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Scienter and Rule 10b-5: Development of a New Standard...

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the still clouded cauldron in which
the oracles continue the stew . . . .[1]

THE SECURITIES AND EXCHANGE ACT OF 1934 has had extensive impact on public awareness of corporate information, and has unquestionably provided substantial protection to the investing public. The anti-fraud provisions of this act, and the regulations promulgated thereunder, engendered a number of issues material to the determination of the standards for violations. Perhaps the most difficult and confusing of these issues has been the concept of scienter.

On March 15, 1974 the United States Court of Appeals for the Ninth Circuit for the first time had an opportunity in *White v. Abrams*[2] to lift the haze which had enveloped its earlier opinions in *Ellis v. Carter*[3] and *Royal Air Properties, Inc. v. Smith.*[4] After prolonged debate by a number of commentators[5] prompted by the court's ambivalent statements in *Ellis* and *Royal Air Properties* concerning the sufficiency of negligence in meeting the scienter requirement[6] in an action for damages under rule 10b-5,[7] the court at last clarified its position. In light of the court's earlier statements on the scienter issue, its pronouncements came as no surprise. Its methodology for reaching its conclusions, however, was both startling and extremely gratifying to those who have urged that the concept of scienter is both misunderstood and misapplied in the context of 10b-5.[8] The court stated:

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[1] Lanza v. Drexel & Co., CCH FED. SEC. L. REP. ¶ 92,826, at 90,103 (S.D. N.Y. 1970), *aff'd,* 479 F.2d 1277 (2d Cir. 1973) (Judge Frankel).

[2] 495 F.2d 724 (9th Cir. 1974).

[3] 291 F.2d 270 (9th Cir. 1961).

[4] 312 F.2d 210 (9th Cir. 1962).

[5] *See, e.g.,* Bucklo, *Scienter and Rule 10b-5,* 67 NW. U.L. REV. 562, 581-84 (1972); Jennings, *Insider Trading in Corporate Securities: A Survey of Hazards and Disclosure Obligations Under Rule 10b-5,* 62 NW. U.L. REV. 809, 817-19 (1968); 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, 1207 (1970). *See also* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 855, 868 (2d Cir. 1968), *cert. denied,* 394 U.S. 976 (1969).

[6] No court has yet successfully succeeded in defining "scienter" in usable terminology. Therefore, as it is used in this note, the term will refer to a degree of fault, *e.g.,* intent to defraud, negligence, etc. As such, when considering the issue of negligence versus scienter sufficient to impute liability, negligence will be referred to as a form of, rather than an alternative to, scienter.

[7] 17 C.F.R. § 240.10b-5 (1973).

[8] *See* 2 A. BROMBERG, SECURITIES LAW: FRAUD § 8.4 (503), at 204.103 (1971) [hereinafter cited as BROMBERG] ("Probably the most important step toward clarifying the law of *scienter* would be to ban the word."); Mann, *supra* note 5, at 1220 ("The 10b-5 cases are not explainable by attempting to fit them into nebulous legal categories of fraud, negligence or some degree of scienter.").

> [W]e reject scienter or any other discussion of state of mind as a necessary and separate element of a 10b-5 action. The proper standard to be applied is the extent of the duty that rule 10b-5 imposes on the particular defendant. In making this determination the court should focus on the goals of the securities fraud legislation by considering a number of factors that have been found to be significant in securities transactions.[9]

Possibly the most intriguing aspect of this holding is its relationship to the standards posited in a series of cases recently decided by the Second Circuit Court of Appeals.[10] In three cases decided in March and April of 1973, the Second Circuit developed a standard radically different from any previously stated in its prior opinions regarding the relationship between scienter and rule 10b-5. Their new standard was most clearly enunciated by Judge Timbers in *Cohen v. Franchard Corp.*[11]

> The standard for determining liability under Rule 10b-5 essentially is whether plaintiff has established that defendant either knew the material facts that were misstated or omitted and should have realized their significance, or failed or refused to ascertain and disclose such facts when they were readily available to him and he had reasonable grounds to believe that they existed.[12]

The most obvious similarity between the standards postulated by the two circuits is the utter lack of reference to scienter. Not so obvious is the dissimilarity in their treatments of the negligence issue.[13]

The elimination of the scienter concept by both circuits comes after much confusion with the term, its meaning, and its application; despite this, the move was nevertheless unexpected. The courts' treatments of negligence, however, come as no surprise, the Second Cir-

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[9] White v. Abrams, 495 F.2d 724, 734-35 (9th Cir. 1974).

[10] Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341 (2d Cir.), *cert. denied,* 414 U.S. 910 (1973); Lanza v. Drexel & Co., 479 F.2d 1277 (2d Cir. 1973); Cohen v. Franchard Corp., 478 F.2d 115 (2d Cir.), *cert. denied,* 414 U.S. 857 (1973).

[11] 478 F.2d 115 (2d Cir.), *cert. denied,* 414 U.S. 857 (1973).

[12] *Id.* at 123.

[13] The extent of the controversy over the issue of whether proof of negligence is sufficient for the imputation of liability under rule 10b-5 is best demonstrated by the volume of commentary devoted to it. *See* Bucklo, *supra* note 5; Epstein, *The Scienter Requirement in Actions Under Rule 10b-5,* 48 N.C.L. REV. 482 (1970); Mann, *supra* note 5; Note, *Scienter and Rule 10b-5,* 69 COLUM. L. REV. 1057 (1969); Note, *Proof of Scienter Necessary in a Private Suit Under SEC Anti-Fraud Rule 10b-5,* 63 MICH. L. REV. 1070 (1965); Comment, *Outside Director's Liability for Misleading Corporate Statements,* 59 CORNELL L. REV. 728, 737-44 (1974); Comment, *Negligent Misrepresentations Under Rule 10b-5,* 32 U. CHI. L. REV. 824 (1965).

cuit having stated repeatedly that it favors a requirement of more than mere negligence to impute liability under rule 10b-5,[14] and the Ninth Circuit having long since established that its standard would, at the very least, include negligence.[15]

Several questions arise in comparing these two circuit's analogous and yet widely divergent opinions on the standards for violations of rule 10b-5. Is the passing of the concept of scienter from the 10b-5 scene necessarily a beneficial measure? Was its meaning ever really applicable in 10b-5 cases? Should mere negligence be actionable under the rule? And which of the two standards enunciated by the courts better conforms to the requirements of the rule?

The purpose of this note will be to discuss and, where possible, to answer these questions. In so doing, it will be necessary to consider the development of scienter in the context of common law fraud, as well as prior 10b-5 actions; congressional intent with regard to private actions under the rule; judicial interpretation of this intent; and finally, the four recent cases developing new standards.

Common Law Fraud

The divergent views espoused by the different circuits regarding the proof necessary to impose liability under rule 10b-5 is in no small part attributable to the confusion surrounding the elements required to impose liability for fraud or deceit under the common law. Although the courts have stated repeatedly that the proof needed to impute liability under 10b-5 is not as stringent as that for common law fraud,[16] nevertheless reference is quite often made to these same elements.[17] Thus today's courts face the same confusion as their common law predecessors in attempting to ascertain the precise standard short of which conduct becomes reprehensible, and *ergo*, liability obtains.

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[14] Republic Technology Fund, Inc. v. Lionel Corp., 483 F.2d 540 (2d Cir. 1973), *cert. denied*, ____ U.S. ____, 94 S.Ct. 1416 (1974); Shemtob v. Shearson, Hammill & Co., 448 F.2d 442 (2d Cir. 1971); Globus v. Law Research Service, Inc., 418 F.2d 1276 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970); Heit v. Weitzen, 402 F.2d 909 (2d Cir. 1968), *cert. denied*, 395 U.S. 903 (1969); Fischmann v. Raytheon Mfg. Co., 188 F.2d 783 (2d Cir. 1951). *See* text accompanying notes 65-100 *infra*.

[15] *See* Royal Air Properties, v. Smith, 312 F.2d 210 (9th Cir. 1962); Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961). *See also* text accompanying notes 59-64 and 101-109 *infra*.

[16] Douglass v. Glenn E. Hinton Industries, Inc., 440 F.2d 912, 915 (9th Cir. 1971), specificially stating that the holding of Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961) was that scienter was unnecessary as an element under rule 10b-5.

[17] Globus v. Law Research Service, Inc., 418 F.2d 1276 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970), affirming the lower court's jury verdict for the plaintiff, stating, at 1291:

> [T]he trend is clearly away from enforcing a scienter requirement equal to the "intent to defraud" required for common law fraud. Before there may be a violation of the securities acts there need not be present all of the same elements essential to a common law fraud . . . .

(Continued on next page)

At common law, an action for the tort of deceit encompassed the concept of fraud as an element which had to be proven before damages could be awarded.[18] A contract could be rescinded for an innocent misrepresentation,[19] but if damages were sought it became necessary to prove that the defendant made the false representation "fraudulently."[20] This element of fraud is included in the term scienter, undoubtedly the most cumbersome concept in common law deceit,[21] which can be defined as defendant's knowledge of his falsity.[22]

But this is not necessarily the only definition that can be attributed to scienter. The elusiveness of the term and its underlying concepts is exemplified by the definition and explanation found in an early Michigan case, *People v. Gould*:[23]

> Scienter is not a word of mystery, or magic meaning. It is merely an expressive word retained from the old Latin forms of pleading signifying in the connection commonly used that the alleged crime or tort was done designedly, understandingly, knowingly, or with guilty knowledge. If necessary to affirmatively negative the supposition of ignorant innocence under the facts alleged in this information, scienter is plainly apparent.[24]

(Continued from preceding page)

SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) (en banc), *cert denied*, 394 U.S. 976 (1969) (Judge Waterman giving a liberal view of the intent requirement); Shemtob v. Shearson Hammill & Co., 448 F.2d 442 (2d Cir. 1971) (reaffirming the necessity of proving scienter in a private damage action).

[18] W. PROSSER, THE LAW OF TORTS § 105, at 685-86 (4th ed. 1971), states the elements to be proven in the tort action of deceit.

1. A false representation made by the defendant. In the ordinary case, this representation must be one of fact.
2. Knowledge or belief on the part of the defendant that the representation is false — or, what is regarded as equivalent, that he has not sufficient basis of information to make it. This element often is given the technical name of "scienter."
3. An intention to induce the plaintiff to act or refrain from action in reliance upon the misrepresentation.
4. Justifiable reliance upon the representation on the part of the plaintiff, in taking action or refraining from it.
5. Damage to the plaintiff, resulting from such reliance. [citations omitted]

Furthermore, in Cohen v. Metropolitan Life Insurance Co., 444 S.W.2d 498, 505 (Mo. App. 1969), it is stated that "[t]he rule is firmly established that the existence of a fraudulent intent or an intent to deceive is an indispensable element."

[19] *See* BROMBERG, *supra* note 8, § 8.4 (120), at 204 (1971).

[20] M. BIGELOW, THE LAW OF TORTS 87 (8th ed. 1907).

[21] W. PROSSER, THE LAW OF TORTS § 107, at 700-01 (4th ed. 1971) (termed *scienter* difficult of proof and elusive as a matter of psychology).

[22] 37 AM.JUR. 2d. *Fraud & Deceit* § 197, at 260-61 (1968).

[23] People v. Gould, 237 Mich. 156, 211 N.W. 346 (1926).

[24] *Id.* at 164, 211 N.W. at 348-49.

For those who, upon reading the *Gould* definition of scienter, still find the definition not "plainly apparent,"[25] there are many more vantage points from which to view this elusive term. It can be referred to as knowledge,[26] guilty knowledge,[27] knowledge with intent to deceive,[28] such knowledge as charges a person with the consequences of his act,[29] a false representation made with knowledge of its falsity,[30] or simply a fraudulent intent.[31]

Albeit these definitions may ostensibly be confusing, it is important to discern that the prime concern is with the defendant's state of mind.[32] The courts attempt, on a case by case basis, to cull

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[25] *Id.*

[26] BLACK'S LAW DICTIONARY 1512 (4th ed. 1951).

[27] State v. Lisbon Sales Book Co., 176 Ohio St. 482, 485, 200 N.E.2d 590, 593 (1964).

[28] *See* BROMBERG, *supra* note 8, § 8.4 (110), at 203 (1971).

[29] Shriver v. Union Stockyards Nat'l Bank, 117 Kan. 638, 648, 232 P.1062, 1067 (1925).

[30] 37 AM. JUR. 2d, *Fraud & Deceit* § 197, at 260 (1968).

[31] Serrano v. Miller & Teasdale Commission Co., 117 Mo. App. 185, 195, 93 S.W. 810, 813 (1906).

[32] *See* Epstein, *The Scienter Requirement In Actions Under Rule 10b-5,* 48 N.C. L. REV. 482, 483 (1970), wherein the author cites and isolates the five possible states of mind of the defendant as classified by Dean Keeton:

> [A] person makes a misrepresentation (1) justifiably convinced of the truth of the statement, or (2) believing in the truth of the statement but knowing that he has insufficient knowledge on which to base such a belief, or (3) having no genuine belief whatsoever in either the truth or the falsity of the statement, or (4) realizing that the statement was probably false, or (5) convinced of the falsity of the statement.

See also, Terry, *Intent to Defraud,* 25 YALE L. J. 87, 90 (1915), wherein the writer discusses, in depth, the various elements of the concept of intent to defraud which, of course, is determinative of the defendant's state of mind. The statement is made that intent is made up of seven elements:

> A. Intent to make a representation, to convey an idea to another. When the representation is made in words, there is seldom any question as to this element. But a fraudulent misrepresentation can be made by conduct without words. In such a case the question may arise, whether the actor really intended that any one should draw from his conduct any inference as to the existence of a fact.
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> B. Intent to address or direct the representation to some one. If a misrepresentation is directed to one person, but comes to another who is deceived by it and acts upon it to his injury, there is no fraud against the latter. But a representation may be directed to a class of persons and so to each individual of that class, or even to the whole public, as in the case of a lying advertisement.
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> C. Intent that the representation bear a certain meaning, amounting the assertion of a certain fact. A representation may be capable of several meanings, in some of which it may be false and fraudulent and in others not.
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> D. Knowledge that the representation, in its aforesaid meaning, is false. This, as has been said, is the element that makes the intent amount to culpable rather than to mere simple intention.
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> E. Intent that the addressee shall believe the representation.
>
> F. Intent that he shall act upon it in a certain way.
>
> G. Intent that his so acting upon it shall produce a certain consequence.

