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# INSIDER LIABILITY UNDER RULE 10b-5 — THE CURRENT STATE OF THE LAW

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Of the rules adopted by the Securities and Exchange Commission (SEC) under section 10(b) of the Securities Exchange Act of 1934,<sup>1</sup> the most important and far-reaching is rule 10b-5.<sup>2</sup> Based on the theory that the market for a security should reflect the judgments of purchasers and sellers with equal access to all relevant information, rule 10b-5 is principally directed at the person who has access to more information than the average purchaser or seller — the insider.<sup>3</sup> However, it is not always clear which persons are considered insiders for the purposes of rule 10b-5; nor is it clear what acts or omissions give rise to liability, or the extent of such liability, under the rule. What has become increasingly clear is that the application of the rule has signaled an “Era of Anticipation” for every individual involved in a securities transaction covered by 10b-5.<sup>4</sup>

## WHO IS AN INSIDER?

Corporate officers and directors,<sup>5</sup> controlling stockholders of the issuer,<sup>6</sup> and the issuer itself<sup>7</sup> are all considered “insiders” for the pur-

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<sup>1</sup> 15 U.S.C. § 78j(b) (1970).

<sup>2</sup> 17 C.F.R. § 240.10b-5 (1974):

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 a national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

<sup>3</sup> Liability under rule 10b-5 flows from

the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and . . . the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing.

*In re* Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961) (footnote omitted).

<sup>4</sup> Rule 10b-5 covers unregistered securities as well as securities registered on a national exchange. In fact, a significant percentage of all litigation instituted under 10b-5 arises from direct face-to-face transactions involving securities of closely held corporations not actively traded in any market.

<sup>5</sup> *Ross v. Licht*, 263 F. Supp. 395 (S.D.N.Y. 1967).

<sup>6</sup> *Rogen v. Ilkon Corp.*, 361 F.2d 260 (1st Cir. 1966).

<sup>7</sup> *Kohler v. Kohler Co.*, 319 F.2d 634 (7th Cir. 1963).

poses of rule 10b-5. Clearly, these individuals would have access to more information than the average purchaser or seller. However, the scope of the term "insider" is not limited to this enumerated class of individuals. In *SEC v. Texas Gulf Sulphur Co.*,<sup>8</sup> for example, a company engineer, two company geologists, an attorney, and an office manager were all considered insiders within the broad scope of 10b-5.<sup>9</sup>

A broker-dealer may be liable under rule 10b-5<sup>10</sup> for a wide variety of misrepresentations or omissions concerning stock he is trading for a customer. A few of the litigated situations peculiar to a broker-customer relationship have involved misrepresentations of the margin on which the stock may be purchased,<sup>11</sup> misrepresenting outstanding securities as a new issue,<sup>12</sup> omissions as to the availability of a better price for purchase of the security,<sup>13</sup> and domination of the market by the broker-dealer.<sup>14</sup>

Nor have securities lawyers escaped the web of liability under 10b-5. It had generally been assumed that lawyers had no liability in connection with securities transactions other than liability to their clients for malpractice or other negligent conduct.<sup>15</sup> However, in *SEC v. National Student Marketing Corp.*,<sup>16</sup> two law firms themselves were charged with violations of the antifraud provisions for the manner in which they had represented two merger partners by failing to disclose certain adverse financial information.<sup>17</sup> Apparently, the SEC is taking the position that an attorney's first duty when he learns a client is acting improperly is to the public, rather than to his client.<sup>18</sup> Such a view

<sup>8</sup> 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969).

<sup>9</sup> The court considered sales made in the names of insiders' wives as having been made by the insiders, since any other approach would have been "unrealistic." *Id.* at 841.

<sup>10</sup> The broker-dealer may be concurrently liable under rule 15c1-2, 17 C.F.R. § 240c1-2 (1974). For a discussion of the special problems of underwriters, see Freund & Hacker, *Cutting Up the Humble Pie: A Practical Approach to Apportioning Litigation Risks Among Underwriters*, 48 ST. JOHN'S L. REV. 461 (1974).

<sup>11</sup> *Smith v. Bear*, 237 F.2d 79 (2d Cir. 1956).

<sup>12</sup> *In re Indiana State Sec. Corp.*, 38 S.E.C. 118 (1957).

<sup>13</sup> *SEC v. Seaboard Sec. Corp.*, CCH FED. SEC. L. REP. ¶ 91,697 (S.D.N.Y. June 6, 1966).

<sup>14</sup> *In re S.T. Jackson & Co.*, 36 S.E.C. 631 (1950).

<sup>15</sup> Naturally, when attorneys acted in other capacities, such as officer or director, they could be subject to liability under 10b-5. In addition, the standard of conduct applicable to them might, in certain instances, be higher than that applicable to laymen. See *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968).

<sup>16</sup> 360 F. Supp. 284 (D.D.C. 1973).

<sup>17</sup> The complaint alleged that the firms had knowledge that auditors had uncovered certain inaccurate information in previously certified financial statements. Despite the foregoing, proxy statements were distributed without mentioning the changes suggested by the auditors. Both law firms opined that all steps required to consummate the merger had been validly taken. *Id.* at 292-94.

<sup>18</sup> This position appears to contradict the traditional concept that an attorney is an

of attorney responsibility was given further credence in *Myerhofer v. Empire Fire & Marine Insurance Co.*<sup>19</sup> when the Second Circuit held that a lawyer did not violate the legal canons of ethics requiring him to preserve a client's confidences where he had reported his client's allegedly improper actions to both the SEC and adversary counsel.<sup>20</sup>

Moreover, liability can attach to those who are not themselves closely associated with an issuer if they make use of nonpublic information gleaned from those traditionally considered insiders. Such "tippee" liability was demonstrated in *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith*,<sup>21</sup> where Merrill Lynch, underwriter for an upcoming issue of Douglas Aircraft debentures, informed a number of its institutional customers that Douglas' earnings would be considerably lower than expected. When these "tippees" sold large blocks of Douglas stock before public release of the earnings forecast, the court recognized a valid 10b-5 action against both Merrill Lynch and its tippees.<sup>22</sup>

The question becomes more difficult as the relationship between the tipper and tippee becomes more remote, if the disclosure takes the form of "informed speculation" rather than hard factual information, and if the tippee is not aware that the tip involves any breach of trust. Thus, one who by chance overhears a conversation and picks up certain confidential information would probably not be included in the class of persons considered tippees. Certainly, it would be difficult to prove that information was acquired in this manner. Such "locker room" disclosures involve information which, by the nature of the conversation overheard, would probably be considered a matter of public knowledge; it is the "board room" disclosure which may lead to liability under 10b-5.

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agent and that his first duty is to act in a fiduciary manner on behalf of his client and to maintain strict confidence as to any information of a privileged nature that the client reveals. See ABA CODE OF PROFESSIONAL RESPONSIBILITY DR 4-101.

<sup>19</sup> 497 F.2d 1190 (2d Cir. 1974).

<sup>20</sup> The court appeared to rely, however, on the fact that the attorney made the disclosure to defend himself against charges of wrongdoing, and reasoned that the canons permit such self defense. *Id.* at 1195-96.

<sup>21</sup> 495 F.2d 228 (2d Cir. 1974).

