



---

Summer 6-1-1975

## Factors Determining The Degree Of Culpability Necessary For Violation Of The Federal Securities Laws In Information Transmission Cases

David S. Ruder

Follow this and additional works at: <https://scholarlycommons.law.wlu.edu/wlulr>



Part of the [Accounting Law Commons](#), and the [Securities Law Commons](#)

---

### Recommended Citation

David S. Ruder, *Factors Determining The Degree Of Culpability Necessary For Violation Of The Federal Securities Laws In Information Transmission Cases*, 32 Wash. & Lee L. Rev. 571 (1975). Available at: <https://scholarlycommons.law.wlu.edu/wlulr/vol32/iss3/2>

This Article is brought to you for free and open access by the Washington and Lee Law Review at Washington and Lee University School of Law Scholarly Commons. It has been accepted for inclusion in Washington and Lee Law Review by an authorized editor of Washington and Lee University School of Law Scholarly Commons. For more information, please contact [christensena@wlu.edu](mailto:christensena@wlu.edu).

# Washington and Lee Law Review

Member of the National and Southern Law Review Conferences

---

Volume XXXII

Summer 1975

Number 3

---

## FACTORS DETERMINING THE DEGREE OF CULPABILITY NECESSARY FOR VIOLATION OF THE FEDERAL SECURITIES LAWS IN INFORMATION TRANSMISSION CASES

DAVID S. RUDER\*

Recent developments have raised serious questions concerning the standards of conduct required of various persons under the federal securities laws. This article discusses certain factors which affect the duties and liabilities of individuals who are involved directly or indirectly with the preparation of information and its transmission to the public,<sup>1</sup> concluding that the factors to be considered in determining whether a defendant's state of mind justifies imposition of civil liability or injunction should include: the likelihood that plaintiff has relied upon the defendant; the defendant's remoteness from the plaintiff's investment decision; the benefit which may accrue to the defendant; the defendant's occupation; the nature of the proceeding in which violation of the law is being asserted; and the effect upon securities law disclosure goals.

### *State of Mind - Recent Decisions*

As Rule 10b-5,<sup>2</sup> the primary vehicle for imposing securities law fraud obligations, has expanded in importance, the difficulties of analysis have also grown. In the crucial area of the degree of culpability necessary to support liability, developments have reached an extremely important stage. Under today's complicated analysis, the approach which a court takes in evaluating a defendant's state of

---

\*Professor of Law, Northwestern University School of Law, Chicago, Illinois. B.A. (1951), Williams College; J.D. (1957), University of Wisconsin.

<sup>1</sup>The communication of this information may take place in press releases, required filings under the federal securities laws, proxy solicitations, reports to stockholders, press releases or other public communications.

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

mind may be of decisive importance. In cases involving information transmission, the state of mind question may be phrased either in terms of negligence or in terms of duty of inquiry as follows:

1. Will the defendant be liable for negligence in transmitting misleading information to the public?
2. Did the defendant owe a duty to make inquiry at the time misleading information was transmitted by him or others to the public?

The above questions have been considered directly or indirectly in several recent cases. The Second Circuit recently held in *Lanza v. Drexel & Co.*<sup>3</sup> that an outside director need not answer in damages for failure to make detailed inquiries regarding documents transmitted to others in connection with his corporation's unregistered securities transactions. In *SEC v. Spectrum, Ltd.*,<sup>4</sup> the same court held in an action for injunction that a lawyer has a duty to search out underlying facts when rendering an opinion which has the effect of permitting unregistered securities to be sold. In *White v. Abrams*,<sup>5</sup> the Ninth Circuit recently declared that a flexible standard varying with the relationships between the parties should govern obligations under Rule 10b-5. The Second Circuit has also recognized that the relationship involved may affect the standard of culpability, stating in *Gerstle v. Gamble-Skogmo, Inc.*<sup>6</sup> that the existence of privity of contract may "bear heavily" on the appropriate standard.

Most recently the United States Supreme Court has granted a petition for a writ of certiorari in *Hochfelder v. Ernst & Ernst*,<sup>7</sup> a case decided by the Seventh Circuit involving an attempt to impose liability upon an accountant because of the accountant's failure to make adequate investigation. The case involves significant questions regarding the state of mind necessary to support liability under the federal securities laws.

*Hochfelder v. Ernst & Ernst*<sup>8</sup> was preceded by several other cases in the Seventh Circuit involving the fraud of Leston B. Nay. Nay, president of a broker-dealer firm, First Securities Company of Chicago, had induced friends and customers of his firm to invest funds in a fictitious escrow account, promising to pay them substantial

<sup>3</sup>479 F.2d 1277, 1309 (2d Cir. 1973) (en banc).

<sup>4</sup>489 F.2d 535, 541-42 (2d Cir. 1973).

<sup>5</sup>495 F.2d 724 (9th Cir. 1974).

<sup>6</sup>478 F.2d 1281, 1300 (2d Cir. 1973) (suit under Securities Exchange Act § 14(a) for proxy rule violations).

<sup>7</sup>503 F.2d 1100 (7th Cir. 1974), cert. granted, 43 U.S.L.W. 3545 (U.S. Apr. 14, 1975) (No. 74-1042).

<sup>8</sup>*Id.*

amounts in interest each year. Nay appropriated the funds for his own use and finally committed suicide.<sup>9</sup>

The first of the two early opinions involving Nay's activities, *SEC v. First Securities Co. of Chicago*,<sup>10</sup> created significant uncertainty with regard to the duties of persons remote from securities transactions through its statement that liability may be founded on "less than actual knowledge and participation in the activity proscribed by section 10 and Rule 10b-5."<sup>11</sup> The latter statement was repeated and amplified in *Hochfelder v. Midwest Stock Exchange*,<sup>12</sup> in which the Seventh Circuit dealt with a claim that the Midwest Stock Exchange should have discovered Nay's fraud. In suing Midwest, plaintiff alleged that the exchange failed to fulfill two separate obligations: 1) a duty to make inquiry regarding the activities of member firms; and 2) a duty to take action once information about a member firm's fraud was known. The court was asked to find that Midwest, which had no actual knowledge of Nay's fraud, should be charged with constructive knowledge of that fraud and be held liable for its inaction. The Seventh Circuit stated that the issues were whether Midwest had fulfilled its duty as a national securities exchange under Section 6 of the Securities Exchange Act of 1934 and whether Midwest had aided and abetted Nay's fraud by action or inaction.<sup>12.1</sup> It held that Midwest had satisfied its duty of inquiry, finding in favor of Midwest on both issues and stating the following:

[A]s our analysis of Midwest's section 6 duty of self-regulation demonstrates, Midwest adequately satisfied its duty of inquiry and had no reason to know of or suspect Nay's

---

<sup>9</sup>In the first of five Seventh Circuit decisions involving his suicide, *SEC v. First Securities Co.*, 463 F.2d 981 (7th Cir. 1972), *cert. denied*, 409 U.S. 880 (1972), the court dealt with an appeal from the disallowance of claims by fifteen persons against First Securities Company in receivership proceedings following Nay's death. The court of appeals reversed a district court finding which had denied the escrow investors' claims. A second Seventh Circuit opinion involving Nay's fraud, also entitled *SEC v. First Securities Co.*, 466 F.2d 1035 (7th Cir. 1972), *cert. denied* 409 U.S. 1041 (1972) involved Nay's swindle of Arnold Schueren. Over the years Nay had pledged or sold securities of Schueren for his own purposes while continuing to send Schueren bogus safe-keeping receipts and "dividend checks" purportedly relating to those securities. The Seventh Circuit held that Schueren was properly a claimant against First Securities Company even though the fraud had not been conducted formally through First Securities. A fifth decision recently dealt with the priorities of various claimants against the assets of First Securities. See *SEC v. First Securities Co.*, 507 F.2d 417 (7th Cir. 1974).

