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Securities Regulation-Outside Director's Liability for Misleading Corporate Statements

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Securities Regulation—OUTSIDE DIRECTOR'S LIABILITY FOR MISLEADING CORPORATE STATEMENTS

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

In *Escott v. BarChris Construction Corp.*,[1] the United States District Court for the Southern District of New York held that officers and directors of the bankrupt[2] Barchris Corporation were civilly liable under section 11 of the Securities Act of 1933[3] for misleading statements appearing in a BarChris prospectus.[4] *BarChris* recognized that even an outside director[5] who is not directly

[1] 283 F. Supp. 643 (S.D.N.Y. 1968). This landmark decision has been the subject of extensive discussion. *See, e.g.*, Folk, *Civil Liabilities Under the Federal Securities Acts: The BarChris Case* (pts. 1-2), 55 VA. L. REV. 1, 199 (1969); Note, *Escott v. BarChris: "Reasonable Investigation" and Prospectus Liability Under Section 11 of the Securities Act of 1933*, 82 HARV. L. REV. 908 (1969); Comment, *Escott v. BarChris Construction Corp.: "Due Diligence" Defenses Under Section 11 of the Securities Act of 1933*, 16 U.C.L.A. L. REV. 177 (1968). *See also* Annot., 2 A.L.R. Fed. 180 (1969); Note, *BarChris: Due Diligence Refined*, 68 COLO. L. REV. 1411 (1968).

[2] The dramatic rise and fall of the BarChris Construction Corporation is discussed at length in *BarChris*. 283 F. Supp. at 653-80. It is also traced in Lanza v. Drexel & Co., 479 F.2d 1277, 1280-88 (2d Cir. 1973); *see* notes 23-30 and accompanying text *infra*.

[3] 15 U.S.C. § 77k (1970). Section 11 is a long and elaborate scheme which imposes liability on a corporation, its directors and underwriters, or anyone signing a registration statement for any untrue statement of a material fact or omission to state a material fact in a registration statement. Liability extends to "any person" acquiring the security. *Id.* § 77k(a). No defenses are available to the issuing corporation, but other defendants may escape liability by establishing the "due diligence" defense of § 11(b). *Id.* § 77k(b). While the numerous refinements of this defense are beyond the scope of this Note, they are well described in the materials cited above. *See* note 1 *supra*. Suffice it to say that a corporate director can only escape liability by showing that

> he had, after reasonable investigation, reasonable ground to 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.

15 U.S.C. § 77k(b)(3) (1970).

Section 11 places the burden on the director to establish that he had no knowledge of the misstatement or omission, and that he could not have discovered it with reasonable investigation.

[4] BarChris had issued a series of 5 1/2% subordinated debentures under a prospectus which was misleading in several ways. For example, sales figures were overstated and cash balances were misrepresented. 283 F. Supp. at 659-61. A class action was brought by certain purchasers of the debentures under § 11 of the 1933 Act.

[5] The term "outside director" is not defined in the securities laws. However, an extra-legal distinction between "inside" and "outside" directors has developed; inside directors are those actively involved in the management and operation of the corporation. Professor Folk has stated:

> One distinctive feature of *BarChris* is the liability which it views section 11 as

involved in the day-to-day management of the corporation[6] could be liable for a misleading statement or material omission in a registration statement.[7] To avoid liability, the outside director must sustain a "due diligence" defense.[8] However, the court left little doubt that such a defense would be difficult to sustain.[9]

The *BarChris* court considered only liability for misleading statements made in a registration statement. However, much important corporate information is transmitted by means of press releases, advertisements, and oral representations.[10] *BarChris* did not consider liability for misleading statements in such mediums. Nevertheless, five weeks after *BarChris,* the Second Circuit, in the landmark case of *SEC v. Texas Gulf Sulfur Co.,*[11] demonstrated that

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> imposing upon "outside" directors: directors who are not also officers of the corporation or who otherwise have no specific and intimate relationship to the corporation which would afford them either actual knowledge of corporate affairs or such ready access thereto as to confer a right to such information.

Folk, *supra* note 1, at 26; *see* Lanza v. Drexel & Co., 479 F.2d 1277, 1281-89 (2d Cir. 1973) (similar description of outside director role). Professor Bishop has pointed out that "[t]here seems to be a general consensus that outside directors—*i.e.,* directors who are not full-time employees of the corporation—are desirable." Bishop, *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers,* 77 YALE L.J. 1078, 1092 (1968); *see* Estes, *Outside Directors: More Vulnerable Than Ever,* 51 HARV. BUS. REV. 107 (1973).

For the purpose of this Note, an "outside director" will be defined as a director who is not an employee and is not directly involved in the day-to-day management of the corporation.

[6] Rather than being involved in the details of management, the outside director has overall policy responsibility. According to the court in *Lanza,* this responsibility involves such activities as authorization of share issues, approval of important transactions, and general supervision of management. *See* 479 F.2d at 1307-09. *See also* Blough, *The Outside Director at Work on the Board,* 45 N.Y.S.B.J. 467, 472 (1973); Estes, *supra* note 5, at 113.

[7] *See* 283 F. Supp. at 687-89; Folk, *supra* note 1, at 26-27. Perhaps the most significant aspect of *BarChris* was the § 11 liability imposed upon two outside directors who had only been directors for about a month, and who had had no significant involvement with the corporation. However, they had failed to inquire into the accuracy of the registration statement and were thereby found not to have exercised "due diligence" as required by § 11. *See generally* Blough, *supra* note 6; Estes, *supra* note 5.

[8] *See* notes 3 & 7 *supra.*

[9] None of the *BarChris* defendants were able to sustain the "due diligence" defense. 283 F. Supp. at 685-86.

[10] *See, e.g.,* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) (misleading press release issued by corporation). *See also* notes 11-15 *infra.*

[11] 401 F.2d 833 (2d Cir. 1968). For extensive discussions of this case, 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 (1968); Sandler & Conwill, *Texas Gulf Sulphur; Reform in the Securities Marketplace,* 30 OHIO ST. L.J. 225 (1969); Note, *SEC v. Texas Gulf Sulphur,* 82 HARV. L. REV. 938 (1969); Comment, *Texas Gulf Sulphur: A Logical and Necessary Extension of Judicial History?,* 17 U. KAN. L. REV. 263 (1969). *See also* Comment, *Fashioning a Lid for Pandora's Box: A Legitimate Role for Rule 10b-5 in Private Actions Against Insider Trading on a National Stock Exchange,* 16 U.C.L.A.L. REV. 404 (1969); *Symposium—Rule 10b-5: Developments in the Law,* 63 NW. U.L. REV. 452 (1968).

Rule 10b-5[12] is a potent weapon against any misleading corporate statement.[13] Specifically, the Texas Gulf Sulphur Company was held to have acted in violation of Rule 10b-5 because of a materially misleading press release[14] issued by several of its officers which inaccurately down-played the significance of a monumental strike of ore in Canada.[15] However, as in *BarChris,* important questions regarding the extent and scope of an outside director's liability[16] were left unanswered. One such question is whether an outside

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[12] Rule 10b-5 states:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
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> (1) To employ any device, scheme, or artifice to defraud,
>
> (2) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1973).

