CORPORATIONS—SECURITIES—NON-PARTICIPATING DIRECTOR OWES NO DUTY UNDER RULE 10b-5 TO INSURE THAT ALL MATERIAL, ADVERSE INFORMATION IS CONVEYED TO PROSPECTIVE PURCHASERS—*Lanza v. Drexel & Co.*, 479 F.2d 1277 (2d Cir. 1973).

In December of 1961, the plaintiffs, members of the Lanza family and sole owners of all 20,000 shares of stock in the Victor Billiard Company (Victor), exchanged their stock for 20,428 shares in the BarChris Construction Company (BarChris).[1] Within one year of this exchange, BarChris filed a petition in bankruptcy.[2] The plaintiffs were unsuccessful in an attempt to recover their Victor stock in a recission action and, as a result, were forced to borrow $100,000 to pay the trustee in bankruptcy for its return.[3] The Lanzas subsequently commenced an action in the United States District Court for the Southern District of New York against various former directors and officers of BarChris seeking both compensatory and punitive damages, and contending that the named parties had induced them to enter the original exchange transaction by a number of misrepresentations and material omissions.[4] The plaintiffs premised their claim on section 10(b) of the Securities Exchange Act of 1934 (the 1934 Act),[5] rule 10b-5 promulgated thereunder,[6] section 17(a) of the Securities Act of 1933 (the 1933 Act),[7] common law fraud, and a theory of prima facie tort.[8]

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1 Lanza v. Drexel & Co., 479 F.2d 1277, 1280 (2d Cir. 1973).

2 *Id.*

3 *Id.*

4 *Id.*

5 15 U.S.C. § 78j(b) (1970). Section 10(b) 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—
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> . . . .
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> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

6 17 C.F.R. § 240.10b-5 (1972). Rule 10b-5 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interestate [*sic*] commerce, or of the mails or of any facility of any national securities exchange,
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> (a) To employ any device, scheme, or artifice to defraud,
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> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
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> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
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> in connection with the purchase or sale of any security.

After a five week trial, the district court found that the Lanzas had been misled by various omissions and material misstatements in the exchange transaction.[9] While the court held a number of defendants liable, one of the BarChris directors, Bertram Coleman, was found to have no liability.[10] After considering the evidence, the court concluded that Coleman was not only unaware of the deception that had taken place, but that, under the circumstances, he had sufficiently complied with any duty that he might have had regarding the investigation of material facts and disclosure of such facts to the plaintiffs.[11]

However, the court did qualify its holding. By pointing out that outside directors such as Coleman may have a duty to inform third parties who are relying upon misleading statements or omissions when becoming involved in a transaction, it appears that the court based its disposition toward Coleman upon the facts of the case.[12] Concluding

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For a recent bibliography of material dealing with rule 10b-5, see 1 SECURITIES REG. L.J. 96 (1973).

7 15 U.S.C. § 77q(a) (1970). Section 17(a) provides:

> It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—
> (1) to employ any device, scheme, or artifice to defraud, or
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission 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
> (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

8 479 F.2d at 1280. Both the district court and the Court of Appeals for the Second Circuit decided to treat the requirements of a private action under rule 10b-5 and section 17(a) as identical for purposes of this case. *Id.* at 1280 n.2.

9 Lanza v. Drexel & Co., CCH FED. SEC. L. REP. ¶ 92,826, at 90,092 (S.D.N.Y. 1970). Judge Frankel listed ten ways in which the prospectus alone, presented to the plaintiffs' representative, was false and misleading. In addition, there were inaccuracies found to exist in both the annual report and financial statement which had been presented for consideration. *Id.* at 90,092-94. Numerous important facts regarding occurrences prior to the exchange transaction were also not disclosed to the plaintiffs. *Id.* at 90,096-97.

10 479 F.2d at 1280. In order to meet a demand for working capital in 1961, BarChris sold a series of debentures. Coleman was a partner in the firm of Drexel & Company, which was the primary underwriter of the debenture transaction. Acting as Drexel's representative, Coleman had become a director of BarChris and served in that capacity from April of 1961 through March of 1962, at which time he resigned. He was later named chairman of the board and served in that position from July of 1962 until BarChris filed its petition for bankruptcy. *Id.* at 1282 & n.7. For an analysis of the facts which led to the debenture transaction and BarChris' financial situation, see Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 652-80 (S.D.N.Y. 1968).

11 479 F.2d at 1289. The court of appeals quoted the district court's opinion in reaching these conclusions. *Id.* at 1288-89.

