Abrogation of Plaintiff's Due Care Requirement in Private Actions under Rule 10b-5

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Notes

ABROGATION OF PLAINTIFF'S DUE CARE
REQUIREMENT IN PRIVATE ACTIONS
UNDER RULE 10b–5

Some courts seem to have required a private plaintiff to show that he acted with due care before allowing recovery under rule 10b–5. The author examines this supposed due care requirement and finds it to be analogous to the contributory negligence doctrine. Since the Supreme Court in Ernst & Ernst v. Hochfelder restricted private recovery under rule 10b–5 to situations in which the defendant acted with scienter, the author concludes that recent cases have appropriately rejected the due care requirement.

RULE 10b–5\(^1\) WAS PROMULGATED under the authority of section 10(b), the general antifraud provision of the Securities Exchange Act of 1934. Clauses (a) and (c) of the rule broadly prohibit any party from engaging in any activity which is a fraud or operates as a fraud, while clause (b) specifically prohibits half-truths and misstatements of material fact.\(^2\) However, in some instances, plaintiffs have been precluded from recovery under rule 10b–5 because they failed to seek out and analyze material information about a securities transaction in a prudent manner.\(^3\) The standard against which the adequacy of

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   It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate [sic] 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.


2. Arguably, complete omissions are not prohibited under the language of rule 10b–5. Clause (b) prohibits half-truths and misstatements only. Thus complete omissions could only be reached by the broad language found in clauses (a) or (c). For purposes of this Note it will be assumed that complete omissions are actionable under rule 10b–5.

the plaintiff's conduct was judged was one of simple negligence.\textsuperscript{4}

Imposing a due care requirement upon the plaintiff appeared to be a tenable judicial approach to restrict litigation under rule 10b--5 when the defendant had negligently violated the securities laws. However, in light of the recent Supreme Court decision in \textit{Ernst & Ernst v. Hochfelder},\textsuperscript{5} which limits private recovery under rule 10b--5 to cases in which the defendant acted with scienter,\textsuperscript{6} the propriety of the due care requirement must be reconsidered. Indeed, recent judicial developments indicate a relaxation of the due care requirement; the victim of a fraudulent securities transaction need no longer establish that he investigated the offender's misconduct in order to recover in a private action under rule 10b--5.\textsuperscript{7} This Note examines the policy behind, and purposes underlying, the establishment of the implied private right of action under rule 10b--5 in conjunction with the case law discussing the due care requirement. In addition, the Note evaluates the propriety of allowing a defendant who has intentionally violated the antifraud provisions of the federal securities laws to escape liability simply because his victim has failed to exercise due care.

I. LIMITATIONS ON PRIVATE ACTIONS UNDER RULE 10B--5

For the past three decades federal courts have implied the existence of private rights of action for violations of rule 10b--5.\textsuperscript{8} The implied


6. In \textit{Hochfelder}, the Supreme Court defined scienter as intent to deceive and left open the question whether reckless behavior could constitute scienter. \textit{Id.} at 194 n.12. \textit{See} note 49 infra.


Although § 10(b) does not by its terms create an express civil remedy for its violation, and there is no indication that Congress, or the Commission when
private right of action is justified by the general principle of tort law that violation of a legislative enactment or administrative regulation designed to prevent a particular type of harm can give rise to a civil remedy. Of the five general federal antifraud provisions available to a person injured in a securities transaction, rule 10b-5 produces the greatest amount of litigation. The popularity of rule 10b-5 is due to two major factors: the scope of rule 10b-5 is broader than the other antifraud provisions, and the development of the rule has been


There is another major rationale for allowing implied private rights of action under rule 10b-5. Implied private rights of action serve not only to compensate injured parties for losses suffered in a securities transaction, they also provide necessary supplemental enforcement of the securities laws. This supplementary enforcement rationale was adopted in Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730 (1975), (citing J.I. Case Co. v. Borak, 377 U.S. 426, 432 (1964)). See section VI infra.


11. As the Supreme Court noted in SEC v. National Sec., Inc., 393 U.S. 453 (1969): "§ 10(b) and Rule 10b-5 may well be the most litigated provisions in the federal securities laws." Id. at 465. Professor Bromberg has observed that "10b-5 is generating almost as much litigation as all the other general antifraud provisions together, and several times as much as the expressed liabilities." 1 A. Bromberg, supra note 9, at § 2.5(6).

12. There are several reasons a plaintiff may choose to bring an action under rule 10b-5 rather than the other antifraud provisions of the securities laws. Most importantly, the statute of limitations is determined by state law and may run longer than the one year statute of limitations applicable under §§ 11 and 12 of the Securities Act, 15 U.S.C. §§ 77k, 77l, and 77m (1970). Second, only the purchaser of a security can bring an action under §§ 11(a), 12(2), and 17(a) of the Securities Act, 15 U.S.C. §§ 77k, 77l, and 77q (1970). Rule 10b-5 may be utilized by a buyer or seller of a security. Third, not every antifraud provision covers omissions. Sections 11(a) and 12(2) of the Securities Act, 15 U.S.C. §§ 77k, 77l (1970) and clause (b) of rule 10b-5 embrace material untruths or half-truths. Section 11(a) also covers complete omissions and rule 10b-5 covers pure nondisclosure where there is a duty to disclose. Rule 15c1-2, 17 C.F.R. § 240, 15c1-2 (1977), and clause (c) of rule 10b-5 also encompass acts, practices, or courses of business which operate or would tend to operate as a fraud or deceit. Only clause (a) of rule 10b-5 and § 17(a) of the Securities Act, 15 U.S.C. § 77q (1970), reach devices, schemes, and artifices to defraud. Section 17(a) is probably closest to rule 10b-5 in the breadth of its coverage, but its use is limited because not all courts recognize an implied private right of action.
fostered by expansive and flexible judicial interpretation.\(^\text{13}\)

Since rule 10b–5 has become the catchall provision of the federal securities laws, some authorities have expressed concern that continued indiscriminate extension of the rule may transform it into an insurance policy for foolish investors.\(^\text{14}\) The drafters of the Exchange Act were aware of the far-reaching potential of its antifraud provisions. They provided that “the rights and remedies provided by this title shall be in addition to any and all other rights, and remedies that may exist at law or in equity . . . .”\(^\text{15}\) Courts have followed this mandate against foreclosing common law remedies, but they have sought to limit the potentially over-broad reach of rule 10b–5 by subjecting 10b–5 plaintiffs to traditional common law defenses\(^\text{16}\) including waiver, estoppel, laches,\(^\text{17}\) and in pari delicto.\(^\text{18}\) Nevertheless, in enacting section 10(b) of the Exchange Act, Congress did not foresee private actions under the antifraud rules promulgated under that section and there are few congressional guidelines defining the perimeters of a private right of action under rule 10b–5.\(^\text{19}\) At times the courts have paid close attention to the specific language of the rule to narrow its impact. For example, in *Blue Chip Stamps v. Manor Drug Stores*\(^\text{20}\) the Supreme Court held under § 17(a). Although § 11(a) covers pure omissions, § 11 liability is limited to misrepresentations in the registration statements covering the purchased securities. Rule 15c1–2 is similarly limited to misrepresentations by brokers or dealers. See 1 A. Bromberg, *supra* note 9, at § 2.5(4).


17. *Royal Air Prop., Inc. v. Smith*, 312 F.2d 210 (9th Cir. 1962). Waiver is the intentional or voluntary relinquishment of a known legal right. Estoppel arises when one is precluded from asserting a right because of previous actions which were inconsistent with that right. Laches occurs when the plaintiff fails to prosecute his claim within a reasonable period. See Note, *Applicability of Waiver, Estoppel, and Laches Defenses to Private Suits Under the Securities Act and S.E.C. Rule 10b–5: Deterrence and Equity in Balance*, 73 Yale L.J. 1477 n.7 (1964).

18. The in pari delicto defense may be raised by the defendant when the plaintiff has also violated rule 10b–5. See *Woolf v. S.D. Cohn & Co.*, 515 F.2d 591 (5th Cir. 1975); *Kuehnert v. Texstar Corp.*, 412 F.2d 700 (5th Cir. 1969). *Contra*, *Nathanson v. Weis, Voisin, Cannon, Inc.*, 325 F. Supp. 50 (S.D.N.Y. 1971).

19. Courts have relied on the express liability sections of the securities laws to describe the scope of the implied private right of action under rule 10b–5. See section III B infra.

that the "in connection with the purchase or sale of any security" requirement of rule 10b-5 limited the class of potential plaintiffs to those who were either purchasers or sellers of a security. More frequently, because the language of rule 10b-5 is not specific, the courts are forced to develop their own standards for private recovery under the rule.21

These standards generally take the form of specific elements which a plaintiff must plead and prove.22 In order to invoke the private remedy of rule 10b-5 the plaintiff must first establish the materiality of the information which was not properly disclosed.23 The Supreme Court has held: "An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in [making his decision]."24 The test of materiality is, therefore, an objective one.25 In some situations this results in an affirmative obligation to disclose information which a reasonable and prudent person might consider pertinent to an investment choice.26 Conversely, the materiality element precludes recovery where the plaintiff could not reasonably contend that the misrepresentation, half-truth, or omission played or would have played an important role in his investment decision.