[33] *See* Miller, *Scienter In Deceit and Estoppel,* 6 IND. L. J. 152, 157 (1930), in which the author states that Lord Herschell, in Peek v. Derry, 14 App. Cas. 337 (1889), intimated that scienter could "be imputed where the Defendant's words reasonably permit the inference that he knows the truth though, in fact, he has no actual knowledge."

from the defendant's actions, or inactions, the requisite amount of fraud needed to impose liability. The problem is, of course, that quite often the defendant's state of mind is not easily determinable. Thus the courts and the commentators[33] found it necessary to expand the scienter concept and label that type of fraud which can be proven as "fraudulent at law,"[34] and that type which is not readily observable as "conclusively presumed"[35] or "imputed."[36] As the late Professor Pomeroy observed:

> It is now a settled doctrine of the law that there can be no fraud, misrepresentation, or concealment without some moral delinquency. There is no actual fraud, legal fraud, which is not also a moral fraud. This immoral element consists in the necessary guilty knowledge and consequent intent to deceive — sometimes designated by the technical term "scienter." The very essence of the legal conception is the fraudulent intention flowing from the guilty knowledge. No misrepresentation is fraudulent at law, unless it is made with actual knowledge of its falsity, or under such circumstances that the law must necessarily impute such knowledge to the party at the time he makes it.[37]

This definition is closely akin to the three methods of proving scienter discussed in *Serrano v. Miller*:[38]

> First. A false representation, made with knowledge of its falsity by the utteror, is scienter in law, and therefore proof that the party made the false representation concerning a material fact, with knowledge that the representation was false at the time it was made, satisfies the law in so far as scienter is concerned, for, from the fact that the representation was made with knowledge of its falsity, it must be taken that it was made with an intent to deceive and the corrupt element or evil design — actual knowledge of its falsity being present, scienter is thereby established. . . . Second. When a party makes a representation of a material fact as of his own knowledge, when in truth he has no knowledge whatever on the subject either of its truth or its falsity . . . the law will constructively supply the scienter because of the reckless conduct of the utteror for the very good reason that a positive statement of fact implies knowledge of such fact,

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[34] J. POMEROY, EQUITY JURISPRUDENCE § 884, at 450-51 (1907) [hereinafter cited as POMEROY].

[35] Watson v. Jones, 41 Fla. 241, 247, 25 So. 678, 682 (1899).

[36] *See* POMEROY, *supra* note 34, at 450-51 (1907).

[37] *Id.*

[38] 117 Mo. App. 185, 93 S.W. 810 (1906).

> and, if the party who makes it has no knowledge upon the subject, he is telling scienter what is untrue — he is affirming his knowledge, when in truth he has no knowledge to affirm. Third. The law will . . . constructively supply scienter when the party, by reason of his peculiar position, has "special means of knowledge," and . . . makes representations which he ought to have known, if he did not, to be false.[39]

It is interesting to note that the third definition borders on, and is probably analogous to, negligence. When a person makes representations which "he ought to have known, if he did not, to be false," the logical interpretation is that he was negligent. This is a far cry from the "intent to deceive" in the first definition, but nonetheless it is one form of common law scienter.

These same three patterns establishing scienter are also discussed in *Wheeler v. Baars*:[40]

> A false representation made with knowledge of its falsity — made scienter, in technical phrase — affords, if other elements of liability are present, a right of action in damages. A false representation may be made scienter, in contemplation of law, in any of the following ways: (1) With actual knowledge of its falsity; (2) with knowledge either of its truth or falsity; or (3) under circumstances in which the person making it ought to have known, if he did not know, of its falsity.[41]

In *Ward v. Trimble*,[42] the Court of Appeals of Kentucky, in 1898, found the president of a bank, who sold stock in the bank to the plaintiff, liable in damages for fraud. The plaintiff, relying on a published statement from the bank regarding its financial condition, contended that the president of the bank misled him because the statement was false and the president should have known it to be false. The court found it unnecessary to decide if the president had actual knowledge of the falsity, and held:

> For leaving out of view the question whether he did in fact know the statement was untrue, being in a situation to know, and where it was his duty to know, he, in contemplation of law, did know it, and consequently such statement is held to be fraudulent.[43]

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[39] *Id.* at 195-97, 93 S.W. at 813.

[40] 33 Fla. 696, 15 So. 584 (1894).

[41] *Id.* at 710, 15 So. 584, 588, *quoting from,* 1 BIGELOW, FRAUDS 509.

[42] 103 Ky. L. Rptr. 153, 44 S.W. 450 (Ct. App. 1898).

[43] *Id.* at 159, 44 S.W. at 452, *quoting from,* Prewitt v. Trimble, 92 Ky. L. Rptr. 176, 182, 17 S.W. 356, 358 (1891).

Again negligence as a substitute for scienter can be surmised from *Ward,* and the list of possible definitions for common law scienter expands. Some are consistent, and some are not, (*e.g.*, intentional versus negligent) and the courts today, by using the term scienter to establish liability under rule 10b-5, are, quite naturally, finding the term as difficult to apply as did their common law predecessors.

Judicial Interpretation of the Scienter Requirement

During the past twenty years, the decisions interpreting the scienter requirement in the context of a 10b-5 action have been legion. The Second Circuit has been both the most prolific and the most conservative of all the circuits,[44] and consequently, their recent pronouncements on the issue harbor substantial import. Conversely, even though the Ninth Circuit has long been at the opposite end of the spectrum,[45] its recent declarations concerning the test for determining violations of rule 10b-5 must also be accorded great weight. Thus, this section will be concerned primarily with cases decided in the Second and Ninth Circuits, which provide the historic backdrop for these courts' most recent pronouncements.

The Basic Dichotomy

In *Fischmann v. Raytheon Mfg. Co.*,[46] decided in 1951 by the Second Circuit, the problem regarding the necessity for proving fraud or scienter in a private action under rule 10b-5 first surfaced. In this

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[44] The Second Circuit has consistently held that some form of the traditional scienter requirement is necessary in a 10b-5 action. *See* text accompanying notes 65-100 *infra;* Bucklo, *Scienter and Rule 10b-5, supra* note 5, at 576-81. Other circuits have used various phraseology in deciding on the issue, which can be interpreted as requiring something less. *See, e.g.:* Seventh Circuit — Dasho v. Susquehanna Corp., 461 F.2d 11 (7th Cir. 1972) (actual knowledge and bad faith intent to mislead need not be shown); Parrent v. Midwest Rug Mills, Inc., 455 F.2d 123 (7th Cir. 1972) (court chose state securities law statute of limitation specifically agreeing with Vanderboom v. Sexton, 422 F.2d 1233 (8th Cir. 1970), wherein court noted that rule 10b-5, like the state blue sky law, does not require proof of scienter); Kohler v. Kohler Co., 319 F.2d 634 (7th Cir. 1963) ("knowledge of the falsity or misleading character of a statement and a bad faith intent to mislead or misrepresent are not required to prove a violation of the statute."); Eighth Circuit — Vanderboom v. Sexton, 422 F.2d 1233 (8th Cir. 1970) (in choosing appropriate statute of limitations, court noted that rule 10b-5 did not require proof of scienter); City Nat'l Bank v. Vanderboom, 422 F.2d 221 (8th Cir.), *cert. denied,* 399 U.S. 905 (1970) (court disagreed with the Second Circuit insofar as that court did not accept a negligence test); Myzel v. Fields, 386 F.2d 718 (8th Cir. 1967) (proof of scienter is not required);Ninth Circuit — Royal Air Properties, Inc. v. Smith, 312 F.2d 210 (9th Cir. 1962) (plaintiff will make prima facie case when he supplies proof of either a material misstatement or an omission of a material fact); Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961) (the statute speaks in terms of "any manipulative device or contrivance," and there is "no reason to go beyond the plain meaning of the word 'any' "); Tenth Circuit — Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90 (10th Cir. 1971) (defendant can avoid liability if he sustains the burden of proving that he did not know, and in the exercise of reasonable care would not have known, of the challenged misrepresentations or omissions); Gilbert v. Nixon, 429 F.2d 348 (10th Cir. 1970) (court used reasonable care standards with regard to knowledge of misrepresentations); Stevens v. Vowell, 343 F.2d 374 (10th Cir. 1965) (finding of negligence would be sufficient).

[45] *See* Bucklo, *supra* note 5, at 581.

[46] 188 F.2d 783 (2d. Cir. 1951).

case shareholders had brought suit under section 11 of the Securities Act of 1933[47] and rule 10b-5 alleging that they had purchased shares in reliance upon a prospectus and registration statement, both of which were later found to contain untrue statements and material omissions. The district court dismissed the complaint, noting that rule 10b-5 and section 11 do not necessarily cover the same proscribed conduct.[48] The court concluded that section 11 deals with misleading statements and material omissions in a registration statement, whereas rule 10b-5 proscribes the same conduct but in connection with the purchase or sale of a security. The Second Circuit reversed, predicated on what they felt was an improper distinction between section 11 and rule 10b-5 by the district court. The court stated:

> We think that when, to conduct actionable under § 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 . . . .[49]

It is evident that the *Fischmann* court placed an added burden on a 10b-5 plaintiff through the addition of the "ingredient of fraud" with which a plaintiff under section 11 did not have to contend. The reasons for this added burden, however, are not as explicit, and hence the underlying intent can only be surmised. Quite possibly the court's rationale is based, to some extent, on the fact that a private remedy is express in a section 11 action, while merely implied under rule 10b-5.[50] Whatever the reason, the court seemed willing to employ the element of fraud to differentiate between the applicability of the two, yet the court's definition of the term fraud was noticeably absent from the opinion.[51] One would expect that at least a suggestion of the court's rationale underlying its proposition that an action under rule 10b-5 requires proof of fraud might be discernable from the two cases cited in *Fischmann*.[52] Unfortunately,

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[47] 15 U.S.C. § 77k (1970).

[48] Fischmann v. Raytheon Mfg. Co., 9 F.R.D. 707, 709 (S.D.N.Y. 1949). The court held that relief was not available under § 11 of the 1933 Act, since suit had been brought by common shareholders, whereas the prospectus was addressed to preferred shareholders.

[49] Fischmann v. Raytheon Mfg. Co., 188 F.2d 783, 786-87 (2d Cir. 1951).

[50] § 11 of the 1933 Act reads in part:

> In case any part of the registration statement . . . contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security . . . may . . . sue . . . .

Rule 10b-5 contains no clause even remotely similar.

[51] The court, in an illustration designed to buttress its rationale, did imply that the "ingredient of fraud" would consist of action taken knowingly with an intent to defraud. Fischmann v. Raytheon Mfg. Co., 188 F.2d 783, 787 (2d Cir. 1951).

[52] Norris & Hirschberg, Inc. v SEC, 177 F.2d 228 (D.C. Cir. 1949); Ward LaFrance Truck Corp., 13 S.E.C. 372 (1943).

such is not the case.[53] The only indication of what the court considered to be an accurate definition of the fraud requirement can be found in the court's acceptance of that portion of the complaint which alleged scienter[54] — "the defendants knew or should have known that the statements herein alleged were false and misleading."[55] This language implies that some form of constructive knowledge would have been sufficient to establish the necessary scienter.[56] And regardless of the court's *use* of the term "fraud," the distinction between constructive knowledge and the scienter requirement necessary to impute liability under section 11 is at best a subtle one.[57]

Irrespective of this fact, commentators have long considered *Fischmann* to be the outer limit in stringency for the scienter requirement,[58] a dubious conclusion indicating the difficulties inherent in any attempt to interpret a court's definition of scienter.

Considered the other extreme in its analysis of the conduct necessary for imposing liability under rule 10b-5 is *Ellis v. Carter*,[59] decided in 1961 by the Ninth Circuit. In *Ellis*, the defendant averred that under rule 10b-5 the plaintiff must prove "genuine fraud, as distinct from a mere misstatement or omission."[60] The court, in dismissing this contention, characterized such a burden as

> a challenge to the validity of subparagraph (2) of the rule . . . predicated on the idea that a proscription of material misstatements and half truths without using fraud or *scienter* language is not a permissible implementation of section 10(b).[61]

The court went on to state:

> Had Congress intended to limit this authority [to prescribe regulations] to regulations proscribing common-law fraud, it would probably have said so.[62]

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[53] In Norris & Hirschberg, Inc. v. SEC, 177 F.2d 228 (D.C. Cir. 1949), there is no discussion of scienter. In Ward LaFrance Truck Corp., 13 S.E.C. 372 (1943), the Commission noted that 10b-5 applies to purchases "the same broad antifraud provisions" found in § 17 (a) of the 1933 Act for sales. Ward LaFrance Truck Corp., *supra* at 381 n. 8.

[54] *See* BROMBERG, *supra* note 8, § 8.4 (506), at 204.109 (1971).

[55] Fischmann v. Raytheon Mfg. Co., 188 F.2d 783, 791 (2d Cir. 1951) (Appendix: ¶23).

[56] *Id.*

[57] § 11 employs a form of constructive knowledge as a scienter element. *See* BROMBERG, *supra* note 8, § 8.4 (320) at 204.18 (1971).

[58] *See* Bucklo, *supra* note 5, at 566; Note, *Scienter and Rule 10b-5*, *supra* note 13, at 1064; Note, *Scienter in Private Damage Actions Under Rule 10b-5*, 57 GEO. L. J. 1108, 1110 (1969).

[59] 291 F.2d 270 (9th Cir. 1961).

[60] *Id.* at 274.

[61] *Id.*

[62] *Id.*

The interpretation given *Ellis* by the courts and the commentators has ranged from that of strict liability,[63] wherein no form of scienter need be shown, to negligence[64] as a standard for determining proscribed conduct under rule 10b-5. Unless one is willing to accept the constructive knowledge interpretation of the fraud requirement enunciated in *Fischmann,* each of the interpretations given the *Ellis* decision, both of which discard the shackles of the traditional scienter requirement, is inapposite to the *Fischmann* standards. Thus, quite early, the positions the two circuits would take were decided; the only remaining task lay in the semantic refinement of their theories.

The Second Circuit

Subsequent to *Fischmann,* the Second Circuit discussed the scienter requirement of rule 10b-5 in a number of cases. Considered collectively, these cases are ambiguous and confusing, and any attempt to decipher a common meaning of or definition for scienter is futile. Consequently, they will be dealt with individually.

