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NOTES & COMMENTS

THE DEVELOPMENT OF A FLEXIBLE DUTY STANDARD OF LIABILITY UNDER SEC RULE 10b-5

Rule 10b-5[1] is the Securities and Exchange Commission's broadest prohibition against manipulative and deceptive practices in securities transactions. The rule generally prohibits fraudulent practices, but more specifically it makes unlawful false statements or omissions of material facts in connection with the purchase or sale of a security. Unlike some sections of the securities laws,[2] Rule 10b-5 does not grant private parties a cause of action. Courts recognized a private right of action under the rule shortly after its adoption,[3] how-

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[1]Enacted pursuant to statutory authority granted in § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1970), Rule 10b-5 provides:

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

17 C.F.R. § 240.10b-5 (1973).

[2]The Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1970), provides two specific civil actions. Section 11, 15 U.S.C. § 77k (1970), imposes almost absolute liability on persons connected with the drafting and filing of a false registration statement. Defenses are limited in a § 11 action, and the plaintiff must not have known of the omission or untruth of the statement and may be required to post a bond for costs of the suit. Damages are limited to the actual cost of the securities issued, and there is a relatively short statute of limitations. Section 12, 15 U.S.C. § 77*l* (1970), allows a private action for false statements in a stock prospectus. The defendant has the burden of proof to demonstrate that he did not know or could not have known by exercise of due diligence the falsity of the statements made. The plaintiff must lack knowledge of the falsity of the statement in the prospectus, may recover only the consideration paid and interest, and is subject to a short statute of limitations. The Securities Exchange Act confers a private right of action only in § 18, 15 U.S.C. § 78r (1970), for misleading statements in reports, applications or documents filed pursuant to the act, rules or regulations. *See generally* 1 A. BROMBERG, SECURITIES LAW: FRAUD, RULE 10b-5, §§ 2.1, 2.3 (1973) [hereinafter cited as BROMBERG].

[3]A private right of action under Rule 10b-5 was not granted until five years after the rule was adopted. Kardon v. National Gypsum Co., 73 F. Supp. 798 (E.D. Pa. 1947).

ever, acknowledging that private suits were necessary to enforce the rule and effectuate the broad purposes of the securities laws.[4]

In an attempt to limit the judicially created private action under Rule 10b-5, courts formulated certain elements, proof of which was necessary for recovery by a private plaintiff. These elements included a connection with the purchase or sale of a security,[5] materiality,[6] privity,[7] causation, reliance,[8] damages and scienter.[9] The judicial

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[4]Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 241 n.18 (2d Cir. 1974). *Cf.* J. I. Case Co. v. Borak, 377 U.S. 426, 432 (1964) (private enforcement of proxy rules provides a necessary supplement to SEC action).

[5]The requirement of some "connection with the purchase or sale of any security," found in the text of the rule, has been liberally construed by the courts. The Second Circuit has interpreted "connection" to mean that the manipulative or deceptive device employed be of the nature that would cause reasonable investors to rely on it and, in connection with the device, so relying, cause them to purchase or sell a corporation's securities. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 860 (2d Cir. 1968), *cert. denied,* 394 U.S. 976 (1969). *See also* Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 239-40 (2d Cir. 1974); 2 BROMBERG, § 7.6. A strict definition of the terms "purchase or sale" was first established in Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir.), *cert. denied,* 343 U.S. 956 (1952). The *Birnbaum* Rule has been extensively criticized for its restrictive limitations on standing to sue under Rule 10b-5, and has been substantially diluted by the courts. *See, e.g.,* Vine v. Beneficial Fin. Co., 374 F.2d 627 (2d Cir.), *cert. denied,* 389 U.S. 970 (1967) (standing granted to plaintiff who was not an actual seller, but who became a forced seller as a result of a merger). Some courts have rejected the *Birnbaum* Rule outright. Eason v. GMAC, 490 F.2d 654 (7th Cir. 1973), *cert. denied,* 416 U.S. 960 (1974). *See* Note, *The Birnbaum Rule Rejected: Will Analysis of Right to Bring Private Actions Under § 10(b) Be Simplified?,* 31 WASH. & LEE L. REV. 757 (1974).

[6]Rule 10b-5(b) prohibits misrepresentations or omissions of material facts. Material facts are generally defined as facts which would affect a reasonable investor's decision to purchase or sell securities. *See* Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-54 (1972) (facts are material in that a reasonable investor might have considered them important); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968), *cert. denied,* 394 U.S. 976 (1969) (facts such as a reasonable investor would rely on in purchasing or selling securities).

[7]Some "semblance of privity" between the plaintiff and defendant was first required in Joseph v. Farnsworth Radio & Television Corp., 99 F. Supp. 701, 706 (S.D.N.Y. 1951), *aff'd,* 198 F.2d 883 (2d Cir. 1952). Presumably the reference is to privity of contract between plaintiff and defendant. 2 BROMBERG § 8.5(511) at 207. This requirement has now been generally rejected by courts. *See, e.g.,* Sargent v. Genesco, Inc., 492 F.2d 750, 759-60 (5th Cir. 1974); Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90, 101 (10th Cir.), *cert. denied,* 404 U.S. 1004 (1971). The practical effect of not requiring privity is to allow purchasers or sellers on national securities markets to sue violators of the rule without demonstrating face-to-face contact. *See, e.g.,* Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 353 F. Supp. 264 (S.D.N.Y. 1972), *aff'd,* 495 F.2d 228 (2d Cir. 1974).

[8]The text of Rule 10b-5 does not require causation or reliance for recovery. Courts frequently state that a showing of causation is necessary, *see* Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 353 F. Supp. 264, 274 (S.D.N.Y. 1972), and cases cited

development of these elements has led to a gradual dilution of their limiting effect,[10] and the elimination of some elements altogether.[11] In the case of all but scienter, nearly uniform application among the circuit courts has resulted.[12] Scienter, unlike the other elements, has not been uniformly defined. While all courts have rejected the strict common law definition of scienter, they have differed in their interpretation of the precise state of mind requirement for liability.[13] Some courts have held negligence sufficient, while others have required more than negligent conduct.

In addition to the scienter conflict, the relaxed requirements for granting recovery have led to a change in the method of analyzing the elements of liability. In earlier private litigation under Rule 10b-5, liability was determined by reference to the particular elements developed by the courts.[14] The subsequent dilution of the elements led some courts to analyze liability in terms of a duty which the rule

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therein, without stating to what degree the defendant must have caused the plaintiff's injury. While some commentators point out that there is simply no causal connection between violations of Rule 10b-5 involving nondisclosure and injury to investors on open markets who would have traded anyway, this view has been rejected by courts. *See Id. at 276-79.* Similar problems exist with regard to reliance on the defendant's actions. Reliance and causation are no longer clearly distinguishable, according to Professor Bromberg. 2 BROMBERG § 8.6(1). *See also* Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 239 (2d Cir. 1974). The Supreme Court has noted that under circumstances of nondisclosure, positive proof of reliance is not necessary for recovery. Similarly, failure to disclose a material fact when the defendant was obligated to disclose it has established the requisite causation in fact. Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-54 (1972). *See also* Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d at 239-40.

[9]At common law scienter meant knowledge or belief by the defendant that the representation was false, or possession by the defendant of insufficient information on which to make the representation. W. PROSSER, HANDBOOK OF THE LAW OF TORTS, §105, at 685-86 (4th ed. 1971). Scienter, as used in securities fraud cases, has been characterized as intent to deceive, Trussell v. United Underwriters, Ltd., 228 F. Supp. 757 (D. Colo. 1964); knowledge or recklessness, Cohen v. Franchard Corp., 478 F.2d 115, 123 (2d Cir.), *cert. denied,* 414 U.S. 857 (1973); and negligence or lack of due diligence, Batchelor v. Legg & Co., 52 F.R.D. 553, 556-57 (D. Md. 1971). *See also* 2 BROMBERG § 8.4(500). When the term scienter is used in this note it is done so in the loosest sense of the term as it existed at common law. When used it will generally indicate a state of mind encompassing intent, knowledge, recklessness and negligence. When scienter is used in a specific sense, such as negligence, it also includes higher degrees as well, such as recklessness, knowledge and intent.

[10]*See* notes 5-6, 8-9 *supra.*

[11]*See* note 7 *supra.*

[12]This is not strictly true, as application of the *Birnbaum* Rule illustrates. *See* note 5 *supra.*

[13]*See* text accompanying notes 24-26 *infra.*

[14]*See* text accompanying notes 5-9 *supra.*

imposed upon the defendant.[15] The use of a duty analysis did not represent a major substantive change in the elements required for recovery, but only an alteration in the conceptual framework of liability. Thus, while the established elements of liability remained unchanged, duty analysis began to emerge as a new analytical method for determining liability.

In a recently decided case, *White v. Abrams,*[16] the Ninth Circuit Court of Appeals adopted a duty analysis which differed from that used by other courts, most notably the Second Circuit. The *White* court's duty analysis departed from earlier formulations of liability in two respects. Most significantly, the court rejected any single definition of the scienter element as an appropriate characterization of the requisite state of mind for imposition of liability.[17] The court also proposed a flexible duty standard,[18] and indicated that the duty imposed would vary with the circumstances of each case. Both of these factors, variable scienter and flexible duty, were combined into a single liability test for Rule 10b-5 private actions.[19] Furthermore, while other courts adopting a duty analysis have not altered the substantive elements of liability, *White* significantly departed from the earlier more rigid standards, and broadened the definition of scienter. Finally, in a more subtle development, the court extended the duty analysis beyond earlier articulations by greatly expanding

[15]A duty of disclosure is derived from clause (b) of Rule 10b-5, 17 C.F.R. § 240.10b-5(b) (1973), which proscribes untrue statements of material fact or omissions of material fact necessary to make statements made, in light of the circumstances under which they are made, not misleading. *See, e.g.,* Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341, 362-63 (2d Cir.), *cert. denied,* 414 U.S. 910 (1973). The duty has also been expressed as a duty to convey undisclosed information to prospective purchasers of securities. Lanza v. Drexel & Co., 479 F.2d 1277, 1289 (2d Cir. 1973). Although no court has specifically so stated, presumably the duty to disclose includes a duty not to misrepresent, since Rule 10b-5 proscribes both misrepresentations and omissions.

[16]495 F.2d 724 (9th Cir. 1974).

[17]*Id.* at 734. Other courts have established a uniform scienter requirement which would hold a defendant liable under Rule 10b-5 for either negligent, reckless, or knowing conduct, assuming all other elements of liability are proved. Precisely which degree of scienter will suffice is a matter of dispute among circuit courts. *See* text accompanying notes 24-26 *infra. White* suggests, however, that scienter is a variable factor which in combination with the duty of disclosure may vary according to the facts of each case. *See* text accompanying notes 101-03 *infra.*

[18]495 F.2d at 734-36.

[19]*Id.* Compare Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341, 363-64 (2d Cir.), *cert. denied,* 414 U.S. 910 (1973), which established a two-step duty test for liability, requiring a breach of a duty of disclosure which was at least reckless or knowing.

the potential scope of duty imposed by the rule and factors to be used in defining the duty.

