WACHTELL, LIPTON, ROSEN & KATZ

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To Our Clients

Recent Developments

1. Rule 10b-5; Accountants' Liaibilities; Scienter; Knowing or Reckless Conduct. The Supreme Court decision in the Hochfelder case left open the question whether the scienter requirement necessary to establish a Rule 10b-5 violation is satisfied by proof of actual knowledge of a misrepresentation or omission or by recklessness. In McLean v. Alexander, CCH Fed. Sec. L. Rep. ¶ 95,725 (D. Del. Aug. 13, 1976) the court answered in the affirmative. Essentially in McLean the accountant certified accounts receivable without confirmations from the debtors and without resolving internal inconsistencies in the records of the company whose balance sheet was certified. The accountant responded to management pressure to complete the audit in a short period and did not question management beyond obtaining a normal representation letter and did not qualify his opinion or consult with counsel or another accountant. McLean also held that if there is a due diligence duty on the plaintiff in a Rule 10b-5 action, in the absence of a "red flag" it does not extend to investigating certified financial statements; that reliance is established if the financial statements were a substantial factor in the investment decision; and that accountants liability under Rule 10b-5 extends to members of the investing public. For an interesting factual variation in the context of a Dun & Bradstreet report based on a company's published data see, Mallinckrodt Chemical Works v. Goldman, Sachs & Co., CCH Fed. Sec. L. Rep. ¶ 95,721 (S.D.N.Y. Sept. 14, 1976).

2. Rule 10b-5; Inside Information; Liability to Persons Who Trade in the Open Market. Fridrich v. Bradford, CCH Fed. Sec. L. Rep. ¶ 95,723 (4th Cir. Sept. 15, 1976) reached the opposite result from Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 353 F. Supp. 264 (S.D.N.Y. 1973), aff'd 495 F.2d 228 (2d Cir. 1974) and held that persons who trade on inside information are liable under Rule 10b-5 only to those persons with whom they trade and are not liable to others who happen to trade in the open market subsequent to the defendant's trades but prior to the public disclosure of the information. The court also reached the same result as to Rule 10b-6. The court said, ". . . extension of the

private remedy to impersonal market cases where plaintiffs have neither dealt with defendants nor been influenced in their trading decisions by any act of the defendants would present a situation wholly lacking in the natural limitations on damages present in cases dealing with face-to-face transactions." A concurring opinion rationalizes Shapiro and Fridrich on the basis that in Shapiro the defendant tipped a series of traders and "poisoned" the market over a period of time while in Fridrich the insider trading was limited to six days and there was no tipping. The concurring opinion states:

> "To repeat, the wrong which gives rise to the duty to 'disclose or abstain' is the act of trading without disclosure. Neither an insider's trading when he is not in possession of material inside information, nor the decision to abstain from trading when he does possess such information, gives rise to a duty of disclosure. That duty arises only when necessary to equalize the information available to outside investors who are actively trading with an insider who is privy to undisclosed material facts. When the insider ceases trading, the informational imbalance ends and the market returns to its normal state. However, where there is tipping in conjunction with insider trading the circumstances are significantly altered. When an insider tips material information to selected traders he is perpetuating the informational imbalance in the market and breaching a separate duty to treat all persons in the market alike. By tipping, the insider has set off a chain of events which perhaps may only be remedied by full public disclosure. Shapiro was not a case of straight insider trading but involved tipping on a mass scale. The complaint was essentially aimed at Merrill Lynch's policy of selective leakage of information about Douglas' financial straits to favored customers who in turn unloaded their shares in the market to unwary purchasers. Under these circumstances, the District Court in Shapiro may have correctly defined the class of potential plaintiffs to include those in the market up to the point of effective public disclosure."

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