

STUDENT COMMENTS

LANZA V. DREXEL & CO. AND RULE 10b-5: APPROACHING THE SCIENTER CONTROVERSY IN PRIVATE ACTIONS

Federal regulation of securities transactions emerged from the aftermath of the market crash of 1929¹ in the form of the federal securities acts.² The basic purpose of these acts is to provide investors with full disclosure of all material information and generally to "insure the maintenance of fair and honest markets."³ Under the acts a number of different provisions protect investors from losses due to improper conduct in connection with the sale and purchase of securities in interstate commerce.⁴ Recently, however, investors have come to rely heavily on a single provision of federal law⁵—section 10(b) of the Securities Exchange Act of 1934⁶ and Rule 10b-5⁷ promulgated under its authority.⁸

One reason for this increasing reliance has been that the restrictive provisions regarding the statute of limitations and the measure of damages of other sections of the securities laws make a suit under 10b-5 preferable for many plaintiffs.⁹ A second reason has been that while Rule 10b-5 was originally viewed as an enforcement measure for the Securities and Exchange Commission (SEC),¹⁰ and while the

¹ Note, Civil Liability Under Section 10B and Rule 10b-5: A Suggestion for Replacing the Doctrine of Privity, 74 Yale L.J. 658 (1965); Comment, 57 Geo. L.J. 1108 (1969).

² Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1970); Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78hh (1970).

³ Securities Exchange Act of 1934, § 2, 15 U.S.C. § 78b (1970).

⁴ See, e.g., Securities Act of 1933, §§ 11, 12, 15 U.S.C. §§ 77k, 77l (1970); Securities Exchange Act of 1934, §§ 9, 10(b), 18, 15 U.S.C. §§ 78i, 78j(b), 78r (1970).

⁵ Comment, *supra* note 1, at 1108.

⁶ 15 U.S.C. § 78j (1970), which provides in pertinent part:

It shall be unlawful for any person . . . (b) To use or employ, in connection with the purchase or sale of any security . . . 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.

⁷ 17 C.F.R. § 240.10b-5 (1973), which provides:

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

(a) To employ any device, scheme, or 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.

⁸ See 15 U.S.C. § 78j(b) (1970).

⁹ See D. Vagts, Basic Corporation Law 561 (1973).

¹⁰ See Comment, Remedies for Private Parties Under Rule 10b-5, 10 B.C. Ind. & Com. L. Rev. 337 (1969).

provisions of the rule do not specifically provide for a private cause of action,¹¹ the federal courts have implied a civil remedy for which the injured investor may bring suit.¹²

With the expanding use of 10b-5 as a basis for civil suits, questions have emerged and still remain unanswered as to the scope of liability under the rule. The most difficult and unsettled questions concern the requirement of scienter.¹³ *Lanza v. Drexel & Co.*¹⁴ represents a recent entry by the Second Circuit into the controversy surrounding the state of mind necessary for the imposition of liability on defendants under Rule 10b-5, that is, whether some form of scienter is required or whether negligence is sufficient. *Lanza* is of special significance because it represents the first case in which the Second Circuit has been presented with the opportunity to impose a standard of negligence on the specific facts of the case, rather than by way of dictum, in a private cause of action. As prior cases are examined it will become apparent that even where the court appears to adopt a negligence standard it does so only in dictum, since fraud, or at least scienter, is present in the facts. Notwithstanding the court's apparent attempt to definitively resolve the scienter/negligence controversy and to clarify the scope of 10b-5, it will be seen that *Lanza* falls short of achieving such a general resolution of the problem.

The plaintiffs in *Lanza*, the sole owners of the Victor Billiard Company (Victor), exchanged all of their Victor stock for 20,428 shares of the BarChris Construction Company (BarChris).¹⁵ After BarChris filed a petition in bankruptcy less than one year later,¹⁶ the plaintiffs commenced an action against the former officers and directors of BarChris based, *inter alia*, on section 10(b) of the 1934 Act and Rule 10b-5.¹⁷ The district court¹⁸ found that certain officers

¹¹ See 2 A. Bromberg, *Securities Law* § 8.4(505), at 204.106 (1973).

¹² *Kardon v. National Gypsum Co.*, 73 F. Supp. 798 (E.D. Pa. 1947), was the first case to find civil liability under the rule. Since *Kardon*, a private cause of action under Rule 10b-5 has been upheld specifically or in dictum in every circuit except the Eighth Circuit and the District of Columbia Circuit, where the question has apparently never been raised. See *Nash v. J. Arthur Warner & Co.*, 137 F. Supp. 615 (D. Mass. 1955) (First Circuit); *Fischman v. Raytheon Mfg. Co.*, 188 F.2d 783 (2d Cir. 1951); *Speed v. Transamerica Corp.*, 235 F.2d 369 (3d Cir. 1956); *Beury v. Beury*, 127 F. Supp. 786 (S.D.W. Va. 1954) (Fourth Circuit); *Hooper v. Mountain States Sec. Corp.*, 282 F.2d 195 (5th Cir. 1960), cert. denied, 365 U.S. 814 (1961); *Texas Continental Life Ins. Co. v. Dunne*, 307 F.2d 242 (6th Cir. 1962); *Kohler v. Kohler Co.*, 208 F. Supp. 808 (E.D. Wis. 1962), aff'd, 319 F.2d 634 (7th Cir. 1963); *Errion v. Connell*, 236 F.2d 447 (9th Cir. 1956); *Estate Counseling Serv., Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 303 F.2d 527 (10th Cir. 1962).

The Supreme Court has recently determined that a private right of action can be inferred in *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 10 (1971).

¹³ See 2 A. Bromberg, *supra* note 11, § 8.4(501), at 204.101.

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

¹⁵ *Id.* at 1280.

¹⁶ *Id.*

¹⁷ *Id.*

¹⁸ [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 92,826, at 90,089 (S.D.N.Y. 1970).

and directors of BarChris had misled the plaintiffs through material misstatements and omissions.¹⁹ The court also found that defendant Bertram D. Coleman, an independent director of BarChris, was not liable to the plaintiffs.²⁰ Sitting en banc, the United States Court of Appeals for the Second Circuit affirmed, finding that Coleman in his capacity as director and as a non-participant in the transaction owed no duty to insure that all material adverse information was conveyed to the prospective purchasers of BarChris stock.²¹

The purpose of this comment is to examine the *Lanza* decision, but not as an isolated occurrence. The case will be analyzed as the most recent in a long, arduous progression of cases which have attempted to settle the controversy as to whether negligence or scienter is the proper standard of conduct in a 10b-5 action. The multitude of sometimes confusing and contradictory opinions of the courts and commentators with regard to the scienter/negligence controversy will be reviewed. Following this review, four underlying causes of this controversy will be examined. Finally, an attempt will be made to present a method of approaching and analyzing cases in this area, and this method of approach will be applied in an analysis of the *Lanza* opinion.

I. THE RULE 10b-5 SCIENTER CONTROVERSY

In the entire scope of securities law, no issues are more "afire" than those which surround Rule 10b-5.²² An extensive debate has raged in the courts and in the commentaries over the extent to which the common law elements necessary for the proof of fraud²³ are incorporated into section 10(b) and Rule 10b-5. For many of these elements, the debate has been settled. Congress did not intend that every false, misleading or omitted fact should give rise to a cause of action;²⁴ rather the misstatement or omission must be with respect to a material matter.²⁵ Reliance also appears to be an essential

¹⁹ Id. at 90,100.

²⁰ Id. at 90,104.

²¹ 479 F.2d at 1289.

²² See Sommer, Rule 10b-5: Notes for Legislation, 17 [Case] W. Res. L. Rev. 1029 (1966).

²³ The five common law elements of fraud are: (1) a false representation (2) of a material fact (3) made with knowledge (scienter) of the falsity for the purpose of inducing the plaintiff to rely upon it and (4) upon which the plaintiff actually relied (5) to his detriment. W. Prosser, Handbook of the Law of Torts 685-86 (4th ed. 1971).

²⁴ See 78 Cong. Rec. 7707 (1934) (remarks of Rep. Rayburn); *Kohn v. American Metal Climax, Inc.*, 458 F.2d 255, 279 (3d Cir. 1972).

²⁵ The Second Circuit defined materiality for the purpose of § 10(b) in *SEC v. Texas Gulf Sulphur*, 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969):

As we stated in *List v. Fashion Park, Inc.*, 340 F.2d 457, 462, "The basic test of materiality . . . is whether a reasonable man would attach importance [to the fact misrepresented] . . . in determining his choice of action in the transaction in question"

401 F.2d at 849 (emphasis in original).

element of an action for damages under 10b-5.²⁶ In addition, the plaintiff must have suffered some injury, and the defendant's misconduct must have caused that injury.²⁷ Though the requirement that the plaintiff be a purchaser or seller of securities has long been attacked, such a relationship is still necessary for a 10b-5 cause of action.²⁸ The federal courts, however, have relaxed the requirement of privity between the plaintiff and defendant.²⁹

Following a general trend of "steady relaxation," the courts are no longer preoccupied with the extent to which these elements are required in a 10b-5 cause of action.³⁰ However, the question of whether or not there should be a requirement of scienter in private actions has never been settled³¹—[t]hirty panel discussions, seventy-five scholarly articles and uncounted cases later, the great debate rages on."³²

Historically three prominent positions have emerged in the courts with respect to the scienter/negligence controversy.³³ The first was enunciated in *Fischman v. Raytheon Manufacturing Co.*,³⁴ which involved a suit for damages arising from a purchase of stock where untrue representations were alleged to have been made in a prospectus and registration statement. Here the Court of Appeals for the Second Circuit laid down the rule that "proof of fraud is required in suits under § 10(b) of the 1934 Act and Rule X-10B-5."³⁵ The action of the defendant must be knowing and with an intent to defraud; hence scienter is required. While federal courts within the Second Circuit have followed *Fischman* in several cases,³⁶ only one court³⁷ outside of the circuit has done so.³⁸

²⁶ See *Rogen v. Ilkon Corp.*, 361 F.2d 260, 266 (1st Cir. 1966); *List v. Fashion Park, Inc.*, 340 F.2d 457, 462-63 (2d Cir.), cert. denied, 382 U.S. 811 (1965). In *Fashion Park*, the Second Circuit defined the test both objectively and subjectively: "Thus, to the requirement that the individual plaintiff must have acted upon the fact misrepresented, is added the parallel requirement that a reasonable man would also have acted upon the fact misrepresented." 340 F.2d at 462 (emphasis in original).