An understanding of the standard of liability proposed in *White v. Abrams* requires an analysis of earlier cases which established scienter standards and applied duty analysis under Rule 10b-5. It can then be determined whether *White* really suggests any new standard of liability in terms of scienter, the possible duties imposed by the rule, or factors governing the scope of the duty. Finally, it must be determined whether the flexible duty test proposed by *White* is a workable standard which adequately identifies the necessary requisites for liability in private damage actions under the rule.

Previous Case Law

Federal courts have exercised extensive discretion in formulating appropriate standards of scienter under Rule 10b-5.[20] Some early decisions rejected proof of scienter in its strictest common law meaning of intent to mislead or deceive the plaintiff, and instead required proof that the defendant knew the representation was false.[21] Other courts disregarded the proof of fraud requirement and suggested that negligence[22] or strict liability[23] would suffice for recovery. However,

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[20]The Supreme Court has heard only three cases involving Rule 10b-5. They are Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972); Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6 (1971); SEC v. National Sec., Inc., 393 U.S. 453 (1969). The Court has taken a broad view of the securities laws, indicating that they should be construed "not technically and restrictively, but flexibly to effectuate their remedial purposes." SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 195 (1963).

[21]*See, e.g.,* Globus v. Law Research Serv., Inc., 418 F.2d 1276, 1290-91 (2d Cir. 1969), *cert. denied,* 397 U.S. 913 (1970) (trend is clearly away from enforcing scienter equal to intent to defraud); Trussell v. United Underwriters, Ltd., 228 F. Supp. 757, 771-72 (D. Colo. 1964) (statutory language implies knowing or intentional conduct).

[22]*See* Parrent v. Midwest Rug Mills, Inc., 455 F.2d 123, 126 (7th Cir. 1972); City Nat'l Bank v. Vanderboom, 422 F.2d 221, 230 (8th Cir.), *cert. denied,* 399 U.S. 905 (1970); Myzel v. Fields, 386 F.2d 718, 747 (8th Cir. 1967), *cert. denied,* 390 U.S. 951 (1968); Stevens v. Vowell, 343 F.2d 374, 379 (10th Cir. 1965); Blakely v. Lisac, 357 F. Supp. 255 (D. Ore. 1972), *appeal pending,* 9th Cir., CCH FED. SEC. L. REP. ¶ 73,031; Batchelor v. Legg & Co., 52 F.R.D. 553 (D. Md. 1971). The category of negligence has generated a controversy among both courts and commentators as to its sufficiency for liability under Rule 10b-5. *See* Kohn v. American Metal Climax, Inc., 458 F.2d 255, 280-81 (3d Cir.) (Adams, J., concurring and dissenting), *cert. denied,* 409 U.S. 874 (1972); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 866-67 (2d Cir. 1968) (Friendly, J., concurring), *cert. denied,* 394 U.S. 976 (1969); Bucklo, *Scienter and Rule 10b-5,* 67 Nw. U.L. REV. 562 (1972); Ruder, *Texas Gulf Sulphur-The Second Round: Privity and State of Mind in Rule 10b-5 Purchase and Sale Cases,* 63 Nw. U.L. REV. 423 (1968); Comment, *Negligent Misrepresentation Under Rule 10b-5,* 32 U. CHI. L. REV. 824

the rejection of common law notions of scienter has not eliminated the requirement altogether. While courts still frequently use the term "scienter," its common law meaning has been diluted to a state of mind concept which has been expressed in three different versions. The three standards currently used among the circuit courts are: actual knowledge of falsity or reckless disregard for the truth,[24] more than mere negligence,[25] and negligence.[26] The distinction has narrowed to a question of whether a negligence standard or a stricter standard of recklessness or knowledge should be applied in private damage actions.[27] The leading proponent of the stricter standard is the Second Circuit,[28] while the Seventh, Eighth, Ninth and Tenth

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(1965); Note, *Proof of Scienter Necessary in a Private Suit Under SEC Anti-Fraud Rule 10b-5,* 63 MICH. L. REV. 1070 (1965).

One commentator has pointed out that even though some circuits claim to impose a negligence standard, either by direct holding or implication, no circuit court has ever actually imposed liability solely for negligent misrepresentation or nondisclosure. Bucklo, *Scienter and Rule 10b-5,* 67 NW. U.L. REV. 562, 590 (1972).

[23]Myzel v. Fields, 386 F.2d 718, 747 (8th Cir. 1967), *cert. denied,* 390 U.S. 951 (1968) (Rule 10b-5 includes even innocent disclosures which may amount to manipulative or deceptive conduct); Stevens v. Vowell, 343 F.2d 374, 379 (10th Cir. 1965) (only necessary to prove one of the prohibited actions), *reaffirmed in* Kerbs v. Fall River Indus., Inc., 502 F.2d 731, 739 n.6 (10th Cir. 1974). *But see* Bucklo, *Scienter and Rule 10b-5,* 67 NW. U.L. REV. 562, 590 (1972) (stating that no liability has yet been imposed for less than knowing or reckless conduct).

[24]Cohen v. Franchard Corp., 478 F.2d 115 (2d Cir.), *cert. denied,* 414 U.S. 857 (1973). The *Cohen* court defined recklessness or knowledge:

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

Id. at 123, *followed in* Vohs v. Dickson, 495 F.2d 607, 622 (5th Cir. 1974). *See also* Rochez Bros., Inc. v. Rhoades, 491 F.2d 402, 407 (3d Cir. 1973) (actual knowledge satisfies any scienter requirement).

[25]Sargent v. Genesco, Inc., 492 F.2d 750, 761 (5th Cir. 1974); Smallwood v. Pearl Brewing Co., 489 F.2d 579, 606 (5th Cir.) *cert. denied,* 43 U.S.L.W. 3202 (Oct. 15, 1974).

[26]*See* cases cited in note 22 *supra.*

[27]The degree of scienter required differs, however, when the SEC sues to enforce Rule 10b-5. In enforcement actions, negligence is generally considered sufficient scienter for issuance of an injunction. *See, e.g.,* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 854-55 (2d Cir. 1968), *cert. denied,* 394 U.S. 976 (1969) (in an enforcement action negligent insider conduct is unlawful). *But see* SEC v. Texas Gulf Sulphur Co., 312 F. Supp. 77 (S.D.N.Y. 1970) (on remand; injunction against corporation denied, no likelihood of repetition of conduct).

[28]*See, e.g.,* Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341, 362 (2d

Circuits[29] are generally believed to allow recovery for negligence.[30]

The conflict among circuit courts over the necessary degree of scienter is understandable in view of the various sources which have been considered in an attempt to determine the proper standard to be applied under Rule 10b-5. The text of the rule states necessary elements for recovery,[31] but it does not suggest with certainty the degree of scienter required for liability.[32] Because the rule itself does not resolve the scienter question, courts have with little success examined the legislative history of § 10(b) of the Securities Exchange Act.[33] The administrative history of Rule 10b-5 is similarly inconclusive,[34] although it does lend credence to the conclusion that the rule was promulgated as an antifraud regulation,[35] requiring some form of

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Cir.), *cert. denied*, 414 U.S. 910 (1973); Cohen v. Franchard Corp., 478 F.2d 115, 123 (2d Cir.), *cert. denied*, 414 U.S. 857 (1973).

[29]*See* cases cited in note 22 *supra*.

[30]*See, e.g.*, Comment, *Scienter in Private Damage Actions Under Rule 10b-5*, 57 GEO. L.J. 1108, 1117 n.61 (1969); Comment, *Liability Under Rule 10b-5 for Negligently Misleading Corporate Releases: A Proposal for the Apportionment of Losses*, 122 U. PA. L. REV. 162, 165 n.14 (1973). *See also* notes 70 & 75 *infra*.

[31]*See* notes 1, 5-9 *supra*.

[32]Clauses (a) and (c) of Rule 10b-5 use the terms defraud, fraud or deceit, which presumably include some form of scienter. On the other hand, clause (b) prohibits untrue statements or omissions of material fact without reference to fraud or scienter. *See* Epstein, *The Scienter Requirement in Actions Under Rule 10b-5*, 48 N.C. L. REV. 482 (1970); Comment, *Negligent Misrepresentation Under Rule 10b-5*, 32 U. CHI. L. REV. 824 (1965). Articulating scienter as a congressionally imposed culpability requirement for liability under the securities acts which requires greater than negligent conduct avoids this constructional argument. *See* text accompanying notes 40-41 *infra*.

[33]Professor Bromberg writes that "[s]ection 10(b) was one of the least controversial parts of the 1934 Act." 1 BROMBERG, § 2.2(300), at 331. Of the approximately one thousand pages of hearings conducted by the House, references to § 10(b) would barely fill one page. The same is true for the Senate version of the bill. Thomas G. Corcoran, one of the drafters of the 1934 Act, when testifying before the House Committee on Interstate and Foreign Commerce, characterized § 10(b) as a catch-all clause to prevent manipulative devices. *Id.*

[34]The particular circumstances surrounding the promulgation of Rule 10b-5 are related in *Conference on Codification of the Federal Securities Laws*, 22 BUS. LAW. 793, 922 (1967). *See also*, 1 BROMBERG, § 2.2(400).

[35]Securities Exchange Act Release No. 3230, effective May 21, 1942, announced Rule 10b-5. The release provided in part:

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

SEC Securities Exchange Act Release No. 3230 (May 21, 1942).

scienter prior to allowing recovery. Still another formulation balanced the degree of proof required by the private liability provisions of the 1933 Securities Act[36] against the broader recovery allowed under the implied Rule 10b-5 private action to determine the applicable scienter standard.[37] Because none of these sources was conclusive of the scienter issue, no judicial consensus on the proper standard emerged.

In addition to these varied sources, the gradual pre-emption of specific liability provisions by Rule 10b-5[38] and the decline of the common law fraud basis of liability[39] led courts to examine the broad purposes and general scheme of prohibitions and private recovery under the securities acts as a whole.[40] The result of this examination was not a new standard of liability under Rule 10b-5, but an articulation of scienter as a congressionally imposed culpability requirement. While this development may have encouraged an abandonment of the traditional scienter label, courts still formulated culpability in terms of negligence, recklessness, knowledge, or intent, depending

[36]*See* note 2 *supra.*

[37]*See, e.g.,* Fischman v. Raytheon Mfg. Co., 188 F.2d 783 (2d Cir. 1951); Weber v. C.M.P. Corp., 242 F. Supp. 321 (S.D.N.Y. 1965). The express liability provisions were balanced against Rule 10b-5 in one case by requiring knowing or intentional conduct under the rule, as opposed to § 12(2) of the Securities Act, which, the court said, imposed a negligence standard on the defendant. Thiele v. Shields, 131 F. Supp. 416 (S.D.N.Y. 1955).

[38]*See* Vanderboom v. Sexton, 422 F.2d 1233 (8th Cir.), *cert. denied,* 400 U.S. 852 (1970) (§ 12(2) of the Securities Act is not an exclusive remedy); Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961) (Congress in effect nullified the limits expressed in the 1933 Act by the 1934 Act); Blakely v. Lisac, 357 F. Supp. 255 (D. Ore. 1972), *appeal pending,* 9th Cir., CCH FED. SEC. L. REP. ¶ 73,031. In SEC v. National Sec., Inc., 393 U.S. 453 (1969), the Supreme Court commented upon the conflicting remedies between express and implied rights of action, stating: "The fact that there may well be some overlap is neither unusual nor unfortunate." *Id.* at 468.

