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Director's Duty Under 10b-5 (Lanza v. Drexel & Co.)

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SECURITIES LAW

DIRECTOR'S DUTY UNDER 10b-5

Lanza v. Drexel & Co.

The liability of an outside director to respond in damages for violations of rule 10b-5[1] committed by his co-directors recently came under close scrutiny by the Second Circuit. In *Lanza v. Drexel & Co.*,[2] the court sitting en banc, decided 6-4 that "a director in his capacity as a director (a non-participant in the transaction) owes no duty to insure that all material, adverse information is conveyed to prospective purchasers of the stock of the corporation on whose board he sits."[3] More significantly, the court held that "no violation of rule 10b-5 occurs 'in the absence of allegation of facts amounting to *scienter*, intent to defraud, reckless disregard for the truth, or knowing use of a device, scheme or artiface to defraud. It is insufficient to allege mere negligence.' "[4]

The case involved a merger between BarChris Construction Corporation (BarChris) and Victor Billard Company (Victor) on December 14, 1961. BarChris was a manufacturer of bowling alleys and equipment. BarChris' practices of extending credit to customers after a comparatively small down payment, and making sale and leaseback arrangements, required that the corporation have a large amount of cash to finance construction. In 1961 Bertram D. Coleman joined the

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1 Rule 10b-5, 17 C.F.R. § 240.10b-5 (1970):

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange.

(1) to employ any device, scheme, or artifice to defraud,

(2) to make any untrue statement of 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

(3) 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.

2 479 F.2d 1277 (2d Cir. 1973) (en banc).

3 *Id.* at 1289.

4 *Id.* at 1304-05, *quoting* Shemtob v. Shearson, Hammill & Co., 448 F.2d 442, 445 (2d Cir. 1971). In *Shemtob*, the plaintiff had maintained a stock account with the defendant brokerage house. The value of the stock dropped to the point where it was no longer adequate to secure the margin requirements set by agreement. As a result, the defendant liquidated the account and plaintiff filed this action alleging violations of rule 10b-5. It was argued that the defendant had failed to sell out the account promptly, thus causing the plaintiff increased losses. Also, the sale was alleged to be improper, since it was made by defendant without first giving the plaintiff an opportunity to post additional margin. The court felt that such allegations amounted to no more than a breach of contract action and could not rise to the level of 10b-5 violations without allegations of scienter or fraud. In the absence of such allegations, plaintiff's complaint was dismissed.

board of directors of BarChris in connection with a debenture offering to raise needed capital. Coleman was a partner in Drexel & Co., the brokerage firm underwriting the offering.

The Victor-BarChris merger came about through negotiations which began in March, 1961 between Kircher, treasurer and director of BarChris, and Shulman, an accountant representing Victor. On November 6, the BarChris board approved the necessary exchange of stock and empowered two directors to enter into an acquisition with the Victor shareholders. On November 21, the acquisition contract was approved. Coleman did not attend the November 6 meeting and knew nothing about the proposed merger until he received the minutes of the meeting in the mail. He attended the November 21 meeting and voted in favor of the acquisition but did not attend the closing on December 14.[5]

In addition to certain oral misrepresentations made by Kircher, there was false or misleading information contained in the 1960 BarChris annual report, the 1961 debenture prospectus, and BarChris' financial statement for the first six months of 1961, all of which were given to Shulman during the negotiations. Essentially these documents failed to disclose certain anticipated losses of BarChris due to failures of its customers to whom unsecured loans were made. It was not until a special meeting of the BarChris board on December 6 that Coleman became aware of the serious problems in BarChris, but even then he did not realize their extent.[6] He generally accepted the explanations of the other board members.[7] At no time did he know of the false picture presented to the Victor shareholders.[8]

The plaintiffs sought to hold Coleman liable for negligence and to hold Drexel & Co. liable as a controlling person under section 20(a)

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[5] 479 F.2d at 1283-87.

[6] This was the "point of crisis" meeting, at which BarChris's corporate problems were highlighted. At this meeting Coleman recommended that an outside consultant be brought in to help straighten out the internal affairs. *Id.* at 1286-88.