<sup>10</sup>463 F.2d 981 (7th Cir. 1972), *cert. denied*, 409 U.S. 880 (1972).

<sup>11</sup>463 F.2d at 987. For an earlier analysis and discussion of *S.E.C. v. First Securities Co.*, see Horwich & Ruder, *Seventh Circuit Review - Securities Law*, 50 CHI.-KENT L. REV. 362, 377-79 (1973).

<sup>12</sup>503 F.2d 364 (7th Cir. 1974), *cert. denied*, 419 U.S. 875 (1974).

<sup>12.1</sup>503 F.2d at 367, 374.

fraudulent escrow scheme. Failing proof that Midwest knew or should have known of Nay's fraud we need not further our inquiry into the other elements of a claim for aiding and abetting solely by inaction.<sup>13</sup>

Following the Seventh Circuit's decision in *Hochfelder v. Midwest Stock Exchange*, the Supreme Court declined to issue a writ of certiorari sought by the plaintiff.<sup>14</sup>

Subsequent to its *Midwest Stock Exchange* decision, the Seventh Circuit held in *Hochfelder v. Ernst & Ernst*<sup>15</sup> that the accountant charged with making examination of the books and records of First Securities had not necessarily satisfied duties of inquiry which it owed under Section 17(a) and Rule 17a-5 of the Securities Exchange Act of 1934.<sup>16</sup> Again, a writ of certiorari was sought from the United States Supreme Court, in this instance by the accountant defendant rather than by the plaintiff Hochfelder. In its brief seeking the writ, Ernst & Ernst emphasized that the Seventh Circuit had expressed willingness to impose liability upon the accountant to a remote group of investors because of its alleged failure to make adequate investigation. It advanced the contention that a split between circuit courts with regard to whether a defendant could be held liable for negligence under the securities laws was a primary reason why a petition should be granted. This time the Supreme Court granted the petition.

In reviewing *Hochfelder v. Ernst & Ernst*<sup>17</sup> the Supreme Court can be expected to center upon the statement of the Seventh Circuit contained in both the *Midwest* and *Ernst & Ernst* decisions that:

[W]e are not prepared to hold that a claim for aiding and abetting solely by inaction cannot be made under Rule 10b-5. In invoking such a rule, however, we would not go so far as to charge a party with aiding and abetting who somehow unwittingly facilitated the wrongful acts of another. Rather, to invoke such a rule investors must show that the party charged with aiding and abetting had knowledge of or, but for a breach of duty of inquiry, should have had knowledge of the fraud, and that possessing such knowledge the party failed to act due to an improper motive or breach of a duty of disclosure.<sup>18</sup>

In both the *Midwest* and *Ernst & Ernst* phases of the *Hochfelder* cases, the Seventh Circuit expressed its willingness to impose liabil-

---

<sup>13</sup>503 F.2d at 374-75.

<sup>14</sup>419 U.S. 875 (1974).

<sup>15</sup>503 F.2d 1100 (7th Cir. 1974), cert. granted, 43 U.S.L.W. 3545 (U.S. Apr. 14, 1975) (No. 74-1042).

<sup>16</sup>It remanded the case to the district court for a trial on the facts. 503 F.2d at 1119.

<sup>17</sup>See note 7 *supra*.

<sup>18</sup>503 F.2d at 374; see 503 F.2d at 1104.

ity upon defendants in securities law cases based upon failure of a duty of investigation and failure to take action once information is known.

### *State of Mind - Analysis*

For purposes of analysis, several categories relating to state of mind may be considered:

1. Deliberate conduct exists when the defendant has an intent to injure others.
2. Knowing conduct exists when the defendant acts with the knowledge that his acts may injure others. Knowing conduct would include knowing misrepresentation or nondisclosure.
3. Reckless conduct exists when the defendant acts in conscious disregard of, or indifference to, the risk that others will be misled. This conduct includes what is sometimes referred to as "gross negligence."
4. Negligent conduct exists when the defendant acts unreasonably but does not act with conscious disregard of consequences.
5. Innocent conduct exists when the defendant cannot reasonably be expected to know the true facts.<sup>19</sup>

Although the above distinctions represent many years of accumulated common law analysis, they nevertheless have failed to provide the required degree of predictability under the federal securities laws. Perhaps because of the many variables available, the federal circuit courts of appeals are widely split regarding the state of mind required to establish liability.

In the Second Circuit "proof of a willful or reckless disregard for the truth is necessary to establish liability under Rule 10b-5."<sup>20</sup> The Fifth Circuit has recently agreed with the Second Circuit's position, stating that "some culpability beyond mere negligence is required for liability under 10b-5."<sup>21</sup> The Tenth Circuit also agrees that something in addition to negligence is required:

[T]his court has repeatedly declined to extend the [federal securities] acts to cases of simple negligence not involving some fraudulent purpose or species of scienter within their

---

<sup>19</sup>Ruder & Cross, *Limitations on Civil Liability Under Rule 10b-5*, 1972 DUKE L.J. 1125, 1140 (footnote omitted).

<sup>20</sup>*Lanza v. Drexel & Co.*, 479 F.2d 1277, 1306 (2d Cir. 1973) (en banc) (footnote omitted).

<sup>21</sup>*Vohs v. Dickson*, 495 F.2d 607, 622 (5th Cir. 1974), citing *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579, 606 (5th Cir. 1974), and *Sargent v. Genesco, Inc.*, 492 F.2d 750, 761 (5th Cir. 1974).

scope and purpose.<sup>22</sup>

Despite the position of the Second, Fifth and Tenth Circuits requiring some culpability beyond negligence, other Circuits have determined that negligence will support Rule 10b-5 liability. The Eighth Circuit reached this conclusion relatively long ago<sup>23</sup> and most recently, the Seventh Circuit stated in *Tomera v. Galt*<sup>24</sup> that "Rule 10b-5 claimants need not prove nor plead scienter."<sup>25</sup>

The split between those circuits holding that something beyond negligence is required in order to establish liability under Rule 10b-5 and those circuits holding that Rule 10b-5 claimants need only prove negligence is emphasized by the middle ground positions of other circuits. In *Rochez Bros., Inc. v. Rhoades*,<sup>26</sup> the Third Circuit recently stated that it has "never been faced squarely" with the scienter question, and indicated that it would not rush to rule on the problem.<sup>27</sup> In *White v. Abrams*,<sup>28</sup> the Ninth Circuit, which has long been thought to have adopted negligence as a standard because of its statements in *Ellis v. Carter*<sup>29</sup> and *Royal Air Properties v. Smith*,<sup>30</sup>

---

<sup>22</sup>*Clegg v. Conk*, 507 F.2d 1351, 1362 (10th Cir. 1974), cert. denied, 43 U.S.L.W. 3659 (June 16, 1975). See also *Zabriskie v. Lewis*, 507 F.2d 546 (10th Cir. 1974): "When liability is to be imposed on participants, aiders and abettors, and co-conspirators knowing participation in the fraudulent scheme must be shown." *Id.* at 554.

<sup>23</sup>*Vanderboom v. Sexton*, 422 F.2d 1233, 1239 (8th Cir.), cert. denied, 400 U.S. 852 (1970); accord, *City Nat'l Bank v. Vanderboom*, 422 F.2d 221, 230 (8th Cir.), cert. denied, 399 U.S. 905 (1970).

<sup>24</sup>511 F.2d 504 (7th Cir. 1975).