<sup>22</sup> In reaching its conclusion, the *Shapiro* court noted that

[s]ince upon the admitted facts before us the selling defendants [tippees] knew or should have known of the confidential corporate source of the revised earnings information and they knew of its non-public nature, they were under a duty not to trade in Douglas stock without publicly disclosing such information.

*Id.* at 238.

The court relied in part upon the holding in *SEC v. Texas Gulf Sulphur Co.*, 446 F.2d 1301 (2d Cir.), *cert. denied*, 404 U.S. 1005 (1971), where a tipper was held liable for the profits of his tippees. See generally Note, *Deterrence of Tippee Trading Under Rule 10b-5*, 38 U. CHI. L. REV. 372 (1971); Note, *Liability of "Tippees" Under Rule 10b-5 of the Securities Exchange Act of 1934*, 30 WASH. & LEE L. REV. 527-47 (1973).

In short, when one realizes that the courts are concerned with safeguarding against that inherent unfairness exhibited when an individual takes advantage of those with whom he is dealing,<sup>23</sup> it appears that anyone who is in a unique position of access to information of relevance to a securities transaction may be an "insider" for purposes of liability under rule 10b-5.<sup>24</sup>

#### WHAT CONSTITUTES A VIOLATION OF RULE 10b-5?

Although rule 10b-5 requires truthful disclosure of "material facts,"<sup>25</sup> the distinction between fact and opinion for the purposes of determining what information must be disclosed under 10b-5 is often difficult to discern. "Educated guesses," "informed opinions," and "reliable predictions" cannot strictly be classified as facts, but may nevertheless lead to liability.<sup>26</sup> Furthermore, the courts have employed differing formulas in defining what constitutes "material" information. While most definitions focus on whether the information would affect the decisions of a reasonable investor,<sup>27</sup> several decisions indicate that the standards used to determine materiality will differ with the position of the plaintiff. In *List v. Fashion Park, Inc.*,<sup>28</sup> judgment was entered in favor of the defendant where the plaintiff, Albert List, was a well-known financier. In *Kohler v. Kohler Co.*,<sup>29</sup> the court denied recovery where the plaintiff had been an executive of the defendant

<sup>23</sup> See note 3 *supra*.

<sup>24</sup> In addition to individuals, corporations themselves may be held in violation of 10b-5. See, e.g., *Mitchell v. Texas Gulf Sulphur Co.*, 446 F.2d 90 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971), where a corporation was held liable for issuing a misleading press release. It has been suggested that public companies that repurchase their own stock to "go private" may be liable under 10b-5 as well. SEC Commissioner A. A. Sommer recently indicated that the practice of "squeezing out" minority stockholders is both illegal and unethical under the antifraud provisions of the securities law. N.Y. Times, Nov. 15, 1974, at 51, col. 2.

<sup>25</sup> 17 C.F.R. § 240.10b-5(2) (1974).

<sup>26</sup> See, e.g., *Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544 (E.D.N.Y. 1971). Leasco was attracted to the possibility of a merger with the Reliance Insurance Co. (Reliance) because of the large amount of cash that Reliance possessed above that required to meet its contingent liabilities to its shareholders. Leasco was unsure of the exact amount of this "surplus surplus" and could only estimate it from published reports which later proved inaccurate. Citing its inability to determine adequately the amount of such surplus, Leasco made no mention of it in its exchange offer registration statement. Nonetheless, the court held that it should have disclosed its opinion regarding the existence of the surplus (of which it was certain) with an appropriate "hedge" clause as to its amount. Although the case was decided under section 11 of the Securities Act of 1933, 15 U.S.C. § 77k (1970), on this issue, the decision is equally applicable to rule 10b-5.

<sup>27</sup> 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); *List v. Fashion Park, Inc.*, 340 F.2d 457 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965).

<sup>28</sup> 340 F.2d 457 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965).

<sup>29</sup> 319 F.2d 634 (7th Cir. 1963).

company for over twenty years. The court found that the defendant

could fairly deal with [the plaintiff] who had had many years of intimate acquaintance with the affairs of the corporation, . . . who had extrinsic sources of sound business advice, and who himself was promoting a speedy sale, in a manner that might not be fair if plaintiff had been a novice to stock transactions or the corporation's activities.<sup>30</sup>

Generally, it is difficult to determine whether a given piece of information is material without examining additional facts and circumstances surrounding the transaction. However, once such subjective considerations are deemed necessary in deciding the issue, clarity and uniformity become impossible and *materiality* will continue to be the critical issue in most 10b-5 litigation.<sup>31</sup>

An objective analysis of the requisite elements of a 10b-5 violation is further confounded when *reliance*<sup>32</sup> and *causation* are considered. For the most part, courts have not considered reliance, causation and materiality as strictly separate elements, and decisions have been based upon the presence of different combinations of these elements. The Second Circuit, combining reliance and materiality, has suggested that "[t]he proper test is whether the plaintiff would have been influenced to act differently than he did act if the defendant had disclosed to him the undisclosed fact."<sup>33</sup> Obviously, the court was implying that the undisclosed fact must have been sufficiently material to have caused the plaintiff to rely on it and, therefore, be misled. Less helpful is the seemingly implied tautology that the reasonableness of the plaintiff's reliance will be determined by the materiality of the defendant's statements. Indeed, a court has recently held that reliance can be presumed from a finding of materiality,<sup>34</sup> while, in cases of affirmative misrepresentation, materiality can be implied from a finding of reliance.<sup>35</sup>

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<sup>30</sup> *Id.* at 642.

<sup>31</sup> 2 A. BROMBERG, *SECURITIES LAW: FRAUD—SEC RULE 10b-5* 202 (1971). See generally Jacobs, *What is a Misleading Statement or Omission Under Rule 10b-5?*, 42 *FORD. L. REV.* 243 (1973).

<sup>32</sup> Although rule 10b-5 omits any reference to reliance, it has been held that reliance is required for a plaintiff to recover damages for a private injury. *Rogen v. Ilikon Corp.*, 361 F.2d 260 (1st Cir. 1966); *List v. Fashion Park, Inc.*, 340 F.2d 457 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965). However, a showing of reliance is not required in an action brought by the SEC seeking an injunction to prevent further fraudulent practices. *N. Sims Organ & Co. v. SEC*, 293 F.2d 78 (2d Cir. 1961), *cert. denied*, 368 U.S. 968 (1962). Nor is reliance required in a nondisclosure situation, whether or not the parties are dealing face to face. *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972).

<sup>33</sup> *List v. Fashion Park, Inc.*, 340 F.2d 457, 463 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965).

<sup>34</sup> *Dorfman v. First Boston Corp.* — F. Supp. — (E.D. Pa. 1974), *discussed in* 249 *B.N.A. SEC. REG. L. REP. A-7*, Apr. 24, 1974.

<sup>35</sup> *Janigan v. Taylor*, 344 F.2d 781 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965).

