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Scienter and the Flexible Duty Under Rule 10b-5

INTRODUCTION: SCIENTER AND THE PROPER 10b-5 STANDARD

A major focus of private litigation under rule 10b-5¹ is the determination of the proper standard or duty applicable to alleged violators of the rule. Legislative² and administrative³ histories are not helpful in establishing a civil action standard, for they are couched in the language of common law fraud. The rule itself is written in strict liability language.⁴

Realizing that rule 10b-5 was enacted to deter many forms of fraudulent activity,⁵ most courts have rejected the extreme standards of strict liability⁶ and common law fraud,⁷ and have chosen an intermediate test

¹A private right of action under rule 10b-5 was not always available. It is clear today, however, that one exists. *Superintendent of Ins. v. Bankers Life and Cas. Co.*, 404 U.S. 6, 13 n.9 (1971) (Supreme Court recognizes a private action); *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946); 6 L. LOSS, *SECURITIES REGULATION* 3871 (1969); Note, *Proof of Scienter Necessary in a Private Suit Under SEC Anti-fraud Rule 10b-5*, 63 MICH. L.R. 1070, 1072 (1965).

²"The [Senate] Report . . . is replete with words and phrases indicating that the act was designed primarily to prohibit fraudulent activities. Nowhere does the Report imply that liability without culpability would attach for material misrepresentations." *Kohn v. American Metal Climax, Inc.*, 458 F.2d 255, 277 (3d Cir. 1972).

³Upon releasing rule 10b-5, the SEC stated, "the new rule closes a loophole in the protections against fraud . . . by prohibiting individuals or companies from buying securities if they engage in fraud in their purchase." SEC, *Securities Exchange Act of 1934 Release No. 3230* (May 21, 1942).

⁴Rule 10b-5, 17 C.F.R. § 240.10b-5 (Supp. 1974), *Employment of Manipulative and Deceptive Devices*.

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.

⁵See *Kohn v. American Metal Climax, Inc.*, 458 F.2d 255, 278 (3d Cir. 1972); *Trussel v. United Underwriters, Ltd.*, 228 F. Supp. 757, 771 (D. Colo. 1964) (for recovery in a private action, a party must prove violation of a criminal statute); 1 A. BROMBERG, *SECURITIES LAW: FRAUD SEC RULE 10b-5* § 2.2 (420) at 22.7 (1970); Comment, *Negligent Misrepresentations Under Rule 10b-5*, 32 U. CHI. L. REV. 824, 825 (1965).

⁶"If we choose to deter, say, misrepresentations, we may think it wise to go all the way and make innocent misrepresentations actionable. But this reduces incentives to be careful, since care is no defense (though it may still prevent a misrepresentation from occurring)." 2 A. BROMBERG, *SECURITIES LAW: FRAUD SEC RULE 10b-5*, § 8.4(508) at 204.114 (1971). "Moreover, despite some dicta suggesting that the second clause [Rule 10b-5(b)] provides for absolute liability, no court has been willing to apply such a stringent standard." 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).

⁷"There has . . . been a growing recognition by common-law courts that the doctrines of fraud and deceit which developed around transactions involving land and other tangible

they refer to as *scienter*. *Scienter*, however, is a term of art and its definition changes with the court and the facts of the particular case.⁸ Judges and commentators can be found to support the proposition that the version of *scienter* to be applied in rule 10b-5 cases is a combination of one or more of the following: knowledge,⁹ intent,¹⁰ recklessness,¹¹ or negligence.¹² Bromberg states that "[p]robably the most important step in clarifying the law of *scienter* would be to ban the word."¹³ Another commentator, Mann,¹⁴ suggests that the proper analysis is to develop a flexible standard which can adjust to the wide variety of conduct found in alleged rule 10b-5 violations. Rather than elicit criteria which might enable courts to use the proposed standard, Mann merely cites cases holding the defendant to a higher or lower duty

items of wealth are ill suited to the sale of such intangibles as advice and securities, and that accordingly, the doctrines must be adapted to the merchandise in issue (footnotes omitted)." *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194 (1963); *See also Ellis v. Carter*, 291 F.2d 270 (9th Cir. 1961).

⁸Bromberg breaks *scienter* into three general categories with sub-areas under each as follows:

- I. Knowledge
 - A. Actual
 - B. Constructive Knowledge
- II. State of Mind
 - A. Intent
 - B. Purpose or Motive
 - C. Bad Faith
- III. Care
 - A. Recklessness
 - B. Negligence

2 A. BROMBERG, *supra* note 6, § 8.4(504) at 204.104.

⁹*See generally* *Lanza v. Drexel and Co.*, 479 F.2d 1277, 1304-05 (2d Cir. 1973); *Bowman & Bourdon, Inc. v. Rohr*, 296 F. Supp. 847, 852 (D. Mass. 1969) *aff'd per curiam* 417 F.2d 780 (1st Cir. 1969); *Globus v. Law Research, Inc.*, 287 F. Supp. 188, 197-98 (S.D.N.Y. 1968); 2 A. BROMBERG, *supra* note 6, § 8.4(504) at 204.104-05; Bucklo, *Scienter and Rule 10b-5*, 67 Nw. U.L. REV. 562, 570 (1972).

¹⁰*See generally* *Myzel v. Fields*, 386 F.2d 718, 734-35 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968); *Gerstle v. Ganble-Skogmo, Inc.*, 298 F. Supp. 66, 97 (E.D.N.Y. 1969); *O'Neill v. Maytag*, 230 F. Supp. 235, 239 (S.D.N.Y. 1964), *aff'd* 339 F.2d 764 (2d Cir. 1964); *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, 441-42, 444 n.107 (1968).