[39]The decline of a common law fraud basis for liability is evidenced in at least two respects under Rule 10b-5. Courts have generally rejected scienter in the common law fraud definition, *see* note 21, *supra,* in spite of the constructional argument that it is required by clauses (a) and (c) of the rule. *See* note 32 *supra.* This reluctance rigidly to apply common law fraud concepts to Rule 10b-5 can also be seen in the now general rejection of a privity requirement for liability. *See, e.g.,* Sargent v. Genesco, Inc., 492 F.2d 750, 759-60 (5th Cir. 1974); Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90 (10th Cir.), *cert. denied,* 404 U.S. 1004 (1971). Other factors required for common law fraud, and still required in Rule 10b-5 cases, are attributable to the requirements of the rule itself, such as materiality, connection with the purchase or sale of a security, and some contact with interstate commerce. *See generally* notes 1 and 5-9 *supra.*

[40]*See* Lanza v. Drexel & Co., 479 F.2d 1277 (2d Cir. 1973); Kohn v. American Metal Climax, Inc., 458 F.2d 255, 280 (3d Cir.) (Adams, J., concurring and dissenting), *cert. denied,* 409 U.S. 874 (1972).

upon the standard of the particular circuit.[41] But this recently developed conceptualization of culpability complemented the concurrent development of duty analysis in securities fraud litigation.

Use of duty concepts in Rule 10b-5 cases is not new. The first case to impose civil liability under the rule characterized the violation in terms of duty.[42] Later courts also discussed duty, particularly when some form of fiduciary responsibility was involved.[43] The Second Circuit recently adopted a duty analysis standard and suggested that Rule 10b-5 imposes a form of fiduciary duty upon parties to securities transactions.[44] The court in *Chris-Craft Industries, Inc. v. Piper Aircraft Corp.*[45] explained:

> The initial inquiry in each case is what duty of disclosure the law should impose upon the person being sued . . . . Those with greater access to information, or having a special relationship to investors making use of the information, often may have an affirmative duty of disclosure. When making a representation, they are required to ascertain what is material as of the time of the transaction and to disclose fully "those material facts about which the [investor] is presumably uninformed and which would, in reasonable anticipation, affect his judgment.[46]

[41]*See* Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341, 362 (2d Cir.), *cert. denied,* 414 U.S. 910 (1973); Kohn v. American Metal Climax, Inc., 458 F.2d 255, 280 (3d Cir.) (Adams, J., concurring and dissenting), *cert. denied,* 409 U.S. 874 (1972).

[42]Kardon v. National Gypsum Co., 73 F. Supp. 798 (E.D. Pa. 1947) (Plaintiff's case was established when defendant's duty and its breach were proved).

[43]Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972) (defendant was a market maker); Lanza v. Drexel & Co., 479 F.2d 1277 (2d Cir. 1973) (corporate director); Kohler v. Kohler Co., 319 F.2d 634 (7th Cir. 1963) (majority stockholder); Canizaro v. Kohlmeyer & Co., 370 F. Supp. 282 (E.D. La. 1974), *appeal pending,* 5th Cir., CCH FED. SEC. L. REP. ¶ 73,031 (customer-broker suit); Aetna Cas. & Sur. Co. v. Paine, Webber, Jackson & Curtis, [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,748 (N.D. Ill. 1970) (broker).

[44]*See* text accompanying note 46 *infra.*

[45]480 F.2d 341 (2d Cir.), *cert. denied,* 414 U.S. 910 (1973). The *Chris-Craft* case involved a private action under § 14(e) of the Securities Exchange Act, 15 U.S.C. § 78n(e) (1970), which prohibits fraudulent, deceptive or manipulative practices in tender offers. Piper Aircraft, with the aid of Bangor Punta Industries, successfully defended a takeover attempt by Chris-Craft. Chris-Craft alleged fraud in connection with the competing exchange offer to Piper shareholders by Bangor Punta. A primary issue in the case was whether or not a private right of action existed under § 14(e). In granting a private right of action under § 14(e) the *Chris-Craft* court followed previously developed principles under Rule 10b-5 regarding the elements of a private action. 480 F.2d at 362. For this reason the court's analysis is persuasive authority for Rule 10b-5 as well.

[46]*Id.* at 363 (citations omitted).

Although *Chris-Craft* involved a private action under the tender offer provisions of the Securities Exchange Act, the court relied extensively upon principles developed for determining liability under Rule 10b-5.[47] The court noted that the defendant Piper had failed to disclose to outside shareholders the extent of its managing shareholders' financial interest in an exchange offer competing with Chris-Craft's tender offer. Piper had an affirmative duty to disclose this material fact, the court held, based upon the special relationship between the defendant and its investors, and Piper's superior access to information.[48] The duty imposed upon Piper was not limited to disclosure, but also required the defendant to ascertain which facts were material to the tender offer and counter offer, and to make a reasonable effort to discover those facts. Thus, two distinct duties were imposed under Rule 10b-5 by *Chris-Craft*: an affirmative duty of disclosure, and a separate duty to ascertain or to use reasonable diligence to discover material facts. The court did not, however, make these duties the sole test of liability.

In addition to its formulation of duty under Rule 10b-5, the Second Circuit in *Chris-Craft* also articulated a separate culpability requirement, stating that a knowing or reckless failure to discharge the duty of disclosure would constitute sufficiently culpable conduct for liability.[49] The culpability standard applied was essentially the same standard of scienter previously used by the Second Circuit.[50] Hence,

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[47]*Id.*

[48]These factors as used by the *Chris-Craft* court did not represent any substantive change in the law of Rule 10b-5. Material facts had previously been defined in the circuit as facts which would affect a reasonable investor's decision to purchase or sell securities. *See* note 6 *supra*. Special relationships of a fiduciary or confidential nature have also been a basis for liability in securities fraud cases. *See* note 43 *supra*. The problem of unequal access to information, in the form of unauthorized trading on undisclosed corporate information was first addressed by *In re* Cady, Roberts & Co., 40 S.E.C. 907 (1961), when Chairman Cary stated:

> Analytically, the obligation to disclose inside information or forego trading rests on two principal elements; first, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing.

Id. at 912. *See also* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 852 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969) (intent of Congress was to provide equal access to information).

[49]480 F.2d at 363. Compare this with the concurring opinion by Judge Gurfein. 480 F.2d at 398.

[50]*See, e.g.*, Cohen v. Franchard Corp., 478 F.2d 115, 123 (2d Cir.), *cert. denied*,

imposition of liability in *Chris-Craft* was contingent upon the defendants' breach of duty, and that this breach was at least knowing or reckless.[51]

The Second Circuit's articulation of liability primarily in terms of a duty standard and a culpability requirement was a departure from earlier judicial analysis which had relied upon the elements of common law fraud as the basis for determining liability. *Chris-Craft* did not, however, establish a broad duty standard for general application. The court did not specify which special relationships, aside from the particular fact situation before it, would require affirmative duties of disclosure or investigation, or what other factors might be relevent in determining the scope of the duty imposed upon the defendant. Nevertheless, while the court did not fully explain the implications of its duty standard, it did establish a new paradigm for analyzing the issues and interests at stake in securities fraud litigation. The Second Circuit again used a duty analysis in a case[52] decided one month after *Chris-Craft*, thereby establishing a definitive standard for the circuit. It remained uncertain whether other circuits would follow, thus leading to general application of a duty standard with its potential capacity for a major transformation of the substantive elements of liability.

White v. Abrams

The Ninth Circuit's adoption of a duty standard in *White v.*

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414 U.S. 857 (1973). The *Chris-Craft* court rejected liability for a negligent breach of duty by noting that the function of the scienter requirement was to confine imposition of liability to those defendants whose conduct was sufficiently culpable to justify the penalty sought. 480 F.2d at 362. The *Chris-Craft* court is one of the few courts to admit candidly that one purpose of the scienter or culpability requirement is to protect defendants from potentially enormous liability for merely negligent violations of Rule 10b-5. *Accord,* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 866-67 (2d Cir. 1968), (Friendly, J., concurring) *cert. denied,* 394 U.S. 976 (1969) (the consequences of holding that negligence in drafting a press release may impose civil liability on the corporation would fall upon holders of the corporation's stock and would defeat the objective of full disclosure); Herpich v. Wallace, 430 F.2d 792, 804 (5th Cir. 1970) (courts have sought to construct workable limits on liability which will accommodate the interests of investors, the business community, and public generally). *See also* 2 BROMBERG, § 8.4 (508); Ruder, *Texas Gulf Sulphur-The Second Round: Privity and State of Mind in Rule 10b-5 Purchase and Sale Cases,* 63 NW. U.L. REV. 423 (1968) (suggesting that restitution damages in the Texas Gulf Sulphur litigation could amount to between $84 million and $390 million, depending upon the period selected in which recovery would be allowed); Comment, *The Role of Scienter and the Need to Limit Damages in Rule 10b-5 Actions-The Texas Gulf Sulphur Litigation,* 59 KY. L.J. 891 (1971).

[51] 480 F.2d at 364.

[52] Lanza v. Drexel & Co., 479 F.2d 1277 (2d Cir. 1973).

Abrams[53] firmly established this analytical approach as the most novel procedure for determining liability under Rule 10b-5. The case arose out of the bankruptcy proceedings of the Richmond Corporations, a network of corporations controlled by Theodore Richmond.[54] The defendant, Paul Abrams, was a friend of and financial advisor to the plaintiffs, the White Group.[55] Although not a seller of securities, Abrams recommended and arranged for the White Group to purchase stock and promissory notes of the Richmond Corporations, for which he received commissions from Richmond. The White Group charged Abrams with violating § 17(a) of the Securities Act,[56] § 10(b) of the Securities Exchange Act,[57] Rule 10b-5, and with common law fraud. The plaintiffs alleged that Abrams misrepresented that he had investigated Richmond Corporations and its financial statements and had found them to be sound; that the money would be used to purchase new franchises and equipment; and that Richmond Corporations had large earnings which would enable it to pay high interest rates on the loans. Abrams was also charged with failing to disclose that he had received a large commission on each investment made in Richmond Corporations through his efforts; that he had sold similar securities and notes with higher rates of return to other persons; and that Manufacturers Credit Corporation, the controlling corporation, owned no assets other than stock in various Richmond controlled corporations. The jury found in favor of the plaintiffs on the securities fraud claim, but found for the defendant on the common law fraud claim.[58]

The particular point of appeal in *White* was a jury instruction which would have imposed absolute liability upon the defendant.[59] The court of appeals rejected an absolute liability standard, reversed the verdict, and remanded the case for a new trial. In an opinion

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[53] 495 F.2d 724 (9th Cir. 1974).

[54] *See* Manufacturers Credit Corp. v. SEC, 395 F.2d 833 (3d Cir. 1968), for details of the structure of Richmond Corporations and the bankruptcy proceedings.

[55] The White Group included Mr. and Mrs. J. Arthur White, their daughter, and friends who invested in Richmond Corporations through the defendant.

[56] 15 U.S.C. § 77q(a) (1970).

[57] 15 U.S.C. § 78j(b) (1970).

[58] 495 F.2d at 726-28.