²⁷ *List v. Fashion Park, Inc.*, 340 F.2d 457, 462 (2d Cir.), cert. denied, 382 U.S. 811 (1965). See also Note, supra note 1, at 661.

²⁸ See, e.g., *Birmbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir. 1952).

²⁹ See, e.g., *Texas Continental Life Ins. Co. v. Dunne*, 307 F.2d 242 (6th Cir. 1962); *Pettit v. American Stock Exch.*, 217 F. Supp. 21 (S.D.N.Y. 1963).

³⁰ See 2 A. Bromberg, supra note 11, § 8.4(502), at 204.102.

³¹ Id.

³² 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).

³³ See Bucklo, Scienter and Rule 10b-5, 67 Nw. U.L. Rev. 562, 564-67 (1972); Epstein, The Scienter Requirement in Actions Under Rule 10b-5, 48 N.C.L. Rev. 482, 484-88 (1970).

³⁴ 188 F.2d 783 (2d Cir. 1951).

³⁵ Id. at 786.

³⁶ E.g., *Globus v. Law Research Serv., Inc.*, 287 F. Supp. 188, 197-98 (S.D.N.Y. 1968); *Gould v. Tricon, Inc.*, 272 F. Supp. 385, 393 (S.D.N.Y. 1967); *Richland v. Crandall*, 262 F. Supp. 538, 553 n.12 (S.D.N.Y. 1967); *Weber v. C.M.P. Corp.*, 242 F. Supp. 321, 324-25 (S.D.N.Y. 1965).

³⁷ See *Trussell v. United Underwriters, Ltd.*, 228 F. Supp. 757 (D. Colo. 1964). The precedential value of *Trussell*, however, is questionable. In *Stevens v. Vowell*, 343 F.2d 374,

The second position is that taken by the Ninth Circuit in *Ellis v. Carter*.³⁹ *Ellis* involved an action for damages resulting from the defendants' misrepresentation that if the plaintiff would purchase shares of the corporation at a price in excess of the market price, he would gain a voice in the corporate management. The *Ellis* court rejected the contention that the plaintiff, in an action under Rule 10b-5, "must allege and ultimately prove genuine fraud, as distinct from 'a mere misstatement or omission' . . ."⁴⁰ It is difficult to see how this language requires any fault whatsoever on the part of the defendant.⁴¹ Indeed it has been suggested that the *Ellis* case is authority that Rule 10b-5 prohibits not only negligent conduct, but also purely innocent misrepresentations⁴²—although no court has actually gone to this extreme.⁴³ While several courts have indicated support for the *Ellis* position by way of dictum,⁴⁴ only one district court can be said to have actually based its decision on *Ellis*.⁴⁵

The third position is that of the Second Circuit in *SEC v. Texas Gulf Sulphur Co.*⁴⁶ In *Texas Gulf Sulphur* a misleading press release concerning a discovery of mineral deposits was coupled with intensive insider trading. The SEC brought an action to enjoin the corporation and the individual defendants from continuing such activity. The Second Circuit held that an injunction under Rule 10b-5 could be based on mere negligence in the issuance of a corporate press release, stating that "lack of diligence, constructive fraud, or unreasonable or negligent conduct" would fulfill the requirement of the rule.⁴⁷ An injunction could ensue if "the misleading statement resulted from a lack of due diligence . . ."⁴⁸

While *Texas Gulf Sulphur* has been much cited in subsequent cases and much discussed in the commentaries, it has provided no real answer to the scienter/negligence controversy with respect to

379 (10th Cir. 1965), the court of appeals stated: "It is not necessary to allege or prove common law fraud to make out a case under the statute and rule." Then in *Parker v. Baltimore Paint & Chem. Corp.*, 244 F. Supp. 267, 270 (D. Colo. 1965), the Colorado district court found this to be dictum and reaffirmed *Trussell*.

³⁸ See Epstein, *supra* note 33, at 485.

³⁹ 291 F.2d 270 (9th Cir. 1961).

⁴⁰ *Id.* at 274. In accepting the contention that fraud is not necessary under 10b-5 the *Ellis* court purported to reaffirm *Matheson v. Armbrust*, 284 F.2d 670 (9th Cir. 1960); however, in *Matheson* there was a finding of intentional fraud. *Id.* at 672.

⁴¹ See R. Jennings & H. Marsh, *Securities Regulation* 1071 (3d ed. 1972).

⁴² Epstein, *supra* note 33, at 486.

⁴³ *Id.* Language in some cases, however, seems to support such a holding. See, e.g., *Royal Air Properties, Inc. v. Smith*, 312 F.2d 210, 212 (9th Cir. 1962).

⁴⁴ *Myzel v. Fields*, 386 F.2d 718, 734-35 (8th Cir. 1967), cert. denied, 390 U.S. 951 (1968); *Stevens v. Vowell*, 343 F.2d 374, 379-80 (10th Cir. 1965); *Kohler v. Kohler Co.*, 319 F.2d 634, 637 (7th Cir. 1963).

⁴⁵ *Hendricks v. Flato Realty Invs.*, [1967-1969 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 92,290, at 97,388 (S.D. Tex. 1968).

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

⁴⁷ 401 F.2d at 855.

⁴⁸ *Id.* at 863.

private actions. In *Astor v. Texas Gulf Sulphur Co.*,⁴⁹ one of the opinions which followed in the wake of *SEC v. Texas Gulf Sulphur Co.*, the court found "the great debate over ordinary negligence vs. scienter in private actions" unresolved.⁵⁰ In sum, the case law arising under Rule 10b-5, at least with regard to the scienter/negligence issue, appears to be in a "chaotic mess,"⁵¹ with no clear trend emerging.⁵²

The commentators are in no more agreement than the courts on the scienter issue;⁵³ they are divided on what the law is and on what it should be.⁵⁴ Finding no solace in the opinions of the courts, the scholarly writings or the rule itself, one commentator has decided that the 10b-5 scienter issue represents a question of policy that the SEC is best equipped to handle.⁵⁵

Short of dramatic legislative or administrative intervention, however, the courts will continue to define the scope of liability under Rule 10b-5 on a case-by-case basis. It is therefore important to identify the sources of the confusion and unfortunate lack of consistency that envelop the 10b-5 scienter question. It is submitted that there are four underlying causes of this confusion: the nature of the federal court system, the breadth of Rule 10b-5, the lack of congressional guidance and the approach which the courts have adopted in their opinions.

A. The Federal Court System

Stare decisis operates within, but not between, each of the eleven judicial circuits which comprise the federal court system.⁵⁶ As a result the Ninth Circuit in *Ellis* could find negligence sufficient to impose liability under 10b-5, even though the Second Circuit in *Fischman* found an intent to defraud necessary. Since the United

⁴⁹ 306 F. Supp. 1333 (S.D.N.Y. 1969).

⁵⁰ Id. at 1343-44.

⁵¹ Hamilton, Book Review, 46 Texas L. Rev. 815 (1968).

⁵² See Epstein, *supra* note 33, at 489.

⁵³ Numerous possible standards of conduct under Rule 10b-5 have been discussed by the commentators. See, e.g., Note, 63 Mich. L. Rev. 1070, 1074 (1965) (would require scienter); Jennings, Insider Tradings in Corporate Securities: A Survey of Hazards and Disclosure Obligations Under Rule 10b-5, 62 Nw. U.L. Rev. 809, 818 (1968) (would require scienter except that if the plaintiff and defendant are in a fiduciary-type relationship, negligence would be sufficient); Comment, Securities Regulation: Shareholder Derivative Actions Against Insiders Under Rule 10b-5, 1966 Duke L.J. 166, 171-72 (would require at least "watered down" scienter); Comment, Private Remedies Available Under Rule 10b-5, 20 Sw. L.J. 620, 621 (1966) (same); Comment, Negligent Misrepresentations Under Rule 10b-5, 32 U. Chi. L. Rev. 824, 844 (1965) (would extend liability to include negligent misrepresentations); Israels, Book Review, 77 Yale L.J. 1585, 1593 (1968) (same); 2 A. Bromberg, *supra* note 11, § 8.4(513) (recommends a flexible transactional approach); Mann, *supra* note 32 (same); Ruder, *Texas Gulf Sulphur—The Second Round: Privity and State of Mind in Rule 10b-5 Purchase and Sale Cases*, 63 Nw. U.L. Rev. 423, 444-45 n.107 (1968) (same); Comment, 57 Geo. L.J. 1108, 1115-17 (1969) (same).

⁵⁴ See Epstein, *supra* note 33, at 489.

⁵⁵ Id. at 504.

⁵⁶ See 1B J. Moore, Federal Practice ¶ 0.402(1), at 61 (2d ed. 1965).