¹¹*SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 883, 868 (2d Cir. 1968) (en banc) (concurring opinion); *Trussell v. United Underwriters, Ltd.*, 228 F. Supp. 757, 772-73 (D. Colo. 1964); Professor Loss says that "*scienter* has been . . . variously defined to mean everything from knowing falsity with an implication of *mens rea*, through the various gradations of recklessness, down to such non-action as is virtually equivalent to negligence or even liability without fault" 3 L. LOSS, *SECURITIES REGULATIONS* 1432 (2d ed. 1961).

¹²*See generally* *City Nat'l. Bank v. Vanderboom*, 422 F.2d 221, 229-31 (8th Cir. 1970), *cert. denied*, 399 U.S. 905 (1970); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 854-55 (2d Cir. 1968); Sandler and Conwill, *Texas Gulf Sulphur; Reform in the Securities Marketplace*, 30 OHIO ST. L.J. 225, 270-72 (1969); Note, *Scienter and Rule 10b-5*, 69 COLUM. L. REV. 1057-67 (1969).

¹³2 A. BROMBERG, *supra* note 6, § 8.4(503) at 204.103.

¹⁴Mann, *supra* note 6, at 1209-20.

depending on the presence or absence of certain facts.¹⁵

I. ADOPTION OF A FLEXIBLE DUTY APPROACH

It is within this context that the Ninth Circuit Court of Appeals in *White v. Abrams*,¹⁶ announced that past definitions of scienter are unworkable and adopted a standard based on duty which adjusts to the particular fact situation of each case.¹⁷ The court stated that the strictness of the duty depends on the particular facts involved, and then listed five specific factors that the jury may use to determine the defendant's particular duty.

In *White*, a group of investors, who had a long and trusted relationship with the defendant Abrams, were induced by him to loan money at 12 to 14 percent interest per annum and to buy stock in twenty-six corporations controlled and owned by Theodore Richmond. When the Richmond corporations went bankrupt in 1967, the plaintiffs charged Abrams with common law fraud and violation of rule 10b-5, alleging that he misrepresented (1) the financial position of Richmond and his corporations, (2) the use to be made of the loaned funds, and (3) the Richmond corporations' earnings. Plaintiffs also alleged that Abrams did not disclose (1) that he earned large commissions on investments in the Richmond corporations and (2) that similar investments were made through Abrams at higher interest rates (up to 20 percent).¹⁸ The district court interpreted two prior Ninth Circuit Court of Appeals decisions¹⁹ to require a strict liability jury instruction and Abrams was found liable.²⁰ The court of appeals, however, held that the jury charge was erroneous and that a flexible duty standard was required under rule 10b-5. Without limiting the trial court from varying the factors to be considered by the jury, the court listed the following as some to be considered:

... (1) the relationship of the defendant to the plaintiff, (2) the defendant's access to the information as compared to plaintiff's access, (3) the benefit that the defendant derives from the relationship, (4) the defendant's awareness of whether the plaintiff was relying upon their relationship in making his investment decisions, and (5) the defendant's activity in initiating the securities transaction in question.²¹

¹⁵Mann supports rejection of the phrases of negligence and scienter for a balancing approach which would consider the relationship of the parties, type of relief sought, the plaintiff's character, and the motivation and nature of the culpable conduct. *Id.* at 1206-09.

¹⁶495 F.2d 724 (9th Cir. 1974).

¹⁷The *White* court cites Mann, *supra* note 6, at 1209 and 2 A. BROMBERG, *supra* note 6, § 8.4(513) at 204.115 (1971) in announcing that past definitions of scienter are unworkable. 495 F.2d at 733-34.

¹⁸495 F.2d at 727 (9th Cir. 1974).

¹⁹*Royal Air Properties, Inc. v. Smith*, 312 F.2d 210 (9th Cir. 1962); *Ellis v. Carter*, 291 F.2d 270 (9th Cir. 1961).

²⁰495 F.2d at 734 (9th Cir. 1974).

²¹*Id.* at 735-36.

Another case adopting the flexible duty approach for rule 10b-5 cases is *Hochfelder v. Ernst & Ernst*,²² which was decided subsequent to but did not mention *White*. Because *Hochfelder* adopts a flexible duty without expanding it beyond the traditional negligence concept of causation, duty, and breach, this comment will be confined to the five factors listed in *White* and the analysis therein. The purpose of this comment is (1) to analyze the factors listed in *White* in terms of the purposes of rule 10b-5, (2) to discuss some reasons why the presence or absence of the factors in a particular case cause the standard to become more stringent or lax, and (3) to explain how the adoption of a flexible standard effectuates the purposes behind enactment of the rule. This approach is novel because it focuses on a duty which changes according to the particular facts. Other courts have required differing versions of *scienter* depending on the existence or absence of the factors listed in *White*, but none has adopted the unique approach of a flexible duty.

II. THE PURPOSE OF RULE 10b-5

The basic purpose of rule 10b-5 is to deter fraudulent activity in securities transactions. Its major thrust, similar to that of the federal securities laws taken as a whole, is one of full disclosure — the basic premise being that persons should be able to deal as they wish. Of course, they cannot deal as they wish unless they are fully aware of all the material facts. Although congressional history does not clearly state the purpose of the rule in these terms,²³ the Supreme Court has said that the purpose of securities legislation in general is “. . . to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry.”²⁴ Thus, the purpose is not to create a scheme of investor’s insurance²⁵ in which courts analyze each transaction to insure its fairness, but rather to prompt parties to fully disclose material facts by imposing penalties²⁶ for failure to do so. Each party is then left to decide for himself whether he will purchase or sell the securities. With full disclosure, parties can still enter into unfair trans-

²²503 F.2d 1100 (7th Cir. 1974).