[59] The jury instruction provided:

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

495 F.2d at 728. (emphasis added).

written by Judge Wallace, the Ninth Circuit addressed three significant points. The court noted that some form of scienter was necessary for recovery, and thereby rejected absolute liability under the rule.[60] Nevertheless, Judge Wallace also proposed a standard of pleading and proof necessary to establish a prima facie case,[61] as distinguished from that proof necessary to prevail on the merits, which effectively encompassed strict liability. Finally, a flexible duty standard was established to govern liability in Rule 10b-5 litigation.[62]

In establishing a flexible duty standard, the *White* court departed in several fundamental respects from the Second Circuit's standard as announced in *Chris-Craft.* The *White* court rejected any separate consideration of duty and culpability, and suggested that liability would be determined under a single duty test which included the necessary degree of scienter.[63] The Ninth Circuit also rejected the Second Circuit minimum culpability standard.[64] Rather than establish a different minimum standard, the court proposed a variable scienter concept that necessitated a determination of the requisite degree of scienter on a case-by-case basis. The rejection of separate duty and scienter tests in conjunction with variable scienter allowed the court to formulate a flexible duty standard which encompassed a greater spectrum of duty than that proposed in the *Chris-Craft* case.[65] Similarly, *White* suggested a broader range of factors to be utilized by the trial court in formulating the appropriate duty to apply in a particular case. Thus, while *White* departed significantly from *Chris-Craft's* formulation of duty and limited scienter standard, the *White* court's flexible duty standard greatly expanded the potential characterizations of duty imposed under Rule 10b-5 and the possible factors creating those duties.

The Standard of Pleading

Although *White's* substantive impact on Rule 10b-5 case law centers on the proposed flexible duty standard, more subtle consequences can be attributed to the court's clarification of the standard of pleading and its rejection of strict liability. *White v. Abrams* was the first Ninth Circuit case to review two earlier cases from that circuit which dealt with the scienter requirement. The earlier cases,

[60] 495 F.2d at 728, 734.
[61] *Id.* at 728-30.
[62] *Id.* at 730-36.
[63] *Id.* at 734-36.
[64] *Id.* at 732-33.
[65] *Id.* at 735-36.

Ellis v. Carter[66] and *Royal Air Properties, Inc. v. Smith,*[67] had been cited by other circuit courts as authority for imposing a negligence[68] or strict liability[69] standard under Rule 10b-5. Judge Wallace rejected a strict liability interpretation of *Ellis* and *Royal Air,*[70] and noted that liability without fault was contrary to the basic thrust of § 10(b) of the Securities Exchange Act and of the rule.[71]

In both *Ellis* and *Royal Air* the Ninth Circuit had ruled that it was unnecessary to allege or prove common law fraud in an action under § 10(b) or Rule 10b-5.[72] Citing *Ellis* for authority, the *Royal Air*

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[66]291 F.2d 270 (9th Cir. 1961). *Ellis* involved a suit between joint venturers in a plan to take over the management of Republic Pictures Corp. The plaintiff was induced to buy stock at a premium price from the defendant by the promise that the shares would give the plaintiff a role in managing Republic. The plaintiff was subsequently excluded from management by the defendant and other parties to the fraud.

[67]312 F.2d 210 (9th Cir. 1962). A stock purchaser who was subsequently elected a corporate officer sued the defendant corporation for misrepresentation and nondisclosure in violation of Rule 10b-5. The violation involved a stock prospectus which misstated anticipated return on investment and omitted mention of an outstanding corporate debt. The corporate defendant appealed from the trial court's disallowance of equitable defenses. The appellate court sustained the defendant's appeal and remanded the case for a new trial.

[68]*See, e.g.,* Lanza v. Drexel & Co., 479 F.2d 1277, 1305 (2d Cir. 1973); City Nat'l Bank v. Vanderboom, 422 F.2d 221, 230 n.9 (8th Cir.), *cert. denied,* 399 U.S. 905 (1970); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 855 (2d Cir. 1968), *cert. denied,* 394 U.S. 976 (1969); Myzel v. Fields, 386 F.2d 718, 747 (8th Cir. 1967), *cert. denied,* 390 U.S. 951 (1968).

[69]*See* Stevens v. Vowell, 343 F.2d 374, 379-80 (10th Cir. 1965), *citing* Royal Air Properties, Inc. v. Smith, 312 F.2d 210 (9th Cir. 1962), *and* Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961).

[70]495 F.2d at 734. In spite of *White's* limitation on Royal Air Properties, Inc. v. Smith, 312 F.2d 210 (9th Cir. 1962), and Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961), the Tenth Circuit failed to reexamine its strict liability scienter standard in Kerbs v. Fall River Indus., Inc., 502 F.2d 731, 739 n.6 (10th Cir. 1974), which reaffirmed Stevens v. Vowell, 343 F.2d 374 (10th Cir. 1965) (not necessary to prove common law fraud; must prove only one of the prohibited actions). *Stevens* cited *Ellis and Royal Air* as authority for its strict liability holding. 343 F.2d at 379-80. It is noteworthy that although the Tenth Circuit purports to impose a strict liability standard, it has yet to impose liability for innocent misrepresentations or omissions of material fact in a securities fraud case. *See* Financial Indus. Fund, Inc. v. McDonnell Douglas Corp., 474 F.2d 514 (10th Cir.), *cert. denied,* 414 U.S. 874 (1973) (due diligence defense and good faith of defendant precluded liability for nondisclosure); Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90 (10th Cir.), *cert. denied,* 404 U.S. 1004 (1971) (liability based on deceitful and fraudulent misrepresentation); Allen v. H.K. Porter Co., 452 F.2d 675 (10th Cir. 1971) (agreed basis for liability rested on knowing misstatement or omission of a material fact). The Tenth Circuit has now rejected both negligence and strict liability as adequate scienter for recovery under Rule 10b-5. Clegg v. Conk, CCH FED. SEC. L. REP. ¶ 94,897 (10th Cir. Dec. 5, 1974).

[71]495 F.2d at 728.

[72]The court in Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961), stated:

> Section 10(b) speaks in terms of the use of "any manipulative device

court had stated that "Rule 10b-5(b) . . . only requires proof of a material misstatement or an omission of a material fact in connection with the purchase or sale of any security to make out a prima facie case."[73] While stating that allegations or proof of common law fraud were unnecessary,[74] *Ellis* had not otherwise explained what standard should be applied to the pleadings or to ultimate proof of liability.[75] *Royal Air,* on the other hand, established a standard of pleading and proof of a prima facie case which required merely an alleged violation of the rule by the defendant, and no particular averment of scienter.[76] Noting that neither case was a decision on the merits,[77] the *White*

> or contrivance" . . . . Had Congress intended to [proscribe] common-law fraud, it would probably have said so. We see no reason to go beyond the plain meaning of the word "any", indicating that the use of manipulative or deceptive devices or contrivances of whatever kind may be forbidden, to construe the statute as if it read "any fraudulent" devices.

Id. at 274, *quoted in* White v. Abrams, 495 F.2d 724, 729 (9th Cir. 1974). The *Ellis* court also rejected the defendants' claim that explicit provisions for liability in the Securities Act limited Rule 10b-5 by stating that Congress in effect nullified limits established on private actions under the Securities Act when it passed § 10(b) of the Securities Exchange Act one year later. 291 F.2d at 274.

[73]312 F.2d at 212, *quoted in* White v. Abrams, 495 F.2d 724, 729 (9th Cir. 1974).

[74]*See* note 72 *supra.*

[75]Other courts have cited *Ellis* as establishing a negligence standard, *see* note 68 *supra,* or a strict liability standard, Stevens v. Vowell, 343 F.2d 374, 379-80 (10th Cir. 1965). At best, the holding in *Ellis* can be characterized as rejecting the necessity for allegation and proof of common law fraud by the plaintiff in Rule 10b-5 cases. *See* note 72 *supra.* The Ninth Circuit subsequently reaffirmed this principle in Royal Air Properties, Inc. v. Smith, 312 F.2d 210, 212 (9th Cir. 1962). But the statement that common law fraud or scienter need not be proved in Rule 10b-5 cases does not necessarily mean that negligence or strict liability will suffice. This distinction is a common problem in many cases which are interpreted as establishing a strict liability or negligence standard under Rule 10b-5. Only a few cases contain language which clearly implies a standard of strict liability. *See* Myzel v. Fields, 386 F.2d 718, 747 (8th Cir. 1967), *cert. denied,* 390 U.S. 951 (1968) (Rule 10b-5 includes even innocent disclosures which may amount to manipulative or deceptive conduct); Stevens v. Vowell, 343 F.2d 374, 379 (10th Cir. 1965) (only necessary to prove one of the prohibited actions). *Contra* White v. Abrams, 495 F.2d 724, 728 (9th Cir. 1974) (rejecting liability without fault). Similarly, only a handful of cases have applied a negligence standard under Rule 10b-5 using the term negligence. Blakely v. Lisac, 357 F. Supp. 255 (D. Ore. 1972), *appeal pending,* 9th Cir., CCH FED. SEC. L. REP. ¶ 73,031; Batchelor v. Legg & Co., 52 F.R.D. 545 (D. Md. 1971). *See also* note 70 *supra.*

[76]*See* text accompanying note 73 *supra.*

[77]*See* Royal Air Properties, Inc. v. Smith, 312 F.2d 210 (9th Cir. 1962) (appealing disallowance of equitable defenses at trial), *aff'd,* 333 F.2d 568 (1964) (judgment for plaintiff after second trial); Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961) (reversing dismissal on pleadings), *aff'd,* 328 F.2d 573 (1964) (affirming trial court dismissal after plaintiff's presentation of evidence).

Court stated that those decisions did not establish the proper standard for liability. The court concluded, however, that they denoted the proper standard for pleading and for stating a prima facie case under Rule 10b-5. These standards were not to be misconstrued as the standard for liability. Judge Wallace explained: "[i]n Rule 10b-5 cases, where much of the evidence needed by the plaintiff to prove his case is in the hands of the defendant, we require a lesser amount of evidence to avoid a directed verdict or dismissal at the end of the plaintiff's case than we require for a final judgment."[78]

A liberal pleading policy for Rule 10b-5 cases is not innovative in view of the theory behind the Federal Rules of Civil Procedure that pleadings should be construed to do substantial justice.[79] In the case of fraud, however, the rules require particular pleading of the circumstances and facts constituting the fraud.[80] The implication of *White's* reliance on *Royal Air* is that no allegation of scienter will be necessary to satisfy the particularity requirement of the federal rules. In other words, the standard to be applied to pleadings and prima facie proof is one of strict liability.[81]

The effect of this strict liability standard was not unintentional; Judge Wallace noted that cross-examination of the defendant's witnesses may enable the plaintiff to strengthen his case sufficiently to prove the degree of scienter required for final judgment.[82] Thus, the ultimate impact of *White's* pre-judgment strict liability standard will be to encourage Rule 10b-5 litigation. *White* effectively forecloses any

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[78] 495 F.2d at 729-30.

[79] *See* FED. R. CIV. P. 8(f); C. WRIGHT, HANDBOOK OF THE LAW OF FEDERAL COURTS, § 68 (2d ed. 1970).

[80] FED. R. CIV. P. 9(b); C. WRIGHT, HANDBOOK OF THE LAW OF FEDERAL COURTS, § 68, at 289 (2d ed. 1970).

