SMU Dedman School of Law

SMU Law Review

Volume 28
Issue 1 *Annual Survey of Texas Law*

Article 17

January 1974

The Liability of Outside Directors as Aiders and Abettors under Rule 10b-5

Dana G. Kirk

Recommended Citation

Dana G. Kirk, Comment, *The Liability of Outside Directors as Aiders and Abettors under Rule 10b-5*, 28 Sw L.J. 391 (1974)
https://scholar.smu.edu/smulr/vol28/iss1/17

This Comment is brought to you for free and open access by the Law Journals at SMU Scholar. It has been accepted for inclusion in SMU Law Review by an authorized administrator of SMU Scholar. For more information, please visit http://digitalrepository.smu.edu.

COMMENTS

THE LIABILITY OF "OUTSIDE" DIRECTORS AS AIDERS AND ABETTORS UNDER RULE 10b-5

by Dana G. Kirk

In recent years there has been explosive growth of securities fraud litigation under rule 10b-5.[1] With this growth has come an extension of liability to those who are not primary wrongdoers, but whose activities are merely collaterally related to the primary wrong.[2] The liability of each defendant under rule 10b-5 varies with the degree of participation and knowledge of the fraudulent transaction which is attributable to him.[3] However, the liability imposed by rule 10b-5 generally applies only to transactions which involve acts reasonably associated with the purchase or sale of securities,[4] and does not dictate the standards of a director's responsibility in the ordinary management of corporate affairs apart from securities transactions.[5]

Privity of contract has been virtually eliminated as a condition of recovery under rule 10b-5,[6] and consequently many persons who are not direct parties to the fraudulent transaction but who are adversely affected by it may recover.[7] The possibility of multiple plaintiffs has substantially increased the potential damages[8] which might be awarded, and because a defendant who is merely secondarily liable may be required to share the burden equally with those who are primarily liable,[9] the possible liability of the secondary participant is great.

This Comment focuses upon the potential secondary liability of "outside" directors (those who do not participate in the day-to-day management of the corporation) for the fraudulent acts of others associated with the management of the enterprise. Part I is an examination of the historical perspective of the director's responsibility at common law for fraudulent misrepresentations, and a review of the manner and methods by which rule

1. SEC rule 10b-5, 17 C.F.R. § 240.10b-5 (1973).
2. Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, in Pari Delicto, Indemnification and Contribution,* 120 U. PA. L. REV. 597, 599 (1972).
3. *Id.*
4. SEC v. National Sec., Inc., 393 U.S. 453 (1969).
5. State statutory and case law has generally controlled the corporate director's responsibility with respect to the management of the corporation. *In re* Franchard Corp., SEC Securities Act Release No. 4710 (July 31, 1964). Conversely, the developments centering around the antifraud provisions in Securities Exchange Act § 10(b), 15 U.S.C. § 78j(b) (1970), and rule 10b-5, 17 C.F.R. § 240.10b-5 (1973), have significantly contributed to the development of a federal common law with respect to the purchase and sale of securities. Brief for SEC as Amicus Curiae at 4, Lanza v. Drexel & Co., 479 F.2d 1277 (2d Cir. 1973).
6. 2 A. BROMBERG, SECURITIES LAW: FRAUD § 8.5(120), at 206 (1973) [hereinafter cited as BROMBERG].
7. The Federal Rules of Civil Procedure have been conducive to suits by multiple plaintiffs, especially with regard to class actions and derivative suits. FED. R. CIV. P. 23, 23.1.
8. *See* Heit v. Weitzen, 402 F.2d 909 (2d Cir. 1968), *cert. denied,* 395 U.S. 903 (1969); Cochran v. Channing Corp., 211 F. Supp. 239 (S.D.N.Y. 1962).
9. Ruder, *supra* note 2, at 647-51.

10b-5 has expanded this duty. In Part II an important distinction is drawn between the requisite knowledge of a participant and that required of an aider and abettor, as well as a distinction between the concepts of aiding and abetting and conspiracy. This section also deals in some detail with the elements of liability under rule 10b-5 for an aider and abettor. In Part III the liability of an outside director as an aider and abettor under rule 10b-5 is analyzed and *Lanza v. Drexel & Co.*,[10] and *SEC v. Spectrum, Ltd.*,[11] two cases of significance in this area, are examined with particularity. Part IV contains a discussion of methods of reducing the outside director's liability as an aider and abettor. Finally, Part V sets forth some conclusions to be drawn from the discussion in general and highlights some policy considerations.

I. DIRECTOR'S DUTY AT COMMON LAW

A. *Outside Director's Responsibility for a Fraudulent Misrepresentation of Another at Common Law*

The common law is relevant to the interpretation and application of rule 10b-5 and section 10(b)[12] of the Securities Exchange Act of 1934 not only because directors' duties have been determined by case law in the past but also because the duties of directors are still governed by state case law as well as federal law.[13] At early common law there was no duty upon directors to insure that all adverse information concerning a sale or purchase of corporate securities was conveyed to prospective purchasers.[14] In *Dovey v. Cory*,[15] a leading English case, a non-participant director was exonerated from responsibility for fraudulent misrepresentations made by other officers and directors in the form of a balance sheet which misstated profits. Cory was an outside director in that he did not participate in the management or preparation of financial reports of the company. Although it was argued that Cory should have been cognizant of the "network of conspiracy and fraud by which he was surrounded,"[16] there was no evidence that he had any direct knowledge of the fraudulent scheme. Lord Halsbury rejected the invitation to find liability for breach of a duty to investigate. Instead he held that a director may properly rely on the integrity and professional competence of other officers and directors in the conduct of the business and that he may properly rely upon financial statements prepared for the company.[17]

---

10. 479 F.2d 1277 (2d Cir. 1973).
11. 489 F.2d 535 (2d Cir. 1973).
12. 15 U.S.C. § 78(b) (1970).
13. Lanza v. Drexel & Co., 479 F.2d 1277, 1291 (2d Cir. 1973).
14. *Id.* at 1292. If the corporation itself were in privity with the plaintiff, it appears that even at common law it had a duty not to induce the plaintiff to enter a transaction by affirmative misrepresentation. *See* BROMBERG § 8.5(110), at 205.
15. [1901] A.C. 477. *See also* Blakely v. Lisac, 357 F. Supp. 255 (D. Ore. 1972), for a more recent American case which follows the same rationale as *Dovey*, in refusing to hold a director responsible for misrepresentations in financial statements.
16. [1901] A.C. 477, 485.
17. Lord Halsbury said:

> I cannot think that it can be expected of a director that he should be watching either the inferior officers of the bank or verifying the calculations of the auditors himself. The business of life could not go on if

Judge Learned Hand in the leading American case of *Barnes v. Andrews*[18] refused to hold an outside director liable for fraudulent statements in a circular distributed by the management. Hand employed the rationale that the outside director might justifiably place confidence in those who prepared the circular and that an outside director could not be charged with the duty of detailed supervision of the business.[19] The outside director's liability at common law for the fraudulent misrepresentations of others would seem to turn on whether or not he had knowledge of the wrongful act.[20] However, it has been suggested that at common law an outside director could be held liable on the basis of constructive knowledge of the fraudulent misrepresentation, that is, careless or reckless disregard for the truth or falsity of a statement.[21]

B. *Standing To Sue—The Dissolution of Privity*

At common law privity of contract was a requisite element in an action to recover damages for fraud.[22] The plaintiff could sue only the person from whom he bought or to whom he sold.[23] In the leading English case of *Peek v. Gurney*,[24] the directors of a corporation distributed a prospectus which contained fraudulent misrepresentations in expectation of inducing investors to buy their stock. The court held that a plaintiff who purchased stock in an open market transaction and not directly from the defendant in the original offering could not recover for the damages which he suffered in reliance upon the misrepresentation. The court limited standing to sue to those whom the defendants had desired to influence in the primary offering.[25] However, as the case law progressed, courts began to allow suit against a defendant who had fraudulently induced the plaintiff to buy from another.[26]

Privity as a necessary element to an action for fraudulent misrepresentation has been eroded by the advent of modern communication devices which

---

> people could not trust those who are put into a position of trust for the express purpose of attending to details of management.

Id. at 486.

18. 298 F. 614 (S.D.N.Y. 1924).

19. The opinion further indicated that merely a general awareness of business affairs was not sufficient knowledge to result in liability of an outside director for specific fraudulent business transactions by the management. *Id.* at 616.

20.
> If, for whatever reason, the director took no part in the preparation, ratification or issuance of the false statement or circular, he is not liable, it has been held, to purchasers who acted on the faith of the statement. He has done nothing. And he is not to be held vicariously for the fraud or negligence of others, co-directors, executives or underwriters, unless he has constituted them his 'agents.'