Once the plaintiff has established that the defendant has misrepresented material information, he must demonstrate actual (subjective) reliance.27 As stated by one court, the purpose underlying proof of

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21. The Supreme Court pointed out in Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1974), that: "[W]e are dealing with a private cause of action which has been judicially found to exist, and which will have to be judicially delimited one way or another unless and until Congress addresses the question." Id. at 749.
22. Dupuy v. Dupuy, 551 F.2d 1005, 1014 (5th Cir. 1977).
26. See Rochez Bros., Inc. where the court explained: "Materiality . . . provides the basis for defendant's duty to disclose . . . ." 491 F.2d at 410.

There is a parallel between reliance and materiality. Reliance is a question of whether the individual plaintiff acted upon the fact misrepresented. Materiality requires that a reasonable man would have attached importance to the fact. 340 F.2d at 462-63. Some courts have merged the two elements and measured the plaintiff's conduct against that of a reasonable man with the attributes of the plaintiff. See Frigitemp Corp. v. Financial Dynamics Fund, 524 F.2d 275 (2d Cir. 1975); City Nat'l Bank v. Vanderboom, 422 F.2d
reliance is "to certify that the conduct of the defendant actually caused the plaintiff's injury." Not only must the plaintiff prove actual reliance, but he must also establish that his reliance was justifiable under the circumstances. A court may properly conclude that the plaintiff caused his own injury where his conduct is shown to be utterly unreasonable, or reckless in light of the circumstances surrounding the transaction. In these cases the court will consider evidence such as the plaintiff's business acumen, his access to information and his familiarity with the affairs of the corporation to determine whether the plaintiff acted in a reckless manner. In extreme cases, where the plaintiff had no right to rely, recovery will be denied. For example, there can be no justifiable reliance on information which is patently false.

Both actual and justifiable (objective) reliance are necessary elements of a 10b-5 claim based on misrepresentation, but the Supreme Court has indicated that proof of reliance is not a prerequisite for recovery where the defendant has failed to disclose material facts.
Requiring a plaintiff to show reliance on an omission poses serious conceptual problems. Although concealing the information may have affected the plaintiff’s investment decision, the plaintiff could not argue that he relied upon the omission because the information was unknown at the time of the transaction. To eliminate this difficulty, courts have created the concept of presumed or constructive reliance, an objective standard, in omission cases. Once materiality of the omitted fact is demonstrated, and constructive reliance is established, the burden of disproving the plaintiff’s actual or subjective reliance shifts to the defendant.\textsuperscript{35}

In addition to the elements which the plaintiff must plead and prove, or which the court presumes—materiality, reliance, and justifiable reliance—many courts have suggested that the plaintiff must also exercise due care in order to recover under rule 10b–5.\textsuperscript{36} The standard against which the plaintiff’s due care has been measured is one of simple negligence.\textsuperscript{37} Therefore, in cases where both parties acted negligently, the plaintiff may be precluded from recovery because he failed to conduct an investigation which would have revealed the defendant’s misrepresentation.\textsuperscript{38}

Some courts have purportedly adopted the due care requirement, yet do not require the plaintiff to exercise the care of a reasonable man in all circumstances.\textsuperscript{39} For example, a plaintiff who actually relied on a misrepresentation has recovered, notwithstanding his failure to investigate, where the deception was caused by one who owed a fiduciary obligation to him. In this situation, justifiable reliance on a trust relationship cuts off the plaintiff’s individual obligation to exercise due care.\textsuperscript{40} Once justifiable reliance is proven, where a fiduciary relationship is involved, there is no need to establish due care. Since justifiable reliance is terminated only upon a showing that the plaintiff acted recklessly, presumably the plaintiff may be negligent and still justifiably rely on the defendant’s statements. Therefore, where the plaintiff


\textsuperscript{36} See, e.g., Dupuy v. Dupuy, 551 F.2d 1005 (5th Cir. 1977); Holdsworth v. Strong, 545 F.2d 687 (10th Cir. 1976), cert. denied, 430 U.S. 955 (1977); Straub v. Vaisman & Co., 540 F.2d 591 (3d Cir. 1976); Clement A. Evans & Co. v. McAlpine, 434 F.2d 100 (5th Cir. 1970), cert. denied, 402 U.S. 988 (1971); Myzel v. Fields, 386 F.2d 718 (8th Cir. 1967).

\textsuperscript{37} See note 4 supra.

\textsuperscript{38} See note 27 supra.

\textsuperscript{39} See note 36 supra.

\textsuperscript{40} Holdsworth v. Strong, 545 F.2d 687, 696–97 (10th Cir. 1973), cert. denied, 430 U.S. 955 (1977).
has shown justifiable reliance his claim should not falter on the element of due care which looks only to simple negligence.

The due care requirement has not been universally accepted by the courts. Moreover, some of the decisions which purport to impose a duty of due care did so only in situations where the information the plaintiff lacked was not material to the transaction. The analysis of the plaintiff's conduct in these cases is curious in light of the fact that those courts found no violation of rule 10b–5. Other courts have required the plaintiff to prove due care only where the defendant's misstatement was negligently made. The due care requirement can then be defended as a doctrine of contributory negligence counter-balancing the low burden on the plaintiff to show only the defendant's negligence. However, the vitality of the due care requirement is now in doubt because the private plaintiff must show the defendant acted with scienter to recover under rule 10b–5.

In Ernst & Ernst v. Hochfelder, customers of a brokerage firm were induced by its president to invest funds in escrow accounts that he represented to be profitable investments. In reality, no escrow accounts were ever established, and the president converted the funds to his personal use. The customers brought an action against the accounting firm of Ernst & Ernst, alleging that it "had failed to utilize

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41. See, e.g., Colvin v. Dempsey-Tegeler & Co., 477 F.2d 1283, 1287, 1289 (5th Cir. 1973) (contributory negligence of plaintiff does not bar action per se); Carroll v. First Nat'l Bank, 413 F.2d 353, 358 (7th Cir. 1969) (contributory negligence not an issue at pleading stage, "whatever [its] relevance" at trial); Myzel v. Fields, 386 F.2d 718, 736 (8th Cir. 1967).


43. See notes 115–19 infra and accompanying text.


'appropriate auditing procedures' in its audits' of the brokerage firm's books and records, thereby aiding and abetting the fraudulent escrow scheme. The customers did not allege fraud or intentional misconduct but based their claim on a negligence theory. Concluding that the allegation of negligent conduct did not state an implied, private cause of action under rule 10b–5, the Supreme Court explained: "The words 'manipulative or deceptive' used in conjunction with 'device or contrivance' strongly suggest that § 10(b) was intended to proscribe knowing or intentional misconduct." Thus, "§ 10(b) was addressed to practices that involve some element of scienter and cannot be read to impose liability for negligent conduct alone." Keeping in mind that the underlying rationale of the Exchange Act is to protect investors from fraud in the securities markets, and in light of the Hochfelder decision restricting private recovery under rule 10b–5 to schemes in which the defendant acted with scienter, the requirement that the victim of deceptive conduct exercise due care in detecting the offender's fraud has been rendered indefensible, a proposition demonstrated in the following section.

II. PLAINTIFF'S DUE CARE REQUIREMENT AFTER HOCHELFER

Since Hochfelder was decided, a number of courts have reevaluated the due care requirement. In Straub v. Vaisman, members of the plaintiff class purchased stock through the defendant brokerage firm, and less than a month after the purchase the corporation filed a Chapter XI bankruptcy. On several prior occasions Straub had purchased securities through the firm on the recommendations of its agent. The plaintiffs sued for rescission under rule 10b–5 alleging, inter alia, that as financial adviser to the insolvent corporation the brokerage firm had inside information about the imminent bankruptcy.

47. Id. at 190.
48. Id. at 197.
49. Id. at 201. In a footnote the Court refrained from deciding whether proof of recklessness would establish scienter.

In this opinion the term "scienter" refers to a mental state embracing intent to deceive, manipulate, or defraud. In certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act. We need not address here the question whether, in some circumstances, reckless behavior is sufficient for civil liability under § 10(b) and Rule 10b–5.

51. 540 F.2d 591 (3d Cir. 1976).
The district court found that this nondisclosure of material information constituted an intentional violation of rule 10b–5.\textsuperscript{52} On appeal the firm contended that the plaintiff class should have lost because their representative, a sophisticated investor,\textsuperscript{53} failed to exercise due care prior to the purchase. (Apparently he had neither investigated the financial status of the corporation nor demanded a prospectus.) Such inquiry, the defendant argued, would have disclosed the stock's true value.

The Third Circuit recognized the plaintiff's lack of due care as an affirmative defense. However, the standard imposed was a flexible one, requiring only that the "plaintiff act reasonably."\textsuperscript{54} The court reasoned that the standard must be set in light of such factors as "fiduciary relationship, opportunity to detect the fraud, sophistication of the plaintiff, the existence of longstanding business or personal relationships, and access to the relevant information."\textsuperscript{55} Applying this test to the facts, the court concluded that a sophisticated investor such as the plaintiff might reasonably rely upon the honesty of the firm since "[i]ntegrity is still the mainstay of commerce and makes it possible for an almost limitless number of transactions to take place without resort to the courts."\textsuperscript{56} The Third Circuit hedged in its decision. It was wary of the defendant's attempt to escape liability despite the intentional scheme to defraud, yet it was cognizant that the due care requirement was accepted among courts and commentators as a means of encouraging investor caution.\textsuperscript{57} Therefore, the court chose a flexible, case by case approach to intentional fraud situations.