[81] *Accord,* Stevens v. Vowell, 343 F.2d 374, 379 n.3 (10th Cir. 1965). The Second Circuit, to the contrary, requires pleading of some form of scienter or culpability amounting at least to knowledge or recklessness. Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 353 F. Supp. 264, 272 (S.D.N.Y. 1972), *aff'd,* 495 F.2d 228 (2d Cir. 1974) (no claim stated absent allegation of scienter, intent to defraud, reckless disregard for the truth, or knowledge); Shemtob v. Shearson, Hammill & Co., 448 F.2d 442, 445 (2d Cir. 1971) (complaint dismissed absent allegations of scienter, intent, recklessness or knowledge); Schoenbaum v. Firstbrook, 405 F.2d 215 (2d Cir. 1968), *cert. denied,* 395 U.S. 906 (1969) (complaint dismissed, no knowledge).

[82] Judge Wallace stated:

> [I]t is inadvisable to sustain a defendant's motion to dismiss midway through the trial, even though technically the plaintiff may not have yet developed sufficient evidence for a final judgment, since as the defendant proceeds with his case, the plaintiff may well on cross-examination be able to develop points that will strengthen his case.

495 F.2d at 730.

dismissal based on a lack of scienter until all the evidence has been heard, thereby enabling plaintiffs to force a trial on the merits through all stages short of final judgment without any allegation or proof of scienter.[83] These procedural developments, however, assume less immediate importance in light of the proposed standard of liability.

The Flexible Duty Standard

The rejection of strict liability under Rule 10b-5 and the limitation of *Ellis* and *Royal Air* enabled the *White* court to formulate a new standard of liability in the light of recent case law development. The *White* court relied principally on two recent cases[84] and found that a duty analysis was the correct approach to determining liability under the rule. The court regarded as particularly persuasive the rationale used by the Supreme Court in *Affiliated Ute Citizens v. United States.*[85] Instead of relying on the Court's holding in *Affiliated Ute Citizens,*[86] the *White* court examined the analysis employed and noted that "the Court did not analyze the defendants' conduct in

[83]The conclusion that dismissal will be avoided assumes, of course, that the plaintiff has made a reasonable showing of materiality, causation, damages, interstate commerce, and a connection with the purchase or sale of a security.

[84]Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972); Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341 (2d Cir.), *cert. denied,* 414 U.S. 910 (1973).

[85]406 U.S. 128 (1972). Plaintiffs sued a bank and two employees under Rule 10b-5 for fraud in effecting the sale of shares of stock in a corporation formed to supervise the distribution of certain tribal assets under the Ute Partition Act. The Court held both the bank and employees liable, stating that their failure to disclose their market maker status and the prevailing market price at which they were reselling shares to non-Indian investors violated Rule 10b-5. Under the circumstances of the case, which involved nondisclosure, positive proof of reliance was not a prerequisite to recovery. It was necessary to show that facts withheld were material in the sense that a reasonable investor might have considered them important in making his decision to sell. This obligation to disclose and the withholding of a material fact established the requisite element of causation in fact. *Id.* at 153-54. The facts of the case indicated actual knowledge on the part of the defendants, but the Court failed to comment upon any scienter requirement or what minimum degree of scienter would be necessary for liability.

[86]The *Affiliated Ute Citizens* case was doubtful authority for *White.* As Judge Wallace acknowledged, *Affiliated Ute Citizens* did not involve the scope of duty imposed by clause (b) of Rule 10b-5. *Id.* at 152-53. The issue on appeal in *White* was a jury instruction, *see* note 59 *supra,* which, the defendant successfully argued, improperly defined the scope of duty imposed by Rule 10b-5(b). Reliance on the *Affiliated Ute Citizens* case was not misplaced, however, in that Judge Wallace relied on the factors the Court used in finding a duty of disclosure, rather than the holding of the case.

terms of the elements of common law fraud, but rather as what kind of a *duty* rule 10b-5 imposes."[87] Drawing upon *Affiliated Ute Citizens,* the *White* court proposed five factors to be considered in defining the extent of the duty imposed upon a particular defendant:

1. The relationship of the defendant to the plaintiff;[88]
2. the defendant's access to the information as compared to the plaintiff's access;[89]

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[87]495 F.2d at 731. (footnote omitted).

[88]*Id.* at 735. The *White* court cited as supporting this factor Vine v. Beneficial Fin. Co., 374 F.2d 627 (2d Cir.), *cert. denied,* 389 U.S. 970 (1967); Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961); and Brennan v. Midwestern United Life Ins. Co., 259 F. Supp. 673 (N.D. Ind. 1966) (motion to dismiss denied), 286 F. Supp. 702 (N.D. Ind. 1968) (on merits), *aff'd,* 417 F.2d 147 (7th Cir. 1969), *cert. denied,* 397 U.S. 989 (1970). 495 F.2d at 735 n.16. *Vine* concerned shareholders of different classes of stock, the defendant corporation having secured approval of an allegedly unfair merger through nonplaintiff stockholders. Plaintiff shareholders were left in the position of forced sellers for less than fair value. *Ellis* concerned alleged fraud between joint venturers. In *Brennan,* purchasers of stock sued defendant-issuer, Midwestern United Life Ins. Co., as an aider-abettor to Rule 10b-5 violations committed by the broker, who had become bankrupt without delivering stock certificates it had sold. Denying defendant's motion to dismiss, the court said that the statute and rule impose a duty on those with superior access to information not to take advantage of it. 259 F. Supp. at 681. In view of the special relationship between the corporation and its shareholders, the defendant-issuer had an affirmative duty to report the improper activities of its broker. Failure to do so subjected it to liability as an aider-abettor. *Id.* at 682. In securities fraud litigation courts have generally recognized that certain relationships create a duty of disclosure between plaintiff and defendant. *See, e.g.,* Hecht v. Harris, Upham & Co., 430 F.2d 1202 (9th Cir. 1970) (customer's action against broker for churning); Hanly v. SEC, 415 F.2d 589 (2d Cir. 1969) (customer-broker); Kohler v. Kohler Co., 319 F.2d 634 (7th Cir. 1963) (statute created a form of fiduciary duty between insiders and outsiders when they dealt in corporate securities); Ruszkowski v. Hugh Johnson & Co., 302 F. Supp. 1371 (W.D.N.Y. 1969) (rumor not material, no violation of broker duty to customer). *See also* Lanza v. Drexel & Co., 479 F.2d 1277, 1317 (2d Cir. 1973) (Hays, J., concurring and dissenting).

[89]495 F.2d at 735. The access factor has been important in cases involving insider trading. The rationale is that when an insider obtains information intended for corporate purposes by virtue of his position, it is inherently unfair for him to take advantage of that information knowing it is unavailable to those with whom he is dealing. *See* Schoenbaum v. Firstbrook, 268 F. Supp. 395 (S.D.N.Y. 1967), *aff'd,* 405 F.2d 200 (2d Cir.), *modified,* 405 F.2d 215 (2d Cir. 1968), *cert. denied,* 395 U.S. 906 (1969). The *White* court cites *Schoenbaum* as authority for access as a factor in determining the defendant's duty under Rule 10b-5. Some commentators have said that insider trading on undisclosed information should not be unlawful because there is no causal connection between nondisclosure and an unknowing seller's decision to sell. The injury to investors, they note, is no greater because of insider trading on undisclosed information. Courts have uniformly rejected this theory. Financial Indus. Fund, Inc. v. McDonnell Douglas Corp., 315 F. Supp. 42, 44 (D. Colo. 1970), *rev'd on other grounds,* 474 F.2d 514 (10th Cir.), *cert. denied,* 414 U.S. 874 (1973). The Second Circuit also

3. the benefit that the defendant derives from the relationship;[90]
4. the defendant's awareness of whether the plaintiff was relying on their relationship in making his investment decisions;[91] and,

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rejected this theory, saying that anyone in possession of inside information either must disclose it to the investing public, or if he cannot disclose, must abstain from trading. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968), *cert. denied,* 394 U.S. 976 (1969); *accord,* Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 353 F. Supp. 264, 276 (S.D.N.Y. 1972), *aff'd,* 495 F.2d 228, 236 (2d Cir. 1974).

[90] 495 F.2d at 735. The *White* court cited Affiliated Ute Citizens v. United States, 406 U.S. 128, 152-53 (1972) for this guideline. 495 F.2d at 735 n.18. Benefit has not played an important role as such in the rationale of securities fraud cases, but in *Affiliated Ute Citizens,* the fact that the defendants were market makers in the sale of shares seems to have been important to the Court. Other courts have considered benefit to the defendant in terms of reducing the standard of actionable conduct when defendants are acting in their own self interest to the detriment of the plaintiff's interest. *See* Kohn v. American Metal Climax, Inc., 458 F.2d 255, 287 (3d Cir.) (Adams, J., concurring and dissenting), *cert. denied,* 409 U.S. 874 (1972); Kramer v. Scientific Control Corp., 365 F. Supp. 780, 791 n.14 (E.D. Pa. 1973); Globus, Inc. v. Jaroff, 266 F. Supp. 524 (S.D.N.Y. 1967).

[91] 495 F.2d at 735. In Drake v. Thor Power Tool Co., 282 F. Supp. 94 (N.D. Ill. 1967), a defendant accountant who certified a false financial statement was denied dismissal of the complaint against him because he knew the statement would be directed at the investing public. *Id.* at 104. The *Drake* court thought it important that certified public accountants have assumed a special relationship to the investing public and should not be immunized from suit for fraud. *Id.* This is the only authority cited by the *White* court for the factor of a defendant's awareness of plaintiff's reliance on the relationship. 495 F.2d at 735-36 n.19. This reliance should not be confused with the reliance element of common law fraud, which was curtailed by the Supreme Court in *Affiliated Ute Citizens*: In that case the Court reversed a lower court decision which required evidence of reliance on a misrepresentation of material fact. Under the circumstances, which involved nondisclosure, the Court stated that positive proof of reliance was not a prerequisite for recovery. *See* note 85 *supra. See also* Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90, 102-03 (10th Cir.), *cert. denied,* 404 U.S. 1004 (1971) (plaintiffs selling shares in reliance on a misleading press release denied recovery when sold seven days after misleading release corrected). The Ninth Circuit declined to hold an accountant liable under Rule 10b-5 for a misleading prospectus where there were discrepancies between a financial statement and the prospectus. Wessel v. Buhler, 437 F.2d 279 (9th Cir. 1971). The court denied the plaintiff's claim that the accountant, who admittedly had prepared false financial statements, had a duty to prospective investors to disclose knowledge of the corporation's irregular finances. "We find nothing in Rule 10b-5 that purports to impose liability on anyone whose conduct consists solely of inaction." *Id.* at 283. *Wessel* can be distinguished from *Drake,* however, by the fact that the false financial statements were not prepared in connection with the purchase or sale of securities. Nor was there any evidence that the plaintiffs had ever seen the statements before purchasing the securities, thereby negating any causal connection between the accountant's conduct and the plaintiff's injury. *Id.* at 282.