Shulman, *Civil Liability and the Securities Act*, 43 YALE L.J. 227, 240 (1933).

21. *Id.* at 242.

22. *See* W. PROSSER, LAW OF TORTS 702-03 (4th ed. 1971), for a general discussion of how more remote plaintiffs could recover for misrepresentations upon which they relied to their detriment.

23. BROMBERG, § 8.5(110), at 205.

24. L.R. 6 Eng. & Ir. App. 377 (1873).

25. *See* W. PROSSER, *supra* note 22, at 702.

26. *See, e.g.*, Willcox v. Harriman Sec. Corp., 10 F. Supp. 532 (S.D.N.Y. 1933); Holloway v. Forsyth, 226 Mass. 358, 115 N.E. 483 (1917). *See also* Prosser, *Misrepresentations and Third Persons*, 19 VAND. L. REV. 231 (1966).

provide a medium through which one misrepresentation may affect many persons.[27] Because of the complex economy of our modern society, one misrepresentation may overlap into several transactions and cause widespread mischief. Likewise, the privity requirement has all but disappeared from actions under rule 10b-5.[28] Generally, the courts have allowed plaintiffs injured in open market transactions to sue various defendants with whom they are not in privity for violation of the fraud provisions of rule 10b-5.[29] This result is substantiated by the phraseology of rule 10b-5[30] which extends liability to "any person" who makes a fraudulent misrepresentation in violation of the rule either "directly" or "indirectly" or "in connection with the purchase or sale of any security."[31]

Both the courts and the commentators seem to view the abandonment of privity as an advantageous method to provide the flexibility which is necessary to effectuate the remedial purposes of rule 10b-5.[32]

Without the protection against suit that the "armor" of privity once provided, the outside director is a potentially vulnerable target for the imaginative plaintiff. However, if he is not a participant in the wrongful act, it is generally agreed that some degree of knowledge of the wrongful act will be required in order for liability to be imposed upon him.[33]

II. SECONDARY LIABILITY UNDER RULE 10b-5

A. *Theories of Liability*

Although the dissolution of privity has dramatically expanded the class of those who have standing to sue and to be sued under rule 10b-5, the

27. The *Texas Gulf Sulphur* litigation demonstrates how misrepresentations can adversely affect many investors in open market transactions. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969).

28. Privity is still required in actions for recission of the security transaction. *See*, 3 L. Loss, SECURITIES REGULATION 1626-27 (1961).

29. *See, e.g.*, Lanza v. Drexel & Co., 479 F.2d 1277 (2d Cir. 1973), where an outside director was sued by an individual adversely affected in a transaction in which the director was not a party. *See also* Fischer v. Kletz, 266 F. Supp. 180 (S.D.N.Y. 1967) (accountant for issuing company sued by open market buyer); Cochran v. Channing, 211 F. Supp. 239 (S.D.N.Y. 1962) (open market buyer sued controlling stockholder).

30. SEC rule 10b-5, 17 C.F.R. § 240.10b-5 (1973).

31. *Id.* In Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952), Judge Learned Hand set out the much noted "Birnbaum Doctrine" which has been read to refuse causes of action under rule 10b-5 to all those who are not purchasers or sellers of securities. Many courts have stretched the meaning of "purchasers" or "sellers" to include a variety of persons not encompassed by the clear meaning of the words. Rather than indulge this fiction to preserve the constrictive *Birnbaum* test, the Seventh Circuit in Eason v. General Motors Acceptance Corp., 490 F.2d 654 (7th Cir. 1973), extended the standing to sue under rule 10b-5 to the limits which were originally set out by the "case or controversy" requisites of U.S. CONST. art. III. *See* Frothingham v. Mellon, 262 U.S. 447 (1923). Thus, the protection of rule 10b-5 now extends to investors who suffer significant injury as a direct consequence of fraud in connection with a securities transaction, even though they did not directly participate in the purchase or sale of the security.

32. Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972); Carroll v. First Nat'l Bank, 413 F.2d 353 (7th Cir. 1969), *cert. denied*, 396 U.S. 1003 (1970). BROMBERG § 8.5(512), at 208.1. *See* Ruder & Cross, *Limitations on Civil Liability Under Rule 10b-5*, 1972 DUKE L.J. 1125.

33. BROMBERG § 8.5(582), at 208.42; Ruder, *supra* note 2, at 620; Ruder, Wheat & Loss, *Standards of Conduct Under the Federal Securities Acts*, 27 BUS. LAW. 75 (1972) [hereinafter cited as *Standards of Conduct*].

plaintiff must still establish either a direct violation or a significant connection with the violation by the defendant. Three important concepts have been used by the courts to describe the degree of involvement and corresponding liability of the actor under rule 10b-5: participation, aiding and abetting, and conspiracy.[34]

Participation. Participation is a term used by the courts to describe the most direct involvement in the violation.[35] Generally the violator will be a buyer or a seller in the transaction. However, persons who actively induce a transaction by misrepresentations or nondisclosures may also be considered to be participants.[36]

As a general premise, persons who actively participate in the transaction will be held to a higher standard of care than those who only participate in a collateral way.[37] Similarly, experts or professionals[38] may be held to a higher standard of care because investors may be expected to place greater reliance in their statements.[39] It has also been argued that persons in higher echelons of management may be held by a stricter standard of care with respect to misrepresentations than those in lower positions because the higher ranking personnel have more control over the decision process and investors place greater reliance in their statements.[40] This seems to place the outside director in a precarious position, because he takes part in the

---

34. The courts have failed to draw any distinct boundaries between the classification of defendants as participators, aiders and abettors, or conspirators primarily because the concepts seem to describe different degrees of involvement rather than separate kinds of involvement. Also, plaintiffs are unwilling to settle for only one theory of recovery but instead allege that recovery should be granted on the basis of a combination of these concepts. For instance, in Carroll v. First Nat'l Bank, 413 F.2d 353, 355 (7th Cir. 1969), *cert. denied*, 396 U.S. 1003 (1970), the complaint was phrased in terms of participation and conspiracy. Due to the fact that many complaints may allege more than one of these degrees of involvement, the courts might deal with participation, aiding and abetting, and conspiracy allegations simultaneously, which sometimes has produced language that is indistinct. In *Carroll*, although the complaint was phrased in terms of participation or conspiracy, the court stated that the defendant was alleged to be an aider and abettor. *Id.* at 357. *See also* SEC v. National Bankers Life Ins. Co., 324 F. Supp. 189, 197 (N.D. Tex.), *aff'd*, 448 F.2d 652 (5th Cir. 1971).

35. For an excellent discussion of the different degrees of involvement of defendants under rule 10b-5, *see* BROMBERG § 8.5(515), at 208.4-.6.

36. *See, e.g.*, Drake v. Thor Power Tool Co., 282 F. Supp. 94 (N.D. Ill. 1967); H.L. Green Co. v. Childree, 185 F. Supp. 95 (S.D.N.Y. 1960).

37. 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, 1210 (1970). BROMBERG § 8.5(582), at 208.43.

38. The leading case concerning professional persons' independent duty to the public is Fischer v. Kletz, 266 F. Supp. 180 (S.D.N.Y. 1967), which indicated that an accountant could be liable to an open market trader for failing to disclose after-acquired financial information. *Accord*, Drake v. Thor Power Tool Co., 282 F. Supp. 94 (N.D. Ill. 1967).

39. Although the courts have generally required some degree of knowing misrepresentation on the part of the professional person or expert, H.L. Green Co. v. Childree, 185 F. Supp. 95 (S.D.N.Y. 1960); Ultramares Corp. v. Touche, 255 N.Y. 170, 174 N.E. 441 (1931), it is arguable that recovery should be allowed for negligent misrepresentations by those which the professional person intended to influence. RESTATEMENT (SECOND) OF TORTS, Explanatory Notes § 552, at 56 (Tent. Draft No. 11, 1965).