<sup>25</sup>*Id.* at 508. In its *Tomera* decision, the Seventh Circuit did not specifically define the term "scienter," but it apparently meant to adopt a negligence standard for Rule 10b-5 liability. The court referred to *Parrent v. Midwest Rug Mills, Inc.*, 455 F.2d 123 (7th Cir. 1972), in which it had utilized a negligence standard in selecting a statute of limitations under Rule 10b-5 and which in turn had relied upon the Eighth Circuit's decision in *Vanderboom v. Sexton*, 422 F.2d 1233 (8th Cir.), cert. denied, 400 U.S. 852 (1970). *Tomera* also noted *Vanderboom's* reliance upon *Ellis v. Carter*, 291 F.2d 270 (9th Cir. 1961), to sustain the Eighth Circuit's negligence standard of scienter. The Seventh Circuit's *Tomera* decision also referred to *Dasho v. Susquehanna Corp.*, 461 F.2d 11 (7th Cir.), cert. denied, 408 U.S. 925 (1972), with a "Cf." citation, apparently intending to establish that the *Dasho* implication that scienter might be required in regard to directors' liability was not consistent with the *Tomera* decision. 511 F.2d at 509.

<sup>26</sup>491 F.2d 402, 407 (3d Cir. 1973).

<sup>27</sup>The *Rochez Bros.* court did, however, find that actual knowledge of the fraudulent misrepresentation would be sufficient scienter, reserving the question of the adequacy of recklessness for a later decision. 491 F.2d at 402, 407. See also *Fenstermacher v. Philadelphia Nat'l Bank*, 493 F.2d 333, 340 (3d Cir. 1974).

<sup>28</sup>495 F.2d 724 (9th Cir. 1974).

<sup>29</sup>291 F.2d 270, 274 (9th Cir. 1961), cited in, e.g., *Vanderboom v. Sexton*, 422 F.2d 1233, 1239 (8th Cir.), cert. denied, 400 U.S. 852 (1970).

<sup>30</sup>312 F.2d 210, 212 (9th Cir. 1962), cited in *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 854 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969).

recently rejected concentration on labels and adopted its flexible duty concept, stating:

[T]he court should . . . require the jury to consider the relationship of the defendant to the plaintiff, the defendant's access to the information as compared to the plaintiff's access, the benefit that the defendant derives from the relationship, the defendant's awareness of whether the plaintiff was relying upon their relationship in making his investment decisions and the defendant's activity in initiating the securities transaction in question.<sup>31</sup>

The split between circuits regarding the state of mind question has naturally created uncertainty with regard to the standard to be used in imposing liability. Most frequently the question will be phrased as whether a defendant will be liable to a particular plaintiff or class of plaintiffs for negligence.<sup>32</sup> The answer may well depend upon the relationships between the parties. Although the flexible duty standard of *White v. Abrams* is subject to criticism because of its failure to provide better guidelines for conduct, its concentration upon the relationships between parties appears to be correct.<sup>32.1</sup>

#### *Relationship Between Parties As a Relevant Consideration*

In the context of an action based upon transmission of misleading information, the parties may be relatively close to or relatively remote from each other. In some situations information will be trans-

---

<sup>31</sup>*Id.* at 735-36 (footnotes omitted). The court applied its flexible duty standard in *Marx v. Computer Sciences Corp.*, 507 F.2d 485 (9th Cir. 1974), a case involving earnings forecasts which reversed a summary judgment granted in favor of the defendants because it was not clear that the defendants had met their duties imposed under Rule 10b-5. Subsequently, the Ninth Circuit Court of Appeals has made it clear that its *White v. Abrams* opinion permits liability to be imposed for negligence. See *Robinson v. Cupples Container Co.*, 513 F.2d 1274 (9th Cir. 1975); *Clark v. Watchie*, 513 F.2d 994 (9th Cir. 1975).

<sup>32</sup>In any event, it is virtually certain in all circuits that liability will be imposed for something less than deliberate conduct.

<sup>32.1</sup>See text accompanying note 31 *supra*. The *White* court suggested the following rationale:

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 has 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.

495 F.2d at 736.



mitted for the purpose of inducing the plaintiff's reliance in a securities transaction or its equivalent. Such transactions may include face-to-face purchase transactions, sales of securities by a corporation or its controlling shareholders pursuant to a registration statement under the Securities Act of 1933,<sup>33</sup> or a corporate transaction which requires a vote of shareholders and is the equivalent of a purchase or sale.<sup>34</sup> In such transactions the corporation itself usually transmits the information and will usually benefit from any misrepresentations. In contrast, many purchase and sale transactions will take place in the impersonal securities markets, remote from the person or corporation transmitting information.

One method of distinguishing between the types of transactions involved is to ask whether the plaintiffs were engaged in a securities transaction with the defendant. If a contractual relationship exists, the relationship may be described as one of privity of contract. Even when privity in the traditional sense does not exist, the relationship may be close enough so that it is the equivalent of privity for Rule 10b-5 purposes.

Most courts currently hold that privity of contract is not an essential element for recovery. In doing so they have devoted little discussion to state of mind considerations, primarily because the defendants' conduct has clearly been highly culpable.<sup>34.1</sup> For instance, one of the first cases declaring that privity of contract is not a required element for recovery under Rule 10b-5, *Cochran v. Channing Corp.*,<sup>35</sup> involved a deliberate scheme by corporate insiders to purchase minority shares by omitting a quarterly dividend in order to drive down the market price. Another early case, *Texas Continental Life Insurance Co. v. Bankers Bond Co., Inc.*,<sup>36</sup> involved sales of securities by the wrongdoer to an intermediary who sold to a third party. The third party was permitted to sue the original seller who had engaged in knowing misrepresentations.

Two cases involving information transmission are consistent with the proposition that elimination of privity has usually occurred in cases of knowing or deliberate conduct. *Heit v. Weitzen*,<sup>37</sup> holding

<sup>33</sup>15 U.S.C. § 77(a)-(aa) (1970).

<sup>34</sup>SEC Rule 145, promulgated under the 1933 Act, now treats such transactions as a sale, 17 C.F.R. 230.145 (1974). See also SEC v. National Securities, Inc., 393 U.S. 453 (1969); Vine v. Beneficial Fin. Co., 374 F.2d 627 (2d Cir.), cert. denied, 389 U.S. 970 (1967).

<sup>34.1</sup>For a general discussion balancing the factors of scienter, privity and the nature of the fraud in terms of misrepresentation or nondisclosure, see Ruder, *Texas Gulf Sulphur—The Second Round: Privity and State of Mind in Rule 10b-5 Purchase and Sale Cases*, 63 Nw. U.L. Rev. 423, 442-44 (1968).

<sup>35</sup>211 F. Supp. 239, 245 (S.D.N.Y. 1962).

<sup>36</sup>187 F. Supp. 14, 24-25 (W.D.Ky. 1960), rev'd on other grounds sub nom., *Texas Continental Life Ins. Co. v. Dunne*, 307 F.2d 242 (6th Cir. 1962).

<sup>37</sup>402 F.2d 909, 913 (2d Cir. 1968), cert. denied, 395 U.S. 903 (1969).

that "[t]here is no necessity for contemporaneous trading in securities by insiders or by the corporation itself," involved misleading SEC filings made intentionally in order to defraud the government in transactions unrelated to plaintiffs' purchase transactions. Similarly in *Mitchell v. Texas Gulf Sulphur Co.*,<sup>38</sup> the court affirmed imposition of liability upon Texas Gulf Sulphur Co. for press releases characterized as intentionally misleading, even though the company had not engaged in securities transactions.

The case which most clearly deals with the question whether the characteristics of the securities transaction affect the obligation owed is *Gerstle v. Gamble-Skogmo, Inc.*<sup>39</sup> In that case, the Second Circuit was faced with a proxy statement which had been used to solicit the permission of shareholders for a corporate transaction in which their interests in the corporation would be substantially changed. The *Gerstle* court recognized that it had recently held in *Lanza v. Drexel & Co.*<sup>40</sup> that scienter is a required element for imposing liability under Rule 10b-5 and sought to distinguish Rule 10b-5 from Rule 14a-9, which governs proxy solicitation. It did so by emphasizing privity, stating that:

[W]hile "privity" is not required for most actions under the securities laws, its existence may bear heavily on the appropriate standard of culpability. . . .<sup>41</sup>

Analyzing the particular transaction, the court noted that the required proxy statement "serves many of the same functions as a registration statement" and, despite its *Lanza* decision, adopted a negligence standard:

[A] broad standard of culpability here will serve to reinforce the high duty of care owed by a controlling corporation to minority shareholders in the preparation of a proxy statement seeking their acquiescence . . . .<sup>42</sup>

The Second Circuit's *Gerstle* decision seems to recognize that a defendant's obligations may be affected by the nature of the transaction and in this regard seems to parallel the flexible duty standard of the Ninth Circuit in *White v. Abrams*.<sup>43</sup> In other situations, the

---

<sup>38</sup>446 F.2d 90 (10th Cir.), cert. denied, 404 U.S. 1004 (1971).

