹ of the Securities Exchange Act of 1934. Since the rule was first articulated in *Birnbaum v. Newport Steel Corp.*,² its literal application has been rare³ and it has been emasculated to such an extent that it is virtually non-existent in some jurisdictions.⁴ *Eason v. General Motors Acceptance Corp.*,⁵ is the first decision expressly to reject *Birnbaum's* standing limitation and its precedential value has been somewhat cemented by the

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1. 17 C.F.R. § 240.10b-5 (1973). The rule provides:
It shall be unlawful for any person, directly or indirectly, by use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
 - (a) To employ any devise, scheme or artifice to defraud,
 - (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
 - (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security. (Emphasis added.)
 2. 193 F.2d 461 (2d Cir. 1952), *cert. denied*, 343 U.S. 956 (1952).
 3. *Compare* Tully v. Mott Supermarkets Inc., 337 F. Supp. 834 (D.N.J. 1972) with Mount Clemens Industries, Inc. v. Bell, 464 F.2d 339 (9th Cir. 1972). Tully expresses a view that may be regarded as typical of the current trend. The court showed dismay at any argument which attempts to "revive the spectre of the *Birnbaum* buyer-seller doctrine at a point in time when both courts and legal scholars are seeking to bury it." *Id.* at 839. For other examples of the various circuit court views of the purchaser-seller limitation, see notes 27, 31, 33 *infra* and accompanying text.
 4. Tully v. Mott Supermarkets Inc., 337 F. Supp. 834 (D.N.J. 1972); Vine v. Beneficial Fin. Co., 374 F.2d 627 (2d Cir. 1967), *cert. denied*, 389 U.S. 970 (1967).
 5. 490 F.2d 654 (7th Cir. 1973), *cert. denied*, 94 S. Ct. 1979 (1974).

defendants' failure to obtain certification of the issue.

The plaintiffs in *Eason* were shareholders in Bank Service Corporation, an enterprise which sought to purchase an automobile dealership-leasing company. In exchange for the seller's business, Bank Service agreed to issue a substantial number of its own shares and assume liabilities in the form of notes payable to GMAC, the seller's inventory financier. The plaintiffs individually guaranteed the notes and future liabilities payable to GMAC.

The newly-acquired business failed, Bank Service defaulted on the notes and GMAC sued the plaintiffs as guarantors. The plaintiffs countered with a 10b-5 action against GMAC and the seller, alleging that they had been defrauded in connection with the purchase and sale of securities. According to the plaintiffs, the dealership had been doomed to failure because of its unsound financial condition, a fact allegedly concealed by GMAC during the course of negotiations.⁶ Had it not been for material misstatements on the part of the seller and GMAC, Bank Service would not have purchased the dealership.

In order to satisfy the purchaser-seller requirement of *Birnbaum*, the plaintiffs claimed they were constructive sellers of the Bank Service shares, that their individual guarantees were securities, and that the notes themselves were securities.⁷ Alternatively,

6. It is not clear why the dealership was doomed to failure. See Brief for Appellants at 9, *Eason v. General Motors Acceptance Corp.*, 490 F.2d 654 (7th Cir. 1973), where these allegations (set forth in the plaintiffs' third amended complaint) were assumed true for the purposes of determining the issue of standing. 490 F.2d at 656.

7. The plaintiffs' alternative theories appear to be well within accepted interpretations of the *Birnbaum* rule, see notes 29, 30 and 32 and accompanying text *infra*, with the exception of the theory which would classify the notes themselves as securities. For an interesting discussion of when notes may be classified as securities, see Comment, *Commercial Notes and Definition of 'Security' Under Securities Exchange Act of 1934: A Note is a Note is a Note?*, 52 NEB. L. REV. 478 (1973).

Normally the plaintiffs could have sued derivatively, enforcing the rights of Bank Service. Apparently, this approach was precluded by the failure to make a proper demand upon the corporation. See Reply Brief for Appellants at 21, *Eason v. General Motors Acceptance Corp.*, *supra* note 5.