[13] *Texas Gulf Sulphur* was an enforcement proceeding brought by the SEC against the company. The majority held that a misleading press release, even if only misleading because of negligence, could constitute a 10b-5 violation in an SEC enforcement action. 401 F.2d at 862. However, a dispute among the judges of the Second Circuit developed as to whether the same standards for liability should apply in a private cause of action. The majority declined to hold that mere negligence would suffice in a private action for damages: "We do not find it necessary to decide whether just a lack of due diligence on the part of TGS, absent a showing of bad faith, would subject the corporation to any liability for damages." *Id.* at 863. Judge Friendly, concurring, would have decided that mere negligence was not sufficient for imposition of liability in a private cause of action even though he agreed that it was sufficient in an SEC action. *Id.* at 866-69. *See generally* note 11 *supra.*

Since *Texas Gulf Sulphur,* the volume of 10b-5 litigation has accelerated rapidly, and the scope of that rule has expanded. *See, e.g.,* Jacobs, *The Impact of Securities Exchange Act Rule 10b-5 on Broker-Dealers,* 57 CORNELL L. REV. 869 (1972); Roantree, *The Continuing Development of Rule 10b-5 as a Means of Enforcing the Fiduciary Duties of Directors and Controlling Shareholders,* 34 U. PITT. L. REV. 201 (1972); Talesnick, *Corporate Silence and Rule 10b-5: Does a Publicly Held Corporation Have an Affirmative Obligation To Disclose?,* 49 DENVER L. REV. 369 (1973); Note, *Superintendent of Insurance v. Bankers Life and Casualty Co.: Supreme Court Expansion of Rule 10b-5,* 26 SW. L.J. 800 (1972).

Of course, there have been some limitations placed on this trend. *See, e.g.,* Ruder, *Limitations on Civil Liability Under Rule 10b-5,* 1972 DUKE L.J. 1125; Note, *Naked Allegations of Unfairness in Merger Ratios Present No Cognizable Federal Claim Under Section 10(b) or Rule 10b-5 Where There Is Full Disclosure,* 41 FORDHAM L. REV. 742 (1973); Comment, *Rule 10b-5—Second Circuit Holds Rule 10b-5 Inapplicable to Corporate Mismanagement When Full Disclosure Is Made to All Shareholders—Popkin v. Bishop,* 47 N.Y.U.L. REV. 1229 (1972). *See also* Jacobs, *The Role of Securities Exchange Act Rule 10b-5 in the Regulation of Corporate Mismanagement,* 59 CORNELL L. REV. 27 (1973).

[14] 401 F.2d at 862-64; Ruder, *supra* note 11, at 447-50.

[15] 401 F.2d at 843-47.

[16] *See* note 13 *supra* and notes 65-67 and accompanying text *infra.*

director who approves a corporate transaction, negotiated by officers, is liable under Rule 10b-5 for misrepresentations made by those officers during the negotiations.[17] This question has important practical ramifications. Competent and independent outside directors are essential to a well-managed corporation.[18] Strict liability placed upon outside directors for fraud perpetrated by insiders might deter competent individuals from serving on corporate boards.[19] Moreover, since an outside director, by definition, is not involved in the day-to-day operation of the corporation, it arguably would be unfair to hold him liable for fraud over which he had little control and about which he had no knowledge. Surely, an outside director is physically incapable of learning every technical detail of the transactions which he is called upon to approve.[20] On the other hand, outside directors should not be permitted mechanically to approve corporate fraud and escape liability on the facile ground that they are "outsiders." This would contravene the most basic policy of the securities laws—investor protection.[21] Therefore, a balance must be struck.

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[17] This, indeed, is the central issue in *Lanza*. *See* notes 22-39 *infra*.

[18] Bishop, *supra* note 5, at 1092-93; Estes, *supra* note 5, at 107, 114. *See generally* Blough, *supra* note 6.

[19] *See, e.g.*, Douglas & Bates, *The Federal Securities Act of 1933*, 43 YALE L.J. 171, 195 (1933) (emphasis added, footnotes omitted):

> Furthermore, though there may be some or many directors who do not "direct" (in the sense that they merely draw prestige and fees from the position) there are a great many, particularly of the larger and more complicated enterprises, who do and yet are not personally familiar with all details of operation. *Nor could their services be obtained in most cases if they were required to investigate details of the enterprise.* The experience and judgment of men of affairs is of great value to most of our more important corporations. To deprive enterprises of this asset would seem uneconomic in view of the slight gains which may be expected.

[20] *See* notes 5 & 8 *supra*. *See also* Blough, *supra* note 6, at 472.

[21] There has never been any doubt that the theoretical bases for the securities laws are investor protection and full disclosure. The Securities Act of 1933 was enacted, in the words of its preamble, "[t]o provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent fraud in the sale thereof." 48 Stat. 74; *see* Douglas & Bates, *supra* note 19, at 172-73.

The Supreme Court of the United States has affirmed that the securities laws must be read flexibly to promote investor protection, particularly against breaches of trust by fiduciaries. It was pointed out, in Superintendent of Insurance v. Bankers Life & Cas. Co., 404 U.S. 6, 11-12 (1971) (emphasis added), that

> [t]he Congress made clear that "disregard of trust relationships by those whom the law should regard as fiduciaries, are all a single seamless web" along with manipulation, investor's ignorance, and the like. H.R. Rep. No. 1383, 73d Cong., 2d Sess., 6. . . . [B]road discretionary powers in the regulatory agency "have been found practically essential." *Id.*, at 7. Hence, we do not read § 10(b) as narrowly as the Court of Appeals . . . . *Section 10b must be read flexibly, not technically and restrictively.*

Cf. J.I. Case Co. v. Borak, 377 U.S. 426, 432 (1964).

I

Lanza v. Drexel & Co.—Attempting To Strike a Balance

A. Lanza's *Background*

The Second Circuit addressed the difficult and important questions surrounding the liability of outside directors in the recent case of *Lanza v. Drexel & Co.*[22] Ironically, *Lanza* involved a suit against a former outside director of the defunct BarChris Construction Corporation,[23] Bertram D. Coleman. Prior to December 1961, the officers and directors of BarChris recognized that the industry was over-extended[24] and that a serious cash squeeze was developing.[25] It was doubtful that the meteoric growth of the bowling alley industry could continue.[26] Indeed, on December 6, 1961, it became necessary for the BarChris officers to call a "point of crisis" meeting, which was attended by Coleman.[27]

It was in this context of record profits but dismal projections, that the BarChris officers negotiated a share exchange with plaintiff Frank Lanza, the president of Victor Billiard Company.[28] Twenty thousand shares of Victor Billiard were to be exchanged for 20,428 shares of BarChris.[29] During the negotiations, Lanza was informed of BarChris's record profits, but he was never told of the discouraging prospects for the industry.[30] The share exchange was approved by the BarChris directors,[31] including Cole-

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22 479 F.2d 1277 (2d Cir. 1973), *aff'g* [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 92,826, at 90,089 (S.D.N.Y. 1970).

