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Ninth Circuit Review—The State of Mind Requirement in Rule 10b-5 Actions: A Critical Analysis of *White v. Abrams'* Flexible Duty Standard

Richard Gebo Morris

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**THE STATE OF MIND REQUIREMENT IN RULE
10b-5 ACTIONS: A CRITICAL ANALYSIS OF
WHITE v. ABRAMS' "FLEXIBLE DUTY
STANDARD"**

I. INTRODUCTION

Under the authority of section 10(b)¹ of the Securities Exchange Act of 1934, the Securities and Exchange Commission promulgated rule 10b-5 (the Rule)² which prohibits fraud³ by any person in connection with the purchase or sale of any security. Although the express terms of section 10(b) and rule 10b-5 do not provide a private remedy, the federal courts have firmly established that such a remedy exists.³ The

1. Section 10(b) provides:

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

.....
(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b) (1970).

2. 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 (1975). The Securities and Exchange Commission, upon publication of the rule, stated:

The previously existing rules against fraud in the purchase of securities applied only to brokers and dealers. The new rule [10b-5] closes a loophole in the protection against fraud administered by the Commission by prohibiting individuals or companies from buying securities if they engage in fraud in their purchase.

SEC Sec. Exch. Act. Rel. No. 3230 (May 21, 1942). See 1 A. BROMBERG, SECURITIES LAW: FRAUD § 2.2(410), at 22.6 (1974) [hereinafter cited as BROMBERG], for a descriptive account of the "birth" of rule 10b-5.

3. See *Janigan v. Taylor*, 344 F.2d 781 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965); *Ellis v. Carter*, 291 F.2d 270 (9th Cir. 1961), *dismissal aff'd*, 328 F.2d 573 (1964); *Fischman v. Raytheon Mfg. Co.*, 188 F.2d 783 (2d Cir. 1951); *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946). For a discussion of the theories on which

courts, however, have disagreed considerably in regard to what elements are essential to establish liability.⁴ Of the elements which have been deemed necessary, the requisite state of mind of the defendant has proven to be one of the most controversial and difficult aspects of rule 10b-5 litigation.⁵

The fundamental issue in this controversy is whether the defendant must be shown to have had actual knowledge of the falsity upon which the action is based. In deciding this issue several distinct and divergent approaches have been suggested. First, is the approach which applies a *scienter* standard. This requires that actual knowledge or reckless disre-

implied liability rests see 1 BROMBERG, *supra* note 2, § 2.4(1), at 27; Ruder, *Texas Gulf Sulphur—The Second Round*, 63 NW. U.L. REV. 423, 430-33 (1968).

4. The requisite state of mind is only one of the elements which must be proven to sustain a rule 10b-5 action. For a discussion of other potential aspects of rule 10b-5 litigation, including privity, materiality, reliance, and causation, see 2 BROMBERG, *supra* note 2, at ch. 8.

5. *Id.* § 8.4(000), at 203. There are several factors which account for the confusion surrounding the proper standard to be applied in rule 10b-5 actions. First, the Supreme Court has yet to decide a rule 10b-5 action in which it has reached the state of mind issue. *But see* Hochfelder v. Ernst & Ernst, 503 F.2d 1100 (7th Cir. 1974), *cert. granted*, 421 U.S. 909 (1975); note 80 *infra*. For this reason, and the fact that in the federal court system *stare decisis* operates only within and not among the several circuits, there is no requirement that the circuits agree on and conform to any one approach to the problem. See Comment, *Lanza v. Drexel & Co. and Rule 10b-5: Approaching the Scienter Controversy in Private Actions*, 15 B.C. INS. & COM. L. REV. 526, 531-32 (1974) [hereinafter cited as *Approaching the Scienter Controversy*].

Second, there is virtually no legislative guidance to help solve the issue. The entire congressional debate on § 10(b) is minimal. Bromberg notes that "[o]f nearly a thousand pages of hearings in the House [on the Securities Exchange Act of 1934], the combined references to § 10(b) . . . would scarcely fill a page. Much the same is true in the Senate." 1 BROMBERG, *supra* note 2, § 2.2 (331), at 22.2-3.

Third, the variety of complex fact situations in which a rule 10b-5 violation may occur, the types of rule 10b-5 suits which may be brought (*e.g.*, administrative sanctions, civil suits, injunctions) and the types of defendants which may be charged with a violation (see text accompanying notes 48-55 *infra* for a discussion of the distinction between "primary" and "secondary" defendants), all point to the difficulty in applying a single state of mind standard. *Approaching the Scienter Controversy, supra*, at 533.

This confusion is understandable given that neither section 10b nor rule 10b-5 specify a state of mind requirement. Additionally, this confusion is exacerbated by the varying use of terms employed to refer to the state of mind requirement. 2 BROMBERG, *supra* note 2, § 8.4 (503-04), at 204.102; Bucklo, *Scienter and Rule 10b-5*, 67 NW. U.L. REV. 562, 564 (1972) [hereinafter cited as Bucklo]; White v. Abrams, 495 F.2d 724, 728 n.3 (9th Cir. 1974). As Professor Bromberg states:

It is apparent that the various words are used at least in part because of habits and predilections of individual judges who may be thinking of the same thing but describing it in a different language. Similarly, there is no assurance that two persons using the same word mean the same thing.

2 BROMBERG, *supra* note 2, § 8.4 (503), at 204.103.

gard for the truth of the falsity⁶ be proven to establish liability.⁷ Second is the negligence theory, which requires a plaintiff to prove that the defendant knew or "should have known" of the falsity.⁸ Third is the strict liability approach, which requires no showing of knowledge, either actual or constructive.⁹

Recently, the Ninth Circuit, in *White v. Abrams*,¹⁰ rejected "scienter or any other discussion of state of mind as a necessary and separate element of a 10b-5 action."¹¹ In so doing, the court posited what was purported to be a fourth approach to the state of mind problem, the "flexible duty standard," which "not only [focuses] on the duty of the defendant, but [allows] a flexible standard to meet the varied factual contexts" of 10b-5 litigation.¹²

A review of these approaches to the state of mind issue will lead to the following conclusions. (1) In a complex rule 10b-5 case, involving multiple defendants, the application of a duty analysis to determine the defendants' status as either "primary or secondary"¹³ appears to be a reasonable starting point for determining the liabilities of the various

6. The term "falsity" as used here and throughout this Note means the fraudulent device, scheme, statement or omission on which the rule 10b-5 action is based.

7. See text accompanying notes 15-22 *infra*, for a discussion of the *scienter* standard. The use of the term "scienter" has added considerable confusion to the state of mind controversy. It has been said that the term is broad enough to encompass "lack of diligence, constructive fraud, or unreasonable or negligent conduct." *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 855 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969). However, an inspection of rule 10b-5 cases and articles dealing with *scienter* reveals that the most popular use of the term is in its traditional or common law sense, that is, actual knowledge or reckless disregard for the truth of the falsity. For example, the RESTATEMENT OF TORTS § 526 (1934) provides:

A misrepresentation in a business transaction is fraudulent if the maker
 (a) knows or believes the matter to be otherwise than is represented, or
 (b) knows that he has not the confidence in its existence or non-existence asserted by his statement of knowledge or belief, or
 (c) knows that he has not the basis for his knowledge or belief professed by his assertion.

To avoid confusion with the most commonly accepted use of the term and the term as used by the courts in the leading cases cited herein, *scienter*, in this article, will be used in its traditional sense.

8. See text accompanying notes 23-24 *infra* for a discussion of the negligence standard.

9. See text accompanying notes 25-36 *infra*.

10. 495 F.2d 724 (9th Cir. 1974).

11. *Id.* at 734.