5. the defendant's activity in initiating the securities transaction in question.[92]

These factors do not suggest a "but for" test to determine whether a duty may be imposed upon the defendant. Instead of proposing the factors as quantitative indicators of duty, the *White* court applied them to define the quality of the relationship between plaintiff and defendant in any given case. The court did not specify how the factors should be weighed in determining what special relationship would create a particular duty,[93] but offered two examples to explain their relation to the duty imposed:

> Where the defendant derives great benefit from a relationship of extreme trust and confidence with the plaintiff, the defendant knowing that plaintiff completely relies upon him for information to which he has ready access, but to which plaintiff was no access, the law imposes a duty upon the defendant to use extreme care in assuring that all material information is accurate and disclosed. . . . On the other hand, where the defendant's relationship with the plaintiff is so casual that a reasonably prudent person would not rely upon it in making investment decisions, the defendant's only duty is not to misrepresent intentionally material facts.[94]

These examples, together with explicit language in the case, indicate

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[92] 495 F.2d at 735-36. This factor seems most relevant to cases involving customer-broker suits. Two courts have denied recovery to customers initiating transactions. Canizaro v. Kohlmeyer & Co., 370 F. Supp. 282 (E.D. La. 1974), *appeal pending*, 5th Cir., CCH FED. SEC. L. REP. ¶ 73,031; Ruszkowski v. Hugh Johnson & Co., 302 F. Supp. 1371 (W.D.N.Y. 1969). In establishing this element the *White* court followed one commentator's suggestion that this factor explained results which courts had reached in two conflicting cases. *See* Mann, *Rule 10b-5: Evolution of a Continuum of Conduct to Replace the Catch Phrases of Negligence and Scienter*, 45 N.Y.U.L. REV. 1206, 1219-20 (1970). The court distinguished O'Neill v. Maytag, 339 F.2d 764 (2d Cir. 1964), in which the CAB ordered a reexchange of stock between two airlines at a ratio unfavorable to the plaintiff's corporation, from Ruckle v. Roto American Corp., 339 F.2d 24 (2d Cir. 1964), in which directors actively participated in the issue and sale of new shares to perpetuate themselves in control of the corporation. 495 F.2d at 736 n.20. The *White* court similarly characterized Globus, Inc. v. Jaroff, 266 F. Supp. 524 (S.D.N.Y. 1967), which held that a corporate derivative suit properly alleged fraud or deceit in the issuance of a proxy statement concerning a stock option plan which greatly benefited directors and in which they actively participated. *Id.* at 531.

[93] *White* suggested one consideration in weighing the factors. "In making this determination the court should focus on the goals of the securities fraud legislation . . . ." 495 F.2d at 735.

[94] *Id.* at 736.

that both duty and scienter are flexible concepts to be applied in varying degrees in different cases.[95] What the court did not make explicit, but what is essential to an understanding of the functioning of the standard, is the distinction between flexible duty and variable scienter.

The examples offered by the court distinguish between two different duties: a duty of disclosure and a duty of non-misrepresentation. They further suggest that where a special relationship is present, disclosure is required. The factors present in the first example indicate a close and confidential relationship between the parties. Confidential or fiduciary relationships have traditionally given rise to duties of fair dealing, good faith, and full and fair disclosure of all material facts by the fiduciary.[96] Similarly, when such a confidential relationship involves a securities transaction, Rule 10b-5 imposes a concurrent quasi-fiduciary duty of disclosure. On the other hand, when the quality of the relationship is casual and factors indicating trust and confidence are not present, the only duty imposed may be to refrain from misrepresenting material facts.[97]

The courts have also imposed a third duty, aside from disclosure or non-misrepresentation. When a special or confidential relationship exists, the duty has not been discussed solely as one of disclosure, but includes a duty to investigate and ascertain material facts as well.[98] Such a duty of investigation was recognized by the Second Circuit in the *Chris-Craft* case and by the *White* court as well. That court stated that "the duty to investigate and disclose material facts will

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[95] *See* notes 100 & 102 *infra.*

[96] *See* H. HENN, HANDBOOK OF THE LAW OF CORPORATIONS, § 235 (2d ed. 1970); W. PROSSER, HANDBOOK OF THE LAW OF TORTS, § 106 (4th ed. 1971).

[97] A distinction between misrepresentation and nondisclosure is also supported by the text of the rule. Affiliated Ute Citizens v. United States, 406 U.S. 128, 152-53 (1972). *Contra,* List v. Fashion Park, Inc., 340 F.2d 457 (2d Cir.), *cert. denied,* 382 U.S. 811 (1965). *See also* Epstein, *The Scienter Requirement in Actions Under Rule 10b-5,* 48 N.C. L. REV. 482 (1970); Comment, *Negligent Misrepresentation Under Rule 10b-5,* 32 U. CHI. L. REV. 824 (1965). Clauses (a) and (c) of the rule are broad prohibitions against fraud or practices which would operate as a fraud, *see* note 1 *supra,* proscribing both misrepresentation and nondisclosure. *See* Affiliated Ute Citizens, *supra* at 152-53. Clause (b), however, only prohibits untrue statements or omissions of material fact "necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading." 17 C.F.R. § 240.10b-5(b) (1973). Hence, clause (b) requires some statement to be operative, and thereby prohibits only misrepresentations or omissions made in connection with some affirmative representation, and not pure nondisclosure.

[98] *See* White v. Abrams, 495 F.2d 724, 732 (9th Cir. 1974); Chris-Craft Indus. Inc. v. Piper Aircraft Corp., 480 F.2d 341 (2d Cir.), *cert. denied,* 414 U.S. 910 (1973); Lanza v. Drexel & Co., 479 F.2d 1277 (2d Cir. 1973).

necessarily vary according to the fact situation."[99] What should be clearly understood, then, is that three distinct duties may be imposed under Rule 10b-5: a duty not to misrepresent, an affirmative duty of disclosure, and a duty to investigate and ascertain material facts. Thus, when speaking of a flexible duty standard, *White* indicated that Rule 10b-5 does not impose a single duty of disclosure, but may impose any or all of these duties upon the defendant, depending upon the facts of the case. In a casual relationship, the only duty may be to refrain from misrepresentation. In a confidential relationship, however, the duty will be to investigate, ascertain, and disclose material facts, with an implicit duty not to misrepresent.

The *White* court did not articulate the flexible duty standard solely in terms of duty. Rather than formulate the duty only as that of disclosure, investigation or abstention from misrepresentation, the court also defined the nature of the duty imposed in terms of the degree of scienter required for liability. This dual characterization incorporated scienter into the flexible duty standard instead of treating duty and scienter as separate elements.[100] Arguably this single test which incorporates scienter is indistinguishable from the two-step duty and culpability standard of the Second Circuit since both questions must be determined whichever test is applied. The *White* court, however, rejected the Second Circuit's duty theory which "set a lower limit on the duty by requiring more than negligent conduct for liability,"[101] and concluded that any single standard of scienter was unworkable.[102] Judge Wallace's illustrations further suggested that when a confidential relationship is present, negligence may be the appropriate scienter standard. On the other hand, when the relation-

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[99] 495 F.2d at 736.

[100] The court's rejection of any single degree of scienter as the standard of liability did not foreclose all consideration of scienter. In summarizing the flexible duty standard, Judge Wallace said:

> While rejecting scienter and state of mind concepts as the standard itself, [the flexible duty standard] requires the court to consider state of mind as an important factor in determining the scope of duty that rule 10b-5 imposes.

Id.

[101] *Id.* at 733.

[102] Judge Wallace stated:

> We believe that the cases and commentators demonstrate that any attempt to limit the scope of duty in all 10b-5 cases by the use of one standard for state of mind or scienter is confusing and unworkable. Consequently, we reject scienter or any other discussion of state of mind as a necessary and separate element of a 10b-5 action.

Id. at 734 (footnotes omitted).

ship is only casual, an intentional breach of duty may be necessary for liability.

White was the first case to propose that scienter should be a variable factor in determining liability under Rule 10b-5. All other courts which have adopted a scienter standard have indicated that liability should be uniformly imposed for more than negligent conduct.[103] Thus, when a negligent breach of duty is sufficient for imposition of liability under the *White* flexible duty standard, a less stringent standard than that of circuits requiring recklessness will effectively be applied. On the other hand when, under the *White* analysis, a knowing breach of duty is required, recovery will be more difficult than under the minimum recklessness standard applied by other circuit courts.

The Second Circuit, unlike the Ninth, established a duty standard in *Chris-Craft,* but retained the scienter requirement of reckless or knowing conduct as a separate test of liability.[104] Although *White* suggested a single liability test of duty which includes scienter, *Chris-Craft* posed a two step analysis. The fundamental distinction between the two circuits is the degree of scienter required. The Second Circuit imposed liability upon proof of reckless, knowing, or intentional conduct, thereby establishing a minimum recklessness standard for all cases.[105] The Ninth Circuit, however, rejected any minimum standard as applicable in all instances and announced a variable standard to be applied on a case-by-case basis.[106]

The scienter distinction added a further dimension to the duty standard posed in *Chris-Craft* and adopted by *White.* The Second Circuit duty standard was formulated in terms of investigation and disclosure, while the *White* standard suggested a broader approach to duty, encompassing non-misrepresentation as well. The *White* court's additional inclusion of a variable scienter requirement within the duty test created a standard broader and more flexible than that of the Second Circuit, and thus more suitable for application to the varied factual contexts of Rule 10b-5 cases. Both courts noted that unequal access to information and existence of a special relationship between plaintiff and defendant may impose an affirmative duty to disclose material facts under Rule 10b-5. *White* provided three additional guidelines to determine the precise scope of the duty imposed, giving trial courts a broader basis for determining duty. Thus, the

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[103]*See* notes 24-28 *supra.*

[104]*See* text accompanying notes 47-51 *supra.*

[105]*See* text accompanying notes 49-51 *supra.*

[106]*See* text accompanying notes 101-02 *supra.*

flexible duty standard adds a significant perspective to the Second Circuit's standard by more fully articulating what particular duties may be imposed under the rule and by indicating what additional factors may create various duties.

The Workability of the Standard

The *White* court's approach to duty and scienter will permit trial courts to exercise broad discretion in determining liability under Rule 10b-5. Whereas prior to *White* the scienter requirement generally had been fulfilled by proof of negligence or recklessness, *White* has established that no particular definition of scienter is appropriate in all cases. Courts implementing the flexible duty standard, after reviewing the facts of each case in light of *White's* five factors, will be free to determine the nature of the duty imposed. However, this determination is made more difficult by the *White* court's failure to explain the weight to be given any of the factors it enumerated to assist in determining the duty standard.[107] This failure to provide additional guidance beyond the two illustrations leaves trial courts following *White* free to determine from previous decisions the relative importance of each factor in a particular situation.

If trial courts, in attempting to find more specific guidance, mechanically apply the results obtained by earlier courts in similar situations, the duty standards derived may include a de facto uniform scienter standard.[108] Such a result would not only contravene *White's* premise that a single scienter standard is unworkable, but would force upon trial courts the rigidity and inflexibility which the *White* court sought to alleviate. Nor would such a development be desirable. A major advantage of the *White* duty standard is that it provides a flexible framework within which courts can analyze and assess liability in Rule 10b-5 cases. Without rigid scienter standards determining liability in all situations, it will be unnecessary for courts to manipulate duty concepts to avoid liability for conduct which is greater than negligent but arguably does not merit imposition of liability.[109] This

[107]Judge Wallace also noted that additions or adaptations could be made to the enumerated factors when applying them to a particular case. 495 F.2d at 735.