23 In essence, the Second Circuit accepted the fact findings of the original *BarChris* court. Indeed, in setting up the factual background for its opinion, the *Lanza* court quoted lengthy portions of the findings of fact in *BarChris*. *See* 479 F.2d at 1281-89.

24 283 F. Supp. at 654.

25 *Id.*

26 *Id.*

27 479 F.2d at 1286-87. At this meeting, Coleman learned of the serious adverse developments facing BarChris. He also learned of the growing internal conflict within BarChris's management and was made aware of a misleading public statement which had been issued in October 1961. *Id.* Although he apparently protested this statement, he took no action to insure that the Victor purchasers were informed of its inaccuracy. *See* notes 29-32 and accompanying text *infra*.

28 479 F.2d at 1287.

29 *Id.* at 1280.

30 The chronology of the negotiations is discussed in *Lanza*. *See id.* at 1283-84. *See also id.* at 1312-14 (Hays, J., dissenting); *id.* at 1321 (Timbers, J., dissenting).

31 On November 6, 1961, the BarChris board, without Coleman present, adopted the tentative agreement with Victor. Kircher and Birnbaum, two BarChris officers, were empowered to form an exchange contract. On November 13, Coleman was sent minutes of the meeting and learned of the exchange with Victor. On November 21, the contract was

man, a "respected and weighty" outside director who had not been involved in the negotiations with Lanza.[32] Coleman was unaware of the specific misrepresentations made to Lanza by the BarChris officers.[33] However, he was fully aware of the discouraging developments in the industry,[34] yet he admittedly made no investigation into the content of the negotiations.[35]

There is no doubt that if Coleman had known of the misrepresentations to Victor, his approval of the transaction would have violated Rule 10b-5.[36] The question in *Lanza*, however, was whether Coleman, as an outside director who " 'neither participated in nor knew of any deception,' "[37] could be liable because he had officially approved the fraudulent transaction.

The plaintiffs argued that there existed two possible bases of

presented to the board and approved. Coleman was present and voted for approval. The closing took place on December 14, 1961, eight days after the point of crisis meeting. *Id.* at 1280.

[32] *Id.* at 1318; *see id.* at 1283.

[33] *Id.* at 1289. This was found by the district court, and the Second Circuit could not say it was "clearly erroneous" under Federal Rule of Civil Procedure 52(a). *Id.*

[34] *Id.* at 1284-86.

[35] The court's discussion of Coleman's activities makes no mention of any investigation by Coleman into the Victor transaction. As both dissents point out, Coleman did nothing at all with respect to the transaction; his approval was completely ministerial. *See id.* at 1318 (Hays, J., dissenting); *id.* at 1320-21 (Timbers, J., dissenting). The majority was careful to note that in general, Coleman had been a conscientious director. *Id.* at 1284-89. However, the plaintiffs' claim was based on a specific transaction which Coleman had approved. *See* notes 77-95 and accompanying text *infra*. *See also* note 21 *supra*.

[36] The court indicates at several points that if Coleman had been aware of the misrepresentations, he would have been liable. For example the court said: "Absent *knowledge* or substantial participation we have refused to impose such affirmative duties of disclosure upon Rule 10b-5 defendants." 479 F.2d at 1302 (emphasis added). Later, the court, in discussing the prerequisites of 10b-5 liability, remarked: "[N]ormally, [the inquiry] will be to determine whether the defendants *knew* the material facts misstated or omitted, or failed or refused, after being put on notice of a possible material failure of disclosure, to apprise themselves of the facts." *Id.* at 1306 n.98 (emphasis added). Indeed, the opinion is replete with references to the fact that had Coleman had knowledge of the misstatements, he would have been liable. *See, e.g., id.* at 1281, 1284, 1288-89.

The rationale for such liability stems, in part, from Brennan v. Midwestern United Life Ins. Co., 259 F. Supp. 673 (N.D. Ind. 1966), *motion to dismiss denied*, 286 F. Supp. 702 (1968), *aff'd*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970). In *Brennan*, the plaintiffs ordered and paid for shares of Midwestern, but the brokerage firm with which they were dealing misapplied the funds toward ill-fated speculation. The plaintiffs sued Midwestern on the ground that, although the violation had been committed by salesmen employed by the brokerage firm, Midwestern was *aware* of the violation and refused to report it. This knowledge made Midwestern an "aider and abettor" in the fraud. *See, e.g.,* 259 F. Supp. at 681-82.

This rationale would have applied to Coleman if he had known of the misrepresentations because he had approved the transaction. Indeed, even if he had voted against the transaction, it is arguable that he should have been held liable. *See* note 84 *infra*.

[37] 479 F.2d at 1284.

liability against Coleman. First, it was argued that Coleman had an affirmative duty as a director to convey all adverse corporate information which he knew to prospective purchasers of the corporation's shares.[38] However, the court rejected this argument.[39] Second, it was argued that because Coleman could have discovered the misleading statements made during the Victor negotiations if he had exercised due care, he therefore was negligent in approving the fraudulent transaction. This negligence, the plaintiffs maintained, should be a sufficient basis for liability under Rule 10b-5.[40] This argument forced the Second Circuit to resolve the long-standing issue of whether scienter[41] is a requisite element of recovery under Rule 10b-5. Although the district court had evaded the sensitive scienter issue,[42] the court of appeals found that scienter *is* required, and that "[a] director's liability to prospective purchasers under Rule 10b-5 can only be secondary, such as that of an aider and abettor, a conspirator, or a substantial participant in fraud perpetrated by others."[43] In short, the court found that Coleman, as an outside director, had no duty to convey adverse information about his company to prospective purchasers, and further that liability for misleading statements made in negotiations could be based only on proof of scienter. Negligent approval of a fraudulent transaction by an outside director was held not actionable.

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[38] *Id.* at 1288-89. Unfortunately, in emphasizing the general "duty to convey" aspect of the case, the court gave inadequate consideration to the possible existence of a duty to investigate the status of particular negotiations. A successful investigation would give the director knowledge of fraud, and failure to act when armed with such knowledge would he a sufficient basis for liability. *See* note 36 *supra*.

[39] 479 F.2d at 1289; *see* notes 42-53 and accompanying text *infra*.

[40] 479 F.2d at 1299-1309.

[41] The issue of whether scienter should be required in a private cause of action under Rule 10b-5 was first raised by Judge Friendly, concurring in *Texas Gulf Sulphur*. *See* note 13 *supra*. The meaning of scienter, as accepted by the *Lanza* court (479 F.2d at 1301) and as used in this Note is "intent to defraud, reckless disregard for the truth, or knowing use of a device, scheme or artifice to defraud." *See* Shemtob v. Shearson, Hammill & Co., 448 F.2d 442, 445 (2d Cir. 1971). In essence, the scienter requirement involves a degree of culpability beyond mere negligence.