40. *See* Mann, *supra* note 37, at 1212-13. He argues persuasively that the court in SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969), held defendants to different standards of care depending on their level of management with respect to misrepresentations made by the corporation.

ultimate decision process, but frequently is not cognizant of lower management functions that could lead to violations of rule 10b-5. Therefore, to characterize the director as a participant in the scheme to defraud simply because of his management level would seem unjust. Some degree of knowledge should be required before liability in imposed on the outside director or other similarly situated defendants under rule 10b-5.[41]

The circuits are split concerning the degree of knowledge which will be required on the part of the participant to establish liability under rule 10b-5.[42] Some courts have indicated that the participant must exhibit *scienter*, that is, some degree of actual knowledge of the fraudulent misrepresentations.[43] Other courts have purported to apply a negligence standard, although no court has yet decided a case in which liability was imposed upon a participant under rule 10b-5 for negligence alone.[44] Some courts seem to arrive at the proper standard of knowledge to be applied by focusing upon the facts of the case rather than becoming preoccupied with whether the proper degree of knowledge or negligence was proven.[45]

It is necessary to distinguish between the director's participation in the fraudulent mismanagement of the corporation and his participation in deceptive conduct associated with the sale or purchase of securities which would give rise to liability under rule 10b-5. In *O'Neill v. Maytag*[46] the court refused a cause of action under rule 10b-5 by stockholders against members of the board of directors of National Airlines who unanimously approved

41. It has been suggested that the greater the actor's involvement in the violative transaction, the less knowledge will be required to establish liability. Fry v. Schumaker, 83 F. Supp. 476 (E.D. Pa. 1947).

42. The Second Circuit has generally required some knowledge by the alleged participant of the fraudulent misrepresentation. *See, e.g.*, Shemtob v. Shearson Hammill & Co., 448 F.2d 442 (2d Cir. 1971); Fischman v. Ratheon Mfg. Co., 188 F.2d 783 (2d Cir. 1951). However, in SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969), the court of appeals accepted a constructive knowledge standard, *i.e.*, defendants' lack of knowledge is the result of conduct which is so reckless or careless that knowledge will be attributed to the defendant. The Tenth Circuit has also required *scienter*. Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90, 102 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971).

The Ninth Circuit in Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961), has been said to have rejected *scienter* as a requisite for suit under rule 10b-5. However, it has been observed that in that case the facts were sufficient to establish actual knowledge, so it could be argued that this circuit has not yet decided a case where liability was imposed under rule 10b-5 for merely negligent conduct. Bucklo, *Scienter and Rule 10b-5*, 67 Nw. L. REV. 562, 584 (1972). The Eighth Circuit seems to concur in principle with the Ninth Circuit in eliminating the *scienter* requirement. Vanderboom v. Sexton, 422 F.2d 1233 (8th Cir.), *cert. denied*, 400 U.S. 852 (1970); Myzel v. Fields, 386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968).

43. *See, e.g.*, Financial Indus. Fund, Inc. v. McDonnell Douglas Corp., 315 F. Supp. 42, 44 (D. Colo. 1970), *rev'd on other grounds*, 474 F.2d 514 (10th Cir. 1973).

44. *See* Bucklo, *supra* note 42, at 570. *But see* BROMBERG § 8.4(585), at 204.214-.217, for an in-depth discussion of several cases which sustained complaints based on merely negligent conduct by the participant.

45. In Crane Co. v. Westinghouse Air Brake Co., 419 F.2d 787 (2d Cir. 1969), *cert. denied*, 400 U.S. 822 (1970), the court considered the defendant's economic motivations along with other factors in determining liability. Some courts have been more willing to hold a defendant who is in a fiduciary relationship with the plaintiff to a higher standard of care, *see, e.g.*, Trussell v. United Underwriters, Ltd., 228 F. Supp. 757 (D. Colo. 1964), and, conversely, the expertise of the plaintiff in financial matters has been held to lower the standard of conduct which is required of the defendant. *See, e.g.*, Sandor v. Ruffer, Ballan & Co., 309 F. Supp. 849 (S.D.N.Y. 1970). For a general discussion see Mann, *supra* note 37, at 1210-19.

46. 339 F.2d 764 (2d Cir. 1964).

a stock re-exchange transaction which required that the corporation repurchase its own stock at an excessive price.[47] The court held that the duty allegedly breached was only the general duty existing among directors, officers, and stockholders, and thus no cause of action was stated under rule 10b-5 because the directors did not participate in any deceptive conduct associated with the securities transaction. However, in *Ruckle v. Roto American Corp.*[48] the court sustained a cause of action brought by a minority director under rule 10b-5 against the majority of the board of directors who allegedly failed to disclose to the remaining directors information pertinent to a proposed stock issuance transaction by the corporation.[49]

Implicit in this discussion of a higher standard of care for participants is the tacit assumption that there is a lower standard of responsibility for those who are only indirectly involved with the transaction. This secondary liability of outside directors and other defendants similarly circumstanced is the next subject of inquiry.

Distinction Between Aiding and Abetting and Conspiracy. The courts have not clearly distinguished between the concepts of conspiracy and aiding and abetting and have frequently used the terms interchangeably.[50] Therefore, it is appropriate to begin a discussion of secondary liability by determining what is meant by these terms and examining some of the characteristics of each theory of recovery.[51] Perhaps the clearest definition of aiding and abetting which has been applied in rule 10b-5 cases was derived from the *Restatement of Torts*,[52] which provides, in essence, that aiding and abetting occurs when the defendant knows that the primary offender's conduct constitutes a breach of duty and nevertheless gives substantial assistance or encouragement to the primary offender.[53] In conspiracy, on the other hand, the defendant is held liable if he agreed to participate in the act which violates rule 10b-5.[54]

---

47. The Civil Aeronautics Board ordered the Pan American Airlines and National Airlines to either sell or re-exchange the stock because it was not deemed to be in the public interest to allow control of companies to become mingled. *Id.* at 766.

48. 339 F.2d 24 (2d Cir. 1964).

49. *See* Mann, *supra* note 37, at 1219-20.

50. *See, e.g.*, SEC v. National Bankers Life Ins. Co., 324 F. Supp. 189 (N.D. Tex.), *aff'd*, 448 F.2d 652 (5th Cir. 1971); H.L. Green Co. v. Childree, 185 F. Supp. 95 (S.D.N.Y. 1960).

51. Both theories have their origins in criminal law. BROMBERG § 8.5(540), at 208.29.

52. RESTATEMENT OF TORTS § 876 (1933):

> [P]ersons acting in concert for harm resulting to a third person from the tortious conduct of another, a person is liable if he
>
> (a) orders or induces such conduct, knowing of the conditions under which the act is done or intending the consequences which ensue, or
>
> (b) knows that the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other so to conduct himself, or
>
> (c) gives substantial assistance to the other in accomplishing a tortious result and his own conduct, separately considered, constitutes a breach of duty to the third person.

53. This definition was cited with approval in the district court decision in the landmark case of Brennan v. Midwestern United Life Ins. Co., 259 F. Supp. 673, 680 (N.D. Ind. 1966), *aff'd*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970).

54. "The gist of conspiracy is the agreement; . . . [which goes] a step beyond mere aiding, abetting . . . ." Pinkerston v. United States, 328 U.S. 640, 649 (1946).

The distinction appears to be that aiding and abetting involves either an act which expedites the primary wrong or gives encouragement to the primary offender which may sometimes take the form of failure to interfere.[55] Thus, liability may be established for aiding and abetting even if no agreement is proven.[56] To juxtapose the three concepts—participation, conspiracy, and aiding and abetting—in terms of degrees of involvement, it would seem that participation would entail direct participation in the wrongful act, while aiding and abetting would involve indirect assistance in the primary wrong and conspiracy would fall somewhere between the two.[57] The element of agreement in conspiracy suggests an overt act in actually making the agreement and at least some degree of participation in accomplishing a common goal. In contrast, aiding and abetting is ancillary to a primary and independent wrong and may take the form of an act that is not in itself a violation of rule 10b-5, or even simple inaction which encourages the primary violator.[58]

B. *Elements of Aiding and Abetting Under Rule 10b-5*

Independent Wrong. In order for liability to be imposed on the secondary defendant there must exist an independent act which violates rule 10b-5 to which his act of assistance may attach.[59] However, courts have not emphasized the importance of establishing which acts are primary wrongs and which are secondary.[60] This distinction is also an important aspect of the court's determination of whether the alleged aider and abettor had the requisite knowledge of the wrongful act, because the court must identify the act in question before it can determine whether the defendant had knowledge of it.[61]

Generally, the primary wrong is easily isolated, although as the transactions become more complex and the fraudulent schemes more resourceful, this determination may become more difficult. In *Sprayregen v. Livingston Oil Co.*[62] a cause of action was stated against a director as an aider and abettor because he gave his approval to a misleading speech by another director. In this simple situation the primary culpable act is clearly the misleading speech. Likewise, in *Pettit v. American Stock Exchange*[63] the American Stock Exchange was alleged to be an aider and abettor in a scheme by the primary offender involving the fraudulent issuance of stock.