SEC v. Texas Gulf Sulphur Co.,[65] decided in 1968, is probably the single most important decision in the 10b-5 arena. Despite its importance, however, it succeeded in compounding existing confusion regarding the scienter requirement of the rule. This confusion stems from the discrepancies within the majority opinion of Judge Waterman, and from the disparities between the majority opinion and the concurring opinion of Judge Friendly.[66]

Judge Waterman offered substantial commentary on the applicability of good faith as a defense in an action under 10b-5, as well as a general discussion of the scienter requirement.[67] Taken individually, these comments are readily comprehensible, but taken as a whole they are somewhat confusing. As a result, it is very dif-

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[63] *See* BROMBERG, *supra* note 8, § 8.9 n. 102.

[64] *See, e.g.,* City Nat'l Bank v. Vanderboom, 442 F.2d 221, 230 n. 9 (8th Cir.), *cert. denied,* 399 U.S. 905 (1970); Note, *Proof of Scienter, supra* note 13, at 1077.

[65] 401 F.2d 833 (2d Cir. 1968), *cert. denied,* 394 U.S. 976 (1969). A brief outline of the facts follows: late in 1963, a TGS exploration group completed drilling in an area thought to contain extensive mineral deposits. The evaluation of the information from this drill hole was later found to be material information by the Second Circuit. Prior to public disclosure, several insiders purchased TGS stock. In addition, four days prior to a press conference announcing a substantial ore strike, the company attempted to quiet rumors concerning the strike via a public statement. The SEC alleged that this statement (April 12 press release) was misleading and deceptive. The SEC brought suit under rule 10b-5 against both the TGS insiders and TGS itself. The case has been extensively analyzed by a number of commentators. *See* Ruder, *Texas Gulf Sulphur — The Second Round: Privity and State of Mind in Rule 10b-5 Purchase and Sale Cases,* 63 NW. U.L. REV. 423 (1968); Sandler & Conwill, *Texas Gulf Sulphur; Reform in the Securities Marketplace,* 30 OHIO ST. L.J. 225 (1964); Note, *SEC v. Texas Gulf Sulphur,* 82 HARV. L. REV. 938 (1969).

[66] 401 F.2d at 868.

[67] *Id.* at 854-55, 862.

ficult to ascertain exactly what Judge Waterman determined to be the standard for conduct violative of the rule, and conversely, the standard for a defense in a 10b-5 action.

The first notable comment by Judge Waterman, that "proof of a specific intent to defraud is unnecessary,"[68] implies that a less stringent scienter requirement than the *Fischmann* court's "fraud" was sufficient. Judge Waterman expanded this concept:

> [I]n an enforcement proceeding for equitable or prophylactic relief, the common law standard of deceptive conduct has been modified in the interests of broader protection for the investing public so that *negligent insider conduct* has become *unlawful.*[69] (Emphasis added)

He then observed that "a similar standard has been adopted in private actions . . . ,"[70] and supported these conclusions with the statement that the implementation of a negligence standard "comports with the administrative and the legislative purposes underlying the Rule."[71] Some attempt was then made to reconcile this rationale with the language in *Fischmann* by observing that

> some form of the traditional scienter requirement . . . sometimes defined as "fraud" . . . is preserved.[72]

In a later discussion on the question of corporate liability for a misleading press release, Judge Waterman skirted the issue:

> [T]he only remedy the Commission seeks against the corporation is an injunction . . . and therefore we do not find it necessary to decide whether just a lack of due diligence on the part of TGS, absent a showing of bad faith, would subject the corporation to any liability for damages.[73]

The analysis is puzzling. After having determined that mere negligence may be sufficient for insider liability, Judge Waterman then suggested that a "showing of bad faith" coupled with a "lack of due digilence" *may* also be required before the imposition of

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[68] *Id.* at 854.

[69] *Id.* at 854-55.

[70] *Id.* at 855. It should be noted that Judge Waterman cited solely non-Second Circuit decisions as support for this statement. It is questionable whether Judge Waterman truly meant to apply a negligence standard in the Second Circuit, especially in light of the fact that the basis for his decision was clearly not negligence.

[71] *Id.*

[72] *Id.*

[73] *Id.* at 863.

liability on a corporation.[74] Thus, another standard borrowed from the common law appears in a 10b-5 action. The attendant result is more confusion of the already disconcerting array of standards applicable to a 10b-5 cause of action.

It is interesting to note that, although a discussion of negligence is usually centered around the defendant's non-discovery of material facts, Judge Waterman's discussion regarding negligence by insiders was not concerned with the insiders' negligence in failing to ascertain the necessary information, but rather with their negligence in *not disclosing* that information to the investing public.[75]

This concern was shared by Judge Friendly in his concurring opinion in which he agreed with Judge Waterman's results but disagreed with the analysis used to attain them. Judge Friendly was not convinced that the imposition of liability for damages under rule 10b-5, without a scienter requirement attendant thereto, would not surpass the authority vested in the SEC by section 10(b) to protect the public from "any manipulative or deceptive device or contrivance."[76] This disagreement was further demonstrated by the following language in his opinion:

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[74] Although Judge Waterman declined to treat the question of negligence with regard to corporate liability, he did note that:

> It seems clear, however, that if corporate management demonstrates that it was diligent in ascertaining that the information it published was the whole truth and that such diligently obtained information was disseminated in good faith, Rule 10b-5 would not have been violated. 401 F.2d at 868 n. 4.

It appears that Judge Waterman is again considering a negligence standard with regard to the scienter requirement.

[75] Defendant's knowledge of the drill results was not in dispute. *Id.* at 852-53. Rather, the issue centered on whether the defendants had bought Texas Gulf Sulphur (TGS) stock before the information concerning the ore strike had been sufficiently distributed to the public, thus their use of a good faith defense to the charge. The court found specifically that Crawford "sought to and did 'beat the news.'" *Id.* at 853. With regard to Coates and Clayton, the court felt that any lack of knowledge of the public disclosure was unreasonable, which in turn can be interpreted as either negligence or recklessness. Clayton had ordered two hundred shares of stock on the day preceding the public announcement, whereas Coates had left the April 16 press conference and ordered two thousand shares before the news could possibly have appeared over the Dow Jones tape. *Id.* at 847, 854 n. 19.

[76] *Id.* at 867-68. Rule 10b-5 provides:

> 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,
>
> (a) To employ any device, scheme or artiface 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 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 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 (1973). Judge Friendly's main concern was with clause (b) of the rule, which makes no mention of fraud and which he felt was based not on rule 10b-5 but on § 17(a)(2) of the 1933 Act. Judge Friendly insisted that this section was clearly in-

(Continued on next page)

> [T]he April 12 press release would be the worst possible case for the award of damages for merely negligent misstatement as distinguished from the kind of recklessness that is equivalent to willful fraud . . . .[77]

Thus, Judge Friendly clearly disagreed with Judge Waterman's view of negligence as the standard to be used for imposing liability for damages. However, his reference to "recklessness . . . equivalent to willful fraud"[78] is little aid in discerning the scienter requirement he advocated as being necessary. The disagreement surrounding scienter, negligence, and the standards under 10b-5 in the Second Circuit is further exemplified by the fact that two judges specifically dissented from the results of the case,[79] while two others agreed with Judge Friendly's analysis of the scienter issue.[80]

The problem in the circuit again became apparent in *Heit v. Weitzen*,[81] decided in the same year as *TGS*. In *Heit* the court shied away from the question of negligence liability entirely, stating simply that the complaint was sufficient since besides alleging negligence it also alleged actual knowledge, and as such the complaint satisfied the scienter requirement, "whether the scienter test ultimately applied be strict or liberal."[82]

Again in the same year *SEC v. Great American Industries, Inc.*[83] was decided. The court there held that the failure of the defendants to disclose material facts constituted common law fraud. Judge

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tended by Congress to afford only injunctive relief or in appropriate circumstances, criminal liability. *See* H.R. REP. NO. 85, 73d Cong., 1st Sess. 9-10 (1933), *cited in,* 401 F.2d at 867.

> Once it had been established, however, that an aggrieved buyer has a private action under Section 10(b) of the 1934 Act, there seemed little practical point in denying the existence of such a right under Section 17 — with the important proviso that fraud, as distinct from mere negligence, must be alleged. SEC v. Texas Gulf Sulphur, 401 F.2d 833, 867 (2d Cir. 1968), *cert. denied,* 394 U.S. 976 (1969).

[77] SEC v. Texas Gulf Sulphur, 401 F.2d 833, 868 (2d Cir. 1968), *cert. denied,* 394 U.S. 976 (1969), *citing* SEC v. Frank, 388 F.2d 486, 489 (2d Cir. 1968).

[78] Judge Friendly apparently felt that a traditional reading of the scienter requirement was necessary in a suit for money damages, whereas he was willing to accept Judge Waterman's negligence standard for injunctive relief where it "can be of such great public benefit and do so little harm to legitimate activity." 401 F.2d at 868.

[79] Judges Moore and Lumbard dissented entirely from the imposition of liability on the corporation for the misleading press release. *Id.* at 870.

[80] Judges Kaufman and Anderson. *Id.* at 869.

[81] 402 F.2d 909 (2d Cir. 1968).

[82] *Id.* at 914.

[83] 407 F.2d 453 (2d Cir. 1968) (en banc), *cert. denied,* 385 U.S. 920 (1969).

Friendly commented that the actions of the defendants were not merely negligent, "but something more."[84] In a concurring opinion, however, Judge Kaufman noted that

> Those who buy or sell securities may no longer assume that the unmended fences of common law fraud will remain the outer limits of liability under Rule 10b-5 . . . .
>
> . . . .
>
> [T]he rule's proscription is . . . "closer to unfairness than what either lawyers or laymen usually think of as fraud."[85]

Judge Kaufman's statements in his concurring opinion, which implied that the court went beyond what is considered the traditional scienter requirement in order to render its decision, appeared to be a misinterpretation of the majority's findings in the case because it is clear from the facts that the omissions were made knowingly.[86]

A year later, in *Globus v. Law Research Service, Inc.*,[87] the confusion was not yet resolved. In an action for damages caused by reliance upon a misleading offering circular, the Second Circuit affirmed a jury verdict for the plaintiff. In its instructions to the jury, the court had cautioned that, before the defendants could be held liable, the jury

> must conclude the appellants "knew the statement was misleading or knew of the existnce of facts which, if disclosed, would have shown it to be misleading."[88]

The defendants, however, requested the jury be instructed that in order to find the defendants liable, the jury must find that the "appellants intended to defraud appellees . . . ."[89] The court felt this instruction too strict.

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[84] *Id.* at 458. The actions referred to were the failure of the defendant-seller and finders to disclose that five-sixths of the consideration received in a sale of property to GAI would go to persons other than the seller, and statements in press releases and in Form 8-K reports which exaggerated the feasibility of putting a mine into working operation. *Id.* at 455.

[85] *Id.* at 462, *citing* BROMBERG, *supra* note 8, § 1.1, at 5 (1971).

[86] Although GAI was aware that it would not put the mine it had purchased in operation within 90 days, unless additional investigations showed that it would be warranted, they nevertheless stated that the mine could be in operation within 90 to 120 days in a press release. In addition, they repeated this same statement in even stronger terms in an 8-K report which was filed with the SEC. 407 F.2d 453, 456 (2d Cir. 1968) (en banc), *cert. denied*, 395 U.S. 920 (1969).

[87] 418 F.2d 1276 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970). *Globus* involved an action for damages caused by reliance upon a misleading offering circular. The prospectus had emphasized a contract between Law Research Service and Sperry Rand Corp., but it had failed to mention a dispute and a lawsuit between the two corporations.

[88] *Id.* at 1290.

[89] *Id.*

In noting that an allegation of actual knowledge of falsity is sufficient to sustain a claim, the court stated that the "trend is clearly away from enforcing a scienter requirement equal to the 'intent to defraud' required in common law fraud."[90] The court further observed that "whatever the outcome of the great debate over ordinary negligence versus scienter in private actions under 10(b) and Rule 10b-5 . . . it is clear that . . . the instruction satisfied the scienter requirement imposed by prior cases."[91]

In what might seem a complete about-face from the "trend . . . away from enforcing a scienter requirement equal to the 'intent to defraud' "[92] as enunciated in *Globus*, the Second Circuit in 1971 decided *Shemtob v. Shearson, Hammill & Co.*[93] In affirming the dismissal of plaintiffs' complaint, the court stated:

> Thus plaintiffs' claim is nothing more than a garden-variety customer's suit against a broker for breach of contract, which cannot be bootstrapped into an alleged violation of . . . Rule 10b-5 . . . .[94]

The court noted that liability would not be imputed absent a showing 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 . . . .[95]

Although *Shemtob* has been cited primarily as support for the proposition that mere negligence will not suffice to sustain a 10b-5 action,[96] this reasoning being based on the fact that the case was decided in a factual situation in which "a judicial choice between *scienter* and negligence . . ."[97] was required, nevertheless a careful analysis of the court's holding leads to a different conclusion. In reality the court simply dismissed the claim for lack of federal jur-

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[90] *Id.* at 1291.

[91] *Id.*

[92] *Id.*

[93] 448 F..2d 442 (2d Cir. 1971). The case arose as a result of Shearson's having failed to honor an oral contract with the Shemtobs, wherein Shearson had allegedly agreed to lower the Shemtob's margin requirement to 25% and forbear from liquidating their securities account held by Shearson until having given them an opportunity to provide additional capital. 448 F.2d at 444.

[94] *Id.* at 445.

[95] *Id.*

[96] *See, e.g.,* Republic Technology Fund, Inc. v. Lionel Corp., 483 F.2d 540, 551 (2d Cir. 1973); Lanza v. Drexel & Co., 479 F.2d 1277, 1301 (2d Cir. 1973); Cohen v. Franchard Corp., 478 F.2d 115, 123 (2d Cir.), *cert. denied,* 414 U.S. 857 (1973); Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341, 397 (2d Cir.) (Mansfield dissenting), *cert. denied,* 414 U.S. 910 (1973). *See also* Bucklo, *supra* note 5, at 563.