<sup>39</sup>478 F.2d 1281 (2d Cir. 1973). The court in *Gerstle* was faced with a suit under SEC Rule 14(a)(9), not Rule 10b-5. But the principles used by the court in determining the standard under Rule 14(a)(9) usefully illustrate how the same analysis may be applied to Rule 10b-5. Cf. *Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 480 F.2d 341 (2d Cir.), cert. denied, 414 U.S. 910 (1973).

<sup>40</sup>479 F.2d 1277 (2d Cir. 1973).

<sup>41</sup>478 F.2d at 1300.

<sup>42</sup>*Id.*

<sup>43</sup>495 F.2d 724 (9th Cir. 1974).

Second Circuit has indicated a willingness to assess culpability in relation to the facts of the particular transaction. In *Chris Craft Industries, Inc. v. Piper Aircraft Corp.*,<sup>44</sup> a case involving an attempted corporate acquisition and decided under Section 14(e), it stated:

The function of what has been called the "scienter" requirement is to confine the imposition of liability to those whose conduct has been sufficiently culpable to justify the penalty sought to be exacted. The initial inquiry in each case is what duty of disclosure the law should impose upon the person being sued.<sup>45</sup>

Subsequently, in *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*,<sup>46</sup> the Second Circuit interpreted its rule that those in possession of material non-public corporate information must make appropriate disclosure of that information or refrain from trading. The court found that both trading and non-trading defendants knew that material revised earnings information was non-public.<sup>47</sup> It denied a privity defense and held the defendants liable to a class of purchasers in anonymous market transactions.<sup>48</sup>

#### *Disclosure and Fairness Considerations*

In utilizing concepts of privity and state of mind to determine liability in connection with information transmission, a court will be required to determine whether its policy choices will achieve good results with regard to both fairness and disclosure policy.<sup>49</sup> In the SEC

<sup>44</sup>480 F.2d 341, (2d Cir.), *cert. denied*, 414 U.S. 910 (1973). The *Chris-Craft* case was a private damage action involving fraud in defeating an attempted takeover of Piper through a tender offer by Chris-Craft. The court generally followed principles developed under Rule 10b-5 to formulate the elements of a claim under § 14(e) of the Securities Exchange Act. 15 U.S.C. § 78n(e) (1970). 480 F.2d at 362.

<sup>45</sup>*Id.* at 363 (citations omitted).

<sup>46</sup>495 F.2d 228 (2d Cir. 1974).

<sup>47</sup>*Id.* at 238.

<sup>48</sup>However, in recognition of the possibility of "Draconian liability," the circuit court left "the fashioning of appropriate relief, including the proper measure of damages" to the district court. *Id.* at 242. *But cf.* *Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 516 F.2d 172 (2d Cir. 1975) (Section 14(e) action; damages assessed at \$26 million plus prejudgment interest).

<sup>49</sup>In *Mitchell v. Texas Gulf Sulphur*, 446 F.2d 90 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971), the court found that the company's press release was intentionally misleading and as a result it held the corporate defendant liable to purchasers who relied upon that representation, even though the company itself had not engaged in securities transactions. *See also* *Financial Indus. Fund, Inc. v. McDonnell Douglas Corp.*, 474 F.2d 514 (10th Cir.), *cert. denied*, 414 U.S. 874 (1973) (timing of release of adverse financial report is a matter of corporate discretion; defendant exercised good faith and due diligence in disclosing information, so not liable under Rule 10b-5).

injunctive proceeding, *S.E.C. v. Texas Gulf Sulphur Co.*,<sup>50</sup> Judge Friendly raised both problems by questioning whether a corporation issuing a negligent press release should be liable to persons engaged in anonymous market transactions. He emphasized the negative aspects by stating:

The consequences of holding that negligence in the drafting of a press release . . . may impose civil liability on the corporation are frightening.<sup>51</sup>

In the subsequent *Gerstle*<sup>52</sup> decision, Judge Friendly expressed his concern regarding disclosure policy. After concluding that proof of negligence is sufficient to impose liability upon a corporation which uses a misleading proxy, Judge Friendly referred to Rule 10b-5 cases and indicated that if privity or its equivalent were absent in information transmission cases, the court would not utilize such a high standard:

[M]any 10b-5 cases relate to statements issued by corporations, without legal obligation to do so, as a result of what the SEC has properly called "a commendable and growing recognition on the part of industry and the investment community of the importance of informing security holders and the public generally with respect to important business and financial developments." . . . Imposition of too liberal a standard with respect to culpability would deter this, particularly in light of

---

<sup>50</sup>401 F.2d 833, 866 (2d Cir. 1968) (en banc) (Friendly, J., concurring), *cert. denied*, 394 U.S. 976 (1969).

<sup>51</sup>401 F.2d at 866. He continued:

As has been well said, of a situation where time pressures and consequent risks were less, "One source of perplexity as to the appropriate bounds of the civil remedy for misleading filings is that any remedy imposed against the issuer itself is indirectly imposed on all holders of the common stock, usually the most important segment of the total category of investors intended to be protected." Milton Cohen, *Truth in Securities Revisited*, 79 Harv. L. Rev. 1340, 1370 (1967). Beyond this, a rule imposing a civil liability in such cases would work directly counter to what the SEC has properly called "a commendable and growing recognition on the part of industry and the investment community of the importance of informing security holders and the public generally with respect to important business and financial developments." Securities Act Interpretation Release No. 3844 (Oct. 8, 1957). If the only choices open to a corporation are either to remain silent and let false rumors do their work, or to make a communication, not legally required, at the risk that a slip of the pen or failure properly to amass or weigh the facts—all judged in the bright gleam of hindsight—will lead to large judgments, payable in the last analysis by innocent investors, for the benefit of speculators and their lawyers, most corporations would opt for the former.

*Id.* at 866-67.

<sup>52</sup>*Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281 (2d Cir. 1973).

the almost unlimited liability that may result. . . .<sup>53</sup>

Judge Adams of the Third Circuit also expressed concern regarding fairness in his dissent in *Kohn v. American Metal Climax, Inc.*:<sup>54</sup>

It is fitting that in the face-to-face confrontations, courts should impose a higher standard of disclosure by lessening the degree of culpability upon which liability can be imposed. From a practical standpoint, in such situations, the amount of damages is relatively finite, whereas in a suit on behalf of a class composed of thousands of shareholders, damages might well extend into millions of dollars. When faced with such huge potential payments, the brunt of which will be borne by innocent shareholders of the defendant corporation, the courts seem to have proceeded more slowly, by requiring that the plaintiff class prove conduct closer to the traditional concepts of actionable fraud.<sup>55</sup>

#### *Reliance and Foreseeability as Factors Influencing Results*

The theory that liability for transmitting misrepresentations to the investing public may depend upon the relationship between those transmitting and those receiving the information may also be expressed in terms of reliance and foreseeability. In all instances it can be expected that those transmitting corporate information will reasonably foresee that individuals receiving the information will rely upon it. Reliance may exist in an individual transaction, such as a face-to-face securities purchase, or a loan transaction. It may also

---

<sup>53</sup>*Id.* at 1300 (citations omitted).

<sup>54</sup>458 F.2d 255 (3d Cir.), *cert. denied*, 409 U.S. 874 (1972).