The fact that the court was presented with several means of allowing standing, yet chose to ignore the common principle that courts will decide an issue on the narrowest ground possible, supports the view that *Eason* may have been nothing more than a challenge to the Supreme Court to reassess the *Birnbaum* Rule. Additional support for this proposition is found in an unexplainable note included in the opinion: "This opinion has been circulated to all judges in regular active service; no judge has requested that the case be reheard *en banc*." 490 F.2d at 661, n.31.

they asked that the *Birnbaum* rule be discarded, urging that there was no vitality remaining in it.⁸

Despite GMAC's arguments to the contrary,⁹ the *Eason* court discarded the rule, opting for a more flexible standing requirement which determines the propriety of a 10b-5 action by looking to whether the plaintiff is an *investor*, injured as a result of fraud in a securities transaction.¹⁰ The court determined that giving Rule 10b-5 a broad and flexible construction¹¹ necessarily resulted in ex-

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8. This purchase-seller requirement was a judicially-imposed limitation and does not flow from the language of the statute or the rule. The statute and rule prohibit any person from doing certain acts 'in connection with' purchases and sales 'which would operate as a fraud or deceit upon any person.' They speak in the negative. They proscribe actions. These proscriptions, to repeat the language of the Supreme Court . . . 'are broad and, by repeated use of the word 'any' are obviously intended to be inclusive.'
- Brief for Appellants at 22, *Eason v. General Motors Acceptance Corp.*, note 5 *supra*.
9. GMAC first argued that the purchaser-seller standing limitation of *Birnbaum* is constitutionally compelled, relying upon *Herpich v. Wallace*, 430 F.2d 792 (5th Cir. 1970). The court rejected this argument, stating that constitutional requirements were satisfied so long as the plaintiffs were members of a class to be protected by 10b-5 and their complaint insured a real and adverse interest apart from that of the defendant. The court rejected earlier interpretations of *Birnbaum* which held that 10b-5 claims were insufficient in a constitutional and jurisdictional sense unless the plaintiff had suffered an injury which was cognizable under the rule. "Instead of stating the issue in terms of standing, we think it is more useful to ask whether the plaintiffs were members of the class for whose special benefit Rule 10b-5 was adopted." 490 F.2d at 658.
- GMAC next argued that a loosening of standing requirements under 10b-5 would propagate an unmanageable flood of litigation. *Eason* determined, however, that increased litigation due to a relaxation of the standing requirements was purely speculative and that such a fear was, more likely than not, prompted by a belief that the species of fraud to be proved under 10b-5 was always easier to prove than common law fraud. The court felt that this was an unwarranted belief. 490 F.2d at 660. This offhand dismissal seems to fly in the face of the unquestionable ease of proving fraud available to prospective 10b-5 plaintiffs. See *Lanza v. Drexel*, 479 F.2d 1277 (2d Cir. 1973).
- Finally GMAC argued that the *Birnbaum* standing requirement should be maintained in the interest of preserving a national consistency in securities litigation. *Eason*, however, charged that task to the Supreme Court. 490 F.2d at 661.
10. "Thus, the statutory authorization for the rule refers to the prohibition of deceptive devices 'for the protection of investors.'" 490 F.2d at 659.
11. The court felt that flexible construction was mandated by the decision of the Supreme Court in *Tcherepnin v. Knight*, 389 U.S. 332 (1967). "[A] formal purchaser-seller limitation is not consistent with the overriding requirement that, in construing the 1934 Act, 'form should be

tending the protection of the rule to investors as a class, the legislators' intended beneficiaries.¹² According to the reasoning in *Eason*, all investors are members of the class to be benefited by the rule.