States Supreme Court has thus far not resolved the controversy, an unfortunate lack of consistency persists among the circuits.

B. *The Breadth of Rule 10b-5*

A second major factor contributing to the confusion has been the breadth of Rule 10b-5.⁵⁷ The essence of the rule is that anyone who

trading for his own account in the securities of a corporation has "access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone" may not take "advantage of such information knowing it is unavailable to those with whom he is dealing," i.e., the investing public.⁵⁸

Thus, 10b-5 encompasses an "extraordinary variety" of persons and situations.⁵⁹ From the aspect of potential defendants, Rule 10b-5 covers any insider.⁶⁰ As the *Texas Gulf Sulphur* court noted, this includes "anyone in possession of material inside information"⁶¹ Thus, corporate directors and officers,⁶² geologists and electrical engineers,⁶³ accounting firms⁶⁴ and numerous others have become 10b-5 defendants. There is also an extremely broad pool of potential plaintiffs under the rule. Plaintiffs have ranged from the former director and secretary of the defendant corporation⁶⁵ to simple speculators in securities.⁶⁶

Rule 10b-5 also covers a broad spectrum of transactions that range from the direct or personal (e.g., face-to-face exchanges) to the indirect or impersonal (e.g., general market trading).⁶⁷ The rule also encompasses a number of different relationships between the parties (e.g., fiduciary-beneficiary, broker-customer).⁶⁸

Another aspect of the breadth of Rule 10b-5 is that not only SEC suits, but also private civil actions come within the scope of the rule.⁶⁹ Many courts have taken the position that the requirements of

⁵⁷ 2 A. Bromberg, *supra* note 11, § 8.4(507).

⁵⁸ *Texas Gulf Sulphur*, 401 F.2d at 848, quoting *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 912 (1961).

⁵⁹ 2 A. Bromberg, *supra* note 11, § 8.4(507).

⁶⁰ See note 7 *supra*.

⁶¹ 401 F.2d at 848.

⁶² E.g., defendants Stephens (president) and Fogarty (executive vice-president) in *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968); defendant Coleman (director) in *Lanza v. Drexel & Co.*, 479 F.2d 1277 (2d Cir. 1973).

⁶³ E.g., defendants Darke (geologist) and Clayton (electrical engineer) in *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968).

⁶⁴ E.g., Peat, Marwick, Mitchell & Co. in *Drake v. Thor Power Tool Co.*, 282 F. Supp. 94 (N.D. Ill. 1967).

⁶⁵ E.g., Kohler (director and secretary) in *Kohler v. Kohler Co.*, 319 F.2d 634 (7th Cir. 1963).

⁶⁶ See, e.g., *Astor v. Texas Gulf Sulphur Co.*, 306 F. Supp. 1333 (S.D.N.Y. 1969).

⁶⁷ See 2 A. Bromberg, *Securities Law* § 8.4(513), at 204.115 (1973).

⁶⁸ See *id.*

⁶⁹ See note 12 *supra*.

proof and the elements of an SEC-initiated action should be less stringent than those in a cause of action for damages brought by a private individual.⁷⁰ As the United States Supreme Court pointed out in *SEC v. Capital Gains Research Bureau, Inc.*,⁷¹ the elements of a cause of action for fraud vary "with the nature of the relief sought," and "[i]t is not necessary in a suit for equitable relief or prophylactic relief to establish all the elements required in a suit for monetary damages."⁷²

A final factor which contributes to the rule's breadth is that 10b-5 prohibits not only material misstatements, but also material omissions.⁷³

C. Lack of Congressional Guidance

Congress did not specifically provide for a private cause of action under section 10(b) of the Securities Exchange Act of 1934, and therefore the language of this section and of Rule 10b-5 does not specify the elements of such an action.⁷⁴ Moreover, since 10(b) was one of the least controversial sections of the 1934 Act, there is a dearth of congressional debate and comment on this provision.⁷⁵ As a result, the legislative history of section 10(b) offers no real guidance as to the standard to be employed under the rule.⁷⁶

D. The Approach of the Courts

The federal courts themselves have contributed in a number of ways to the confusion as to the appropriate standard in a 10b-5 action, and the Second Circuit's decision in *Texas Gulf Sulphur* furnishes a clear example of several sources of confusion. First, the use of dictum in numerous opinions has caused confusion as to the specific holding of the court. The *Texas Gulf Sulphur* majority found that the "common law standard of deceptive conduct has been modified in the interests of a broader protection for the investing public so that negligent insider conduct has become unlawful."⁷⁷

⁷⁰ See, e.g., *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 193 (1963); *Mutual Shares Corp. v. Genesco, Inc.*, 384 F.2d 540, 547 (2d Cir. 1967).

⁷¹ 375 U.S. 180 (1963).

⁷² *Id.* at 193.

⁷³ See, e.g., *List v. Fashion Park, Inc.*, 340 F.2d 457, 462 (2d Cir. 1965). See also A. Bromberg, *supra* note 67, § 8.2, at 197.

⁷⁴ 2 A. Bromberg, *supra* note 67, § 8.4(505), at 204.106.

⁷⁵ 1 A. Bromberg, *supra* note 67, § 2.2(331), at 22.2-.3 states:

Of nearly a thousand pages of hearings in the House, the combined references to § 10(b) . . . would scarcely fill a page. Much the same is true in the Senate.

The several Committee Reports merely paraphrase the language of the several Bills and add little or nothing to the evidence on intent

The floor debates are no more enlightening.

⁷⁶ 2 A. Bromberg, *supra* note 67, § 8.4(505), at 204.106.

The administrative history of Rule 10b-5 has proved no more enlightening. See *Kohn v. American Metal Climax, Inc.*, 458 F.2d 255, 277-78 (3d Cir. 1972). The administrative history of 10b-5 was also examined by the *Lanza* court. See 479 F.2d at 1290, 1299.

⁷⁷ 401 F.2d at 854-55.

However, Judge Friendly, who concurred on the facts of the case, noted that the imposition of liability on the defendants did not require such a metamorphosis of *Fischman v. Raytheon Manufacturing Co.*,⁷⁸ which had required fraud for 10b-5 liability, because the defendants had knowledge equivalent to scienter.⁷⁹ Thus, it was unnecessary for the majority to discuss negligence in light of the defendants' conduct, and the court's approval of a negligence standard was dictum.⁸⁰ Indeed, no defendant has yet been held liable for negligent conduct on the specific facts of the case in a private cause of action under 10b-5;⁸¹ the courts that have accepted the negligence standard have done so in dictum.

The confusion concerning the scienter/negligence issue has also been increased by the fact that the courts have employed various definitions of scienter, which have at times been imprecise and contradictory.⁸² Scienter has been variously defined to include actual knowledge, knowing falsity, intent, various gradations of recklessness, and even what is virtually negligence, or even innocence.⁸³ As a result, there is simply no assurance that judges using the same word mean the same thing.⁸⁴ Negligence has fared no better.⁸⁵ The opinion of the majority in *Texas Gulf Sulphur* provides an example of this semantic confusion. The court stated that "'some 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 the standard . . ."⁸⁶ The various terms employed by the court are simply not interchangeable with each other.⁸⁷

Finally, the federal courts have contributed to the confusion by attempting to impose a single standard of conduct (either negligence or some form of scienter) under a very broad rule which encompasses different types of parties and different types of actions. Differing kinds of relief are sought under the rule for different conduct (misstatements and nondisclosure). In fact, each case involves different facts which do not lend themselves to "sweeping statements" regarding the elements required for the imposition of liability under Rule 10b-5.⁸⁸ In *Texas Gulf Sulphur*, Judge Friendly was careful to

⁷⁸ 188 F.2d 783 (2d Cir. 1951).

⁷⁹ 401 F.2d at 868 n.4 (concurring opinion).

⁸⁰ See Bucklo, *Scienter and Rule 10b-5*, 67 Nw. U.L. Rev. 562, 578 (1972).

⁸¹ *Id.* at 570.

⁸² See 2 A. Bromberg, *supra* note 67, § 8.4(503), at 204.102.

⁸³ See *id.* § 8.4(501), at 204.101; 3 L. Loss, *Securities Regulation* 1432 (2d ed. 1961); Epstein, *The Scienter Requirement in Actions Under Rule 10b-5*, 48 N.C.L. Rev. 482, 483 (1970).

⁸⁴ See 2 A. Bromberg, *supra* note 67, § 8.4(503), at 204.103.

⁸⁵ See Bucklo, *supra* note 80, at 564, 567.

⁸⁶ 401 F.2d at 855, quoting *Barnes v. Osofsky*, 373 F.2d 269 (2d Cir. 1967) (emphasis added by court).

⁸⁷ Bucklo, *supra* note 80, at 567.