Nor can an analysis of causation be separated from the concepts of materiality and reliance. If the nondisclosure or misstatement is material and if the plaintiff has relied on it to his detriment, causation need not be independently considered. Even in cases where there is no actual reliance, the causation requirement may be satisfied by a showing that the defendant failed in his duty to disclose material information. Furthermore, in what appears to be the most far-reaching development in this area, the Second Circuit held this year that such nondisclosure results in liability not only to the purchasers of the actual shares sold by defendants, but to all persons "who, during the same period . . . purchased . . . stock in the open market without knowledge of the material inside information which was in the possession of defendants."<sup>36</sup>

Clearly, materiality, reliance and causation are closely connected and there exists a great deal of overlap in considering each element. Apparently, the more flagrant or deliberate the 10b-5 violation, the weaker the connective link needs to be.<sup>37</sup> Less clear is the impact of these "requirements" on insiders. Despite the courts' recognition of the interrelationships among materiality, reliance and causation, these elements themselves remain undefined. Insiders continue to be faced with potential liability for failing to disclose or misrepresenting a fact or opinion, the materiality of which will be subjectively determined by the circumstances surrounding each transaction, and which need neither be directly relied upon nor directly cause plaintiffs' injuries.

#### REQUIREMENT OF THE INTENT TO DEFRAUD

In *Fischman v. Raytheon Manufacturing Co.*,<sup>38</sup> Judge Frank observed in dictum that, to maintain an action under rule 10b-5, the plaintiff must show an "ingredient of fraud."<sup>39</sup> This view was followed by the Second Circuit in *Shemtob v. Shearson, Hammill & Co.*,<sup>40</sup> which held that "[i]t is insufficient to allege mere negligence"<sup>41</sup> and that

<sup>36</sup> *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith*, 495 F.2d 228, 241 (2d Cir. 1974) (footnote omitted). See also *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972).

<sup>37</sup> See 2 A. BROMBERG, SECURITIES LAW: FRAUD—SEC RULE 10b-5 202 (1971).

<sup>38</sup> 188 F.2d 783 (2d Cir. 1951).

<sup>39</sup> *Id.* at 787. The court distinguished between an action brought under the Securities Act § 11, 15 U.S.C. § 77k (1970), requiring no proof of fraud or deceit and an action brought under the Securities Exchange Act § 10(b), 15 U.S.C. § 78j(b) (1970), where "proof of fraud is required . . . ." 188 F.2d at 786.

<sup>40</sup> 448 F.2d 442 (2d Cir. 1971).

<sup>41</sup> *Id.* at 445 (citations omitted). In dismissing the plaintiff's complaint, the court noted that

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 § 10(b) of the Exchange Act, or Rule 10b-5, in the absence of an

nothing less than reckless disregard of the truth would support a 10b-5 action. However, many courts have held that no evil motive or intent to deceive need be proved.

In *Kohler v. Kohler Co.*,<sup>42</sup> the plaintiff alleged that he had been induced to sell his stock in the defendant company at less than its fair market value by virtue of the misrepresentations and omissions of the company's accountant.<sup>43</sup> In concluding that the plaintiff stated a valid 10b-5 action, the Seventh Circuit declared that neither an intent to deceive nor knowledge of falsity are required for liability as an insider.<sup>44</sup> In *Ellis v. Carter*,<sup>45</sup> the Ninth Circuit echoed this view in interpreting the statutory language of the provision:

Section 10(b) speaks in terms of the use of "any manipulative device or contrivance" in contravention of rules and regulations as might be prescribed by the Commission. It would have been difficult to frame the authority to prescribe regulations in broader terms. Had Congress intended to limit this authority to regulations proscribing common-law fraud, it would probably have said so. We see no reason to go beyond the plain meaning of the word "any", indicating that the use of manipulative or deceptive devices or contrivances of whatever kind may be forbidden, to construe the statute as if it read "any fraudulent" devices.<sup>46</sup>

The Second Circuit has recognized that, when the 10b-5 action takes the form of injunctive proceedings by the SEC, no showing of scienter is required.<sup>47</sup>

Generally, those courts which have voiced acceptance of a negligence standard have done so in cases where there has been scienter as

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.

*Id.* (emphasis in original).

<sup>42</sup> 319 F.2d 634 (7th Cir. 1963).

<sup>43</sup> *Id.* at 636-37.

<sup>44</sup> The court concluded that "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 . . ." *Id.* at 637.

<sup>45</sup> 291 F.2d 270 (9th Cir. 1961).

<sup>46</sup> *Id.* at 274.

<sup>47</sup> *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969). The Second Circuit noted that

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

*Id.* at 855 (footnotes, citations omitted) (emphasis in original).



well. In *Myzel v. Fields*,<sup>48</sup> the Eighth Circuit applied a negligence standard where the insiders purchased stock after knowingly misrepresenting the state of the corporation's finances.<sup>49</sup> Even the *Ellis* decision has been criticized as not completely eliminating a scienter requirement.<sup>50</sup> Apparently, an insider's liability rests upon some middle ground requiring some degree of scienter rather than a showing of mere negligence, but not necessarily requiring all the traditional elements of common law fraud.<sup>51</sup> As with the elements of materiality, causation and reliance, the requirements of scienter and/or negligence must be viewed in light of the particular facts of each alleged violation. The more active the participation by the violating insider, the higher the standard of care to which the insider will be held; the more flagrant the violation, the less stringent the requirement of "some element" of fraud.<sup>52</sup>

#### STANDING — THE PURCHASE OR SALE REQUIREMENT

Although rule 10b-5 prohibits the employment of deceptive and manipulative practices "in connection with the purchase or sale of any security,"<sup>53</sup> the interpretation of this phrase has been left to the courts in determining who can bring an action under 10b-5. *Birnbaum v. Newport Steel Corp.*<sup>54</sup> established that a 10b-5 action could only be maintained if there were an actual purchase or sale.<sup>55</sup> To obtain relief under 10b-5, then, it is not enough that the material information withheld or misstated would have influenced a plaintiff to purchase or sell

<sup>48</sup> 386 F.2d 718 (8th Cir. 1967), cert. denied, 390 U.S. 951 (1968).

<sup>49</sup> See Bucklo, *Scienter and Rule 10b-5*, 67 NW. U.L. REV. 562, 563 (1972), where the author indicates that whenever a court has determined that negligence is sufficient, it has rarely been crucial to their decision.

<sup>50</sup> One commentator has argued that the facts in *Ellis* were sufficient to establish actual knowledge. *Id.* at 584.

<sup>51</sup> In *Vanderboom v. Sexton*, 422 F.2d 1233 (8th Cir.), cert. denied, 400 U.S. 852 (1970), the Eighth Circuit was concerned with determining whether a 10b-5 action was barred by the statute of limitations. In deciding that the Arkansas Blue Sky Law, ARK. STAT. ANN. § 1256(e) (1966), as amended (Cum. Supp. 1973), was controlling, the court noted that the Blue Sky Law resembled 10b-5 rather than common law fraud in that 10b-5 applied to "negligent as well as knowing and intentional misrepresentations." *Id.* at 1233. See also *Financial Indus. Fund, Inc. v. McDonnell Douglas Corp.*, 474 F.2d 514 (10th Cir. 1973); *Hecht v. Harris, Upham & Co.*, 430 F.2d 1202 (9th Cir. 1970).

<sup>52</sup> For a full discussion of such a flexible standard, see Mann, *Rule 10b-5: Evolution of a Continuum of Conduct to Replace the Catch Phrases of Negligence and Scienter*, 45 N.Y.U.L. REV. 1206 (1970).

<sup>53</sup> 17 C.F.R. § 240.10b-5(3) (1974).

<sup>54</sup> 193 F.2d 461 (2d Cir.), cert. denied, 343 U.S. 956 (1952).