<sup>55</sup>*Id.* at 286. Similarly the SEC recognized in a recent amicus brief that motive and benefit are relevant to recovery when liability is asserted against a corporation in non-privy transactions:

Although there are strong public policies that militate in favor of imposing liability upon a corporation for the acts of its officers and authorized agents, a court may well be concerned that the wrongful acts of officers in violation of Rule 10b-5 not expose the shareholders of a publicly-owned corporation to undue liability. Of course no reason exists, either in equity or in the objectives of the federal securities laws, to permit a corporation to retain profits or any other forms of benefits it may have derived from the wrongful acts of its officers or agents. But where the corporation has not benefitted, the courts may find it equitable, and consistent with the basis upon which a right of action has been implied under Rule 10b-5, to limit an award of damages against it.

Brief for the Securities and Exchange Commission as Amicus Curiae in Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit at 27-28, *Manor Drug Stores v. Blue Chip Stamps*, 492 F.2d 136 (9th Cir. 1974), *reversed*, 95 S. Ct. 1917 (1975). The text of this article was completed prior to the Supreme Court's *Blue Chip Stamps* opinion.

exist when a group of persons rely upon information in specific transactions, such as the purchase of securities pursuant to a registration statement or a proxy oriented corporate transaction. Larger groups may also rely when engaging in purchase or sale transactions in the impersonal securities markets. Examination of expected reliance in terms of foreseeability may assist in identifying the appropriate standard.

As with other areas of development under Rule 10b-5, it may be useful to turn to common law parallels to determine the standards which should be employed. One readily available source of common law comparison is the law relating to accountants' liabilities.<sup>56</sup> Accountants' cases offer particularly useful concepts because in performing public auditing and certification functions accountants accept a degree of responsibility for reliable information transmission.<sup>57</sup> The reliance element is also present, since the individual accountant usually can foresee that his certificate regarding financial information will be relied upon by others in investment and commercial transactions.<sup>58</sup>

For purposes of analogy to federal securities law problems, the significant question is whether an accountant will be liable for misrepresentations made and relied upon by the investing public.<sup>59</sup> In this regard, the significant starting point is that privity of contract nor-

<sup>56</sup>If the accountant is employed merely to "write-up" the books of the client, he normally accepts the client's records as being correct and has no obligation to make further investigation. The question of an accountant's obligation to engage in audit activities when employed only for "write-up" purposes has created substantial controversy in the accounting profession. See 1136 *Tenants' Corp. v. Max Rothenberg & Co.*, 36 App. Div.2d 804, 319 N.Y.S.2d 1007 (1971), *motion to dismiss appeal denied*, 28 N.Y.2d 991, 323 N.Y.S.2d 844 (1971), *aff'd. mem.*, 30 N.Y.2d 585, 281 N.E.2d 846, 330 N.Y.S.2d 800 (1972).

<sup>57</sup>In contrast to write-up services, audit services require the accountant to test the reliability of a client's records as well as internal controls. See generally, *Statements on Auditing Standards, Auditing Standards Executive Committee, American Institute of Certified Public Accountants*, CCH AICPA PROFESSIONAL STANDARDS, AU § 100 (1974). An accountant's duties of inquiry do not ordinarily include an obligation to discover theft or defalcations:

[T]he ordinary examination directed to the expression of an opinion on financial statements is not primarily or specifically designed, and cannot be relied upon, to disclose defalcations and other similar irregularities . . . .

*Auditing Standards Executive Committee (AICPA), Statements on Auditing Standards*, CCH AICPA PROFESSIONAL STANDARDS, AU § 110.05 (1974).

<sup>58</sup>If an accountant certified a client's financial statement he represents not only that an audit has been conducted, but also that the financial information has been presented in accordance with generally accepted accounting principles. See generally *Accepted Accounting Principles—Pervasive Principles*, CCH AICPA PROFESSIONAL STANDARDS, AC § 1026 (1974).

<sup>59</sup>An accountant's liability to his client for failure to perform his engagement properly will normally be imposed under contract principles. For instance an accountant employed to file tax returns may be subject to liability to his client for a failure to

mally will not exist, *i.e.*, the accountant will not have entered into a contractual relationship with the investor who is relying upon his accounting statement. In that situation an accountant making a consciously false misrepresentation will be liable at common law to all persons who reasonably rely upon the misrepresentation even though privity of contract does not exist. This principle is set forth in proposed § 531 of the Restatement of Torts:

One who makes a fraudulent misrepresentation is subject to liability for pecuniary loss

(a) to the persons or class of persons whom he intends or has reason to expect to act or refrain from action in reliance upon the misrepresentation; and

(b) for pecuniary loss suffered by them through their reliance in the type of transaction in which he intends or has reason to expect their conduct to be influenced.<sup>60</sup>

For this purpose the Restatement's term "fraudulent" means "consciously false,"<sup>61</sup> so the standard is still a high one.

The more difficult question is whether accountants should be liable for misrepresentations which are negligently or recklessly made. *Ultramares Corp. v. Touche*<sup>62</sup> presented this problem in an action for damages suffered because of negligent misrepresentations by accountants. The court denied liability for negligence with the much quoted statement that such liability might "expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class."<sup>63</sup> In *State Street Trust Co. v. Ernst & Ernst*,<sup>64</sup> the court imposed liability upon accountants who recklessly prepared corporate financial statements upon which a lender relied. This case involved recklessness which can be equated with knowing conduct.<sup>65</sup>

---

on time. *L. B. Laboratories, Inc. v. Mitchell*, 39 Cal.2d 56, 59, 244 P.2d 385, 389 (1952). Liability may also be imposed in tort in favor of the client. *Ryan v. Kanne*, 170 N.W.2d 395 (Iowa 1969) (affirmative representations that the payables had been confirmed when they had not been confirmed); *Stanley L. Bloch, Inc. v. Klein*, 45 Misc. 2d 1054, 258 N.Y.S.2d 501 (S.Ct. 1965) (representation that the financial statement was audited when it was not). With regard to third party liability, see Fiflis, *Current Problems of Accountants' Responsibilities to Third Parties*, 28 VAN. L. REV. 31 (1975).

<sup>60</sup>RESTATEMENT (SECOND) OF TORTS § 531 (Tent. Draft No. 10, 1964).

<sup>61</sup>RESTATEMENT OF TORTS, Explanatory Notes § 552, comment 8 at 98 (Tent. Draft No. 10, 1964).

<sup>62</sup>255 N.Y. 170, 174 N.E. 441 (1931).

<sup>63</sup>255 N.Y. at 179, 174 N.E. at 444.

<sup>64</sup>278 N.Y. 104, 15 N.E.2d 416 (1938).

<sup>65</sup>See discussions of the differences and similarities between knowledge and recklessness in Ruder & Cross, *Limitations on Civil Liability Under Rule 10b-5*, 1972 DUKE L.J. 1125, 1140. In the context of alleged securities fraud, some courts have suggested that awareness of facts suggesting deception or fraud raises a duty of inquiry. Failure to inquire further may amount to recklessness. See, *e.g.*, *Lanza v. Drexel & Co.*, 479 F.2d 1277, 1306 n.98 (2d Cir. 1973).

Both the *Ultramares* and *State Street Trust* cases involved identification of the persons who will foreseeably rely upon the financial statements. In *Ultramares* the foreseeable group was large and indefinite. In the *State Street Trust* case the lender was an easily identified person whom the accountant could have reasonably foreseen would rely upon the financial statement.