12 CCH FED. SEC. L. REP. ¶ 92,826, at 90,104-05. The circumstances that led to the completion of the Victor-BarChris exchange transaction involved a number of meetings

its discussion of Coleman's duty to inform the plaintiffs of the misstatements and omissions, the court stated that "[w]hatever requirement of due diligence there is under Rule 10b-5, it was satisfied by Coleman's personal inquiries to the responsible parties within the corporation."[13] The complaint against him was dismissed.[14]

The primary issue raised on appeal was the extent of Coleman's liability.[15] As stated by the Court of Appeals for the Second Circuit, the specific question was

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from March to November of 1961, at which Shulman, the Lanzas' accountant and representative, spoke primarily with Kircher, who was the treasurer and a board member of BarChris. During this time, Shulman was supplied with various materials relating to BarChris' financial and business status. Coleman was not present at any of these meetings and apparently was unaware that they had taken place. On November 6, 1961, the board of directors approved the exchange. Once again, Coleman was not present and did not learn of what had happened at that meeting until he received the minutes in the mail approximately one week later. The exchange contract was presented to the board and approved on November 21, at which time Coleman was present. The closing followed on December 14. 479 F.2d at 1280, 1283-84.

Although Coleman was aware of a number of developments that were unfavorable to BarChris' financial position, his conduct seems to show that he acted reasonably in attempting to prevent future difficulties. Following the release of the corporation's financial statement in August, he asked Kircher about the reported drop in earnings that BarChris was realizing. When told that a particular customer of BarChris had gone bankrupt, leaving BarChris in an unsecured position, Coleman demanded that steps be taken to make sure this did not happen in connection with other customers. *Id.* at 1285.

Despite his awareness of such problems, Coleman believed that the business and financial condition of BarChris was good, in light of the fact that earnings figures prepared by the accounting department and Kircher were higher than those of the previous year. *See id.* at 1286.

On December 6, a meeting of the board was called to discuss the resignation of BarChris' president. Coleman was present. At that time, Kircher read a statement opposing the elevation of the vice president to that post and indicating, among other things, that BarChris was faced with sharp competition, a drop in earnings, and poor organization and judgment by its officers. Realizing that there existed management difficulties, Coleman expressed the opinion that the corporation was in need of a management consultant. *Id.* at 1286-88.

Despite these problems, it appears that Coleman trusted Kircher and did not doubt his judgment. As stated by the district court, "[t]he accounting devices of Kircher *et al.* deceived not only the investing public, but Coleman as well." CCH FED. SEC. L. REP. ¶ 92,826, at 90,105.

13 CCH FED. SEC. L. REP. ¶ 92,826, at 90,105. At this point the court distinguished what it considered to be the requirement of due diligence in rule 10b-5 with that in section 11(a) of the 1933 Act:

> While . . . Coleman's inquiry was not satisfactory for the due diligence requirement of § 11(a) of the Securities Act of 1933, that high standard—designed as it was to put a heavy burden of accurate disclosure on those seeking to register a new public issue—is not incorporated in Rule 10b-5, which applies to *all* corporate documents and releases, not just to registration statements or prospectuses.

Id. (emphasis in original). For further discussion of section 11, see note 69 *infra*.

14 CCH FED. SEC. L. REP. ¶ 92,826, at 90,107.

15 479 F.2d at 1281. In addition, Kircher, the treasurer and a board member of Bar-

> [w]hat duty, if any, does Rule 10b-5 impose on a director in Coleman's position to insure that all material, adverse information is conveyed to prospective purchasers of the corporation's stock where the director does not know that these prospective purchasers are not receiving all such information?[16]

In *Lanza v. Drexel & Co.*,[17] the court, sitting en banc, held that a director who is a non-participant in a transaction owes no duty to insure that such information is conveyed to prospective purchasers.[18] The court further concluded that the liability of a director in this position under rule 10b-5 is merely secondary, comparing it to "that of an aider and abettor, a conspirator, or a substantial participant in fraud perpetrated by others."[19] Reviewing the evidence, the court agreed with the decision of the court below that Coleman had neither been aware of, nor knowingly participated in, the misrepresentations made to the plaintiffs, and therefore was not liable in this secondary manner.[20] The court also rejected the plaintiffs' contention that Coleman, even in the absence of a duty to convey such material information, was liable because he had been negligent in not ascertaining whether adverse facts concerning BarChris' financial situation, of which he had prior knowledge, had been accurately and completely disclosed.[21] Consequently, the dismissal of the charges against Coleman was affirmed.[22]

In establishing the Securities Exchange Act of 1934, it was the intent of Congress to

> substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry.[23]

This attitude seems to pervade the development of what has been

Chris, was appealing the denial of demand for a jury trial after there had been an initial waiver of that right. *Id.* at 1309-10. The court of appeals affirmed the lower court's decision on this issue after concluding its lengthy discussion of Coleman. *Id.* at 1311.

16 *Id.* at 1289.

17 479 F.2d 1277 (2d Cir. 1973).

18 *Id.* at 1289.

19 *Id.* (footnote omitted).