<sup>55</sup> The court noted that § 10(b) was directed solely at that type of misrepresentation or fraudulent practice usually associated with the sale or purchase of securities rather than at fraudulent mismanagement of corporate affairs and that rule 10b-5 extended protection only to the defrauded purchaser or seller. *Id.* at 464. This view was reaffirmed in *Iroquois Indus., Inc. v. Syracuse China Corp.*, 417 F.2d 963 (2d Cir. 1969).

if he remained out of the market. Accordingly, it has been generally accepted that the 10b-5 plaintiff must be either a buyer or seller of the security, and the illegal act must have been in connection with the plaintiff's purchase or sale. However, some courts have not hesitated to overlook the absence of a traditional purchase or sale and find a "constructive" transaction to preserve the integrity of 10b-5.

Even the Second Circuit, which enunciated the *Birnbaum* rule, has held that a minority shareholder of a corporation involved in a short-form merger was a "forced seller" of his stock since, although he retained possession of his certificates, after the merger he had no choice except to have them converted into shares in the surviving corporation or have them appraised.<sup>56</sup> The erosion of this dubious doctrine has further been reinforced by the same court in its recent decision in *Schlick v. Penn-Dixie Cement Corp.*<sup>57</sup> There it was held that section 10(b) applies equally to fraudulent management practices relating to a potential merger or acquisition and is not limited to the type of fraud *traditionally* associated with the purchase and sale of securities.<sup>58</sup>

Primary reliance was placed on the Supreme Court's decision in *Superintendent of Insurance v. Bankers Life & Casualty Insurance Co.*,<sup>59</sup> wherein it was stated:

We agree that Congress by § 10(b) did not seek to regulate transactions which constitute no more than internal corporate mismanagement. But we read § 10(b) to mean that Congress meant to bar deceptive devices and contrivances in the purchase or sale of securities whether conducted in the organized markets or face to face.<sup>60</sup>

The *Schlick* court upheld a complaint founded upon sections 10(b) and 14(a) of the Securities Exchange Act, although on its face the complaint involved a claim that a majority shareholder had fraudulently "squeezed out," in a merger, the minority shareholder interests for grossly inadequate consideration, despite the fact that the terms of the merger were fully disclosed in the proxy material.

The corporate defendant acquired a 53 percent interest in the acquiree over a two-year period and was able to place six of its own directors on the acquiree's nine-person board. Thereafter, the defendant-parent company allegedly embarked on a course of conduct

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<sup>56</sup> *Vine v. Beneficial Fin. Co.*, 374 F.2d 627 (2d Cir.), cert. denied, 389 U.S. 970 (1967). See also *International Controls Corp. v. Vesco*, 490 F.2d 1334 (2d Cir. 1974), where the court considered a stock dividend a "sale" for 10b-5 standing.

<sup>57</sup> Civil No. 73-2677 (2d Cir., Oct. 31, 1974).

<sup>58</sup> *Id.* at 5854.

<sup>59</sup> 404 U.S. 6 (1971).

<sup>60</sup> *Id.* at 12.

wherein the market price of the acquiree's stock was manipulated and depressed to enable the defendant to propose and approve an artificial and unfair exchange ratio for the 47 percent minority of the acquiree. The lower court held that the gravamen of the complaint was a claim of an unfair merger — one ripe for state adjudication, but not the kind of violation that the federal statutes were designed to remedy.<sup>61</sup> However, the Second Circuit disagreed, apparently because the section 10(b) claim contained requisite allegations as to the effectuation of a scheme to defraud which included market manipulation.

Furthermore, in upholding the section 14(a) claim, based upon a false and misleading proxy statement, it was of no moment to the court that the defendant-parent had sufficient votes to effect the merger irrespective of any omissions in the proxy statement. The court noted:

The equities call for protection of the minority shareholder when he is the most helpless, as when neither disinterested director nor disinterested shareholder voting exists as a safeguard. To require strict causation would "sanction all manner of fraud and overreaching in the fortuitous circumstance that a controlling shareholder exists."<sup>62</sup>

Thus, the Second Circuit is virtually insisting on full disclosure of an allegedly unfair exchange ratio, perhaps in the hope that "even a rapacious controlling management" would not "want its dirty linen out on the line and thereby expose itself to suit . . ."<sup>63</sup> Accordingly, it now appears that, in view of the current trend of "squeeze-outs" of minority shareholders at low market prices, the courts in the Second Circuit can be expected to liberally apply rule 10b-5 and other federal statutes to protect minority interests, even in the case of an artfully drawn proxy statement which makes full disclosure — except, of course, for admitting the alleged penultimate facts, *i.e.*, the scheme, the manipulation, and the unfair exchange ratio.

One district court has gone so far as to state that a sale was not a necessary condition for a 10b-5 suit, finding a legislative intent to protect agreements to buy and sell as well as completed sales, provided damages can be shown.<sup>64</sup> In *Eason v. General Motors Acceptance Corp.*,<sup>65</sup> the Seventh Circuit found that shareholders who individually guaranteed certain liabilities which the corporation had assumed in purchasing a franchise from the defendants could bring a 10b-5 action

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<sup>61</sup> *Schlick v. Penn-Dixie Cement Corp.*, Civil No. 73-1467 (S.D.N.Y., Sept. 26, 1973).

<sup>62</sup> Civil No. 73-2677, at 5861 (2d Cir., Oct. 31, 1974).

<sup>63</sup> *Id.* at 5862.

<sup>64</sup> *Commerce Reporting Co. v. Puretec, Inc.*, 290 F. Supp. 715 (S.D.N.Y. 1968).

<sup>65</sup> 490 F.2d 654 (7th Cir. 1973), *cert. denied*, 416 U.S. 960 (1974).

for fraud. Although neither purchasers nor sellers of a security, the court held that the plaintiffs were among that "special class" of investors protected by rule 10b-5.<sup>66</sup>

Nevertheless, a number of courts apparently continue to follow the judicial standing requirement imposed by *Birnbaum*.<sup>67</sup> Unfortunately, the Supreme Court has allowed confusion to prevail by declining to review either the Seventh Circuit's repudiation of the *Birnbaum* doctrine<sup>68</sup> or the Third Circuit's decision to adhere to it.<sup>69</sup> Of course, there is no such confusion relating to a 10b-5 action seeking injunctive relief, whether brought by the SEC or an individual. In either case, the plaintiff need be neither an actual nor constructive purchaser or seller.<sup>70</sup>

If, under ordinary circumstances, the plaintiff must be a buyer or seller to maintain an action under 10b-5, the question then arises whether the defendant may be liable under the rule without being a buyer or seller of the securities. In *SEC v. Texas Gulf Sulphur Co.*,<sup>71</sup> the Second Circuit confronted this question in determining whether a corporation violated 10b-5 by merely issuing a deceptive press release.<sup>72</sup> Answering in the affirmative, the court construed the "in connection with" requirement broadly and held that this clause was satisfied whenever the defendant-insider employed a device

of a sort that would cause reasonable investors to rely thereon, and, in connection therewith, so relying, cause them to purchase or sell a corporation's securities. There is no indication that Congress in-

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<sup>66</sup> *Id.* at 659-61.