12. *Id.*

13. See text at notes 48-52 *infra* for a discussion of the distinction between "primary" and "secondary" defendants.

defendants and allocating the rights (indemnity and contribution)¹⁴ among them. (2) Policy considerations underlying federal securities laws dictate the application of a negligence or "should have known" standard to primary defendants and a more stringent *scienter* standard to secondary defendants. (3) Notwithstanding its language, *White v. Abrams* suggests nothing more than a negligence standard in the guise of a different label, *i.e.*, the "flexible duty standard." The standard suggested in *White* was not meant to, and should not have, application to secondary defendants.

II. THE STATE OF MIND STANDARDS UNDER RULE 10b-5

A. *Scienter*

The references to fraud and deceit in clauses 1 and 3 of the Rule¹⁵ have provided the basis of the claim that *scienter*, actual knowledge or reckless disregard for the truth, clearly an element of common law fraud,¹⁶ is required for liability under the Rule.¹⁷ The Second Circuit decision in *Fischman v. Raytheon Manufacturing Company*,¹⁸ is cited for this, the most restrictive approach to rule 10b-5 liability. In that case, holders of preferred and common stock of Raytheon brought a class action under section 11 of the Securities Act of 1933¹⁹ and rule 10b-5, alleging that they had purchased their shares on the basis of a misleading prospectus. The district court, finding that the shares purchased by the plaintiffs were not the subject of the prospectus, dismissed the section 11 claim, and then went on to dismiss the entire complaint on the theory that rule 10b-5 does not cover the same conduct at which section 11 is directed.²⁰ The Second Circuit, in reversing the dismissal of the 10b-5 action, stated:

[W]hen to conduct actionable under section 11 of the 1933 Act, there is added the ingredient of *fraud*, then that conduct becomes actionable under §10(b) of the 1934 Act and the Rule²¹

14. See generally Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, in Pari Delicto, Indemnification, and Contribution*, 120 U.P. L. REV. 597 (1972) [hereinafter cited as Ruder].

15. 17 C.F.R. § 240.10b-5 (1975).

16. See discussion and authorities cited in Bucklo, *supra* note 5, at 572, 574-75.

17. See, e.g., 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, 1207-08 (1970) [hereinafter cited as Mann].

18. 188 F.2d 783 (2d Cir. 1951).

19. 15 U.S.C. § 77k (1970).

20. 9 F.R.D. 707 (S.D.N.Y. 1949), *rev'd*, 188 F.2d 783 (2d Cir. 1951).

21. 188 F.2d at 787 (emphasis added).

Since a requisite element of common law fraud is *scienter*, the court impliedly held that *scienter*, or action taken knowingly with the intent to defraud, must be shown to establish a violation of the Rule.²²

B. Negligence

The second approach to the state of mind issue, most commonly termed the "negligence theory," lies somewhere between the extremes of *scienter* and strict liability. This approach was taken in *SEC v. Texas Gulf Sulphur Co.*,²³ a Second Circuit case in which plaintiffs sought to enjoin conduct by Texas Gulf Sulphur and certain of its officers, directors, and employees, and to compel the rescission of securities transactions engaged in by the individual defendants who possessed "inside information." Although the court applied a standard which it termed "scienter," by broadening the definition of *scienter* to include "lack of diligence, constructive fraud, or unreasonable or negligent conduct,"²⁴ it effectively supplanted traditional or common law *scienter* with a standard which would impose liability for negligence.

Reduced to its basic terms, this approach suggests that the state of mind standard which will suffice for liability is a "should have known" standard, that is, if the other elements of the action are established, liability will attach if a defendant knew or should have known of the falsity. In applying this standard one adheres to traditional principles of negligence. Thus, the question is whether due care was exercised under the circumstances; the bench mark is the reasonable person.

C. Strict Liability

Another approach suggests that to establish liability under rule 10b-5, it is only necessary to prove one of the prohibited actions, such as a material misstatement of fact.²⁵ Such an approach calls for the application of a standard at the end of the state of mind spectrum opposite from the *scienter* standard. Under this approach liability is imposed on a no-fault basis. Although not widely accepted, this standard has found support.

*Ellis v. Carter*²⁶ and *Royal Air Properties, Inc. v. Smith*,²⁷ two Ninth

22. *Id.*

23. 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

24. *Id.* at 855.

25. *See, e.g., Stevens v. Vowell*, 343 F.2d 374, 379 (10th Cir. 1965).

26. 291 F.2d 270 (9th Cir. 1961).

27. 312 F.2d 210 (9th Cir. 1962).

Circuit cases, are often cited for this approach to the state of mind issue.²⁸ The *Ellis* court rejected the notion set forth in *Fischman* that proof of common law fraud or *scienter* must be shown.²⁹ In so holding, the court stated:

We disagree [that a 10b-5 violation requires proof of genuine fraud or *scienter*]. Section 10(b) speaks in terms of the use of "any manipulative device or contrivance" in contravention of rules and regulations as might be prescribed by the Commission. . . . Had Congress intended to limit this authority to regulations proscribing common law fraud, it would probably have said so. We see no reason to go beyond the plain meaning of the word "any", indicating that the use of manipulative or deceptive devices or contrivances of whatever kind may be forbidden, to construe the statute as if it read "any *fraudulent*" devices.³⁰

Although this language expressly rejected a traditional *scienter* requirement, it is questionable whether the court meant to imply that strict liability would be imposed for a material misrepresentation or whether the state of mind requirement had merely been relaxed to some standard, not defined, between *scienter* and strict liability.³¹

It may be concluded that, notwithstanding the dicta,³² no court has yet imposed liability on a strict liability basis. The Ninth Circuit's position on this issue was made clear in *White v. Abrams*³³ where the court attempted to clarify the confusion caused by *Ellis*. In *White*, the court ruled that the lower court erred in giving a jury instruction which imposed strict liability,³⁴ and stated that it is erroneous to construe any Ninth Circuit decision as creating a standard of strict liability.³⁵ In support of its position the court noted:

[T]here is no indication that Congress . . . or . . . the Securities Exchange Commission . . . intended that "anyone should be an insurer

28. Bucklo, *supra* note 5, at 565; BROMBERG, *supra* note 2, § 8.4 (630), at 204, 242-43.

29. 291 F.2d at 274.

30. *Id.* (emphasis added).

31. For commentary on *Ellis*, see authorities cited in *White v. Abrams*, 495 F.2d 724, 730 (9th Cir. 1974).

32. See also, e.g., the following statement in *Stevens v. Vowell*, 343 F.2d 374 (10th Cir. 1965):

It is not necessary to allege or prove common law fraud to make out a case under the statute and rule (10b-5). It is only necessary to prove one of the prohibited actions such as the material misstatement of fact or the omission to state a material fact.

Id. at 379.

33. 495 F.2d 724 (9th Cir. 1974).

34. *Id.* at 728. See text accompanying notes 38-41 *infra*.

35. 495 F.2d at 734.

against false or misleading statements made non-negligently or in good faith."³⁶

III. WHITE V. ABRAMS: A NEW APPROACH?

The Ninth Circuit has been involved in the state of mind controversy at least since the circuit's often misunderstood decision in *Ellis v. Carter*. Recently, however, the court made a comprehensive attempt to clarify the problem by way of its decision in *White v. Abrams*. In *White*, defendant Abrams, for a commission, solicited loans for the Richmond corporations (Richmond), operators of bus lines. White gave loans and purchased stock on the faith of alleged misrepresentations by Abrams to the effect that Abrams had personally investigated the financial condition of Richmond and that the corporations were financially sound. When Richmond collapsed, leaving \$58,000,000 in debts outstanding, White brought suit charging, *inter alia*,³⁷ a violation of rule 10b-5. The jury returned a verdict in favor of White following an instruction ordering them to find for the plaintiff if they found that a material misrepresentation had been made in connection with the sale of securities, "even if . . . [Abrams] did not know the falsity of the misrepresentation."³⁸ The Ninth Circuit reversed, finding that the trial court erred in giving an instruction which imposed absolute liability: "The instruction . . . imposes a liability without fault which we find to be contrary to the basic thrust of the statute and rule."³⁹

By way of guidance for retrial and as a suggested approach for courts to take when faced with a rule 10b-5 case, the court proceeded with the development of the "flexible duty standard." The court pointed out that because of the enormous variability and complexity of the factual circumstances encompassed by rule 10b-5 cases, the application of a single state of mind standard is unworkable.⁴⁰ Consequently, the court

36. 495 F.2d at 728, quoting *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).

