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Nonparticipating Corporate Director Owes No Duty to Insure That All Material, Adverse Information Is Conveyed to Prospective Purchasers.

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in personam jurisidiction by the forum. This further liberalization holds much validity given the commercial realities of today's business world, however, this liberalization should not be permitted to proceed to such a degree that every state assumes the role of Tobago in trying to impose their jurisdiction upon the world.[50]

James P. Brennan

CORPORATIONS—Rule 10b-5—Nonparticipating Corporate Director Owes No Duty to Insure That All Material, Adverse Information Is Conveyed To Prospective Purchasers

Lanza v. Drexel & Co., CCH FED. SEC. L. REP. ¶ 93,959 (2d Cir. April 26, 1973).

On December 14, 1961, plaintiffs, sole owners of Victor Billiard Company (Victor), exchanged their 20,000 shares for 20,428 shares of BarChris Construction Company (BarChris). On October 29, 1962, BarChris filed a petition for an agreement under Chapter XI of the Bankruptcy Act.[1] Pursuant to a settlement agreement with BarChris trustees, plaintiffs, upon payment of $100,000 in borrowed funds, recovered their Victor shares. They then filed suit against former officers and directors of BarChris, alleging, *inter alia*, a violation of section 10(b)[2] of the Securities Exchange Act of 1934 (1934 Act), specifically Rule 10b-5[3] promulgated thereunder. The trial court found that plaintiffs, through their accountant, had been led by material misstatements and omissions on the part of certain officers and directors of BarChris to enter the exchange agreement.[4]

50. Buchanan v. Rucker, 9 East 192 (K.B. 1808). *See* Cardozo, *The Reach of the Legislature and the Grasp of Jurisdiction*, 43 CORNELL L.Q. 210, 213 (1958).

1. For a detailed financial analysis of BarChris operations up to May 16, 1961, see Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 652-80 (S.D.N.Y. 1968).

2. 15 U.S.C. § 78j(b) (1970).

3. 17 C.F.R. 240.10b-5 (1972). Other legal grounds for plaintiffs' claims included § 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q(a) (1970), common law fraud doctrines, and a theory of prima facie tort.

4. The trial court concluded that plaintiffs had sustained compensable damages in the amount of $100,000 plus interest. Those defendants held liable under Rule 10b-5 included Christie Vitolo, president, Leonard Russo, director and vice president, and Theodore Kircher, director and treasurer.

Plaintiffs appealed the trial court's refusal to hold defendant Coleman,[5] a director who neither participated in nor knew of any deception practiced upon plaintiffs during the exchange negotiations, liable under Rule 10b-5. Held—*Affirmed.* 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. A director's liability to prospective purchasers under Rule 10b-5 can thus be only secondary, such as that of an aider and abettor, a conspirator, or a substantial participant in fraud perpetrated by others.[6]

The proposal and subsequent passage of the Securities Act of 1933[7] came in response to President Roosevelt's message to Congress on March 29, 1933.[8] The purpose of the legislation was to insure that issues of new securities offered to the public were accompanied by full disclosure so as "to protect the public with the least possible interference to honest business."[9] The Act expressly sets forth, within a disclosure framework, a set of regulations and requirements for registration of new public offerings, imposing civil, administrative and criminal sanctions for violation of their various provisions. The anti-fraud provision of the 1933 Act makes certain practices unlawful in the offer or sale of any securities which would operate as a fraud or deceit upon the purchaser.[10]

While the 1933 Act dealt primarily with the original distribution process of securities, the 1934 Act concerned itself with speculative trading in securities after their entry into the market place. The general provisions of the 1934 Act specifically apply to purchases and sales, section 10(b) of the Act prohibiting any manipulative or deceptive device or contrivance, which violates the Commission rules, in connection with the purchase or sale of

5. Bertram D. Coleman, a partner of Drexel & Co., the lead underwriter of a 1961 debenture offering, joined the board of directors for the purpose of monitoring the activities of Bar Chris, in which Drexel had made a substantial investment. Plaintiffs attempted to hold Drexel liable on a theory of *respondeat superior* for Coleman's alleged unlawful conduct. The complaint against Drexel was dismissed with Coleman's acquittal.

6. Lanza v. Drexel & Co., CCH FED. SEC. L. REP. ¶ 93,959 at 93,810 (2d Cir. April 26, 1973) [citations will be to page numbers].

7. 15 U.S.C. §§ 77a to aa (1970).