²³Cox, *Fraud in the Eyes of the Beholder: Rule 10b-5's Application to Acts of Corporate Mismanagement*, 47 N.Y.U.L. REV. 674, 675 n.3 (1972); Ruder, *Civil Liability Under Rule 10b-5: Judicial Revision of Legislative Intent?*, 57 Nw. U.L. REV. 627, 642-60 (1963).

²⁴SEC v. Capital Gains Research Bureau, 375 U.S. 180, 186 (1963).

²⁵E.g., *List v. Fashion Park, Inc.*, 340 F.2d 457, 463 (2d Cir. 1965), *cert. denied*, 382 U.S. 811 (1965).

²⁶Criminal sanctions are not the only possible penalties under the rule. Courts have realized that a private action can also have a penalizing and deterring effect on those involved in securities transactions. For this reason, Stone has commented that civil actions help police the securities market by (1) the bringing of cases that the SEC cannot bring because of its limited resources, (2) providing for potentially higher monetary damages than criminal proceedings, (3) and by filling in the gaps left by the singular application of criminal penalties.

actions, but they will do so knowingly, and fraudulent activity will be deterred.

While deterrence is a worthwhile goal, it should be recognized that all fraud cannot be prevented. Thus, another purpose of rule 10b-5 is to make judicial machinery available which will restore plaintiffs who have relied on less than full and accurate disclosure. Upon showing a violation of the rule, plaintiffs are then entitled to damages and/or rescission of the sale to compensate them for their loss.

III. FORESEEABILITY OF RELIANCE AND BENEFIT TO DEFENDANT

The flexible duty standard, as developed by the factors listed in *White*, is based primarily on two important concepts — the foreseeability of the plaintiff's reliance by the defendant and the benefit that the defendant derives from the transaction. Reliance is not a new concept in rule 10b-5 litigation, but the flexible duty approach uses it differently than most courts have done in the past. The traditional use of reliance has been to make it a necessary element of causation.²⁷ Under the flexible duty approach, the plaintiff's reasonable reliance upon defendant's misrepresentation or failure to disclose is still a necessary element in the proof of causation, but the foreseeability of that reliance by the defendant also affects the defendant's duty. Whenever it is reasonably foreseeable to a defendant that the plaintiff may rely upon his information or judgment, the defendant is under a more stringent duty to truthfully disclose all material facts. In this context, three of the factors listed in *White* — relationship, access to information,²⁸ and awareness of reliance — become crucial as elements of proof which substantiate foreseeability of reliance. When these factors are proved, the defendant's duty becomes more stringent because the probability and foreseeability of reliance are greater.

Another important factor which causes the duty to vary is the benefit defendant receives from the securities transaction. The reasoning is that the motivation to mislead is greater when the deceiver stands to be rewarded for such action. The court addressed this problem directly in one factor and indirectly in another, holding the defendant to a higher duty when he actually benefits from or when he is active in initiating the transaction. Together, initiation and benefit are elements of proof

(The criminal sections of the Exchange Act are probably not sufficient deterrents because of their limited \$10,000 penalty, the reluctance of investors to institute criminal actions, and the problems following discovery and prosecution.) Stone, *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, 411 (1969).

²⁷See Comment, *Reliance Under Rule 10b-5: Is the "Reasonable Investor" Reasonable?*, 72 COLUM. L. REV. 562, 565 (1972).

²⁸Reliance is only justified if the plaintiff knows or has reason to know of the defendant's access to information. If the plaintiff has no knowledge, his reliance is unreasonable.

giving foundation to the probability of an improper motive or intent.²⁹

A. Foreseeability of Reliance: Relationship of Defendant to Plaintiff

The relationship of the parties in a securities transaction has been crucial to the outcome of many cases.³⁰ In *Mills v. Sarjem Corp.*,³¹ former shareholders brought suit against the purchasers of their shares who were involved in a scheme to gain control of a bridge building corporation and then sell the bridges to the county at a profit. Noting that the transaction was at arms length and that the shares were purchased at a price above fair market value, the court held that the purchasers had no duty to divulge their future plans concerning the resale of the property because no fiduciary relationship existed between the parties.³² In another case, *Phillips v. Reynolds & Co.*,³³ it was held that no duty to disclose material facts existed under rule 10b-5 absent a special relationship between the parties.³⁴ The defendant-broker was not held liable for failure to disclose a corporate deficit of nine million dollars when plaintiff had information explaining that twelve million dollars had been put into the corporation without profit.

The existence of a fiduciary relationship has been an important consideration the courts have used to apply a higher and more exacting duty upon defendants.³⁵ A formal fiduciary relationship exists when one of the parties is in a position classified by the law as a fiduciary. The three most important fiduciary positions found in securities law are broker-dealer,³⁶ director,³⁷ and corporate insider.³⁸ Persons in all three posi-

²⁹The *White* court says, "we reject scienter or any other discussion of state of mind as a necessary and separate element of a 10b-5 action." 495 F.2d at 734. Later on the court states, however, "While rejecting scienter and state of mind concepts as the standard itself, it [the flexible duty] requires the court to consider state of mind as an important factor in determining the scope of duty that Rule 10b-5 imposes." 495 F.2d at 736.

³⁰*See, e.g.,* *Chris-Craft Industries, Inc. v. Piper Aircraft Corp.*, 480 F.2d 341, 363 (2d Cir. 1973); *Branham v. Material Systems Corp.*, 354 F. Supp. 1048, 1054 (S.D. Fla. 1973); *Rothschild v. Teledyne, Inc.*, 328 F. Supp. 1054, 1056-57 (N.D. Ill. 1971); *Brennan v. Midwestern United Life Ins. Co.*, 259 F. Supp. 673, 681-82 (N.D. Ind. 1966), *aff'd*, 417 F.2d 147 (7th Cir. 1969).