[108]Since all other circuit courts would find liability under Rule 10b-5 for conduct greater than negligence, *see* notes 24-26 *supra,* implicit within their holdings is a single minimum scienter standard of liability.

[109]Compare the majority opinion with the dissenting opinions in Lanza v. Drexel & Co., 479 F.2d 1277 (2d Cir. 1973). The majority opinion characterized the defendant's duty as one to investigate a stock transaction and convey material adverse information to the prospective purchasers. *Id.* at 1289. The director was not held liable

does not mean, however, that earlier cases will be totally disregarded. Trial courts which attempt to articulate precisely the requirements for recovery will be influenced by earlier cases in choosing and attaching importance to the factors which create the requisite duty and state of mind for liability.

Of the five factors indicative of duty which were suggested by Judge Wallace,[110] three primarily characterize the nature of the relationship between the plaintiff and defendant: the benefit the defendant derives from the relationship, awareness of the plaintiff's reliance, and the defendant's initiation of the transaction. Each of these factors is important in varying degrees to the determination of liability. For example, the defendant need not benefit from the relationship or transaction to be held liable.[111] Failure to disclose a benefit or interest in the purchase or sale of securities violates Rule 10b-5,[112] but lack of such interest is not a bar to recovery by the plaintiff.[113] Likewise, awareness by the defendant that the plaintiff may rely on the relationship or the defendant's expertise is not dispositive of the liability issue,[114] although sometimes it is considered by the court.[115] Finally, evaluating the defendant's conduct in initiating the transaction is significant only in certain factual situations,[116] primarily those involving confidential relations between parties to the suit. While none of the three factors are individually dispositive of liability in an isolated context, together they characterize the extent of the relationship between the plaintiff and defendant, which was another factor proposed by Judge Wallace. Thus, within the special relationship context, the factors assume collective importance, and in this context any one of these four factors may become determinative of liability.

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under Rule 10b-5 for his negligent failure to investigate and convey the information. *Id.* at 1309. Two dissenting opinions were filed. One characterized the director's conduct as reckless, thus meeting the Second Circuit's scienter standard of liability. *Id.* at 1320. The other dissent found the director's conduct negligent, which, in the judge's opinion, was sufficient for liability. *Id.* at 1317-19.

[110] *See* text accompanying notes 88-92 *supra.*

[111] *See* note 90 *supra.*

[112] Affiliated Ute Citizens v. United States, 406 U.S. 128, 152-54 (1972) (defendants had affirmative duty to disclose fact that they were market makers); *accord,* Chasins v. Smith, Barney & Co., 438 F.2d 1167, 1172 (2d Cir. 1970).

[113] *See, e.g.,* Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90, 100-03 (10th Cir.), *cert. denied,* 404 U.S. 1004 (1971).

[114] *Compare* Wessel v. Buhler, 437 F.2d 279 (9th Cir. 1971), *with* Drake v. Thor Power Tool Co., 282 F. Supp. 94 (N.D. Ill. 1967). *See also* note 91 *supra.*

[115] *See, e.g.,* Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972); Chasins v. Smith, Barney & Co., 438 F.2d 1167 (2d Cir. 1970).

[116] *See* note 92 *supra.*

Unequal access to information, the fifth factor used by the *White* court, is frequently, although not exclusively, found in special relationships. The access factor by itself has been more influential than the first three factors in the determination of liability. When a plaintiff has the same access to material information as the defendant, no duty of disclosure is required even where a fiduciary relationship exists.[117] But trading with knowledge of undisclosed information, which is not equally available to the injured parties, violates the rule.[118] Consequently, the access factor is dispositive of liability in only one manner: equal access bars recovery when the information is not disclosed to the plaintiff.

All of the factors proposed in *White* are considerations which define the quality of the relationship between plaintiff and defendant. This relationship is in reality a function of the other four factors, and was one reason for imposing a duty of disclosure in both *Chris-Craft*[119] and *White.*[120] Hence, an examination of those Rule 10b-5 cases which have involved a special relationship between parties may illustrate the interplay of *White's* guidelines in determining the required duty in particular cases.

One traditionally special relationship—that between stockbroker and customer—exemplifies the duty standard as imposed concurrently by quasi-fiduciary principles and Rule 10b-5. Even before private actions were granted under Rule 10b-5, stockbrokers were held to high standards of duty toward customers.[121] Thus, when a broker made recommendations to his customer, the customer could justifiably assume that the broker had made a reasonable investigation of material facts, had a reasonable basis for his recommendation, and had disclosed any lack of information and risks arising therefrom.[122] This traditional quasi-fiduciary duty was incorporated into the duty imposed by Rule 10b-5, which proscribed fraudulent practices in connection with the purchase or sale of securities, making the fidu-

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[117]Arber v. Essex Wire Corp., 490 F.2d 414, 420 (6th Cir.), *cert. denied,* 43 U.S.L.W. 3202 (Oct. 15, 1974).

[118]Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 353 F. Supp. 264, 276 (S.D.N.Y. 1972), *aff'd,* 495 F.2d 228, 236 (2d Cir. 1974); *In re* Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961).

[119]*See* text accompanying note 46 *supra.*

[120]*See* text accompanying note 88 *supra.*

[121]*See* Charles Hughes & Co. v. SEC, 139 F.2d 434 (2d Cir. 1943), *cert. denied,* 321 U.S. 786 (1944).

[122]Hanly v. SEC, 415 F.2d 589, 597 (2d Cir. 1969).

ciary duty owed to the customer co-extensive with the duty imposed by the rule.[123]

In applying these co-extensive duties to brokers, courts have held that when a broker had discretionary power to buy or sell for a customer's account, failure to disclose the extent of excessive purchases and sales effected to generate brokerage commissions subjected him to liability under Rule 10b-5.[124] Similarly, failure of a broker to disclose the fact that he was a market maker[125] in the securities he recommended to his customer, knowing the customer would rely on his recommendation, also violated the rule.[126] Both of these instances illustrate situations in which all five factors enumerated by the *White* court are present: (1) an extremely close relationship between customer and broker; (2) better broker access to information than the plaintiff's access; (3) benefit to the broker in commissions from purchases or sales; (4) the broker's knowledge that the plaintiff would rely on the advice given, or the broker's expertise, in making investment decisions; and, (5) the broker either initiating the transaction or making a recommendation to his customer. Presence of all the *White* court's factors suggests a duty of disclosure imposed upon the broker by Rule 10b-5, and a breach of that duty when he failed to disclose the extent of trading or his self interest in the transaction.

On the other hand, a broker who characterized information as a rumor to a plaintiff who was a knowledgeable investor and who initiated the transaction, was not liable under Rule 10b-5 for misrepresentation or nondisclosure.[127] In that instance nonliability was predicated upon the fact that the information disclosed was not material. However, in terms of duty, the result could also be rationalized as a finding that the broker fulfilled his duty of disclosure by calling the information a rumor. The customer, being a sophisticated investor, assumed the risk of unreliability when he purchased the security

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[123] *See, e.g.*, Stevens v. Abbott, Proctor & Paine, 288 F. Supp. 836, 846-47 (E.D. Va. 1968).

[124] Hecht v. Harris, Upham & Co., 430 F.2d 1202, 1209 (9th Cir. 1970); Stevens v. Abbott, Proctor & Paine, 288 F. Supp. 836, 845-46 (E.D. Va. 1968). Significantly, however, courts which have allowed recovery under Rule 10b-5 have not granted recovery for the concurrent common law fraud claim. *See, e.g.*, White v. Abrams, 495 F.2d 724, 727 (9th Cir. 1974) (jury found defendant guilty of violating Rule 10b-5, but not guilty of common law fraud); Stevens v. Abbott, Proctor & Paine, *supra*, at 847-48 (dismissing common law fraud claim absent clear, cogent and convincing evidence).

[125] A market maker is a dealer who holds himself out as willing to buy and sell for his own account on a continual basis. S.E.C. Rule 17a-9(f)(1). 17 C.F.R. 240.17a-9(f)(1) (1974).

[126] Chasins v. Smith, Barney & Co., 438 F.2d 1167 (2d Cir. 1970).

[127] *Cf.* Ruszkowski v. Hugh Johnson & Co., 302 F. Supp. 1371 (W.D.N.Y. 1969).

knowing that the information was potentially inaccurate.

Similarly, when a plaintiff who was an experienced speculator provided a broker only one day to investigate and make a recommendation concerning the purchase of a security from a third party, no recovery was allowed for the broker's negligence in making the investigation.[128] The broker, who did not positively recommend the security to the plaintiff, had failed to discover and disclose that the security had been offered at less than the asked price a short time earlier. Additionally, he had neither discovered that the seller's broker was no longer in business, nor had he consulted the stock offering circular. Under the circumstances, it was held that the broker had fulfilled his duty to investigate. Finally, several cases have held that a broker who merely acts as the customer's agent in executing orders to purchase or sell has a minimal duty.[129]

These instances suggest the manner in which factors enumerated in *White* may be utilized to determine the specific duty imposed by Rule 10b-5. When the relationship between customer and broker is "confidential," and the customer places considerable reliance upon the broker's actions or recommendations, a duty to disclose fully all material facts will be imposed on the broker. When the broker discloses the material fact that the information is merely a rumor, the disclosure duty is fulfilled. A negligent failure to investigate and disclose information, however, does not violate the duty imposed by the rule when the customer fails to allow sufficient time for adequate investigation. And when a customer-broker relationship is casual and the broker merely executes the customer's orders, the duty to the customer is minimal, perhaps requiring only disclosure of known adverse material facts.

In all these instances, as the nature of the relationship tends toward an arms-length transaction, the duty imposed decreases from a duty to exercise due care in investigating and disclosing material facts to a duty only to disclose known facts. Similarly, although some factors not suggested by the *White* court had been considered in these cases,[130] a rough scale of descending duty and scienter can be per-

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[128]Canizaro v. Kohlmeyer & Co., 370 F. Supp. 282 (E.D. La. 1974), *appeal pending*, 5th Cir., CCH FED. SEC. L. REP. ¶ 73,031.

[129]*Id.* Aetna Cas. & Sur. Co. v. Paine, Webber, Jackson & Curtis, [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,748 (N.D. Ill. 1970).

[130]The due diligence of the plaintiff to avoid the fraud or consequences of the misrepresentation or nondisclosure has been increasingly scrutinized by courts before allowing recovery under Rule 10b-5. *See, e.g.*, Clement A. Evans & Co. v. McAlpine, 434 F.2d 100 (5th Cir. 1970), *cert. denied*, 402 U.S. 988 (1971); Canizaro v. Kohlmeyer & Co., 370 F. Supp. 282 (E.D. La. 1974), *appeal pending*, 5th Cir., CCH FED. SEC. L.

ceived as the relationship varies from confidential to arms-length.

Not all Rule 10b-5 cases, however, involve the type of fiduciary relationship which exists between customer and broker. The traditional fiduciary duties of brokers to customers suggest that negligence may be an appropriate standard of scienter in certain cases. But when the relationship is one which has not normally justified imposition of a negligence standard, as that between corporation and shareholder,[131] fiduciary principles applied in customer-broker cases do not form an adequate basis for imposing duties under Rule 10b-5. Considerations which govern confidential relations, such as privity, the benefit the defendant receives from the relationship, or the defendant's action in initiating the transaction are less important when suits involve corporate or private purchasers of securities on national markets.