<sup>67</sup> See, e.g., *Sargent v. Genesco, Inc.*, 492 F.2d 750 (5th Cir. 1974); *James v. Gerber Products Co.*, 483 F.2d 944 (6th Cir. 1973); *Mount Clemens Indus., Inc. v. Bell*, 464 F.2d 339 (9th Cir. 1972). But see *Eason v. General Motors Acceptance Corp.*, 490 F.2d 654 (7th Cir. 1973). For a detailed criticism of the purchaser-seller requirement, see Lowenfels, *Demise of the Birnbaum Doctrine: A New Era for Rule 10b-5*, 54 VA. L. REV. 268 (1968).

<sup>68</sup> *Eason v. General Motors Acceptance Corp.*, 490 F.2d 654 (7th Cir. 1973), cert. denied, 416 U.S. 960 (1974).

<sup>69</sup> *Landy v. Federal Deposit Ins. Corp.*, 486 F.2d 139 (3d Cir. 1973), cert. denied, 416 U.S. 960 (1974).

<sup>70</sup> See *SEC v. National Sec., Inc.*, 393 U.S. 453 (1969) (interpretation of the statutory role of the SEC); *Kahan v. Rosenstiel*, 424 F.2d 161 (3d Cir.), cert. denied, 398 U.S. 950 (1970) (private party has standing to seek injunctive relief if neither a purchaser nor seller, provided there exists a causal connection between alleged violation and injury); accord, *Britt v. Cyril Bath Co.*, 417 F.2d 433 (6th Cir. 1969); *Mutual Shares Corp. v. Genesco, Inc.*, 384 F.2d 540 (2d Cir. 1967).

<sup>71</sup> 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969).

<sup>72</sup> In an attempt to quell rumors that a major ore strike was in the making, Texas Gulf Sulphur issued a press release which, in effect, labeled the reports as exaggerated speculation. However, one day after issuing the press release, the company did in fact make a major ore strike. The SEC alleged that Texas Gulf Sulphur deliberately misstated preliminary drilling reports in the press release to quell the rumors, rather than accurately report the preliminary findings already in their possession and upon which the rumors were based. *Id.* at 843-47.

tended that the corporation or persons responsible for the issuance of a misleading statement would not violate the section unless they engaged in related securities transactions or otherwise acted with wrongful motives . . . .<sup>73</sup>

In *Heit v. Weitzen*,<sup>74</sup> the court found the defendant liable for issuing a misleading financial statement and flatly stated that "[t]here is no necessity for contemporaneous trading in securities by insiders or by the corporation itself [*sic*]."<sup>75</sup>

In sum, it would appear that rule 10b-5 may be successfully invoked against persons or corporations who are neither purchasers nor sellers, but who, as "insiders," are responsible for misrepresentations or omissions which have resulted in injury to the deceived plaintiff. On the other hand, in the absence of a request for only injunctive relief, the injured plaintiff must first establish proper standing as an actual, or "constructive," purchaser or seller of securities.

#### THE MEASURE OF DAMAGES AND EXTENT OF LIABILITY

In theory, damages are assessed under 10b-5 to make the rule an effective deterrent and to award the prudent investor an amount that equals the loss he has suffered through the conduct of the insider. However, both the nature and the extent of such damages have defied attempts at uniform classification.<sup>76</sup>

In the initial finding of an implied private cause of action under rule 10b-5, the court in *Kardon v. National Gypsum Co.*<sup>77</sup> held that disregard of the statute was a tort and, as such, the offending insider was required to compensate individual plaintiffs for their injuries.<sup>78</sup> However, later decisions have implied that merely compensating the prudent investor does not provide an effective deterrent. Accordingly, in order to insure that no insider profits from his transaction, the courts

<sup>73</sup> *Id.* at 860.

<sup>74</sup> 402 F.2d 909 (2d Cir. 1968), *cert. denied*, 395 U.S. 903 (1969).

<sup>75</sup> *Id.* at 913. See text accompanying notes 5-24 *supra* for a discussion of who is liable under 10b-5.

<sup>76</sup> See Note, *Damages to Uninformed Traders for Insider Trading on Impersonal Exchanges*, 74 COLUM. L. REV. 299 (1974); Note, *The Measure of Damages in Rule 10b-5 Cases Involving Actively Traded Securities*, 26 STAN. L. REV. 371 (1974); Note, *Measurement of Damages in Private Actions Under Rule 10b-5*, 1968 WASH. U.L.Q. 165; Note, *Securities Regulation—Damages for SEC Rule 10b-5 Violations*, 49 TEX. L. REV. 1141 (1971).

<sup>77</sup> 69 F. Supp. 512 (E.D. Pa. 1946).

<sup>78</sup> *Id.* at 513, *citing* RESTATEMENT OF TORTS § 286 (1934). However, it must be assumed that the defrauded plaintiff has dealt directly with the insider since such a tort theory of liability would seem to require a showing that a "particular" interest has been invaded and a "particular" harm has resulted. See RESTATEMENT (SECOND) OF TORTS § 286 (1965); Note, *Damages to Uninformed Traders for Insider Trading on Impersonal Exchanges*, 74 COLUM. L. REV. 299, 303 (1974).

have generally ordered disgorgement of all profits earned as a result of insider trading.<sup>79</sup> The Second Circuit has gone so far as to hold that an insider who purchased securities and profited from his use of non-public information was required to disgorge not only the actual profits realized when he later sold the securities, but also the "paper" profits he had achieved prior to the date of the actual sale.<sup>80</sup> This court appears to be holding that once public disclosure is made and all investors are trading on an equal footing, the violator must bear the risk of the market himself as part of his measure of damages under 10b-5.

In direct face-to-face transactions, such as in *Kardon*, compensating the injured party is a practical and fair deterrent to insider trading. If the insider actually profits from his illegal transaction, perhaps preserving the integrity of 10b-5's deterrent effect should outweigh the defendant's "over-compensating" the defrauded plaintiff by requiring a disgorgement of profits. However, when the insider is required to compensate *all* traders affected directly or indirectly by his 10b-5 violation, and the level of potential damages becomes staggering,<sup>81</sup> one could question whether the elements of just compensation and disgorgement of profits may have been subordinated to the courts' quest for an effective deterrent against unfair use of inside information.

The Tenth Circuit's decision in the Texas Gulf Sulphur litigation<sup>82</sup> is illustrative. Texas Gulf Sulphur issued a misleading press release concerning an ore strike made in Canada on April 12th. The curative release giving all of the correct facts was made available on April 16th. However, the court held that anyone who sold between April 16th and April 20th was still selling based on the misleading information given out on April 12th. Thus, the measure of damages was held to be the difference in cost that would have enabled a reasonable investor to *reacquire* Texas Gulf Sulphur securities within a

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<sup>79</sup> See, e.g., *SEC v. Manor Nursing Centers, Inc.*, 458 F.2d 1082 (2d Cir. 1972); *Myzel v. Fields*, 386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968); *Janigan v. Taylor*, 344 F.2d 781 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965); *Rochez Bros., Inc. v. Rhoades*, 353 F. Supp. 795 (W.D. Pa. 1973).

<sup>80</sup> *SEC v. Shapiro*, 494 F.2d 1301 (2d Cir. 1974). The court reasoned that a contrary holding would create a serious anomaly that might encourage insider trading. To require disgorgement only of actual profits in cases where the price of the stock subsequently fell would create a heads-I-win-tails-you-lose opportunity for the violator; he could keep subsequent profits but not suffer subsequent losses. Such a rule would emasculate the deterrent effect of Rule 10b-5. *Id.* at 1309.