37. The complaint also alleged violations of 15 U.S.C. § 77q (1970) (fraudulent interstate transactions), and also contained a count for common law fraud. 495 F.2d at 727.

38. *Id.* at 728.

39. *Id.* It can be argued that the trial court's instruction did not necessarily impose strict liability, *i.e.*, the statement that liability will be imposed even if he did not know of the falsity is an arguably less strict standard than the statement that liability will be imposed even if he did not know *or had no reason to know* of the falsity which clearly imposes absolute liability. However, the argument is weak, and even if valid, the instruction is unclear and misleading. The court's finding of error was clearly proper.

40. *Id.* at 734.

rejected *scienter*, or any other fixed standard that would apply to 10b-5 violations:

The proper standard to be applied is the extent of the duty that Rule 10b-5 imposes on this particular defendant. In making this determination the court should focus on the goals of the securities fraud legislation by considering a number of factors that have been found to be significant in securities transactions.⁴¹

The court then listed several of these "factors" which include "the relationship of the defendant to the plaintiff" and "the benefit that the defendant derives from the relationship."⁴² Finally, the court gave examples of the flexible duty standard in operation:

Where the defendant derives great benefit from a relationship of extreme trust and confidence with the plaintiff . . . the law imposes a duty upon the defendant to use extreme care in assuring that all material information is accurate and disclosed. If the defendant has breached his duty he is liable under Rule 10b-5. . . . 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.⁴³

IV. A WORKABLE SOLUTION

Of the aforementioned approaches to the state of mind issue none has gained enough support to be considered the accepted position.⁴⁴ The state of mind controversy today is more viable than it has ever been,⁴⁵

41. *Id.* at 734-35.

42. *Id.* at 735. Additional factors cited by the court: the defendant's access to the information as compared to the plaintiff's access; 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. *Id.* at 735-36. To these factors, the court in *Jackson v. Bache & Co.*, 381 F. Supp. 71 (N.D. Cal. 1974), a case involving the liability of a registered representative (the primary defendant) of a large brokerage firm (the secondary defendant) would add; the relationship between the plaintiffs and the primary defendant; and the relationship between the primary defendant and the secondary defendant. *Id.* at 87.

43. 495 F.2d at 736.

44. This situation stems in part from the difficulty in applying a single standard to the variety of complex fact situations in which a rule 10b-5 violation may occur, the types of rule 10b-5 suits which may be brought, and the types of defendants which may be charged with a violation. See note 5 *supra* for the other factors which add to the confusion regarding the proper standard to be applied.

45. As one commentator notes:

Thirty panel discussions, seventy-five scholarly articles and uncounted cases later, the great debate rages on. Should a 10b-5 defendant's conduct be judged on the basis of *scienter* or ordinary negligence or something in between?

there remains the need for a workable and practical solution to multiple-defendant, rule 10b-5 cases. One scholar, Professor Ruder,⁴⁶ has suggested such a solution which has met with acceptance by several courts and commentators.⁴⁷

Ruder begins his analysis by distinguishing between primary and secondary defendants. Primary defendants are those who have breached an independent duty owed by them to the public.⁴⁸ Under such a definition, those who make a material misrepresentation and those who fail to disclose material information when some special relationship imposes upon them an affirmative duty to do so,⁴⁹ are classified as primary wrongdoers. Secondary defendants owe no independent duty to the public and are potentially liable only because some primary defendant has violated such a duty.⁵⁰ Thus, those who merely aid and abet⁵¹ or

Mann, *supra* note 17, at 1206. Mann's article was published in 1970. If that commentator had had the benefit of foresight he would have been able to expand the number of "panel discussions," "scholarly articles," and "unaccounted cases." For a sampling of some of the more recent articles dealing with state of mind or *scienter* in the context of rule 10b-5 liability, see Bucklo, *supra* note 5; Ruder, *supra* note 14; *Approaching the Scierter Controversy*, *supra* note 5; Comment, *Scierter in Private Damage Actions Under Rule 10b-5*, 57 GEO. L.J. 1108 (1969); Note, *The Role of Scierter and the Need to Limit Damages in Rule 10b-5 Actions—The Texas Gulf Sulphur Litigation*, 59 KX. L.J. 891 (1971).

Supportive of the comment that the controversy remains viable in 1974 is a statement made by Professor Bromberg:

Scierter is the most unsettled element of a plaintiff's [rule 10b-5] case. . . . [M]any of the Circuits—particularly the midwestern and western ones—will find a violation based on negligence of [sic] constructive knowledge of falsity or omission. The Second Circuit seemed to be headed that way, but in recent cases has said very firmly that something more is necessary: at least recklessness or willfulness. This important limiting element remains unsettled nationally.

Bromberg, *Are There Limits to 10b-5*, 29 BUS. LAW. 167, 172 (Special Issue, Mar. 1974) (citations omitted).

46. Ruder, *supra* note 14.

47. See, e.g., SEC v. Coffey, 493 F.2d 1304, 1315 (6th Cir. 1974); Landy v. Federal Deposit Ins. Corp., 486 F.2d 139, 162 (3d Cir. 1973), *cert. denied*, 416 U.S. 960 (1974); Lanza v. Drexel & Co., 479 F.2d 1277, 1289 (2d Cir. 1973); Freeman, *Opinion Letters and Professionalism*, 1973 DUKE L.J. 371, 403; Mann, *Prevention of Improper Securities Transactions by Employees: The Responsibility for and Feasibility of Adopting Preventative Programs*, 25 HASTINGS L.J. 355 (1974). *Contra*, White v. Abrams, 495 F.2d 724, 734 (9th Cir. 1974); SEC v. Spectrum, Ltd., 489 F.2d 535, 542 (2d Cir. 1973).

48. Ruder, *supra* note 14, at 600.

49. Individuals who occupy a position of public trust, including corporate directors and professionals such as attorneys, accountants and brokers, may owe separate duties to the public arising solely by virtue of their "special relationship." See Ruder, *supra* note 14, at 641-44. For a further discussion of affirmative duties which arise from such a relationship and the status of defendants who owe such duties, see text accompanying notes 82-97, 101, 104-07, 114-16, *infra*.

50. Ruder, *supra* note 14, at 600.

51. The key elements necessary to establish liability as an aider and abettor of a rule

conspire⁵² to commit a rule 10b-5 violation are classified as secondary wrongdoers.

An example of this distinction may prove helpful. Assume a business promoter sells securities to investors and in so doing defrauds them. Further, assume that the promoter acquired financing for the scheme through a lending institution and enlisted the services of an accountant to prepare a financial statement for presentation to the investors. If a rule 10b-5 suit is brought by the defrauded investors, the promoter, because *his* scheme was the basis for the fraud, would be a primary defendant. The lending institution, if joined, would be a secondary defendant since its liability, *e.g.*, on an aiding and abetting theory, arises only because of the primary wrongdoing. The accountant could possibly be a primary or secondary defendant. If the accountant had prepared an accurate and complete financial statement which was used by the promoter in carrying out the fraud then the accountant, like the lending institution, would be a secondary defendant, liable only because of the primary wrongdoing. If, however, the accountant had prepared a false or incomplete statement which itself acted to deceive the investors, then, because the accountant had an independent duty to make full and accurate disclosure, a breach of that duty would result in primary liability.