20 *Id.*

21 *Id.* at 1304-06. In this regard, the court stated that "proof of a willful or reckless disregard for the truth is necessary to establish liability under Rule 10b-5." *Id.* at 1306 (footnote omitted). While the court went on to say that "[a] director may have an obligation to maintain an awareness of significant corporate developments and to consider any material, adverse developments which come to his attention," it felt that Coleman had sufficiently met this standard. *Id.* For further discussion of the conduct necessary for liability under rule 10b-5, see note 76 *infra*.

22 479 F.2d at 1289.

23 SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963) (citing H.R. REP. NO. 85, 73d Cong., 1st Sess. 2 (1933)).

described as the "federal law of corporations,"[24] which, although dealing with various areas of the 1933 and 1934 Acts, has placed heavy emphasis on the evolution of corporate management's civil liability under section 10(b) and rule 10b-5.[25] Nevertheless, this philosophy of full disclosure, by itself, does little to aid in a proper interpretation of the rule. Because the language used in the construction of 10b-5 is broad, it has led to uncertainty regarding what actions the rule is intended to prohibit.[26] An examination of the 1933 and 1934 Acts, and rule 10b-5 specifically, is insufficient to supply "the legal measuring rod"[27] necessary for such interpretation. Consequently, various aspects of the rule's legislative history and its development through case law must be considered.

A review of the history of the 1934 Act and rule 10b-5 reveals that there is a definite lack of reference to a director's duty to convey adverse, material information to prospective purchasers or to insure that information provided is accurate. A Senate Report in 1934,[28] dealing generally with the 1934 Act, uses language suggesting that the main thrust of the Act was to prohibit fraudulent schemes against purchasers, not to create liability in the absence of culpability on the part of the person being charged.[29] Similiarly, it is significant to note that at the

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24 *E.g.,* Drake v. Thor Power Tool Co., 282 F. Supp. 94, 97 (N.D. Ill. 1967); W. KNEPPER, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS 129 (2d ed. 1973) [hereinafter cited as KNEPPER].

25 KNEPPER, *supra* note 24, at 129. The author, quoting from Green v. Wolf Corp., 406 F.2d 291, 295 (2d Cir. 1968), points out that rule 10b-5 represents approximately one-third of all contemporary cases brought under SEC statutes and is the cause of almost as much litigation as all of the other federal securities antifraud provisions combined. KNEPPER, *supra* note 24, at 130.

26 Kohn v. American Metal Climax, Inc., 458 F.2d 255, 276-77 (3d Cir.) (Adams, J., concurring and dissenting), *cert. denied,* 409 U.S. 874 (1972); *see* Drake v. Thor Power Tool Co., 282 F. Supp. 94, 102 (N.D. Ill. 1967).

27 Kohn v. American Metal Climax, Inc., 458 F.2d 255, 277 (3d Cir.) (Adams, J., concurring and dissenting), *cert. denied,* 409 U.S. 874 (1972). Judge Adams provides a recent analysis of the history and development of rule 10b-5. 458 F.2d at 276-316.

28 S. REP. No. 792, 73d Cong., 2d Sess. (1934). The Report states in pertinent part:

> [T]he bill provides that any person who unlawfully manipulates the price of a security, or who induces transactions in a security by means of false or misleading statements, or who makes a false or misleading statement in the report of a corporation, shall be liable in damages . . . .

Id. at 12-13.

29 The Report is discussed in the *Lanza* decision:

> This report likewise contains no evidence of any attention to the obligations of directors to insure that all material, adverse information is conveyed to prospective purchasers of the company's stock. Indeed, this report's explanation of the civil liability provisions of the bill gives rise to the inference that no such duty was intended . . . .

479 F.2d at 1291 n.35.

time rule 10b-5 was promulgated, the Securities Exchange Commission (SEC), in an official release concerning that rule, made frequent use of the word fraud:

> "The Securities and Exchange Commission today announced the adoption of a rule prohibiting *fraud* by any person in connection with the purchase of securities. The previously existing rules against *fraud* in the purchase of securities applied only to brokers and dealers. The new rule closes a loophole in the protections against *fraud* administered by the Commission by prohibiting individuals or companies from buying securities if they engage in *fraud* in their purchase."[30]

In that same year, the SEC's annual report reiterated that the reason for the rule was protection of investors against fraudulent activities.[31]

Thus, the background of rule 10b-5 seems to suggest that in establishing the rule, Congress sought to create an antifraud provision under which liability would arise due to an individual's intentional actions to deceive, rather than a provision that would specifically impose upon an outside director a duty to convey adverse, material information that might affect the actions of a prospective purchaser. Nevertheless, this history does not conclusively reject the possibility that such a requirement may arise, and therefore does little to delineate the proper interpretation of the rule regarding this issue.