[97] Bucklo, *supra* note 5, at 563.

isdiction. The court expressly stated that jurisdiction is acquired only if the allegations in the complaint indicate that federal jurisdiction has been properly invoked.[98] In *Shemtob*, however, the action was clearly grounded on breach of contract by defendant, and by no stretch of the imagination could damages be recovered for a violation of 10b-5. Hence, the real issue treated by the court, and the only material point the case stands for, is that the court will not accept a 10b-5 cause of action grounded on allegations of misconduct which have absolutely no relationship to conduct proscribed under the rule.[99] It should be noted, however, that in discussing the central issue the court used various catch phrases to define the standards for liability under the rule — catch phrases, which, while they did somewhat define limits beyond which conduct becomes actionable, were in no manner satisfactory definitions for standards to determine liability.[100]

The Ninth Circuit

In the Ninth Circuit, soon after the decision in *Ellis v. Carter*,[101] the court again faced the question of the scienter requirement in *Royal Air Properties, Inc. v. Smith*.[102] The complaint alleged that the defendant, who was the president and founder of a real estate corporation, induced the plaintiff into purchasing shares of stock in the corporation via a prospectus in which profits and returns were estimated — although absent from the prospectus were the cost of the land the corporation proposed to develop, a $165,000 mortgage on the land, and information regarding the fact that $82,500 of the mortgage was due in less than five months and the balance due in seventeen months.[103] The court, noting that a prima facie violation of rule 10b-5 existed, reversed a judgment for the plaintiff and remanded for a hearing on the issues of estoppel, waiver, and laches

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[98] Shemtob v. Shearson, Hammill & Co., 448 F.2d 442, 445 (2d Cir. 1971).

[99] *Id.* at 445:

> These allegations, even when accepted as true and construed liberally and most favorably to the pleader, amount to a claim that Shearson failed to sell out the Shemtobs promptly, as stated in Shearson's May 1 telegram . . . and that Shearson eventually sold them out without giving them an opportunity to post additional margin, in breach of the alleged May 4, 1970, oral "novation" or modification of the February 4, 1969, written agreement.
>
> This is not the first attempt to employ the rule to obtain federal court jurisdiction in actions traditionally deemed breach of contract or corporate mismanagement. The Second Circuit has expressed its concern over this. *See, e.g.*, Ryan v. J. Walter Co., 453 F.2d 444 (2d Cir. 1971); Fershtman v. Schectman, 450 F.2d 1357 (2d Cir. 1971).

[100] The court used traditional terminology — "scienter, intent to defraud, reckless disregard for the truth. . . ." 448 F.2d at 445.

[101] 291 F.2d 270 (9th Cir. 1961).

[102] 312 F.2d 210 (9th Cir. 1962).

[103] *Id.* at 212. Neither was the plaintiff told of the previous corporate president's resignation just prior to plaintiff's stock purchase, nor of his demand for repayment of a loan to the corporation and his refusal to accept stock in the corporation as payment.

resulting from plaintiff's knowledge, or constructive knowledge, two year prior to the suit, of the misstatements and nondisclosures contained in defendant's prospectus.[104] On the issue of scienter, the court stated that

> rule 10b-5, a proper implementation of section 10(b), only requires proof of a material misstatement or an omission of a material fact in connection with the purchase or sale of any security to make out a prima facie case.[105]

This language would appear to preclude, much as in *Ellis*, the necessity for proof of any type of scienter for the imposition of liability under 10b-5. Alternatively, when considering the court's statement that "common law fraud need not be alleged or ultimately proven,"[106] an interpretation can be made which is very similar to the philosophy of the Second Circuit; *i.e.*, that something less than common law fraud will suffice. However, the obvious question left unanswered by the court is exactly which standard it will apply.

In *Hecht v. Harris, Upham & Co.*,[107] the final case decided in the Ninth Circuit prior to *White v. Abrams*,[108] the court did little to dispel the confusion it had created. The case involved a broker-dealer who was held liable for churning a customer's accounts. The court held that the "gist of an allegation of churning is fraud in law and differs from common law fraud [since] [p]roof of a specific intent to defraud is unnecessary."[109] Under the facts of the case the fraud was evident, hence the court's statement that "proof of a specific intent to defraud is unnecessary" is essentially unenlightening.

Synthesis

A summation of the various opinions in the two circuits discussed to this point leads to several conclusions. In the Second Circuit the standard for liability appears to have fallen somewhere between an actual showing of an intent to defraud and a showing of mere negligence. Included within this standard is a reckless disregard for the truth and a knowing use of a device, scheme or artifice to defraud. Conversely, in the Ninth Circuit the standard used for the imposition of liability appears to have fallen somewhere between a form of strict liability, with no scienter requirement, and reckless disregard for the truth.

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[104] *Id.* at 213.

[105] *Id.* at 212.

[106] *Id.*

[107] 430 F.2d 1202 (9th Cir. 1970).

[108] 495 F.2d 724 (9th Cir. 1974).

[109] Hecht v. Harris, Upham & Co., 430 F.2d 1202, 1209 (9th Cir. 1970).

Of course, the inherent difficulty in analyzing the foregoing decisions is that when different judges employ similar terminology they often attach varying meanings to their words. Therein lies the crux of the problem with the term scienter. The result has been that, until very recently, the pronouncements of different courts on the scienter requirement have been difficult, if not impossible, to decipher. One authority has even suggested that the single most important step toward clarifying the law of scienter would be to ban the word entirely.[110] To be sure, this is a radical suggestion; nonetheless, outright dismissal of the suggestion as impractical would be premature. Moreover, recent cases in the Second and Ninth Circuits have effectively obviated dependence on the term. However, before substantiating this statement with an analysis of the most recent decisions, the policy considerations and the legislative intent, behind the issue of scienter as it applies to rule 10b-5 must be understood.

Legislative Intent and Public Policy

The federal securities laws of 1933 and 1934 were enacted soon after, and to some degree as a result of, the stock market crash of 1929. They were intended to protect investors through full disclosure of all pertinent information concerning new stock issues and to generally "ensure the maintenance of fair and honest [securities] markets."[111] The object was to maintain a high level of integrity in the market, in such a manner as not to interfere with conformed ethical business standards, while curbing "unnecessary, unwise and destructive speculation."[112] This was accomplished through express injunctive and criminal remedies, and under several sections, express civil remedies.

Rule 10b-5 is an agency enactment which proscribes certain conduct outlined in section 10(b) of the 1934 Act,[113] and is necessary because section 10(b) is not self-implementing. This factor in itself limits any attempt at comprehending the legislative intent concerning the limits of 10b-5 liability and the elements thereunder. This, coupled with the fact that private actions for damages under the rule are not expressly granted, but have been implied only from the language of the rule by the courts, makes it increasingly difficult to discern any clear guidelines from the legislative history. If the legislature had intended a civil action under section 10(b) it should have so stated. Nevertheless, the courts have not been reluctant to imply a private right of action on the basis that an implication of a private right does not so much depend on the existence of affirmative con-

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[110] BROMBERG, *supra* note 8.

[111] 15 U.S.C. § 78b (1970).

[112] H.R. REP. NO. 1383, 73d Cong., 2d Sess. 2 (1934).

[113] 15 U.S.C. § 78j(b) (1970).

gressional intent as it does on the absence of evidence that Congress did not so intend.[114] As a result of this judicial doctrine, however, any analysis of the legislative intent regarding the elements of 10b-5 is somewhat fictitious. Thus the entire spectrum of securities law and the underlying intent must be purused with an eye toward the view stated by the Supreme Court in *SEC v. Capital Gains Research Bureau, Inc.*:[115]

> Congress intended . . . securities legislation "enacted for the purpose of avoiding frauds" [to be construed] not technically and restrictively but rather flexibly to effectuate its remedial purposes.[116]

Since nothing in the history and development of rule 10b-5 illuminates the question of what substantive elements must be proven, other sections of federal securities legislation which are similar to rule 10b-5 may be helpful in determining its proper interpretation.

Section 9(a)[117] of the 1934 Act proscribes the same type of conduct contained in 10b-5's prohibition of "any manipulative or deceptive device or contrivance," but 9(a) has elements of intent, knowledge and purpose, and section 9(e)[118] limits civil liability for violation of section 9[119] (including section 9(a)) to persons who willfully violate its proscriptions. It would seem logical, therefore, that Congress and the SEC wished to go beyond the rather rigid proscriptions found in section 9(a) by means of rule 10b-5.

In section 17(a),[120] the three operative clauses deal with (1) a device, scheme or artifice to defraud, (2) material misstatements or omissions, and (3) any practice which would operate as a fraud or deceit. This section is phrased virtually the same as rule 10b-5, and in point of fact the rule was essentially taken directly from it.[121] As a result, the scienter requirements are the same as those under rule 10b-5.[122]

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[114] *See* Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341, 360-61 (2d Cir.), *cert. denied,* 414 U.S. 910 (1973). *See also* Boone v. Baugh, 308 F.2d 711 (8th Cir. 1962); Texas Continental Life Ins. Co. v. Dunne, 307 F.2d 242 (6th Cir. 1962); Errion v. Connell, 236 F.2d 447 (9th Cir. 1956).

[115] 375 U.S. 180 (1963).

[116] *Id.* at 195.

[117] 15 U.S.C. § 78i(a) (1970).

[118] 15 U.S.C. § 78i(e) (1970).

[119] 15 U.S.C. § 78i (1970).

[120] 15 U.S.C. § 77q(a) (1970).

[121] *See* Freeman, *Administrative Procedures,* 22 Bus. Law. 891, 922 (1967).

[122] *See, e.g.,* Fischman v. Raytheon Mfg. Co., 188 F.2d 783, 787 n. 2 (2d Cir. 1951); Globus v. Law Research Serv., Inc., 287 F.Supp. 188 (S.D.N.Y. 1968), *modified,* 418 F.2d 1276 (2d Cir. 1969), *cert. denied,* 397 U.S. 913 (1970).

Two other sections analogous to rule 10b-5 in which the legislative policy has found expression are sections 11[123] and 12(2)[124] of the 1933 Act. Proscribed under section 11 are false and misleading statements as well as omissions in registration statements, both with express private remedies.[125] Both sections 11 and 12(2) have short statutes of limitations and provisions for posting security for the protection of the defendant.[126] Both sections sanction actions instigated only by buyers, not sellers, and under 12(2) there must be privity between buyer and seller. Furthermore, under 12(2) reliance is not a necessary element for a successful cause of action, and in addition, negligent misstatements will suffice to establish culpability.

As has already been noted, these sections give an express civil remedy, while the 10b-5 civil remedy is implied. Since this has not concerned the courts, the problem becomes instead: how far should rule 10b-5 extend; and should it be permitted to nullify the two sections by giving a plaintiff their benefits without the corresponding restrictions Congress imposed upon their use.

Since section 11 deals only with misstatements or omissions in registration statements, this problem is limited by the smaller number of situations applicable to its provisions — smaller when compared to the great number of situations in which there can be violations of securities laws beyond the issuance stage.

Section 12(2), however, being broader in scope than section 11, is cause for greater concern. Section 12(2) applies only to purchasers, and if rule 10b-5 were read in the restrictive manner in which 12(2) is written, seller-plaintiffs would be affected in an utterly arbitrary, negative manner. This is, of course, undesirable since the rule allows either purchasers or sellers to bring suit. Thus, the courts were faced with the dilemma to either force artificial limitations on the rule, thereby thwarting whatever intent lay behind Congress' deletion of such limitations in the rule, or to limit the effectiveness of section 12(2) by creating a more attractive alternative remedy through invocation of rule 10b-5. The courts with singular ability have succeeded in ignoring this dilemma to date,[127] and

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[123] 15 U.S.C. § 77k (1970).

[124] 15 U.S.C. § 77l(2) (1970).

[125] § 11 provides:

> [A]ny person acquiring such security . . . may, either at law or in equity, in any court of competent jurisdiction, sue . . . .

§ 12(2) provides:

> Any person who . . . shall be liable to the person purchasing such security from him. . . .

[126] 15 U.S.C. § 77m (1970).

[127] *See, e.g.*, Trussell v. United Underwriters, Ltd., 228 F.Supp. 757 (D. Colo. 1964). Only two cases stand out as examples wherein the court refused to permit a buyer to sue under rule 10b-5 because of the express right created in the 1933 Act. *See* Rosenberg v. Globe

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there can be little doubt that under rule 10b-5 either purchasers or sellers may sue, with little difference in the elements necessary to be proven or the remedies available.

However, despite the fact that suit is available, there still exists the question as to what extent the legislative intent regarding rule 10b-5 should be considered when defining the standards for imposition of liability under the rule. Possibly this can be ascertained through an analysis of the limits of these standards as reflected in sections 11 and 12(2). The Second Circuit, in *Fischmann v. Raytheon Mfg. Co.*,[128] apparently interpreted this dichotomy of legislative intent behind the different sections by limiting 10b-5 to fraud, while applying section 11 to negligent misrepresentations and omissions. The obvious problem with this approach is that it is difficult, if not impossible, to ascribe a precise meaning to the term fraud.

The Ninth Circuit opinion in *Ellis v. Carter*,[129] on the other hand, while not only showing a willingness to ignore the problems of express versus implied rights of action, seemed willing to find violations for negligence under the rule. Since the *White v. Abrams*[130] decision reaffirmed this particular aspect of the *Ellis* decision, it seems that some illumination could be cast on the issue of which limitation on liability under the rule is the more realistic in light of the intent behind the rule.

The *Ellis* court, instead of defining, or at least differentiating between, the express civil remedies contained in sections 11 and 12(2) and those implied in rule 10b-5, felt that the beneficial results of its decision, based on the rule, far outweighed the danger of nullifying section 12(2).[131] Ignoring the obvious point that courts should not permit an *implied* right of action to become preferred to an *express* right of action,[132] the court instead gave weight to the apparently dominant policy of Congress "to provide complete and effective sanctions, public and private, in respect to duties and obligations imposed under the two acts."[133] Furthermore, no distinction

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Aircraft Corp., 80 F.Supp. 123 (E.D. Pa. 1948), wherein the court held that plaintiff's sole remedy was under the 1933 Act, "[n]o other interpretation can avoid making a completely incongruous piece of legislation out of the two statutes in question." *Id.* at 125. *Accord,* Montague v. Electronic Corp. of America, 76 F.Supp. 933 (S.D..N.Y. 1948).

[128] 188 F.2d 783 (2d Cir. 1951).

[129] 291 F.2d 270 (9th Cir. 1961).

[130] 495 F.2d 724 (9th Cir. 1974).