---

55. BROMBERG § 8.5(533), at 208.24.
56. *Standards of Conduct* 80.
57. Professor Bromberg has proposed a helpful conceptual analogy in terms of business organization forms. "[P]articipants are partners managing a single fraudulent operation, aider-abettors are agents assisting the partners, and conspirators are partners managing separate economically integrated operations." BROMBERG § 8.5(515), at 208.6.
58. Brennan v. Midwestern United Life Ins. Co., 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970). In this landmark case the court found the defendant secondarily liable as an aider and abettor for failure to take action to report a security dealer who was speculating with customer's funds in a fraudulent manner.
59. Ruder, *supra* note 2, at 628. This article contains an excellent discussion of the elements of both conspiracy and aiding and abetting.
60. *Id.*
61. *Id.* at 630.
62. 295 F. Supp. 1376 (S.D.N.Y. 1968).
63. 217 F. Supp. 21 (S.D.N.Y. 1963).

The particular fraudulent acts to which the aiding and abetting was associated are easily discernible since they center around the issuance of one company's stock. However, in *Carpenter v. Hall*[64] the plaintiff named two primary defendants and ninety-one secondary defendants consisting of persons, partnerships, and corporations who allegedly aided and abetted or conspired with the primary defendants in a fraudulent scheme. In such a complex situation where each secondary defendant only knew of part of the whole fraudulent scheme, it is essential to identify the independent wrong to which each secondary defendant's act of aiding and abetting is alleged to be attached.

Knowledge. The plaintiff must not only show that there was an independent wrong but also that the defendant had knowledge of the wrong and, nevertheless, gave assistance to the primary wrongdoer.[65] Generally, the courts have required some degree of actual or constructive knowledge, whether the case is against participants, aiders and abettors, or conspirators.[66] As previously noted, some courts have advocated the elimination of knowledge of the fraudulent scheme as a prerequisite to imposition of liability upon a primary participant.[67] Although this result is consistent with the accepted judicial philosophy that the rule should be flexibly construed in order to accomplish its remedial purpose,[68] different considerations enter into eliminating knowledge as an element of secondary liability and substituting a duty of inquiry or a "should have known" standard.[69] An aider and abettor's or conspirator's acts often occur in the ordinary course of business and may become objectionable only in their relation to the primary violation.[70] By eliminating the knowledge requirement the courts would be placing a severe burden on commerce because each individual would be forced to investigate the activities of the party he is assisting in order to protect himself against the imposition of liability for the fraudulent acts of others of which he has no direct knowledge.[71]

64. 311 F. Supp. 1099, 1103 (S.D. Tex. 1970). "The complaint consists of 32 long legal pages, which sets out in great detail the alleged improper and unlawful conduct of the 93 Defendants describing the special acts of the particular Defendants on named dates and in definite ways."

65. RESTATEMENT OF TORTS § 876 (1939).

66. BROMBERG § 8.5(582), at 298.43.

67. When the *scienter* threshold is lowered the courts generally require more reliance by the plaintiff upon the negligent misrepresentation. Comment, *Negligent Misrepresentations Under Rule 10b-5*, 32 U. CHI. L. REV. 824, 841-42 (1965). This reliance depends on two factors—whether the plaintiff reasonably relied on the misrepresentation, City Nat'l Bank v. Vanderbloom, 422 F.2d 221 (8th Cir.), *cert. denied*, 399 U.S. 905 (1970); Phillips v. Reynolds & Co., 294 F. Supp. 1249 (E.D. Pa. 1969), and the relationship between the plaintiff and defendant. For example, if the defendant was performing professional services for the plaintiff or was in a fiduciary relationship with him, the plaintiff could reasonably place more reliance in his representations and courts would seem more willing to hold the defendant liable for negligent misrepresentations in this special situation. *See, e.g.*, SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969); Drake v. Thor Power Tool Co., 282 F. Supp. 94 (N.D. Ill. 1967).

68. Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972); SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963).

69. Ruder, *supra* note 2, at 632.

70. BROMBERG § 8.5(582), at 208.43.

71. This would be an apparent reversion to the older philosophy espoused by Judge Hand in Barnes v. Andrews, 298 F. 614 (S.D.N.Y. 1924). *But see* SEC v. Spectrum,

If knowledge is a requisite to secondary liability under rule 10b-5, what kind of knowledge will be sufficient to satisfy this requirement? The courts seem to be in general agreement that liability will be found where the person who is allegedly secondarily liable has knowledge of the unlawful purpose or conduct of the primary wrongdoer.[72] In *Kardon v. National Gypsum Co.*,[73] the first civil liability case construed under rule 10b-5, the court indicated that liability would be imposed upon a conspirator when he knew of the nondisclosure of the primary wrongdoer. Similarly, in *Brennan v. Midwestern United Life Insurance Co.*[74] the Seventh Circuit required prior knowledge of the fraudulent activity in order for the defendant to be held liable as an aider and abettor. The courts have also utilized the same standard in construing Securities and Exchange Commission disciplinary proceedings involving the aiding and abetting of fraudulent misrepresentations.[75]

Another perplexing problem for the courts has been whether and to what extent recklessness or carelessness in failing to become aware of the fraudulent conduct can be used to establish constructive knowledge. In *SEC v. First Securities Co.*[76] the Seventh Circuit stated that "liability predicated on aiding and abetting may be founded on less than actual knowledge and participation in the activity proscribed by section 10 and rule 10b-5." In that case a securities firm was held liable as an aider and abettor to fraudulent acts by its president because it failed to supervise his activities properly and because the firm held him out to the public as a successful investment counselor. Although there was no evidence that the securities firm had direct knowledge, its acts were deemed by the court to be sufficiently reckless that knowledge should be imputed and liability established. *Buttery v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*[77] is another case in which liability was found when no direct knowledge of the fraudulent scheme was attributable to the aider and abettor. The court held a broker-dealer liable as an aider and abettor to a customer's fraudulent activities because he allowed the customer to trade securities through a cash account in spite of

---

Ltd., 489 F.2d 535 (2d Cir. 1973), where the court in dicta rejected this general premise, and endorsed a negligence standard for imposition of liability upon aiders and abettors in an injunction suit.

72. Gilbert v. Nixon, 429 F.2d 348, 357 (10th Cir. 1970); Fischman v. Ratheon Mfg. Co., 188 F.2d 783 (2d Cir. 1951). *See also* RESTATEMENT OF TORTS § 876b (1939): "For harm resulting to a third person from the tortious conduct of another, a person is liable if he . . . knows that the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other so to conduct himself."

73. 69 F. Supp. 512 (E.D. Pa. 1946).

74. 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970).

75. In Gross v. SEC, 418 F.2d 103, 107 (2d Cir. 1969), the court stated that "On the basis of the [secondary defendant's] participation in the management of the firm and his knowledge of the course of conduct in which his firm was engaging . . . the Commission could have concluded that he 'aided and abetted' activities of the firm which were found to be in violation of the federal securities law anti-fraud provisions." It must be noted, however, that the SEC has express statutory authority to discipline a broker-dealer or salesman for aiding and abetting the violation of SEC provisions. Securities Exchange Act of 1934, § 15(b)(5)(E), 15 U.S.C. § 78(o)(b)(5) (1970). *See* BROMBERG § 8.5(539), at 208.27.

76. 463 F.2d 981, 987 (7th Cir.), *cert. denied*, 409 U.S. 880 (1972); *accord*, Pettit v. American Stock Exchange, 217 F. Supp. 21 (S.D.N.Y. 1963).