\textsuperscript{52} Id. at 594. The district court also found that the brokerage firm's president and sole shareholder held a controlling interest in the investment company whose shares were purchased; that the president was an officer and consultant of the investment company; that the defendant firm was a market maker in the insolvent investment company's shares; and that the market price at the time of sale was less than the price the plaintiff had paid. Id.

\textsuperscript{53} Straub was the managing director of a portfolio management firm which handled discretionary securities accounts. Id.

\textsuperscript{54} Id. at 598.

\textsuperscript{55} Id.

\textsuperscript{56} Id. The court also found that since the plaintiff did not have access to information concerning the corporation's plan to declare bankruptcy and the transaction took place during the Christmas holiday season, which afforded little opportunity for investigation, lack of due care was not established. Id.

The fundamental problem with this flexible approach to the due care requirement is contained within its definition. The duty of care increases in direct proportion to the level of the individual investor's business sophistication. By varying the standard according to factors such as the plaintiff's business acumen or access to material information, the court is, in effect, encouraging potential violators to vary their disclosure depending on the relative knowledge and sophistication of their victims. This approach conflicts with one of the purposes underlying rule 10b-5—that every investor should have equal access to financial information. Moreover, if the standard of disclosure varies according to the attributes of the particular investor, the SEC enforcement mechanisms based on structured disclosure would break down because there would no longer be a single standard by which to measure statutory compliance.

Despite the retention of the due care requirement in Straub, it would be a rare occasion when a defendant who intentionally misrepresented or failed to disclose material information would escape liability under this flexible due care standard. Recovery would certainly be granted where there was a fiduciary relationship between the parties, as there is in the vast majority of securities transactions, because reliance on a relationship of trust is reasonable. Only in those few cases where the plaintiffs are corporate insiders or where the plaintiffs have had complete access to information in an arm's length transaction, could lack of due care be urged successfully. The court in Straub also made the plaintiff's case easier by placing the burden on the defendant to establish the plaintiff's negligence. For this reason, it can be argued that the due care requirement emerged from Straub as only a shadow of its former self.

In the Tenth Circuit decision, Holdsworth v. Strong, what remained of the due care requirement disappeared. In Holdsworth, the plaintiff and defendant, who were close friends, formed a corporation with a third party, issuing an equal number of shares to the parties and their wives. While it was contemplated that everyone would participate in the management of the corporation, the defendant soon assumed complete control. The corporation was eventually reorganized and the defendant became the majority shareholder. Several years later, the

58. See Texas Gulf Sulphur Co., where the court stated: "Rule [10b-5] is based in policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information . . . ." 401 F.2d at 848.

59. For a discussion of the fiduciary relationship in rule 10b-5 private actions, see notes 96-105 infra and accompanying text.

60. 545 F.2d 687 (10th Cir. 1976), cert. denied, 430 U.S. 955 (1977).
defendant notified the plaintiff husband that the corporation had invaded its capital when the last dividends were issued and that no future dividends would be paid. In the same communication the defendant offered to purchase the plaintiffs' interest in the corporation. In an action for rescission, it was established that the defendant induced the plaintiffs to sell their securities to him on the basis of intentional misrepresentations and omissions. The defendant had misstated the stock's value at the time of the transaction and had failed to disclose to the plaintiffs that he had diverted surplus funds from the corporation to himself and other members of his family. The defendant argued that the plaintiff husband, who was an officer and director of the corporation and an attorney and accountant as well, had failed to exercise due care in selling his shares.

Initially, the Tenth Circuit noted that, while it may be reasonable to hold the plaintiff to a due care standard in situations where the defendant would be subject to liability for negligent conduct, no rational purpose was served by imposing such a burden on the plaintiff where intentional fraud had been established. The court then reassessed the due care requirement in light of Hochfelder. The court reasoned that if the plaintiff must prove intentional misconduct on the part of the defendant and the defendant were permitted to defend on the basis of the plaintiff's negligence, then the private rule 10b–5 remedy would be severely limited. To prevent such a result, the court analogized to the common law action of deceit and resolved that the plaintiff is not obligated to inquire into the validity of an intentional misrepresentation, except in rare circumstances. Later in the opinion the court attempted to define those rare circumstances, stating, "a plaintiff may not reasonably or justifiably rely on a misrepresentation where its falsity is palpable." At the same time the court opted to retain the due care requirement, concluding, "[i]f contributory fault of plaintiff is to cancel out wanton or intentional fraud, it ought to be gross conduct somewhat comparable to that of defendant."

Under this approach due care could be used to preclude recovery

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61. The defendant indicated the corporation was unable to pay dividends, but the evidence indicated that the corporation actually had a gross income exceeding $100,000 in the year of the misstatement. Holdsworth v. Strong, 545 F.2d 687, 690 (10th Cir. 1976), cert. denied, 430 U.S. 955 (1977).
62. Analyzing the negligence-intent standard distinction, the court stated: The circuits which have imposed the due diligence requirement have done so in the context of the application to the defendant of a negligence standard . . . [however] where liability requires proof of intentional misconduct, the exaction of a due diligence standard from the plaintiff becomes irrational and unrelated. 545 F.2d at 692.
63. Id. at 694.
64. Id. at 693.
only in cases where the plaintiff acted recklessly, in total disregard of an obvious falsity. However, the standard by which due care is measured is negligence. Justifiable reliance is the element which is defeated in extreme cases such as those involving a patent falsity. It is the plaintiff’s failure to prove that the defendant actually caused harm to the plaintiff which bars recovery in the rare case, and not the failure to exercise due care. A reckless plaintiff who fails to open his eyes to the obvious will be precluded from relief regardless of whether he undertook an investigation.

The *Holdsworth* court concluded that the plaintiff had proven that his reliance on the defendant’s misrepresentations was justifiable under the circumstances. Although the plaintiff was a sophisticated investor as well as a corporate insider, it was reasonable for him to rely on the defendant’s statements because the friendship between the parties was so close as to be “quasi fiduciary.” Once the plaintiff has proven actual reliance and that his reliance was not utterly unreasonable under the circumstances, he will recover even though he negligently failed to undertake reasonable precautions for his own protection.

While the Tenth Circuit in *Holdsworth* did not expressly abrogate the due care requirement, it accomplished the same result through implication. The court conceded that the due care requirement may be imposed where the plaintiff is grossly negligent in failing to recognize a patently false misrepresentation. This scenario, however, should be analyzed as a failure on the part of the plaintiff to establish justifiable reliance, rather than a failure to exercise due care. Once the plaintiff has established justifiable and actual reliance on a material misrepresentation, the plaintiff is under no duty of inquiry. It follows, then, that in a material omission case where reliance is presumed, due care should not be a required element. The *Holdsworth* decision has, in effect, eliminated the due care requirement for cases in which a defendant has intentionally defrauded his victim.

In *Dupuy v. Dupuy*, a case decided after *Holdsworth*, the Fifth Circuit had an opportunity to reevaluate the due care requirement in a suit involving omissions as well as misrepresentations. The court found that the plaintiff’s brother, who was his business partner, had intentionally induced the plaintiff to sell his stock in a closely held land development corporation without disclosing that the corporation had recently entered into a financing agreement with an outsider. The financing significantly increased the value of the venture property. The brother also understated the property’s worth. The defendant argued

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65. *Id.* at 696–97.
66. 551 F.2d 1005 (5th Cir. 1977).
that his brother had failed to exercise due care: as an insider he could have made an independent investigation of the shares' value and verified the defendant's statement. Finding no distinction between misrepresentations and omissions, the court purported to adopt a due care requirement—separate from the elements of materiality and reliance. First the court noted that general principles of tort law disallow the contributory negligence defense where the defendant's fraud was intentional. Second, investor protection—the basic objective of the federal securities laws—is thwarted if the plaintiff’s burden of care is greater than that on the defendant. Accordingly, the court rejected a negligence standard which would have gauged the plaintiff’s conduct against that of a reasonable and prudent person with the plaintiff’s characteristics, and opted for a recklessness standard, stating: "The Court should ask whether [plaintiff] intentionally refused to investigate in disregard of a risk known to him or so obvious that he must be taken to have been aware of it, and so great as to make it highly probable that harm would follow." The court found that the plaintiff did not know that the corporation would be receiving new financing.

By equating lack of due care with intentional or reckless disregard of a known risk or an obvious falsity, the Dupuy court makes the same mistake as the Holdsworth court: the minimum measure of due care is negligence not recklessness. Finding that the plaintiff acted in a reckless manner would bar recovery because his reliance was unjustifiable. The additional question, whether the reckless plaintiff searched for the omitted information, need not be addressed. Therefore, the court could not have established an affirmative due care requirement in Dupuy.