[7] Reliance by directors on the reports of others relating to the corporations' financial condition is not uncommon. *See, e.g.*, N.Y. BUS. CORP. LAW § 717 (McKinney 1963), which permits directors, when acting in good faith in discharging their duties, to "rely upon financial statements of the corporation represented to them to be correct by the president or the officer of the corporation having charge of its books of accounts . . . ." It is also proper for the board of directors to delegate some of its authority to executive committees comprised of a portion of the total directors of the company. The committee's reports may then be relied upon by the remaining directors. Based on such reliance, in delegated matters, a committee member will be held to stricter standards of liability than a nonmember director. *See* Kavanaugh v. Gould, 147 App. Div. 281, 290, 131 N.Y.S. 1059, 1066 (3d Dep't 1911); Syracuse Television Inc. v. Channel 9, Syracuse, Inc., 51 Misc. 2d 188, 273 N.Y.S.2d 16 (Sup. Ct. Onondaga County 1966).

[8] 479 F.2d at 1287-89.

of the Securities Exchange Act of 1934 (1934 Act).[9] At a non-jury trial before District Judge Frankel, the defendant Coleman was held not liable to plaintiffs under either rule 10b-5 or section 20(a).[10]

This decision was appealed to the Second Circuit where it was heard en banc. Judge Moore, speaking for the majority, framed the issue as "[w]hat duty, if any, does rule 10b-5 impose on a director in Coleman's position to insure that all material, adverse information is conveyed to prospective purchasers of the corporation's stock where the director does not know that these prospective purchasers are not receiving all such information?"[11] In finding no such duty,[12] the court relied on the common law, the legislative history of the Securities Acts, case law developments under these Acts, and public policy.

At common law a director could not be held liable to the purchasers for the fraud or negligence of others in connection with the sale of securities no matter how negligent he was in his inattentiveness to his own company's affairs.[13] The court noted that this was due to the idea that "a director's first loyalty must be to the shareholders of the company on whose board he sits,"[14] and not to those of a company with whom his company is negotiating.

In construing rule 10b-5 through the history of the Securities Acts, the court noted that section 11 of the Securities Act of 1933 (1933 Act),[15] which makes a signer of a registration statement liable for

9 15 U.S.C. § 78t(a) (1970):

> Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

10 The holding of the district court was reiterated by the Second Circuit, 479 F.2d at 1280.

11 *Id.* at 1289.

12 *See* note 3 *supra* and accompanying text.

13 *See* Barnes v. Andrews, 298 F. 614 (S.D.N.Y. 1924), where a director was deemed to be exempt from liability although he had failed to read circulars sent to prospective purchasers of the corporation's stock. The circulars had been prepared by another and were shown to be fraudulent. The court felt it unnecessary for the director to compare the information contained therein to the true facts. One author has noted "non-participation in the issuance of a prospectus or circular has been for directors a quite invulnerable armor against civil liability." Shulman, *Civil Liability and the Securities Act*, 43 YALE L.J. 227, 241 (1933).

14 479 F.2d at 1293.

15 15 U.S.C. § 77k (1970). This section relates to civil liability in connection with false registration statements and provides, *inter alia*, that any person who signs a registration statement can be sued but that

> [n]otwithstanding the provisions of subsection (a) of this section no person, other than the issuer, shall be liable as provided therein who shall sustain the burden of proof . . . that . . . he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement

misrepresentation, allows a defense of due diligence. Section 11 only applies to public offerings. Looking to section 12(2) of the 1933 Act,[16] which applies to private offerings as well, the court observed that directors could be held liable only if they were participants in the transaction or if there was scienter.[17] The court interpreted this as evidencing a congressional intent that the duties of directors in a private offering would be less than those in public offerings.[18] To extend a duty of due diligence to directors under rule 10b-5 would be to ignore this congressional intent by nullifying "the private offering exemption and . . .

> became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statement therein not misleading . . . .

Id. at § 77k(b)(3). The leading decision concerning the due diligence defense is Escott v. BarChris Const. Corp., 283 F. Supp. 643 (S.D.N.Y. 1968). In that action, purchasers of corporate debentures brought suit against several parties. Among the defendants were both inside and outside directors. The plaintiffs showed that a prospectus included in a registration statement omitted material information and set forth substantially misstated data in an unaudited financial statement. The court considered the liability of each class of defendants separately. None of the inside directors presented evidence of any investigation of the facts set forth in the registration statement. Thus, they were unable to meet the due diligence requirement. The outside directors were also held liable since they had failed to use "that reasonable care to investigate the facts which a prudent man would employ in the management of his own property." *Id.* at 688.