77. 410 F.2d 135, 144 (7th Cir.), *cert. denied*, 396 U.S. 838 (1969).

his awareness that the customer was financially unstable and engaged in erratic trading practices.[78]

SEC v. National Bankers Life Insurance Co.[79] comes to some interesting conclusions concerning constructive knowledge. The lawsuit arose out of a complex stock fraud scheme involving thirteen corporations and fifteen individuals. Each person or corporation which was alleged to be secondarily liable had only a limited knowledge of the overall fraudulent operation. The court stated that "the defendant must have some *general awareness* that his role is part of a complex activity and that the overall conduct is in some way improper,"[80] and added that the degree of knowledge required of an aider and abettor should be greater when the scheme was more complex. "The knowledge requirement for liability under such a [complex] scheme is more than that required to hold someone as an aider and abettor to a single sale of unregistered stock or a single fraudulent act . . . ."[81]

This standard proposed in *National Bankers Life*—general awareness of the overall improper conduct and that the act performed by the aider and abettor contributes to the improper conduct[82]—seems to substantially limit the degree of constructive knowledge which can be attributed to the aider and abettor in those situations sufficiently complex to warrant this approach. The problem, of course, is in determining which schemes are complex enough to apply this "general awareness test." It is also arguable that the knowledge required under this new test is very close to actual knowledge, since, in order to have an awareness of the overall fraudulent scheme plus an understanding of how the act fits into that scheme, the aider and abettor would have to have some cognizance of the entire fraudulent scheme of the primary wrongdoer. A more flexible interpretation of the knowledge requirement would be more in keeping with the remedial purposes of rule 10b-5.[83]

It has been held that knowledge can be established by circumstantial evidence[84] or by inference.[85] Also, a complaint which alleged that the defendant aider and abettor knew or should have known of the primary offense has been held to be valid.[86] However, the cases give no clear indication of how much or what kind of evidence will be sufficient to establish actual or constructive knowledge.[87]

To summarize, the courts have required some degree of actual or constructive knowledge by the aider and abettor of the improper conduct of the primary offender.[88] However, a standard which requires no knowledge

---

78. *Id.* at 136-37.
79. 324 F. Supp. 189 (N.D. Tex.), *aff'd*, 448 F.2d 652 (5th Cir. 1971).
80. 324 F. Supp. at 195 (emphasis added).
81. *Id.*
82. Judge Sarah T. Hughes is not alone in requiring that knowledge extend further in a complex transaction. *See* Wyndham Associates v. Bintliff, 398 F.2d 614 (2d Cir.), *cert. denied*, 393 U.S. 977 (1968).
83. *See* cases cited note 68 *supra*.
84. SEC v. Scott Taylor & Co., 183 F. Supp. 904, 908 (S.D.N.Y. 1959).
85. Trussell v. United Underwriters, Ltd., 228 F. Supp. 757 (D. Colo. 1964).
86. Pettit v. American Stock Exchange, 217 F. Supp. 21 (S.D.N.Y. 1963).
87. BROMBERG § 8.5(583), at 208.45.
88. Ruder, *supra* note 2, at 638.

whatsoever of the violative conduct by the aider and abettor, but rather imposes an affirmative duty upon the secondary offender to insure that the primary participant has not misstated or omitted to state material facts relevant to the securities transaction,[89] seems inherently unfair. In the absence of circumstances which would put him on notice of a possible violation, such a standard would place an onerous burden upon a person who has not directly participated in the violative conduct. Accordingly, it is unreasonable to place upon an outside director the duty to supervise securities transactions which are negotiated by the management personnel of the corporation upon whose board he serves.[90]

The Nature of the Act: Affirmative Conduct. The courts have had no trouble in imposing secondary liability on those who knowingly perform acts which substantially contribute to the fraudulent scheme of the primary wrongdoer. For example, one of the more common situations in which liability is found for aiding and abetting is in the preparation of financial statements containing fraudulent misrepresentations.[91] However, courts have indicated that even more passive conduct such as providing the primary participant with office space, telephone facilities, and the benefit of the aider and abettor's good business reputation could give rise to secondary liability.[92] In *Blakely v. Lisac*[93] the court followed the same rationale in holding a financial advisor liable as an aider and abettor when he allowed his name and reputation to be used to lend credibility to a fraudulent prospectus. Similarly, in a recent Seventh Circuit case, *SEC v. First Securities Co.*,[94] the court found a securities firm liable as an aider and abettor when it indirectly contributed to the fraudulent conduct of its president by holding him out to the public as a successful and reliable investment counselor. Another Seventh Circuit case held a brokerage firm liable as an aider and abettor for the fraudulent acts of a customer, when it allowed the customer to trade through a cash account even though it knew he traded recklessly and was financially unstable.[95] The concept of aiding and abetting by affirmative conduct[96] was further extended when a court upheld a complaint against the

89. Judge Hays, dissenting in Lanza v. Drexel & Co., 479 F.2d 1277, 1317 (2d Cir. 1973), seems to favor the imposition of secondary liability under rule 10b-5 upon aiders and abettors (specifically outside directors) even in the absence of circumstances which would put them on notice of a violation by the primary participant.

90. In the majority opinion of Lanza v. Drexel & Co., 479 F.2d 1277, 1289 (2d Cir. 1973), Judge Moore rejected the invitation to impose liability upon an outside director for failure to supervise a securities transaction of the corporation by investigating the negotiations between the corporation and the prospective purchaser to make sure that material adverse information had been conveyed by corporate management.

91. *See, e.g.*, Fischer v. Kletz, 266 F. Supp. 180, 196-97 (S.D.N.Y. 1967); *cf.* H.L. Green Co. v. Childree, 185 F. Supp. 96 (S.D.N.Y. 1960).

92. Anderson v. Francis I. duPont & Co., 291 F. Supp. 705 (D. Minn. 1968). Although the court discusses the acts of the alleged aider and abettor which assisted the primary wrongdoer, there is language in the opinion which suggests that such indirect assistance might be viewed by the court as aiding and abetting by inaction. *Id.* at 709.

93. 357 F. Supp. 255 (D. Ore. 1972).

94. 463 F.2d 981, 986-87 (7th Cir.), *cert. denied*, 409 U.S. 880 (1972).

95. Buttrey v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 410 F.2d 135 (7th Cir.), *cert. denied*, 396 U.S. 838 (1969).

96. In pleading an aiding and abetting claim it is usually more advantageous for the plaintiff to plead affirmative conduct if there is any hope for success, because an

American Stock Exchange, alleging that it had aided and abetted a broker in fraudulent transactions because it failed to take disciplinary action against the broker.[97] Although the court did not discuss the possibility that the exchange could be liable for aiding and abetting by inaction, the facts are more susceptible to an inaction theory.[98]

Silence or Inaction. Perhaps the greatest potential risk which the outside director faces in the aiding and abetting field is that of being sued for aiding and abetting by inaction.[99] This inaction theory had its birth in the district court decision in *Brennan v. Midwestern United Life Insurance Co.*,[100] where the court considered a scheme by a securities dealer to delay the delivery of stock certificates to customers, and thereby create a period in which he could fraudulently speculate with their money. Liability was imposed on Midwestern because, although it knew of the fraudulent scheme, it failed to refer complaining customers directly to the Indiana Securities Commission, but rather referred them first to the securities dealer. Midwestern indirectly benefited from aiding the dealer, for by purchasing Midwestern shares he pushed the stock price up, making it possible for Midwestern to acquire other companies by exchanging their shares for the other companies, based on the market price of the securities. The court concluded that Midwestern's acquiescence through silence in the fraudulent conduct of the dealer constituted aiding and abetting.[101]

The Ninth Circuit has come to a contrary result in *Wessel v. Buhler*,[102] a case involving an accountant who allegedly failed to disclose his knowledge of fraudulent financial records to prospective investors. The court refused the invitation to find liability solely for inaction and interpreted rule 10b-5 to impose liability for an omission of fact only when it is necessary to clarify an affirmative statement which has been made.[103] Perhaps the distinction between *Brennan* and *Wessel* lies in the fact that in *Brennan* the alleged aider and abettor had benefited from remaining silent while in *Wessel* the accountant had received no extra benefits by virtue of his silence.[104]

---

allegation of silence or inaction is much more vulnerable to dismissal as a less-tested theory of recovery. BROMBERG § 8.5(596), at 208.55.

97. Pettit v. American Stock Exchange, 217 F. Supp. 21 (S.D.N.Y. 1963).

98. The court characterizes the stock exchange as a conduit through which the fraudulent transactions were consummated and to this extent there seemed to be some basis for the affirmative conduct approach taken by the court. *Id.* at 24.

99. *See Standards of Conduct* 81.

100. 259 F. Supp. 673 (N.D. Ind. 1966), *aff'd*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970).

101. The district court's decision is arguably not as conclusive a determination due to the language of the Seventh Circuit in reviewing the case, indicating that Midwestern had also been guilty of affirmative acts which would constitute aiding and abetting. Brennan v. Midwestern United Life Ins. Co., 417 F.2d 147, 154 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970).

102. 437 F.2d 279 (9th Cir. 1971).

103. *Id.* at 283.

104. Professor Bromberg has argued that liability should not be imposed on the aider and abettor solely for inaction in the absence of some benefit derived from the silence. In both participation and conspiracy some overt act is necessary for the imposition of liability. Thus, it would seem unjust to impose liability in aiding and abetting contexts for complete nonfeasance. BROMBERG § 8.5(533), at 208.25.