A third illustrative case, *Ryan v. Kanne*,<sup>66</sup> involved negligence rather than recklessness or intentional conduct and raised directly the question whether an accountant could be liable for negligence in non-privy transactions. The court imposed liability upon an accountant who negligently prepared a misleading financial report knowing both the identity of the non-privy plaintiff and the plaintiff's intent to rely on the report in purchasing stock. In imposing liability, the court emphasized the "strength of the proposition that an accountant should be liable in negligence for careless financial misrepresentation relied upon by actually foreseen and limited classes of persons."<sup>67</sup> Nevertheless it expressly noted that liability for negligence should *not* extend to "all foreseeable persons who may rely upon the report."<sup>68</sup>

This common law emphasis upon foreseeability was recently analyzed by the Seventh Circuit in *Hochfelder v. Ernst & Ernst*,<sup>69</sup> discussed above. In that case the court held that the accountant was not liable under common law to a broad class of investors for negligent conduct. The court identified two groups of persons to whom the accountant might be liable for negligence. It first described the "foreseen plaintiff" as follows:

[T]hose third persons, whose potential reliance on the financial statements was specifically known to the accountant . . . .<sup>70</sup>

It then identified the "foreseeable plaintiff":

[T]hose who, although not themselves foreseen, are members of a limited class whose reliance on the financial statements is specifically foreseen.<sup>71</sup>

The court indicated that persons falling outside of these groups were not entitled to recover under common law theories.

This identification of groups based upon foreseeability recognizes

<sup>66</sup>170 N.W.2d 395 (Iowa 1969).

<sup>67</sup>*Id.* at 402. See also RESTATEMENT (SECOND) OF TORTS § 552 (Tent. Draft No. 12, 1966).

<sup>68</sup>170 N.W.2d at 403.

<sup>69</sup>503 F.2d 1100 (7th Cir. 1974), *cert. granted*, 43 U.S.L.W. 3545 (U.S. Apr. 14, 1975) (No. 74-1042).

<sup>70</sup>503 F.2d at 1107.

<sup>71</sup>*Id.*



that the concepts of reliance and foreseeability are relative and subject to policy judgments. Clearly an accountant can foresee that financial statements bearing his certificate will be widely relied upon by persons making investment decisions. Despite this fact, common law courts have limited liability for negligent conduct by drawing lines which recognize the potential unfairness of imposing immense damages for negligence. These lines are indistinct, but nevertheless useful, since at some point potential plaintiffs are so remote from the accountant and so numerous that negligent but good faith conduct should not give rise to liability.

From the federal securities law viewpoint the common law accountants' cases thus seem to confirm a trend in information transmission cases by which liability may depend upon the interrelationship between the defendant's state of mind and privity, with the latter related in turn to reliance, foreseeability, and securities law policy. Since information transmitted by a corporation or others will be relied upon by individuals in making investment decisions, similar problems exist in identifying the particular circumstances in which liability for negligence should be placed upon those involved in the transmission of information.

#### *Duty of Inquiry*

Analysis may be further advanced by phrasing the negligence question in terms of a duty of inquiry, again referring to accountants' duties by way of illustration. For instance, under some circumstances, an accountant may be subject to liability for failure to make the inquiries required under AICPA auditing standards.<sup>72</sup> Assuming he has attempted to comply with his responsibilities, his conduct is in good faith and if actionable falls into the negligence category.

In the securities law context, an accountant's duty of inquiry to a non-privity class can be illustrated by Section 11 of the Securities Act of 1933. Section 11(a)(4) of that Act imposes liability for untrue statements of certain material facts made in a registration statement upon "every accountant, . . . who has with his consent been named as having prepared or certified any part of the registration statement."<sup>73</sup> In dealing with state of mind, Section 11 provides a defense for an accountant to the effect that he will not be liable if

he had, after reasonable investigation, reasonable ground to

---

<sup>72</sup>The accountant may not be protected even if he *has* complied with GAAP. See *United States v. Simon*, 425 F.2d 796 (2d Cir. 1969), *cert. denied*, 397 U.S. 1006 (1970); *Herzfeld v. Laventhol, Krekstein, Horwath & Horwath*, 378 F. Supp. 112 (S.D.N.Y. 1974).

<sup>73</sup>15 U.S.C. § 77k(a)(4) (1970).

believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading . . . .<sup>74</sup>

This defense imposes a duty of inquiry upon the accountant and has the effect of creating liability for negligent failure to fulfill that duty.<sup>75</sup>

Section 11 exemplifies the 1933 Act's policy of imposing special obligations depending on the nature of the transaction. It extends liability for negligence to a class of purchasers who have no contractual relationship to the accountant. Liability is imposed for negligent breach of a duty of inquiry in this non-privity setting because the accountant's participation is essential to the issuer, which in turn obtains benefit from the sale of its securities.

#### *Duty of Inquiry in the Aiding and Abetting Setting*

A degree of confusion relating to state of mind under the federal securities laws has recently been introduced through the doctrine of aiding and abetting. As may be expected with any relatively new doctrine, courts have been imprecise in its application. Currently, most questions in the aiding and abetting context are arising in actions seeking damages or injunction for breach of a duty of inquiry.

As analyzed above, duty of inquiry is an aspect of negligence. If a court grants damages or injunctive relief in the information transmission context, it will do so because the defendant has breached his duty of inquiry with regard to transmitted information, not because the defendant has aided another person's wrongful conduct. Nevertheless, since recent cases use aiding and abetting terminology, it is useful to examine "duty of inquiry" concepts as they appear in aiding and abetting cases.<sup>76</sup>

The case which has given the greatest impetus to the current use of aiding and abetting theory is *Brennan v. Midwestern United Life Insurance Co.*<sup>77</sup> In that case the trial court found that Michael Dobich

---

<sup>74</sup>15 U.S.C. § 77k(b)(3)(B)(i) (1970).

<sup>75</sup>The leading case interpreting the due diligence standard under § 11 is *Escott v. BarChris Constr. Co.*, 283 F. Supp. 643 (S.D.N.Y. 1968).

<sup>76</sup>The following comments are based in part upon two articles by the author: *Aiding and Abetting Liability*, 7 *Review of Securities Regulation* 882 (Sept. 4, 1974); *Ruder, Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification, and Contribution*, 120 U. PA. L. REV. 597 (1972) [hereinafter cited as *Ruder, Multiple Defendants*].

<sup>77</sup>259 F. Supp. 673 (N.D. Ind. 1966) (*motion to dismiss denied*), 286 F. Supp. 702

and Dobich Securities Corporation violated the securities laws by dealing in a fraudulent manner with customers' money. Dobich accomplished his fraud by accepting orders and payments for stock of Midwestern United Life Insurance Company and then using his customers' payments to speculate on the commodities market. Liability was imposed upon Midwestern on the grounds that it knew that Dobich was violating the securities laws and that it had actively assisted him.

The district court in *Brennan* relied primarily upon § 876 of the Restatement of Torts to impose liability upon the corporation. The section provides in pertinent part:

876. Persons Acting in Concert

For harm resulting to a third person from the tortious conduct of another, a person is liable if he

(a) orders or induces such conduct, knowing of the conditions under which the act is done or intending the consequences which ensue, or

(b) knows that the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other so to conduct himself . . . .<sup>78</sup>

Applying subsection (b), the court held that aiding and abetting liability exists when the person giving substantial assistance to the wrongdoer knows that the other's conduct constitutes a breach of duty.<sup>78.1</sup> The circuit court, on appeal, substantially endorsed the district court's reasoning and opinion.<sup>78.2</sup> This approach was followed in *Landy v. Federal Deposit Insurance Corporation*:<sup>79</sup>

Three elements are thus required for liability:

(1) that an independent wrong exists; (2) that the aider or abettor know of that wrong's existence; and (3) that substantial assistance be given in effecting that wrong.<sup>80</sup>

Both *Brennan* and *Landy* seemed to require that the defendant have knowledge of the wrongdoing before liability could be imposed. Developments since those cases indicate that despite the statement in *Landy*, some courts will be willing to impose "aiding and abetting" liability if the defendant should have made inquiry which would have alerted him to the fact that an independent wrong existed. It is this

(N.D. Ind. 1968) (on merits), *aff'd*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970).

<sup>78</sup>RESTATEMENT OF TORTS § 876 (1939).