The courts have realized the difficulty of interpreting rule 10b-5, and have often turned to prior case law dealing with the rule in their efforts to provide definitive guidelines.[32] In doing so, it is important to note that certain issues that have a bearing on the duty to convey have already been resolved. It is well established that 10b-5 implies a private right of action,[33] thus eliminating the requirement that a public offering or a registered security be involved. Furthermore, interpreta-

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30 Kohn v. American Metal Climax, Inc., 458 F.2d 255, 278 (3d Cir.) (quoting from SEC Securities Act Release No. 3230 (May 21, 1942)) (emphasis by the court), *cert. denied*, 409 U.S. 874 (1972).

31 8 SEC ANN. REP. (1942) states:

> During the fiscal year the Commission adopted Rule X-10B-5 as an additional protection to investors. The new rule prohibits *fraud* by any person in connection with the purchase of securities, while the previously existing rules against *fraud* in the purchase of securities applied only to brokers and dealers.

Id. at 10 (emphasis added).

32 *See, e.g.*, Drake v. Thor Power Tool Co., 282 F. Supp. 94, 97 (N.D. Ill. 1967); *cf.* Demarco v. Edens, 390 F.2d 836, 842 (2d Cir. 1968).

33 Drake v. Thor Power Tool Co., 282 F. Supp. 94, 97 (N.D. Ill. 1967); Kardon v. National Gypsum Co., 69 F. Supp. 512, 513 (E.D. Pa. 1946); E. GADSBY, THE FEDERAL SECURITIES EXCHANGE ACT OF 1934 § 5.03, at 5-10 (11A BUSINESS ORGANIZATIONS rev. 1973) [hereinafter cited as GADSBY]; KNEPPER, *supra* note 24, at 129.

tion has made it clear that the rule's prohibition of affirmative false representation covers the intentional lack of disclosure of material facts by both officers and directors.[34]

It is important to realize, however, that in the cases in which officers and directors have been charged with violation of the duty to disclose, the courts have discussed this duty primarily in connection with corporate "insiders."[35] An insider has been described as "one who is in a peculiarly favorable position to know of important corporate developments."[36] Further, there is no requirement that the individual be a corporate officer, as long as he "is in possession of information the publication of which might affect the value of the company's securities."[37]

Nevertheless, there are limitations on the situations in which information must be disclosed under the rule. It has been held that a corporate insider must disclose only material information that will affect the purchase or sale of corporate stock.[38] The generally accepted test for materiality is whether a particular fact would influence the actions of the other party involved in the purchase or sale.[39] In addition, even when a duty of disclosure arises, it will not be applied unreasonably. This attitude was expressed by the Seventh Circuit in *Kohler v. Kohler Co.*[40] In *Kohler*, the court felt that an insider should be re-

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[34] GADSBY, *supra* note 33, § 5.03[1][b], at 5-15; KNEPPER, *supra* note 24, at 167.

[35] *E.g.*, Kohler v. Kohler Co., 319 F.2d 634, 637 (7th Cir. 1963). In discussing rule 10b-5, the *Kohler* court stated that the rule

> was intended to create a form of fiduciary relationship between so-called corporate "insiders" and "outsiders" with whom they deal in company securities which places upon the insider duties more exacting than mere abstention from what generally is thought to be fraudulent practices.

Id. The court went on to state that any limitations on the duties must be determined through a case by case method. *Id.* at 637-38. *See also* Connelly v. Balkwill, 174 F. Supp. 49 (N.D. Ohio 1959), wherein the court stated that

> when read as a whole, Rule X 10b-5 imposes the duty to speak and to make a full disclosure of material facts in those circumstances where silence would constitute fraud.

Id. at 59.

[36] GADSBY, *supra* note 33, § 5.03[1][b], at 5-17.

[37] *Id.* at 5-18. For further discussion of insiders and rule 10b-5, see Painter, *Inside Information: Growing Pains for the Development of Federal Corporation Law Under Rule 10b-5*, 65 COLUM. L. REV. 1361 (1965); Comment, *Insider Liability Under Securities Exchange Act Rule 10b-5: The Cady, Roberts Doctrine*, 30 U. CHI. L. REV. 121 (1962).

[38] *See, e.g.*, Rogen v. Ilikon Corp., 361 F.2d 260, 266 (1st Cir. 1966); Ruckle v. Roto Am. Corp., 339 F.2d 24, 27 (2d Cir. 1964); Kohler v. Kohler Co., 319 F.2d 634, 642 (7th Cir. 1963); Royal Air Properties, Inc. v. Smith, 312 F.2d 210, 212 (9th Cir. 1962); Reed v. Riddle Airlines, 266 F.2d 314, 315 (5th Cir. 1959); Kardon v. National Gypsum Co., 73 F. Supp. 798, 800 (E.D. Pa. 1947).

[39] *See, e.g.*, Speed v. Transamerica Corp., 99 F. Supp. 808, 828-29 (D. Del. 1951).