The *BarChris* decision leads one court to note that the requirements of due diligence vary from one director to another.

> Inside directors with intimate knowledge of corporate affairs and of the particular transactions will be expected to make a more complete investigation and have more extensive knowledge of facts supporting or contradicting inclusions in the registration statements than outside directors.

Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544, 577 (E.D.N.Y. 1971). *See* Comment, BarChris: *Easing the Burden of "Due Diligence" under Section 11*, 117 U. PA. L. REV. 735 (1969); Comment, BarChris: *Due Diligence Refined*, 68 COLUM. L. REV. 1411 (1968).

16 15 U.S.C. § 77(2) (1970):

Any person who . . .

> (2) offers or sells a security (whether or not exempted by the provisions of section 77c of this title . . .), by the use of any means or instrument of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable to the person purchasing such security from him . . . .

17 479 F.2d at 1298. As to scienter, the court in Barnes v. Osofsky, 373 F.2d 269, 272 (2d Cir. 1967), felt that within section 12(2) "some form of the traditional scienter requirement . . . is preserved." However, it has been noted that the section is significantly similar both in wording and effect to the due diligence defense of section 11. *See* Folk, *Civil Liabilities Under the Federal Securities Acts, the* BarChris *Case*, 55 VA. L. REV. 199 (1969).

The participation required for section 12(2) protection need not be confined to the immediate seller. In Zachman v. Erwin, 186 F. Supp. 691 (S.D. Tex. 1960), a cause of action under this section arose against a director who helped falsify a financial statement used to induce the plaintiffs to buy certain securities.

18 479 F.2d at 1299.

the limitation of the due diligence duty to registration statements."[19] Moreover, it would also nullify section 20(a) of the 1934 Act, which places liability on a person who is in control of a violator of the Securities Acts but allows such a controlling person to raise the defense of good faith. The court reasoned that the congressional intent in enacting this section was to hold liable "only . . . those directors . . . who are in some meaningful sense culpable participants in the fraud perpetuated by controlled persons."[20]

The court next proceeded to explore the development of case law imposing liability for omissions on directors under the Securities Acts. The cases examined relied primarily on section 12(2) of the 1933 Act or section 20(a) of the 1934 Act. In *Mader v. Armel*,[21] the plaintiff sought to hold two directors liable under section 20(a). The Sixth Circuit held that one was not a controlling person and that the other, though a controlling person, had established a defense of good faith. In *Moerman v. Zipco, Inc.*,[22] the plaintiff sued certain officers and directors under section 12 and rule 10b-5. The case involved material omissions by one of the officers of the corporation during negotiations for the sale of a stock subscription to the plaintiff. Although the section 12 claim was barred by the statute of limitations, the officer was found liable under the rule. The district court further held that the liability of the other directors would rest on section 20 of the 1934 Act.[23]

In examining case law defining directors' duties under the rule, the *Lanza* court gave special attention to Second Circuit precedent.[24]

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19 *Id.*

20 *Id.*

21 461 F.2d 1123 (6th Cir.), *cert. denied*, 409 U.S. 1023 (1972).

22 302 F. Supp. 439 (E.D.N.Y. 1969), *aff'd on opinion below*, 422 F.2d 871 (2d Cir.), *rehearing denied*, 430 F.2d 362 (1970). The plaintiff had been told there would only be a limited number of shareholders in the company. When he mentioned this information to the firm's president, the officer did not indicate that this was incorrect. As a result, plaintiff purchased shares in the company. Since the president knew at the time of the conversation that there would be a large number of shareholders in the firm, he was held liable under 10b-5.

Plaintiff also tried to have four directors held liable, two of whom also served as corporate officers. Since he had no prior dealing with these parties, it was necessary to allege violations of section 20 and to prove control. The court came to the broad conclusion that "persons who act as directors are in control of the corporation." *Id.* at 447. However, the defendants were able to avoid liability by showing good faith.

23 *Id.* at 446.