⁸⁸ Ruder, *supra* note 53, at 450.

distinguish an SEC action for injunctive relief from a private action for damages, and his concurring opinion confined the language of the court to the former.⁸⁹

As a result of the use of dictum, inconsistent terminology and an ostensible attempt to impose a single standard, *Texas Gulf Sulphur*, clearly a landmark case in this area of the law, has left an "unfortunate legacy of uncertainty" concerning the requirement of scienter in 10b-5 actions.⁹⁰

II. A SUGGESTED APPROACH TO 10b-5 CASES

Several observations should be made concerning the underlying causes of the confusion over the scienter/negligence issue. First, in each case where the courts have found negligence sufficient for the imposition of liability under Rule 10b-5, scienter has actually existed.⁹¹ Thus, the language employed by the courts must be analyzed critically in light of the particular facts of each case to determine the rationale underlying the court's decision.⁹² Next, the use of "catch phrases and categories" has avoided rather than promoted a resolution of the scienter/negligence controversy.⁹³ Much of the confusion could be quieted if more concern was shown for the meaning of the terms utilized by the courts.⁹⁴ Finally, given the enormous diversity of 10b-5, perhaps no single standard of conduct is sufficient in all facets of the application of the rule⁹⁵ and there is a real need for flexibility.⁹⁶ As the Supreme Court noted in *SEC v. Capital Gains Research Bureau, Inc.*,⁹⁷ the determination of liability has varied "with the nature of the relief sought, the relationship between the parties, and the merchandise in issue."⁹⁸ Underneath the language of the opinions perhaps this is the approach which the courts have taken all along—feigning consistent standards, while in fact deciding each case on the basis of its individual facts.⁹⁹

It is submitted that the following method of approaching the cases in this area accomplishes these objectives and avoids the confusion which has hindered efforts to determine a standard, or standards, of conduct in 10b-5 actions. The method which is suggested herein for approaching 10b-5 cases, and which will be em-

⁸⁹ 401 F.2d at 868 (concurring opinion).

⁹⁰ Comment, 57 Geo. L.J. 1108, 1117 (1969).

⁹¹ See, e.g., *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968); *Royal Air Properties, Inc. v. Smith*, 312 F.2d 210 (9th Cir. 1962); *Ellis v. Carter*, 291 F.2d 270 (9th Cir. 1961). See also Bucklo, *supra* note 80, at 570.

⁹² *Kohn v. American Metal Climax, Inc.*, 458 F.2d 255, 286 (3d Cir. 1972).

⁹³ 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, 1206-07 (1970).

⁹⁴ Bucklo, *supra* note 80, at 567.

⁹⁵ Mann, *supra* note 93, at 1220.

⁹⁶ 2 A. Bromberg, *supra* note 67, § 8.4(513), at 204.115.

⁹⁷ 375 U.S. 180 (1963).

⁹⁸ *Id.* at 193.

⁹⁹ Mann, *supra* note 93, at 1207.

ployed in analyzing the *Lanza* decision, is comprised of four steps: (a) determining the facts of the case, (b) analyzing the court's treatment of those facts, (c) analyzing the law upon which the court has based its decision, and (d) considering the public policy arguments which the court employs. It is not to be inferred that this method represents a startling new departure, but rather a rigorous application of legal method principles, from which many courts have strayed in analyzing 10b-5 cases.

A. *Determining the Facts of the Case*

The first step in analyzing a 10b-5 case, indeed any case, is the determination of the facts of the case with specificity. It has been suggested that with each particular case "remembering what is not involved is as important as determining what is."¹⁰⁰ Since stare decisis does not bind the courts in one circuit to the decisions of another,¹⁰¹ the circuit in which the case has been decided should be noted. Next, a distinction should be made between SEC and private actions,¹⁰² after which the specific facts of the particular case need to be isolated. Who is the defendant and what is his relationship to the corporation whose stocks are being traded? Is he a director or an officer, or is he in the lower echelons of management? Perhaps he is a stockbroker, or someone else outside the corporation. The plaintiff must then be identified with similar specificity. Next, the relationship between the parties (fiduciary-beneficiary, broker-customer, etc.) and the nature of the transaction (direct or indirect, personal or impersonal) must be determined. Finally, has there been a misstatement or an omission of a material fact?

Lanza v. Drexel & Co.,¹⁰³ decided by the United States Court of Appeals for the Second Circuit, sitting en banc, involved a private cause of action for damages.¹⁰⁴ The plaintiffs, Frank Lanza, Jr., Marie Lanza Sharbo, and Clare Lanza Stefano, were the sole owners of the Victor Billiard Company (Victor), a closely-held family corporation. On December 14, 1961 they exchanged all of the stock of Victor for 20,428 shares of the BarChris Construction Company (BarChris).¹⁰⁵ Less than one year later, BarChris filed a

¹⁰⁰ SEC v. National Sec., Inc., 393 U.S. 453, 465 (1969).

¹⁰¹ See 1B J. Moore, Federal Practice ¶ 0.402(1), at 61 (2d ed. 1965).

¹⁰² As has already been pointed out, the elements required for private as opposed to SEC actions are not necessarily the same. See text at notes 69-72, 88-89 supra.

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

¹⁰⁴ On Sept. 16, 1971, a panel composed of Judges Moore, Smith and Hays heard oral argument on this appeal. Before an opinion was filed, the court of appeals ordered sua sponte that the appeal be argued before the court en banc. Id. at 1279-80.

¹⁰⁵ Id. at 1280. BarChris was also involved in *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968). In *Escott*, BarChris raised needed working capital from the sale of debentures. Drexel & Co., a Philadelphia brokerage and investment banking firm, was the principal underwriter of the debenture offering. Bertram Coleman, a partner in Drexel, joined the BarChris board of directors in connection with this transaction in April 1961. The action against BarChris in *Escott* was based on § 11 of the Securities Act of 1933, 15 U.S.C. § 77k

petition in bankruptcy.¹⁰⁶ After an unsuccessful effort to recover their shares,¹⁰⁷ the plaintiffs borrowed \$100,000 to pay the trustee in bankruptcy for the return of their Victor stock.¹⁰⁸ The plaintiffs thereupon commenced an action for compensatory and punitive damages against the former officers and directors of BarChris.¹⁰⁹ Their suit was based, *inter alia*, on section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5.¹¹⁰

The district court¹¹¹ found that the plaintiffs, through their accountant and representative Sidney Shulman,¹¹² had been led by the material misstatements and omissions of certain officers and directors of BarChris to exchange their Victor shares for BarChris shares.¹¹³ The court also found that defendant Bertram D. Coleman, who represented the interests of Drexel as an independent director on the BarChris board,¹¹⁴ was not liable to the plaintiffs.¹¹⁵ With respect to Coleman, the district court held that he did not participate in or know of any deception practiced upon the plaintiffs, and that under these circumstances, he was under no duty to investigate more than he did or to seek out and advise the plaintiffs in any way.¹¹⁶

The plaintiffs appealed the decision of the district court exonerating Coleman.¹¹⁷ The majority of the Court of Appeals for the Second Circuit viewed the issue presented as:

(1970), which permits any person who has acquired a security issued under a registration statement with a material misstatement or omission of a required statement to sue "every person who signed the registration statement." 15 U.S.C. § 77k(a)(1) (1970). Since Coleman had signed the BarChris registration statement, which was found to be misleading, he was held liable.

¹⁰⁶ 479 F.2d at 1280.

¹⁰⁷ Plaintiffs brought a rescission action against the trustee in bankruptcy appointed for BarChris. *Id.*

¹⁰⁸ *Id.*

¹⁰⁹ *Id.* Defendants included Christie Vitolo, president of BarChris; Leonard Russo, director and vice-president; Theodore Kircher, director and treasurer; Leborio Pugliese, vice-president; John Ames Ballard, director; Bertram D. Coleman, director; and the firm of which Coleman was a partner, Drexel & Co. *Id.*

¹¹⁰ *Id.* The plaintiffs' action was also based on § 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a) (1970), common law fraud, and a theory of *prima facie* tort. *Id.*

¹¹¹ *Lanza v. Drexel & Co.*, [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 92,826, at 90,089 (S.D.N.Y. 1970).

¹¹² Because the plaintiffs had "modest academic training" and were not knowledgeable in finance, accounting or securities, they relied upon their accountant of many years, Sidney Shulman, throughout the negotiations. His role in the transaction was plain to all concerned on both sides of the deal. 479 F.2d at 1283.

¹¹³ [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. at 90,100. Defendants Vitolo, Russo and Kircher were held liable to plaintiffs under Rule 10b-5 and under common law fraud. *Id.* at 90,101. Vitolo and Russo were also held liable under § 20(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78t(a) (1970). *Id.* at 90, 102-03.

¹¹⁴ Drexel wanted one of its partners in a position to oversee the activities of a company in which it was going to make a large investment. 479 F.2d at 1311.

¹¹⁵ [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. at 90,104.

¹¹⁶ *Id.*

¹¹⁷ 479 F.2d at 1280. Defendant Kircher appealed the district court's denial of his demand for a trial by jury. However, Kircher's appeal was not submitted to the en banc

What duty, if any, does Rule 10b-5 impose upon 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?¹¹⁸

In its opinion, the *Lanza* majority asserted that it was mindful that generalizations were major hazards in Rule 10b-5 cases and therefore "set out in detail" the evidence regarding Coleman's knowledge of, and participation in, the negotiations which lead to the Victor-BarChris exchange.¹¹⁹ The negotiations for the exchange began in March 1961, and the closing took place on December 14 of the same year. During that period of time a number of meetings took place between certain officers and directors of BarChris and Shulman, the Lanzas' accountant.¹²⁰ Coleman was not present at these meetings, nor was he even aware of their existence or purpose.¹²¹ He was never advised of the substance of the negotiations,¹²² nor of what information had been given to the plaintiffs.¹²³ Indeed, it was not until after the closing that he had any knowledge or belief that BarChris had published any false or misleading figures.¹²⁴ Coleman was not aware, or even suspicious, that the Lanzas were being deceived during the negotiations,¹²⁵ and he himself never communicated anything to the plaintiffs or their accountant.¹²⁶

On November 6, 1961, the BarChris board approved the Victor exchange. Coleman was not present at this meeting,¹²⁷ however,

court. Defendants Vitolo and Pugliese reached a settlement with the plaintiffs. Defendant Russo's appeal was dismissed by the court as untimely. The plaintiffs did not argue before the en banc court that the dismissal of their complaint as to defendant Ballard was erroneous. See id. at 1280-81 & n.4.