[40] 319 F.2d 634 (7th Cir. 1963).

quired to "exercise reasonable and due diligence" both in determining what is material at the time the transaction is taking place, and in completely disclosing any material facts of which an outsider might be uninformed and which would most likely influence his judgment.[41] The court then noted that the requirements of the rule are satisfied "[w]hen the totality of facts and circumstances indicates that such diligence has been observed."[42]

Although prior cases have dealt with an insider's duty to disclose under rule 10b-5, none have specifically discussed this issue in connection with outside directors. However, by analogy, a number have shed light on the subject. *Wessel v. Buhler*[43] involved the liability of an independent accountant (Jordan) for an alleged violation of the rule. Jordan had been hired to prepare various financial statements for a corporation, and in doing so, had become aware of serious deficiencies in the corporation's financial condition.[44] Upon completion, the statements were given to the board of directors and used in a manner unrelated to the issuance of stock.[45] None had been made " 'in a manner reasonably calculated to influence the investing public.' "[46] The plaintiffs, claiming that they had made purchases of the corporation's stock in reliance upon certain prospectuses, contended that Jordan owed them a duty to disclose his knowledge of the adverse financial condition of the corporation and that, by failing to do so, Jordan had become an aider and abettor in the deception.[47] This contention was flatly rejected by the court:

> We find nothing in Rule 10b-5 that purports to impose liability on anyone whose conduct consists solely of inaction. . . . We perceive no reason, consonant with the congressional purpose in enacting the Securities and Exchange Act of 1934, thus to expand Rule 10b-5 liability.[48]

A Second Circuit decision discussed in the *Lanza* opinion[49] is *Moerman v. Zipco, Inc.*[50] In *Moerman*, the plaintiff based his decision to purchase corporate stock upon information received from an officer

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41 *Id.* at 642.
42 *Id.*
43 437 F.2d 279 (9th Cir. 1971).
44 *Id.* at 281.
45 *Id.* at 282.
46 *Id.*
47 *Id.* at 283.
48 *Id.* (citations omitted).
49 479 F.2d at 1301.
50 302 F. Supp. 439 (E.D.N.Y. 1969), *aff'd*, 422 F.2d 871 (2d Cir. 1970).

of the corporation (Nasser) during various conversations. It was the opinion of the court that Nasser had failed to disclose all the material information of which he had knowledge that would have affected the plaintiff's purchase, and therefore was liable under rule 10b-5.[51] The import of the *Moerman* decision is the court's attitude toward the other directors who were also being charged. In discussing the liability of these other defendants, it did not even consider the question of whether they were liable under rule 10b-5:

> Since [the plaintiff] had no significant contact with any defendant other than [the officer held liable under the rule], the liability of the other defendant officers and directors *must rest solely* on Section 20 of the Securities Exchange Act . . . .[52]

Equally important was the court's attitude toward the responsibility of these directors, who neither knew of nor induced Nasser's fraudulent acts, for the actions of the officers of the corporation:

> Directors cannot be expected to exercise the kind of supervision over a corporation president that brokers must exercise over salesmen.[53]

The common law is also relevant to the proper interpretation of rule 10b-5,[54] since it has been recognized that "courts generally interpret statutes in the context of the common law."[55] It appears that a director owed no duty to convey adverse, material information to prospective purchasers of stock in the absence of deceit. This view reappears in both English and American decisions prior to the passing of the 1933 and 1934 Acts. Such cases have stated that corporate directors are not insurers of the truthfulness and ability of the officers and employees that they have selected.[56]

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51 *See* 302 F. Supp. at 446. The plaintiff had been led to believe that he was to be one of only a few shareholders when, in reality, this was untrue. *Id.* at 443.

52 *Id.* at 446-47 (emphasis added). Section 20 of the Securities Exchange Act, 15 U.S.C. § 78t (1970), states in pertinent part:

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

53 302 F. Supp. at 447.

54 *See* Comment, *Negligent Misrepresentations Under Rule 10b-5*, 32 U. CHI. L. REV. 824, 828 (1965).

55 Royal Air Properties, Inc. v. Smith, 312 F.2d 210, 213 (9th Cir. 1962).

56 In Briggs v. Spaulding, 141 U.S. 132 (1891), a national bank failed as the result of illegal loans which had been authorized by the bank's president. *Id.* at 142. In charging the directors of the bank, it was not alleged that they had been aware of or had acquiesced in

The 1901 case of *Dovey v. Cory*[57] is an excellent example of the English common law position. In *Dovey*, a director of a bank (Cory) had been charged in connection with the fraudulent preparation of a balance sheet. It was established that Cory had not been aware of the fraudulent actions committed by particular officers and directors of the bank who prepared the balance sheet in question.[58] Directing its attention to the liability of all persons in positions comparable to that of a director, the court considered the issue to be "how far they are called upon to distrust and be on their guard against the possibility of fraud being committed by their subordinates."[59] The court then went on to clearly answer this question:

> It is obvious if there is such a duty it must render anything like an intelligent devolution of labour impossible. . . . I cannot think that it can be expected of a director that he should be watching either the inferior officers of the bank or verifying the calculations of the auditors himself. The business of life could not go on if people could not trust those who are put into a position of trust for the express purpose of attending to details of management.[60]

Indicative of the American viewpoint are Judge Learned Hand's remarks in the 1924 case of *Barnes v. Andrews*.[61] The plaintiff in *Barnes* was attempting to hold an outside director liable for the expenses of printing circulars containing false statements which had been used in the sale of corporate shares.[62] In rejecting the plaintiff's claim, Judge Hand seemed sensitive to the difficulties that an outside director would face if he were unable to place reasonable reliance upon the officers and other directors in the corporation:

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the illegal actions. *Id.* at 145. Finding no liability on the part of the defendants, the Supreme Court discussed the responsibility of directors in such situations:

> They are not insurers of the fidelity of the agents whom they have appointed, who are not their agents but the agents of the corporation; and they cannot be held responsible for losses resulting from the wrongful acts or omissions of other directors or agents, unless the loss is a consequence of their own neglect of duty, either for failure to supervise the business with attention or in neglecting to use proper care in the appointment of agents.

Id. at 147. For further cases supporting this view of director liability, see Cory Mann George Corp. v. Old, 23 F.2d 803, 807-08 (4th Cir. 1928); Dresser v. Bates, 250 F. 525, 538-40 (1st Cir. 1918); Warner v. Penoyer, 91 F. 587, 590-92 (2d Cir. 1898); Rankin v. Cooper, 149 F. 1010, 1013 (W.D. Ark. 1907).

57 [1901] A.C. 477. The court in *Lanza* found the discussion of this case helpful in its analysis of the development of common law in the area of fraudulent corporate transactions. 479 F.2d at 1291-92.

58 [1901] A.C. at 481-82.

59 *Id.* at 485.

60 *Id.* at 485-86.

61 298 F. 614 (S.D.N.Y. 1924). This case is also discussed in *Lanza* at 479 F.2d at 1292.

62 298 F. at 615.

> It seems to me too much to say that [the outside director] must read the circulars sent out to prospective purchasers and test them against the facts. . . . To hold otherwise is practically to charge him with detailed supervision of the business, which, consistently carried out, would have taken most of his time. If a director must go so far as that, there will be no directors.[63]

Thus, it appears that the general principle at common law regarding directors was that liability should be imposed only as a consequence of their own actions, and not for the misconduct of others.[64]

Faced with both the background concerning rule 10b-5 and the common law attitudes toward the duty to convey, the court in *Lanza* was in effect being asked by the plaintiffs to interpret the rule as requiring an outside director such as Coleman to insure the truthfulness of all material information that the corporation presents to prospective purchasers.[65] The court was unable to look to any prior case law dealing squarely with the possibility of such duty arising under the rule. Consequently, it gave serious consideration to both the legislative intent behind the 1933 and 1934 Acts, and areas of case law that might have been indicative of developing trends concerning management liability of this nature.[66]

In further attempting to interpret the rule, the court discussed it in connection with sections 11 and 12, two antifraud provisions found in the 1933 Act.[67] It was the court's opinion that to impose a duty to convey upon directors under rule 10b-5 would be ignoring the intent of Congress in creating sections 11 and 12.[68] Those sections explicitly limit the types of actions which can be brought thereunder to those involving public offerings and original purchases respectively.[69]

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63 *Id.* at 620.

64 Shulman, *Civil Liability and the Securities Act*, 43 YALE L.J. 227, 240 (1933). The author proposes that "[d]enial of recovery to a plaintiff may . . . be rested upon a finding that the defendant did not personally participate in the misrepresentation." *Id.*

65 It should be noted that the scope of duty imposed upon a director such as Coleman was a matter of concern that arose as a result of the decision in Escott v. BarChris Constr. Corp., 283 F. Supp. 643 (S.D.N.Y. 1968). One commentator has observed:

> Considering Coleman solely as a director, another question emerges. To what extent may he rely upon reports of officers and other responsible corporate personnel? The answer is far from clear.

Folk, *Civil Liabilities Under the Federal Securities Acts: The BarChris Case—Part I—Section 11 of the Securities Act of 1933*, 55 VA. L. REV. 1, 39 (1969).

66 479 F.2d at 1289-93.

67 *Id.* at 1298-99.

68 *Id.* at 1299.