[42] [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. at 90,104-06. The district court said:

> Coleman did not know that the documents which plaintiffs received while he was on the board were materially false, nor did he have any reason to suspect that they were.
>
> Whatever requirement of due diligence there is under Rule 10b-5, it was satisfied by Coleman's personal inquiries to the responsible parties . . . .

Id. at 90,105. *But see* notes 77-95 and accompanying text *infra*.

[43] 479 F.2d at 1289. The court continued:

> Because Coleman owed no duty as a director to insure that [the purchasers]

B. *The Duty To Convey Adverse Information to Prospective Purchasers*

At the outset, the court dealt with the issue of whether Coleman had a directorial duty to convey adverse information about his corporation to prospective purchasers of its stock. If the court found that Rule 10b-5 imposed such a duty upon outside directors, then Coleman would have been liable.[44] He was undeniably aware of adverse developments in the bowling alley industry[45] but he did not convey this knowledge to the purchasers. However, if no duty to convey exists, then Coleman could only be liable if he was aware of the specific misrepresentations made during the negotiations, or if he actually participated in the fraud.[46]

The court of appeals found that neither the common law[47] nor the legislative history of the securities laws[48] supported a conclu-

> received information not conveyed to them by [the insiders who negotiated the transaction], and because Coleman was not an aider and abettor of, a conspirator in, or a substantial participant in the fraud perpetrated upon these plaintiffs, the complaint . . . was properly dismissed.

Id.

[44] The plaintiffs' claim was based on Rule 10b-5, and both the district court and the court of appeals focused almost exclusively on the parameters of that section. *See, e.g., id.* Section 11 was inapplicable in *Lanza* because the Victor acquisition constituted a "private offering" under § 4(2) of the 1933 Act and further because the claim involved "several non-registration statement communications." *Id.* at 1298. Section 11 only applies to material misstatements or omissions in a registration statement.

[45] *See* note 34 and accompanying text *supra.*

[46] *See* note 43 and accompanying text *supra.*

[47] 479 F.2d at 1291-93. The court of appeals began its common law analysis by asserting that common law is relevant to a director's duty to convey "because it was against a common law background that Section 10(b) was passed." *Id.* at 1291. Finding no duty to convey at common law, the court emphasized the right of directors to rely on management to honestly "attend . . . to the details of management." *Id.* at 1292. Although this may be an accurate statement of the common law, this principle does not seem particularly useful in analyzing Rule 10b-5. Certainly, the policies of the securities statutes have gone well beyond the common law in securing investor protection. *See generally* III L. Loss, SECURITIES REGULATION 1430-44 (2d ed. 1961); VI *id.* at 3534-55 (Supp. 1969).

[48] 479 F.2d at 1293-99. The court thoroughly analyzed the many conflicting and ambiguous legislative reports from the hearings on § 11. *See, e.g.,* H.R. REP. No. 85, 73d Cong., 1st Sess. 5, 9-10, 22-23 (1933); H.R. REP. No. 152, 73d Cong., 1st Sess. 26 (1933); S. REP. No. 47, 73d Cong., 1st Sess. 4-5 (1933). The upshot of these reports is that the Senate believed that merely to sign the misleading statement should be sufficient for liability (*see* 77 CONG. REC. 2981 (1933) (debate on S. 875, 73d Cong., 1st Sess. 9 (1933))), while the House believed that honesty and good faith should provide a defense. *See* H.R. REP. No. 85, 73d Cong., 1st Sess. 22-23 (1933). The result of this difference was a conference committee recommendation that the director have the burden of "proving that [he] had used reasonable care to assure the accuracy of these statements." *See* H.R. REP. No. 152, 73d Cong., 1st Sess. 26 (1933).

The court argued (479 F.2d at 1293) that this legislative background of § 11 proves that "Congress did not intend Section 10(b) of the 1934 Act to impose a duty to convey on directors." However, it is difficult to appreciate why the "due diligence" defenses under § 11, sion that a duty to convey adverse information to prospective purchasers should be imposed on outside directors. The court pointed out that if Rule 10b-5 imposes the same duty to convey as section 11, the more rigid procedural requirements of section 11 could be rendered nugatory.[49] The majority pointed out that

> [t]o impose a duty to convey upon directors under Rule 10b-5 would be to ignore th(e) Congressional intent. It would take away from directors what is granted to them by the private offering exemption and by *the limitation of the due diligence duty to registration statements.*[50]

The court's argument assumes that the imposition of a "duty to convey" would transplant section 11's affirmative disclosure obligations to Rule 10b-5 without the accompanying safeguards of the "due diligence" defenses provided for by section 11. It is entirely true that many technical aspects of the "due diligence" defenses would be inapplicable to a case brought under Rule

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which deals with registration statements, should release a director from his general fiduciary obligations. *See* H.R. REP. No. 152, 73d Cong., 1st Sess. 26 (1933).

The court's arguments concerning § 11 become weaker when viewed in the context of the facts of *Lanza.* Even if it is agreed that directors may reasonably rely on management with respect to the day-to-day details of management, it is difficult to characterize the Victor transaction as such. *See* notes 78-79 and accompanying text *infra.*

[49] 479 F.2d at 1298-99. Section 11b(3)(A) provides that the director will be liable for any misleading statement or material omission in the registration statement *unless,* with respect to any portion of the statement "not purporting to be made on the authority of an expert," he sustains the burden of proof that "he had, after reasonable investigation, reasonable ground to believe and did believe . . . that the statements therein were true and that there was no omission to state a material fact." Section 11b(3)(B) continues that liability will be imposed on the defendant for any misleading statement or material omission in any portion of the statement "purporting to be made upon his authority as an expert," *unless* he sustains the same burden as established in 11b(3)(A) or else unless he proves that the representation was not a "fair copy or extract from his report or valuation as an expert." Section 11b(3)(C) then provides a lesser standard of liability on the non-expert defendant with respect to the portions of the statement "purporting to he made on the authority of an expert." Under this section, the director must simply prove that he had "no reasonable ground to believe, and did not believe . . . that the statements therein were untrue or that there was an omission to state a material fact." Section 11b(3)(D) then provides that the defendant has the same burden with respect to a statement by a puhlic official or one purporting to he a public document as he would have with respect to an expertized statement under 11b(3)(C).

Further discussion of these "due diligence" defenses may be found in note 3 *supra.* In addition to the "due diligence" defenses, § 11 allows the defendant to escape liability if he resigns before the effective date of the statement *and* advises the Commission and issuer that he will not be responsible. *See* § 11h(1)(A-B), 15 U.S.C. § 77k(b)(2) (1970). Also, under § 11b(2), liability may be avoided if the statement became effective without the defendant's knowledge, provided that the defendant promptly gives the Commission and the public notice of his lack of knowledge.

Section 11 continues by establishing an elaborate method for recovery of damages. *See* § 11(e), 15 U.S.C. § 77k(e) (1970).