The *Chris-Craft* case[132] provides one example of the application of duty in a non-fiduciary situation. That case involved a failure to disclose to Piper shareholders the personal financial interest of the corporation's inside shareholders in a counter offer to a takeover bid by Chris-Craft. Noting that a special relationship may create a duty to disclose material facts, the Second Circuit stated that, on the facts of the case, corporate insiders had a special responsibility to be meticulous and precise in their representations to shareholders concerning tender offers.[133] Thus, the *Chris-Craft* court apparently found a special relationship between the corporation and its stockholders which, under Rule 10b-5, required disclosure of all material facts in transactions involving purchase or sale of securities, but with a predetermined scienter standard of at least reckless or knowing conduct.

Under these circumstances, factors important in determining liability included the undisclosed benefit to inside corporate shareholders, the materiality of this fact to outside shareholders who were receiving the tender offer and counter offer, and the inside shareholders' activities in supporting the counter offer to Chris-Craft's takeover bid. While these considerations can be articulated to approximate the *White* court's principles governing scope of duty, they do not reflect

REP. ¶ 73,031; Ruszkowski v. Hugh Johnson & Co., 302 F. Supp. 1371 (W.D.N.Y. 1969). In some cases, lack of due diligence by the plaintiff has prevented his recovery. *See, e.g.,* Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90, 103 (10th Cir.), *cert. denied,* 404 U.S. 1004 (1971) (plaintiffs selling shares more than one week after full disclosure of material facts denied recovery); Branham v. Material Sys. Corp., 354 F. Supp. 1048 (S.D. Fla. 1973).

[131] *See* H. HENN, HANDBOOK OF THE LAW OF CORPORATIONS, §§ 235, 240 (2d ed. 1970).

[132] *See* text accompanying notes 44-51 *supra.*

[133] 489 F.2d at 364-65.

the traditional interests of trust and confidence present in a fiduciary situation.

The particular duty imposed by Rule 10b-5 is co-extensive with the broker's fiduciary duty to his customer. When, however, the traditional special relationship is not present, the duty imposed and the factors which will create the duty should be derived from the rule and not from principles formulated to govern fiduciaries or brokers. Thus, courts following *White* must make the transition from duties arising out of fiduciary relations to duties created exclusively by Rule 10b-5.[134] Implicit in these duties will be a requisite degree of scienter for liability, which must also be determined by the trial court. While the *White* court did not suggest what standards will be appropriate in all cases, it provided an analytical framework which may result in less

[134]Rather than rely on fiduciary principles as a guide for the duty and degree of scienter to impose upon a defendant, courts must derive a duty from the rule which will govern situations involving corporate defendants and private investors in national securities markets. A duty not to misrepresent can be derived from the rule with no difficulty, since misrepresentation is fraudulent conduct which the rule clearly forbids. But when the duty involves investigation and disclosure, more difficult questions are involved. Full and fair disclosure of material facts is one object of the federal securities laws. SEC v. Capital Gains Research Bureau, 375 U.S. 180, 186 (1963) (a fundamental purpose was to substitute a philosophy of full disclosure for the philosophy of caveat emptor); Popkin v. Bishop, 464 F.2d 714 (2d Cir. 1972). Although full disclosure should fulfill the duty imposed by Rule 10b-5, precisely when disclosure is required is a matter of debate. *See* Financial Indus. Fund, Inc. v. McDonnell Douglas Corp., 474 F.2d 514, 518 (10th Cir.), *cert. denied,* 414 U.S. 874 (1973) (release of information is a matter of corporate discretion); Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90, 99 (10th Cir.), *cert. denied,* 404 U.S. 1004 (1971) (did not decide if there was any duty to disclose, but what was said was fraudulent). A defendant trading securities on undisclosed information violates Rule 10b-5. Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 353 F. Supp. 264 (S.D.N.Y. 1972); *In re* Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961). From these cases has emerged a corporate discretion defense in nondisclosure cases, provided the corporate defendant is not trading in his own securities. *See Bromberg, Are There Limits to Rule 10b-5?*, 29 BUS. LAW. 167, 168 (1974). A duty to investigate further complicates the problem. A defendant could disclose all known facts, but recklessly or negligently fail to investigate and disclose additional facts which are material to the transaction. When the breach of duty is reckless, knowledge can be imputed to the defendant, placing him on notice, which raises a duty of inquiry. *See, e.g.,* Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341, 371 (2d Cir.), *cert. denied,* 414 U.S. 910 (1973) (notice of facts suggesting deception raises a duty of inquiry); Cohen v. Franchard Corp., 478 F.2d 115, 123 (2d Cir.), *cert. denied,* 414 U.S. 857 (1973). A failure to investigate facts which were not known, but should have been known, is a pure negligence standard under Rule 10b-5. Whether liability should be imposed for a negligent failure to investigate and disclose material facts when the plaintiff and defendant do not stand in some traditional form of fiduciary relationship is a decision which trial courts following *White* must make and which is beyond the scope of *White* and this note.

confusion and fewer contradictory results in Rule 10b-5 cases.[135]

Trial courts effecting this transition from fiduciary based duties to Rule 10b-5 derived duties either will resort to earlier precedent to resolve the issues of duty and scienter, or will formulate new standards in terms of the various duties which may arise under Rule 10b-5, free from rigid scienter concepts. In the former case, because many of the factors determinative of liability will remain unchanged, standards applied by earlier courts may be controlling. Under the latter course, courts which innovatively apply *White* will be able to deal flexibly with cases before them and develop new concepts of duty and scienter, either stricter or more lenient than earlier standards. Either course is possible, and conflicting interpretations of *White* have already emerged.[136]

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[135]Under these circumstances courts must consider the defendant's awareness of potential harm to investors from misrepresentation or nondisclosure, or the amount of damages as opposed to the culpability of the conduct violating the rule. *See* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 862-63 (2d Cir. 1968), *cert. denied,* 394 U.S. 976 (1969) (Rule 10b-5 violated when misleading or incomplete information was released in a manner calculated to influence the investing public). *See also* note 50 *supra.* On the other hand, it has been contended that there is no legitimate policy reason for disallowing recovery by investors injured by misleading corporate press releases solely because of their numbers. Painter, *Rule 10b-5: The Recodification Thicket,* 45 ST. JOHN'S L. REV. 699, 727 (1971). Another consideration is whether the defendant was trading in a security without disclosing material information unknown to injured parties. *See* Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 353 F. Supp. 264, 276 (S.D.N.Y. 1972) (by trading, defendant assumed a duty to disclose to all potential buyers); SEC v. Texas Gulf Sulphur Co., *supra* at 848 (anyone in possession of material inside information must disclose it to the investing public or abstain from trading). The plaintiff's own diligence to avoid the fraud or ascertain material facts has increasingly become significant in Rule 10b-5 litigation. *See, e.g.,* Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90, 103 (10th Cir.), *cert. denied,* 404 U.S. 1004 (1971) (shareholders who sold more than one week after all material facts were disclosed denied recovery). None of these considerations suggests an appropriate scienter standard for open market transactions, and it is unlikely that the current disagreement among circuit courts will be resolved in the near future unless the Supreme Court intervenes. A decision from the Supreme Court on the question has become less likely. Three Rule 10b-5 cases involving a scienter issue, Hochfelder v. Midwest Stock Exchange, 503 F.2d. 364 (7th Cir. 1974); Arber v. Essex Wire Corp., 490 F.2d 414 (6th Cir. 1974); Smallwood v. Pearl Brewing Co., 489 F.2d 579 (5th Cir. 1974), were recently denied review by the Court. 43 U.S.L.W. 3202 (Oct. 15, 1974).

[136]Two courts have cited *White* for authority. One court read the decision as imposing a negligence standard. Little v. First California Co., CCH FED. SEC. L. REP. ¶ 94,745 (D. Ariz. July 11, 1974). The other court cited *White,* noting that if a sufficiently high duty was established, a Rule 10b-5 action based on negligence and breach of fiduciary duty could be maintained. Larsen v. Blyth & Co., BNA SEC. REG. L. REP. 266 at A-13 (D. Ore. Aug. 16, 1974).

The Seventh Circuit recently suggested that it has adopted a flexible duty stan-

Conclusion

White v. Abrams did not suggest any substantive answer to the question of when negligence will suffice for liability under Rule 10b-5. The most significant aspect of *White* was its rejection of any one scienter standard as appropriate for liability in all cases, freeing lower courts from a scienter standard which had hardened into a choice between negligence or recklessness. Without rigid scienter standards, trial courts in the Ninth Circuit will be able to deal flexibly and realistically with Rule 10b-5 cases by focusing precisely on what duties exist between particular parties, and the requisite state of mind necessary for liability. What specific standards and duties will ultimately be applied will be determined by trial courts applying *White.* While it foreclosed strict liability under the rule, *White* suggests that a negligence standard will suffice in some cases. In a development of potentially greater impact, *White* also suggests that in certain instances negligence or even knowledge will be insufficient scienter, thereby intimating that plaintiffs may be held to stricter standards of proof than previously applied in any circuit.

White's most immediate impact will be upon the duty analysis standard of liability, regardless of the scienter standard which will ultimately be applied in particular situations. *White* has broadened extensively the potential range of duties that Rule 10b-5 imposes, the

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dard of liability. *See* Hochfelder v. Ernst & Ernst, 503 F.2d 1100 (7th Cir. 1974), *petition for cert. filed*, 43 U.S.L.W. 3475 (U.S. Feb. 20, 1975) (No. 74-1042). The case involved a suit against an accounting firm as an aider-abettor to a stock fraud scheme. Denying the defendant's argument that as a matter of law knowledge of the scheme was necessary for liability as an aider-abettor, the court noted that a claim could be maintained under Rule 10b-5 by showing that the defendant had knowledge, or but for a breach of duty of inquiry, should have had knowledge of the fraud. Possession of such knowledge, the court stated, in conjunction with a failure to act or breach of duty of disclosure, would allow recovery by the plaintiff. The court then continued:

> The foregoing elements comprise a flexible standard of liability which should be amplified according to the pecularities of each case. Accordingly, where, as here, it is urged that the defendant through action as well as inaction has facilitated the fraud of another, a claim for aiding and abetting is made on demonstrating: (1) that the defendant had a duty of inquiry; (2) the plaintiff was a beneficiary of that duty of inquiry; (3) the defendant breached the duty of inquiry; (4) concomitant with the breach of duty of inquiry the defendant breached a duty of disclosure; and (5) there is a causal connection between the breach of duty of inquiry and disclosure and the facilitation of the underlying fraud; that is, adequate inquiry and subsequent disclosure would have led to the discovery of the underlying fraud or its prevention.

Id. at 1104.

The Seventh Circuit did not refer to *White v. Abrams* in its opinion.

factors to apply in determining these duties, and the possible variations of scienter necessary for recovery in any case. This analytical framework for determining liability will be viable only if courts will precisely articulate the duty involved in each case and will clearly define the factors relied on in determining the scope of the duty and appropriate scienter standard. If trial courts merely articulate duty in terms of prior standards, then the flexible duty standard will represent a change in name only and not in substantive analysis. But if courts thoroughly pursue the *White* standard, a significant change in liability theory and substantive elements of recovery will result. The precise direction and degree of that change await the decisions of future courts.

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