The second step in Professor Ruder's analysis distinguishes the knowledge requirement essential to establish secondary liability from the requirement which will suffice for primary defendants. Policy considerations mandate that for primary defendants, a negligence or should have known standard rather than *scienter* is proper. Secondary defendants, on the other hand, should be subject to liability only when, in assisting or agreeing to take part in the primary defendant's wrongdoing, they acted knowingly or in reckless disregard of the truth.⁵³

10b-5 violation are: (1) a rule 10b-5 violation committed by some other party, (2) *knowledge* by the aider and abettor of the illegal act, and (3) substantial assistance by the aider and abettor in that wrong. *SEC v. Coffey*, 493 F.2d 1304, 1316 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975); *Landy v. Federal Deposit Ins. Corp.*, 486 F.2d 139, 162-63 (3d Cir. 1973), *cert. denied*, 416 U.S. 960 (1974); RESTATEMENT OF TORTS § 876 (1934) ("For harm resulting to a third person from the tortious conduct of another, a person is liable if he . . . (b) *knows* that the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other . . .").

52. The key elements necessary to establish civil liability under rule 10b-5 for conspiracy are: (1) the existence of independent wrong, (2) the conspirator's *knowledge* of the illegal scheme, and (3) an agreement between the primary defendant and the conspirator to bring about the wrongful act. *See Ruder, supra* note 14, at 630.

53. *Id.* at 632-33.

Although elimination of a scienter requirement in order to establish violation [*sic*] by the primary participant may be urged upon the grounds that maximum protection of investors will be provided by requiring exercise of care when engaging in activities that might injure others, different considerations enter into eliminating scienter as an element of aiding and abetting or conspiracy and substituting a duty of inquiry or a "should have known" standard. In most cases, the alleged aider and abettor (or conspirator) will merely be engaging in customary business activities, such as loaning money, managing a corporation, preparing financial statements, distributing press releases, completing brokerage transactions, or giving legal advice. If each of these parties will be required to investigate the ultimate activities of the party whom he is assisting a burden may be imposed upon business activities that is too great.⁵⁴

Professor Ruder's approach to the state of mind problem seems theoretically sound and practically workable, especially in complex cases involving multiple defendants.⁵⁵ As regards primary defendants, his suggestion that elimination of *scienter* would not be unduly harsh comports with the Supreme Court's position that "[s]ection 10(b) must be read flexibly, not technically and restrictively,"⁵⁶ "to effectuate its remedial purpose."⁵⁷ It also comports with the current trend towards eliminating the elements of common law fraud as necessary for a rule 10b-5 violation.⁵⁸

V. A CRITIQUE OF WHITE V. ABRAMS AND THE FLEXIBLE DUTY STANDARD

The foregoing discussion of the various approaches to the state of mind issue was intended to provide an understanding of the parameters of the problem. Given such a background, *White's* "flexible duty standard" and the limits of its application may be adequately defined.

54. *Id.*

55. Professor Ruder's approach is especially helpful in determining liability and allocating rights among the various wrongdoers. For a comprehensive analysis of this problem of contribution, indemnification and *in pari delicto*, see *id.* at 646 *et seq.*

56. *Superintendent of Ins. v. Banker's Life & Cas. Co.*, 404 U.S. 6, 12-13 (1971).

57. *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963). Although the Court was referring specifically to the Investment Advisors Act of 1940, the statement expressly covered all securities legislation enacted for the purpose of avoiding fraud (which, of course, encompasses rule 10b-5).

58. See, e.g., *White v. Abrams*, 495 F.2d 724, 730 (9th Cir. 1974); *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153 (1972) (actual reliance need not be shown); text accompanying notes 27-32 *supra*. See generally 2 BROMBERG, *supra* note 2, § 8.1, at 8.9.

At first reading, *White* appears to provide that which it intended and purported to provide, that is, a unique approach to the state of mind problem with broad application. However, while the court's opinion is sound and workable in the circumstances of that particular case, the standard suggested in *White* is not unique, nor does the opinion cover the whole range of rule 10b-5 defendants. Furthermore, the court's rather startling and somewhat confusing statement that "we reject scienter or any other discussion of state of mind as a necessary and separate element of a 10b-5 action,"⁵⁹ is likely to add to, rather than reduce, the confusion surrounding the state of mind requirement. Finally, the court's general language regarding the proper approach to rule 10b-5 cases⁶⁰ can be expected to provide little guidance in complex cases involving multiple defendants.

In the absence of specific language by the *White* court defining the "flexible duty standard," the court's examples of its standard in operation are helpful in understanding the approach. The court gave two such examples: one, where the defendant derives great benefit from his fiduciary relationship with the plaintiff, and the other, where the relationship is so casual that the plaintiff could not reasonably rely on defendant in making his investment decisions.⁶¹ In the first example, the court noted that the relationship is such that the defendant owes a high degree of care to assure that no material misrepresentations are made. In the other example, the plaintiff's reliance on defendant's representations being unreasonable, the defendant's only duty is not to misrepresent intentionally.⁶²

The Ninth Circuit suggests that the relationship between the plaintiff and the defendant and the extent to which the plaintiff relies on the defendant in making investment decisions are determinative of the degree of care which the defendant must exercise to avoid liability under the Rule. In short, the court's "flexible duty standard" is nothing more than a call for due care under the circumstances. When one is reminded that in applying a negligence standard the degree of care or duty owed will also vary with the circumstances, the court's statement, expressly rejecting a negligence standard, is tempered, if not contradicted. The contention that the *White* approach closely parallels the "negligence theory"⁶³ is supported by the observation that both approaches reach the

59. 495 F.2d at 734.

60. *Id.* at 735.

61. *Id.* at 736.

62. *Id.*

63. See text accompanying notes 23-29 *supra*.

same conclusions when applied to the two examples given by the *White* court.

Applying a negligence standard to the court's first example, where the defendant owes a high degree of care due to his position of extreme trust, the defendant will be subject to liability for a misrepresentation if it can be shown that a reasonable person, occupying the same position of extreme trust, would not have made such a statement. The duty imposed and the liability for breach are the same under each approach.

As to the court's second example, where the relationship between the plaintiff and defendant is so casual that no reasonable person would rely on defendant's representations, the defendant could not be held liable under conventional principles of negligence since the plaintiff could not "justifiably" rely on such information.⁶⁴ This does not mean, however, that the defendant would escape liability under the "negligence theory." Those who argue for the application of that theory have not abandoned actual knowledge of fraud as a possible basis for liability under the Rule. Proponents of such a theory have merely suggested that, in the interest of providing maximum protection to the investing public, negligence should suffice for liability where actual knowledge is absent.⁶⁵ Thus, although liability in this example may not rest on mere negligence, liability may nevertheless be imposed under the "negligence theory" for *intentional* or fraudulent misrepresentations against which justifiable reliance is not a defense.⁶⁶ The conclusion reached by applying the "negligence theory" is thus consistent with the conclusion reached when applying the "flexible duty" standard.

As regards the scope of *White* and the "flexible duty standard" a strong argument can be made that the decision applies only to primary defendants, notwithstanding the court's implication that the scope of the opinion covers all wrongdoers, primary and secondary alike.⁶⁷ First,

64. RESTATEMENT OF TORTS § 552 (Tent. Draft No. 12, 1966) provides:

(a) One who, in the course of his business, profession or employment, or a transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their *justifiable reliance* upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information (emphasis added).