[50] 479 F.2d at 1299.

10b-5.[51] However, this does not suggest that the "duty to convey" could not fairly be imposed under Rule 10b-5. A duty to convey under Rule 10b-5 could require a standard of conduct less demanding than under section 11—a standard of conduct akin to traditional notions of "reasonableness" and "negligence."[52] Therefore, it is misleading to suggest that a Rule 10b-5 duty to convey would undermine section 11. Nevertheless, the court rejected this view and concluded that Rule 10b-5 should impose no duty to convey on Coleman. As an outside director, Coleman had a right to rely on the officers to make full and fair disclosure to the plaintiffs.[53]

The court then turned to a second and more important issue. Even without a duty to convey adverse information, Coleman would clearly have a duty to rectify misrepresentations made to the plaintiffs, if he knew of such misrepresentations. However, what if *by negligence* he was unaware of the misrepresentations? Would such negligence provide a sufficient basis for civil liability under Rule 10b-5?

C. *The Scienter Requirement*

A director who aids, abets, or participates in the transaction, or who has knowledge of misstatements, can escape 10b-5 liability

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[51] For a discussion of these technical aspects of the "due diligence" defense, see notes 3 & 49 *supra*.

[52] Section 11 imposes liability beyond traditional notions of negligence.

In order to avoid liability under § 11, a potential defendant (other than an issuer) must make a reasonable investigation of the accuracy of statements made in the registration statement. Such an investigation might not automatically be required to avoid negligence liability under 10b-5. *See* § 11(b), 15 U.S.C. § 77k(b) (1970). Of course, the quality of a § 11 reasonable investigation will vary with different classes of defendants.

In contrast, a duty to convey under Rule 10b-5 would not involve such an automatic duty—it would require only that the director act reasonably.

[53] 479 F.2d at 1300-01, 1306-07. In holding that Coleman had a right to rely on BarChris's officers to convey the adverse information to the purchasers, the court cited Mader v. Armel, 461 F.2d 1134 (6th Cir. 1972), and Moerman v. Zipco, Inc., 302 F. Supp. 439 (E.D.N.Y. 1969), *aff'd*, 422 F.2d 871, *rehearing denied*, 430 F.2d 362 (2d Cir. 1970). However, in *Mader*, the Sixth Circuit merely affirmed a finding that the defendant director "did not have the slightest idea anything was wrong," and relied on the technical reports of Peat, Marwick, an accounting firm with an excellent reputation. 461 F.2d at 1126. This stands in striking contrast to the facts in *Lanza*, where the defendant director was fully aware that "something was wrong" with the industry, and had substantial reason to believe that misleading statements had been made. *See* notes 80-94 and accompanying text *infra*.

In *Moerman*, the district court did use language supporting the director's right to rely on management. 302 F. Supp. at 447. However, any right to rely afforded to directors should only apply to the routine details of management, not to the extraordinary matters which require directorial approval. *See* notes 78-79 and accompanying text *infra*. The Victor exchange in *Lanza* required such approval, and was far from a routine detail of management. Therefore, it is difficult to understand how the court could emphasize a "right to rely," given the facts of the case.

only by ensuring that the misstatements are rectified before the transaction is approved.[54] Thus, participation or knowledge gives rise to a duty to convey.[55] However, the *Lanza* court found that Coleman had no knowledge of the specific misrepresentations made in the Victor negotiations, and was not an aider, abettor, or participant in the transaction.[56] As a result, it became necessary for the court to determine whether a nonparticipant outside director who approves a transaction can be liable under Rule 10b-5 if his approval is only negligent—*i.e.*, if "due care" would have led him to the discovery of the fraud. The plaintiffs' rationale was that "Coleman *knew* many disquieting facts about BarChris, particularly certain adverse financial developments and the *making of misleading statements to the financial community* by BarChris officers."[57] This knowledge made it "inexcusable" not to investigate whether full disclosure had been made in the negotiations.[58] Furthermore: "The plaintiffs suggested that if Coleman had inquired into the details of the . . . negotiations, he would have discovered the fraud. In that event, Coleman *could not have approved the sale of BarChris's stock to the Lanzas without incurring liability.*"[59]

In short, the plaintiffs were suggesting that negligent failure to

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[54] 479 F.2d at 1302-05. In support of the proposition that "participation" in the concealment would give rise to a 10b-5 claim, the court relied on the case of Brennan v. Midwestern United Life Ins. Co., 259 F. Supp. 673 (N.D. Ind. 1966), *motion to dismiss denied,* 286 F. Supp. 702 (1968), *aff'd,* 417 F.2d 147 (7th Cir. 1969), *cert. denied,* 397 U.S. 989 (1970). *See* note 36 *supra.* In *Brennan,* the court affirmed that 10b-5 liability could be imposed on any "participant" in a fraudulent transaction and broadly defined participation by stating that

> duties are often found to arise in the face of special relationships, and there are circumstances under which a person or a corporation may give the requisite assistance *or encouragement* to a wrongdoer so as to constitute an *aiding and abetting by merely failing to take action.*

259 F. Supp. at 681-82 (emphasis added); *see* 479 F.2d at 1303. Therefore, viewing *Lanza* and *Brennan* together, an outside director can be liable to purchasers when he aids, abets or even "encourages" officers acting fradulently. It follows that if a director is called upon to approve a transaction, and if he is aware of misrepresentations which have been made to prospective purchasers, he may avoid liability *only* through rectifying the misrepresentations *by disclosure to the purchasers. See* Pettit v. American Stock Exch., 217 F. Supp. 21 (S.D.N.Y. 1963). This rationale further implies that a duty to convey arises automatically for anyone who is involved in the negotiations leading to a corporate transaction.

It might reasonably be suggested that Coleman's affirmative approval of the fraudulent transaction itself constituted participation. However, the court's holding suggests that mere approval, in the absence of fraud or recklessness, is not sufficient participation to warrant imposition of liability.

[55] *See* 479 F.2d at 1302.

[56] *See, e.g., id.* at 1304. *Lanza* is replete with statements to the effect that Coleman was not involved in the negotiations and did not directly participate in making the material misstatements. *See, e.g., id.* at 1284.

[57] *Id.* at 1304 (emphasis added).

[58] *Id.*

[59] *Id.* (emphasis added).

discover the misrepresentations should constitute a sufficient basis for liability under Rule 10b-5,[60] and that scienter should not be required.[61] However, the Second Circuit rejected the plaintiffs' argument and held that scienter is a necessary element of a claim under Rule 10b-5.[62] "Mere negligence" is insufficient.[63] Liability must be predicated upon participation in the concealment, knowledge of the misstatements, or at least recklessness[64] in the failure to discover the misstatements. Furthermore, the court apparently believed that because an outside director has a reasonable right to rely on management in the daily conduct of the business, Coleman was under no duty to investigate the underlying content of the Victor negotiations.[65]

The precedent and reasoning used by the Second Circuit in imposing a scienter requirement on Rule 10b-5 are suspect. The court cited *Shemtob v. Shearson, Hammill & Co.*,[66] remarking that *Shemtob* "eliminated any doubt that proof of scienter is required in private actions in this circuit."[67] However, *Shemtob* arguably was not decided as a 10b-5 case. Rather, it was a "garden variety customer's

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[60] *Id.* The court said:

> Recognizing, however, that the record in this case cannot support a holding that Coleman's failure to inquire was in any way willful or calculated, plaintiffs, and our dissenting Brothers, urge that liability exists under Rule 10b-5 for a "negligent" omission to state material facts.