8. In his message, the President stated:

> Of course, the Federal Government cannot and should not take any action which might be construed as approving or guaranteeing that newly issued securities are sound in the sense that their value will be maintained or that the properties which they represent will earn profit.
>
> There is, however, an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public.

S. REP. No. 47 at 6-7 and H.R. REP. No. 85 at 1-2, 73d Cong., 1st Sess. (1933).

9. S. REP. No. 47 at 7, 73d Cong., 1st Sess. (1933).

10. 15 U.S.C. § 77q(a) (1970).

any security.[11] Under the authority of section 10(b), the Securities and Exchange Commission in May 1942, promulgated Rule 10b-5,[12] which substantially incorporates the language of section 17(a) of the 1933 Act.[13] The thrust of the rule was directed toward closing a loophole in the securities laws by extending protection against fraud to include transactions of purchase.[14] The Rule is an anti-fraud proscription declaring it unlawful for a person buying or selling a security to fail to state, or to misstate, a material fact or generally to engage in any conduct of a fraudulent nature regarding the transaction.[15]

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11. Section 10(b) provides the following:

> 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—
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> . . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b) (1970).

12. Rule 10b-5 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interestate [sic] commerce, or of the mails, or of any facility of any national securities exchange,
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> (a) To employ any device, scheme, or artifice to defraud,
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> (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
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> (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.

17 C.F.R. 240.10b-5 (1972).

13. Professor Loss states of the Rule:

> In the revision program of 1941 the Commission and the securities industry jointly suggested an Amendment to extend § 17(a) of the Securities Act to the purchase as well as the sale of securities. When this program was shelved, the Commission in May 1942 hit upon a solution to this problem which from hindsight appears exceedingly simple and obvious. Acting under § 10(b), which had been in the Exchange Act from the beginning, the Commission adopted Rule 10b-5 . . . which merely borrows the language of § 17(a) of the Securities Act, except for the reference in Clause (2) *to obtaining money or property by means of* an untrue statement or half-truth, and applies it "in connection with the purchase or sale of any security" . . . .

3 L. LOSS, SECURITIES REGULATION, pp. 1426-27 (2d ed. 1961) (footnotes omitted).

14. Concerning the adoption of the Rule, the SEC stated:

> The Securities and Exchange Commission today announced the adoption of a rule prohibiting fraud by any person in connection with the purchase of securities. The previously existing rules against fraud in the purchase of securities applied only to brokers and dealers. The new rule closes a loophole in the protections against fraud administered by the Commission by prohibiting individuals or companies from buying securities if they engage in fraud in their purchase.

SEC Exchange Act Release No. 3230, May 21, 1942. *See also* Freeman, *Conference on Codification of the Federal Securities Law*, 22 BUS. LAW. 793, 891, 922 (1967), where Freeman relates that the rule was promulgated in response to a complaint that a Boston corporation president was fraudulently purchasing shares of his own company by misrepresenting their actual worth to the sellers.

15. 17 C.F.R. 240.10b-5 (1972).

Following the decision of *Kardon v. National Gypsum Co.*,[16] holding that a defrauded buyer or seller could sue the other party to a securities transaction under section 10(b) by implying a civil remedy not expressly provided in the 1934 Act, disagreement developed among the federal district and circuit courts as to the requisites needed to sustain liability under Rule 10b-5.[17] The courts, in an effort to formulate effective guidelines, have examined the common law elements of fraud.[18] The element of *scienter* has posed particular problems.[19] One of the earliest cases to discuss the *scienter* requirement was the Court of Appeals for the Second Circuit's 1951 decision in *Fischman v. Raytheon Mfg. Co.*[20] In that case, plaintiffs, common stockholders of the Raytheon Company, alleged both a violation of section 11 of the 1933 Act,[21] and a violation of Rule 10b-5. The Court of Appeals for the Second Circuit, in reversing the dismissal of the complaint, indicated that both causes of action could arise from a common nucleus of operative fact, stating that:

> [W]hen, to conduct actionable under section 11 of the 1933 Act, there is added the ingredient of fraud, then that conduct becomes actionable under 10(b) of the 1934 Act and the Rule . . . .[22]

The court in *Fischman* implied that knowledge of the wrongdoing would have to be shown in order to support the Rule 10b-5 action.[23]

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16. 69 F. Supp. 512 (E.D. Pa. 1946). For a discussion of private right theories as applied to Rule 10b-5, *see* Ruder, *Texas Gulf Sulphur—The Second Round*, 63 NW. U.L. REV. 423, 430-33 (1968).