65. See text accompanying notes 24-25 *supra*.

66. RESTATEMENT OF TORTS § 531 (Tent. Draft No. 10, 1964) provides:

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 to refrain from action in *reliance* upon the misrepresentation (emphasis added).

67. By adopting such a duty analysis, we avoid the confusion that arises from clas-

Abrams was a primary wrongdoer. He had allegedly breached a direct duty to White by making the false statements himself. Thus, application of the flexible duty standard to secondary defendants, if possible, must be by way of dicta. Second, it may reasonably be assumed that the two examples given by the court to demonstrate the operation of the *White* standard are at the extreme ends of the spectrum of relationships with which the court was dealing. The defendants, as illustrated in those examples, are communicators of the false information; it is their representations on which the plaintiffs are relying. This circumstance identifies primary wrongdoers only.⁶⁸ Third, the effective thrust of *White*, in fact its express holding, is the creation of a standard which looks solely to the defendant's duty. Secondary defendants, by definition, owe no independent duty to a plaintiff; their liability arises solely because the primary defendant has breached such a duty. None of the court's factors or examples provide guidance for determining the state of mind standard to be applied where no independent duty runs from the defendant to plaintiff, such as, for example, where a bank has lent money to a primary defendant. Only the very broadest reading of *White* could have applicability to such a case.

Although the scope of the *White* opinion and its flexible duty standard appears limited to cases involving only primary liability, the court's approach as to primary defendants is not unsound. Except for the possible confusion which may result from the court's rather general language, *White* can be expected to provide reasonable guidance in cases involving primary liability.⁶⁹ As to suits involving secondary, as

sifying the defendants as primary and secondary, or from classifying the transactions as direct and indirect.

495 F.2d at 734.

68. Persons who make representations or omissions are properly classified as primary defendants, never secondary defendants. See text accompanying notes 48-52 *supra*.

69. See *Marx v. Computer Sciences Corp.*, 507 F.2d 485 (9th Cir. 1974), decided some eight months after *White*. In *Marx*, Computer Sciences Corporation (CSC) made an optimistic earnings forecast under circumstances not justifying such optimism. Additionally, CSC failed to disclose in its forecast that one of its projects, previously represented to the public as being currently expensed, was in fact still capitalized. Marx, following the release of the forecast, purchased shares in CSC. The forecast proved incorrect—the difference between the predicted earnings figure and the actual figure arising largely from the writeoff of the project which CSC had, unknowingly to the public, not included in its forecast. Marx brought suit under rule 10b-5 alleging damages resulting from a false and misleading forecast. The district court granted summary judgment for CSC.

The Ninth Circuit, recognizing that a financial forecast is essentially an opinion and that "a reasoned and justified statement of opinion, one with a sound factual or historical basis, is not actionable," (*id.* at 490, quoting *G & M, Inc. v. Newbern*, 488

well as primary defendants, the approach suggested by Professor Ruder provides a practical method for determining liability.

VI. A WORKABLE SOLUTION IN OPERATION

The most encouraging observation regarding Ruder's approach is that it produces results consistent with those reached by the courts in dealing with rule 10b-5 cases. Even though several courts have stated that they reject Ruder's analysis,⁷⁰ they have nevertheless applied a standard consistent with it.⁷¹ This apparent contradiction is explained in part by

F.2d 742, 745-46 (9th Cir. 1973)) looked to *White* for guidance on the question of what fault is necessary to establish CSC's liability. In vacating and remanding, the court applied the flexible duty standard, and found that "the great importance attached to an earnings forecast, CSC's knowledge that investors would heavily rely thereon, and the disparity between the parties in access to the information necessary to judge the accuracy of the forecast," (*id.*) could give rise to a duty on CSC's part not to ignore facts which could seriously affect the forecast. Although the court concluded that the record would not prove that the forecast was intentionally or knowingly false, it could not "agree that CSC . . . was justifiably optimistic in its prediction and hence that the same may not be found actionably 'untrue.'" (*Id.*) It is believed that *Marx* correctly applied the "flexible duty standard" in assessing the duty owed by CSC, a primary defendant. It is to be noted that an application of the negligence standard, given CSC's duty of care under the circumstances, would lead to the same result reached in *Marx*. See also *Clark v. Watchie*, 513 F.2d 994, 999 (9th Cir. 1975) and *Robinson v. Cupples Container Co.*, 513 F.2d 1274, 1278 (9th Cir. 1975) for other instances where the Ninth Circuit has applied its flexible duty standard in analyzing the liability of primary defendants. For a complex Ninth Circuit case involving both primary and secondary defendants, see *Jackson v. Bache & Co.*, 381 F. Supp. 71 (N.D. Cal. 1974), a case decided the same day that a petition for rehearing *White* was denied. Applying the "flexible duty standard" of *White* in determining the liability of the primary defendant in *Jackson*, the court concluded that the relationship between the defendant and the plaintiffs was so casual that no duty ran from him to the plaintiffs. Since, additionally, there was no evidence of actual knowledge on this defendant's part, the court refused to find liability. *Id.* at 93. Having found no violation by the primary defendant, the court's analysis of secondary liability was unnecessary since secondary defendants are liable only if a primary violation is proved. Furthermore, the court's then perfunctory examination of secondary liability was restricted to the "controlling persons" section of § 20 of the 1934 Act (15 U.S.C. § 78t (1970)), the court concluding that that section provides the exclusive method of imposing liability on secondary defendants. 381 F. Supp. at 95. This conclusion is unfortunate for two reasons. First, neither the SEC nor the courts have been content to rest secondary liability on the controlling persons sections. Rather, these sections are likely to be relied on only when necessary to impose liability. Ruder, *supra* note 14, at 601, 609. Second, by relying exclusively on section 20, which imposes liability on controlling persons for mere negligence, the court missed its chance to apply *White's* flexible duty standard, if applicable, to secondary defendants, or to reach the conclusion, expressed herein, that secondary liability, based on an aiding and abetting or conspiracy theory, requires *scienter*.

70. See sources cited in note 47 *supra*.

71. See notes 98-100 *infra* and accompanying text.

the fact that proper application of the theory requires a complete understanding of the distinction between primary and secondary defendants and the appropriate knowledge standards to be applied to each. An analysis of several leading rule 10b-5 cases serves to illustrate the application and test the practicality of Professor Ruder's approach to liability under the Rule.

In *Brennan v. Midwestern United Life Insurance Co.*,⁷² a case dealing with liability of aiders and abettors, Dobich Securities Corp., transfer agent and broker for Midwestern, and Dobich's president, Michael Dobich, were dealing in a fraudulent manner with money acquired from purchasers of Midwestern stock. When Midwestern became aware of these activities, through complaints from stock purchasers who had not yet received their stock, Midwestern merely notified Mr. Dobich, warning him to cease such activity. Having found that Midwestern had actual knowledge of Dobich's illegal activities,⁷³ the Seventh Circuit went on to find that Midwestern's notice to Dobich, in lieu of a letter to the SEC, was a signal to Dobich to arrange for delivery of the shares and to thereby satisfy the stock purchaser's complaints. The court found that this action encouraged Dobich and substantially *aided* and *abetted* him in the continuation of his fraudulent activities without fear of a report from Midwestern to the SEC.⁷⁴ As to the contention that Midwestern's failure to inform the SEC of the improper activities was in itself enough to constitute aiding and abetting, the court held that silence *plus* the affirmative act of notifying Dobich was a form of aiding and abetting cognizable under the Rule.⁷⁵

Applying Professor Ruder's approach, Midwestern's status was properly analyzed as that of an aider and abettor since its liability arose only because Dobich had violated the law; that is, Midwestern itself did not owe any direct duty to the public. Although the lower court decision in *Brennan*⁷⁶ may be cited for the proposition that in some circumstances silence or inaction alone may constitute aiding and abetting,⁷⁷ it is important to note that the Seventh Circuit refused to take such a strong position holding that "Midwestern's . . . silence . . . *combined with its*

72. 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970).