24 479 F.2d at 1301-02. Here the court made a statement which may result in the limitation of this case to its particular facts and which is seemingly contradictory to some of the later statements of the court on the issue of scienter. Judge Moore said:

> We recognize that *participation* by a director in the dissemination of false information . . . may subject such a director to liability under the Rule. But it is quite a different matter to hold a director liable in damages for failing to insure

In rejecting the plaintiffs' claim that Coleman would be liable for negligence under the rule absent any affirmative duty to disclose, the court focused on the language in *SEC v. Texas Gulf Sulphur Co.* (*TGS*).[25] There the Second Circuit had stated that,

> a review of other sections of the act from which Rule 10b-5 seems to have been drawn suggests that implementation of a standard of conduct that encompasses negligence as well as active fraud comports with the administrative and the legislative purposes underlying the Rule. Finally we note that this position is not, as asserted by defendants, irreconcilable with previous language in this circuit because "*some form* of the traditional scienter requirements," . . . sometimes defined as "fraud," . . . is preserved. This requirement, whether it be termed lack of diligence, constructive fraud, or unreasonable or negligent conduct, remains implicit in this standard . . . .[26]

The *Lanza* court noted that the *TGS* case was distinguishable in that it concerned an SEC enforcement proceeding for injunction.[27] However, the court felt that any doubt as to whether scienter would be required was affirmatively resolved in its later holding in *Shemtob v. Shearson, Hammill & Co.*[28]

It is submitted that this latter statement by the court was not an accurate characterization of the law as it existed at the time of the *Lanza* case. As Judge Hays noted in his dissenting opinion, it was not clear whether the Second Circuit had previously required scienter.[29] The first case imposing such a requirement, *Fischman v. Raytheon Manufacturing Co.*,[30] was later confused by the statement of the *TGS*

> that all material adverse information is conveyed to prospective purchasers of the company's stock absent substantial participation in the concealment or knowledge of it.

Id. at 1302 (emphasis in original). This implies that unknowing participation in the fraud will serve as a substitute for scienter. But actual participation would probably subject the director to liability under section 12(2) of the 1933 Act if he were unable to show due diligence. *See* note 16 *supra.*

25 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied,* 394 U.S. 976 (1969).

26 *Id.* at 855. For a general discussion of the scienter requirements of 10b-5 see Epstein, *The Scienter Requirements in Actions Under Rule 10b-5,* 48 N.C.L. Rev. 482 (1970); Note, *Scienter and Rule 10b-5,* 69 Colum. L. Rev. 1057 (1969).

27 479 F.2d at 1304. In *TGS*, three concurring opinions also noted this factor.

28 448 F.2d 442 (2d Cir. 1971).

29 479 F.2d at 1318-19.

30 188 F.2d 783 (2d Cir. 1951). *Raytheon* held that misrepresentations contained in a prospectus and registration statement which could not be sued upon under section 11 by a purchaser who had not bought registered securities could nevertheless be a basis for a suit under section 10(b) of the 1934 Act and rule 10b-5 where the false statements were allegedly fraudulent. The court stated that "proof of fraud is required in suits under § 10(b) of the 1934 Act and rule X-10B-5, which was validly promulgated by the S.E.C. pursuant to that section." *Id.* at 786.

court quoted above. Decisions subsequent to *TGS* evidenced a new uncertainty as to the need for scienter under the rule. In *Heit v. Weitzen*,[31] the court declined to decide whether there was a scienter requirement, finding the plaintiff's complaint sufficient either way. In *Globus v. Law Research Service, Inc.*,[32] the court found that a jury instruction which did not require an intent to defraud was sufficient whether the standard was scienter or negligence since the instruction had required scienter. It is submitted that *Shemtob v. Shearson, Hammill & Co.*,[33] relied on by the *Lanza* court, did not definitively establish a scienter requirement either. *Shemtob* involved a suit against a broker because of failure to follow instructions, and did not involve any misrepresentation or concealment whatsoever. Despite strong dictum concerning scienter,[34] the holding of *Shemtob* was narrow, *viz.*, "only that the complaint failed to state a claim for relief under 10b-5 on the ground that the suit was a garden-variety customer's suit against a broker for breach of contract."[35]

The Second Circuit has not been alone in determining whether the negligence or scienter standard applies. While other circuits have decided that negligence is sufficient, it has very rarely been crucial to the decisions in those cases.[36] Frequently, the rule is stated in dictum[37]

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31 402 F.2d 909 (2d Cir. 1968), *cert. denied*, 395 U.S. 903 (1969). It was alleged in *Heit* that corporate financial statements failed to disclose that a substantial portion of the firm's income was derived from overcharging on government contracts. Plaintiffs claimed that in reliance on such misrepresentations, they purchased debentures and common stock of the corporation and subsequently suffered losses on their investments.