To some extent, the court felt compelled to reach its conclusion because of the Supreme Court's decision in *Superintendent of Insurance v. Bankers Life & Casualty Co.*¹³ The court in that case was also presented the opportunity to rule on the propriety of the *Birnbaum* doctrine. *Bankers Life* involved a clever manipulation by a hopeful purchaser of Manhattan Casualty Company who floated the purchase price with the company's assets.¹⁴ The purchaser induced a trust company to issue a large check without collateral. The check was given to Banker's Life in payment for Manhattan and, concomitantly, the purchaser caused all of Manhattan's treasury bonds to be sold. The proceeds were used to cover the check. Too thinly capitalized, Manhattan ended up in the charge of the Superintendent of Insurance. Although the sale of the treasury bonds was untainted, the Court held that fraud had been perpetrated "in connection with" the sale and was therefore actionable. The *Eason* court found significance in *Bankers Life*. "[T]he basic holding of *Birnbaum* was repudiated by a unanimous Supreme Court in the *Bankers Life* case. We are convinced that the purchaser-seller limitation is nothing more than an appendage to that holding without independent justification."¹⁵

It is important to note that the actual holding in *Birnbaum* was twofold. In addition to the purchaser-seller limitation, *Birnbaum* also limited the scope of fraud cognizable under Rule 10b-5 by ruling that it must be that type which is "usually associated with the purchase or sale of a security."¹⁶ The *Bankers Life* Court commented that fraud cognizable under 10b-5 should include deceptive practices that "touch" an "investor's" sale of a security, thus paving the way for 10b-5 coverage of issues that have heretofore been relegated to common law determination.¹⁷ Evidently the *Eason* court

disregarded for substance and the emphasis should be on the economic reality.'" 490 F.2d at 659.

12. 490 F.2d at 659. *Birnbaum* expressly rejected the idea that the phrase "any person in connection with the purchase or sale" described the rule's protected class. See, Note, 100 U. PA. L. REV. 1251 (1952).
13. 404 U.S. 6 (1971), *rev'g* 430 F.2d 355 (2d Cir. 1970).
14. For an excellent discussion of the complex fact pattern in *Bankers Life*, see Ryan, *Bankers Life: Birnbaum Reconsidered*, 4 LOYOLA U.L.J. 47 (1973).
15. 490 F.2d at 661.
16. *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461, 464 (2d Cir. 1952).
17. The Court in *Bankers Life* avoided the procedural holding of *Birnbaum*, *viz.*, that 10b-5 plaintiffs must qualify as purchasers or sellers

reasoned that broadening the scope of actionable fraud under 10b-5 apodictically results in a dilution of the standing requirement.¹⁸ Perhaps the court read too much into the phrase "touch" an "investor."¹⁹ On the other hand, it is possible that the court's logic and rationale were merely a facade, and the real purpose of the decision was to tempt the Supreme Court into revisiting the issue.

Securities practitioners will undoubtedly raise an eyebrow at the *Eason* decision. Some of the imminent skepticism may be caused by the court's obvious reliance on *Bankers Life*, a decision which unquestionably did not alter the existing status of *Birnbaum's* standing requirements.²⁰ Others are sure to question the propriety of the decision in light of the Third Circuit's recent affirmation of the *Birnbaum* doctrine,²¹ a decision that was also based on an interpretation of *Bankers Life*. Still others will protest what appears to be yet another expansion of the scope of Rule 10b-5.²²

of securities, and dealt only with the scope of fraud cognizable under 10b-5.

Interestingly, Justice Douglas noted: "[W]e express no opinion as to [the injured investor's] standing under § 10b and Rule 10b-5 on other phases of the complaint." 404 U.S. at 13, n.10. The import is less clear than it would first appear to be. On the one hand, *Bankers Life* can be read as an express affirmation of *Birnbaum*. See, *Landy v. Federal Deposit Insurance Corp.*, 486 F.2d 139 (3d Cir. 1973) and *Ryan*, *Bankers Life: Birnbaum Reconsidered*, 4 LOYOLA U.L.J. 47 (1973). Quite another interpretation is possible, however. The reluctance of the court to deal with standing specifically may mean that the court was satisfied with the current interpretations of *Birnbaum*.