In McLean v. Alexander, a case decided after Straub but before the Holdsworth opinion was reported, the Delaware District Court determined whether reckless misrepresentations by a defendant could be redressed by a private action under rule 10b-5, a problem left open by the Supreme Court in Hochfelder. In McLean, a highly sophisticated investor was induced to purchase stock in a closely held corporation for an inflated price partially on the basis of misrepresentations concerning the marketability of the company’s product and the opinion of an accountant who reported that certain accounts receivable were "considered fully collectible." The court first determined that reckless preparation of the audit by the accountant was within the scope of the Hochfelder scienter standard. The court’s approach to the due care requirement was similar to the flexible case by case

67. Id. at 1020.
69. Id. at 1077.
70. Id. at 1080-84.
method employed by the Third Circuit in Straub.\textsuperscript{71} The plaintiff's duty to scrutinize the defendant's statements varied with the plaintiff's level of business sophistication. The court recognized that in light of Hochfelder, the validity of the due care requirement as it applied to intentional misconduct cases was being openly challenged,\textsuperscript{72} but in McLean the defendant's conduct was reckless, not intentional, thus the court concluded that there is "a wide spectrum of prohibited behavior between negligence and specific intent to defraud. In that uncharted land of knowing and reckless misconduct, defendant should be entitled to contest liability by asserting a due diligence defense."\textsuperscript{73} The defense failed in McLean because the court concluded that the plaintiff could justifiably rely on the corporate records without having to verify an independent financial audit. This analysis is incorrect. Once justifiable reliance is established, the obligation of due care is extinguished. Therefore, it can be said that the due care requirement has been eliminated since one may justifiably rely on a reckless statement and still be negligent.

In a subsequent case, Sundstrand Corp. v. Sun Chemical Corp.\textsuperscript{74} the plaintiff established at trial that certain defendants had either deliberately or recklessly misrepresented the earnings record of a corporation and thereby induced the plaintiff to enter into a stock option transfer agreement. In considering the liability of the defendants, the Seventh Circuit concluded that the defendants' reckless conduct was within the boundaries of the scienter requirement announced in Hochfelder. The court summarily rejected the defendants' argument that the plaintiff had failed to exercise due care, determining that such a defense was not available. While the court stated that the due care defense could not be raised "in an intentional fraud case,"\textsuperscript{75} since the decision's alternative basis was reckless conduct on the part of the defendants, the court seems to suggest that the due care requirement is similarly inapplicable in the latter context. The plaintiff had only to prove materiality and reliance to establish a causal connection between the misrepresentation and its injury in order to recover.\textsuperscript{76}

\textsuperscript{71} Id. at 1078.
\textsuperscript{72} Id. (citing Straub v. Vaisman, 540 F.2d 591 (3d Cir. 1976)).
\textsuperscript{73} Id.
\textsuperscript{74} 553 F.2d 1033 (7th Cir. 1977).
\textsuperscript{75} Id. at 1040.
\textsuperscript{76} Hirsch v. du Pont, 553 F.2d 750 (2d Cir. 1977), is the only decision since Hochfelder that has suggested that the due care requirement has continuing vitality. However, because the case did not involve an intentional or reckless violation of rule 10b-5, its impact should be limited. In Hirsch, purchasers of partnership interests sued the New York Stock Exchange and an accounting firm claiming that they had failed to disclose financial information concerning a brokerage firm in which the plaintiffs had
What can be said, therefore, about the plaintiff's due care requirement since Hochfelder, is that although the courts are generally unwilling to repudiate the due care requirement entirely, they have not required private plaintiffs to establish due care to recover in actions under rule 10b-5. Those courts nominally retaining the due care requirement are applying it in a manner that suggests it is becoming synonymous with justifiable reliance. This creates a potential analytical problem.

III. STATUTORY ANALYSIS AND THE DUE CARE REQUIREMENT

A. The Common Law Tort Analogy to Private Actions Under Rule 10b-5

The Supreme Court pointed out in SEC v. Capital Gains Research Bureau, Inc. that under the securities laws the principles of common law actions for fraud and deceit should not be applied "technically" as [they had] traditionally been applied in damage suits between parties to arm's-length transactions involving land and ordinary chattles" but rather "remedially as the courts had adapted [them] to the prevention of fraudulent securities transactions by fiduciaries." In reaching this conclusion, the Court noted that the

invested. The Second Circuit found that neither defendant owed the plaintiffs a duty to disclose that the brokerage firm once had a capital deficiency which it cured by selling long-term securities. In dicta, the court indicated that the plaintiffs, because of their status as sophisticated investors and their access to financial information, should have made a more thorough investigation of the firm's financial structure. The court handled the due care requirement in a cursory fashion. Moreover, the court intimated that the plaintiffs had actual knowledge of the financial information. Therefore, the opinion is not especially compelling concerning the due care requirement in the context of intentional fraud.

78. 54 Stat. 582, as amended by 15 U.S.C. § 80b-6 (1970). Although Capital Gains was an action brought under the Investment Advisers Act of 1940, the reasoning applies equally well to 10b-5 actions because the 1940 act contains clauses (a) and (c) of rule 10b-5.
79. 375 U.S. at 194-95. For the proposition that rule 10b-5 is broader than common law tort actions, see Herpich v. Wallace, 430 F.2d 792, 802 (5th Cir. 1970) ("Together the section and the rule aim at reaching 'misleading or deceptive activities, whether or not they are precisely and technically sufficient to sustain a common law action for fraud and deceit.' " (quoting Cady, Roberts & Co., 40 S.E.C. 907 (1961)); Kohler v. Kohler Co., 319 F.2d 634, 637 (7th Cir. 1963). Professor Bromberg has stated: [E]lements like scienter, (including both knowledge of falsity and intent to deceive), justifiable reliance, and causation have been difficult for plaintiffs in securities cases [under the common law]. And nondisclosure cases have rarely been actionable.

When it turned its attention to securities legislation, Congress plainly expressed its wish that injured investors have an easier time. . . . [Therefore, rule] 10b-5 and the other federal fraud provisions are not limited to common-law fraud.

common law actions of fraud and deceit, as they had developed around transactions involving land and tangible personality, were "ill-suited to the sale of such intangibles as . . . securities." Nevertheless, courts have drawn analogies to common law and equitable fraud theories for the purpose of delineating the scope of rule 10b-5. For instance, the Supreme Court in *Hochfelder* construed the words "manipulative," "deceptive," "device" and "contrivance" as requiring a showing of scienter on the part of the defendant in a private action under rule 10b-5. Scienter is an element of an action for intentional misrepresentation or deceit at common law. The precedent value of common law principles in rule 10b-5 private actions is also evident in both the *Straub* and *Holdsworth* opinions.

Because the courts have relied heavily on common law principles to shape the boundaries of rule 10b-5, they should be helpful in evaluating the viability of the due care requirement where the defendant has intentionally violated the rule. The American Law Institute, when it revised the Restatement of Torts, came out resolutely against imposing a due care requirement on the plaintiff. It rejected a pro-

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80. 375 U.S. at 194.
82. According to the late Dean Prosser, the elements of an action at law for deceit are:

1. A false representation made by the defendant. . . .
2. Knowledge or belief on the part of the defendant that the representation is false—or, what is regarded as equivalent, that he has not a sufficient basis of information to make it. This element is given the technical name of "scienter."
3. An intention to induce the plaintiff to act or to refrain from action in reliance upon the misrepresentation.
4. Justifiable reliance upon the representation on the part of the plaintiff, in taking action or refraining from it.
5. Damage to the plaintiff, resulting from such reliance.


83. 540 F.2d at 597 ("Although not determinative, the common law torts of misrepresentation and deceit are relevant in interpreting Rule 10b-5.").
85. The ALI decided to adhere to the existing Restatement, subject to editorial changes. *See* 42 ALI PROCEEDINGS 331 (1965). The Restatement provides: "[T]he recipient in a business transaction of a fraudulent misrepresentation of fact is justified in relying upon its truth, although he might have ascertained the falsity of the representation had he made an investigation." *Restatement of Torts* § 540 (1938).

Comment a to § 540 contains a factual example which departs from the position of a number of courts by tying due care to the plaintiff's access to material information or constructive knowledge. A defendant who misrepresented his financial condition cannot
posed revision which would have barred a plaintiff from recovery in a deceit action if "he knows or has reason to know of facts which make his reliance unreasonable." The Institute refused to hold the victim of an intentional deceit to the standard of a reasonable man of ordinary prudence and thereby allow the defrauder to escape liability. They rejected the revision because it amounted to allowing a contributory negligence defense to an intentional tort.

The drafters of the new Contracts Restatement adopted the position of the Restatement Second of Torts concerning the due care requirement where the plaintiff is bringing an action for avoidance or reformation of a contract. Moreover, the rules apply to innocent as well as to fraudulent misrepresentations. If these common law principles are to be applied remedially and flexibly, an imposition of a duty of inquiry should not be imposed in an action under rule 10b–5, particularly where there has been an intentional violation.