[131] Ellis v. Carter, 291 F.2d 270, 274 (9th Cir. 1961).

[132] *See* Comment, *Negligent Misrepresentations Under Rule 10b-5, supra* note 13, at 831.

[133] Ellis v. Carter, 291 F.2d 270, 274 (9th Cir. 1961).

was made between buyer and seller, "no reason appearing why Congress would have wanted the procedures [of a buyer as opposed to a seller bringing an action under the rule] to be different."[134]

The approach by the *Ellis* court, permitting negligence to suffice in a 10b-5 cause of action, may find Congressional support in section 12(2). Such a statement as "section 12(2) suggests that a negligence standard for securities transactions is most compatible with probable congressional intent,"[135] while implying a rather omnipotent knowledge of an intent almost impossible of proof, is nevertheless not devoid of logic. Congress wished to place the duty of care on the party with the greater access to the material information.[136] The burden of proof was thereby shifted from plaintiff-purchaser to defendant-seller. This shift is *appropos* under section 12(2) for, being part of the 1933 Act and thus concerned with the issuance of securities, its main concern was protecting investors from sellers who *always* had greater access to material information than purchasers. But focusing upon access in a 1934 Act situation is unnecessary once the securities have been issued because subsequent purchasers may well be in a better position to gain access to information than the sellers.[137] In such a case it would be inequitable to *assume* that the seller has more advantage than the buyer to discover material information. Thus in a 10b-5 action, while the same congressional intent found in section 12(2) concerning the problem of access to material information should be of prime importance, the shifting of the burden of proof necessary in 12(2) is inappropriate due to the impossibility of making any prior judgments as to *who* has the greater access to material information.

By eliminating this automatically shifting burden of proof, while retaining an attempt to equalize access to information, the congressional intent behind section 12(2) seems to become embodied in rule 10b-5. The obvious result of an attempt to equalize access to information is to maximize disclosure of information both to shareholders and to the investment public at large. Such a result is considered to be a prime consideration of the securities laws in general, and some courts have suggested that such was the principal intent of Con-

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[134] *Id.*

[135] *See* Comment, *Negligent Misrepresentations Under Rule 10b-5, supra* note 13, at 839.

[136] *See* 77 CONG. REC. 2918 (1933) (remarks of Rep. Rayburn):

> The purpose of this bill is to place the owners of securities on a parity, so far as is possible, with the management of the corporations and to place the buyer on the same plane so far as available information is concerned, with the seller.

[137] *See, e.g.*, SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

gress.[138] If this is so, it would appear that a standard of liability akin to that under section 12(2) might very well be the most acceptable choice. While sections 9 and 18[139] are extremely specialized, dealing with market manipulation and false statements filed with the SEC, section 12(2) is both a general provision and a reasonable one. Acceptance of the premise that the congressional intent of rule 10b-5 is satisfied by employing the standards applicable to section 12(2) (without the shifting burden of proof employed in a section 12(2) cause of action) in effect permits negligence to became part of the scienter requirement.

There are strong arguments, however, against this reasoning. First, it logically can be argued that the scienter requirement needed in an *implied* rule 10b-5 action should be more stringent than that required in an *express* section 12(2) action.[140] Second, it has been suggested that a scienter requirement which includes negligence for rule 10b-5 would surpass the express statutory authority granted the SEC, in section 10(b), to promulgate rules and regulations.[141] The rationale behind this argument is that the critical words of section 10(b), (*i.e.* "manipulative and deceptive devices or contrivances,") were purposely chosen by Congress to avoid the common law rules of deceit, but were clear evidence of a congressional intent not to proscribe merely negligent conduct. The Ninth Circuit, in *Ellis v. Carter,* responded to this second argument by reasoning that since clause (b) of rule 10b-5 requires no scienter on its face, and since "[i]t would have been difficult [for Congress] to frame the authority to prescribe regulations [under section 10(b)] in broader terms,"[142] the plain meaning of the rule should govern without a scienter requirement, or at least, with negligence included in this requirement.[143]

The main problem with the *Ellis* court's approach is the total lack of concern shown for the extraordinary damages which might result

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[138] *See* Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341 (2d Cir.), *cert. denied,* 414 U.S. 910 (1973). The court observed that "a major congressional policy behind the securities laws in general, and the antifraud provisions in particular, is the protection of investors who rely on the completeness and accuracy of information made available to them." *Id.* at 363. *See also* BROMBERG, *supra* note 8, § 7.1, at 142 (1973).

[139] 15 U.S.C. § 78r (1970).

[140] This follows from the fact that to make it less so creates a more attractive alternative remedy, and thus effectively nullifies § 12(2). *See* 3 LOSS, SECURITIES REGULATION 1785 (1961).

[141] *See* SEC v. Texas Gulf Sulphur Co., 461 F.2d 833, 869 (2d Cir. 1968) (Friendly concurring), *cert. denied,* 394 U.S. 976 (1969); Trussell v. United Underwriters, Ltd., 228 F. Supp. 757, 772 (D. Colo. 1964).

[142] Ellis v. Carter, 291 F.2d 270, 274 (9th Cir. 1961).

[143] Until the decision in White v. Abrams, 495 F.2d 724 (9th Cir. 1974), there were uncertainty as to what exactly the Ninth Circuit standard was — either no scienter requirement in the strict sense, *i.e.,* innocent misrepresentation would violate the rule, or a requirement which included negligence at the very least.

from a successful 10b-5 action. For this reason strict scienter supporters have argued that the issue of damages and the state of defendant's mind must be considered together.[144] The plain meaning of this statement is that there should be some limiting factor on the imputation of liability, and this factor should be based upon the degree of defendant's intent or knowing culpability. In point of fact, if 10b-5 awards are granted on the basis of mere negligence by the defendants, it may very well have a negative impact on the disclosure of information to the public. It is quite true that investor injury would be minimized by awarding damages for merely negligent conduct. But at the same time, access to information by these same investors might very well be severely curtailed. Since a duty to disclose does not exist under all conditions and at every moment in time, and often only where special relationships exist, the end result might be that, in the absence of insider trading, a corporation would avoid as much as possible the disclosure of any information not absolutely necessary of disclosure to avoid incurring liability. Voicing the fears of the *Texas Gulf Sulphur* court, the potential damages would be so great that corporations might choose "to remain silent and let false rumors do their work."[145] The attendant result would be the direct antithesis of the underlying intent of all securities legislation — *i.e.*, encouraging the free flow and mutual access of all material securities information to investors as well as corporate insiders.

If a negligence standard gives results inapposite of the congressional intent, and the Second and Ninth Circuits are diametrically opposed on the questions of not only whether to impose a scienter requirement, but also what that requirement entails, in what manner can the correct approach be surmised? It is clear that other sections are of little assistance. It is further clear that the dichotomy of negligence versus some stricter form of scienter, whether it be intent to deceive, knowledge, constructive knowledge, or any of the other standards used by the courts, is based on policy considerations which can only be accurately measured in the context of factual circumstances, and not in an abstract discussion of congressional intent.

Fortunately, the Second and Ninth Circuits have recently enunciated tests which bear some relationship to the realities of the complexities involved. The two courts at least appear to be retreating from the pitfalls of scienter terminology, and are proceeding towards, and may already have arrived at, tests which will serve the purposes of the varied situations covered by rule 10b-5 without using artificial catchphrases or legal fictions. To accomplish this

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[144] *See* Ruder, *Texas Gulf Sulphur — The Second Round: Privity and State of Mind in Rule 10b-5 Purchase and Sales Cases*, 63 NW. U.L. REV. 423, 427 (1968).

[145] SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 867 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

the circuits have exchanged the elusive scienter and negligence concepts for more reasonable standards which encompass a duty concept reflecting the factual circumstances of individual cases. The purpose of the final section of this note will be to explain these standards, to analyze the cases enunciating them, and to show where these new standards will take the courts.

Toward the Development of a New Standard

Prior to the cases discussed in this section, the Second and Ninth Circuits have often been at opposite ends on a continuum defining standards applicable to rule 10b-5. This has made any attempt to interpret and define these standards with certainty impossible — until the courts' most recent pronouncements which shed the shackles of antiquated and elusive terminology and instead found basis in logical *concepts* loose enough to adapt to fluctuating individual factual circumstances.

The Second Circuit

In a series of three cases, *Chris-Craft Industries, Inc. v. Piper Aircraft Corp.*,[146] *Cohen v. Franchard Corp.*,[147] and *Lanza v. Drexel & Co.*,[148] the Second Circuit recently developed a new standard for determining whether conduct is proscribed under rule 10b-5. This standard can be summarized as follows: *Liability will follow when the plaintiff has shown that the defendant had a duty to disclose material facts and plaintiff has established that defendant failed to disclose these material facts or misstated or omitted to state material facts; and defendant either knew the material facts that were misstated or omitted and should have realized their significance, or failed or refused to ascertain and disclose such facts when they were readily available to him and he had reasonable grounds to believe that they existed.*

This standard as noted does not exist in any one of the three aforementioned cases, since it is a reflection of the basic concepts of the three when taken together. Thus, in order to clearly trace the evolution of the standard, the cases will be treated individually.

Chris-Craft Industries, Inc. v. Piper Aircraft Corp.

Chris-Craft was a landmark case in the development of section 14(e),[149] the anti-fraud provision of the Williams Act.[150] While the case was decided solely on the basis of section 14(e), the law applied

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[146] 480 F.2d 341 (2d Cir.), *cert. denied*, 414 U.S. 910 (1973).

[147] 478 F.2d 115 (2d Cir.), *cert. denied*, 414 U.S. 857 (1973).

[148] 479 F.2d 1277 (2d Cir. 1973).

[149] 15 U.S.C. § 78n(e) (1970). The facts of the case were substantially as follows: Chris-Craft Industries (CCI) had made a cash tender offer to Piper Aircraft Corporation (Piper) shareholders, to which Piper management was opposed. Piper recommended rejection of the CCI offer in letters to its shareholders, observing that it was convinced that the offer was

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by the court with respect to the standards for liability is identical to that under rule 10b-5. The *Chris-Craft* court felt that section 14(e) is nothing more than a recodification of rule 10b-5 with a removal of the purchaser-seller limitation which had previously kept the rule from being applied in tender offer cases.[151] As such, the court's holdings on the standards for violations of section 14(e) can be properly applied to rule 10b-5 cases.

In *Chris-Craft,* the court offered, for the first time, some indication of the standards applicable to the conduct which must be shown on the part of defendants in order to prove a violation of the rule. Judge Timbers, writing for the court, gave little more than lip service to the Second Circuit's traditional scienter requirement, noting that the function of the scienter concept is the confinement of liability "to those whose conduct has been sufficiently culpable to justify the penalty sought to be exacted."[152] Proceeding from that point, the concept and terminology of scienter were dropped entirely, and Judge Timbers proceeded to establish a standard composed of duties which varied based on the relationship between the plaintiff and defendant.

He felt that the first inquiry to be made in assessing a suit for violation of the rule is what duty should be imposed upon the defendant. He observed that there are instances where there exists an affirmative duty of disclosure.[153] This concept is not new to the area of 10b-5 liability. In the past, the courts have deliniated several categories of persons who have an affirmative obligation to disclose material facts under certain circumstances,[154] resulting from special relationships between the plaintiff and the defendant. Implied in

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inadequate. Piper took various other defensive maneuvers, including an attempt at selling 300,000 unissued shares to Grumman Aircraft Company, and eventually settled on supporting a competing offer from Bangor Punta Corporation (BPC). BPC eventually won the control contest, but CCI sued alleging violations of various securities laws including rule 10b-5 and section 14(e). The case has been extensively analyzed in student treatments. *See* Note, *Cash Tender Offers: Judicial Interpretation of Section 14(e),* 23 CLEVE. ST. L. REV. 262 (1974); Note, *Securities Regulation — Tender Offers — Unsuccessful Offeror Entitled to Damages and Injunctive Relief for Injury Caused by Violations of Section 14(e),* 51 TEXAS L. REV. 1444 (1973); Note, *Tender Offers: The Liberalization of Standing Requirements under Section 14(e),* 7. U. SAN. FR. L. REV. (1973); Note, *Standing Under the Williams Act, Section 14(e),* 5 U. Toledo L. Rev. 403 (1974).

[150] Pub. L. No. 90-439, 82 Stat. 454 (1968), *amending* 15 U.S.C. §§ 78m-n (1964) (codified at 15 U.S.C. §§ 78m(d)-(e), n(d)-(f) (1970).

[151] 480 F.2d 341, 362. Judge Timbers observed that he deemed "the underlying proscription of § 14(e) [to be] virtually identical to that of Rule 10b-5 . . . ."

[152] *Id.* at 363.

[153] *Id.*

[154] *Insiders: see, e.g.,* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied,* 394 U.S. 976 (1969); Rogen v. Ilikon Corp., 361 F.2d 260 (1st Cir. 1966); Kohler v. Kohler Co., 319 F.2d 634 (7th Cir. 1963); Schoenbaum v. Firstbrook, 268 F.Supp. 385 (S.D.N.Y. 1967), *aff'd,* 405 F.2d 200 (2d Cir.), *modified,* 405 F.2d 215 (2d Cir. 1968), *cert. denied,* 395 U.S. 906 (1969); Ross v. Licht, 263 F.Supp. 395 (S.D.