Id.

The court here seems to ignore "recklessness" as a possible basis of 10b-5 liability. However, recklessness is a firmly established basis for such liability. *See, e.g.*, Lanza v. Drexel & Co., 479 F.2d 1277, 1306 (2d Cir. 1973); Shemtob v. Shearson, Hammill & Co., 448 F.2d 442, 445 (2d Cir. 1971).

[61] If scienter is required, then Coleman would prevail because, in the opinion of the court, he had no knowledge of the misrepresentations made in the negotiations, and did not participate in the transaction. *See, e.g.*, 479 F.2d at 1284. In contrast, if a finding of negligence would sustain a 10b-5 claim, Coleman's knowledge of the adverse financial picture, the internal corporate strife, and his failure to investigate the Victor exchange before giving his approval, would have made liability difficult to avoid.

[62] 479 F.2d at 1304-05.

[63] Citing Shemtob v. Shearson, Hammill & Co., 448 F.2d 442, 445 (2d Cir. 1971), the court said that "it is insufficient to allege mere negligence" in a 10b-5 suit. 479 F.2d at 1305. While this use of *Shemtob* is quite weak (*see* notes 66-69 and accompanying text *infra*), the combination of *Shemtob* and *Lanza* leaves little doubt that the Second Circuit now requires scienter.

[64] 479 F.2d at 1305. *See generally* notes 80-94 and accompanying text *infra*.

[65] The opinion contains a series of references to the right of a director to rely on management. *See, e.g.*, 479 F.2d at 1306-07; *id.* at 1291-92 (discussing common law background); *id.* at 1296 (discussing legislative history); *id.* at 1300-01 (discussing case law development of Rule 10b-5). Because Coleman had a right to rely on management with respect to the Victor negotiations, he had no independent duty to investigate those negotiations. Thus, it became more difficult for the plaintiffs to characterize Coleman's conduct as "reckless."

[66] 448 F.2d 442 (2d Cir. 1971); *see* 479 F.2d at 1304-05.

[67] 479 F.2d at 1304.

suit against a broker for breach of contract."[68] The language in *Shemtob* on which the *Lanza* majority relied to support its conclusion that scienter was necessary to impose liability on Coleman had been passed on only by way of dictum. Indeed, Judge Hays's dissent in *Lanza* concluded, after thorough analysis, that "this court has not yet adjudicated the scienter-negligence issue."[69] Judge Hays also pointed out that several other circuits "have ruled that scienter is not a necessary element of a 10b-5 claim for relief."[70] But despite this trend, the Second Circuit opined that "precedent" imposed a scienter requirement on claims under Rule 10b-5.[71]

The court next profferred several policy arguments to support its scienter requirement. The court emphasized that liability for mere negligence would deter competent individuals from serving on corporate boards,[72] and further, that such liability would be inconsistent with the basic policies of the securities laws.[73] However, the overriding policy of the securities laws, and particularly of Rule 10b-5, is the protection of investors.[74] Therefore, it is difficult to understand how policy arguments support the proposition that a director may negligently approve a fraudulent transaction, without any investigation whatsoever, and thereby escape liability to the victimized investor. Judge Hays, dissenting in *Lanza,* argued that section 10b and Rule 10b-5

> impose upon a director of a corporation that is selling its shares the obligation not to defraud the purchaser by either misstating or omitting to state material facts. *A director cannot escape that duty by failing to inform himself of the facts and developments relevant to the sale of securities.*[75]

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[68] *See* Shemtob v. Shearson, Hammill & Co., 448 F.2d 442, 445 (2d Cir. 1971).

[69] 479 F.2d at 1319.

[70] *Id.; see* note 93 *infra.*

[71] 479 F.2d at 1304.

[72] *Id.* at 1307. Justice Douglas, while a professor, had remarked:

> Nor could [the] services [of many outside directors] be obtained in most cases if they were required to investigate details of the enterprise. The experience and judgment of men of affairs is of great value to most of our more important corporations.

Douglas & Bates, *The Federal Securities Act of 1933,* 43 YALE L.J. 171, 195 (1933); *see* Estes, *supra* note 5, at 107, 114; note 5 *supra.*

The SEC has added:

> Corporate directors are not normally involved in the day-to-day conduct of the company's affairs . . . . 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.

479 F.2d at 1306; *see* Brief for SEC as Amicus Curiae at 5, Lanza v. Drexel & Co., 479 F.2d 1277 (2d Cir. 1973); Blough, *supra* note 6, at 472.

[73] 479 F.2d at 1308-09; *see* note 21 and accompanying text *supra.*

[74] *See* note 21 *supra.*

[75] 479 F.2d at 1317-18 (emphasis added).

Furthermore, there is no tenable reason why competent individuals would be deterred from serving as directors by the imposition of liability for negligent approval of fraudulent transactions, or for the total disregard of their fiduciary obligations. *BarChris* imposed a considerably more severe standard—the affirmative duty of due diligence—to cases involving registration statements. This strict standard has been vigorously applied to outside directors.[76] Yet there is no indication that competent individuals have been deterred, to any significant degree, from serving on boards because of section 11 liability. To the contrary, *BarChris* merely reminds directors of their obligations to the corporation.

Indeed, the Second Circuit's policy reasoning may have the unfortunate effect of encouraging outside directors to avoid investigation into corporate transactions, knowing that only with actual knowledge or recklessness will they be held liable.[77] In addition, it appears that the large scale share exchange between BarChris and Victor was far more than a routine, day-to-day corporate matter. It was an important acquisition which involved extensive negotiations and required directorial approval.[78] Therefore, even if a director has the right reasonably to rely on management regarding routine details, it does not follow that directors should be permitted to refrain from investigating large, important corporate transactions.[79] Thus, neither precedent nor policy would seem to support the court's conclusion that an outside director may negligently approve a fraudulent transaction without liability under Rule 10b-5.

II

Standards for Liability of Outside Directors After *Lanza*

A. *The Restrictive Formulation of the Scienter Requirement*

In formulating a scienter requirement, the court paid lip-service to the well-established rule that "recklessness" would meet

[76] *See* Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 687-89 (S.D.N.Y. 1968) (outside directors unable to sustain due diligence defense, even though they took office *after* registration statement was prepared). *See also* notes 1-9 and accompanying text *supra.*

[77] In certain instances, it might be reckless for a director to fail to investigate a transaction. In *Lanza,* the plaintiffs unsuccessfully suggested (479 F.2d at 1304) and the dissent agreed (*Id.* at 1321) that Coleman was reckless not to make any inquiry into the Victor negotiations. For *Lanza's* possible effect on the recklessness standard, see notes 80-94 and accompanying text *infra.*

[78] 479 F.2d at 1283-84 (majority opinion); *id.* at 1312-13 (Hays, J., dissenting).