The outside director is particularly vulnerable under the inaction theory. A suit could be posited upon the following theory:

> (1) the corporation was engaged in activities which were illegal under the securities acts; (2) although the officer or director did not participate in the activities, he knew that the activities were taking place; and (3) his failure to prevent the activities from taking place should expose him to liability under the securities laws.[105]

In *Blakely v. Lisac*[106] many of these considerations entered into the court's decision that two outside directors would be held responsible for misrepresentations made in an annual report.[107] Here, the outside directors not only did not participate in the preparation of the annual report but also received no profit and loss statement indicating the exact amount of the loss. Nevertheless, they were held responsible for a general knowledge that the company was operating at a loss, and that the loss was not accurately reflected in the annual report. This decision indicates that a director has a duty to stop illegal activities known to him and must disclose material adverse information to prospective investors. It is interesting to note that the court also found the lawyer who helped prepare misleading corporate statements liable both in his professional capacity and in his capacity as director.[108] This dual liability is of particular significance to the outside director who often performs professional services for the company as well as fulfilling the responsibilities of his directorship. As a practical matter, outside directors or professional persons who perform services for the corporation are seldom sued unless the corporation is bankrupt and the inside directors are either insolvent or cannot be located. In this situation only the outside director stands between the investor and total loss.

III. THE POTENTIAL SECONDARY LIABILITY OF OUTSIDE DIRECTORS

A. *Lanza v. Drexel & Co.*

The Second Circuit, in *Lanza v. Drexel & Co.*,[109] considered both the director's duty to convey adverse information to prospective purchasers of corporate stock and the secondary liability of outside directors as aiders and abettors in fraudulent statements made by management to prospective purchasers. In rejecting the negligence standard, the court concluded that a director who is not a participant in the transaction owes no duty to insure that all material adverse information is conveyed to prospective purchasers of the stock of the corporation on whose board he sits.[110] The court reasoned that "[a]bsent knowledge or substantial participation we have refused

105. *Standards of Conduct* 81.
106. 357 F. Supp. 255 (D. Ore. 1972).
107. *Id.* at 264.
108. *Id.* at 266. *See also* SEC v. Spectrum Ltd., 489 F.2d 535 (2d Cir. 1973).
109. 479 F.2d 1277 (2d Cir. 1973).
110. *Id.* at 1289. The court also examined the legislative history relevant to the passage of the 1934 Act, and more particularly § 10(b), and concluded that "[t]o impose a duty to convey upon directors under Rule 10b-5 would be to ignore . . . Congressional intent." *Id.* at 1299.

to impose such affirmative duties of disclosure upon rule 10b-5 defendants."[111] The court determined that the facts of the case did not lend themselves to a finding that Coleman, an outside director and investment advisor for the BarChris Corporation, was secondarily liable as an aider and abettor.

This case arose out of the events which led to the bankruptcy of BarChris Construction Company.[112] The plaintiffs, who were the sole owners of Victor Billiard Company, exchanged 20,000 shares of Victor stock for 20,428 shares of BarChris Construction Company stock. Less than one year later BarChris filed a petition in bankruptcy, and, after an unsuccessful attempt to recover their shares in a rescission action, the plaintiffs brought a civil action against the officers and directors of BarChris. The trial court[113] found several of the corporate officers and management directors liable under rule 10b-5 as participants in the fraudulent scheme, but refused to impose liability upon Coleman as an aider and abettor because he had no knowledge of the fraudulent information conveyed by the treasurer of BarChris to plaintiffs in the negotiations leading to the stock exchange transaction. In affirming the trial court the Second Circuit discussed several cases which have particular relevance to the situation of the outside director. In *Mader v. Armel*[114] plaintiff-shareholders of one corporation sued the officers and directors of another, alleging that the latter had fraudulently induced the plaintiffs to exchange their stock. Apparently, the president of the latter corporation was the primary party involved in the fraud which was perpetrated upon the plaintiffs. Defendants Tibbals and Young were directors who neither knew of nor participated in the fraudulent transaction. The Sixth Circuit, in affirming the dismissal of the complaint against the non-participant directors, found that they had placed implicit confidence in the integrity of the president and had also relied upon erroneous financial data which had been computed by a certified public accountant. Thus, they did nothing directly or indirectly to induce the fraudulent transaction.[115] Another case which is illustrative of the position of an outside director under section 10(b) and rule 10b-5 is *Moerman v. Zipco, Inc.*,[116] in which the trial court held Nasser, the president and director of Zipco, liable for fraudulently inducing plaintiffs to buy Zipco stock. However, the court held that certain outside directors had no significant contact with the plaintiff, and, therefore, were not liable under section 10(b) or rule 10b-5. This decision indicates that a director's obligation to potential purchasers of the corporation's stock is merely secondary unless he actually participated in the fraud-

111. *Id.* at 1302.
112. In Escott v. BarChris Constr. Corp., 283 F. Supp. 643 (S.D.N.Y. 1968), a leading case decided under Securities Act of 1933, § 11, 15 U.S.C. § 77k (1970), the court held officers and directors of BarChris who signed a bond registration statement containing material misstatements, liable to those who bought the securities in the original offering. However, since the transaction involved in this litigation was a private offering rather than a public offering, it has been argued that the duties imposed upon directors should be less stringent since the public interest in private offerings is less pronounced.
113. Lanza v. Drexel & Co., [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,826 (S.D.N.Y. 1970).
114. 461 F.2d 1123 (6th Cir.), *cert. denied*, 409 U.S. 1023 (1972).
115. *Id.* at 1125.
116. 302 F. Supp. 439 (E.D.N.Y. 1969), *aff'd*, 422 F.2d 871 (2d Cir. 1970).

ulent transaction. Therefore, it would seem to be equally applicable to inside directors or corporate officers who took part in the overall management of the corporation but did not participate in the particular fraudulent transaction. Such an extension of this premise would lead to an unjust result because it would exonerate those who have a duty to supervise corporate affairs.[117]

It has been persuasively argued that the reluctance of courts to impose liability upon the unknowing outside director under rule 10b-5 is based upon the realization that there must be a division of labor among corporate personnel and that the functions and responsibilities of an outside director necessarily differ markedly from those of corporate officers and management directors.[118] Moreover, a corporate director is entitled to rely upon advice of corporate counsel or corporate financial statements.[119] Likewise, directors have not been held liable for actions taken in good faith reliance upon representations made by other corporate officers.[120] Thus, the majority in *Lanza* adhered to the philosophy which Judge Learned Hand expressed in *Barnes v. Andrews*,[121] that a corporate director should not be required under threat of liability to investigate and supervise every aspect of the corporation's business. Rather, he may properly rely on the integrity and competence of corporate officers and fellow directors whom he in good faith trusts.[122]

Judge Timbers, dissenting in *Lanza*, did not challenge the majority's conclusion that Coleman had no actual knowledge of the specific fraudulent transactions. Instead the opinion was based on the conclusion that constructive knowledge of the fraudulent conduct could be attributed to Coleman and, therefore, liability should be imposed upon him.[123] The facts demonstrated that he had a general awareness that there was an accelerating decline in the conditions of the business, and a propensity on the part of management to gloss over that fact.[124] Since Coleman had been on the board, BarChris had suffered several major business setbacks, and the working capital was constantly depleted by large cash expenditures necessary for its operation. This adversity was brought directly to Coleman's attention at a "point of crisis"[125] board meeting which occurred eight days before the trans-

117. Judge Hays dissenting in Lanza v. Drexel & Co., 479 F.2d 1277, 1311-20 (2d Cir. 1973), would extend this duty to supervise to outside directors.

118. Brief for Appellee at 35, Lanza v. Drexel & Co., 479 F.2d 1277 (2d Cir. 1973).

119. The New York corporation law expressly provides for good faith reliance by corporate directors upon "financial statements of the corporation represented to them to be correct by the president or the officer of the corporation having charge of its books of accounts, or stated in a written report by an independent public or certified public accountant or firm of such accountants fairly to reflect the financial condition of such corporation." N.Y. BUS. CORP. LAW § 717 (McKinney 1963). For other representative acts which provide the same protection to corporate directors, see ABA-ALI MODEL BUS. CORP. ACT 2d § 48(c), ¶ 1 (West 1971); DEL. GEN. CORP. LAW § 141(e) (Supp. 1972); TEX. BUS. CORP. ACT ANN. art. 2.41 (1973).

120. Brief for Appellee at 35.

121. 298 F. 614 (S.D.N.Y. 1924).

122. Ukropina, *Lanza v. Drexel & Co.: Some Comfort for the Outside Director, but More Needed*, 48 L.A. BAR BULL. 330, 355 (1973).

123. 479 F.2d at 1320-22.