69 Section 11 of the 1933 Act, 15 U.S.C. § 77k (1970), deals with fraud committed in the preparation of registration statements. To escape liability, one must show that, following a reasonable investigation, he had reasonable grounds to believe that the statements

In this regard, the court stated that "duties imposed upon directors in private offerings were intended to be correspondingly less stringent"[70] than those in public offerings. It went on to state that imposing such a duty under rule 10b-5 "would take away from directors what is granted to them by the private offering exemption and by the limitation of the due diligence duty to registration statements."[71]

Further, considering the legislative intent, the court referred to Judge Adam's words in *Kohn v. American Metal Climax, Inc.*:[72]

> "There is no evidence that Congress intended that under Section 10(b) anyone should be an insurer against false or misleading statements made non-negligently or in good faith."[73]

By its rejection of the plaintiffs' contentions that an outside direc-

made were in fact true. 15 U.S.C. § 77k(b)(3). This degree of reasonableness is defined in the section as "that required of a prudent man in the management of his own property." *Id.* § 77k(c).

The burden of proof faced by a defendant under section 11 was dealt with in Escott v. BarChris Constr. Corp., 283 F. Supp. 643 (S.D.N.Y. 1968). The court in *BarChris* was of the opinion that persons charged under the section must prove that they exercised "due diligence" before they can avoid liability. *See id.* at 682-84. Various defendants were held not to have sustained this burden of proof, despite the fact that a number of them were shown to have had no knowledge of the existence of the fraud. *Id.* at 684-703.

Section 11, therefore, does go so far as to impose upon a director of a corporation a duty of reasonable investigation concerning the accuracy of a registration statement. This section, however, imposes such a duty only in connection with registration statements for the public issuance of stock. As pointed out in the *Lanza* decision, the registration of the stock in question was not required because the issuance of that stock did not involve a public offering, and therefore was exempt under section 4(2) of the 1933 Act. 479 F.2d at 1298. Consequently, the plaintiffs did not have a valid cause of action against Coleman under section 11.

Section 12 of the 1933 Act, 15 U.S.C. § 77*l* (1970), is concerned with prospectuses and communications related to the issuance of a security. This section differs from section 11 in that the right of a cause of action can be maintained only by the original purchaser of the security or, in the absence of this requirement of privity, a showing of *scienter*. 479 F.2d at 1298 (citing Barnes v. Osofsky, 373 F.2d 269, 272 (2d Cir. 1967)). The burden of proof that a defendant must sustain to escape liability is essentially the same as that under section 11. *See, e.g.*, Demarco v. Edens, 390 F.2d 836, 842 (2d Cir. 1968); Johns Hopkins Univ. v. Hutton, 297 F. Supp. 1165, 1219 (D. Md. 1968), *aff'd in part, rev'd in part on other grounds*, 422 F.2d 1124 (4th Cir. 1970).

70 479 F.2d at 1299.

71 *Id.*

72 458 F.2d 255 (3d Cir.), *cert. denied*, 409 U.S. 874 (1972).

73 479 F.2d at 1299 (quoting from Kohn v. American Metal Climax, Inc., 458 F.2d 255, 280 (3d Cir. 1972)). In *Kohn*, Judge Adams went on to state:

> Congress and the SEC both intended, before any liability for misrepresentation might attach, that the element of culpability be present. This intent was manifested by the constant usage of words such as "cunning," "manipulative," "deceptive," "fraudulent," "illicit," "fraud," and lack of "good faith," and the absence of language indicating liability for negligent or non-negligent conduct.

458 F.2d at 280.

tor has a duty to convey adverse, material information or that, absent such a duty, he may be liable for his negligent actions, the *Lanza* court has added to the Second Circuit's limited interpretation of liability under rule 10b-5. It would appear that in reaching this decision the court was influenced by its own attitude toward the question of whether an element of *scienter* is required before liability will arise in a private action under the rule. This attitude is clearly expressed in *Shemtob v. Shearson, Hammill & Co.*[74] In that case the court stated that there can be no violation of rule 10b-5

> in the absence of allegation of facts amounting to *scienter*, intent to defraud, reckless disregard for the truth, or knowing use of a device, scheme or artifice to defraud. It is insufficient to allege mere negligence . . . .[75]

The question of *scienter* poses a problem among the circuits, and they are far from agreement on this issue.[76] Nevertheless, it is unlikely that the Second Circuit, which has consistently rejected the notion that negligence alone will make a director liable under the rule, would

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[74] 448 F.2d 442 (2d Cir. 1971).

[75] *Id.* at 445.