[79] Indeed, it seems anomalous to allow a director to rely on management with respect to

this requirement and support a 10b-5 claim. However, the court's application of the scienter requirement to the facts of *Lanza* left the future of the recklessness standard in doubt. The plaintiffs' complaint had been dismissed in district court for failure to state a claim upon which relief could be granted.[80] However, the complaint alleged at least four significant facts regarding Coleman's conduct as a director: (*1*) knowledge of adverse financial information and protracted intracorporate strife;[81] (*2*) knowledge of "misleading statements to the financial community,"[82] which assuredly were transmitted to the plaintiffs as members of the financial community; (*3*) failure to make *any* investigation into the content of the negotiations;[83] and (*4*) approval of the admittedly fraudulent transaction.[84] It is difficult to understand how these four allegations, if proven, would not be deemed to constitute recklessness and thus pass the muster of the scienter requirement. This is especially true in light of Coleman's extensive business experience,[85] and the great importance of the Victor share exchange to BarChris.[86]

It follows that the court has promulgated an extremely restrictive interpretation of the scienter requirement. Indeed, as Judge Timbers pointed out in his dissent, Coleman's conduct, if anything, constituted a "reckless disregard for the truth."[87] Judge Hays agreed, arguing that Coleman had learned of BarChris's unfavorable situation and internal strife at the "point of crisis" meeting

an extraordinary acquisition. This seems to frustrate the very purpose of having outside directors.

[80] Lanza v. Drexel & Co., [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,826 (S.D.N.Y. 1970).

[81] *See, e.g.*, 479 F.2d at 1284-89, 1304.

[82] *Id.* at 1288, 1304.

[83] *Id.* at 1304. Both dissents point out that Coleman took no action whatsoever to inform himself with respect to the Victor acquisition. *Id.* at 1316, 1318 (Hays, J., dissenting); *id.* at 1321 (Timbers, J., dissenting). Coleman's approval of the transaction was completely mechanical, evidencing a failure to fulfill his fiduciary obligations as a director.

[84] There was no doubt that the transaction itself was fraudulent on the basis of the misstatements made by the officers during the negotiations. Indeed, those officers were held liable by the district court in *Lanza.* The finding of a 10b-5 violation by those officers was apparently not appealed. *See id.* at 1280, 1316.

It should be noted that even if Coleman had voted against the fraudulent transaction, under the majority's view of the case he arguably would still have had a duty to correct the misrepresentations made to the purchasers if he had known about them. Because Coleman voted to approve the transaction, the court did not discuss the issue.

[85] *See, e.g., id.* at 1318 (Hays, J., dissenting).

[86] *See id.* at 1283-89. Certainly, the more important the transaction, the less reasonable it is for a director to mechanically rubber-stamp his approval without a reasonable investigation.

[87] *Id.* at 1321.

eight days before the closing of the Victor deal.[88] Judge Hays added that Coleman "made *no attempt* to inquire as to the course of the negotiations,"[89] and concluded:

> Coleman argued that because he was an "outside" director with respect to the negotiations with Victor, he had no duty to intervene. I disagree. The distinction between an "inside" and an "outside" director is irrelevant in this context, because Coleman did *nothing at all.* As a director, Coleman had a duty to keep himself adequately informed as to the activities of the corporation. He could no more close his eyes to the purchase of Victor than he could to other important corporate developments.[90]

Coleman's activities represented a total disregard of directorial responsibility with respect to the Victor acquisition.[91] Furthermore, as the majority admitted, Coleman had actual knowledge of misleading reports to the "financial community."[92] Therefore, the majority is actually saying that knowledge of misleading public statements, knowledge of corporate adversity and managerial strife, and approval of a fraudulent transaction by a highly experienced director does not constitute "scienter," even when that director fails to make the slightest investigation into the transaction. This is an anomalous result at a time when many jurisdictions are abandoning the scienter requirement altogether in favor of a negligence standard.[93]

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[88] *Id.* at 1318.

[89] *Id.*

[90] *Id.* (emphasis added).

[91] The court argued that Coleman's overall conduct as a director was responsible. *Id.* at 1284-89. However, the court's efforts to make Coleman appear to have acted reasonably are unconvincing. When a director attends a "point of crisis" meeting, learns of great corporate adversity, internal strife, and misstatements to the financial community, and eight days later approves a fraudulent transaction without the slightest investigation, it is difficult to characterize his conduct as altogether reasonable. Furthermore, even if Coleman's *overall* conduct as a director was reasonable, his handling of the Victor transaction clearly constituted a total breach of fiduciary responsibility. The United States Supreme Court has made it clear that prevention of such fiduciary breach is a primary intention of the securities laws and Rule 10b-5. *See* Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 11-12 (1971). *See also* note 21 *supra.*

[92] *See* 479 F.2d at 1288, 1304. Surely, the plaintiffs must be considered members of the "financial community." Thus, Coleman's knowledge of misleading statements made to the "financial community" indicated that Coleman at least knew that at some point in time misleading statements had been made to the plaintiffs by his company.

[93] *See, e.g.,* Ellis v. Carter, 291 F.2d 270, 274 (9th Cir. 1961). *See also* City Nat'l Bank v. Vanderboom, 422 F.2d 221, 229-30 (8th Cir.), *cert. denied,* 399 U.S. 905 (1970); Myzel v. Fields, 386 F.2d 718, 734-35 (8th Cir. 1967), *cert. denied,* 390 U.S. 951 (1968); Stevens v. Vowell, 343 F.2d 374, 379-80 (10th Cir. 1965); Royal Air Properties, Inc. v. Smith, 312 F.2d 210, 212 (9th Cir. 1962); *cf.* Gould v. American Hawaiian Steamship Co., 351 F. Supp. 853, 861-62 (D. Del. 1972).

Such a restrictive formulation of the scienter rule is not only unfair to defrauded investors, but may even encourage directors to disengage themselves from corporate matters, because failure to do "anything at all" immunizes them from liability under *Lanza*. Such a result undercuts the primary purpose of federal regulation of securities transactions—the protection of investors.[94]

B. *The Lack of an Integrated Standard of Liability for Outside Directors*

If competent and independent individuals are to be encouraged actively to serve on corporate boards, it is important that they be apprised of the standards of liability to which they will be held under the securities laws. At present, because there is no uniformity among the jurisdictions on whether scienter should be required under Rule 10b-5;[95] a director who commits a single corporate act which has effects in several jurisdictions might be liable in some and not in others. Some victims would recover; others would not. This type of inconsistency is both regrettable and unwarranted. Moreover, the standards of liability under different provisions of the securities laws seem to vary unpredictably. For example, in the recent case of *Gould v. American Hawaiian Steamship Co.*,[96] scienter was not required for a misleading proxy claim based on section 14(a) of the 1934 Act and Rule 14a-9 promulgated thereunder.[97] The court recognized that, like Rule 10b-5, Rule 14a-9 contains no language which necessarily imposes a scienter requirement.[98] Further, those two rules are framed in quite similar terms.[99] In rejecting the scienter requirement for 14a-9, the court fashioned arguments which seem to apply with equal force to Rule 10b-5: "This [standard] rewards the conscientious director by

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[94] *See* note 21 *supra*. Indeed, the imposition of such a low standard of fiduciary obligation under Rule 10b-5 has the result of allowing lesser standards of directorial conduct under 10b-5 than had previously existed under the law of fiduciaries. *See* note 21 *supra*.