³¹133 F. Supp. 753 (D.N.J. 1955).

³²*Id.* at 764.

³³294 F. Supp. 1249 (E.D. Pa. 1969).

³⁴*Id.* at 1255.

³⁵*See generally* cases cited note 30 *supra*; Comment, *supra* note 27 at 574.

³⁶*See, e.g.,* *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194 (1963) (higher duty for fiduciary which Congress recognized the investment advisor to be); *Hanley v. SEC*, 415 F.2d 589, 596 (2d Cir. 1969) (securities dealer has a special relationship with investors because his position implicitly warrants that his representations have adequate support); *O'Neill v. Maytag*, 339 F.2d 764, 768-69 (2d Cir. 1964) (breach of fiduciary duty owed by broker or dealer may very well be the type of fraudulent activity barred by the rule); *Smith v. Bear*, 237 F.2d 79, 87-88 (2d Cir. 1956) (strict liability language applied to a broker-dealer because of his relationship to plaintiff); *Mann, supra* note 6, at 1210.

³⁷*See, e.g.,* *Reed v. Riddle Airlines*, 266 F.2d 314-15, (5th Cir. 1959) (president and general manager held to a higher duty of a fiduciary); *Mann, supra* note 6, at 1210; Note, *Proof of*

tions are held to a higher duty because the law assumes that it is clearly foreseeable to such persons that those who associate with them will probably rely more heavily on the information which they disseminate.³⁹

An informal fiduciary relationship exists when the parties have developed a relationship of trust and reliance over a substantial period of time.⁴⁰ In *Myzel v. Fields*,⁴¹ the Second Circuit considered important the fact that plaintiffs were dependent upon and trusted Myzel, who was not only a close friend and financial advisor, but a relative to the operators of the company. In *Vohs v. Dickson*,⁴² the Fifth Circuit refused to hold a seller liable for failure to inform purchasers as to the nontransferability of the private shares he sold them. Because the court felt it unnecessary to determine whether these shares had actually been issued under a private exemption, it refused to decide whether this failure had contravened a ruling by the Securities and Exchange Commission.⁴³ But the court did consider the relationship which was merely one of fellow employees, and the fact that no other sales had been made which would foster trust in the seller, to conclude that a higher duty was not proper. In essence, the court held that the relationship was not one in which the purchaser's reliance was foreseeable by the seller.

Another kind of relationship that has been given attention by the courts involves professionals, accountants, lawyers, and those with many years of securities experience who make statements as experts.⁴⁴ These defendants are held to a higher standard of care than nonexperts "because investors may be expected to rely on their statements or because they should know better."⁴⁵ In *Drake v. Thor Power Tool Co.*,⁴⁶ an account-

Scienter Necessary in a Private Suit Under SEC Anti-fraud Rule 10b-5, 63 MICH. L. REV. 1070, 1079-80 (1965) (both discuss the higher duty that the law exacts upon those who are "closely associated with an issuing corporation"). *But cf.* *O'Neill v. Maytag*, 339 F.2d 764, 767-68 (breach of a general fiduciary relationship not enough for liability under 10b-5; breach must involve a sale or exchange).

³⁸*See* *Kohler v. Kohler Co.*, 319 F.2d 634, 637-42 (7th Cir. 1963) (rule 10b-5 clearly creates a fiduciary relationship between "insiders" and "outsiders" with the higher duty upon the insiders); *Baumel v. Rosen*, 283 F. Supp. 128, 139-40 (D. Md. 1968) (rule 10b-5 imposes a higher duty upon insiders dealing with outsiders); *Speed v. Transamerica Corp.*, 99 F. Supp. 808, 828-29 (D. Del. 1951) (insiders, such as majority stockholders, cannot purchase minority stockholders' shares without complying with the duty imposed on a fiduciary).

³⁹*See generally* notes 36-38 *supra*.

⁴⁰*White v. Abrams*, 495 F.2d 724, 736 (9th Cir. 1974); *Myzel v. Fields* 386 F.2d 718, 735 (8th Cir. 1968); *Rothschild v. Teledyne, Inc.*, 328 F. Supp. 1054, 1056-57 (N.D. Ill. 1971).

⁴¹386 F.2d 718, 735 (8th Cir. 1968).

⁴²495 F.2d 607 (5th Cir. 1974).

⁴³*Id.* at 625. (SEC had ruled that a seller must inform the buyer as to any limitations on resale and holding of securities because of being issued under an exemption from registration.)

⁴⁴*See generally* *Blakely v. Lisac* 357 F. Supp. 255, 266 (D. Ore. 1972); *Lane v. Midwest Bancshares Corp.*, 337 F. Supp. 1200, 1208-09 (E.D. Ark. 1972); *Bowman & Bourdon Inc. v. Rohr*, 296 F. Supp. 847, 851-52 (D. Mass. 1969), *aff'd* 417 F.2d 780 (1st Cir. 1969); *Drake v. Thor Power Tool Co.*, 282 F. Supp. 94, 104-05 (N.D. Ill. 1967).

⁴⁵*Mann*, *supra* note 6, at 1213.

⁴⁶282 F. Supp. 94 (N.D. Ill. 1967).

ing firm was charged with certifying false financial statements and using incorrect auditing procedures. The court held on a motion to dismiss that accountants have a peculiar relationship with the public and as such cannot be immunized from suit though they have not benefited from their misrepresentations.⁴⁷ In *Blakely v. Lisac*,⁴⁸ the court stated that an attorney could not "escape liability for fraud 'by closing his eyes to what he saw and could readily understand.'"⁴⁹ There, an attorney-director of the corporation was held liable for misleading financial information in the prospectus which he should have investigated.