The en banc court carefully noted that its sole concern was with Coleman's responsibility (if any) for the fraud perpetrated by the other officers and directors, and not with whether such a fraud was in fact perpetrated. Id. at 1281.

¹¹⁸ Id. at 1289. Judge Hays, in his dissenting opinion, expressed the issue somewhat differently:

The question presented to this *en banc* court is whether the director of a corporation should be liable to the purchasers of that corporation's shares when he fails to make any inquiry about the actions of his co-directors and the Company's officers with respect to the representations made in connection with the sale of stock.

Id. at 1317 (dissenting opinion).

¹¹⁹ Id. at 1281.

¹²⁰ Id. at 1283-84.

¹²¹ Id.

¹²² Id. at 1284.

¹²³ Id. at 1286.

¹²⁴ Id. at 1288.

¹²⁵ Id. Indeed, Coleman was of the opinion that the price that BarChris was paying for the Victor stock was too high. Id. at 1286.

¹²⁶ Id. at 1284.

¹²⁷ Id.

and it was not until approximately November 13, when he received the minutes of this meeting, that he first learned of the Victor acquisition.¹²⁸ The only connection which Coleman had with the entire transaction was that he attended the November 21 meeting of the BarChris board of directors, at which the finalized acquisition contract was approved.¹²⁹ When the closing took place on December 14, Coleman did not attend.¹³⁰

On the basis of its detailed examination of these facts, the *Lanza* court concluded that a director who did not participate in the transaction is not under a duty to insure that all material adverse information is conveyed to prospective purchasers of the stock of the corporation on whose board he sits.¹³¹

B. Court's Treatment of the Facts

After a detailed determination of the facts of the case, the second step in the suggested method of approach to 10b-5 cases involves recognition of the treatment which the court gives to these facts. The court may consider the position and expertise of the parties and the relationship between them to be important. Both the common law and securities laws have long established a special duty of care for persons closely associated with an issuing corporation and for professionals in the securities business when they are dealing in a fiduciary capacity with their customers.¹³² It has been suggested that while scienter should ordinarily be required, negligence should be the standard of conduct when a fiduciary relationship exists between the parties.¹³³ Therefore, a 10b-5 defendant may be held to a higher standard when he has a fiduciary obligation to the plaintiff.¹³⁴ As a corollary, the defendant may be held to a lower standard of conduct as the plaintiff's sophistication and ability to protect his own interests increases.¹³⁵

In weighing the facts which may affect the standard of conduct, the court may also consider the economic self-interest of the parties

¹²⁸ Id.

¹²⁹ Id. Thus, when Coleman first became aware of the Victor-BarChris transaction, it had already been completed and approved by the board. It had been negotiated without any participation on Coleman's part or knowledge as to any representations or omissions of material facts made by the officers of BarChris. Id.

¹³⁰ Id.

¹³¹ Id. at 1289.

¹³² See *Aetna Cas. & Sur. Co. v. Paine, Webber, Jackson & Curtis*, [1969-1970 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 92,748, at 99,276 (N.D. Ill. 1970); 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, 1210 (1970).

¹³³ Jennings, Insider Tradings in Corporate Securities: A Survey of Hazards and Disclosure Obligations Under Rule 10b-5, 62 Nw. U.L. Rev. 809, 818 (1968).

¹³⁴ Cf. *Trussell v. United Underwriters, Ltd.*, 228 F. Supp. 757, 774 (D. Colo. 1964). See also Mann, *supra* note 132, at 1214-15.

¹³⁵ See *Kohler v. Kohler Co.*, 319 F.2d 634, 641-42 (7th Cir. 1963); Mann, *supra* note 132, at 1214-15.

to the transaction.¹³⁶ Where the management and board of directors of a corporation are acting in their own self-interest or for a controlling third party, the buyer or seller of the corporation's stock is helpless unless he knows of the conflict of interest and has access to sufficient facts to make a valid judgment.¹³⁷ Therefore, in self-dealing transactions, it does not appear unreasonable that the courts may react by being more inclined toward negligence as the proper standard of actionable conduct.¹³⁸

The court may also consider the nature of the transaction and the degree to which the parties have participated. Those persons who actively participate in or initiate the transaction may be held to a higher standard than those who do not.¹³⁹

Finally, the decision of the court may be influenced by the number of plaintiffs and the question of damages. The result in a case involving a relatively small number of plaintiffs may well be quite different from that in an action brought on behalf of numerous purchasers or sellers.¹⁴⁰ The amount of damages in the former situation is relatively finite. On the other hand, damages in the latter situation might well be millions of dollars.¹⁴¹ When faced with such enormous potential payments, the brunt of which would be borne by the innocent shareholders of the defendant corporation, the courts may proceed more slowly.¹⁴²

In weighing the factual situation of the case, the majority in *Lanza v. Drexel & Co.* considered and emphasized four major facts: (1) the nature of the cause of action, (2) Coleman's position, (3) Coleman's lack of participation in the transaction, and (4) his lack of knowledge. Other facts which could have been taken into account, such as the expertise of the parties, their relationship and their economic self-interest, were never really considered by the court. It appears that Coleman's complete lack of contact with the plaintiffs and his complete lack of awareness of the deception were conclusive in the opinion of the court.

The majority was very careful to point out that *Lanza* involved a private cause of action, noting early in the opinion that the action involved was one for compensatory and punitive damages.¹⁴³ This stress was apparently placed upon the nature of the cause of action because the plaintiffs were urging the imposition of liability on Coleman for negligence, relying heavily on *Texas Gulf Sulphur* as precedent.¹⁴⁴ By stressing that *Lanza* involved a private cause of

¹³⁶ See *Chasins v. Smith, Barney & Co.*, 438 F.2d 1167, 1172 (2d Cir. 1970); Mann, *supra* note 132, at 1210.

¹³⁷ See, e.g., *Kohn v. American Metal Climax, Inc.*, 458 F.2d 255, 287 (3d Cir. 1972).

¹³⁸ *Id.*

¹³⁹ Mann, *supra* note 132, at 1219.

¹⁴⁰ See *Kohn*, 458 F.2d at 286.

¹⁴¹ *Id.*

¹⁴² *Id.*

¹⁴³ 479 F.2d at 1280.

¹⁴⁴ *Id.* at 1304.

action, the majority was able successfully to distinguish *Texas Gulf Sulphur* on the ground that the latter case did not involve a private cause of action, but was an SEC enforcement suit for injunctive relief.¹⁴⁵

Secondly, the *Lanza* court placed great emphasis on Coleman's position. In setting out the facts of the case the court described in detail the nature of Coleman's relationship with BarChris. He was an independent director, placed on the BarChris board as a representative of Drexel & Co. to protect Drexel's financial interest by overseeing the activities of BarChris.¹⁴⁶ The court stressed that, as a director, Coleman's role was to supervise the performance of management.¹⁴⁷ The majority observed that corporate directors are not involved in the day-to-day conduct of the company's affairs.¹⁴⁸ It reasoned that since an important aspect of the supervisory role of a director is trust in the integrity and competence of management,¹⁴⁹ the imposition of liability on directors in a fact situation such as that in *Lanza* would make them insurers of all corporate activities.¹⁵⁰ As a result, they would be forced to personally verify all that the corporate officers had done.¹⁵¹

Thus, Coleman's position as an independent director of BarChris was important to the decision of the court. Yet, on this critical point, the court appeared to be inviting confusion. Coleman was an independent or outside director, *i.e.*, a director who is not a full-time employee of the corporation.¹⁵² However, the court throughout its opinion alternately referred to Coleman as an independent director and as a director. In setting forth its conclusion, for example, the court referred to Coleman as a director.¹⁵³ As a result, the court left some doubt as to whether it was treating Coleman as a director—and therefore speaking of all directors—or whether it was referring only to independent directors. Three factors seem to indicate that the court was addressing itself to independent directors: first, Coleman was in fact an independent director, and to extend the holding of *Lanza* to all directors would go beyond the facts of the case; second, the court used the fact that Coleman was an independent director to support its conclusion with respect to Coleman's knowledge;¹⁵⁴ and finally, the court used the value of independent directors as a policy argument to support its decision.¹⁵⁵

¹⁴⁵ *Id.*

¹⁴⁶ *Id.* at 1282.

¹⁴⁷ *Id.* at 1306.

¹⁴⁸ *Id.*

¹⁴⁹ *Id.*

¹⁵⁰ *Id.* at 1281, 1302.

¹⁵¹ *Id.* at 1307.

¹⁵² Bishop, *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 *Yale L.J.* 1078, 1092 (1968).

¹⁵³ 479 F.2d at 1289, 1309.

¹⁵⁴ See text at note 165 *infra*.

¹⁵⁵ 479 F.2d at 1306-07.