At issue was the sufficiency of the complaint. The court noted that due to *TGS*, there was difficulty as to whether "the appropriate standard in a private damage action should embody a scienter requirement." *Id.* at 913. However, resolution of the problem was postponed. The complaint had alleged that the defendants knew or should have known of the misleading statements.

32 418 F.2d 1276 (2d Cir.), *cert. denied*, 397 U.S. 913 (1970).

33 448 F.2d 442 (2d Cir. 1973).

34 *Id.* at 445. The court noted that the plaintiff's claim had to be dismissed because there was an

> absence of allegation of facts amounting to *scienter*, intent to defraud, reckless disregard for the truth, or knowing use of a device, scheme or artifice to defraud. It is insufficient to allege mere negligence . . . breach of contract or breach of a stock exchange rule. . . . In the absence of any allegation of facts amounting to fraud or *scienter*, the claims . . . are insufficient . . . .

Id.

35 479 F.2d at 1319. (Hays, J., dissenting), *quoting* Schemtob v. Shearson, Hammill & Co., 448 F.2d 442, 445 (2d Cir. 1973).

36 *See* Buckle, *Scienter and Rule 10b-5*, 67 Nw. U.L. Rev. 562 (1972).

37 *Id.* at 563. For example, the courts discuss the negligence standard in decisions where actual knowledge on the part of the alleged violators appears clearly to exist. *See* Myzel v. Field, 386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968) (defendants, insiders of the corporation, purchased plaintiffs' stock after knowingly misrepresenting the firm's financial position); Stevens v. Vowell, 343 F.2d 374 (10th Cir. 1965) (plaintiff invested in defendant's firm after known false statements were made to him regarding the

and repeatedly is a prime factor in deciding what statute of limitations to apply.[38] Nevertheless, the widespread acceptance of a negligence standard, even in cases where there clearly is scienter, shows the tendency on the part of most courts to expand 10b-5 liability to encompass such conduct.

The Ninth Circuit was apparently the earliest to recognize negligence as a basis for liability under 10b-5. In *Ellis v. Carter*,[39] the defendant claimed that common law fraud was necessary under rule 10b-5 In rejecting this contention the court, despite the existence of scienter, took the opposite extreme and held that the prohibition was against any "manipulative or deceptive devices," not merely fraudulent devices.[40] The court never discussed the possibility of a middle ground requiring scienter but not common law fraud.[41]

The Tenth Circuit claims to have a scienter requirement but in *Mitchell v. Texas Gulf Sulphur Co.*[42] and *Gilbert v. Nixon*[43] defined it to include negligence. The exact holding of these cases is unclear. *Gilbert* stated that there would be liability for negligence but this was apparently based on the plaintiff's claims under section 12(2) of the

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ownership of equipment vital to the firm's operations, the placing in trust of plaintiff's investment, and an investment by defendant of an equal sum).

38 *See, e.g.*, Vanderboom v. Sexton, 422 F.2d 1233 (8th Cir.), *cert. denied*, 400 U.S. 852 (1970). *See* notes 51-53 and accompanying text *infra*.

39 291 F.2d 270 (9th Cir. 1961). In holding that the allegations need not speak in terms of fraud or scienter, the court noted:

> Section 10(b) speaks in terms of the use of "any manipulative device or contrivance" in contravention of rules and regulations as might be prescribed by the Commission. It would have been difficult to frame the authority to prescribe regulations in broader terms. Had Congress intended to limit this authority to regulations proscribing common-law fraud, it would probably have said so. We see no reason to go beyond the plain meaning of the word "any", indicating that the use of manipulative or deceptive devices or contrivances of *whatever kind* may be forbidden, to construe the statute as if it read "any fraudulent" devices.

Id. at 294 (emphasis added).

40 *Id.*

41 *See also* Hecht v. Harris, Upham & Co., 430 F.2d 1202 (9th Cir. 1970) (churning is fraud under rule 10b-5 and proof of a specific intent to defraud is unnecessary); Royal Air Properties, Inc. v. Smith, 312 F.2d 210 (9th Cir. 1962) (material misstatement or omission is sufficient to establish a prima facie case under 10b-5, common law fraud is not necessary). In both of these cases there was scienter if not common law fraud.

42 446 F.2d 90, 102 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971). The court noted that the defendants failed to sustain their burden of proving that they had no knowledge of the misrepresentation nor that in the exercise of due diligence they could not have known of the misrepresentation. Based on this standard, the mere absence of scienter would have been insufficient to relieve the defendants of liability.