18. There is some merit in this conclusion. See 2 A. BROMBERG, SECURITIES LAW—FRAUD—SEC RULE 10b-5 § 4.7(565) (1973) [hereinafter cited as BROMBERG].
19. It is doubtful that Justice Douglas intended such an impact from such a phrase, especially in light of his explicit reluctance to deal with standing. See note 17 *supra*.
20. *Id.*
21. *Landy v. FDIC*, 486 F.2d 139 (3d Cir. 1973). *Landy* also looked to the decision in *Bankers Life* and reached a conclusion totally inconsistent with *Eason*:

We conclude, however, that permitting a cause of action to these plaintiffs would not be in keeping with the Congressional purpose in enacting section 10(b); nor is it required by the interpretation in *Bankers Life*. When Congress enacted section 10(b), it did not contemplate the protection of every person injured by a fraudulent scheme in connection with the purchase or sale of securities. Its immediate concern was the protection of the purity of the informational system in the securities market.

Id. at 157. The court neatly forgot to mention that the plaintiffs were "investors" within the meaning of the *Bankers Life* language. See note 17 *supra*.

22. It has been suggested that 10b-5 has already been over expanded. Some cynically suggest that 10b-5 is so expansive that its present ap-

Potential critics of *Eason* should ponder the result in light of the existing decisional law in involving Rule 10b-5 standing requirements. It may well be that *Eason* does nothing more than codify existing practice—a practice which exists despite the formal prerequisites of *Birnbaum*. *Eason's* holding, in broad terms, coheres nicely with the position maintained by the SEC in numerous amicus briefs.²³ In a nutshell, the SEC maintains that Rule 10b-5 was promulgated for the protection of stockholders, and when stockholders are injured as a result of fraud in securities transactions, they should be allowed to sue.²⁴ It is important to note that the SEC's position does not dispense with the requirement of a sale, rather, it rejects the assumption that a proper plaintiff must be on either end of a sale.²⁵

This basic philosophy is not confined to the Seventh Circuit. The demise of the *Birnbaum* doctrine began long before the decision in *Eason* and its existence has long been a sore spot with commentators.²⁶ Exceptions to *Birnbaum* began with the decision of *Mutual Shares Corp. v. Genesco*.²⁷ There the Second Circuit determined that a strict purchaser-seller status should not be required where the suit sought injunctive relief. In effect, the court reasoned that shareholders have authority to act as "enforcement agents" in halting fraudulent practices in securities transactions.²⁸

plication would permit a buyer of stock to sue the seller when the price goes down; the seller could sue the buyer if the price were to go up; and each could sue the other for interest if the price were to remain the same. Marsh, *What Lies Ahead Under Rule 10b-5?*, 24 BUS. LAW. 69 (1968).

23. See, e.g., *Superintendent of Ins. of New York v. Bankers Life & Cas. Co.*, 404 U.S. 6 (1971), *rev'g* 430 F.2d 355 (2d Cir. 1970), and *Drachman v. Harvey*, 453 F.2d 722 (2d Cir. 1972). The SEC protested the stringent adherence to *Birnbaum* in both decisions. More recently, the SEC has urged that *Eason* become the precedent for a wholesale rejection of *Birnbaum*. BNA SEC. REG. L. REP. (April 24, 1974 No. 249).
24. Brief for SEC as Amicus Curiae at 7 n.6, *Superintendent of Ins. v. Bankers Life and Cas. Co.*, 404 U.S. 6 (1971), *rev'g* 430 F.2d 355 (2d Cir. 1970).
25. See, Ryan, *Bankers Life: Birnbaum Reconsidered*, 4 LOYOLA U.L.J. 47, 48 (1973).
26. Leech, *Transactions in Corporate Control*, 104 U. PA. L. REV. 725 (1956); Comment, *The Purchase-Seller Rule: An Archaic Tool for Determining Standing under Rule 10b-5*, 56 GEO. L.J. 1177 (1968); Case Comment, *Standing of Private Parties to Vindicate the Public Interest*, 50 B.U.L. REV. 417 (1970).
27. 384 F.2d 540 (2d Cir. 1967). Although *Mutual Shares* is traditionally cited for this proposition, the exception first appears to have been recognized in *Ruckle v. Roto American Corp.*, 339 F.2d 24 (2d Cir. 1964).
28. "[T]he claim for damages . . . founders both on proof of loss and the causal connection with the alleged violation of the Rule; on the other hand, the claim for injunctive relief largely avoids these issues, may

According to *Genesco* there is propriety in allowing an individual to vindicate public rights; regardless of their lack of formal standing, individuals have an interest in maintaining the sanctity of the securities markets.