A further fact emphasized by the *Lanza* majority in weighing the facts of the case was Coleman's lack of participation in the negotiations leading up to the Victor-BarChris transaction and in the transaction itself. At the beginning of its opinion, the court set out "in detail" the evidence regarding Coleman's lack of participation,¹⁵⁶ and stressed this fact throughout. Coleman did not participate in the negotiations, nor did he communicate any information to the Lanzas or contact them in any way. Because the transaction had been approved at a prior board meeting at which he was not present, the only contact Coleman had with the entire transaction was his presence at the board meeting when the final contract was approved.¹⁵⁷

Inseparably linked to Coleman's lack of participation was his lack of knowledge. Here again, the court set out this evidence "in detail" and stressed the fact throughout the opinion.¹⁵⁸ Not only did Coleman not participate in the deception, but he was completely unaware that the plaintiffs had been deceived.¹⁵⁹ The importance placed on this lack of participation and knowledge on Coleman's part is evidenced by the following statement of the court:

We recognize that *participation* by a director in the dissemination of false information reasonably calculated to influence the investing public may subject such a director to liability under the Rule. But it is quite a different matter to hold a director liable in damages for failing to insure that all material, adverse information is conveyed to prospective purchasers of the company's stock absent substantial participation in the concealment or knowledge of it. Absent knowledge or substantial participation we have refused to impose such affirmative duties of disclosure upon Rule 10b-5 defendants.¹⁶⁰

While these words substantiate the importance which the court placed on Coleman's lack of participation and knowledge, they also raise several questions. First, was it really critical to the decision of the court that Coleman was an independent director, or even a director at all? The opinion could be read as saying that no one—regardless of his position in the corporation—will be held liable where he lacks knowledge and has not participated in the transaction. It appears that knowledgeable participation by a director would expose him to liability. Is participation in the transaction sufficient without knowledge of the deception? Conversely, is knowledge without participation sufficient? Given what the court said about independent directors, do the same standards apply to

¹⁵⁶ Id. at 1281, 1283-84.

¹⁵⁷ Id. at 1283-84.

¹⁵⁸ Id. at 1281, 1284-88.

¹⁵⁹ Id. at 1288.

¹⁶⁰ Id. at 1302 (emphasis in original).

officers? These are questions which can best be answered after variations on the instant facts have been presented to the courts. However, it cannot be overlooked that participation and knowledge are two facts which the *Lanza* court considered to be central.

The majority also focused on another aspect of Coleman's knowledge—his awareness of the financial condition of BarChris. Coleman was apparently aware of many disquieting facts about BarChris.¹⁶¹ It was argued by the plaintiffs that it was inexcusable for Coleman not to have inquired as to whether or not the financial status of BarChris had been fully and accurately disclosed to the prospective buyers, and it was suggested that if Coleman had inquired, he would have discovered the fraud.¹⁶² Relying on *Texas Gulf Sulphur*, Judge Hays' dissent in *Lanza* urged that liability should be imposed upon Coleman for his negligent failure to discover that misrepresentations had been made by the BarChris officers.¹⁶³ The majority, however, disagreed, holding that "a willful or reckless disregard for the truth" is necessary to establish liability.¹⁶⁴ In finding that Coleman did not show such a reckless disregard for the truth, the court stated that Coleman, "displaying an attitude not ordinarily found in outside directors, . . . played an active and concerned role in BarChris's affairs."¹⁶⁵

In sum, after considering the facts which the court in *Lanza* emphasized and considered important, the holding of the case, limited to its facts, is that in a private action under Rule 10b-5, an independent director of the issuing corporation will not be held liable to the purchasers of the corporation's stock when he neither participates in nor knows of the deceit.

C. *Consideration of the Law Upon Which the Court Bases Its Decision*

The third step in approaching Rule 10b-5 cases involves analyzing the law upon which the particular court has based its decision. In 10b-5 cases, the courts have relied on (1) the language of section 10(b) and Rule 10b-5, and the intent of Congress and the SEC in adopting and promulgating these provisions; and (2) case law precedent.

An analysis of the rationale of a court concerning the language of, and legislative history behind, section 10(b) is fraught with difficulty. As noted above,¹⁶⁶ because a private cause of action was not expressly provided for in section 10(b),¹⁶⁷ and because of a

¹⁶¹ *Id.* at 1304.

¹⁶² *Id.*

¹⁶³ *Id.* at 1319 (dissenting opinion).

¹⁶⁴ *Id.* at 1306.

¹⁶⁵ *Id.*

¹⁶⁶ See text at note 74 *supra*.

¹⁶⁷ 2 A. Bromberg, *Securities Law* § 8.4(505), at 204.106 (1973).

dearth of congressional guidance,¹⁶⁸ a court can only infer the scope of coverage of section 10(b) and Rule 10b-5.¹⁶⁹ It is therefore not possible to do more than to analyze the inferences which a court has drawn. Solid arguments have been marshalled to support two major interpretations of the scope of section 10(b): (1) that the legislation is to be interpreted as remedial, expansive, and not confined to common law boundaries extant before 1933;¹⁷⁰ and (2) that the legislation was passed against the background of the common law, and was, for all intents and purposes, a codification of that law.¹⁷¹ Neither view can really be proved correct or incorrect.

If the court finds that its decision is warranted by the case law, the accuracy of the court's perception of the cases upon which it relies must be scrutinized. Has the court used decisions from other circuits which are contrary to the case law development in its own circuit? Does the court adopt the language of a prior court without the meaning which the prior court attached to it? Most importantly, is the court relying on dicta from the cases which it cites?

The court in *Lanza v. Drexel & Co.* based its decision on both legislative intent and case law precedent. The state of the common law in 1933 regarding director liability was the starting point for the majority. The court stated that, at common law, directors did not have a duty to convey material, adverse information to purchasers of stock.¹⁷² It is not argued that the *Lanza* court incorrectly stated the common law rule, but it seems clear that insufficient weight was given by the court to several developments in the common law duty of directors which were in progress in the early 1930's.

To illustrate the American common law view of director liability, the *Lanza* court cited *Barnes v. Andrews*,¹⁷³ an action by a receiver in bankruptcy against a director of a corporation. When the corporation went bankrupt, the plaintiff sought to hold Andrews liable for his inattention and laxity because he had only attended one director's meeting and had never questioned the solvency or the operations of the company. Additionally, the plaintiff asserted that Andrews was liable for the misrepresentations contained in a fraudulent circular issued by the company. However, the *Barnes* court refused to hold him responsible for supervising the preparation of the circular.

The *Lanza* court, in considering *Barnes*, stressed the refusal of that court to hold a director liable for supervision of a specific detail, such as a circular,¹⁷⁴ but ignored the conclusion of the *Barnes* court that a director has a general duty to investigate major developments

¹⁶⁸ 1 A. Bromberg, *supra* note 167, § 2.2(331), at 22.2-3.

¹⁶⁹ 2 A. Bromberg, *supra* note 167, § 8.4(505), at 204.106.

¹⁷⁰ See 1 A. Bromberg, *supra* note 167, § 2.7, at 55 & n.150.

¹⁷¹ See Hill, *The Sale of Controlling Shares*, 70 Harv. L. Rev. 986, 1016 n.101 (1957).

¹⁷² 479 F.2d at 1291.

¹⁷³ 298 F. 614 (S.D.N.Y. 1924).

¹⁷⁴ 479 F.2d at 1292.

within the corporation.¹⁷⁵ In analogizing the facts of the *Lanza* case to those of *Barnes*, it seems that the court incorrectly compared the acquisition of Victor by BarChris to a specific detail in the day-to-day operation of the corporation. In fact, the acquisition was more like the major corporate development which *Barnes* held the director had a duty to investigate.¹⁷⁶

The *Lanza* court's discussion of the common law raises as many questions as it purports to settle. If Congress approved of the common law status of director liability and securities law operation in general, what was the purpose of the securities legislation in 1933 and 1934? The court stated that the common law is important in understanding section 10(b) because it provided the backdrop for the securities legislation, and because director's duties were still controlled, for the most part, by state law.¹⁷⁷ It seems inconceivable that Congress would have enacted this legislation merely to codify, federalize and thereby make uniform an otherwise satisfactory common law. It seems far more likely that the securities legislation was designed to improve upon the common law,¹⁷⁸ particularly to supplement the inadequacies of the common law remedies, thereby affording greater protection to the public.¹⁷⁹ The establishment of the Pecora Committee¹⁸⁰ is evidence that Congress believed that the common law did not eliminate manipulation and deception and was therefore inadequate. This special Senate committee was constituted to investigate the possible connection between the abuses of the public trust by corporate directors and securities dealers and the economic chaos in the country at the time.¹⁸¹ Yet the *Lanza* court minimized the impact of the Pecora Committee's hearings on the passage of the securities laws.¹⁸²

Even if it were to be assumed, however, that the Securities Act of 1933 (the 1933 Act) and the Securities Exchange Act of 1934 (the 1934 Act) were a codification of the common law, another question presents itself. It could hardly have been intended by the Congress that investors, or others to be protected by the securities legislation,

¹⁷⁵ 298 F. at 616.

¹⁷⁶ Judge Hays, in his dissenting opinion in *Lanza*, asserted that Coleman did have a duty to keep himself adequately informed with regard to the activities of the corporation. 479 F.2d at 1318 (dissenting opinion).

¹⁷⁷ 479 F.2d at 1291.

¹⁷⁸ See *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963).

¹⁷⁹ See *Hooper v. Mountain States Sec. Corp.*, 282 F.2d 195, 201 (5th Cir. 1960), cert. denied, 365 U.S. 814 (1961).

¹⁸⁰ Senate Comm. on Banking & Currency, Stock Exchange Practices, S. Rep. No. 1455, 73d Cong., 2d Sess. 1 (1934). See 479 F.2d at 1290. The Pecora Committee is the name given to the Senate investigation of stock market practices and personnel involved in the stock market crash and subsequent economic chaos in the 1929-1934 period.

¹⁸¹ Senate Comm. on Banking & Currency, Stock Exchange Practices, S. Rep. No. 1455, 73d Cong., 2d Sess. 393 (1934).