73. *Id.* at 151.

74. *Id.* at 153.

75. *Id.* at 154.

76. 259 F. Supp. 673 (N.D. Ind. 1966).

77. *Id.* at 680-82. The trial court refused "to hold blindly that silence and inaction cannot constitute aiding and abetting under any possible set of circumstances . . ." *Id.* at 682.

affirmative acts was a form of aiding and abetting cognizable under Section 10(b) and rule 10b-5."⁷⁸ It is suggested that mere inaction or silence should never give rise to rule 10b-5 liability in the absence of an affirmative duty arising out of some special relationship.⁷⁹ If such a duty does exist, resort to a theory of secondary liability, such as aiding and abetting, is unnecessary since direct breach of a duty results in primary liability.⁸⁰ Having concluded that Midwestern's involvement in the wrongdoing was only secondary, the court's finding that liability should be imposed by reason of the fact that Midwestern had *actual* knowledge of Dobich's illegal scheme is consistent with Professor Ruder's suggestion that as to secondary defendants, *scienter* should be the appropriate

78. 417 F.2d 147, 154 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970) (emphasis added).

79. *Landy v. Federal Deposit Ins. Corp.*, 486 F.2d 139, 161 (3d Cir. 1973), *cert. denied*, 416 U.S. 960 (1974) ("It is notable that the court in *Brennan* relied on silence . . . plus affirmative costs [*sic*]. . . . In the absence of a special relationship between the parties, no case has come to our attention imposing liability on the basis of 'mere inaction.'"); *Wessel v. Buhler*, 437 F.2d 279, 283 (9th Cir. 1971).

80. A superficial reading of *Hochfelder v. Ernst & Ernst*, 503 F.2d 1100 (7th Cir. 1974), *cert. granted*, 421 U.S. 909 (1975), may result in a conclusion that the court in that case takes a contrary position since it proceeded under what it termed to be a secondary theory in assessing the plaintiff's claim that inaction alone may suffice for rule 10b-5 liability. ("[A] claim for aiding and abetting solely by inaction can be maintained under Rule 10b-5 . . ." *Id.* at 1104.) However, the court's statement that a claim for "aiding and abetting" is made on demonstrating that the defendant breached a duty of inquiry owing to the plaintiff evidences the true nature of the court's theory of liability. *Id.* Under the definitions of primary and secondary theories of liability as used in this Note, the *Hochfelder* court has proceeded under a theory of primary liability, *i.e.*, the defendant's liability is based on its direct breach of an independent duty, and not on some other primary wrongdoer's breach. The conclusion reached by the *Hochfelder* court, that is, that liability here may be based on breach of a duty of inquiry, is consistent with this author's contention that negligence is a sufficient basis for liability as to primary defendants.

One circumstance in which a primary/secondary analysis creates confusion is the situation where an affirmative duty does not arise until the one to be charged has actual knowledge of the primary violator's breach. *Lanza v. Drexel & Co.*, 479 F.2d 1277 (2d Cir. 1973), held that a director who has not participated in negotiations during which misstatements are made is not subject to liability *absent actual knowledge of the violation*. The court implied that where actual knowledge is found an affirmative duty of disclosure may arise. *Id.* at 1306. Similarly, *SEC v. Coffey*, 493 F.2d 1304 (6th Cir. 1974), refused to impose an affirmative duty on non-participating directors and officers to insure that others are making full disclosure. *Id.* at 1315. However, once actual knowledge is found the court there concludes that "failure to take remedial action would be a form of aiding and abetting." *Id.* at 1316. Professor Ruder's conclusion would seem to require that once having found an affirmative duty, any liability rests on a primary rather than a secondary theory. However, the question of which theory is appropriate in this circumstance appears purely academic as regards the proper standard of knowledge to be applied since, by definition, the duty does not arise until actual knowledge is found.

state of mind standard.⁸¹

In *Lanza v. Drexel & Co.*,⁸² the Second Circuit specifically examined the duty of an "outside" director to convey material information to those who are dealing with "his" corporation. The plaintiffs, who had exchanged shares of Victor Billiard Company stock for shares of BarChris Construction Company stock pursuant to a merger, sued certain officers and directors of BarChris alleging that the plaintiffs had been misled by material misrepresentations and omissions regarding BarChris' financial position and outlook. Coleman, an "outside" director, had neither participated in the negotiations nor did he have actual knowledge of any misstatements. The Second Circuit stated:

[A] director in his capacity as director (a nonparticipant in the transaction) owes no duty to insure that all material, adverse information is conveyed to prospective purchasers of the stock of the corporation on whose board he sits. A director's liability to prospective purchasers under Rule 10b-5 can thus only be secondary, such as that of an aider and abettor, a conspirator, or a substantial participant in fraud perpetrated by others.⁸³

. . . .

Absent knowledge or substantial participation we have refused to impose such affirmative duties of disclosure upon Rule 10b-5 defendants.⁸⁴

Coleman neither participated in nor knew of the misstatements and thus, under the court's rule, he had no duty to scrutinize the negotiations and convey all material facts. Absent an affirmative duty, Coleman's inaction alone could not subject him to liability.⁸⁵

The Second Circuit next turned to the state of mind issue and the plaintiff's contention that even absent an affirmative duty Coleman was liable since he knew many "disquieting" facts about BarChris which would have led a reasonable person to discover the fraud.⁸⁶ Recognizing that other circuits had approved of a negligence standard, the court nevertheless stated that it rejected such a standard,⁸⁷ pointing out that in the Second Circuit "facts amounting to *scienter*, intent to

81. See text accompanying notes 50-52 *supra*.

82. 479 F.2d 1277 (2d Cir. 1973).

83. *Id.* at 1289, citing *Ruder*, *supra* note 14.

84. *Id.* at 1302.

85. See notes 76-80 *supra* and accompanying text. See also note 80 *supra* for a discussion of which theory of liability is applicable where an affirmative duty does not arise until one has actual knowledge.

86. 479 F.2d at 1304.

87. *Id.* at 1305.

defraud, reckless disregard for the truth, or knowing use of a device, scheme or artifice to defraud' " are essential to a rule 10b-5 violation.⁸⁸

In some respects the majority's decision in *Lanza* is unclear.⁸⁹ The case has been cited frequently for the broad proposition that no rule 10b-5 violation can occur in the absence of *scienter* and that mere negligence is not enough.⁹⁰ It is not surprising that such a contention has been made since *Lanza* stated that *scienter* is an essential element in the Second Circuit. However, this statement must not be taken out of context. Following this "scienter" comment, the court stated:

We recognize that *participation* by a director in the dissemination of false information reasonably calculated to influence the investing public may subject such a director to liability under the Rule. But it is quite a different matter to hold a director liable . . . for failing to insure that all material, adverse information is conveyed to prospective purchasers . . . absent substantial participation in the concealment or knowledge of it. *Absent knowledge or substantial participation* we have refused to impose such affirmative duties of disclosure upon Rule 10b-5 defendants.⁹¹

This statement suggests that the court did not intend to extend the *scienter* standard (actual knowledge) to a case involving a director who substantially participates in the dissemination of false information. In that circumstance, the statement here implies that an affirmative duty to insure full disclosure could exist *even absent actual knowledge* and, presumably, a *negligent* breach of that duty would be sufficient for liability.