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Judge Timbers' statement is the fact that it becomes critical under 10b-5 nondisclosure cases to determine exactly what the plaintiff-defendant relationship is, and from that relationship thereby determine the duty imposed. Judge Timbers suggested two of these instances — where one party has greater access to information, and where a special relationship exists between the party making use of the information and the party who has knowledge of the information.[155] There are, to be sure, several of these situations. As will be discussed *infra,* the Ninth Circuit, in the *Abrams* decision, listed various criteria which might be used to determine when such a relationship exists.[156]

Judge Timbers further noted that a party making a representation is required to first ascertain what is material, and then to disclose fully those material facts about which an investor is uninformed and which would, *in reasonable anticipation,* affect his judgment.[157] This is more than just a simple restatement of the law concerning misstatements and omissions under rule 10b-5. Judge Timbers has engrafted on the standard a new tool to be used in restricting liability under the rule. Prior to *Chris-Craft,* the courts had not found it necessary to articulate a standard concerning a defendant's liability in the situation where he knowingly failed to disclose facts which were later determined to be material by a court, but which were, in the reasonable judgment of the defendant at the time of nondisclosure, determined to be something less than material. However, the time was apparently ripe for an all-out assault by the judiciary on the criteria used to determine a violation of rule 10b-5, and Judge Timbers was willing to hoist the standard for the Second Circuit. It should be noted that Judge Mansfield, in a concurring and dissenting opinion, did not feel constrained to agree with Judge Timbers on this particular issue. In point of fact, Judge Mansfield disagreed with Judge Timbers' entire treatment of the standards for a violation of the rule, feeling that the traditional scienter terminology of the Second Circuit would be better suited as the test. It is interesting to note that

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N.Y. 1967). *Tippees: see e.g.,* Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974); Kuehnert v. Texstar Corp., 412 F.2d 700 (5th Cir. 1969); SEC v. Texas Gulf Sulphur Co., *supra;* Ross v. Licht, 263 F.Supp. 395 (S.D.N.Y. 1967); *In re* Cady, Roberts & Co., 40 S.E.C. 907 (1961). *Contra,* Financial Indus. Fund, Inc. v. McDonnell Douglas Corp., 315 F.Supp. 42 (D. Colo. 1970). *Broker-Dealers: see, e.g.,* Chasins v. Smith, Barney & Co., 438 F.2d 1167 (2d Cir. 1970); Wohl v. Blair & Co., 50 F.R.D. 89 (S.D.N.Y. 1970). *See generally* Comment, *Affiliated Ute Citizens v. United States — The Supreme Court Speaks on Rule 10b-5,* 1973 UTAH L. REV. 119.

[155] 480 F.2d at 363.

[156] *See* text accompanying note 204 *infra. See also* Lanza v. Drexel & Co., 479 F.2d 1277, 1320-21 (2d Cir. 1973) (Timbers dissenting). Judge Timbers offered similar criteria upon which he based his determination of liability, reproduced at text accompanying note 191 *infra.*

[155] 480 F.2d at 363.

Judge Mansfield termed Timbers' addition of culpability language, and his qualifications and characterization of the standards for violation of the rule, as "compound[ing] existing confusion as to the law in the area."[158] Judge Mansfield differed directly with Timbers' dual materiality test, and stated in response to this that

> the test of materiality which was adopted by this court in *List, Heit* and *Texas Gulf Sulphur,* remains an objective one. If the corporate officer has knowledge of facts that are material according to that test he cannot in his discretion decide not to disclose them without facing liability . . . .[159]

It would appear that Judge Mansfield is ignoring a very basic fact in his opinion — the realities of the market place. It is hardly equitable to award the huge liabilities which might follow a 10b-5 cause of action on the basis of an objective materiality test to be applied by a judge in the quiet of his chambers. There must be some room for a reasonable judgment by the defendant, whether he be a corporate insider or simply a party selling securities to another. Denying him the exercise of reasonable judgment in determining materiality not only avoids reality, but to some degree contravenes public policy. True, the objective of the securities laws is to protect the investor through free flow of, and equal access to, all material information, but it is also in that same investor's interest to have at the helm of the corporation, in whose securities the investor is dealing, officers and directors who have a pecuniary interest in that corporation beyond mere salary considerations. If a corporate official purchasing or selling securities cannot depend upon the employment of his own reasonable judgment in deciding whether a fact should or should not be disclosed, (*i.e.,* whether it is or is not material), but is instead subject to a later ruling that his actions were unreasonable, simply in light of an objective materiality test, many will be wary, and rightfully so, of owning and trading in securities of their own corporation.[160] It seems intuitively obvious that public policy is undermined if corporate officials are discouraged from taking a more active interest in their corporation, an interest which extends to stock ownership. But this is the ultimate result of employing Judge Mans-

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[158] *Id.* at 398.

[159] *Id.* at 399.

[160] *See* ABA Comment Letter on Material, non-Public Information BNA 233 SRLR D-1, D-5 (1974). The authors, E. H. Fleishman and D. S. Ruder note that:

> [a]s a standard to be applied by courts, administrators, counsellors and purchasers and sellers themselves, this "objective" test has suffered from the absence of any universal measure for gauging. . . .
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> . . . .
>
> Nevertheless, the very factors adding uncertainty to this "objective" test also contribute *that degree of flexibility which is a prerequisite* to any rule or principle to be applied to the near-endless variety of business situations in which securities are brought [*sic*] and sold. (emphasis added).

field's criterion. His test would opt for laboratory-like conditions under which to determine whether there was a violation of the rule, while Judge Timbers' standard would accept and attempt to deal with the exigencies of the market place. Judge Timbers' standard is the more realistic and practical.

Judge Timbers then compared section 11 and rule 10b-5 as they applied to his standard:

> A failure to perform these duties with "due diligence" in issuing registration materials provides a basis for suit under § 11 of the 1933 Act . . . . A knowing or reckless failure to discharge these obligations constitutes sufficiently culpable conduct to justify a judgment under Rule 10b-5 . . . for damages or other appropriate relief against the wrongdoer.[161]

With these words he seemingly set a standard for rule 10b-5 violations which is different from that of section 11 violations. While the possible policy reasons behind such a distinction have been stated earlier, the actual realities of the differentiation are more elusive. The "due diligence" language of Timbers clearly implies a negligence standard for section 11 violations. The language — "a knowing or reckless failure" — just as clearly implies something more for 10b-5 violations, but exactly what is unclear.

Judge Timbers offered a further attempt at clarification:

> In sum, and put as simply as possible, the standards for determining liability . . . [are] whether plaintiff has established that defendants (1) knew the material facts that were misstated or omitted, or (2) failed or refused to ascertain such facts when they were available to him or could have been discovered by him with reasonable effort.[162]

The first problem with this statement is the attempt to state the standard "as simply as possible," for the concept of what conduct suffices for violation of the rule is not one that can be stated simply. The rule is many tentacled and reaches into every aspect of securities dealings, seemingly with very little restriction. For this reason alone, some authorities feel that a single scienter requirement for all aspects of this rule can never be sufficient.[163]

In one sense this is correct. The requirements of scienter had previously never really been defined, and if they were narrowed to a single standard it would never suffice to cover the entire gamut of

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[161] 480 F.2d 341, 363.

[162] *Id.* at 364.

[163] *Cf.* BROMBERG, *supra* note 8, at § 8.4 (513); Mann, *supra* note 5.

10b-5 violations. On the other hand, if one is willing to view the scienter requirement as more than just a simple standard, (*i.e.*, a continuum of standards which consider various relationships and the duties that result therefrom), the concept of a single, though complex, standard may very well be sufficient to define violations of the rule in all cases.

The second problem with Judge Timbers' statement is the use of the terminology "reasonable effort." Does reasonable correspond to a "reckless failure to discharge these obligations," or is it something less? It would seem that the concepts of lack of reasonable effort and reckless failure are hardly synonymous, and yet this is clearly what Judge Timbers implied.[164]

Despite these ambiguities, Judge Timbers went far towards clarifying the 10b-5 elements in *Chris-Craft*. He dispensed with the term scienter, and instead, treated a violation of section 14(e), and consequently rule 10b-5, as resulting from the breach of a duty arising from the relationship between two parties. This standard was further clarified and expanded in *Cohen v. Franchard Corp.*,[165] the next case which considered the issue following *Chris-Craft*.

Cohen v. Franchard Corp.

Franchard is a particularly interesting case because of its treatment of the question whether negligence or something more is needed to impute liability under the rule. The issue in this case revolved around the failure of defendants, promoters of a syndicate, to disclose material facts of which they were not aware to purchasers of partnerships in the syndicate. At the trial level, the plaintiffs had requested a jury instruction which would have had the effect of holding defendants liable "for mere negligence in allowing the dissemination of allegedly false and misleading offering materials."[166] The trial court refused this instruction, and the Second Circuit affirmed. In so doing, the court apparently enunciated a standard which required a showing of more than mere negligence to find a violation of the rule.

Again, as in the *Chris-Craft* case, it is difficult to determine exactly where the court was going. The jury charge which the trial court had used seemed somewhat harsh:

> Guilty knowledge is the key to your decision in this case. The plaintiffs must establish that the defendant whom you are considering had knowledge and intended to defraud these

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[164] Judge Timbers apparently was suggesting that defendant's lack of "reasonable effort" was a "reckless failure" to discharge his obligations. This analysis does not seem to comport with traditional tort terminology which would likely consider defendant's actions which were below a reasonable standard to be negligent

[165] 478 F.2d 115 (2d Cir.), *cert. denied*, 414 U.S. 857 (1973).

[166] *Id.* at 123.

> plaintiffs, or that he acted in reckless disregard for the truth, or that he knowingly used a device, scheme, or artifice to defraud.[167]

Judge Timbers, again writing for the court, interpreted this as a charge which required a showing of "actual knowledge of falsity or reckless disregard for the truth."[168] Under the facts of this case, the important phraseology in the charge is "reckless disregard for the truth." The court's analysis regarding this portion of the charge is similar, but with an important exception, to that in *Chris-Craft.*

Judge Timbers noted that the Second Circuit has consistently refused to hold a private party liable under rule 10b-5 for merely negligent conduct, and supposedly following the same rationale, he insisted on the necessity for a showing "that the defendant was to some extent cognizant of the misstatement or omission."[169] This latter comment may very well be the most important statement in the opinion, when taken together with the following:

> The standard for determining liability under Rule 10b-5 essentially is whether plaintiff has established that defendant either knew the material facts that were misstated or omitted and should have realized their significance, or failed or refused to ascertain and disclose such facts when they were *readily* available to him and he had *reasonable* grounds to believe that they existed.[170] (Emphasis added)

Thus, it appears Judge Timbers would find a defendant cognizant of misstated or omitted facts when he had *reasonable* grounds to believe that they existed and they were *readily* available to him. In light of this, it is difficult to comprehend the rationale for differentiating between the concepts of mere negligence and reckless disregard for the truth. Indeed, it is difficult to imagine what practical application to the problem the terms might have, beyond the mere attempt at conceptualization of the degree of defendant's inaction.[171] With the use of a reasonably prudent man test, the defendant's liability would rest on whether his belief in a fact's non-existence (or better stated — whether his belief in the truth of the facts as stated) was reasonable. Avoiding the pitfalls of terminology, this concept appears far from the "guilty knowledge" to which the trial court's instruction

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[167] *Id.*

[168] *Id.*

[169] *Id.*

[170] *Id.*

[171] The courts, when dealing with rule 10b-5 violations, have never attempted to define the terms "negligence" or "reckless disregard for the truth," apparently believing that their common law predecessors had provided them with fundamental doctrine. Unfortunately, this is not the case. *See* text accompanying notes 16-43 *supra.*

to the jury makes reference, yet the court has merely realigned the test for constructive knowledge — the test the Second Circuit had traditionally used and Judge Mansfield reaffirmed in *Chris-Craft*[172] — with the added stipulation that the facts must have been *readily* available to the defendant. Indeed, the concepts of negligence and reckless disregard for the truth was never really compatible in a 10b-5 context. A test concerned with the reasonableness of defendant's beliefs fits more easily into the framework of a 10b-5 action.

Without recourse to the negligence-reckless disregard synthesis, the court differentiated between conduct which is not violative of the rule and that which is by instituting the "readily available" limitation. The court interpreted the plaintiff's requested instruction as urging the adoption of a standard under which

> failure to discover material facts when such facts could have been ascertained *without inordinate effort* is enough to establish a private action under Rule 10b-5, "particularly where fiduciary relationships require attention."[173] (Emphasis added)

This standard was refused. Thus, the court would distinguish between "readily available" and "without inordinate effort" and would attach liability to the former, but not the latter. Proponents of the old standard might argue that the court has in fact transformed a single question of negligence versus reckless disregard into a dual issue of reasonableness versus unreasonableness of beliefs, and the degree of availability of the omitted facts, thereby confusing the issue beyond necessity.

The counter to this argument is that the sophistication involved in the operation of the rule, due to its vast coverage, demands a parallel sophistication in the analysis used in assessing individual situations and in determining liability. Indeed, it is only in this manner that the dissimilar types of conduct and the numerous fact patterns covered under the rule can adequately be dealt with.

Nevertheless, the court's treatment of the availability concept is somewhat vague. Judge Timbers made no serious attempt to explain or distinguish the concepts of "readily available" and "without inordinate efforts."[174] It is at once apparent that "with inordinate effort" is at the opposite end of the spectrum from "readily available," but where does "without inordinate effort" lie on this continuum? Appar-

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[172] Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341, 398 (2d Cir), *cert. denied,* 414 U.S. 910 (1973).

[173] Cohen v. Franchard Corp., 478 F.2d 115, 123 (2d Cir.), *cert. denied,* 414 U.S. 857 (1973).

[174] *Id.* In point of fact Judge Timbers did no more than mention the term "without inordinate effort," and declined to adopt it as a standard.

ently Judge Timbers felt that it was a concept broad enough to go beyond the limited area of "readily available." This interpretation, when read together with the reasonable beliefs language, and analyzed in light of the court's language with regard to the negligence-reckless disregard dichotomy, portends a rather strict reading of the "readily available" limitation.[175] This is in keeping with the court's traditional attempts at limiting liability to those whose conduct is sufficiently culpable.

Although the *Franchard* court did not advert to the theory of a duty evolving from the relationship of the parties, or that duty's effect on the standards which it posited, it was unquestionably an integral part of its reasoning. The court's manner of dealing with the defendant's conduct, while repeatedly couched in negligence terminology, was partially based on the plaintiff's complete dependence on the defendant's statements.[176] The court's finding of no liability might well have stemmed more from the fact that defendant's conduct was not even negligent let alone reckless, *i.e.*, defendant did not have reasonable grounds to believe that undisclosed material facts existed.[177] This fact suggests that the court might possibly find negligent actions on the part of the defendant sufficiently violative of a duty so as to demand the imputation of liability. The court, however, left the development of this concept of duty to the future.

Lanza v. Drexel and Co.

It was only a fifteen day wait, however, before the Second Circuit continued its assault on the traditional scienter requirement. In *Lanza v. Drexel and Co.*,[178] the court, sitting en banc, discussed the concept of duty as it applied to the conduct of an outside director of BarChris Construction Co. Judge Moore, writing for the court, set out the issue quite clearly:

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[175] Although it is not clear, it appears that the actual holding of the court, affirming the jury verdict of no liability on the part of the defendants, was based on the fact that the court felt that the defendants did not have reasonable grounds to believe that there existed material information of which they had not informed the plaintiffs. The court noted:

> It is not enough for plaintiff to show that defendant failed to detect certain material facts when he had no reason to suspect their existence.