Therefore, the reasoning behind the imposition of a more stringent duty on experts and those in the position of a fiduciary is that the relationship makes plaintiff's reliance more foreseeable to the defendant. In that situation, a strict duty is deemed necessary to deter the defendant from being dishonest. Thus, the imposition of a higher duty makes the parties' positions more equal — facilitating the disclosure of material information, deterring fraudulent activity, and allowing the parties to bargain as they wish.

B. Foreseeability of Reliance: Defendant's Access to Information as Compared to Plaintiff's Access

The comparative access of the parties to information has been the subject of many judicial opinions, with most courts holding the party with the higher access to the higher duty.⁵⁰ The reasoning is best explained in *Speed v. Transamerica Corp.*, where the court said:

The rule is clear. It is unlawful for an insider, such as a majority stockholder, to purchase the stock of minority stockholders without disclosing material facts affecting the value of the stock, known to the majority stockholder by virtue of his inside position but not known to the selling minority stockholder, which information would have affected the judgment of the sellers. *The duty of disclosure stems from the necessity of preventing a corporate insider from utilizing his position to take unfair advantage of the uninformed minority stockholders.* It is an attempt to provide some degree of equalization of bargaining position in order that the minority may exercise an informed judgment in any such transaction.⁵¹

⁴⁷*Id.* at 104-05.

⁴⁸357 F. Supp. 225 (D. Ore. 1972).

⁴⁹*Id.* at 266.

⁵⁰*See generally* *City National Bank v. Vanderboom*, 422 F.2d 221, 230-31 (8th Cir. 1970); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969); *List v. Fashion Park, Inc.*, 340 F.2d 457, 461 (2d Cir. 1965); *Harnett v. Ryan Homes, Inc.*, 360 F. Supp. 878, 886 (W.D. Pa. 1973); *Shapiro v. Merrill Lynch, Pierce, Fenner, and Smith, Inc.*, 353 F. Supp. 264 (S.D.N.Y. 1972); *Gordon v. Lipoff*, 320 F. Supp. 905, 915-16 (W.D. Mo. 1970); *Bennan v. Midwestern United Life Ins. Co.*, 259 F. Supp. 673 (N.D. Ind. 1966).

⁵¹199 F. Supp. 808, 828-29 (D. Del. 1951) (emphasis added).

Traditionally, courts have treated access to information and duty according to three defendant classifications — “insider,”⁵² “tippee,”⁵³ and “broker-dealer.”⁵⁴ While each has been held to a higher duty because of his greater access to information, it should be emphasized that these classifications are legal conclusions and should be rejected if not supported by the facts. The proper analysis then deals with access to information⁵⁵ rather than fitting each defendant into a particular classification. As the court in *Harnett v. Ryan Homes, Inc.*, explained,

The question of who is an “insider,” therefore, cannot be decided on the basis of the title one holds in the corporate organization. A director, or officer, or even the president of a corporation cannot always and invariably be classified as an insider. The analysis turns instead, on the basis of what a party knows or reasonably should know considering the information to which he has access.⁵⁶

In another case, *Vohs v. Dickson*,⁵⁷ the Fifth Circuit refused to hold the defendant to a higher duty even though he was the plaintiff’s superior and “key” employee for a stock purchase plan. The court reasoned that defendant’s superior position did not give him greater access to information.

There are two major reasons why the finding of greater access requires the imposition of a higher duty. First, those with greater access can more easily defraud others⁵⁸ and the imposition of a higher duty pro-

⁵²An insider is assumed to have greater access to information because of his position in the corporation. His status, by definition, entitles him to direct information not available to the public. *Cady, Roberts & Co.*, 40 S.E.C. 907, 911 (1961); Comment, *Affiliated Ute Citizens v. United States — The Supreme Court Speaks on Rule 10b-5*, 1973 UTAH L. REV. 119, 123-24.

⁵³A tippee is distinguished from an insider because his information is received indirectly, e.g., from an insider, rather than directly from the corporation. Courts often confuse the two. *Id.* at 125-26.

⁵⁴A broker-dealer is assumed to have higher access, not because he has some connection to corporate information, but because he is an expert and can better analyze market information. He also is more familiar with how the market information is obtained. *Id.* at 125-26.

⁵⁵

[T]he nondisclosed facts here were in Rhoades’ [defendant’s] personal knowledge or private files and were not available to Rochez [plaintiff] Thus, Rochez’s status as an insider, his financial expertise and his business acumen are all irrelevant, for he had no access to the critical information or any opportunity to discover the non-disclosed facts.

Rochez Bros. Inc. v. Rhoades, 491 F.2d 402, 419 (3d Cir. 1974).

⁵⁶360 F. Supp. 878, 886 (W.D. Pa. 1973) (citation omitted); 32 U. CHI. L. REV. 824 (1965).

⁵⁷495 F.2d 607, 623 (5th Cir. 1974).

⁵⁸

The fraud involved in buying or selling on the basis of inside information is based first on the user’s relationship with the corporation being such as to allow his access to information intended only for a corporate purpose — not for his personal benefit. For the instant, we shall assume this to have been met. Secondly, the fraud rests “. . . upon the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing. *Cady, Roberts & Co.*, 40 S.E.C. 907, 912 (1961).”

fects plaintiffs by making violations of the rule easier to prove. The party with superior access realizes that incomplete disclosures or misrepresentations are easier to prove and is therefore more likely to disclose material information.⁵⁹ Second, the defendant with greater access to information is more likely to be relied upon by the other party,⁶⁰ and a higher duty, which puts both parties in a more equal bargaining position,⁶¹ is necessary to deter the defendant from utilizing plaintiff's reliance unfairly.