¹⁸² The common law regulated the securities field prior to 1933. The Pecora Committee hearings demonstrated how ineffective that regulation was. Yet in the *Lanza* court's determination the securities acts were merely a codification of the common law. 479 F.2d at 1299.

sacrificed possible future protection for a codification of existing law. Yet, there was an unspoken, underlying assumption in the *Lanza* opinion that the common law view prior to the adoption of the securities laws of 1933 and 1934 was still applicable.¹⁸³

In order to lend weight to its assertion that Congress did not intend to replace the common law standard of fraud with an absolute liability standard in enacting section 10(b), the *Lanza* court made several points based on inferences from other sections of the 1933 and 1934 securities legislation. Sections 11¹⁸⁴ and 12¹⁸⁵ of the Securities Act of 1933 impose civil liability upon corporate directors for misleading or inaccurate disclosures of material facts in the registration statement or prospectus required under the Act. In addition, the 1933 Act, as originally enacted, provided for absolute liability under section 15¹⁸⁶ for "control persons," that is, controlling shareholders who controlled a director, if the person being controlled was guilty of a violation of section 11 or 12. After a year in operation, substantial opposition to this feature developed.¹⁸⁷ As a result, Congress amended section 15 in 1934, adding the clause "unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist."¹⁸⁸ An analogous situation exists with regard to section 20 of the 1934 Act,¹⁸⁹ which imposes liability on control persons for violations, by controlled persons, of other sections of the Act. It limits liability, as does the amended section 15, to those control persons not acting in good faith or who induced the acts of the controlled persons. The *Lanza* court reasoned that it is inconsistent to think that Congress intended to provide for absolute liability under section 10(b) when it was diligently excising it from section 15 of the 1933 Act and section 20 of the 1934 Act.¹⁹⁰

This inference, although appealing, is not as helpful as it at first seems to be. The *Lanza* case is concerned with the individual actions or non-actions of Coleman, a director. A statute which relieves a principal of liability for the intentional torts of his agent could not be said to create an inference that the legislature intended to relieve the principal of liability for his own intentional torts.

The *Lanza* court noted that section 11 of the Securities Act of 1933, which imposes liability upon directors for false registration statements, does not contain an absolute liability provision.¹⁹¹ It is

¹⁸³ Id. at 1291, 1298.

¹⁸⁴ 15 U.S.C. § 77k (1970).

¹⁸⁵ 15 U.S.C. § 77l (1970).

¹⁸⁶ Act of May 27, 1933, ch. 38, § 15, 48 Stat. 74.

¹⁸⁷ See 479 F.2d at 1298 n.60.

¹⁸⁸ 15 U.S.C. § 77o (1970), amending, Securities Exchange Act of 1934, ch. 404, § 208, 48 Stat. 908.

¹⁸⁹ 15 U.S.C. § 78t (1970).

¹⁹⁰ 479 F.2d at 1299.

¹⁹¹ Id. at 1294-96. The precise issue of absolute liability for directors under § 11 was

ironic that the court devoted a considerable portion of its opinion to the proposition that legislative intent as to director liability could be inferred from the history of section 11, since Coleman had already been held liable under section 11 in an earlier action¹⁹² involving his activities on the BarChris board of directors. The court's argument could help Coleman's position only if it is shown that the standard of conduct under 10(b) was intended to be lower than that of section 11.

Perhaps it is for this reason that the court made the argument that the Lanzas could not have brought an action under either section 11 or 12 of the 1933 Act. The court stated that a suit under section 11 was not possible because the securities were not registered.¹⁹³ It also stated that a suit under section 12 was not possible because that section requires privity or scienter,¹⁹⁴ and Coleman was found by the district court not to have participated in the negotiations with the Lanzas or to have known about the misleading statements being given to them.¹⁹⁵ The court therefore concluded that, in passing section 10(b), Congress could not have intended to impose upon directors a duty to convey material adverse information, since the imposition of such a duty would negate the protection afforded directors under the private offering exemption of section 11 and the stricter privity standards of section 12.

The Lanzas were defrauded in an exchange of securities,¹⁹⁶ and the court stated that they could not recover against Coleman and Drexel under section 11, 12, 15 or 20.¹⁹⁷ Thus, it seems clear that if the plaintiffs were going to recover for fraud, that recovery would have to be granted under section 10(b) and Rule 10b-5,¹⁹⁸ and the *Lanza* court would have to interpret 10(b) broadly enough to encompass such a cause of action.

The court suggested that the proper scope of section 10(b) can be gauged by analyzing the legislative intent at the time of passage and the common law which was the basis for the legislation.¹⁹⁹

debated and subsequently discarded by Congress. See H.R. Rep. No. 152, 73d Cong., 1st Sess. 26 (1933). The Senate version included absolute liability, but the House was in favor of allowing a due diligence defense. *Id.* The House version was adopted and the firsthand accounts by Landis of the decision to allow a "goodly measure" of reliance seem conclusive. See Landis, *The Legislative History of the Securities Act of 1933*, 28 Geo. Wash. L. Rev. 29, 47-48 (1959). However, it is important to note that a significant sentiment did exist to the effect that absolute liability was the best weapon to combat future securities abuses. See S. Rep. No. 47, 73d Cong., 1st Sess. 4-5 (1933).

The *Lanza* court can fairly be said to have endorsed the House version as the more reasonable and palatable approach to regulation. See 479 F.2d at 1309.

¹⁹² *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968).

¹⁹³ 479 F.2d at 1298.

¹⁹⁴ *Id.*

¹⁹⁵ *Id.* at 1289.

¹⁹⁶ *Id.* at 1280.

¹⁹⁷ *Id.* at 1298.

¹⁹⁸ See 1 A. Bromberg, *supra* note 176, § 2.2(332), at 22.4.

¹⁹⁹ 479 F.2d at 1291.

Upon completion of its analysis of the congressional intent and common law, the court concluded that there was no basis in either for a duty to convey under 10b-5,²⁰⁰ and moved to a consideration of whether prior 10b-5 cases had construed the language of the statute so as to create such a basis.

The *Lanza* court asserted that a careful reading of *Texas Gulf Sulphur*, with its concurring, but limiting, opinions, clearly shows that the negligence standard is sufficient only in a suit for injunctive relief.²⁰¹ The court went further to say that any doubt as to whether the issue of scienter was still open in the Second Circuit was ended by the decision in *Shemtob v. Shearson, Hammill & Co.*²⁰² *Shemtob* was cited by the court as holding that negligence is not sufficient to impose liability in a suit for damages under 10b-5.²⁰³ However, the case was an appeal of a dismissal on the basis that the plaintiffs failed to allege any more than a breach of contract, and is more correctly characterized by the dissent in *Lanza*: "[W]hile stating in dictum that 'it is insufficient to allege mere negligence,' [the *Shemtob* court] actually held only that the complaint failed to state a claim for relief under 10b-5 on the ground that the suit was a 'garden-variety customer's suit against a broker for breach of contract . . .'"²⁰⁴

Much of the confusion in the 10b-5 area results from the use of dicta to substantiate a particular point of view.²⁰⁵ Most language in the cases indicating the sufficiency of negligence for a cause of action under 10b-5 has been dictum in fact situations in which the defendants were guilty of conduct amounting to scienter.²⁰⁶ The *Lanza* court acknowledged this fact,²⁰⁷ but unfortunately seems to be guilty of the same type of dicta search to establish that negligence is not sufficient for 10b-5 liability. In *Levine v. SEC*,²⁰⁸ the revocation of a broker-dealer's registration was affirmed because the court found that the broker-dealer had actual knowledge of misrepresentations to purchasers of stock. Such actual knowledge amounted to scienter. The *Lanza* court, however, cited only the following section of the *Levine* court's decision:

Of course, absent actual knowledge or warning signals, a broker-dealer should not be under a duty to retain his own auditor to re-examine the books of every company, the stock of which he may offer for sale, even accepting the doubtful hypotheses that such permission would be granted.²⁰⁹

²⁰⁰ Id. at 1291, 1299.

²⁰¹ Id. at 1304.

²⁰² 448 F.2d 442 (2d Cir. 1971). See 479 F.2d at 1304.

²⁰³ 479 F.2d at 1304-05.

²⁰⁴ Id. at 1319 (dissenting opinion).

²⁰⁵ See text at notes 77-81 *supra*.

²⁰⁶ Bucklo, *Scienter and Rule 10b-5*, 67 Nw. U.L. Rev. 562, 590 (1972).

²⁰⁷ 479 F.2d at 1305.

²⁰⁸ 436 F.2d 88 (2d Cir. 1971).

²⁰⁹ Id. at 90, quoted in *Lanza*, 479 F.2d at 1302.

In citing *SEC v. Great American Industries, Inc.*,²¹⁰ the *Lanza* court stated that the court had specifically declined to consider whether liability could occur if the defendants neither knew nor had reason to know.²¹¹ However, this was a case which involved a denial of an injunction and the parties were guilty of more than mere negligence.