[95] *See* note 93 and accompanying text *supra*.

[96] 351 F. Supp. 853 (D. Del. 1972); *see* Blough, *supra* note 1. *See also* Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281, 1298-1301 (2d Cir. 1973).

[97] 351 F. Supp. at 864-65.

[98] Rule 14a-9(a) (17 C.F.R. § 240.14a-9(a) (1973)) states:

> No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting or other communication, written or oral, containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading.

[99] 351 F. Supp. at 864. Nevertheless, the court is careful to distinguish its holding from cases under Rule 10b-5. *Id.* at 864-65.

guarding against liability for the diligent, and simultaneously, increases the incentives to more rigorously police proxy materials thereby more effectively protecting the interests of securities investors."[100] Interestingly, the Second Circuit has itself rejected the scienter requirement for cases under 14(a).[101] Thus, despite the great similarity in language, the Second Circuit apparently believes that Rules 10b-5 and 14a-9 should be interpreted to impose different standards.[102] This inconsistency renders it difficult for diligent directors to familiarize themselves with their obligations under the

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[100] *Id.* at 865. However, the court does suggest at least one distinction between *Gould* and *Lanza*:

> The additional burden of imposing a standard of reasonable care or due diligence as opposed to actual knowledge or gross negligence is easily defendahle. This is especially true for the corporate directors in this case since they hold a position of fiduciary trust to the very persons to whom the proxy materials were issued and who are now seeking damages.

Id. In *Gould,* the fiduciary obligation was owed to the plaintiff, while in *Lanza,* Coleman did not have any fiduciary obligation to the purchasers of the BarChris stock. However, this distinction is of limited value, because liability under Rules 10b-5 and 14a-9 is predicated *not* on breach of fiduciary duty, but rather on breach of the *duty not to defraud.* There is no requirement under either rule that the defendant be a fiduciary.

[101] *See, e.g.,* Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281, 1298-1301 (2d Cir. 1973). The *Gerstle* court cited with approval Gould v. American Hawaiian S.S. Co., 351 F. Supp. 853 (D. Del. 1972), which specifically held that scienter should not be required in actions brought under Rule 14a-9. *See* 478 F.2d at 1299. *See also* notes 96-100 and accompanying text *supra.* After approving the *Gould* rationale, *Gerstle* carefully distinguished cases under Rule 14a-9 from those under Rule 10b-5 (478 F.2d at 1298-1300) and affirmed the principle of *Lanza.* The court remarked:

> Although the language of Rule 14a-9(a) closely parallels that of Rule 10b-5, and neither says in so many words that scienter should be a requirement, one of the primary reasons that this court has held that this is required in a private action under Rule 10b-5 [citing *Lanza*] is a concern that without some such requirement the Rule might be invalid.

Id. at 1299.

In *Gerstle,* as in *Gould,* the policy reasoning used by the court in rejecting the scienter standard for Rule 14a-9 seems to apply with equal force to Rule 10b-5. The court recognized that the important policy of "investor protection" would be thwarted by "too liberal a standard of culpability." *Id.* at 1300; *see* note 100 and accompanying text *supra.*

[102] One possible justification for imposing a lesser standard of liability under Rule 10b-5 than under Rule 14a-9 is that Rule 14a-9, like § 11, involves a specific and clearly identifiable securities form. When such a form is issued, the director is on notice that he has a distinct ohligation to verify the accuracy of statements made in that form. In contrast, under Rule 10b-5, liability may result from misstatements in any medium. It is therefore more difficult for the director to assess the parameter of his duties under Rule 10b-5. In the typical 10b-5 case, it is likely to be more difficult for the director to assure himself that no fraud has occurred.

This argument does not, however, suggest that a scienter standard should be imposed under Rule 10b-5. Rather, in determining whether a director acted "reasonably" in meeting his 10b-5 obligations, courts should be aware that it is easier for a director to verify the accuracy of a specific form than of a possibly diffuse series of corporate representations. But under either Rule, if he did not act reasonably, liability should he imposed. *See* notes 98-99 and accompanying text *supra* and note 104 *infra.*

securities laws. Further, in holding that Rule 10b-5 is applicable to cases involving misleading proxies,[103] the United States Supreme Court used no language to suggest that a different standard should be imposed for these two rules. Indeed, the high court has indicated that "10(b) must be read flexibly, not technically and restrictively."[104] To read obscure distinctions into the virtually identical language of Rules 14a-9 and 10b-5 would violate this mandate.

The most consistent and effective approach to the myriad of cases arising under Rules 10b-5 and 14a-9 would be simply to require the outside director to exercise reasonable care to ensure that misleading information is not disseminated.[105] Such an approach is fully consistent with the important policy of investor protection which underlies all securities law. Furthermore, a standard of reasonable care would not deter competent individuals from serving on corporate boards. Rather, the consistency and predictability of such a standard would help clarify the complex and confusing issues surrounding an outside director's potential liability. Thus, qualified men and women would be encouraged to perform their duties with the courage and vigor needed in successful modern enterprises.

CONCLUSION

Lanza can be viewed as a broad affirmation of the right of outside directors to rely on the honesty of management in the conduct of corporate affairs. However, the purpose of having outside directors is to provide helpful independent guidance in important policy matters. This purpose would be frustrated if outside directors were allowed to rubber stamp every transaction with impunity.

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[103] SEC v. National Securities, Inc., 393 U.S. 453 (1969).

[104] *See* Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 11-12 (1971). *See also* note 21 *supra.*

[105] This view is not unlike the official position of the Securities Exchange Commission as expressed in its brief as amicus curiae in the *Lanza* case. The SEC requested that the Second Circuit remand the case to the district court for a finding of fact on whether Coleman had reason to know of the misrepresentations. If Coleman had reason to know of the misleading statements, the SEC would hold him liable. It follows that the SEC would impose a duty to exercise reasonable care to insure that misleading information is not disseminated. However, the court explicitly rejected the SEC approach, indicating that the director should owe no duty to the prospective purchasers. 479 F.2d at 1301-02.

To be sure, directors deserve a reasonable right to rely on management. But this right to rely must be balanced against the overriding policies of investor protection and full disclosure which have been developing since *BarChris* and *Texas Gulf Sulphur*. *Lanza* stands as a roadblock to this development.

William E. Grauer