Courts have also considered the plaintiff's access to information⁶² in determining whether his reliance was foreseeable and reasonable, as stated in *City National Bank v. Vanderboom*:

Not only should the plaintiff have to prove that he relied on defendant's statements, but he must convince the trier of fact that his reliance was reasonable under all the circumstances at the time. In this way recovery would be denied to those who, because of their "business sophistication", acumen, or ready access to the information involved, could reasonably be expected to exercise a higher degree of care and investigation in their dealings.⁶³

Plaintiffs who are experts or have ready access to information have been denied recovery by the process of holding the defendant to a lower duty.⁶⁴ In *Vanderboom*,⁶⁵ a bank loaned money to investors who used the funds to buy stock. When the bank sued to recover on the outstand-

Schoenbaum v. Firstbrook, 268 F. Supp. 385, 395 (S.D.N.Y. 1967), *aff'd*, 405 F.2d 200 (2d Cir.), *modified*, 405 F.2d 215 (2d Cir. 1968); The real problem under rule 10b-5 being the injury to the plaintiff, there is no concern that the defendant violated some fiduciary duty that he owed to the corporation.

⁵⁹*See, e.g.*, *Lanza v. Drexel & Co.*, 479 F.2d 1277 (2d Cir. 1973); *Shell v. Hensley*, 430 F.2d 819, 827 (5th Cir. 1970); *Shapiro v. Merrill Lynch, Pierce, Fenner, & Smith, Inc.*, 353 F. Supp. 264 (S.D.N.Y. 1972); *Gordon v. Lipoff*, 320 F. Supp. 905 (W.D. Mo. 1970); *Brennan v. Midwestern United Life Ins. Co.*, 259 F. Supp. 673, 681 (N.D. Ind. 1966); *But cf. Vohs v. Dickson*, 495 F.2d 607 (5th Cir. 1974). The court refused to hold the defendant liable for knowledge of financial matters where he was an ordinary employee with access because of his ownership of stock. Plaintiff had no access to corporate books.

⁶⁰Reliance is only justified if the plaintiff actually knows that the defendant has higher access or assumes higher access because of the defendant's position — insider, broker-dealer, or corporate director.

⁶¹*Speed v. Transamerica Corp.*, 99 F. Supp. 808, 828-29 (D. Del. 1951).

⁶²The law often assumes that experts or professionals have greater access to information. *See Sandor v. Ruffer, Ballan & Co.*, 309 F. Supp. 849, 859 (S.D.N.Y. 1970).

⁶³422 F.2d 221, 230 n.10 (8th Cir.), *cert. denied*, 399 U.S. 905 (1970) (citation omitted).

⁶⁴*See generally Fey v. Walston, Co.*, 493 F.2d 1036, 1045 (7th Cir. 1974); *Arber v. Essex Wire Corp.*, 490 F.2d 414, 420 (6th Cir. 1974); *Johnson v. Wiggs*, 443 F.2d 803 (5th Cir. 1971) (shareholder who sued the president of the corporation for failure to disclose inside information was barred recovery when the court found that the information was available to plaintiff through the public market); *Clement A. Evans & Co. v. McAlpine*, 434 F.2d 100 (5th Cir. 1970); *Baumel v. Rosen*, 283 F. Supp. 128 (D. Md. 1968); *Lane v. Midwest Bancshares Corp.*, 337 F. Supp. 1200, 1209 (E.D. Ark. 1972) (insider's duty of disclosure depends in part upon the extent of knowledge and access to information of party he is dealing with).

⁶⁵422 F.2d 221 (8th Cir.), *cert. denied*, 399 U.S. 905 (1970).

ing investors' notes, the defendant investors counterclaimed that a bank officer had misrepresented the financial position of those corporations in which the borrowed money had been invested. The counterclaim was dismissed because the court found that the investors had ready access to the information from other sources.⁶⁶ In another case, *Colonial Realty Corp. v. Brunswick Corp.*,⁶⁷ the court refused to find liability when the interest rate and terms of a financial agreement guaranteed by the defendant were left off the company's prospectus. The omission was deemed immaterial because the interest rate had been discussed in various financial magazines and the plaintiff was an experienced dealer in this particular stock.⁶⁸

C. Foreseeability of Reliance: The Defendant's Awareness of Whether the Plaintiff Was Relying upon Their Relationship

The issue of foreseeability and its proof through relationship and comparative access to information is immaterial if it can be proven that the defendant knew that the plaintiff was in fact relying upon their relationship. The guessing game is over, opportunity for abuse is great, and the courts have responded with a higher duty that meets the fact situation.⁶⁹ The higher duty is justified by the same arguments used for relationship and access, but the arguments are even stronger when the issue is not probable, but actual reliance.

D. Benefit to the Defendant: The Benefit That the Defendant Derives from the Relationship

Courts have held defendants to a higher duty where they make representations in the course of an economically motivated transaction.⁷⁰ In *Affiliated Ute Citizens v. United States*,⁷¹ the Supreme Court held that

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The investors had access to all the books and records of AHB and PL and I during the four month option period. . . . (They also had access to the auditor's report) Since the investors . . . had ready access to the information involved, it is reasonable to expect them to exercise a higher degree of care than third parties [bank]

Id. at 231.

⁶⁷337 F. Supp. 546 (S.D.N.Y. 1971).

⁶⁸*Id.* at 557.