86. RESTATEMENT (SECOND) OF TORTS § 540 (Tent. Draft No. 11, 1965). Note that this standard would only protect a plaintiff who is negligent in failing to discover the misrepresentation or omission. Where the plaintiff is misled by a patent falsity, he will still be denied recovery under common law principles. See Seeger v. Odell, 18 Cal. 2d 409, 115 P.2d 977 (1941); Bean v. Bickley, 187 Iowa 689, 174 N.W. 675 (1919); Ellis v. Newbrough, 6 N.M. 181, 27 P. 490 (1891); RESTATEMENT (SECOND) OF CONTRACTS § 341, Comment b (Tent. Draft No. 11, 1976); RESTATEMENT (SECOND) OF TORTS § 541 (Tent. Draft No. 10, 1964). The doctrine that a plaintiff may not rely on that which is so preposterous as to defy credulity is followed by the federal courts in rule 10b–5 private actions. See, e.g., Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90 (10th Cir.), cert. denied, 404 U.S. 1004 (1971); City Nat'l Bank v. Vanderboom, 422 F.2d 221 (8th Cir.), cert. denied, 399 U.S. 905 (1970).

87. 42 ALI PROCEEDINGS 322–31 (1965). According to Dean Prosser, the reporter in favor of the revision, the change did not even require due care. Rather, in those few cases where "red flags" appear, reliance would not be reasonable.

88. The drafters address due care in two chapters in the RESTATEMENT (SECOND) OF CONTRACTS; the two formulations vary little. In Mistake, the mistaken party to a contract will not be denied recovery unless his fault amounts to a failure to act in good faith and in accordance with reasonable standards of fair dealing." RESTATEMENT (SECOND) OF CONTRACTS § 299 (Tent. Draft No. 10, 1975). In Duress and Undue Influence, a recipient's failure to investigate will not make his reliance unjustified unless he failed under the same good faith standard described above. RESTATEMENT (SECOND) OF CONTRACTS § 314 (Tent. Draft No. 11, 1976).


90. The actions of avoidance and reformation evolved from the equitable remedy of rescission which the Chancery Courts developed in response to the restrictive legal action of deceit. The remedy of rescission could be based on innocent misrepresentation whereas its legal counterpart required a showing of intent to defraud. W. PROSSER, supra note 82, at 687.
The due care requirement appears even less viable in light of the major policy considerations underlying rule 10b-5. In *Capital Gains*, the Supreme Court pointed out that a fundamental purpose, common to all the federal securities laws, "was 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." Thus, Congress required full and fair disclosure to the public to insure that investors have the opportunity to make intelligent decisions. The imposition of a due care requirement does not foster full disclosure, nor does permitting a defendant to escape liability because the plaintiff failed to exercise due care promote a high standard of business ethics. This contradiction becomes more apparent when the due care requirement is used, as a matter of equitable discretion, to preclude recovery for victims of intentional misconduct. Mr. Wheeler has argued that "the central principle of equity—equitable relief will be denied when the plaintiff himself has not done equity—offers policy support for denying recovery to a 10b-5 plaintiff who has failed to exercise due care." A few courts have adopted this reasoning, one noting that equitable use of the due care requirement would "promote statutory policies encouraging investor diligence in the interest of the efficiency and stability of the securities market." This is a questionable line of reasoning; a search of the legislative history of the Securities Act and the Exchange Act does not reveal a congressional concern for deterring negligent conduct by investors. Rather, congressional debate centered on promoting a fair securities market by providing redress for fraudulent practices.

Another important factor undercuts the argument for imposing a due care requirement on plaintiffs in 10b-5 actions. Rule 10b-5 is aimed largely at deceptions by brokers and other "fiduciaries" who take advantage of inside information. The fiduciary relationship—be

92. Id. at 186.
95. See S. REP. No. 792, 73d Cong., 2d Sess. 12-13 (1934); H.R. REP. No. 1383, 73d Cong., 2d Sess. 10-11, 20-21 (1934).
it between a broker, corporate officer, director, or principal stockholder and an investor which rule 10b-5 seeks to protect—requires the fiduciary to demonstrate a special degree of care for the beneficiary. At common law the fiduciary is obligated not only to state information truthfully, whether fact or opinion, but also to disclose all material facts to his beneficiary. In addition, in situations where a fiduciary relationship exists, common law fraud may be established without proof of reliance or even a right to rely. Fraud may be established even though the plaintiff lacked ordinary prudence. Under the securities laws even these lenient elements have been relaxed. The Supreme Court has noted that "[i]t is not] necessary in a suit [under the Investment Advisers Act of 1940] against a fiduciary . . . to establish all the elements required in a suit against a party to an arm's length transaction." This principle should apply equally in transactions arising under the Exchange Act. The fiduciary relationship of trust and confidence between plaintiff and defendant was recognized as an important factor in restricting the due care requirement in both Holdsworth and Straub. Therefore, especially in cases involving a relationship of trust or confidence or a fiduciary relationship—which constitute the vast majority of rule 10b-5 civil litigation—the propriety of the due care requirement is open to question.

B. Due Care and the Express Remedy Provisions of the Federal Securities Laws

An analysis of the express civil remedies provided in the federal

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 stockholders, 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. Some courts have called this a fiduciary duty.

Id. at 828–29 (emphasis added).


104. 545 F.2d at 696–97. See text accompanying note 65 supra.

105. 540 F.2d at 598 (knowing that plaintiff had confidence in its agent the defendant brokerage firm abused that trust).
securities laws also illustrates the impropriety of imposing a due care requirement in intentional fraud cases under rule 10b-5. Eight sections of the securities laws create or condition private remedies for misconduct—ranging from negligent to intentional or reckless conduct. In these statutes, Congress narrowly defined the conduct which would preclude a plaintiff's recovery. For example, section 12(2) of the Securities Act, which imposes civil liability for a false or misleading prospectus or oral communication (negligently or intentionally made), bars recovery where the plaintiff purchaser knew of the untruth or omission. Section 9(e) of the Exchange Act, which prohibits intentional manipulative conduct in connection with puts, calls, options or straddles, makes no mention of a plaintiff's knowledge defense. Apparently Congress intended to surpass common law remedies by allowing recovery even where the plaintiff had notice of the manipulative conduct.

While most of these sections would bar a plaintiff who knows of the untruth or omission (and some require a showing of reliance or damage causation in fact), Congress never imposed a due care burden on plaintiffs seeking recovery for intentional misconduct. Although private rights of action under rule 10b-5 are judicial creations, courts have looked to the express civil remedies to help determine the limits of relief in implied actions, and imposing a due care burden in an implied civil remedy case runs contrary to the express liability provisions of the securities laws.

IV. PLAINTIFF'S DUE CARE REQUIREMENT BEFORE HOCHFELDER

Prior to Hochfelder some courts established a due care require-

111. Defining the statute of limitations for actions under §§ 11 or 12(2) of the Securities Act, 15 U.S.C. §§ 77k, 77l (1970), Congress created a "due diligence" requirement. A plaintiff will be barred from recovery one year "after . . . discovery [of the untrue statement or omission] should have been made by the exercise of reasonable diligence . . . ." Securities Act § 13, 15 U.S.C. § 77m (1970). This due care requirement in § 13 has no relation to the due care requirement which is the subject of this Note. The former obligation is imposed on the plaintiff after the transaction, while the latter must be exercised before the transaction.
ment, apparently to counterbalance the plaintiff's relatively low burden of proving negligent conduct or constructive knowledge on the part of the defendant as a basis for recovery under rule 10b–5.113 An analysis of the pre-Hochfelder cases involving an intentional violation of rule 10b–5 reveals that a failure to exercise due care has never barred a plaintiff from relief. The cases in which the courts have focused on the plaintiff's conduct are divided into three broad categories. In the first series of cases the defendants were innocent of violating rule 10b–5, in the second series the defendants had been merely negligent in their actions, and in the third series the defendants were guilty of intentional misconduct. It is only in the second series of cases that the purported due care requirement may have had some validity as a concept of contributory negligence, but the few cases which purport to impose a due care requirement are actually based on the principle that a plaintiff may not rely on that which he knows to be untrue, or that which is patently false.114

A. Plaintiff's Due Care Obligation Where Defendant Was Innocent of Wrongdoing

Many rule 10b–5 cases involve situations where the defendant has established that he had reasonable grounds to believe the plaintiff had knowledge of the undisclosed information. This negates the defendant's obligation to disclose and absolves him of liability. Kohler v. Kohler Co.115 illustrates this defense. The plaintiff seller alleged that insider-shareholders of the defendant corporation failed to disclose details of a pension plan accounting method which reduced the book value of the shares prior to their resale to the corporation. The Seventh Circuit found that the choice of accounting procedures was a good faith business decision. Moreover, the corporation was not obligated to inform the plaintiff of the accounting method employed because the plaintiff was an insider already on constructive and possibly actual notice of the practice since he participated in a directors meeting where

113. Professor Bromberg has stated this rationale:
   "It is noteworthy that the [8th, 9th, and 10th] circuits which have most clearly charged defendant with constructive knowledge or diligence are, by and large, the same courts that have similarly charged plaintiff. There is a logic and a balance in this. A high standard of conduct for defendant justifies a high standard for plaintiff. Stated a little differently, the price plaintiff pays for being relieved of the burden of proving defendant's intent or actual knowledge, is that plaintiff himself must show some diligence."