The court also cited a case decided by the Ninth Circuit, *Wessel v. Buhler*.²¹² In *Wessel*, the plaintiffs claimed that an independent accountant who audited a corporation engaging in a stock issue was under a duty to disclose any adverse financial information which he discovered. The Ninth Circuit rejected this "extraordinary theory of Rule 10b-5 liability."²¹³ The *Lanza* court used this case as an illustration "of the distance we would travel were we to agree with plaintiffs that Rule 10b-5 imposes upon directors a duty to convey."²¹⁴ However, it is not clear how the exclusion of a private accountant from 10b-5 coverage bears on the question whether a director in Coleman's position had a duty to convey information. Vagueness as to coverage on the fringes of a statute is not exculpatory for a party whose conduct was more clearly within the required prohibition.²¹⁵

The *Lanza* court concluded that a survey of the case law development of 10b-5, dicta to the contrary notwithstanding, indicates that an intent to defraud or a willful and reckless disregard for the truth is required in a private right of action for damages under 10b-5.²¹⁶

This intensive analysis by the *Lanza* court of the legislative history and the case law development was presented in the initial sections of the majority opinion. It seems clear that the court was attempting to lay to rest the controversy which has surrounded the debate over congressional intent and the case law precedent for a particular purpose. The court was attempting to demonstrate that its opinion does not represent a sudden break with history and precedent, but rather that both solidly underpin the court's decision to require some form of scienter. The establishment of this underpinning of common law and legislative intent permitted the court to consider the fourth and final step in approaching the 10b-5 case—that is, consideration of the policies and purposes behind the rule and their interaction with the realities of the business world.²¹⁷ While the policies of public interest and investor protection, specifically set forth in section 10(b) of the 1934 Act,²¹⁸ appear far

²¹⁰ 407 F.2d 453 (2d Cir. 1968) (en banc), cert. denied, 395 U.S. 920 (1969).

²¹¹ 479 F.2d at 1302.

²¹² 437 F.2d 279 (9th Cir. 1971), cited in *Lanza*, 479 F.2d at 1300.

²¹³ 437 F.2d at 283.

²¹⁴ 479 F.2d at 1300.

²¹⁵ *Broadrick v. Oklahoma*, 413 U.S. 601, 608, 610 (1973).

²¹⁶ 479 F.2d at 1306.

²¹⁷ See *Kohn v. American Metal Climax, Inc.*, 458 F.2d 255, 287 (3d Cir. 1972).

²¹⁸ 15 U.S.C. § 78j(b) (1970).

too general to be of any real assistance to the courts,²¹⁹ there are numerous other policy considerations to which a court may direct its attention.

D. *Public Policy Arguments Employed by the Court*

The first consideration is that the injury to the plaintiff is the same regardless of whether the defendant's conduct was negligent or willful.²²⁰ A court may also consider the effect of its decision on the flow of information to the public regarding securities, giving attention to the quality as well as the quantity of such information.²²¹ The more difficult it is to establish liability, the more information investors will have. However, with a freer flow of information, quality and accuracy may suffer.²²² The easier it is to establish liability, the more careful will be the representations, and presumably, the higher the quality of information released.²²³ However, the rule may then become, "when in doubt, say as little as possible."²²⁴

A court may consider whether the expectation of full disclosure in an exchange transaction is warranted, given common business practice.²²⁵ Corporations continuously issue news releases, proxy statements, financial and numerous other reports, the subject matter of which is generally quite complex. Because of this complexity, these documents sometimes contain mistakes. The predication of liability on such error, even though the information was issued in good faith, would make these corporations insurers. Such a policy could controvert the disclosure policies of the securities laws by making corporations hesitant to issue any information.²²⁶

Deterrence is one of the common policies which the courts have considered in fashioning 10b-5 liability.²²⁷ Here a court is faced with the problem of how much deterrence can actually be accomplished by changes in the scienter requirement. Another policy which a court might consider is the promotion of uniform enforcement of the securities laws across the country.²²⁸ A final set of important policies and values are the pro-business or pro-minority stockholder viewpoints of various judges.²²⁹ In sum, it would not be unfair to say that the courts of appeals interpret the vague language of section

²¹⁹ 2 A. Bromberg, *Securities Law* § 8.4(508), at 204.114-115 (1973).

²²⁰ *Id.* at 204.111-112.

²²¹ Epstein, *The Scienter Requirement in Actions Under Rule 10b-5*, 48 N.C.L. Rev. 482, 503-04 (1970).

²²² *Id.*

²²³ *Id.*

²²⁴ See *Kohn*, 458 F.2d at 287.

²²⁵ *Id.*

²²⁶ *Id.*

²²⁷ See 2 A. Bromberg, *supra* note 219, § 8.4(508), at 204.114.

²²⁸ See *id.* at 204.115; Comment, *Negligent Misrepresentations Under Rule 10b-5*, 32 U. Chi. L. Rev. 824, 832 n.36 (1965).

²²⁹ See 2 A. Bromberg, *supra* note 219, § 8.4(508), at 204.115.

10(b) and Rule 10b-5 according to their own individual concepts of corporate responsibility.

Though it had the opportunity to utilize any of these policy considerations to support its rationale that directors do not have a duty to disclose material adverse information, the majority in *Lanza* focused primarily on two policy arguments. First, the court reasoned that independent or outside directors are desirable in corporations, that the imposition of a low threshold of liability would discourage individuals of ability and integrity from taking these positions, and therefore that sound public policy supported its decision not to impose a standard of negligence.²³⁰

The *Lanza* opinion is open to criticism with regard to this policy argument. First, while the court placed great emphasis on the value of independent directors to corporations, it failed to realize that there are not substantial differences between inside and outside directors in terms of their duties as directors.²³¹ Secondly, Coleman was actually aware of many disquieting facts concerning the financial condition of BarChris,²³² but the court refused to impose liability on Coleman for nondisclosure.²³³ It supported its decision on the basis that imposition of a duty to disclose would have forced directors to personally verify information given to them by corporate officers and independent accountants.²³⁴ On the facts of *Lanza*, the court overstated the effect of a disclosure duty on directors. Plaintiffs were not actually seeking the imposition upon directors of a duty to seek out information not available to them, but merely to convey the information, material to the transaction, which directors already possessed in their capacity as directors.

The second policy argument which the court used focused on the "agonizingly subtle" choices which face directors concerning disclosure.²³⁵ It is apparent that no purpose would be served by requiring directors to disclose to the investing public every instance of dissension or disagreement among members of the board.²³⁶ Directors can reasonably be expected to differ over the general economic outlook or the corporation's prospects for a good or bad year. Personality clashes may develop between members of the board. Disclosure of such facts would be of little or no benefit to investors, and would have disruptive, if not disastrous, effects on the corporation. Although, it would be unreasonable to suggest that a director act as a tabloid for board room dissension or as a conduit for predictions of doom, this can be distinguished from the situation

²³⁰ 479 F.2d at 1306-07.

²³¹ D. Vagts, Basic Corporation Law 202 (1973).

²³² 479 F.2d at 1288-89.

²³³ Id. at 1281, 1289.

²³⁴ Id. at 1307.

²³⁵ Id. at 1307-09.

²³⁶ Id.

where the director has knowledge that the corporation is in fact experiencing serious financial difficulties. In the latter case such information should be disclosed to investors.

The "agonizingly subtle" choices on disclosure fall between these two extremes. As the *Lanza* court notes, grave consequences can beset the director who makes the wrong choice.²³⁷ Such disclosure by a director could subject him to corporate criticism, adversely affect his position on the board, and possibly result in his dismissal. Most important, as the court notes, is the fact that such disclosure could misrepresent the actual situation of the corporation.²³⁸ In such a case the director could be found liable to both the corporation and the investors.

Yet the *Lanza* majority overstated the effect of the imposition of a duty to disclose in the instant case. The court maintained that if such a duty to disclose were imposed, Coleman would be forced to hold himself out as "a prophet or a modern Cassandra."²³⁹ However, it is submitted that even if a negligence standard had been adopted by the court, Coleman's failure to predict the effects of dissension among the directors and some temporary business setbacks on the future of BarChris would not have constituted negligent conduct on his part.

To the extent that a director has a duty to disclose, this duty does not include the prediction of the future stability of the corporation with its attendant consequences should he be wrong. Yet it does include the duty, particularly in a major corporate transaction, to investigate facts which potentially constitute material adverse information and to disclose such material adverse information to the investing public.

There is one remaining policy comment. In the course of its opinion the court quotes a 1932 law review article to the effect that:

Commercial ethics have improved but it is doubtful whether during the lifetime of any man now living they will reach a peak of perfection which requires those who play the commercial or financial game to lay their cards face upward on the table.²⁴⁰

Since that article was written, society has seen corporations grow even larger and more remote, removed from any control by the stockholders that supposedly own and control them.²⁴¹ The public has also seen illegal campaign contributions, bribes and questionable corporate policies become not infrequent corporate practices in the search for profit. In this context, it would have been refreshing, and

²³⁷ Id. at 1307-08.

²³⁸ Id. at 1308.

²³⁹ Id.

²⁴⁰ Bohlen, Should Negligent Misrepresentations Be Treated as Negligence or Fraud?, 18 Va. L. Rev. 703, 707 (1932), quoted in *Lanza*, 479 F.2d at 1293 n.43.

²⁴¹ See D. Vagts, *supra* note 231, at 14.

perhaps novel, to see the encouragement of honesty and openness on the part of corporate officials by the *Lanza* court. It seems clear that the business world will not sua sponte change its procedures. Yet, the court took a step backward by encouraging or protecting Coleman's apparent lack of concern for those dealing with the corporation.

CONCLUSION

Lanza is a detailed and lengthy opinion which the court hoped would do more than settle the case at hand. The Second Circuit, realizing the importance of its pronouncements in the securities field, has attempted to outline definitively the scope of Rule 10b-5. However, decisions in this area have long been result-oriented, and in all likelihood, *Lanza* will not affect this situation. Despite its attempt to define more clearly the contours of 10b-5 and to settle the scienter controversy in private actions, *Lanza* is not a *Miranda*²⁴² decision in the securities field. If these contours continue to remain vague, perhaps it is for Congress to mark them with greater clarity.

JAMES R. MCGUIRK
PETER E. MOLL

²⁴² *Miranda v. Arizona*, 384 U.S. 436 (1966).