[176] It is self evident that the relationship between plaintiffs and defendants resulted in a duty, since the rule operates to create a duty in a situation where purchasers of securities must rely solely on the statements of sellers when engaging in a transaction. In the *Franchard* case defendants prepared literature to promote the sale of limited partnership interests in Associates, and prepared and filed a prospectus with the Attorney General of New York pursuant to N. Y. GEN. BUS. LAW § 352-e(1)(a), (b) (McKinney 1968). 478 F.2d at 118.

[177] 478 F.2d at 123.

[178] 479 F.2d 1277 (2d Cir. 1973) (en banc). The case centered around an exchange of 20,000 shares (all of the outstanding stock) of Victor Billiard Co., owned by the plaintiffs, for 20,428 shares of BarChris Construction Co.. Less than one year after this exchange, BarChris had filed a petition in bankruptcy. After having unsuccessfully attempted to recover

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> To what extent does a director of corporation A, (1) who does not know that officers or directors of the corporation on whose board he sits have made false representations to, or have failed to disclose the inaccuracy of material information given to, or have omitted to give material information to owners of all the shares of corporation B who are exchanging their stock for that of corporation A, and (2) who has not been a participant in the negotiation of the sale or made any representation with respect thereof, or had any knowledge thereof, owe a duty to such purchaser, to inquire into all statements, oral and documentary, made to the stockholders of B in connection with the transaction before voting to authorize the contract formalizing the sale?[179]

The district court felt that the circumstances of the case dictated a conclusion that no duty existed. The court noted:

> The claim fails because of two propositions, one of fact, the second of law:
>
> 1). Coleman, [the outside director] neither participated in nor knew of any deception practiced upon the plaintiffs;
>
> 2). in the circumstances disclosed by the record, he was under no duty to investigate more than he did at the material times or to seek out and advise the plaintiffs in any way.[180]

The trial court referred to a dual duty, the first being the duty to discover material facts which had not been related to plaintiffs, the second being the duty to disclose these facts to the plaintiffs. Judge Moore, however, referred to these two duties as one — the duty to convey. This oversimplification is the first difficulty encountered with this opinion, which continually refers back to pre-*Chris-Craft* terminology in assessing the scienter requirement.

The court went through an extensive analysis of the legislative intent behind the 1933 and 1934 Acts, as well as common law and public policy considerations, in order to determine that a director of

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their shares in rescission, the plaintiffs brought an action for compensatory and punitive damages against former officers and directors of the company. Defendant Coleman, a partner of defendant Drexel and Company, was a member of the Board of Directors of BarChris. It was alleged, and later proven at trial, that certain officers and directors of the company had, by material misstatements and omissions, misled the plaintiffs into exchanging their stock for that of BarChris. Judge Frankel, writing the district court opinion, held that Coleman, as an outside director of BarChris, was not liable under rule 10b-5, and that Drexel and Company was not liable under the theory of *respondeat superior* for the alleged misconduct of Coleman. This finding was based primarily on the fact that Coleman had not participated in the negotiations with Victor, and had not been aware of the misrepresentations made to Victor.

[179] *Id.* at 1279.

[180] *Id.* at 1289.

a corporation is not an insurer of the truth of corporate statements. But the court also went so far as to say that there is no duty on the part of a director to convey all material adverse information to prospective purchasers of a company's stock.[181] This statement is, quite obviously, misleading. Judge Moore surely did not mean that a director, aware that material facts were kept hidden from prospective purchasers, would not be under a duty to disclose these facts. Rather, it would appear that he was referring to a situation wherein the director is either unaware of such facts and is under no duty to discover them, or is unaware of the failure to communicate such facts to prospective purchasers.[182]

Judge Moore noted that proof of willful or reckless disregard for the truth is necessary to establish a violation of the rule. He further observed that in determining what constitutes such willful or reckless disregard

> the inquiry normally will be to determine whether the defendants knew the material facts misstated or omitted, or failed or refused, after being put on notice of a possible material failure of disclosure, to apprise themselves of the facts where they could have done so without any extraordinary effort.[183]

Unfortunately, Judge Moore failed to further explain and utilize this standard in assessing the defendant's conduct, but simply noted that Coleman had not "willfully closed his eyes or turned his back on the fraudulent nature of the . . . negotiations."[184] This type of cursory analysis is one of the major failings of the opinion, for it is of little assistance in establishing workable standards to quote the *Chris-Craft* standards and then refuse to apply them.

The court's reference to willful or reckless disregard for the truth is a traditional Second Circuit standard, long considered the mainstay as a limit for the imputation of liability.[185] It is not sufficient, however, to circumscribe the area beyond which conduct will not violate the rule; rather, what is needed is an in-depth analysis of the duties and standards of conduct which must be maintained by those in a position to effect investor injury, together with a system

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[181] *Id.*

[182] There is no question, as the court notes, that a director is not an insurer of the truth of corporate statements. *Id.* But, there are situations wherein a director, exercising reasonable judgment, should be aware that either naturally adverse facts concerning the corporation are being concealed from him, or that it is likely that such facts of which he is aware are not being disclosed to parties, to whom, due to the circumstances, the corporation lawfully must disclose. *See* 479 F.2d at 1321 (Timbers dissenting).

[183] *Id.* at 1306 n. 98.

[184] *Id.* at 1306.

[185] *See, e.g.,* Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341, 363 (2d Cir.), *cert. denied,* 414 U.S. 910 (1973).

of tests designed to detect both breaches of those duties and conduct falling below the standard. Judge Timbers, in *Chris-Craft* and *Franchard,* developed a series of tests for this very purpose, leaving only the decision of what variables need be applied to the duty or standard of conduct applicable to a given individual to the inclination of the future courts dealing with a specific fact pattern.

Although the *Lanza* court did not fail to enumerate a number of considerations needed in determining the duty to be applied to an individual (in this case, an outside director), once having done so the court's treatment of his conduct in relation to the standards developed by Judge Timbers is disenheartening.

The dissenting opinions of Judge Hays and Judge Timbers illustrate some of the problems ignored in the majority opinion. Judge Hays' appraisal of the majority's treatment of the defendant's conduct is succinct and direct:

> It is not profitable in considering a case such as this merely to characterize the allegedly unlawful conduct as either negligent or willful and to impose liability only if the conduct was willful. Neither the Act nor the Rule creates such a simple dichotomy.[186]

Rather than phrasing Coleman's duty to the plaintiffs as one which does not include a duty to investigate further than he did, Hays simply maintained that the director of a corporation that is selling its shares has an obligation (or duty) "not to defraud the purchasers by either misstating or omitting to state material facts."[187]

Although Hays did not phrase his analysis in the terms used in the *Chris-Craft-Franchard* standards, his analysis is analogous. He noted that despite Coleman's position, experience and knowledge of the corporation's internal strife, he made no attempt to inquire concerning the course of the negotiations. This analysis is quite acceptable when the *Chris-Craft-Franchard* vernacular is applied, *i.e.,* he failed to ascertain such facts when they were readily available to him.

The important question, which Judge Hays raised in traditional negligence terminology, and which the majority opinion ignored altogether, is whether Coleman had reasonable grounds to believe that the plaintiffs had not been given all the facts. Judge Timbers based

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[186] 479 F.2d at 1317. It appears that the majority's treatment of the problem in this manner has already had an affect. *See* Herzfeld v. Laventhol, Krekstein, Horwath & Horwath, CCH FED. SEC. L. REP. ¶ 94,574 (S.D.N.Y. 1974). The district court in citing *Lanza* noted that the plaintiff must prove that defendant had actual knowledge of any misrepresentations or omission or that his "failure to discover the misrepresentations and omissions amounted to a willful, deliberate, or reckless disregard for the truth that is the equivalent of knowledge." CCH FED. SEC. L. REP. ¶ 94,574, at 96,002.

[187] 479 F.2d at 1317.

his analysis on a reckless disregard for the truth standard, and thereby imputed liability.[188] Judge Hays predicated his finding that Coleman had failed to determine that the condition of the company had worsened considerably since the outset of the negotiations, along with his subsequent failure to disclose this fact on negligence.[189]

It is unfortunate that neither the majority nor the two dissenting judges stated their conclusions in language more amenable to analysis. As has been stated previously, the terminology of negligence and reckless disregard for the truth is difficult to analyze since their use is influenced by a number of variables applicable to each individual factual pattern. Both dissenting judges apparently determined that Coleman did not have reasonable grounds for believing that the deteriorated condition of the company had been related to Victor. If, rather than couching their analysis in negligence-reckless disregard terminology, the court and the dissenters had clearly set out the circumstances and relationships which influenced their decision regarding the reasonableness of Coleman's beliefs, subsequent courts would have been better served.

Judge Timbers somewhat approached this point in his analysis by setting out what he considered to be points which demonstrated Coleman's reckless conduct:

1. Coleman was the most experienced member of the Board with regard to financial and business matters, having been added at the behest of Drexel to protect their substantial interests in BarChris.

2. He was aware that BarChris was acquiring Victor through an exchange of stock, since he had voted for the acquisition.

3. He was aware of the business reversals BarChris had suffered and the severe internal dissension, yet he was unaware of whether this had been disclosed to Victor.

4. Coleman's experience should have told him that since neither the Board nor management would admit to themselves that they had serious problems until the "point of crisis" meeting, management had obviously not revealed these problems to outsiders such as Victor.

5. The very nature of BarChris' internal strife should have caused Coleman to suspect that it had not been related to Victor.

6. Intracorporate dissension is a matter which management typically considers to be within the confidence of the corporation. Those

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[188] *Id.* at 1321.

[189] *Id.* at 1318.

concerned usually experience an optimism that the problem is not as serious as it seems. Thus, there was good reason to suspect that the management of BarChris had not informed Victor of the problem.[190]

Timbers' conclusion that Coleman's conduct amounted to reckless disregard for the truth goes further than Hays' finding that Coleman's conduct amounted to negligence. This in turn goes further than the conclusion of the majority that Coleman's conduct was within the limitations of, and met the responsibility imposed by, rule 10b-5.

The basic observations of the court are twofold:

First, the workings of the rule and the circumstances and relationships involved between plaintiff, defendant and the various intermediate parties impose a duty or standard of care upon the defendant; and it is only a breach of this duty or conduct below the requisite standard which will cause liability to be imposed.

Second, under the facts of this case, the issue revolved around the reasonableness of defendant's belief that Victor had been informed of the problems which BarChris was currently experiencing. A majority of the court (5 judges) felt that these beliefs were reasonable,[191] whereas a minority (4 judges) felt that they were not.[192]

Admittedly, *Lanza* is difficult to analyze in a framework consisting also of *Chris-Craft* and *Franchard*. The standards for liability were poorly articulated, then casually overlooked, as the court lapsed into traditional scienter terminology. Nevertheless, the opinion is important for its formulation of the duty analysis ostensibly used in determining conduct for which the defendant is responsible. By looking beyond the express language of the court and examining the reasoning of the various judges in light of *Chris-Craft* and *Franchard*, a valuable addition to the new standard is discernable in its nascent stage.

Summary

The Second Circuit in a series of three cases has begun developing a new standard for the imputation of liability under rule 10b-5. The court enunciated a series of tests whereby a decision is predicated on the individual circumstances and relationships involved in a particular case as applied to the conduct of the defendant. The first two cases laid down the framework for the analysis under the new standard, while the third case offered the court an opportunity to

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[190] *Id.* at 1320-21.

[191] Judges Moore, Kaufman, Feinberg, Mansfield and Mulligan.

[192] Judge Hays wrote a separate concurring and dissenting opinion, in which he disagreed with the majority's conclusion on the issue of defendant's liability. 479 F.2d at 1311. Judges Smith and Oakes joined in Judge Hays' opinion and Judge Timbers joined in Judge Hays' opinion and wrote a separate concurring and dissenting opinion, in which he disagreed with the results. 479 F.2d at 1320.

examine the negligence issue in light of this new standard. Although the court chose to remain with its traditional viewpoint of not permitting liability for mere negligence, this decision is not too surprising; but it is enlightening when it is considered that the court will most likely implement this rationale through its "*readily* available" and "*reasonable* grounds" limitations. If such is the case, then it is to be hoped that the "negligence-reckless disregard for the truth" dichotomy will disappear in the interpretations.

The Ninth Circuit

The Ninth Circuit, in *White v. Abrams,*[193] while omitting the detail that Judge Timbers employed in *Chris-Craft* and *Franchard,* developed a standard similar to that of the Second Circuit. Procedurally, *Abrams* arose on appeal from a lower court verdict, rendered for the plaintiff, which awarded substantial damages for violations of rules 10b-5.[194] Defendant's contention was that the jury instruction on the question of material misrepresentations was erroneous and improper:

> If you find that defendant made a material misrepresentation to plaintiffs in connection with the sale to plaintiffs of a promissory note or a share of stock, the law is that defendant has violated the Federal securities laws *even if you find that defendant did not know* the falsity of the misrepresentation he made to plaintiffs.[195] (Emphasis added by circuit court)

The court found that this instruction was too stringent, basing its decision on the rationale that the lower court's instruction would, in effect, impose upon Abrams a duty to insure the truthfulness of his representations.

In reversing and remanding, the court noted that nowhere is there any indication that Congress or the SEC intended to make anyone an "insurer against false or misleading statements made non-negligently or in good faith" under section 10(b) or rule 10b-5.[196]

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[193] 495 F.2d 724 (9th Cir. 1974).

[194] The facts of the case are substantially as follows: Abrams was in the business of soliciting loans from private lenders for the Richmond Corporations. White and various other plaintiffs made loans through Abrams to Richmond Corporation from 1959 to 1967, and had purchased their stock in the combined sum of $715,000.00. In 1969, the Richmond Corporation declared bankruptcy with outstanding loans of approximately $58,000,000. In the complaint White alleged that Abrams misrepresented (1) that he had investigated Richmond (who primarily owned and controlled the Richmond Corporation), and his corporations and found them to be financially sound, (2) that Richmond would use the borrowed money to purchase equipment for and upgrade the corporation, and (3) that Richmond had high earnings and could well afford the high interest rates (12-14%). In addition the complaint alleged that Abrams failed to disclose (1) that he was receiving a large commission on each investment made through him, and (2) that he sold similar securities and loans to other persons at higher rates of return (up to 80%). The jury found for plaintiffs in the sum of $1,101,982.00 which was reduced by the court to $867,200.00. Defendant appealed. 495 F.2d at 726-28.