Courts have further diluted the *Birnbaum* doctrine by classifying numerous kinds of transactions as "sales." Issuance of a corporation's own shares²⁹ and mergers³⁰ have been termed "sales" for the purpose of circumventing the *Birnbaum* limitation. In this way courts have conferred purchaser-seller status upon hopeful plaintiffs in an ad hoc fashion, looking to the equities of each specific fact pattern and determining the transaction's true substance and effect, regardless of its form. This process is consistent with the "flexible interpretation" of 10b-5 suggested by the Supreme Court.³¹ Notwithstanding this flexible approach, the courts have felt obligated to pledge formal allegiance to *Birnbaum's* procedural principles. An appearance of consistency is assured by the use of yet another alternative: the constructive purchaser-seller concept.³² Plaintiffs are clothed with the status of a purchaser or seller by broadening the concept of purchase and sale. Courts interpreted these terms more broadly than would be required in the commercial law context.³³

The result of flexibly interpreting the concept of sale has been a near total emasculation of the purchaser-seller limitation. As

cure harm suffered by continuing shareholders, and would afford complete relief against the Rule 10b-5 violation for the future." *Mutual Shares Corp. v. Genesco, Inc.*, 384 F.2d 540, 547 (2d Cir. 1967). Noteworthy is the significance that the court attaches to the causation issue. See also note 39 *infra* and accompanying text.

29. *Schoenbaum v. Firstbrook*, 405 F.2d 215 (2d Cir. 1968), *cert. denied*, 395 U.S. 906 (1968); *Dasho v. Susquehanna Corp.*, 380 F.2d 262 (7th Cir. 1967), *cert. denied*, 389 U.S. 977 (1967).

30. *Vine v. Beneficial Fin. Co.*, 374 F.2d 627 (2d Cir. 1967), *cert. denied*, 389 U.S. 970 (1967).

31. Note 11 *supra*.

32. See *A.T. Brod & Co. v. Perlow*, 375 F.2d 393 (2d Cir. 1967); *Vine v. Beneficial Fin. Co.*, 374 F.2d 627 (2d Cir. 1967), *cert. denied*, 389 U.S. 970 (1967); *Dasho v. Susquehanna Corp.*, 380 F.2d 262 (7th Cir. 1967), *cert. denied*, 389 U.S. 977 (1967).

33. *Dasho v. Susquehanna Corp.*, 380 F.2d 262 (7th Cir. 1967), *cert. denied*, 389 U.S. 977 (1967). Looking to the broad language of the 34 Act, the court in *Dasho* said:

This broad language indicates an intention by Congress that the words 'purchase' and 'sale' are not limited to transactions ordinarily governed by the commercial law of sales. The purpose is evidently to make control of securities transactions reasonably complete and effective to accomplish the purposes of the legislation.

Id. at 266.

Professor Bromberg notes: "the buyer-seller condition has been stretched by broad interpretation to include almost any shareholder affected by a corporate transaction."³⁴

Although commentators have attempted to explain away the numerous exceptions to *Birnbaum*,³⁵ the fact remains that not all of the circuit court theories may be reconciled with any consistently uniform approach. The manifold approaches to 10b-5 standing do, however, suggest one universal principle: courts are relatively unhappy with the purchaser-seller limitation.³⁶

Recently courts have assessed standing in terms of causation, allowing a suit to be maintained so long as the plaintiff can establish a nexus between his loss and the alleged fraud.³⁷ It makes sense to confer standing, irrespective of "purchaser" or "seller" labels, upon a plaintiff who can show causation.

In some situations a showing of causation is not essential to relief. For example, requests for injunctive relief are allowed without regard to the question of standing because "[i]t is not necessary in a suit for equitable or prophylactic relief to establish all the elements required in a suit for monetary damages."³⁸ Arguably, whether the suit seeks injunctive relief or not, if causation can be *easily* demonstrated, a court should likewise be unaffected by "purchaser" or "seller" status. Moreover, the purchaser-seller requirement itself can be seen as a form of the test.³⁹ Arguably,

34. 2 BROMBERG c 8.8 p.222.