⁶⁹*See, e.g.,* *Chris-Craft Industries, Inc. v. Piper Aircraft Corp.*, 480 F.2d 341, 363, 373-74 (2d Cir. 1973); *Myzel v. Fields*, 386 F.2d 718, 736-37 (8th Cir. 1967); *Fischer v. Kletz*, 266 F. Supp. 180, 188 (S.D.N.Y. 1967); *Blakely v. Lisac*, 357 F. Supp. 255, 264 (D. Ore. 1972).

⁷⁰*See, Gordon v. Lipoff*, 320 F. Supp. 905, 916 (W.D. Mo. 1970) (investors who had ready access to information held to a higher duty than third parties who didn't profit from the transaction); *Brennan v. Midwestern United Life Ins. Co.*, 259 F. Supp. 673, 681 (N.D. Ind. 1966) (insider can breach his duty to outsider even though the advantage to be gained comes from third parties); *But cf. Fey v. Walston & Co.*, 493 F.2d 1036, 1048 (7th Cir. 1974) (if salesman fulfills his fiduciary and other obligations of honesty with a customer, additional motive for commissions does not make him liable).

⁷¹406 U.S. 128, 147 (1972).

if the two defendants and the bank had acted merely as transfer agents, they would have had no duty to disclose information. As it was, they were found liable because they benefited from the transactions by way of commissions and higher bank deposits. In *Carr v. Warner*,⁷² the court, in determining that no liability existed, considered the fact that defendants made no unusual profit. In *Chasins v. Smith Barney & Co.*,⁷³ the defendant stock broker was held liable when he failed to advise the plaintiff that he was making a market in securities which he had recommended highly to the plaintiff. The Second Circuit said that the duty is higher "where one [']s motivation is economic self-interest. . . . The economic self-interest of a market-maker in over-the-counter securities may be greater than that of a simple principle, and the market-maker status should have been disclosed."⁷⁴

Although actual benefit is not required for recovery,⁷⁵ its presence is certainly a major factor in the determination of liability. It is easier for the court to find a party who benefited liable than one who did not.⁷⁶ As an element of proof going toward improper motive or intent, benefit is only important when it gives insight into the defendant's probable motives for arranging the transaction. A person in a position to benefit from a securities transaction is considered more likely to shade the truth or to withhold material information, especially when his benefit increases with the falsity of his representation. When the defendant is benefited equally by false or true statements, as in the case of an attorney or an accountant whose benefit is merely a fee for services performed, other considerations of relationship, access to information, and reliance are more material.⁷⁷

E. Benefit to the Defendant: Defendant's Activity in Initiating the Transaction

The defendant's activity in initiating the transaction has been an important factor in several cases.⁷⁸ One commentator⁷⁹ has suggested that initiation is the crucial difference between two cases with similar fact situations. In *Sandor v. Ruffer, Ballan & Co.*,⁸⁰ the court placed great

⁷²137 F. Supp. 611, 614-15 (D. Mass. 1955).

⁷³(1969-1970 Transfer Binder) CCH Fed. Sec. L. Rep. ¶ 92, 712 (2d Cir. July 7, 1970).

⁷⁴*Id.* at 99, 137.

⁷⁵*See* 2 A. BROMBERG, *supra* note 6, § 8.5(584) at 208.47-48.

⁷⁶*Id.* at 204.48.

⁷⁷*Id.*

⁷⁸*See, e.g.*, *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972); *Kuehnert v. Texstar Corp.*, 412 F.2d 700 (5th Cir. 1969); *List v. Fashion Park Inc.*, 340 F.2d 457 (2d Cir. 1965); *Kohler v. Kohler Co.*, 319 F.2d 634, 642 (7th Cir. 1963); *Hecht v. Harris, Upham & Co.*, 283 F. Supp. 417 (N.D. Calif. 1968).

⁷⁹Mann, *supra* note 6 at 1219-20.

⁸⁰309 F. Supp. 849 (S.D.N.Y. 1970).

weight upon the fact that the plaintiff had initiated the transaction and that it was his "lust for new issues" which led him to the defendants. Plaintiff's activity in initiating the deal was significant in the court's holding that the plaintiff had failed to prove material misrepresentations and reliance. Similarly, in *Hafner v. Forest Laboratories Inc.*,⁸¹ the Third Circuit held that no material misrepresentations occurred but asserted that if the defendant had initiated the transactions, triable issues of fact might then have been raised. In *Canizaro v. Kohlmeyer & Co.*,⁸² the court emphasized initiation and participation in the transaction when it stated that a "broker's obligation to his customer to investigate and disclose all material facts must surely increase in direct proportion to the degree of his participation in the sale."⁸³

The purpose for holding the initiator or major participant to a higher duty is based on the assumption that the initiator or participant must stand to benefit from the transaction and, therefore, has more reasons to act with improper motives. It is clear that one with intent to defraud by using secret information can rarely take advantage of his situation unless he becomes involved in a stock transaction. The initiation may be the outgrowth of a plan to defraud through concealment or misrepresentations. This logic applies to all parties in a transaction and case law has reflected this view by holding plaintiffs as well as defendants to a higher duty if they are active in initiating the exchange.⁸⁴

IV. THE FLEXIBLE DUTY AS AFFECTED BY FORESEEABLE RELIANCE AND BENEFIT

Five fact situations encompass the flexible duty as it is affected by foreseeable reliance and benefit. Assuming actual misrepresentations, they are: (1) intent to defraud, (2) foreseeable reliance and benefit, (3) foreseeable reliance, (4) benefit, and (5) a mere misrepresentation of material information — absent any of the other four. How these five situations affect the flexible duty can best be explained by use of the diagram on the following page.