2 A. BROMBERG, supra note 79, at § 8.4. The court in Holdsworth cited this statement with approval. 545 F.2d at 692–93.

114. See text accompanying notes 128–41 infra.

115. 319 F.2d 634 (7th Cir. 1963).
the accounting procedures were discussed. The defendant's burden to disclose was formulated as follows:

On the one hand, corporate insiders must scrupulously disclose to outsiders those material facts about a corporation's business which in reasonable and objective contemplation might affect the value of the corporation's stock. On the other hand, they are not required to search out details that presumably would not influence the person's judgment with whom they are dealing.\(^{116}\)

Since the defendant in \textit{Kohler} was not under a duty to disclose, it could be argued that the plaintiff was obligated to investigate and his failure to exercise due care precluded his recovery. However, this reasoning is unsound because it does not conform to the proper analysis of a 10b–5 private action. The plaintiff must first prove that the defendant was under an obligation to disseminate accurate material information. Only after a duty has been established will the courts consider whether the plaintiff's conduct and reliance create the necessary causal nexus. It was the plaintiff's failure to prove that the defendant was obligated to inform him of the accounting procedures, and not a failure to exercise due care, which precluded the plaintiff's recovery.

The rule of reasonable information disclosure is not limited to dealings between corporate insiders. For example, corporate outsiders in \textit{Arber v. Essex Wire Corp.},\(^{117}\) alleged that they had been fraudulently induced by the president to sell their stock back to the defendant corporation. The claimed omissions included nondisclosure of the stock's book value which was substantially greater than the offering price, and information concerning earnings per share. The court found that the corporation was not under a duty to disclose this "routine" data since it was contained in the books and the records of the corporation which the plaintiffs knew to be readily available.\(^{118}\) On the other hand, the court indicated that this conclusion would not result where the information not disclosed is of an "unusual or extraordinary nature."\(^{119}\)

\(^{116}\) \textit{Id.} at 642.

\(^{117}\) 490 F.2d 414 (6th Cir. 1974).

\(^{118}\) \textit{Id.} at 420. \textit{Accord, Hafner v. Forest Labs., Inc.}, 345 F.2d 167, 168 (2d Cir. 1965) (Defendant insider not obligated to disclose where current price information "was available to the public in the National Daily Quotation Sheets."). \textit{See also} Johnson v. Wiggs, 443 F.2d 803 (5th Cir. 1971); St. Louis Union Trust Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 412 F. Supp. 45, (E.D. Mo. 1976).

\(^{119}\) 490 F.2d at 420. Without explanation or analysis a few courts have explicitly mentioned due care as a burden imposed upon the plaintiff in situations where the defendant was not obligated to make disclosures. For example, in \textit{Financial Indus. Fund, Inc. v. McDonnell Douglas Corp.}, 474 F.2d 514 (10th Cir. 1973), the purchaser claimed
B. Negligent Misrepresentations and Omissions by the Defendant

In cases where the defendant's negligent misrepresentation or omission has constituted an actionable violation of rule 10b-5, courts, at times, have resorted to notions of due care to bar a plaintiff's recovery. The use of due care as a form of contributory negligence in actions based on negligent misrepresentation or omission is understandable. At common law, a plaintiff had to demonstrate objective, reasonable reliance on a defendant's negligent misstatement in order to recover in an action for deceit.\(^{120}\) Thus, a few pre-\textit{Hochfelder} decisions indicated that where a reasonable man would have investigated a defendant's negligent conduct and the plaintiff had failed to do so, recovery should be denied.

The Second Circuit suggested this result in \textit{Frigitemp Corp. v. Financial Dynamics Fund}.\(^{121}\) The defendant mutual funds purchased convertible debentures from a corporation in which the plaintiffs were majority stockholders on the condition that the plaintiffs would contribute 100,000 shares of common stock to the corporation. The plaintiffs alleged that, at the time of the contribution, the defendants were engaged in a scheme to use inside information provided by the shareholders and to buy shares in such volume as to "artificially increase the market price."\(^{122}\) Moreover, the defendants failed to disclose they were buying a large number of shares on the open market prior to the debenture sale. The court required the plaintiffs to establish an intent to defraud and concluded that the defendant mutual funds had not knowingly manipulated the transaction. As to the omission, the court found that the funds were under no duty to disclose the market transactions because the shareholders had transfer sheets in

\footnotesize{that the defendant corporation had made a material omission by delaying the release of a special earnings statement. The court concluded the corporation was not obligated to disclose the earnings statement until sufficient information was available for an accurate release, and continued: "We have expressed the requirement that the plaintiff must also exercise good faith in its purchase, due diligence, and demonstrate reliance on the acts or inaction of the defendant." \textit{Id.} at 517 (emphasis added). The court failed to explain the relevance of due diligence to the specific facts of the case. Similarly, in \textit{Vohs v. Dickson}, 495 F.2d 607 (5th Cir. 1974), the court found that the defendant was not obligated to disclose certain financial matters about a corporation whose stock plaintiffs had purchased because the defendant had no knowledge of the information. The court then added that the "\{p\}laintiffs, too, were charged with a duty of reasonable investigation" which they satisfied by obtaining the company's annual report and discussing the transaction with one of the corporate officers. \textit{Id.} at 623. Language concerning the due care requirements is dicta since the defendants had not violated any duty to disclose.}

\(^{120}\) \textit{RESTATEMENT (SECOND) OF TORTS} § 552(A) (Tent. Draft No. 11, 1965).
\(^{121}\) 524 F.2d 275 (2d Cir. 1975).
\(^{122}\) \textit{Id.} at 281.
their possession showing the prior purchases. In dicta, the court noted that "even if we lower the requirement of scienter on the part of the defendant . . . his reasonable knowledge that the other party already had access to the facts should excuse him from new disclosures which reasonably appear to him repetitive." Although not binding, the dicta in Frigitemp Corp. is instructive as to the role of due care in negligent misconduct cases before Hochfelder. The defendant may be negligent in believing that the plaintiff has access to material information. In other words, an objective reasonable man would have believed that disclosure was inadequate. The opinion also suggests that some quantum of due care must be exercised by the plaintiff; a plaintiff who fails to investigate may be precluded from recovery by contributory negligence where the defendant is merely negligent.

In City National Bank v. Vanderboom, investors counterclaimed that an officer of the plaintiff bank had misrepresented the financial condition of the corporations in which they were interested and thus induced them to borrow money from the bank to purchase shares of the corporations. The district court established that because the officer's misrepresentation could not be imputed to the bank, the bank did not have knowledge of the alleged fraud, and that the bank acted in good faith in making the loans. Since the bank did not sell or offer to sell any security, the district court concluded that the investors lacked standing to sue under the "purchaser-seller" standing requirement of rule 10b–5. The Eighth Circuit affirmed the district court on the standing issue and added in dicta that the alleged negligent misrepresentations and nondisclosures by the bank were not covered by rule 10b–5. The investors claimed that the bank's president had silently acquiesced to the misrepresentations made by the other officer, and had advised them that the corporations were good investments even though the bank knew otherwise because of an independent audit of one of the corporations. The court found that the investors had access to the audit which was made for the corporation and not the bank. Therefore, the Eighth Circuit concluded that an objective reasonable investor, exercising due care, would not have relied on the president's representations. By requiring the plaintiff to demonstrate that he

123. Id. at 282.
125. Id. at 227.
126. Id. at 231. The court formulated the standard for actionable misrepresentations and omissions as follows:

With regard to misrepresentations, the question is whether a reasonable investor, in light of the facts existing at the time of the misrepresentation and in exercise of due care, would have been entitled to rely upon the misrepresentation. With regard to nondisclosures, the issue becomes whether a reasonable
exercised due care, the court balanced the bank's negligent conduct against the contributory negligence of the investors in failing to investigate the corporation's financial stability. In spite of the fact that Vanderboom has been cited for the proposition that a plaintiff has a due care obligation even where the defendant's misconduct was intentional, the opinion suggests that it should be limited to situations in which the defendant was negligent. The result in Vanderboom might very well have been different if the bank officer had intentionally misrepresented the financial condition of the corporations.

C. The Due Care Requirement in Intentional Fraud Situations

While the due care requirement has found some acceptance among the courts in the pre-Hochfelder negligence cases, where it can be analogized to contributory negligence, its application to intentional fraud cases is suspect. The following cases demonstrate that once an intentional violation of rule 10b-5 has been established, the imposition of a due care requirement was more the result of judicial confusion than careful legal analysis.

1. Cases Purporting to Require Due Care

The Eighth Circuit in Myzel v. Fields was the first court to ostensibly impose a due care burden on the plaintiff where the defendant intentionally violated rule 10b-5. Four plaintiffs were induced to sell their stock to the defendant by intentional misstatements and omissions including nondisclosure of a monthly financial statement showing a substantial profit. The defendant was a close friend of the plaintiffs and served as their financial adviser. The court had no difficulty permitting the three plaintiffs, who were outsiders of the corporation, to recover. The fourth plaintiff was sophisticated in financial matters and a member of the board of directors; the court noted that his reliance on the defendant's misrepresentations about the company's value taxed "even the most credulous of minds." This plaintiff "was in a position to investigate or to make an effort to inform himself as to the corporate values." He was on notice of facts which investor, in light of the facts existing at the time of the nondisclosure and in exercise of due care, would have been entitled to receive full disclosure... and would have acted differently had the alleged nondisclosure not occurred. Id. at 230 (emphasis added). Accord, Lane v. Midwest Bancshares Corp., 337 F. Supp. 1200 (E.D. Ark. 1972).