43 429 F.2d 348, 357 (10th Cir. 1970). Throughout the opinion, the test used to ascertain the defendant's liability incorporated a negligence standard. The defendant was forced to prove both that he did not know and that in the exercise of reasonable care he could not have known of the misrepresentation. Clearly, under such a standard, failure to exercise reasonable care could result in liability although scienter was absent.

1933 Act.[44] *Mitchell* involved only a 10b-5 claim but the court quoted *Gilbert* and applied the same standard used therein.[45] In neither of the cases was the defendants' conduct merely negligent. A more recent case, *Financial Industrial Fund, Inc. v. McDonnell Douglas Corp.*,[46] held that plaintiff had failed to meet his burden of proof to show both a duty to disclose and a lack of due care on the part of defendant, and his own freedom from contributory negligence.[47] This is a clear recognition of the negligence standard.

The Eighth Circuit abrogated the need for scienter in four cases. In three, the negligence rule was stated in dictum; in the other, it supported the determination of the appropriate statute of limitations. In *City National Bank of Fort Smith v. Vanderboom*,[48] a bank sued on notes issued by defendants for money lent to an investment corporation of which they were shareholders. The defendants counter-claimed on the basis of statements allegedly made by the president of the bank to the effect that he thought the proposed use of the money was a good investment. The court held that the defendants lacked standing to raise a 10b-5 claim since the corporation was the purchaser of the shares.[49] The court, however, held that negligence would be enough to sustain liability under the rule.[50] In a companion case, *Vanderboom v. Sexton*,[51] a 10b-5 suit was held barred by the statute of limitations contained in the Arkansas Blue-Sky Law.[52] The court applied the

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44 *Id.* at 357.

45 446 F.2d at 102.

46 474 F.2d 514 (10th Cir. 1973).

47 *Id.* at 517. The court noted that a plaintiff as part of its 10b-5 action must exercise "good faith in its purchase [and] due diligence . . . ." *Id.* It was felt that in making its purchase, plaintiff had not exercised reasonable care. The earnings statement indicating the effect of the delays was deemed sufficient to place a reasonable investor on notice as to corporate difficulties. As such, investigation into the income situation of the firm would seem prudent. The absence of such reasonable care by the investor effectively destroys his 10b-5 claim.

48 422 F.2d 221 (8th Cir. 1970).

49 *Id.* at 227-28.

50 The court fashioned a two-step test to determine the applicability of 10b-5. In doing so it noted its substantial agreement with the Second Circuit except to the extent that the Second Circuit did not recognize a negligence standard. The test formulated provided:

> (1) with regard to misrepresentations, the question is whether a reasonable investor . . . would have been entitled to rely upon the misrepresentation. With regard to nondisclosures, the issue becomes whether a reasonable investor . . . would have been entitled to receive full disclosure from the party charged and would have acted differently had the alleged nondisclosure not occurred. (2) If the plaintiff satisfies this "in connection with" step [1], it then becomes necessary to determine whether the defendant's misrepresentation or nondisclosure was made with scienter or *from a lack of due diligence.*

Id. at 230 (emphasis added).

51 422 F.2d 1233 (8th Cir.), *cert. denied*, 400 U.S. 852 (1970).

52 ARK. STAT. ANN. § 67-1256(e) (1966).

statute of limitations for the state law which most resembled the 10b-5 claims. It was felt that the Blue-Sky Law resembled 10b-5 more than did common law fraud because rule 10b-5 applied to "negligent as well as knowing and intentional misrepresentation."[53]

The Seventh Circuit has also adopted a negligence standard for damages under 10b-5. *Kohler v. Kohler Co.*[54] involved a claim that the defendant company should have revealed all the details of its accounting methods to the plaintiff when valuing his shares for the purpose of buying him out. In holding that the corporation had violated no duty to plaintiff the court stated that the rule required a corporate insider "to exercise reasonable and due diligence not only in ascertaining what is material as of the time of the transaction but in disclosing fully those material facts about which the outsider is presumably uninformed and which would, in reasonable anticipation, affect his judgment."[55] The court felt that the facts showed an exercise of the required due diligence.[56]

Finally, the *Lanza* court considered the public policy argument, which was directed to the need for outside directors in corporations and the possibility of determining the service of such directors should they be held to too strict a standard under rule 10b-5.[57] Judge Hays, dissenting, felt that Coleman had breached the duty of even an outside director in his failure to pay any attention at all to corporate affairs.[58]