<sup>78.1</sup>286 F. Supp. at 717.

<sup>78.2</sup>See 417 F.2d at 153-55.

<sup>79</sup>486 F.2d 139 (3d Cir. 1973).

<sup>80</sup>*Id.* at 162-63.

aspect of aiding and abetting that has created confusion and which may have motivated the Supreme Court to review *Hochfelder v. Ernst & Ernst*.

As noted earlier, in *Hochfelder v. Midwest Stock Exchange*,<sup>81</sup> the Seventh Circuit expressed a willingness to invoke liability under aiding and abetting doctrine based upon a breach of a duty of inquiry. In the *Ernst & Ernst*<sup>82</sup> case it held that an accountant owed a duty of inquiry because of its obligations under Section 17(a) and Rule 17a-5 of the Securities Exchange Act of 1934, which require brokers and dealers to report their financial condition.

The Sixth Circuit's decision in *S.E.C. v. Coffey*,<sup>83</sup> involving possible violations by corporate officials, illustrates concern with the duty of inquiry, but reaches opposite results. There the court considered duties under both aiding and abetting and primary liability doctrine. It first stated:

Without meaning to set forth an inflexible definition of aiding and abetting, we find that a person may be held as an aider and abettor only if some other party has committed a securities law violation, if the accused party had general awareness that his role was part of an overall activity that is improper, and if the accused aider-abettor knowingly and substantially assisted the violation.<sup>84</sup>

Applying this aiding and abetting standard, the court refused to find a violation by a corporate board chairman who did not have knowledge of wrongdoing. Likewise, applying primary liability theory, it refused to place liability on him for failure to supervise his subordinates:

Imposing such a duty would effectively make corporate officials primarily liable for any securities law violation by a subordinate. It would disrupt corporate systems of delegation of authority and accountability . . . .<sup>85</sup>

In contrast, in *SEC v. Spectrum, Ltd.*,<sup>86</sup> an injunction action, an attorney was found to owe a duty to make inquiry. The action was

<sup>81</sup>503 F.2d 364 (7th Cir. 1974), *cert. denied*, 419 U.S. 875 (1974).

<sup>82</sup>503 F.2d 1100 (7th Cir. 1974), *petition for cert. granted*, 43 U.S.L.W. 3545 (U.S. Apr. 14, 1975) (No. 74-1042). See text accompanying notes 69-71 *supra*.

<sup>83</sup>493 F.2d 1304 (6th Cir. 1974), *cert. denied*, 43 U.S.L.W. 3416 (U.S. Jan. 27, 1975) (No. 74-661).

<sup>84</sup>*Id.* at 1316 (footnote omitted).

<sup>85</sup>*Id.* at 1315.

<sup>86</sup>489 F.2d 535 (2d Cir. 1973).

brought on aiding and abetting theory, claiming that the attorney's opinion letter was used to facilitate an illegal distribution of unregistered securities. The Second Circuit disagreed with the lower court's holding that actual knowledge of the illegal scheme was required, stating that a "negligence standard" was sufficient in an enforcement proceeding.<sup>87</sup> The reversal amounted to a statement that an attorney preparing an opinion which might facilitate an illegal distribution of unregistered securities has a duty to make inquiry regarding the underlying facts before issuing his opinion.

The apparently conflicting results of the latter two injunction cases may be explained on the basis that the alleged wrongdoers occupied different positions. In *Coffey* the claim was that a board chairman owed a duty of inquiry, while in *Spectrum* the holding was that an attorney engaged in issuing an opinion which would be used in a distribution of securities owed such an obligation. However, the principle remains consistent: in some circumstances breach of a duty of inquiry has been held to constitute a securities law violation.

As the foregoing analysis indicates, aiding and abetting violations may depend upon whether the party alleged to have aided or abetted the particular activity owes a duty of inquiry. However, since violations occur whenever the duty of inquiry is breached, "aiding and abetting" is not the appropriate title. The violation consists of breaching this primary duty, not in breaching a duty to refrain from aiding a wrongdoer.

#### *Duty to Take Action*

Whether liability is "primary" or imposed for "aiding and abetting" it should also be noted that breach of the duty of inquiry alone should not suffice as a basis for imposition of liability under the securities laws. The alleged wrongdoer must have both a duty of inquiry and a duty to take action based upon the knowledge which should have been acquired.

For instance, in *Lanza v. Drexel & Co.*,<sup>88</sup> the Second Circuit dealt with the question whether a non-participating director owes a duty to see that all material adverse information about his company is conveyed to a prospective purchaser of his corporation's stock. The court's opinion dealt with a "duty to convey," but failed to distinguish adequately between the twin duties, the duty to inquire and the duty to take action. The court eventually held that the director did

---

<sup>87</sup>*Id.* at 541.

<sup>88</sup>479 F.2d 1277 (2d Cir. 1973).

not breach his duty of inquiry, but it phrased much of its discussion in terms of a duty to convey.<sup>89</sup>

Other recent cases demonstrate circumstances under which a duty to take action exists once knowledge of wrongdoing is known. For instance, in *Kerbs v. Fall River Industries, Inc.*,<sup>90</sup> a corporate president was held to have a duty to take action when he knew that his subordinates were engaged in stock transactions in which other parties to the transaction were not privy to certain information. In *Rosen v. Dick*<sup>91</sup> a bank which had actual knowledge of a fraud and intended to aid the wrongdoers was held to have violated Rule 10b-5 by its failure to take action.

### *The Beginnings of an Occupational Analysis: Directors' Duties*

Thus far this article has suggested that when misleading information is transmitted to the public and becomes the basis for a claim of liability the applicable policy considerations should include the alleged wrongdoer's state of mind, the remoteness of the plaintiffs' securities transaction and the desirability of encouraging accurate and prompt disclosure of corporate information. Although these factors should always be important, it is also useful to ask whether duties to inquire or to take action arise because of the alleged wrongdoer's occupation. This question has already been examined with regard to accountants, who may owe special responsibilities when they certify the accuracy of a corporation's financial statements. Similar considerations apply to others who may have special responsibilities arising from their occupations or status. Recent cases dealing with the duties of directors illustrate the necessity of considering the occupational factor carefully.

State law cases dealing with directors' liability for negligence have tended to focus upon their responsibilities or obligations to their corporations rather than to the purchasers of securities. Interpretation of directors' conduct in these circumstances may nevertheless be useful in analyzing information transmission cases. The duties of a director to his corporation are well-stated in the standard proposal for revision of § 35 of the Model Business Corporation Act:<sup>92</sup>

---

<sup>89</sup>The fairly clear implication of both the majority and the minority opinions in *Lanza* is that a director who has actual knowledge that his corporation was engaged in a securities transaction based upon misleading misrepresentations would be under a duty to convey the proper information to the other side of the transaction.

<sup>90</sup>502 F.2d 731 (10th Cir. 1974).

<sup>91</sup>CCH FED. SEC. L. REP. ¶ 94,786 at 96,604 (S.D.N.Y. 1974).

<sup>92</sup>*Report of Committee on Corporate Laws: Changes in the Model Business Cor-*

A director shall perform his duties as a director, including his duties as a member of any committee of the board upon which he may serve, in good faith, in a manner he reasonably believes to be in the best interests of the corporation, and with such care as an ordinarily prudent person in a like position would use under similar circumstances.<sup>93</sup>

Under the standard articulated in proposed § 35 and in the common law cases, a director will not be liable to his corporation if he has been diligent and does not have grounds to suspect wrongdoing.<sup>94</sup> The so-called business judgment rule has frequently been invoked to the effect that an informed director will not be liable to his corporation for an honest mistake in judgment.<sup>95</sup> On the other hand, a director clearly has a duty to act diligently. Liability may be imposed upon him if his corporation has been injured under circumstances in which the director has failed to pay attention to corporate affairs and could have prevented the harm.<sup>96</sup>

If this policy has prevailed in cases involving director liability to the corporation, it may also be reliable in determining whether a director should be liable when his corporation transmits misleading information. If a director is protected against errors in judgment in connection with corporate management, one may ask whether the same standard should not also be applicable with regard to his duties in connection with information transmission. Significant questions also exist as to whether these duties will be different if the director or his corporation receives direct benefit from the information transmission.