129. Id. at 736.

130. Id.
would have been disclosed in the corporate books and at directors
meetings. However, the court found other misrepresentations on which
the fourth plaintiff could justifiably rely. The defendant’s brother had
informed the plaintiff that the defendant was “going to get out” of the
company because the corporation was on the verge of bankruptcy.131
The plaintiff then sold his stock to the brother who subsequently
transferred it to the defendant. At no time did the brother reveal that he
was making the transaction for the defendant.

The Eighth Circuit found that the jury could have reasonably
inferred that the result of this artifice was to keep the plaintiff from
investigating the value of the stock. The court concluded that because
of the relationship of trust between the plaintiff and the defendant, and
the fact that the brother did not disclose that he was working for the
defendant, the plaintiff’s reliance was justifiable.132 While the court
seemed to require that a plaintiff exercise due care for his own protec-
tion, in actuality, it did not go that far. Rather, the court implied that
the due care obligation will be imposed upon a reckless plaintiff.133
The fact that a plaintiff was reckless, however, would only negate his
justifiable reliance. Recovery would be denied, not because the reck-
less plaintiff failed to exercise due care, but because he failed to
establish justifiable reliance.

Another case which has been cited for the proposition that due care
is a requirement in intentional misconduct cases is Mitchell v. Texas
Gulf Sulphur Co. 134 The defendant corporation in Mitchell intention-
ally issued a misleading press release concerning mining exploration.
Four days later, the company widely circulated a corrective release.
The court allowed recovery for three plaintiffs who sold their stock in
reliance on the first release and prior to the publication of the second
release. However, recovery was denied to another plaintiff who had
sold his shares six or seven days after the corrective release was issued.
The district court reasoned that at some point after publication of the
curative release the plaintiff could no longer claim reliance on the
original misleading statement. A contrary result would encourage a
stockholder to speculate after publication of the deceptive release,
suing only if he took a loss. The court noted that there is a “require-
ment that stockholders . . . act in good faith and with due diligence in
purchasing and selling stock.”135 While the court spoke in terms of

131. Id. at 737.
132. Id.
133. Id. at 736.
134. 446 F.2d 90 (10th Cir.), cert. denied, 404 U.S. 1004 (1971).
135. Id. at 103.
due diligence, it did not establish a duty of independent investigation. Rather, the case turned on whether, by the time the plaintiff sold his stock, the reasonable investor would have had knowledge of the corrective release.\textsuperscript{136} Thus, the \textit{Mitchell} court employed an objective reasonable reliance test on the due care issue. The widely publicized corrective release was a "red flag" which cut off justifiable reliance. Undoubtedly the court confused the term due diligence with justifiable reliance. Justifiable reliance does not require affirmative action, but an investor cannot be blind to the world and still claim his reliance was justifiable.

In \textit{Clement A. Evans & Co. v. McAlpine},\textsuperscript{137} the Fifth Circuit purported to recognize due care as a separate element, distinct from reliance, in a rule 10b–5 action. In \textit{Evans}, the plaintiff brokerage firm sued the defendant brokerage firm alleging that it devised and participated in a scheme designed to create a facade of financial responsibility for its agent. The plaintiff claimed that because of this misrepresentation it executed trades for the agent and permitted the agent to continue trading even during a three to four month period in which five of his checks were dishonored for insufficient funds. The plaintiff firm eventually took heavy losses on the dishonored checks. This occurred even though Federal Reserve Board Regulation T required that the plaintiff firm freeze the agent's account when the checks failed.\textsuperscript{138} The court's opinion addressed two issues, reliance and due care. The Fifth Circuit found that the plaintiff's reliance was unjustifiable. The dishonored checks and the freeze requirement were unique circumstances which should have alerted the plaintiff that actual reliance was insufficient.\textsuperscript{139} Regarding due care, the Fifth Circuit adopted the standard articulated by the district court: "[T]he plaintiff's sophistication, expertise and business acumen in the financial community, his access to information and opportunity to detect fraud are all relevant considerations in determining the exercise of reasonable diligence."\textsuperscript{140} Although it recognized that this approach had previously been used only in cases where the defendant had negligently misrepresented material information, the court accepted a negligence standard of due care.\textsuperscript{141}

\begin{itemize}
\item 136. \textit{Id.}
\item 137. 434 F.2d 100 (5th Cir. 1970), \textit{cert. denied}, 402 U.S. 988 (1971).
\item 139. 434 F.2d at 104.
\item 140. \textit{Id.}
\item 141. The \textit{McAlpine} court quoted with approval the test employed in \textit{Vanderboom}: "With regard to misrepresentations, the question is whether a reasonable investor, in light of the facts existing at the time of the misrepresentation and in exercise of due care, would have been entitled to rely upon the misrepresentation." \textit{Id.} at 103 (emphasis original).
\end{itemize}
However, the court's broad pronouncement must be read in light of the unique facts of this case. The plaintiff acted recklessly in the face of a patently false representation. Hence, his reckless conduct showed a lack of justifiable reliance. The decision was not actually based on a failure to exercise due care.

The impropriety of the due care requirement in intentional violation cases was recognized later by the Fifth Circuit in *Bird v. Ferry*.

Members of an investment club brought an action against a broker who had employed their financial adviser alleging that the adviser had perpetrated a fraud and used the club's funds for personal speculation. The defendant contended that the plaintiffs, by not reviewing the confirmations and receipts of their transactions, had failed to exercise due care and therefore should be denied recovery under *Evans*. The Fifth Circuit found that the adviser was a quasi-fiduciary and affirmed the district court's finding that the plaintiff had exercised due care. Once the plaintiffs had established justifiable reliance, the court did not require independent verification or affirmative action by the plaintiffs to show due care. Consequently, it would be possible for a plaintiff to act negligently and still justifiably rely, a result which puts the purported due care requirement as articulated by *Evans* in doubt.

2. *Cases Rejecting the Due Care Requirement in Intentional Fraud Situations*

As discussed above, a number of courts have spoken of due care when denying recovery to plaintiffs who have shown a marked indifference to an obvious fraud. Nevertheless, these courts did not set up an affirmative duty of due care. The generally accepted view is that an intentional violation of rule 10b–5 should result in recovery for the victim regardless of whether or not the plaintiff exercised due care.

In *Carrol v. First National Bank*, the plaintiffs alleged that the defendant bank had participated in the creation of a "credit bubble" to peg the market in certain securities. The bank raised the affirmative defense of due care, claiming that the plaintiffs had been negligent in selling the securities. The court rejected this argument, finding that contributory negligence was a defense to negligence but not fraud. As such, *Carrol* constitutes a rejection of the due care requirement in intentional fraud cases.

*Carrol* is consistent with the conclusions reached by the Tenth Circuit in *Gilbert v. Nixon*. There the court found that the defendant

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142. 497 F.2d 112 (5th Cir. 1974).
143. 413 F.2d 353 (7th Cir. 1969), cert. denied, 396 U.S. 1003 (1970).
144. *Id.* at 358.
145. 429 F.2d 348 (10th Cir. 1970).
had deliberately misrepresented the commercial feasibility of an oil well, but remanded the case for a determination of whether the plaintiffs had actual knowledge of the falsity of the misleading statements. The court of appeals instructed the lower court that, "[i]n making such a determination the district court should keep in mind that [the plaintiffs] cannot be charged with the obligation to make independent investigations to verify the accuracy of [the defendant's] representations." 147

The Fifth Circuit, in *Stier v. Smith*, 148 concluded that even a sophisticated investor is not required to make an independent verification to protect himself. Plaintiff Stier was induced by intentional omissions to purchase stock in a franchise operation. While the court of appeals agreed with the district court's conclusion that the plaintiff had adequate access to the information necessary to detect the impropiety, it reasoned that "sophisticated investors, like all others are entitled to the truth." 149 Accordingly, the court reversed the district court decision, stating:

> We should always be wary of holding that a purchaser of securities, who deals with the corporate insider, could have found out omitted material facts by examining the corporate books . . . . To do so is to allow the insider to present prospective purchasers with a mountain of information which they cannot possibly digest and excuse themselves from liability on the basis that they did not provide the right answers because they were not asked the right questions. "Readiness and willingness to disclose are not equivalent to disclosure." 150

These decisions establish that, prior to *Hochfelder*, the plaintiff was not under an affirmative duty to investigate and detect the defendant's intentional fraud. Due care or due diligence arose only where the fraud was patently false and justifiable reliance could not be shown. Thus, due care was not recognized as an affirmative duty before or after the Supreme Court's decision in *Hochfelder*.