In summary, *Lanza v. Drexel* is an important case that should not be so broadly interpreted as to suggest applicability to cases involving primary liability. The case may be cited for the proposition that absent knowledge or substantial participation, "outside" directors have no affirmative duty to insure that all material information is conveyed to purchasers of company stock. Absent a direct duty owed to the public, liability may only be imposed through application of theories of second-

88. *Id.* at 1301, quoting *Shemtob v. Shearson, Hammill & Co.*, 448 F.2d 442, 445 (2d Cir. 1971); accord, *Globus v. Law Research Serv., Inc.*, 418 F.2d 1276 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970); *Gordon v. Burr*, 366 F. Supp. 156 (S.D.N.Y. 1973).

89. *Approaching the Scienter Controversy*, *supra* note 5, at 553.

90. *Mariash v. Morrill*, 496 F.2d 1138, 1145 n.13 (2d Cir. 1974); *White v. Abrams*, 495 F.2d 724, 733 (9th Cir. 1974); *SEC v. Coffey*, 493 F.2d 1304, 1314 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975); 5 ST. MARY L.J. 382, 389 (1973).

91. 479 F.2d at 1302 (emphasis added in part).

ary liability.⁹² Under such a theory, *scienter* is essential.⁹³ The court's analysis is thus consistent with, and reaches the same result as, Professor Ruder's approach, *i.e.*, Coleman was a secondary defendant who escaped liability because he had no actual knowledge of the fraud.

Two recent, factually unique, enforcement proceedings examine the state of mind requirement to be applied to different types of defendants in complex rule 10b-5 cases. *SEC v. Spectrum, Ltd.*⁹⁴ involved a suit for injunctive relief against all parties to an illicit scheme to distribute unregistered securities. At the request of one of the promoters of the scheme, Schiffman, an attorney, issued an opinion which listed the names of those who could and those who could not sell their unregistered shares in a transaction exempt from securities registration requirements. The trial court⁹⁵ found there was no evidence that any unregistered stock had been sold on the basis of Schiffman's letter. Recognizing that Schiffman might still be liable as an aider and abettor, the court held that liability would be imposed only if Schiffman had actual knowledge of the illegal scheme. However, since no evidence had been produced to sustain such a conclusion, the trial court refused to issue a preliminary injunction against Schiffman. On appeal the Second Circuit disapproved of an actual knowledge standard in assessing the liability of secondary defendants. As to this standard, the court stated that it is ". . . a sharp and unjustified departure from the negligence standard which we have repeatedly held to be sufficient in the context of enforcement proceedings seeking equitable or prophylactic relief."⁹⁶ Disapproving of Professor Ruder's statement that imposition of a negligence standard as to secondary defendants places too great a burden on the business activities of such individuals, the court commented that an attorney's opinion "is too essential and the reliance of the public too high to permit due diligence to be cast aside in the name of convenience."⁹⁷

Notwithstanding the court's express disapproval of some of Ruder's comments, a close analysis of the decision reveals that Ruder's theory may not have been rejected. First, the court emphasized that its deci-

92. See text accompanying note 83 *supra*.

93. For the elements of a rule 10b-5 case based on secondary theories see notes 50-52 *supra*.

94. 489 F.2d 535 (2d Cir. 1973).

95. *SEC v. Spectrum, Ltd.*, 54 F.R.D. 70 (S.D.N.Y. 1972).

96. *Id.* at 541; *accord*, *SEC v. Manor Nursing Centers, Inc.*, 458 F.2d 1082, 1096 (2d Cir. 1972); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969); *SEC v. Lum's, Inc.*, 365 F. Supp. 1046 (S.D.N.Y. 1973).

97. 489 F.2d at 542.

sion to impose liability for negligent conduct is to be construed narrowly and should not be applied to more "peripheral participants" in an illegal scheme.⁹⁸ This clearly seems to indicate the court would not impose such a duty as to secondary defendants. Second, it is arguable that Schiffman was only secondarily liable. The court's comments to the effect that the "public trust" demands more of attorneys rendering opinions than "customary activities which prove to be careless"⁹⁹ implies that attorneys, in such a circumstance, owe some duty to potential investors.¹⁰⁰ Where one breaches a direct duty owed to the public, liability is based on theories of primary not secondary liability.¹⁰¹

Although the court in *Spectrum* labeled Schiffman an "aider and abettor", the "duty" language used by the court in rationalizing its de-

98. The court stated:

We could not conclude without emphasizing that the standard of culpability we find appropriate for the author of an opinion letter in an action for injunctive relief only should not be construed to apply to more peripheral participants in an illicit scheme or, for that matter, to criminal prosecutions or private suits for damages.

489 F.2d at 542.

The Sixth Circuit's decision in *SEC v. Coffey*, 493 F.2d 1304 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975), demonstrates that the court's reluctance to apply *Spectrum* to any case except one confined to the very limited factual circumstance illustrated therein. The Sixth Circuit commented:

We do not believe that this application of a negligence standard to that situation [*Spectrum*] compels us to apply a negligence standard in the very different case we confront. Here, there must be some showing that Appellants were aware of the [primary defendants'] alleged misrepresentations.

Id. at 1316 n.30.

99. 489 F.2d at 542.

100. The court suggests that this duty might be to investigate the activities of the party he is assisting and, where such an investigation is inexpedient, to stamp on the face of the letter that the opinion is not to be used in the sale of unregistered securities. *Id.*

101. Ruder, *supra* note 14, at 618. Professor Ruder has stated:

Attention to separate duties owed by professionals such as accountants and brokers emphasizes that in a complicated case involving numerous defendants, liability may be imposed without resort to secondary liability theories if the existence of an independent duty to the public by virtue of special professional status can be shown.

Id. If a duty could arise out of an accountant's or a broker's professional status, surely an attorney, under the proper circumstances, could be held to some duty for which he could be subject to rule 10b-5 liability for failure to properly perform.

In *Spectrum*, defendant Schiffman occupied a status and had a duty similar to the defendant-accountants in *Fischer v. Kletz*, 266 F. Supp. 180 (S.D.N.Y. 1967). In *Fischer*, the court acknowledged the possible liability of accountants who knew that their previously filed financial statements, relied on by the public, were no longer accurate. The court proceeded with an analysis based on a theory of primary liability, *i.e.*, in such a circumstance the defendant owed a direct duty to the investing public. The status of the defendant-CPA in *Wessel v. Buhler*, 437 F.2d 279 (9th Cir. 1971) differed from that of the defendants in *Spectrum* and *Fischer*. In *Wessel*, the primary wrongdoers had altered the figures prepared by the CPA. Because the figures used by the primary wrongdoer to perpetrate his fraud were not certified by the CPA, the CPA had no independent duty to warn of their inaccuracy. Hence, liability could not be based on any "primary" theory.

cision seems to indicate that they proceeded on a theory of primary rather than secondary liability. This is supported by the fact that the court applied the knowledge standard (i.e., negligence) generally considered appropriate as against primary wrongdoers only.

In *SEC v. Coffey*,¹⁰² the Sixth Circuit took the opportunity to comprehensively analyze primary/secondary liability under rule 10b-5. There, King Resources sold its own two-year notes to the State of Ohio through a professional "money-finder." Coffey, the company's financial vice-president, was involved in the transaction to the extent that he gave financial information to a credit rating agency and discussed the terms of the loan with the "money-finder." King, the company's chairman of the board, was involved merely to the extent that he attended the board meetings which had authorized the loans. Neither King nor Coffey had any direct dealings with the State of Ohio. After securing the loans, King Resources collapsed. The SEC brought an action to enjoin defendants, including Coffey, King and the "money-finder." This injunction was sought to prevent violations of securities laws including, *inter alia*, rule 10b-5. The gravamen of the SEC complaint alleged that the defendants had failed to disclose material facts concerning the company's financial position and the intended use of the loan proceeds—omissions which were intended to mislead the credit rating agency and the State of Ohio.