Section 11 of the 1933 Act indicates that a director may be subject to suit<sup>97</sup> under the federal securities laws and that in certain circumstances<sup>98</sup> he may also have due diligence duties similar to those of accountants. Imposition of obligations in the registration statement context makes sense in terms of the relationship test, since a director knows that his company's prospectus will be used to influence persons to purchase securities from the corporation.

*poration Act*, 30 Bus. LAWS. 501 (1975).

<sup>93</sup>*Id.* at 502.

<sup>94</sup>*E.g.*, *Graham v. Allis-Chalmers Mfg. Co.*, 182 A.2d 328 (Ch.Del. 1962).

<sup>95</sup>*E.g.*, *Bodell v. General Gas & Elec. Corp.*, 140 A. 264 (De. 1927).

<sup>96</sup>*DePinto v. Landoe*, 411 F.2d 297 (9th Cir. 1969); *DePinto v. Provident Security Life Ins. Co.*, 374 F.2d 37 (9th Cir. 1967).

<sup>97</sup> 15 U.S.C. § 77k(a)(2)-(3) (1970).

<sup>98</sup> 15 U.S.C. § 77k(b)(3)(A) (1970).

Liability for negligence in information transmission has also been imposed upon directors in a proxy suit involving § 14(a) of the 1934 Act in connection with a corporate transaction. In *Gould v. American Hawaiian Steamship Co.*,<sup>99</sup> liability was imposed where the directors knew that a corporate document was prepared for the purpose of inducing a transaction with the corporation.

As noted earlier, a director's duty to inquire and subsequently to convey information to prospective purchasers of his corporation's stock was at issue in *Lanza v. Drexel & Co.*<sup>100</sup> The *Lanza* circumstances differ from the market transaction cases because the corporation itself was engaged in a securities transaction. But the transaction was also closer to a registered offering situation, since the corporation was purchasing a business in exchange for its own stock. In an en banc decision, the majority of the court stated that a standard of culpability greater than negligence would apply. In interpreting whether the standard had been met the court quoted from an SEC amicus brief indicating that directors have a right to rely on others in performing their functions within the corporation, even in a securities transaction context:

Corporate directors are not normally involved in the day-to-day conduct of the company's affairs. Except in unusual circumstances, they are not expected to, nor do they, participate directly in the implementation of corporate policies. Routine managerial tasks are performed by, and are the responsibility of, the operating officers. Directors have a right to rely on the officers of the corporation to perform their functions in a lawful manner.<sup>101</sup>

The minority seemed to disagree with the majority, but an analysis of the minority opinions indicates that there may not have been major differences in their viewpoints. No judge would have permitted reckless avoidance of a duty to inquire.<sup>102</sup> Apparently all would have imposed liability for failure to take action where warning signals are

---

<sup>99</sup>351 F. Supp. 853 (D. Del. 1972).

<sup>100</sup>479 F.2d 1277 (2d Cir. 1973).

<sup>101</sup>*Id.* at 1306, quoting Brief of SEC as Amicus Curiae at 5, *Lanza v. Drexel & Co.*, 479 F.2d 1277 (2d Cir. 1973).

<sup>102</sup>One dissenting judge stated that a director should not be able to avoid his duties "by failing to inform himself of the facts and developments relevant to the sale of securities." *Id.* at 1317-18 (Hays, J., dissenting). Judge Hays' comment may merely have been a statement that a good faith standard cannot be met merely by reliance on others.



present.<sup>103</sup>

The statutes and cases cited relating to duties of directors suggest that the directors' liability under the securities law will be affected by both the state of mind and relationship factors discussed above and by considerations applicable to his occupation or status. Under Section 11 the duty of inquiry is high because directors bear responsibility for the issuance of securities. Likewise, where, as in *Gould*, proxies are used to solicit votes in a corporate transaction, directors also may have a duty of inquiry.<sup>104</sup> Under circumstances similar to those in *Lanza*, when a corporation is engaged in less formal securities transactions, directors must make inquiries whenever suspicious circumstances exist, but they apparently have the right to rely upon others.

Neither *Gould* nor *Lanza* involved an unlimited class of market investors. The question of directors' duties to inquire with regard to the normal flow of corporate information was not treated in those cases. If *Lanza* is correct, however, directors should be able to protect themselves from liability by well placed reliance on others.<sup>105</sup>

---

<sup>103</sup>Two dissenting judges would have imposed liability because of the director's "reckless disregard for the truth." *Id.* at 1322 (Timbers & Oakes, J.J., dissenting).

<sup>104</sup>*But see* U.S. v. Koenig, CCH FED. SEC. L. REP. ¶ 94,765 (S.D.N.Y. 1974), a criminal case, as follows:

[E]xcept in the case of an SEC civil enforcement suit seeking injunctive relief, mere negligence by a corporate officer or director would not appear sufficient to impose civil liability, and is certainly not sufficient to impose criminal liability.

*Id.* at 96,542.

<sup>105</sup>One solution to the securities law problems may be found in § 18 of the 1934 Act, 15 U.S.C. § 78r (1970), which provides:

"Liability for Misleading Statements"

(a) Any person who shall make or cause to be made any statement in any application, report, or document filed pursuant to this title or any rule or regulation thereunder, or any undertaking contained in a registration statement as provided in subsection (d) of section 15 of this title, which statement was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, shall be liable to any person (not knowing that such statement was false or misleading) who, in reliance upon such statement, shall have purchased or sold a security at a price which was affected by such statement, for damages caused by such reliance, unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading. . . .

### *The Nature of the Proceeding*

The above discussion demonstrates that Rule 10b-5 principles should be applied carefully and that results should depend upon the particular circumstances involved. Likewise it is important to note that standards may be different in Securities and Exchange Commission injunctive actions seeking prospective relief than they are in private damage actions. These distinctions were articulated by Judge Adams in his dissent in *Kohn v. American Metal Climax, Inc.*<sup>106</sup> as follows:

Another distinction lies in the nature of the relief requested. Where the Government or a private party is seeking prospective injunctive relief only, it is appropriate that courts be able to protect the investors and shareholders from *future* harm even though the conduct involved does not amount to common law fraud. . . . On the other hand, when the plaintiff class is seeking retrospective relief, such as substantial money damages or dissolution of a merger, more serious problems arise and a different balance must be struck. When the Act is utilized retrospectively rather than prophylactically, the courts must bear in mind that the civil recovery provisions were designed primarily as a "back-stop" for the criminal provisions, and that the Act operates essentially as a private penal statute. Where the relief discourages conduct through punishment, whether by damages or by divestiture, it is altogether proper, and indeed essential, for courts to cleave close to the Congressional purpose by construing the statute strictly, and to affix liability only where culpable conduct is made out.<sup>107</sup>

### *Conclusion*

This article has identified various factors which may affect securities law liability for transmission of misleading corporate information, with special emphasis upon the state of mind, or culpability, of the alleged wrongdoer.<sup>108</sup> These factors should be weighed carefully in determining liability and in encouraging disclosure of corporate information. It may be hoped that if those charged with responsibility for

---

<sup>106</sup>458 F.2d 255 (3d Cir.), *cert. denied*, 409 U.S. 874 (1972).

<sup>107</sup>*Id.* at 286-87 (citations omitted).

<sup>108</sup>For a recent student discussion of the flexible duty standards, see Note, *The Development of a Flexible Duty Standard Under SEC Rule 10b-5*, 32 WASH. & LEE L. REV. 99 (1975).

making corporate disclosure can expect realistic evaluation of the circumstances surrounding their activities, they will be encouraged toward disclosure rather than being threatened into silence.