V. Economic Analysis of the Due Care Requirement

Following the stock market crash of 1929, there was a growing awareness among government officials, business leaders, and the pub-

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146. *Id.* at 363. Even at common law, actual knowledge of an intentional misrepresentation would bar plaintiff’s recovery. See *Restatement (Second) of Torts* § 541 (Tent. Draft No. 11, 1965).
147. 429 F.2d at 361.
148. 473 F.2d 1205 (5th Cir. 1973).
149. *Id.* at 1207.
150. *Id.* at 1208 (citation omitted).
lic that widespread abuses in the securities markets had to be eliminated in order to avert another economic debacle. This sentiment provided the political impetus for passage of the Securities Act\textsuperscript{151} and the Exchange Act.\textsuperscript{152} In section 2 of the Exchange Act Congress noted that inadequate disclosure of corporate financial affairs had created conditions conducive to manipulation and control of security prices and misdirected speculation. This in turn caused a misallocation of resources in the capital markets and in the nation's economy as a whole.\textsuperscript{153} To protect investors\textsuperscript{154} and to promote rational and informed investment decisions, Congress created a system regulating disclosure of financial information to the investing public,\textsuperscript{155} supported by anti-fraud provisions.\textsuperscript{156} Government regulation also seeks to divest defrauders of their ill-gotten gains and return the funds to their victims.

The stated policy of assuring information dissemination, in order to promote the social goal of intelligent investor decisionmaking, is readily susceptible to economic analysis. The purpose of the discussion herein is not to determine whether the social goal of disclosure constitutes an efficient social policy in the macroeconomic sense.\textsuperscript{157} Congress has determined that protection of the investor is a desirable social goal. However, the provisions for investor protection—regulation of the securities markets and over-the-counter trading—have a cost connected to them, and the money spent by the government and the private sector to effectuate this social goal should be minimized.

\textsuperscript{151} See H.R. REP. No. 85, 73d Cong., 1st Sess. 1–5 (1933).


\textsuperscript{154} The goal of the securities laws is to protect investors from fraud in the securities markets. See Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976) (The Exchange Act "was intended principally to protect investors against manipulation of stock prices").

\textsuperscript{155} In general, § 2 of the Exchange Act and Title 1 of the Securities Act structure disclosure.

As the Supreme Court recently noted in Hochfelder, the Exchange Act "was intended principally to protect investors against manipulation of stock prices through regulation of transactions upon securities exchanges and in over-the-counter markets, and to impose regular reporting requirements on companies whose stock is listed on national securities exchanges." 425 U.S. at 195.

\textsuperscript{156} In Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974), the Second Circuit pointed out: "The purpose behind Section 10(b) and Rule 10b–5 is to protect the investing public and to secure fair dealing in the securities markets by promoting full disclosure of inside information so that an informed judgment can be made by all investors who trade in such markets." Id. at 235.

\textsuperscript{157} For a discussion attacking the disclosure provisions as macroeconomically inefficient, see Demsetz, Perfect Competition, Regulation, and the Stock Market, in \textit{ECONOMIC POLICY AND THE REGULATION OF CORPORATE SECURITIES} 1–22 (H. Manne ed. 1969).
Therefore, this discussion is concerned with the microeconomic ramifications of information failures, be they misrepresentations, half-truths, or omissions, where the information failures are caused by intentional misconduct or inaction on the part of the party responsible for information dissemination.

A. Economics of the Due Care Requirement in Investor Decisionmaking

An intentional information failure coupled with a due care requirement conflicts with the two fundamental congressional objectives underlying securities disclosure regulation: (1) to avoid involuntary wealth redistribution and (2) to keep the cost of protection as low as possible without compromising its effectiveness. When a potential investor lacks material information he cannot make an optimally intelligent investment decision. If the investor, unaware of the information failure, consummates the transaction, he will involuntarily transfer wealth to the defrauder, either by paying an inflated price for the stock or by selling the stock for less than its real value. The difference between the price paid and the real value is a loss to the ignorant investor, and a gain to the party who intentionally caused the information failure; resources have moved away from the protected investor and towards the defrauder. The investor should respond to his loss by instituting a rule 10b-5 private action to recover the defendant’s fraudulent gain. However, a due care requirement would prevent many plaintiff investors from recovering, and subject them to involuntary wealth redistribution, thus conflicting with the wealth distribution criteria of society.

Second, an intentional information failure increases the cost of investor protection. Once information has been produced, the cost of dissemination is marginal. If the plaintiff is required to exercise due care in an intentional violation situation, he will be expending extra resources to verify information already available. Because the cost of independent verification is greater than the cost of disseminating existing information, the aggregate cost of investor protection rises.

158. "Information failure" is a term used by Ronald J. Coffey, in his discussion of the economic effects of information failures on the securities market, to cover both omissive and assertive preventable information failures. Securities Regulation Policy & Analysis (1977) (unpublished multilith, Case Western Reserve Law School).

159. We refer here to haphazard, unexpected wealth redistribution between individuals as opposed to controlled involuntary wealth redistribution through formal governmental systems (through taxes and expenditures).

160. See Professor Rooney’s comments on the paper presented by Professor Demsetz in Economic Policy and the Regulation of Corporate Securities, supra note 157, at 109.
due care requirement thus works at cross purposes to Congress' intent to foster the least cost-preventive method of information disclosure.

B. Economics of the Due Care Requirement in a Fiduciary Relationship

The due care requirement creates even more economic inefficiencies when the party who intentionally causes the information failure is a fiduciary of the investor. As pointed out above,161 rule 10b–5 is aimed primarily at deceptions by brokers and others who take advantage of inside information. The fiduciary relationship implies an economic norm: that the fiduciary will act in the economic best interest of his beneficiary. When the fiduciary intentionally causes an information failure, he is working in opposition to this economic norm. Rule 10b–5 seeks to remedy this breach of trust by causing the fiduciary to return his ill-gotten gains to his beneficiary. The due care requirement pulls in the opposite direction, forcing the beneficiary to expend more resources to monitor his fiduciary and increasing the cost of the trust relationship. This is a clear example of economic waste produced by the due care requirement.162

VI. Due Care and the Deterrent Effect of Rule 10b–5 Private Actions

In addition to compensating harmed investors, rule 10b–5 civil remedies also provide "a necessary supplement to [SEC] action."163 Congress intended the express liability provisions of the Securities Act164 to have a compensatory and, more importantly, an "in ter rorem" effect.165 By allowing compensatory relief for a plaintiff under

161. See notes 96–99 supra and accompanying text.
162. It may be appropriate to do away with the due care requirement even where the fiduciary negligently causes information failure. Involuntary wealth redistribution caused by information failure is even more reprehensible if caused by a fiduciary than when it occurs in an arms' length transaction. When we require the fiduciary to avoid information failures vis à vis the beneficiary, we are honoring, at the least, an implied agreement between the parties. The fiduciary has consented to act in the best interests of his beneficiary. The plaintiff beneficiary in turn, relying on this special arrangement, reposes his trust and confidence in the fiduciary: he trusts the fiduciary to inform him of all material information relating to the trust. The beneficiary is thus diverted from taking steps to avert information failure. The due care requirement, imposing an affirmative obligation on the plaintiff beneficiary to monitor the fiduciary, is thus even more inconsistent in a setting which discourages such vigilance than it is in the context of an arm's length transaction.
rule 10b–5 courts create a deterrent effect by making violations unprofitable for the defendant.

Imposing a due care requirement on the plaintiff in a rule 10b–5 action undercuts this deterrent effect because fewer violators are forced to return their fraudulent gains. A due care requirement might even encourage intentional wrongdoing since potential defrauders may find it profitable to perpetrate securities fraud, realizing that mere negligence on the part of the plaintiff will allow them to retain the fruits of the fraudulent transaction. It can be argued, however, that the doctrines of compensation and deterrence operate independently of one another. A plaintiff’s recovery might be barred because he failed to exercise due care, while the defendant who committed the intentional violation would, nevertheless, be subject to discipline. Unfortunately the SEC is simply not able to investigate and punish every violation of the securities laws. The Fifth Circuit was aware of this limitation when it noted: “The [SEC] has neither the manpower nor the time that complete effective enforcement of the securities laws by it alone would require.” Therefore, private actions under rule 10b–5 are essential deterrents, necessary to effective enforcement of the federal securities laws and they should not be compromised by the imposition of a due care requirement.

VII. CONCLUSION

The imposition of a due care requirement upon plaintiffs may have been appropriate in factual situations where the defendant had negligently violated rule 10b–5. Where both the plaintiff and the defendant were negligent, it did not seem unreasonable to bar the plaintiff from recovery. However, now that implied private actions under rule 10b–5 are limited to situations where the defendant is guilty of intentional misconduct, this contributory negligence rationale is no longer applicable. This is consistent with the common law principle that contributory negligence is not a defense to an intentional tort where only subjective, actual reliance must be proven.

An analysis of the express liability provisions of the federal securities laws reveals that Congress did not intend that investors undertake an independent verification to detect an intentional fraud. The due care requirement contradicts the policy of investor protection which underlies the federal securities laws by allowing a defrauder to keep his ill-

166. See Wheeler, supra note 3, at 786.
gotten gains, thereby penalizing the investor. It also undermines the integrity of the fiduciary relationships on which an investor relies in securities transactions by requiring a plaintiff to monitor the conduct of his fiduciary. Finally, the due care requirement negates the information disclosure philosophy which Congress adopted in the securities laws; it forces an investor to expend resources discovering existing information thus causing economic waste. Accordingly, it is appropriate that a number of federal courts of appeals have, in effect, recently laid to rest suggestions that there should be a plaintiff’s due care requirement in cases where the defendant has intentionally violated rule 10b–5.

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