17. *See, e.g.*, the reference in Cash v. Frederick & Co., CCH FED. SEC. L. REP. ¶ 93,967 at 93,871 (E.D. Wis. 1972) to the "contradiction and confusion over the proper standard for Rule 10b-5."

18. *See, e.g.*, Lanza v. Drexel & Co., CCH FED. SEC. L. REP. ¶ 93,959 at 93,820 (2d Cir. April 26, 1973). *See also* 3 L. LOSS, SECURITIES REGULATION 1430-42 (2d ed. 1961); Comment, *Negligent Misrepresentations Under Rule 10b-5*, 32 U. CHI. L. REV. 824, 828 (1965).

19. Confusion surrounding the element of *scienter* arises both because it is grounded in the ambiguous concept of common law fraud, as noted in W. PROSSER, THE LAW OF TORTS § 105, at 684 (4th ed. 1971), and the fact that courts have been relaxed in a judicial application of the terms as used in Rule 10b-5 actions. *See* 3 L. LOSS, SECURITIES REGULATION 1432 (2d ed. 1961). *Compare* Shemtob v. Shearson, Hammill & Co., 448 F.2d 442, 445 (2d Cir. 1971) (actual or constructive knowledge required), Gould v. Tricon, Inc., 272 F. Supp. 385, 393 (S.D.N.Y. 1967) (Fraudulent conduct essential), Weber v. C.M.P. Corp., 242 F. Supp. 321, 325 (S.D.N.Y. 1965) (deception essential) *and* Trussell v. United Underwriters, Ltd., 228 F. Supp. 757, 772 (D. Colo. 1964) (reckless disregard essential), *with* Ellis v. Carter, 291 F.2d 270, 274 (9th Cir. 1961) (*scienter* requirement rejected) *and* Royal Air Properties, Inc. v. Smith, 312 F.2d 210, 212 (9th Cir. 1962) (no fraud needed).

20. 188 F.2d 783 (2d Cir. 1951).

21. 15 U.S.C. § 77k (1970). Section 11 imposes a duty of investigation upon those directors who sign a registration statement for the public issue of shares. Liability is imposed for failure to comply with the investigation requirement and requires no proof of fraud or deceit.

22. Fischman v. Raytheon Mfg. Co., 188 F.2d 783, 786 (2d Cir. 1951).

23. *Id.* at 787.

A case traditionally cited for the proposition that *scienter* or culpability is not a requisite under Rule 10b-5 is the Court of Appeals for the Ninth Circuit's decision in *Ellis v. Carter*.[24] Here, the court argued that common law fraud is not required under section 10(b) if there is a showing that a "manipulative or deceptive device" was employed in the purchase and sale of securities.[25]

Falling between the divergent viewpoints illustrated by *Fischman* and *Ellis*, are those decisions which advance a negligence theory of liability. Widely quoted in support of the negligence theory is the landmark case of *SEC v. Texas Gulf Sulphur*,[26] where the majority noted:

> [A] review of other sections of the Act from which Rule 10b-5 seems to have been drawn suggests that the 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.[27]

It has been argued that the decision in *Texas Gulf Sulphur* represents a relaxation of the *scienter* requirement,[28] and lower courts have been called upon, in assessing damages under the Rule, to examine the critical distinctions between these conflicting approaches.[29]

In the present case of *Lanza v. Drexel & Co.*,[30] the court, sitting en banc, addressed itself directly to the *scienter* requirement as it relates to the evolution of the law regarding corporate directors' liabilities under Rule 10b-5.[31] The court, in a comprehensive opinion, examined the common law as of the time of the enactment of the 1934 Act, the legislative history of

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24. 291 F.2d 270 (9th Cir. 1961).

25. *Id.* at 274.

26. 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

27. *Id.* at 855.

28. *See* Epstein, *The Scienter Requirement in Actions Under Rule 10b-5*, 48 N.C.L. REV. 482, 487-88 (1970).

29. *See* Bohlen, *Should Negligent Misrepresentations be Treated as Negligence or Fraud?*, 18 VA. L. REV. 703, 712 (1932), where Professor Bohlen states:

> The difference between recklessness and what is sometimes called "mere" negligence is completely ignored and yet this distinction is often of immense importance in tort law. An act to be reckless must be deliberately done . . . . There is always actual culpability where the conduct is reckless. Mere negligence does not necessarily imply anything which can be fairly called culpability . . . .