[76] For a recent analysis of the *scienter* problem, see Bucklo, *Scienter and Rule 10b-5*, 67 Nw. U.L. REV. 562 (1972). The author points out what she believes to be three approaches the courts have taken toward this issue. *Id.* at 564-67. The first, espoused by the Second Circuit, and originally stated in Fischman v. Raytheon Mfg. Co., 188 F.2d 783 (2d Cir. 1951), requires an intent to defraud, thereby implying that mere negligence on the part of the person being charged is insufficient. *See id.* at 786-87. The second, supported by the Ninth Circuit in the often cited case of Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961), rejects the requirement of fraud. The court in *Ellis* felt that Congress had not restricted section 10(b) to common law fraud standards. *Id.* at 274. Bearing this in mind, it would not narrowly construe that section's wording prohibiting "any 'manipulative or deceptive device or contrivance.'" *Id.* at 272. This is generally the argument that opponents of the *scienter* requirement put forth. Those in favor of the *scienter* standard, in turn, use as their argument the very words of the rule, and say that they clearly indicate a requisite of fraud, which in turn, cannot be the result of any action done without knowledge. *See, e.g.*, GADSBY, *supra* note 33, § 5.03[1][d]. Bucklo points out that this approach in *Ellis* has subsequently been used to support arguments prohibiting innocent misrepresentations as well as mere negligent misrepresentations. Bucklo, *supra* at 565. The third approach is one which takes a middle ground. As an example, Bucklo discusses yet another well known case, SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), which states:

> "[S]*ome form* of the traditional scienter requirement," . . . 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 (quoting from Barnes v. Osofsky, 373 F.2d 269, 272 (2d Cir. 1967)) (emphasis by the court) (citation omitted). It should be noted that the first and third approaches discussed both come from the Second Circuit. Since the decision in *Texas Gulf Sulphur*, however, the Second Circuit has clarified its position in Shemtob v. Shearson, Hammill & Co., 448 F.2d 442 (2d Cir. 1971). *See* notes 74 & 75 *supra* and accompanying text.

go so far as to hold that a director, who had no knowledge of a particular fraudulent act or acts perpetrated by other officers or directors of his corporation, should be required to guarantee that all material information being conveyed to prospective purchasers is correct.

Another issue to be considered is whether the *Lanza* decision will be effective as an argument in defending officers who are not outside directors. Outside directors have been defined as "directors who are not full-time employees of the corporation."[77] In adopting this definition, the *Lanza* court also refers to such directors as "non-officer directors."[78] While the court seemed to place heavy emphasis on the fact that Coleman was an outside *non-participating* director,[79] it seems most unlikely that Coleman or a director in a similar capacity would have escaped liability had he in fact been involved in the transaction, regardless of what type of director he might have been. Arguably, the *Lanza* holding could support the contention that any director or officer who had not participated in a particular transaction might escape liability under the rule.

It is interesting to note that Judge Hays, in his dissent, felt that "[t]he distinction between an 'inside' and an 'outside' director is irrelevant" in Coleman's case due to his inaction in the situation.[80] Judge Hays believed that, under the circumstances, Coleman had a responsibility "to keep himself adequately informed."[81] This dissent, however, seems contrary to the trend implied by the history and case law which serves as a background for rule 10b-5.

Looking beyond the court's decision with regard to a director's

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77 Bishop, *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1092 (1968). For further discussion of outside directors, see Blough, *The Outside Director at Work on the Board*, 28 RECORD OF N.Y.C.B.A. 202 (1973); Estes, *Outside Directors: More Vulnerable Than Ever*, HARV. BUS. REV., Jan.-Feb., 1973, at 107; Israels, *A New Look At Corporate Directorship*, 24 BUS. LAW. 727 (1969); Moscow, *The Independent Director*, 28 BUS. LAW. 9 (1972).

78 479 F.2d at 1306.

79 A good example of the court's emphasis of this fact is found in the words of its holding:

> We conclude that a director in his [Coleman's] capacity as a director *(a non-participant in the transaction)* owes no duty to insure that all material, adverse information is conveyed to prospective purchasers of the stock of the corporation on whose board he sits.

Id. at 1289 (emphasis added).

80 *Id.* at 1318.

81 *Id.* Judge Hays later states:

> That Coleman's failure to act was negligent as opposed to calculated should not insulate him from liability when action on his part might have prevented the fraud perpetrated by the corporation whose activities he was under a duty to supervise.

Id. at 1319.

duty to convey, it is clear that *Lanza* is yet another in a long line of cases that deal with the underlying question of whether rule 10b-5 should be limited or sweeping in its scope of liability. The case, by its affirmation of the *scienter* standard, has added fuel to the burning controversy among the circuits as to that issue. Further, in light of the fact that the Second Circuit is a *scienter* circuit, it is far from certain whether other circuits which are opposed to a strict *scienter* standard will follow the *Lanza* holding regarding the liability of outside directors in similar situations. As a result, in its attempt to further clarify the substantive requirements necessary for liability under rule 10b-5, the *Lanza* decision may well bring that issue of the rule's scope one step closer to a Supreme Court confrontation.[82]

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[82] Another author takes the same position. Ukropina, *Lanza v. Drexel & Co.: Some Comfort for the Outside Director, But More Needed*, 48 LOS ANGELES B. BULL. 330, 353 (1973).