124. Brief for SEC as Amicus Curiae at 10.

125. 479 F.2d at 1321.

action with the plaintiff was finalized. Additionally, Coleman was aware that the management had made misleading statements with respect to securities transactions in the past. In view of Coleman's knowledge and experience in financial matters, Judge Timbers felt that the circumstances imposed upon him the duty to inquire into the potentially fraudulent transaction.[126]

Judge Hays, in his dissent, indicated that even if Coleman could not be charged with constructive knowledge, liability should nevertheless be imposed upon him because he did nothing to inform himself of the character of the negotiations.[127] The securities laws have made no distinction between inside and outside directors,[128] but rather impose upon a director of a corporation the obligation not to defraud the other party in a securities transaction by misstating or omitting to state material facts.[129] It was also pointed out that such an interpretation of liability requirements with respect to non-participant, outside directors would be in concert with the legislative purpose and uniform application of section 10(b) and rule 10b-5.[130]

B. *SEC v. Spectrum Ltd.*

The due diligence standard for aiders and abettors which was set out by Judge Hays dissenting in *Lanza* was employed by the Second Circuit in *SEC v. Spectrum Ltd.*,[131] which involved violations of the registration[132] and antifraud[133] provisions of the Securities Act of 1933 and the antifraud provisions[134] of the 1934 Act. The SEC alleged that an attorney had prepared an opinion letter on the basis of which the primary violator had sold unregistered securities. However, the trial court refused to enjoin the attorney from further violations because negligent conduct does not in itself constitute a violation of the securities law. On appeal, the court reversed and remanded the case to the trial court because highly material findings of fact concerning the attorney's knowledge of the primary violation at the time that he prepared the opinion letter had not been made.

In commenting on the appropriate rule of law to be applied by the trial court in resolving the case, the court stated that "imposition of a negligence standard with respect to the conduct of a secondary participant is [not] overly strict at least in the context of this case. The legal profession plays a unique and pivotal role in the effective implementation of the securities laws."[135] The court rejected Professor Ruder's thesis that the aider and abettor whose acts occur in the course of ordinary business and are not in themselves violations should not be required to investigate the ultimate activities of the party he is assisting.[136] In view of the circumstances of

---

126. *Id.*
127. *Id.* at 1319.
128. *Id.* at 1317.
129. *Id.*
130. *Id.* at 1319.
131. 489 F.2d 535 (2d Cir. 1973).
132. 15 U.S.C. § 77(e) (1970).
133. *Id.* § 77q(a).
134. Securities Exchange Act of 1934, § 10b-5, 15 U.S.C. § 78j(b) (1970).
135. 489 F.2d at 541-42.
136. Ruder, *supra* note 2, at 632-633.

this case the court felt that "[t]he preparation of an opinion letter is too essential and the reliance of the public too high to permit due diligence to be cast aside in the name of convenience."[137]

Spectrum may be distinguished from *Lanza* in that it was an injunction suit rather than a private action for damages and the court has repeatedly adhered to a more flexible knowledge requirement where equitable or prophylactic relief is sought.[138] This dichotomy was emphasized by the court in *Spectrum* when it expressly stated that the standard of conduct applied in a suit for injunctive relief should not be construed to apply to private suits for damages.[139] In addition, *Spectrum* may be distinguished from *Lanza* because it involved aiding and abetting by affirmative conduct rather than by a failure to act. The courts have been much more reluctant to impose liability for nonfeasance of an aider and abettor in the absence of some degree of knowledge of the improper conduct,[140] It is also apparent that both the outside director in *Lanza* and the lawyer in *Spectrum* had specialized knowledge which should have made them more acutely aware of the particular fraudulent activity. However, the objectionable conduct of the lawyer was performed in his professional capacity, and under circumstances which would seem to create a fiduciary relationship between him and the parties to the transaction. In similar fact situations the courts have consistently applied closer scrutiny to the conduct of the secondary participant.[141] The impact of the *Spectrum* decision upon the potential liability of outside directors in private actions for damages seems to be diminished in view of the distinguishing factors heretofore discussed.

C. *Standards Applied by the Courts and the SEC*

The theories of secondary liability which are applicable to the outside director fall roughly into three categories. (1) If the outside director has actual knowledge of the fraudulent scheme perpetrated by management, all courts seem to agree that he should be secondarily liable.[142] (2) Some courts and commentators contend that the outside director may be secondarily liable when he has constructive knowledge of the primary wrong.[143] This is simply another way of saying that a duty arises under rule 10b-5 when circumstances exist which would put a reasonable director on notice that there is a potentiality that corporate officers or management have engaged in improper conduct associated with a securities transaction. (3) A third view has been proposed which would impose an affirmative duty upon

137. 489 F.2d at 542.

138. *See, e.g.,* SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1096 (2d Cir. 1972); Hanly v. SEC, 415 F.2d 589, 596 (2d Cir. 1969); Mutual Shares Corp. v. Genesco Inc., 384 F.2d 540, 547 (2d Cir. 1967).

139. 489 F.2d at 541.

140. BROMBERG § 8.5(533), at 208.25.

141. *See, e.g.,* Vine v. Beneficial Fin. Co., 374 F.2d 627 (2d Cir. 1967); Trussell v. United Underwriters, Ltd., 228 F. Supp. 757 (D. Colo. 1964).

142. *See* notes 72-75 *supra*, and accompanying text.

143. In Lanza v. Drexel & Co., 479 F.2d 1277, 1306 (2d Cir. 1973), although the majority had no knowledge of the fraudulent nondisclosure, the court seems to accept the constructive knowledge standard as a basis for liability under rule 10b-5. *See also* Ruder, *supra* note 2, at 638.

the outside director to investigate and supervise securities transactions of the corporation, regardless of whether circumstances exist which would put him on notice of a possible violation of rule 10b-5 by management.[144]

By way of amicus curiae brief in *Lanza* the SEC indicated its awareness of the special situation of the outside director who is not normally involved in the day-to-day conduct of corporate affairs.[145] The Commission expressed agreement with a standard of conduct which would require some actual or constructive knowledge by the outside director of the improper conduct by management. In the absence of circumstances which would put him on notice of a violation, the Commission would refuse to impose upon an outside director a duty to supervise the conduct of management in securities transactions engaged in by the corporation.[146]

The courts and the SEC should carefully construe the facts of each case before imposing liability upon outside directors by simply adhering to a prefabricated standard of conduct. There is no simple formula which will lead to a judicious result in every case because many variables exist which may affect the culpability of the particular defendant.[147] Corporate affairs are too complex to impose a duty to supervise upon directors who participate only in an advisory capacity, unless the circumstances of the particular case as well as the knowledge and experience of the defendant would create such a duty.

IV. Methods of Indemnification of Corporate Directors

Increasingly, the major business decisions of American corporations involve social and political overtones which can only be assessed by a board made up of persons with varied background and experience.[148] The outside director may lend an independent perspective to the corporate decision making process by being able to analyze corporate problems from a viewpoint

144. This approach is implicit in the language of Judge Hays' dissent in Lanza v. Drexel, 479 F.2d 1277, 1317-18 (2d Cir. 1973).

145. *See* Summary of April 6, 1973, address by former SEC Chairman G. Bradford Cook entitled, *The Director's Dilemma*, BNA SEC. REG. G.L. REP. April 11, 1973, at A-7. In this statement Cook revealed that the preparation of an SEC position paper on the liability of outside directors was currently in progress. The full text of former Chairman Cook's statement is set out in [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,302.

146. It is the Commission's view that in the context of a securities transaction a director who approves, but does not otherwise participate in the transaction would not be liable to a third party unless he knew, or had reasonable cause to believe, that the responsible corporate officers had engaged in improper conduct in connection with the transaction. Absent circumstances which would put him on notice of a material failure in disclosure by the corporation, a director, acting with due care and relying in good faith on officers whom he has no reason to believe are acting improperly, would not incur liability under Rule 10b-5 . . . merely by reason of his having authorized or approved the transaction.

Brief for SEC as Amicus Curiae at 5, Lanza v. Drexel & Co., 479 F.2d 1277 (2d Cir. 1973).

147. For an excellent discussion of the various considerations which make the imposition of liability in each case vary according to the particular attributes of the parties involved, see Mann, note 37 *supra*.