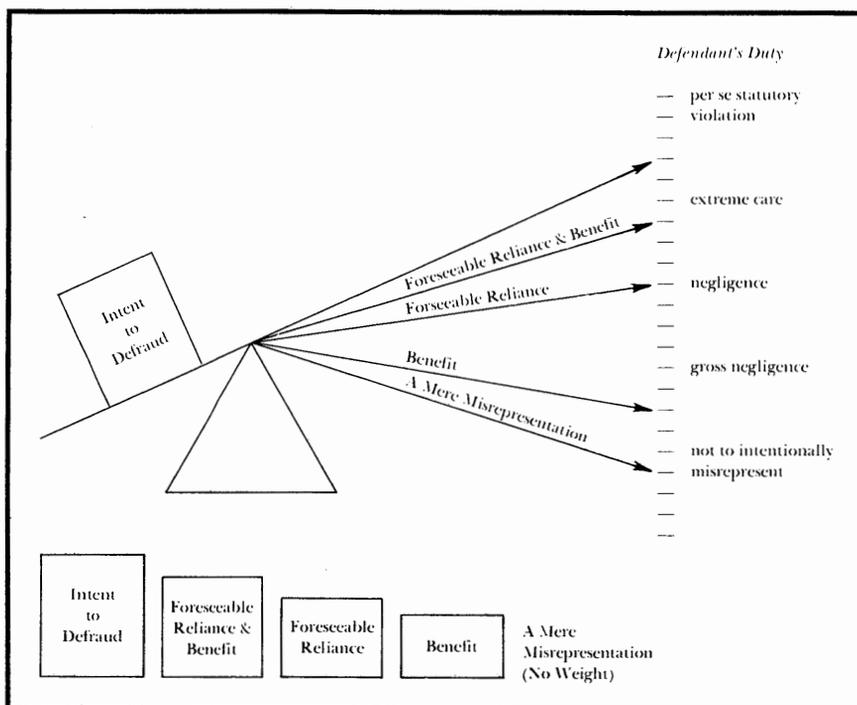
The flexible duty is dependent upon and changes according to the arrangement of the several factors on the scale. Assuming the factors are proven at trial, all of them except a mere misrepresentation would increase the defendant's duty. A mere misrepresentation is shown by putting no weight on the scale and allowing the pointer to rest in the area of no liability. Benefit, alone, would probably not be sufficient for a violation of the rule absent an intentional misrepresentation. The major use of benefit is in combination with other factors which by them-

⁸¹345 F.2d 167, 168 (3d Cir. 1965).

⁸²370 F. Supp. 282 (E.D. La. 1974).

⁸³*Id.* at 289.

⁸⁴See generally *supra* note 78.



selves would not require a high enough duty for a violation. Foreseeable reliance by itself would probably support a violation. The standard would be something higher than negligence since the defendant who can foresee the plaintiff's reliance is not in the same position as the average reasonable man. Foreseeable reliance with benefit does not make for an automatic violation, but the defendant should use extreme care to get information to the plaintiff so as to prevent a material misrepresentation. This is especially so if the defendant stands to benefit from the transaction. Intent to defraud is the highest duty, and if present, rule 10b-5 is always violated since the language of the rule was enacted to deter and specifically forbids fraud.

The effect or weight of each factor varies according to the proof given at trial. For example, proof that the defendant knew the plaintiff was relying on their relationship in making investment decisions would create a greater shift on the scale than would evidence that the defendant had greater access to information, but had not used his access to get more information. In essence, there is a direct relationship between the weight of the evidence in support of each factor and the effect that each factor has on duty as represented by the scale.

**CONCLUSION: THE FLEXIBLE DUTY IS A WORKABLE SOLUTION
TO THE SCIENTER PROBLEM OF RULE 10b-5**

The flexible duty of *White* is an outgrowth of rule 10b-5 litigation and represents one court's attempt to define a standard which meets all the

fact situations possible in a rule 10b-5 violation. In rejecting the application of singular terms, such as *scienter*, the flexible duty approach rejects legal conclusions for a more detailed analysis based on five factors. It gives potential parties a checklist of factors which they can use to determine the degree of care required in their situation to avoid liability.

By giving potential violators a checklist so that duty can be determined before security transactions are engaged in, the court has given effect to the deterrent purpose of the rule without overburdening the market with a duty, such as strict liability, that would keep persons from acting for fear of a violation. This is accomplished by imposing no higher duty than evolves from the facts. For example, only those who benefit from the transaction and who foresee the other party's reliance are burdened with the duty of extreme care. Where these two elements are lacking, the defendant has a lesser duty not to intentionally misrepresent material facts. In both situations, the deterrent effect is the same. The differing standard is justified by the separate facts in each case.

A major problem with the flexible duty is that the extreme care required when foreseeable reliance and benefit are present is too close to strict liability. Broker-dealers, and other experts who would most often be held to the duty of extreme care, may not be able to meet the standard if a misrepresentation is found. The problem is increased by the fact that broker-dealers often cannot obtain liability insurance to protect themselves. Unless they have sufficient assets for self-insurance, one conviction for violating the rule could result in bankruptcy. Courts could remedy this problem, however, by refraining from imposing the extreme care standard unless it is clearly justified by the facts. Another answer may be to equate extreme care with that degree of care exercised by other broker-dealers in similar situations. In any event, courts are capable of adjusting the duty so that it produces fair and just results.

In conclusion, the flexible duty approach is a realistic solution to rule 10b-5. The duty effectuates the purpose of the rule, adjusts to the possible fact situations, and reveals analysis that can be used to determine the applicable standard of care for persons involved in security transactions.