<sup>81</sup> See *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith*, 495 F.2d 228, 241-42 (2d Cir. 1974), where the court discusses the impact of damage awards in private actions brought under 10b-5.

<sup>82</sup> *Mitchell v. Texas Gulf Sulphur Co.*, 446 F.2d 90 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971).

reasonable time after the curative release had been fully disseminated.<sup>83</sup> Furthermore, the court arbitrarily concluded that the measure of damages should be the highest price of Texas Gulf Sulphur stock during the nine following days less the selling price of the shares.<sup>84</sup> However just the ruling may have been in compensating defrauded traders, it must be remembered that there existed no profits to be disgorged in compensation since the defendant had never traded on such "inside information."<sup>85</sup>

Conceding the efficacy of the deterrent element of 10b-5 damages,<sup>86</sup> the question arises as to whether such extensive damages are, in effect, punitive and therefore at odds with section 28(a) of the Securities Exchange Act,<sup>87</sup> which limits recovery to actual damages suffered by a defrauded plaintiff. Although the question has not been directly answered, courts have disallowed specific requests for punitive damages, holding that punitive damages per se are not authorized in private 10b-5 actions.<sup>88</sup>

The extent of an insider's liability is further complicated by a realization that pursuit of a 10b-5 claim does not preclude traditional common law actions for fraud or state actions regulating deceptive practices in securities transactions.<sup>89</sup> In *Diamond v. Oreamuno*,<sup>90</sup> the New York Court of Appeals granted shareholders standing to bring a derivative suit against corporate directors who allegedly breached their fiduciary duty to the corporation by trading on inside information. In *Schein v. Chasen*,<sup>91</sup> the Second Circuit permitted corporate sharehold-

<sup>83</sup> *Id.* at 105.

<sup>84</sup> *Id.* Texas Gulf Sulphur estimated the measure of damages under such a ruling as approaching 14 million dollars.

<sup>85</sup> See text accompanying notes 65-67 *supra*.

<sup>86</sup> Of course, continued 10b-5 litigation itself tends to refute such an assumption.

<sup>87</sup> 15 U.S.C. § 78bb (1970).

<sup>88</sup> See, e.g., *deHass v. Empire Petroleum Co.*, 435 F.2d 1223 (10th Cir. 1970); *Green v. Wolf Corp.*, 406 F.2d 291 (2d Cir. 1968); and *Meisel v. North Jersey Trust Co.*, 216 F. Supp. 469 (S.D.N.Y. 1963), where the courts interpreted section 28(a) to preclude plaintiffs' requests for punitive damages.

<sup>89</sup> Section 28(a) of the Securities Exchange Act provides in pertinent part:

The rights and remedies provided by this chapter shall be in addition to any and all other rights and remedies that may exist at law or in equity . . . . Nothing in this chapter shall affect the jurisdiction of the securities commission (or any agency or officer performing like functions) of any State over any security or any person insofar as it does not conflict with the provisions of this chapter or the rules and regulations thereunder.

15 U.S.C. § 78bb (1970).

<sup>90</sup> 24 N.Y.2d 494, 248 N.E.2d 910, 301 N.Y.S.2d 78 (1969). The plaintiffs brought their suit under N.Y. BUS. CORP. LAW § 626(b) (McKinney 1963), which authorizes such derivative actions.

<sup>91</sup> 478 F.2d 817 (2d Cir. 1973), *vacated*, 42 U.S.L.W. 4603 (U.S. April 29, 1974). The Supreme Court remanded to the Second Circuit to reconsider the efficacy of interpreting Florida law rather than seeking a certification of the question by the Florida Supreme Court.

ers to bring a derivative suit against both the corporate executive who conveyed inside information concerning anticipated earnings and the broker who, having received the "tip," sold over 80,000 shares of stock in the corporation for two mutual fund clients. Without alleging any prior agreement between the executive and the broker, the plaintiffs claimed that each breached a fiduciary duty owed to the shareholders.

Furthermore, the *Schein* court, in finding the defendants jointly and severally liable for the dissemination and misuse of corporate information,<sup>92</sup> considered the tipper-tippee relationship to constitute a "common enterprise." Through the use of this fiction, the court cloaked the tippee with the same fiduciary duty owed to the plaintiffs by the corporate executive (defendant-tipper), and effectively eliminated the requirement that the defendants be unjustly enriched.<sup>93</sup> The net effect of *Diamond* and *Schein* has been to provide a state common law liability parallel to the federal 10b-5 liability already facing an insider and to underscore the unwieldy exposure to liability confronting a defendant who has misused or misstated inside information. In short, at present, there appears to be no single method by which the maximum, or even the minimum, limit of an insider's liability can be determined.

#### RELATED ANTIFRAUD PROVISIONS

Of course, section 10(b) and rule 10b-5 are not the only avenues of enforcement available when insiders buy or sell securities on the basis of information which is not publicly available, or when they engage in fraudulent or misleading practices. Section 11 of the Securities Act of 1933<sup>94</sup> provides a private cause of action against a wide variety of individuals<sup>95</sup> involved in the preparation and issuance of a

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<sup>92</sup> For a discussion of the "strained" use of the common enterprise theory to impose liability in *Schein*, see Note, *Common Law Corporate Recovery for Trading on Non-Public Information*, 74 COLUM. L. REV. 269 (1974); Note, *Inside Information—Common Law Liability*, 48 ST. JOHN'S L. REV. 415 (1973).

<sup>93</sup> The RESTATEMENT (SECOND) OF AGENCY § 312 (1958), cited by the court in *Schein*, 478 F.2d at 823-24, and the RESTATEMENT OF RESTITUTION § 201 (1936) require a finding of a profit made by the defendants.

<sup>94</sup> 15 U.S.C. § 77k (1970).

<sup>95</sup> Individuals who may be held liable include (1) every person who signed the registration statement (including, for example, a selling controlling stockholder); (2) every person who was a director of or partner in the issuer at the time of the filing of the part of the registration statement with respect to which liability is asserted; (3) every person named in the registration statement with his consent as currently being or about to become a partner or director; (4) every accountant, engineer or other expert who has, with his consent, been named as having prepared or certified any part of the registration statement, with respect to that portion of the registration statement or report which was certified by him; and (5) every underwriter with respect to such security. Securities Act § 11(a)(1)-(5), 15 U.S.C. § 77k(a)(1)-(5) (1970).



registration statement containing a materially false statement or an omission of a material fact, and any purchaser acquiring a security covered by such a registration may seek compensatory damages.<sup>96</sup> In addition, any person who offers or sells a security through any means of interstate commerce, by means of a prospectus or oral communication which includes an untrue statement of material fact or omits to state a material fact, may be sued by the immediate purchaser under section 12(2) of the Securities Act.<sup>97</sup> Section 17(a) of the Securities Act<sup>98</sup> is a general antifraud provision which prohibits the unlawful use of interstate commerce to defraud purchasers of securities and is applicable whether or not the securities are registered.<sup>99</sup>

Of more limited effect is section 16(b) of the Securities Exchange Act of 1934,<sup>100</sup> which provides for the recovery of any "short-swing" profits gained by a corporate insider<sup>101</sup> from a sale and purchase or purchase and sale of the corporation's securities within a six-month period. Suit may be brought by the issuer, shareholders of the corporation or even a subsequent purchaser of the corporation's stock.<sup>102</sup> However, not only does the statute limit enforcement to those companies registered under the Securities Exchange Act,<sup>103</sup> but the limited time span during which the insider's actions will create liability and the failure to include the liability of tippees make section 16(b) a less effective tool than the all-encompassing rule 10b-5.