35. See e.g., Whitaker, *The Birnbaum Doctrine: An Assessment*, 23 ALA. L. REV. 543 (1971).

36. See *Tully v. Mott Supermarkets, Inc.*, 337 F. Supp. 834 (D.N.J. 1972). In *Tully* the court made continuing references to the fact that neither § 10b nor Rule 10b-5 contains language which limits the scope of those provisions to actual purchasers or sellers.

The limitation on standing to sue which defendants seek to impose is nowhere to be found in the language of either Section 10b or Rule 10b-5. To imply such a requirement ignores the recent edict by the Supreme Court mandating a flexible as opposed to a technical or restrictive construction of the Rule.

Id. at 839. See also, *Kahan v. Rosenstiel*, 424 F.2d 161, 171 (3d Cir. 1970), *cert. denied*, 398 U.S. 950 (1970).

37. See *Kahan v. Rosenstiel*, 424 F.2d 161, 171 (3d Cir. 1970), *cert. denied*, 398 U.S. 950 (1970) and 1 BROMBERG § 4.7 (565). It has been pointed out that the purchaser-seller requirement helps to ensure a finding of causation. Whitaker, *The Birnbaum Doctrine: An Assessment*, 23 ALA. L. REV. 543 (1971). Such an argument seems to put the cart before the horse. So long as a plaintiff can demonstrate that he suffered injury which was caused by proscribed conduct, he should be brought within the ambit of the rule.

38. *Mutual Shares Corp. v. Genesco, Inc.*, 384 F.2d 540, 547 (2d Cir. 1967).

39. 1 BROMBERG § 4.7 (565); *Kahan v. Rosenstiel*, 424 F.2d 161, 171 (3d Cir. 1970), *cert. denied*, 398 U.S. 950 (1970).

Eason recognized this principle when it held that one may properly bring a 10b-5 suit when he suffers a wrong touching him as an investor.

With such expansive interpretation of the standing limitation, it is little wonder that a court finally elected to dispense with formalistic adherence to *Birnbaum*. *Eason* obviously recognized that the numerous legal fictions employed have swallowed the rule. As the SEC noted, it makes little sense to allow an individual to halt fraudulent activity in an injunctive suit without also allowing him to prove damages that are the result of it.⁴⁰ It would appear from the present state of disarray in the circuit courts⁴¹ that it is only a matter of time before *Eason's* lead is adopted and *Birnbaum* is finally laid to rest.

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40. BNA SEC. REG. L. REP. (April 24, 1974 No. 249).

41. While the unofficial score shows all the circuits, save the seventh, formally adopting the *Birnbaum* principle, standing is not *per se* limited to purchasers and sellers. Broad concepts of "sale" have been applied in the Second, Fifth, Ninth and Tenth Circuits by *Vine v. Beneficial Fin. Co.*, 374 F.2d 627 (2d Cir. 1967), *cert. denied*, 389 U.S. 970; *Herpich v. Wallace*, 430 F.2d 792 (5th Cir. 1970); *Mader v. Armel*, 402 F.2d 158 (6th Cir. 1968), *cert. denied*, 394 U.S. 930 (1969); *Mount Clemons Indus., Inc. v. O.M. Bell*, 464 F.2d 339 (9th Cir. 1972); and *Knauff v. Utah Constr. and Mining Co.*, 408 F.2d 958 (10th Cir. 1969), respectively. On the other hand, the Third Circuit has taken an unusually hard line in maintaining the *Birnbaum* requirement. See *Landy v. FDIC*, 46 F.2d 139 (3d Cir. 1973). Causation as a means of determining standing has been dressed in different clothes and recently been applied in the Fifth Circuit under the guise of "privity," or lack thereof. *Sargent v. Genesco, Inc.*, 492 F.2d 75 (5th Cir. 1974).