[195] *Id.* at 728.

The court further indicated that much criticism and speculation had arisen over its prior opinions in *Ellis v. Carter*[197] and *Royal Air Properties, Inc. v. Smith*,[198] because of its apparent imposition of absolute liability.[199] Any such interpretation was dismissed and the court, instead, introduced what it termed its "flexible duty" standard.

The recent Supreme Court decision in *Affiliated Ute Citizens v. United States*[200] was extensively cited by the court for its treatment of 10b-5 violations in the context of the duty the rule imposes, rather than in terms of the elements of common law fraud. The court noted that

> [a]lthough the elements of common law fraud were important in defining what factors should be considered, they were neither limits nor barriers to the extent of the defendant's duty under the rule.[201]

The *Abrams* court adopted this approach, concluding that the correct procedure is "to examine the totality of the factual context and measure it by the duty imposed on the defendant."[202]

In considering this approach, the court made reference to the Second Circuit's adoption of a similar methodology for determining a violation of the rule found in the *Chris-Craft* and *Lanza* decisions. It differentiated between the approach taken by the Second Circuit and its own by the former's refusal to include negligence within the scope of conduct proscribed under the rule, as opposed to its own treatment of negligence as sufficient to impute liability. The court paid particular attention to Judge Hays' dissent in *Lanza* which, it observed, also adopted a duty approach, albeit without the inclusion of the limitation disallowing liability for negligence.

The court felt that the varied applicability of the rule necessitated a departure from the rigid standards of common law scienter and demanded instead a flexible approach. The proper analysis, as the court saw it, is to focus on the duty of the defendant, while permitting the application of a flexible standard to meet varying factual contexts.

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[196] *Id.* The court noted that the "purpose of rule 10b-5 is to qualify the rule of *caveat emptor* — not to establish a scheme of investors insurance," citing List v. Fashion Park, Inc., 340 F.2d 457, 463 (2d Cir.), *cert denied*, 382 U.S. 811 (1965).

[197] 291 F.2d 270 (9th Cir. 1961).

[198] 312 F.2d 210 (9th Cir. 1962).

[199] White v. Abrams, 495 F.2d 724 (9th Cir. 1974). *See* note 5 *supra.*

[200] 406 U.S. 128 (1972).

[201] White v. Abrams, 495 F.2d 724 (9th Cir. 1974).

[202] The court noted:

> [A] proper analysis of 10b-5 liability . . . is not based upon . . . convenient, differently interpreted, shorthand latin phrases behind which one can sweep complex determinations. 495 F.2d at 732.

The court was adament in its rejection of the scienter standard as well as scienter terminology. It felt that the concepts of negligence and scienter which focus "solely upon state of mind and its various compartmentalizations" are anomalous in a 10b-5 context,[203] and also noted that *Ellis* and *Royal Air Properties* were never intended to focus on state of mind concepts in treating liability under 10b-5.

In enunciating its flexible duty standard, the court was cognizant of the fact that in order to make such a standard applicable to each specific situation, some guidelines must be given to be considered in determining the duty to which the defendant is to be held. The court felt that at the very minimum the following factors should be examined: (1) The relationship of the defendant to the plaintiff;[204] (2) The defendant's access to the information as compared to the plaintiff's access;[205] (3) The benefit that the defendant derives from the relationship;[206] (4) The defendant's awareness of the plaintiff's reliance upon their relationship in making his investment decisions;[207] and (5) The defendant's activity in initiating the securities transaction in question.[208]

Although mention of these considerations is helpful in establishing a duty, the court seems to have neglected to formulate any real standards that can be applied to the facts of a specific instance. This may very well be exactly what the court intended, enunciating no explicit standard, but letting a court-imposed duty derived from

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[203] *Id.* at 734.

[204] *Id.* at 735. As noted by the court, several cases have considered this relationship. *See, e.g.,* Vine v. Beneficial Finance Co., 374 F.2d 627 (2d Cir.), *cert. denied,* 389 U.S. 970 (1967) (action by one class of shareholders against another for approval of unfair merger); Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961) (action against fellow members of a joint venture formed to acquire control of corporation). *Cf.* Brennan v. Midwestern United Life Ins. Co., 259 F. Supp. 673 (N.D. Ind. 1966) (motion to dismiss denied), 286 F. Supp. 702 (N.D. Ind. 1968) (on merits), *aff'd,* 417 F.2d 147 (7th Cir. 1969), *cert. denied,* 397 U.S. 989 (1970) ("duties are often found to arise in the face of special relationships").

[205] 495 F.2d at 735. The issue of access to information runs continually through the cases in which the courts have dealt with insiders, tippees and broker-dealers. *See, e.g.,* Shapiro v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974) (tippees); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied,* 394 U.S. 976 (1969) (insiders); Chasins v. Smith, Barney & Co., 438 F.2d 1167 (2d Cir. 1970). *See generally* Comment, *Affiliated Ute Citizens v. United States — The Supreme Court Speaks on Rule 10b-5,* 1973 UTAH L. REV. 119.

[206] 495 F.2d at 735. *See* Buttrey v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 410 F.2d 135, 144 (7th Cir.), *cert. denied,* 396 U.S. 838 (1969); Brennan v. Midwestern United Life Ins. Co., 286 F.Supp. 702, 715-16 (N.D. Ind. 1968), *aff'd,* 417 F.2d 147 (7th Cir. 1969), *cert. denied,* 397 U.S. 989 (1970).

[207] 495 F.2d at 735-36. The court cites Drake v. Thor Power Tool Co., 282 F.Supp. 94 (N.D. Ill. 1967), as impliedly suggesting that the defendants should be held to a high standard because of their awareness of the fact that the investing public would rely upon the accuracy of their statements.

[208] 495 F.2d at 735-36. *See* Ruchle v. Roto American Corp., 339 F.2d 24 (2d Cir. 1964) (liability of director who had taken active part in issuance of new shares to perpetuate Board's control); Globus, Inc. v. Jaroff, 266 F.Supp. 524 (S.D.N.Y. 1967) (directors actively participated in plan to issue new stock that would have benefited them).

the rule govern all conduct under the rule. To be sure, this will accomplish what the court intended. The question which must be raised, however, is whether the court has gone too far.

Judge Wallace noted:

> Where the defendant derives great benefit from a relationship of extreme trust and confidence with the plaintiff, the defendant knowing that plaintiff completely relies upon him for information to which he had ready access, but to which plaintiff had no access, the law imposes a duty upon the defendant to use extreme care in assuring that all material information is accurate and disclosed. If the defendant has breached this duty, he is liable under rule 10b-5 . . . .[209]

Obviously, there are no limiting factors in this standard.[210] The court is willing to impose rather rigid requirements where the circumstances warrant. The court contrasted this situation with those circumstances wherein the relationship between the plaintiff and the defendant was so casual that a reasonably prudent person would not rely upon it in making investment decisions. In such a case, Judge Wallace felt that only intentional misrepresentation need be avoided for an individual to remain outside the play of the rule.

The problem with this treatment of the standard is that both examples are of situations in which even the most stringent court would most likely find similar results. The real difficulty with the standard will arise when the solutions are not so clear-cut.

Nonetheless, the *Abrams* court has established a rather unique standard for liability under the rule, and has gone to great lengths to explain the underlying concept. The standard does away with the state of mind concepts of scienter and negligence and, in their stead, treats the duty resulting from the operation of the rule, and the relationship between the plaintiff and the defendant, as the meaningful element in the application of the rule. For this reason alone, the *Abrams* decision will do much to eradicate the confusion surrounding the standards for violations of the rule.

The questionable aspect of the decision is the court's failure to place any limiting factors on the imputation of liability under the rule. This omission is in sharp contrast to the dual limitation system of the Second Circuit.

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[209] 495 F.2d at 736.

[210] This statement is somewhat misleading. Professor Bromberg has noted that there are, besides some form of scienter, still some limits on the use of the rule: (1) materiality, (2) the requirement that there be a security, (3) the requirement of causation, and (4) for non-privity defendants, the requirement of some degree of participation, aiding-abetting, or conspiracy. Bromberg, *Are There Limits to Rule 10b-5?*, 29 BUS. LAW. 167, 167-68 (1974).

The Concept of Duty to Disclose

At this time, a reiteration and comparison of the recent standards the two circuit courts have espoused would be beneficial.

The Ninth Circuit's standard balances both the duty arising from the operation of the rule and the relationship between the plaintiff and the defendant against the conduct of the defendant. A violation of rule 10b-5 exists whenever the defendant, through his substandard conduct, has breached this duty.

The Second Circuit's similar, but much more complex standard, also acknowledges both the duty arising from the operation of the rule and the relationship between the plaintiff and the defendant, and contrasts these with the conduct of the defendant. But two very important limitations are placed on the imputation of liability. In failing to discover and disclose material facts, liability will follow only where the facts were readily available to the defendant and he had reasonable grounds to believe that they existed.

It is obvious that under either standard the only meaningful variable is the relationship between the plaintiff and the defendant. In the Ninth Circuit's standard, this relationship is directly reflected in the duty imposed upon the defendant; whereas in the Second Circuit, the relationship will be reflected not only in this duty, but also in the interpretation of "readily available" information and the "reasonable grounds" standard for believing the information exists.

Questions naturally arise as to what differences will result if the two standards are applied in the same factual context, and specifically, what considerations will be used to determine the standard of conduct which the defendant must maintain in order to avoid liability under the rule.

Another look at the Second Circuit cases may yield some clue. In *Lanza,* the Second Circuit employed the limitations on its duty concept to avoid imputing liability to the defendant. The court determined that while a duty existed, it was not one which required a stringent standard of conduct; and thus defendant's conduct was not such as to violate the standard or to breach the duty. The Ninth Circuit, viewing the same case, might very well have come to a different conclusion, and as a result would have found the defendant more culpable. This would seemingly follow from the court's desire to include negligence within the conduct prohibited by the rule, and its analysis of the defendant's access to material information, as compared to the plaintiff's access, would have led it to conclude that a duty existed and defendant's conduct was such as to violate that duty.

The Second Circuit's treatment of the issue in *Lanza* is comparable to its treatment in *Franchard,* wherein the court again utilized its delimiting factors to avoid imputing liability to the defendants.

Here the Ninth Circuit might well agree with the analysis of the case. The Second Circuit spoke in terms of facts not "readily available" to the defendant and lack of "reasonable grounds" to believe that those facts existed. The Ninth Circuit would likely have found that, while a duty existed, the conduct of the defendants simply did not fall below the requisite standard and thus did not breach the duty.

The foregoing suggests that perhaps the courts will ultimately use a similar analysis in treating fact situations wherein a duty has been established, and the dichotomy between the two courts may be determined and possibly resolved by the manner in which the Second Circuit applies its two delimiting factors. The concept of a duty to disclose in a 10b-5 context is not really new to the courts, although the situations employing it are somewhat narrow when compared to the overall scope of the rule.[211] Expanding this concept will probably lead to discrepancies between the two courts based on their individual views as to what degree of conduct should be governed under the rule. Irrespective of this fact, a great deal of difficulty should not be expected in dealing with these concepts in the future.

What can be expected is that the Ninth Circuit, and perhaps several others taking their cue from that court, will begin to deal with what has been known as the scienter element with much less difficulty than in the past. The concept of a breach of duty lends itself with ease to consideration in a 10b-5 context. The confusing Latin terminology which, as the *Abrams* court noted, tends to obfuscate the rule should no longer be a consideration.[212] Of course, the Ninth Circuit will continue its attempt to extend the coverage of the rule to negligence situations. But it is quite possible that the standards which the Second Circuit can now begin applying will accomplish much the same result.

Conclusion

It may well be that the four cases dealt with herein have signalled the end of an era. The traditional treatment of a 10b-5 violation in terms of the common law concept of scienter has proven cumbersome and confusing. The courts and commentators, when dealing with scienter in a common law context, have had extreme difficulty in defining the term and, in point of fact, a rational analysis of the

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[211] *See* cases cited in note 154 *supra.*

[212] Perhaps this is more of a hope than a fact. The only case that the Second Circuit has handed down since *Lanza,* discussing the scienter issue, does not follow the duty concept of analysis or the standards set down in *Chris-Craft* and *Franchard.* Republic Technology Fund, Inc. v. Lionel Corp., 483 F.2d 540, 551 (2d Cir. 1973) ("something short of specific intent to defraud is required and something more than 'mere' negligence"). *See also* Republic Technology Fund, Inc. v. Lionel Corp., *supra* at 553 (Mulligan concurring) ("proof of a willful or reckless disregard for the truth"); Herzfeld v. Laventhol, Krekstein, Horwath & Horwath, CCH FED. SEC. L. REP. ¶ 94,576 (S.D.N.Y. 1974).

common law courts' interpretations of the scienter element forces the conclusion that the term became literally a catch-all for various theories upon which the courts wished to base liability.

A purview of 10b-5 cases which purport to analyze the scienter concept evidences the complete state of confusion resulting from attempts to define the term. The courts' definitions have varied from action encompassing fraud, intent to defraud, and reckless disregard for the truth up to and including negligence. Such a wide divergence has made a rational appoach impossible, forcing the courts to rely on antiquated catchwords to determine culpability.

In addition, as a result of the use of scienter terminology, the courts have been unable to adequately define holdings which, in some cases, purportedly found basis in the defendant's negligent action, and in some cases rested on a stricted requirement, *i.e.*, something more than negligence, prior to the imposition of liability. This difficulty, in combination with an inability on the part of the courts to interpret the congressional intent behind section 10(b), led to overwhelming confusion with regard to the limits to which rule 10b-5 extended.

But a new chapter looms. The Second and Ninth Circuits have finally enunciated standards which can be systematically applied to a variety of factual circumstances in a manner lending itself to analysis. Through the use of a duty standard, the two courts have presented a methodology for approaching 10b-5 suits which may offer a solution to their increasingly apparent disparity in attitude toward, and application of, the rule. It is to be hoped that the two courts continue to refine and rely on this approach, and that other courts when faced with 10b-5 cases will, in turn, adopt it.

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