There is obviously a good deal of overlap among all the sections, and many actions for fraud will allege violations of rule 10b-5 as well as one or more of the other sections. Accordingly, although a defrauded seller may be limited to a 10b-5 action, certain defrauded purchasers may maintain actions under 10b-5 as well as under the less extensive sections 11, 12(2), or 17(a) of the 1933 Act.<sup>104</sup> It should be further

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<sup>96</sup> Securities Act §§ 11(e), (g), 15 U.S.C. §§ 77k(e), (g) (1970). See, e.g., *Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544 (E.D.N.Y. 1971); *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968).

<sup>97</sup> 15 U.S.C. § 77l(2) (1970).

<sup>98</sup> *Id.* § 77q(a).

<sup>99</sup> *Id.* § 77q(c).

<sup>100</sup> *Id.* § 78p(b).

<sup>101</sup> For the purposes of this section, only officers, directors and ten percent shareholders are considered "insiders". *Id.* § 78p(a).

<sup>102</sup> *Id.* § 78p(b). See, e.g., *Blau v. Mission Corp.*, 212 F.2d 77 (2d Cir.), cert. denied, 347 U.S. 1016 (1954); *Benisch v. Cameron*, 81 F. Supp. 882 (S.D.N.Y. 1948).

<sup>103</sup> Securities Exchange Act §§ 16(a), (b), 15 U.S.C. §§ 78p(a), (b) (1970).

<sup>104</sup> One such example may involve a false registration statement which would also give rise to an action under 10b-5. Proceeding in this manner may avoid section 11's comparatively short statute of limitations. The outside time limit on a section 11 fraud action is three years, Securities Act § 13, 15 U.S.C. § 77m (1970), whereas the statute of limitations on a 10b-5 action is determined by that of the jurisdiction in which the federal court sits. See note 125 and accompanying text *infra*. On the other hand, if 10b-5 is used

noted that, in addition to damage awards, sanctions for violation of section 17(a) and rule 10b-5 can include injunctive action by the SEC,<sup>105</sup> criminal penalties,<sup>106</sup> suspension or revocation of a broker-dealer's license,<sup>107</sup> expulsion or suspension from the National Association of Securities Dealers (NASD),<sup>108</sup> and suspension or expulsion from a national stock exchange.<sup>109</sup>

#### THE ERA OF ANTICIPATION

In view of the expanding potential for liability under rule 10b-5, *anticipation* of when difficulties may arise is the key to compliance with the rule, as well as the other antifraud provisions. *Any* significant future or pending corporate action, such as underwritings, mergers, acquisitions, contract negotiations, licensing arrangements, and new discoveries or inventions may present problems involving the content, timing, and efficacy of disclosures. When events such as these are in the offing, management would be well-advised to seek the advice of counsel in determining the potential 10b-5 implications. Even when corporate action is in the planning stages, consideration should be given immediately to the nature and timing of the public disclosure of the proposed actions.

Nonetheless, under certain circumstances, a company, its directors and officers may find it necessary to withhold information. If a corporation is engaged in research and development of new products, it may be advantageous, for competitive reasons, not to announce any breakthroughs until the product is fully ready for marketing. A further conflict may arise in connection with preliminary negotiations on merger agreements. Acquisitions or reorganizations are often kept confidential to prevent fluctuations in the price of the corporation's securities. Once again, a course of action dictated by business strategy must be balanced against the legal requirements of full and timely disclosure imposed by 10b-5.

An insider who becomes aware of such material information is faced with the dilemma that no shares may be sold without full and

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in such a situation, the plaintiff may be required to prove scienter rather than mere negligence as permitted in the pure section 11 action. *See Stewart v. Bennett*, 359 F. Supp. 878 (D. Mass. 1973).

<sup>105</sup> Securities Act § 20, 15 U.S.C. § 77t (1970). Securities Exchange Act § 21(e), 15 U.S.C. § 78u(e) (1970).

<sup>106</sup> Securities Act § 24, 15 U.S.C. § 77x (1970). Securities Exchange Act § 32, 15 U.S.C. § 78ff (1970).

<sup>107</sup> Securities Exchange Act § 15(b)(5), 15 U.S.C. § 78o(b) (1970).

<sup>108</sup> *Id.* §§ 15 A(1), (2)(A)-(B), 15 U.S.C. § 78o-3(l).

<sup>109</sup> *Id.* § 19(a)(3), 15 U.S.C. § 78s(a)(3).

prompt disclosure, even though disclosure is either impracticable or competitively disadvantageous. In *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith*,<sup>110</sup> the Second Circuit may have eased the insider's quandary by holding that "[a]nyone in possession of material information must either disclose it to the investing public, or, if he is disabled from disclosing it . . . , must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed."<sup>111</sup> Responding to the problem facing corporate insiders as to when they may trade in their own securities without incurring liability under rule 10b-5, the New York Stock Exchange has set forth the following guidelines:<sup>112</sup>

- (1) A consistent periodic investment program administered by a broker would not create liability.
- (2) Buying or selling motivated by information included in an annual report within a thirty-day period starting one week after annual reports have been sent out can be done without incurring liability.
- (3) An insider should avoid buying or selling prior to the happening of a major development.

"Outside" directors may face similar problems in connection with securities transactions effected by the issuer of which they may be directors. The Second Circuit, sitting en banc, held in *Lanza v. Drexel & Co.*,<sup>113</sup> by a narrow margin, that a member of the board of directors of the BarChris Construction Corporation was not liable in damages to plaintiffs who had received BarChris securities in exchange for stock in the acquired company. Notwithstanding the director's knowledge of the "substantial difficulties"<sup>114</sup> BarChris was experiencing, the court found that he was not responsible for the failures of BarChris management to make proper disclosure to the company to be acquired. The court concluded that

a director in his capacity as a director (a non-participant in the transaction) owes no duty to insure that all material, adverse infor-

<sup>110</sup> 495 F.2d 228 (2d Cir. 1974).

<sup>111</sup> *Id.* at 236, citing *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969).

<sup>112</sup> NEW YORK STOCK EXCHANGE, INC., COMPANY MANUAL A-25 (Supp. 1971).

<sup>113</sup> 479 F.2d 1277 (2d Cir. 1973) (en banc).

<sup>114</sup> The 1960 annual report, the 1961 debenture prospectus and the BarChris financial statement for the first half of 1961 failed to disclose anticipated losses of BarChris resulting from a failure to recoup unsecured loans from its customers. The director, one Coleman, became aware of these problems; however, he never realized their extent nor that the information was being concealed from the company to be acquired. *Id.* at 1283-89.

mation is conveyed to prospective purchasers of the stock of the Corporation on whose board he sits.<sup>115</sup>

However, the Delaware District Court, in *Gould v. American Hawaiian Steamship Co.*,<sup>116</sup> held three "outside" directors of an issuer liable for material omissions from its proxy statement. Apparently, this court does not agree that an outside director has no responsibility to insure that all material information is accurately conveyed.