148. Estes, *Outside Directors More Vulnerable Than Ever*, 51 HARV. BUS. REV., Jan.-Feb. 1973, at 107, 114.

not clouded by constant association with the particular industry.[149] Also, the outside director may be of great value to the stockholders in supervising and advising the management, due to his individual professional competence and judgment.[150] However, at present there are too few competent individuals who are willing to accept directorships because of potential liability which may inure to the unsuspecting outside director.[151] Since rule 10b-5 applies to fraudulent conduct which occurs in relation to buy-and-sell transactions in general, liability may be extended to losses occurring in open market transactions. Thus, if the issuer corporation has one or more widely traded securities outstanding, the potential damages could be of vast proportions.[152]

Courts adhere to a policy of joint and several liability with respect to other securities provisions and, in view of the prevalence of joint and several liability in general tort theory, there is little reason to doubt that rule 10b-5 liability will develop in the same way.[153] In *Pettit v. American Stock Exchange*[154] the court indicated that aiders and abettors would be subjected to liability equal to that of the primary wrongdoers. The Ninth Circuit has refused to apportion liability and has held that those who are only secondarily liable are responsible for the entire amount of damages to the plaintiff.[155] Strict application of joint and several liability to all associated with a violation of rule 10b-5 would be particularly oppressive to the outside director who, by virtue of his position, may be subjected to claims by multiple plaintiffs for cumulative damages. A more equitable approach would be to apportion damages among the various defendants in proportion to their degree of involvement in and knowledge of the fraudulent transaction.[156]

Indemnification and insurance have been two tools which corporations have employed to reduce the risk that their officers or directors will be subjected to a great financial burden because of corporate affairs. Forty-seven

---

149. *Id.*

150. Bishop, *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1092-93 (1968).

151. Although liability will probably not be imposed under rule 10b-5 unless the director has some actual or constructive knowledge of a primary wrong, he may incur absolute liability under Securities Act of 1933, § 11, 15 U.S.C. § 77k (1970), if he signs a registration statement which contains material misstatements. Escott v. BarChris Constr. Corp., 283 F. Supp. 643 (S.D.N.Y. 1968).

152. Dooley, *The Effects of Civil Liability on Investment Banking and the New Issues Market*, 58 VA. L. REV. 776, 825-26 (1972).

153. BROMBERG § 8.5(585), at 208.50.

154. 217 F. Supp. 21, 28 (S.D.N.Y. 1963). *See also* Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341, 363-64 (2d Cir.), *cert. denied*, 414 U.S. 910 (1973).

155. Errion v. Connell, 236 F.2d 447, 456 (9th Cir. 1956); *accord*, Sprayregen v. Livingston Oil Co., 295 F. Supp. 1376, 1378 (S.D.N.Y. 1968); Brennan v. Midwestern United Life Ins. Co., 259 F. Supp. 673, 680 (N.D. Ind. 1966), *aff'd*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970).

156. Professor Bromberg has argued that:

> Given the possible complexities of securities violations, their intricate ramifications, and the suability under 10b-5 of relatively remote and insignificant parties, there will be occasions when it is just and reasonable to apportion liability of lesser wrongdoers. A rigid rule of entire liability would also be out of keeping with the flexibility of remedies for which 10b-5 has become notable.

BROMBERG § 8.5(585), at 208.52.

states now have statutes which provide for the indemnification of officers and directors and several states have enacted statutes providing that corporations may purchase and maintain liability insurance for their officers, directors, and employees.[157] The indemnification statutes usually provide for a mandatory indemnity for legal expenses incurred by a director or officer in a successful legal defense,[158] and some provide for permissive indemnity when, in the view of the board, the individual officer or director was acting in good faith.[159] However, permissive indemnification may be of limited benefit in rule 10b-5 violations because public policy would militate against indemnifying an officer or director for willful misconduct.[160]

Liability insurance for corporate officers and directors has been a popular means of avoiding direct and vicarious financial burdens. Although these policies have various exclusions, one primary objective is to protect an innocent director when he is subject to secondary liability for the wrongdoing of a fellow director or corporate officer.[161] In addition, outside directors may obtain insurance which will protect them from liability associated with a specific securities issue or transaction.[162] Also, at least one company[163] has tailored an insurance policy specifically for the person who serves as an outside director on one or more boards.[164] This type of policy appears to cover negligent acts or omissions, but the language of this and other director liability policies is not conducive to an interpretation that they would cover willful misconduct. Finally, it must be emphasized that since many outside directors also perform professional services for the corporation, additional liability insurance may be necessary to guard against potential liability for action taken by the individual in his professional capacity.

V. CONCLUSION

The dissolution of privity as a necessary element for suit under rule 10b-5 has opened the door for many plaintiffs to recover for the same fraudulent act. However, in order for liability to be imposed upon the outside or non-participant director, the courts have almost unanimously required some involvement in or knowledge of the primary wrong.[165]

A director's involvement in the fraudulent act may take the form of active participation, conspiracy, or aiding and abetting. Generally, participation signals the most direct involvement and often entails actual participation in the buy-sell transaction by a misrepresentation or non-disclosure. Conspiracy involves an agreement between the primary wrongdoer and the conspirator and usually entails some participation by the conspirator in perpe-

157. Knepper, *Corporate Indemnification and Liability Insurance for Corporation Officers and Directors*, 25 Sw. L.J. 240 (1971).
158. *See, e.g.*, TEX. BUS. CORP. ACT ANN. art. 2.02(A)(16) (Supp. 1974).
159. *See, e.g.*, CAL. CORP. CODE § 830(f) (West Supp. 1974).
160. The Texas statute specifically prohibits indemnification to be given to one who is held liable for negligence or misconduct in performance of his duty. TEX. BUS. CORP. ACT ANN. art. 2.02(A)(16) (Supp. 1974).
161. *Cf.* Knepper, *supra* note 157, at 256.
162. *Id.* at 259.
163. St. Paul Fire & Marine Ins. Co. Form 16254 DLP-Rev. 1-67.
164. *See* Knepper, *supra* note 157, at 260.
165. BROMBERG § 8.5(582), at 208.43.

trating the fraud. Aiding and abetting usually involves an act which in itself is not a violation of rule 10b-5 but which serves to expedite the primary wrong. According to the generally accepted definition of aiding and abetting[166] some knowledge of the fraudulent act is required. This knowledge, however, may involve actual knowledge or reckless disregard of the facts. Since aiding and abetting signals the most remote involvement, correspondingly more knowledge of the fraudulent act is required before liability will be imposed on the aider and abettor. However, in *SEC v. Spectrum Ltd.*[167] the court indicated that mere negligent conduct by the aider and abettor would be sufficient for the court to give equitable relief. A few courts[168] have determined that silence or inaction is sufficient for aiding and abetting liability, but the majority of courts and commentators still seem to require some act by the aider and abettor which directly or indirectly contributes to the fraudulent conduct of the primary wrongdoer.

Lanza v. Drexel & Co.[169] is good news to the outside director who fears the imposition of liability upon himself because of the fraudulent acts of fellow directors or management of the corporation. The majority opinion seems to return to the standard set forth by Judge Learned Hand in *Barnes v. Andrews*,[170] in allowing the outside director to rely upon the competence and integrity of other directors and management personnel and, unless given reason to suspect them, to assume they will not engage in fraudulent conduct. More importantly, the Securities and Exchange Commission, by way of amicus curiae brief, indicated its approval of this standard of conduct for outside directors, even though it disagreed with the majority's interpretation of the facts relating to the existence of constructive knowledge in this particular case. Judge Hays' dissent suggests that liability should be imposed on an outside director who fails to properly investigate securities transactions conducted by the management to insure that material nondisclosures or misstatements have not been made. However, this duty to supervise is more akin to the director's management responsibilities and it seems unjust to impose such a duty upon outside directors who act only in an advisory capacity and do not participate in the day-to-day affairs of the corporation.

To encourage competent individuals to accept directorships, corporations have resorted to indemnification and liability insurance designed to protect the director from vicarious liability. Certainly these protective measures accomplish two favorable objectives—to protect the outside director from personal liability and to continue to make funds available to compensate those who are harmed in fraudulent securities transactions. Rule 10b-5 should not be extended by the courts to impose liability for failure to supervise corporate affairs upon outside directors when they possess no actual or constructive knowledge of the primary violation. Such an extension of liability

166. RESTATEMENT OF TORTS § 876 (1939).
167. 489 F.2d 535 (2d Cir. 1973).
168. *See, e.g.*, Blakely v. Lisac, 357 F. Supp. 255 (D. Ore. 1972); Brennan v. Midwestern United Life Ins. Co., 259 F. Supp. 673 (N.D. Ind. 1966), *aff'd*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970).
169. 479 F.2d 1277 (2d Cir. 1973).
170. 298 F. 614 (S.D.N.Y. 1924).

would defeat one of the primary purposes of the rule, which is to protect investors from fraudulent business practices. Surely, the independent judgment and experience of most outside directors does much to protect investors against the fraudulent conduct of corporations and, by discouraging competent individuals from being directors, rule 10b-5 would be allowed to impede the objective which it is designed to attain.