30. CCH FED. SEC. L. REP. ¶ 93,959 (2d Cir. April 26, 1973).

31. In doing so, the court adopted Professor Ruder's analytic framework for determining liability under the Rule. Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification and Contribution*, 120 U. PA. L. REV. 597, 600 (1972). Ruder asserts that in multiple defendant suits where violations of securities laws are alleged, some defendants will be primarily involved in the wrongdoing, while others will be only secondarily implicated. Primary wrongdoers are those owing direct duties to the public, while the liabilities of secondary wrongdoers arise only because another has violated the law. He argues that the culpability of the secondary wrongdoer is less than that of the primary wrongdoer and as such, proof should be shown that the secondary defendant had knowledge, either actual or constructive, of the illegal act for liability to be imposed.

the Securities Act, and relevant case law in an effort to formulate a usable standard of conduct which clearly articulates the *scienter* or knowledge requirement which must be alleged and proved under Rule 10b-5.

Generally, the *scienter* requirement in a common law action for fraudulent misrepresentation encompasses actual knowledge or reckless disregard for the truth.[32] A controversy exists, however, as to whether negligence may be incorporated into an action for fraud or deceit[33] so that possible levels of intent are within a continuum, bounded on the one side by mere negligence or innocent misrepresentation, and on the other by a willful intent to defraud.

In concluding that there was no primary common law duty upon directors to insure that all material, adverse information be conveyed to prospective purchasers of the company's stock, the court in *Lanza* cited as authority the English case of *Dovey v. Cory*,[34] and the United States decision of *Barnes v. Andrews*.[35] Both cases are factually similar to the instant case in that a defendant director was sought to be held liable for damages for fraudulent conduct perpetrated on the plaintiff by other members of the defendant's organization, such fraudulent activity being unkown to the defendant.

Lord Halsbury, writing in *Dovey*, analyzed defendant Cory's liability for neglect of his duties as follows:

> The charge of neglect appears to rest on the assertion that Mr. Cory, like the other directors, did not attend to any details of business not brought before them by the general manager or the chairman, and the argument raises a serious question as to the responsibility of all persons holding positions like that of directors, how far they are called upon to distrust and be on their guard against the possibility of fraud being committed by their subordinates of every degree . . . . The business of life could not go on if people could not trust those who are put into a position of trust for the express purpose of attending to details of management.[36]

Thus, it would appear that in the absence of some degree of culpability, ei-

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32. RESTATEMENT OF TORTS § 526 (1938):
A misrepresentation in a business transaction is fraudulent if the maker
(a) Knows or believes the matter to be otherwise than as represented, or,
(b) Knows that he has not the confidence in its existence or non-existence asserted by his statement of knowledge or belief, or
(c) Knows that he has not the basis for his knowledge or belief professed by his assertion.

33. Professor Loss notes that *scienter*:
has been variously defined to mean everything from knowing falsity with an implication of *mens rea,* through the various gradations of recklessness, down to such non-action as is virtually equivalent to negligence or even liability without fault . . . .
3 L. LOSS, SECURITIES REGULATION, 1432 (2d ed. 1961).

34. [1901] A.C. 477.

35. 298 F. 614 (S.D.N.Y. 1924).

36. Lanza v. Drexel & Co., CCH FED. SEC. L. REP. ¶ 93,959 at 93,821 (2d Cir. April 26, 1973), *quoting* Dovey v. Cory, [1901] A.C. 477.

ther actual knowledge of the fraud, or a reckless disregard for the truth so that knowledge will be attributed to the director, no liability would ensue against an unknowing, nonparticipating director at common law.[37]

After an exhaustive review of the legislative history of the Securities Acts of 1933 and 1934, the court in *Lanza* concluded that it was the framer's intent to require that the element of culpability be present in those cases arising under section 10(b) and Rule 10b-5.[38] There is little evidence to show a Congressional intent to impose a stricter duty on directors than existed before the statutory enactments.[39] If, then, the contention that liability should be imposed for mere negligence is to be sustained, support for such a contention must be found in the weight of judicial precedent.