Moreover, in view of the closeness of the vote in *Lanza*, it is conceivable that future decisions will begin to take into account such factors as experience, knowledge, relationship to the corporation and its officers, and involvement in its affairs in determining potential liability for outside directors. It may be unrealistic to hold that an outside director does not have an affirmative duty to investigate or inquire about the conduct of the officers of the corporation with respect to compliance with 10b-5.<sup>117</sup> Accordingly, the director may have a duty to do more than simply approve the transaction. As with inside directors and officers, he must anticipate, and, upon finding problems, he would be well-advised to disclose.

Turning to tipper-tippee liability, if investment decisions or any information that may affect the price of securities cannot be fully disclosed to the general public, no disclosure whatsoever should be made except to those persons who are required to know by virtue of

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<sup>115</sup> *Id.* at 1289.

<sup>116</sup> 351 F. Supp. 853 (D. Del. 1972). The court easily found a duty to accurately disclose material information and the only significant issue was whether a standard of negligence or scienter should apply to establish a breach of the director's duty under § 14(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78n(a) (1970). Since the court found negligence the applicable standard, 351 F. Supp. at 864-65, the *Gould* decision may be especially appropriate in those jurisdictions purporting to maintain a negligence standard for 10b-5 actions. See text accompanying notes 43-53 *supra*. See also *SEC v. National Sec., Inc.*, 393 U.S. 453 (1969), where the Court rejected the contention that § 10(b) did not cover proxy material.

Respondents' . . . argument that Rule 10b-5 does not cover misrepresentations which occur in connection with proxy solicitations can be dismissed rather quickly. . . . [T]he existence or non-existence of regulation under § 14 would not affect the scope of § 10(b) and Rule 10b-5. . . . Section 10(b) applies to all proscribed conduct in connection with a purchase or sale of any security; § 14 applies to all proxy solicitations, whether or not in connection with a purchase or sale. The fact that there may well be some overlap is neither unusual nor unfortunate.

*Id.* at 468.

<sup>117</sup> In one of the dissenting opinions in *Lanza*, Judge Hays concluded that the outside director should have been held liable on the grounds that his financial sophistication, taken together with his awareness of the increasing difficulties of BarChris, should have made him vigilant enough to at least inquire whether the company being acquired was fully informed. 479 F.2d at 1318-19 (Hays, J., dissenting). Indeed, another dissenter believed that the facts even demonstrated that the outside director "acted in reckless disregard for the truth." *Id.* at 1320 (Timbers, J., dissenting).

their positions in the corporation. Once some outsiders become aware of this information through tips or other leaks, the temptation of these outsiders to trade in the securities of the corporation may be too great to withstand. Since the corporation and the insider responsible for the leak may be liable under rule 10b-5 for violations by such tippees, one must anticipate the potential problem and take precautionary measures. In addition, any disclosures which are made must be factually correct and given the widest possible dissemination. To insure compliance, this may well be best accomplished through news releases to wire services, financial newspapers and, perhaps, selected metropolitan newspapers.

Counsel must do much more than anticipate clients' noncompliance with rule 10b-5, since it appears that attorneys can be held individually liable as "insiders."<sup>118</sup> It is thus possible that an attorney may be required to reveal to the other party to a transaction, traditionally considered to be at arm's length, information formerly considered confidential. While it is difficult to say whether, as a matter of public policy, this is a wise development, it is not difficult to recognize that attorneys must now anticipate the consequences of their own as well as their clients' actions in a securities transaction covered by rule 10b-5.

The Second Circuit, in *SEC v. Spectrum, Ltd.*,<sup>119</sup> noted that the legal profession "plays a unique and pivotal role in the effective implementation of the securities laws."<sup>120</sup> Thus, even the opinions of counsel concerning the legality of the issue<sup>121</sup> may raise the question of counsel's responsibility for the accuracy of the document and liability under rule 10b-5.<sup>122</sup> As the *Spectrum* court commented:

The public trust demands more of its legal advisers than 'customary' activities which prove to be careless. And, to be sure, where expediency precludes thorough investigation, an attorney can prevent the illicit use of his opinion letter by prohibiting its utilization in the sale of unregistered securities by a statement to that effect clearly appearing on the face of the letter.<sup>123</sup>

To minimize this risk even further, the counsel named in a prospectus should anticipate potential liability and carefully specify that his participation was limited to passing on the legality of the issue as

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<sup>118</sup> See text accompanying notes 16-20 *supra*.

<sup>119</sup> 489 F.2d 535 (2d Cir. 1973).

<sup>120</sup> *Id.* at 542.

<sup>121</sup> An opinion of counsel concerning the legality of the issue must appear as an exhibit to the registration statement and the name of counsel must also appear in the prospectus. Securities Act §§ 7, 10(a), 15 U.S.C. §§ 77(g), (j) (1970).

<sup>122</sup> Cheek, *Counsel Named in a Prospectus*, 6 REV. OF SEC. REG. 939 (1973).

<sup>123</sup> 489 F.2d at 542.

a matter of local corporate law. An additional consideration may include the elimination of the firm name from the cover of the prospectus. The firm name should only be included under the "Legal Opinion" heading as preferred over "Legal Matters" which may be too broad.

Of course, defenses to actions for violations of rule 10b-5 might involve claims that the substantive elements required for an action, such as reliance, materiality, causation, or the existence of a transaction are lacking. However, as has been discussed, it is difficult to prepare a defense on such elusive grounds. In some circumstances, one may rely on the equitable defenses of laches, waiver, and estoppel.<sup>124</sup> In other cases, perhaps a claim can be made that the statute of limitations has run. Yet, even the statute of limitations fails to provide a standardized defense for delinquent insiders. Not only are 10b-5 actions governed by the statute of limitations for fraud in each applicable state jurisdiction, but the tolling of the statute may vary with the actions of each individual plaintiff.<sup>125</sup>

#### CONCLUSION

As the requirements and scope of section 10(b) and rule 10b-5 are formulated with each judicial decision, potential liability must be accepted as a given for all involved in a securities transaction. The necessity of anticipation has become more than a euphemism. Corporate directors, officers, brokers, attorneys, and others must anticipate when they may become insiders, what they must disclose and how, and when, if at all, they may trade in corporate securities. While it may be impossible to anticipate with precision every conceivable situation which may give rise to liability, the expanding scope of 10b-5 and the increasing level of recoverable damages makes such anticipation imperative.

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<sup>124</sup> See, e.g., *Royal Air Properties, Inc. v. Smith*, 312 F.2d 210, 213 (9th Cir. 1962), *aff'd on remand*, 333 F.2d 568 (1964), where the court held that a rescission action was subject to the traditional equitable defenses of waiver, laches and estoppel. See also *Walpert v. Bart*, 280 F. Supp. 1006 (D. Md. 1967). For a discussion of the use of traditional remedies incorporated in 10b-5, see Weiskopf, *Remedies Under Rule 10b-5*, 45 Sr. JOHN'S L. REV. 733 (1971).

<sup>125</sup> See *Janigan v. Taylor*, 344 F.2d 781 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965). See generally Bateman & Keith, *Statutes of Limitations Applicable to Private Actions Under SEC Rule 10b-5: Complexity in Need of Reform*, 39 Mo. L. REV. 165 (1974).