The Sixth Circuit reversed the trial court's holding¹⁰³ that the defendants had violated rule 10b-5 by using the word "prime" to secure the loans.¹⁰⁴ The court reasoned that since all parties understood the use of the term, no party was misled.¹⁰⁵ However, the court intimated that conduct of defendants, other than the use of the word "prime," could be a basis for liability. In giving guidance for disposition on remand, the court suggested an examination of both primary and secondary theories of liability. The court stated that Coffey, who had personally sent financial information to the credit agency, could be found "primarily" liable under the rule 10b-5 if "he omitted material facts necessary to make the statements made to NCO (the credit rating agency) not misleading."¹⁰⁶ To sustain Coffey's liability on a primary theory it would be necessary to "prove that the alleged omissions represent facts which

102. 493 F.2d 1304 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975).

103. *SEC v. Coffey*, 351 F. Supp. 236 (S.D. Ohio 1972).

104. *Id.* at 254.

105. 493 F.2d at 1313.

106. *Id.* at 1314.

were known or *should have been known* by Coffey"¹⁰⁷

Although this language is generally used by the courts in applying a negligence or constructive knowledge standard of liability, the court apparently did not intend to impose such a standard for, immediately following the comment, the court stated that "[i]n addition . . . it is essential . . . that Coffey's inaction was in 'wilful or reckless disregard for the truth.'"¹⁰⁸ Such language is not properly associated with a negligence or constructive knowledge standard but is readily identified as a form of *scienter*.¹⁰⁹ The court's rejection of the negligence standard and effective retention of *scienter* as requisite for liability under rule 10b-5 is unfortunate and surprising. First, the court was suggesting a standard in the context of primary liability. Second, numerous courts have held that, in enforcement proceedings, mere negligence will suffice not only as to primary defendants but secondary wrongdoers as well.¹¹⁰

In regard to the issue of Coffey's primary liability for the misrepresentations made to the State of Ohio, and King's primary liability for the misrepresentations made to the State and NCO, the court concluded that the defendants, not having participated in the negotiations or misrepresentations, could not be found primarily liable absent an affirmative duty imposed on the defendants as either an officer or director to investigate and supervise the activities in which fraud may be occurring.¹¹¹ The court stated:

We refuse to impose such a duty. Our refusal is in accordance with other decisions which have declined to impose duties on persons not in a special relationship with a buyer or seller of securities.¹¹²

107. *Id.* (emphasis added).

108. *Id.*

109. *See, e.g.*, text accompanying note 53 *supra*.

110. Defendant King, like Coleman in *Lanza*, was a director who had not participated in the negotiations. In both cases, the court of appeals found no affirmative duty to convey. If the defendant had participated in the transaction, then "[a] duty to disclose naturally devolved on those who had direct contacts with 'the other side.'" 493 F.2d at 1315. This statement is similar to the Second Circuit's comment in *Lanza* that participation by a director may subject him to liability under the Rule. 479 F.2d at 1302.

111. 493 F.2d at 1315.

112. *Id.*, citing *Lanza v. Drexel & Co.*, 479 F.2d 1277 (2d Cir. 1973); *Mader v. Armel*, 461 F.2d 1123 (6th Cir. 1972); *SEC v. Great American Indus., Inc.*, 407 F.2d 453 (2d Cir. 1968).

The Sixth Circuit bounced back into the *scienter* controversy by making the statement that, having found no direct duty owed by King or Coffey, "we need not reach the thorny general question whether . . . *scienter* must be shown . . . or whether mere negligence . . . suffices" 493 F.2d at 1315 n.25. It must be concluded, notwith-

Thus the Sixth Circuit refused to acknowledge a special relationship between non-participating officers and directors of a corporation and purchasers of the corporation's securities.¹¹³

Recognizing that an analysis of King's and Coffey's liability would be incomplete without a discussion of theories of secondary liability, the court then dealt with the "aiding and abetting" issue, *i.e.*, whether King and/or Coffey aided and abetted in any deception which the money-finder may have perpetrated on the State of Ohio. The court, citing Professor Ruder's article, held that *scienter* was a necessary element for liability of one aiding and abetting under rule 10b-5.¹¹⁴ Since there was no evidence to sustain a finding that King knew of or assisted in the money-finder's deception, the court concluded that he should not be held liable.¹¹⁵

As to Coffey, if it was found that through his contact with the money-finder he became aware of the deception, "his knowledge that a violation was occurring would be established and his failure to take remedial action would be a form of aiding and abetting¹¹⁶ Inaction may be a form of assistance in certain cases . . . where it is shown that the silence of the accused aider and abettor was consciously intended to aid the securities law violation."¹¹⁷ Although the court cited Professor Ruder's article,¹¹⁸ as well as *Brennan v. Midwestern*,¹¹⁹ and other cases,¹²⁰ for its contention that inaction can be a form of aiding and abetting, it is arguable that those cases stand for that proposition,¹²¹ while Professor Ruder expressly rejects such an idea.¹²² If Coffey had learned of the deception he would have been in a position similar to that of Midwest-

standing contradictory language in the opinion, that the issue is undecided in the Sixth Circuit.

113. *Accord*, *Lanza v. Drexel & Co.*, 479 F.2d 1277 (2d Cir. 1973).

114. 493 F.2d at 1316.

115. *Id.* at 1318.

116. *Id.* at 1316.

117. *Id.* at 1317. The contention made by the court here is similar to that made by the Seventh Circuit in *Hochfelder v. Ernst & Ernst*, 503 F.2d 1100 (1974), *cert. granted*, 421 U.S. 909 (1975). The court's holding is discussed at note 80 *supra*.

118. Ruder, *supra* note 14, at 641-44.

119. 417 F.2d 147, 154-55 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970).

120. *Wessel v. Buhler*, 437 F.2d 279, 283 (9th Cir. 1971); *Fischer v. Kletz*, 266 F. Supp. 180, 195 (S.D.N.Y. 1967).

121. Both *Wessel v. Buhler*, 437 F.2d 279 (9th Cir. 1971) and *Fischer v. Kletz*, 266 F. Supp. 180 (S.D.N.Y. 1967) involved the issue of an accountant's liability, and indicate that inaction alone may be sufficient only in those circumstances in which the defendant has a duty to act. See note 101 *supra* for a further discussion of these cases.

122. See text accompanying notes 76-80 *supra*.

ern in *Brennan*. There the court specifically left open the question of whether inaction alone might constitute aiding and abetting.¹²³

CONCLUSION

Securities fraud litigation, specifically Rule 10b-5, is a difficult area of law. As regards the controversial state of mind issue, the courts are desperately in need of some practical guidelines. Although *White v. Abram's* "flexible duty standard" is sound, it is limited to cases dealing with primary liability only. Until the Supreme Court takes the initiative and formulates some meaningful standards with broad applicability,¹²⁴ the primary/secondary approach suggested herein provides a reasonable method with which to analyze a complex, multiple defendant suit, sort out the liabilities, and allocate the rights among the various defendants.

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123. *Brennan v. Midwestern United Life Ins. Co.*, 417 F.2d 147, 154 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970); *accord*, *Landy v. Federal Deposit Ins. Corp.*, 486 F.2d 139, 161 (3d Cir. 1973).

124. It is possible that such a resolution by the Supreme Court may occur in *Hochfelder v. Ernst & Ernst*, 503 F.2d 1100 (7th Cir. 1974), *cert. granted*, 421 U.S. 909 (1975), a rule 10b-5 case involving a claim that defendant-accountants breached a duty of inquiry owing to the plaintiffs and thereby permitted a fraud to be perpetrated on plaintiffs. This case gives the Court the opportunity to clarify the distinctions between primary and secondary defendants and to set forth the state of mind standards to be applied to each. Under the approach suggested herein, the accountants in *Hochfelder* occupy the status of primary defendants and conventional principles of negligence should thus be applied in determining their liability. *See* note 80 *supra*.