It has been stated that the judicial trend is toward extending the application of Rule 10b-5 by doing away with the requirement of *scienter*.[40] The better view would seem to be that of a recent commentator, who, in analyzing those cases in which the element of *scienter* was discussed, found a disparity between the *scienter* language employed by the courts, and the actual fact situations upon which the decisions rested.[41] The writer concluded that in no case has liability been imposed for mere negligence in private actions under Rule 10b-5.[42]

A discussion of several cases most often cited as rejecting a *scienter* requirement proves illuminating. *Ellis v. Carter*[43] was a private action for damages resulting from defendant's misrepresentation to the plaintiff in a joint venture to acquire control of a corporation. The misrepresentation was basically that if plaintiff would purchase shares of the corporation at a price in excess of the market price, he would receive a voice in the corporate management. The Court of Appeals for the Seventh Circuit, in reversing and remanding for trial on the issues, rejected defendant's claim that plaintiff must allege and prove "genuine fraud," as distinguished from "a mere misstatement or commission."[44] The court stated that Congress intended liability if there existed "any manipulative or deceptive device or contrivance in contravention of rules and regulations."[45] The statement was an unnecessary addition to the opinion, since the alleged facts, if proved, would show actual knowledge of any misrepresentation. *Stevens v. Vowell*[46] is another example

37. Lanza v. Drexel & Co., CCH FED. SEC. L. REP. ¶ 93,959 at 93,820 (2d Cir. April 26, 1973).
38. *Id.* at 93,826-27.
39. *Id.* at 93,819-27.
40. *See, e.g.*, Globus v. Law Research Serv., Inc., 418 F.2d 1276, 1291 (2d Cir. 1969).
41. Bucklo, *Scienter and Rule 10b-5*, 67 NW. U.L. REV. 562, 563 (1972).
42. *Id.* at 590.
43. 291 F.2d 270 (9th Cir. 1961).
44. *Id.* at 275-76.
45. *Id.* at 279.
46. 343 F.2d 374 (10th Cir. 1965).

of a case where the court asserts that it is not necessary to allege common law fraud to recover damages under section 10(b), although the facts demonstrated a situation where outright manipulation, constituting fraud, existed.[47]

The majority in *Lanza* did not find such statements approving a "negligence" standard to be persuasive. It reaffirmed its holding in *Shemtob v. Shearson, Hammill & Co.*,[48] that no violation of Rule 10b-5 occurs, "in the absence 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."[49]

While *Shemtob* precludes mere negligence from being a basis for liability, the test employed in *Lanza* provides that the lowest level of a *scienter* continuum for Rule 10b-5 purposes will be actual knowledge or reckless disregard for the truth.[50]

In his dissenting opinion,[51] Judge Hays rejects the negligence/*scienter* standard, stating: "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."[52]

The dissent would interpret the "omission to state material facts" language of subsection (b) of Rule 10b-5 to include both an omission occurring as part of an affirmative act, and an omission occurring as a result of a failure to act because of negligence.[53] Such an interpretation of the statute would appear to be in opposition to the Congressional intent, which indicates, when the Securities Acts of 1933 and 1934 are read as a whole, that knowledge of the actual omission, or reckless conduct attributing knowledge, should be a parameter of Rule 10b-5 liability.[54]

Judge Timbers joined in the dissent, arguing that Coleman's conduct

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47. *Id.*

48. 448 F.2d 442 (2d Cir. 1971).

49. Lanza v. Drexel & Co., CCH FED. SEC. L. REP. ¶ 93,959 at 93,831 (2d Cir. April 26, 1973), *quoting* Shemtob v. Shearson, Hammill, & Co., 448 F.2d 442, 445 (2d Cir. 1971).

50. The court stated that:

> Under the *Shemtob* test, a plaintiff claiming a violation of Rule 10b-5 who cannot prove that the defendant had actual knowledge of any misrepresentations and omissions must establish, in order to succeed in his action, that the defendant's failure to discover the misrepresentations and omissions amounted to a willful, deliberate, or reckless disregard for the truth that is the equivalent of knowledge.

Lanza v. Drexel & Co., CCH FED. SEC. L. REP. ¶ 93,959 at 93,831 (2d Cir. April 26, 1973).

51. *Id.* at 93,836 (dissenting opinion).

52. *Id.* at 93,840. *See generally* Mann, *Rule 10b-5: Evolution of a Continuum of Conduct to Replace the Catch Phrases of Negligence and Scienter*, 45 N.Y.U.L. REV. 1206 (1970).

53. *Id.* at 93,842.

54. Lanza v. Drexel & Co., CCH FED. SEC. L. REP. ¶ 93,959 at 93,819-27 (2d Cir. April 26, 1973).