The impact of *Lanza* is not entirely clear. Judge Hays in his dissent stated that

> it is not profitable in considering a case such as this merely to characterize the allegedly unlawful conduct as either negligent or wilful and to impose liability only if the conduct was wilful. . . . The relationship of the parties and the transaction involved must be analyzed in order to determine whether the Act and the Rule impose a duty on one party with respect to the other and the nature of that duty.[59]

Although the majority said that scienter was required under 10b-5,

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[53] 422 F.2d at 1238. *See also*, Travis v. Anthes Imperial Ltd., 473 F.2d 515 (8th Cir. 1973) (the requirements for a 10b-5 suit include negligence where the issue was whether the "in connection with" element was satisfied).

[54] 319 F.2d 634 (7th Cir. 1963).

[55] *Id.* at 642.

[56] *See also* Dasho v. Susquehanna Corp., 461 F.2d 11 (7th Cir. 1972) (scienter not necessary for violation of proxy rules, same requirements apply as in 10b-5 case); Parrent v. Midwest Rug Mills, Inc., 455 F.2d 123 (7th Cir. 1972) (three-year statute of limitations of Illinois securities law applied to bar 10b-5 action because the absence of a scienter requirement makes it resemble the securities law more than common law fraud).

[57] 479 F.2d at 1306-07.

[58] *Id.* at 1319-20.

[59] *Id.* at 1317.

they did so only after finding that 10b-5 did not impose a duty to disclose on this outside director. This implies that the court was following the admonition of Judge Hays. Additionally, a statement by Judge Moore suggests further that the scienter requirement announced in *Lanza* is not the sole test for 10b-5 liability.[60]

The precise holding of *Lanza* is that a director who is a nonparticipant in a transaction and who personally makes no misrepresentations will not be held liable for mere negligence contributing to the fraud perpetrated upon the other party to the transaction.

The scienter requirement for liability where the defendant is not directly involved in the transaction is probably a beneficial rule. The cases in other circuits which have recognized a standard of negligence have all concerned persons involved in the unlawful transaction in one way or another. This is certainly far different from imposing liability on a director who had nothing whatsoever to do with the wrongful conduct. Whether the Second Circuit will apply a negligence standard in circumstances other than those presented here remains to be decided.

INSIDE INFORMATION — COMMON LAW LIABILITY

Schein v. Chasen

Insider trading in public securities markets has long been subject to condemnation.[1] In order to combat this undesirable practice, Congress has vested the courts and the SEC with a complete arsenal of weapons. Of primary significance[2] among these is section 10b of the Securities Exchange Act of 1934,[3] and rule 10b-5 enacted pursuant

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60 *See* note 24 *supra*.

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1 *See* 2 L. Loss, Securities Regulation 1037 (2d ed. 1961) [hereinafter cited as Loss]. Such condemnation has not been universal, however. See H. Manne, Insider Trading and the Stock Market (1966). *See also* Manne, *Insider Trading and the Law Professors*, 23 Vand. L. Rev. 547 (1970), and the authorities cited therein at nn.2 & 4. *Compare* Ferber, *The Case Against Insider Trading: A Response to Professor Manne*, 23 Vand. L. Rev. 621 (1970), *with* Manne, *A Rejoinder to Mr. Ferber*, 23 Vand. L. Rev. 627 (1970).

2 Another formidable weapon for dealing with insider trading is section 16(b) of the 1934 Act, 15 U.S.C. § 78(p)(b) (1970). Liability under section 16(b) is limited to true insiders: directors, officers and controlling (10% or more) shareholders. Any profit made by such an insider as a result of a purchase and sale or sale and purchase of corporation securities within a six month period may be recovered by the corporation or by any security holder on behalf of the company in a quasi-derivative suit. As a streamlined statute imputing absolute liability, section 16(b) implements the policy that an insider should not be "playing the market" in his own corporation's securities. *See* Smolowe v. DeLendo Corp., 136 F.2d 231, 235-36 (2d Cir.), *cert. denied*, 320 U.S. 751 (1973); Loss, *supra* note 1, at 1041 *et seq*. However, section 16(b) lacks the broad scope of rule 10b-5 and thus is less effective as a general deterrent to the many varying types of insider trading.

3 Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1970), provides: