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Judith Woodward

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PLAINTIFF'S REQUIREMENT OF DUE CARE IN PRIVATE 10b-5 ACTIONS: THE EFFECT OF ERNST & ERNST v. HOCHFELDER

Lacking any clear statutory guidelines to the imposition of private recovery under rule 10b-5 of the Securities Exchange Act of 1934,¹ the courts have formulated several prerequisites to the remedy on a case-by-case basis.² Along with requiring materiality,³ reliance,⁴ and recently, scienter,⁵ an increasing number of courts demand a showing of caution and diligence on the part of an investor who claims to have been the victim of securities fraud.⁶

1. Rule 10b-5, promulgated by the Securities and Exchange Commission in 1942 pursuant to § 10 of the Securities Exchange Act of 1934, 15 U.S.C. § 78j (1970), provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the 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.

17 C.F.R. § 240.10b-5 (1977).

2. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730 (1975); *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 150 (1972); *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 13 (1971); Wheeler, *Plaintiff's Duty of Due Care Under Rule 10b-5: An Implied Defense to an Implied Remedy*, 70 Nw. U.L. REV. 561, 566 (1976) [hereinafter cited as Wheeler].

3. *Thomas v. Duralite Co.*, 524 F.2d 577, 583 (3d Cir. 1975); *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374, 381 (2d Cir. 1974), *cert. denied*, 421 U.S. 976 (1975); *Rochez Bros. v. Rhoades*, 491 F.2d 402, 410 (3d Cir. 1974), *cert. denied*, 425 U.S. 993 (1976); *List v. Fashion Park, Inc.*, 340 F.2d 457, 462 (2d Cir. 1965).

4. *Holdsworth v. Strong*, 545 F.2d 687, 694 (10th Cir. 1976), *cert. denied*, 97 S. Ct. 1600 (1977); *Titan Group, Inc. v. Faggen*, 513 F.2d 234, 239 (2d Cir.), *cert. denied*, 423 U.S. 840 (1975); *Rochez Bros. v. Rhoades*, 491 F.2d 402, 410 (3d Cir. 1974), *cert. denied*, 425 U.S. 993 (1976). This element provides the causal link between a defendant's conduct and the plaintiff's injuries. Actual reliance need no longer be shown where an omission is alleged. See notes 72-73 *infra* and accompanying text.

5. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976); text accompanying notes 83-86 *infra*.

6. Eight circuits so far have found the conduct of the plaintiff to be relevant in determining 10b-5 liability. See, e.g., *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033 (7th Cir.), *cert. denied*, 98 S. Ct. 225 (1977); *Hirsh v. Du Point*, 553 F.2d 750 (2d Cir. 1977); *Dupuy v. Dupuy*, 551 F.2d 1005 (5th Cir.), *cert. denied*, 98 S. Ct. 312 (1977); *Holdsworth v. Strong*, 545 F.2d 687 (10th Cir. 1976), *cert. denied*, 97 S. Ct. 1600 (1977);

This requirement of due care, or due diligence, has been described by the courts in a variety of ways.⁷ However, there is agreement that the aggrieved party to a transaction must have used common sense and acted reasonably in assessing the information available to him,⁸ and must have exercised a certain amount of effort to discover any further relevant facts.⁹ In other words, a claimant must show that the fraud was committed in spite of his own reasonable attempts to protect his interests.¹⁰ The

Straub v. Vaisman & Co., 540 F.2d 591 (3d Cir. 1976); *Rochez Bros. v. Rhoades*, 491 F.2d 402 (3d Cir. 1974), *cert. denied*, 425 U.S. 993 (1976); *Arber v. Essex Wire Corp.*, 490 F.2d 414 (6th Cir.), *cert. denied*, 419 U.S. 830 (1974); *Mitchell v. Texas Gulf Sulphur Co.*, 446 F.2d 90 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971); *Clement A. Evans & Co. v. McAlpine*, 434 F.2d 100 (5th Cir. 1970), *cert. denied*, 402 U.S. 988 (1971); *City Nat'l Bank v. Vanderboom*, 422 F.2d 221 (8th Cir.), *cert. denied*, 399 U.S. 905 (1970); *Rogen v. Ilikon Corp.*, 361 F.2d 260 (1st Cir. 1966). *See also* *NBI Mortgage Inv. Corp. v. Chemical Bank*, [Current Binder] FED. SEC. L. REP. (CCH) ¶ 96,066 (S.D.N.Y. 1977); *McLean v. Alexander*, 420 F. Supp. 1057 (D. Del. 1976); *Hutto v. Texas Income Properties Corp.*, 416 F. Supp. 478 (S.D. Tex. 1976); *Eichen v. E.F. Hutton & Co.*, 402 F. Supp. 823 (S.D. Cal. 1975); *Ferland v. Orange Groves of Fla., Inc.*, 377 F. Supp. 690 (M.D. Fla. 1974); *Chelsea Assocs. v. Rapanos*, 376 F. Supp. 929 (E.D. Mich. 1974); *Taylor v. Smith, Burney & Co.*, 358 F. Supp. 892 (D. Utah 1973); *Kaplan v. Vornado, Inc.*, 341 F. Supp. 212 (N.D. Ill. 1971). *Contra*, *Carroll v. First Nat'l Bank*, 413 F.2d 353 (7th Cir. 1969), *cert. denied*, 396 U.S. 1003 (1970). *See also* 2 A. BROMBERG, SECURITIES LAW: FRAUD—SEC RULE 10B-5, ¶ 8.4 (544), at 204.178 (1977) [hereinafter cited as BROMBERG].

7. Various terms have been used by the courts to denote substantially the same requirement of caution and care by the plaintiff. *See* *Bird v. Ferry*, 497 F.2d 112, 114 (5th Cir. 1974) ("due diligence"); *Vohs v. Dickson*, 495 F.2d 607, 623 (5th Cir. 1974) ("duty of reasonable investigation"); *Rochez Bros. v. Rhoades*, 491 F.2d 402, 409 (3d Cir. 1974), *cert. denied*, 425 U.S. 993 (1976) ("duty of due care"); *see also* *Wheeler*, *supra* note 2, at 563 n.7.

For purposes of this comment, the term "due care" will be used to describe this requirement but not to refer to any particular standard of care by the plaintiff.

8. *Rochez Bros. v. Rhoades*, 491 F.2d 402, 409 (3d Cir. 1974), *cert. denied*, 425 U.S. 993 (1976); *Arber v. Essex Wire Corp.*, 490 F.2d 414, 420 (6th Cir.), *cert. denied*, 419 U.S. 830 (1974); *Mitchell v. Texas Gulf Sulphur Co.*, 446 F.2d 90, 103 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971); *City Nat'l Bank v. Vanderboom*, 422 F.2d 221, 231 (8th Cir.), *cert. denied*, 399 U.S. 905 (1970); *Hafner v. Forest Laboratories*, 345 F.2d 167, 168 (2d Cir. 1965); *McLean v. Alexander*, 420 F. Supp. 1057, 1079 (D. Del. 1976).

9. *Thomas v. Duralite Co.*, 524 F.2d 577, 585 (3d Cir. 1975); *Kohler v. Kohler Co.*, 319 F.2d 634 (7th Cir. 1963); *Jackson v. Oppenheim*, 411 F. Supp. 659, 669 (S.D.N.Y. 1974), *aff'd on other grounds*, 533 F.2d 826 (2d Cir. 1976); *Branham v. Material Sys. Corp.*, 354 F. Supp. 1048, 1056 (S.D. Fla. 1973). *Cf.* *McLean v. Alexander*, 420 F. Supp. 1057, 1079 (D. Del. 1976) (plaintiff was justified in relying on a certified accounting statement without making an independent investigation into its factual basis); *Hutto v. Texas Income Properties Corp.*, 416 F. Supp. 478, 483 (S.D. Tex. 1976) (plaintiff not required to continually investigate throughout a prolonged negotiation after a basic agreement is reached).

10. *Dupuy v. Dupuy*, 551 F.2d 1005 (5th Cir.), *cert. denied*, 98 S. Ct. 312 (1977); *Thomas v. Duralite Co.*, 524 F.2d 577 (3d Cir. 1975); *Rochez Bros. v. Rhoades*, 491 F.2d 402 (3d Cir. 1974), *cert. denied*, 425 U.S. 993 (1976); *McLean v. Alexander*, 420 F. Supp. 1057 (D. Del. 1976).

courts will hold a plaintiff to the standard of care of a reasonable person acting in similar circumstances and in possession of a similar amount of experience and sophistication in the investment field.¹¹

To compel private claimants under rule 10b-5 to exercise due care not only encourages investor caution in securities transactions,¹² but also reduces the number of 10b-5 claims.¹³ Until recently, when the Supreme Court in *Ernst & Ernst v. Hochfelder*¹⁴ held that scienter was required for any private 10b-5 recovery,¹⁵ the circuits were split as to the standard of liability to be imposed.¹⁶ For example, a plaintiff's lack of care has been used to bar recovery in actions based upon defendant's negligence as well as in actions where defendant's knowing conduct falls short of specific intent to harm.¹⁷

However, the *Hochfelder* decision has raised strong doubts as to the continuing validity of any examination of the victim's conduct where it would bar recovery for knowing or intentional fraud.¹⁸ Although the

11. *Dupuy v. Dupuy*, 551 F.2d 1005, 1016 (5th Cir.), *cert. denied*, 98 S. Ct. 312 (1977); *McLean v. Alexander*, 420 F. Supp. 1057, 1077 (D. Del. 1976). The standard is basically an objective one based on the knowledge and status of the plaintiff at the time of the transaction.

12. *Dupuy v. Dupuy*, 551 F.2d 1005, 1016 (5th Cir.), *cert. denied*, 98 S. Ct. 312 (1977); *Straub v. Vaisman & Co.*, 540 F.2d 591, 597 (3d Cir. 1976).

13. In recent years the scope of recovery under rule 10b-5 has been greatly expanded by the courts through a broadening of the definition of a security, an elimination of the privity requirement, and a relaxation of the purchaser—seller rule. See *Dupuy v. Dupuy*, 551 F.2d 1005, 1119 (5th Cir.), *cert. denied*, 98 S. Ct. 312 (1977); *Straub v. Vaisman & Co.*, 540 F.2d 591, 597 (3d Cir. 1976); *Clement A. Evans & Co. v. McAlpine*, 434 F.2d 100, 104 (5th Cir. 1970), *cert. denied*, 402 U.S. 988 (1971); *McLean v. Alexander*, 420 F. Supp. 1057, 1077 (D. Del. 1976). See also Note, *The Due Diligence Requirement for Plaintiff Under Rule 10b-5*, 1975 DUKE L.J. 753, 753 [hereinafter cited as DUKE]; 1 BROMBERG, *supra* note 6, § 2.5(6) (more litigation has been brought under rule 10b-5 than all other antifraud provisions combined).

14. 425 U.S. 185 (1976), *rev'g* 503 F.2d 1100 (7th Cir. 1974).

15. *Id.* at 193.

16. At the time the Supreme Court handed down the *Hochfelder* decision, the circuits were in dispute on the issue of the proper standard of liability for 10b-5 actions. Three circuits required scienter. *Clegg v. Conk*, 507 F.2d 1351, 1361-62 (10th Cir. 1974), *cert. denied*, 422 U.S. 1007 (1975); *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579, 606 (5th Cir.), *cert. denied*, 419 U.S. 873 (1974); *Lanza v. Drexel & Co.*, 479 F.2d 1277, 1306 (2d Cir. 1973). Two circuits indicated that they might require scienter. *Carras v. Burns*, 516 F.2d 251, 256 (4th Cir. 1975); *Rochez Bros. v. Rhoades*, 491 F.2d 402, 407-08 (3d Cir. 1974), *cert. denied*, 425 U.S. 993 (1976). Three circuits had held that scienter would not be required. *White v. Abrams*, 495 F.2d 724, 730 (9th Cir. 1974) ("flexible duty" standard for defendant, based on circumstances shown); *Vanderboom v. Sexton*, 422 F.2d 1233, 1239 (8th Cir.), *cert. denied*, 400 U.S. 852 (1970); *Myzel v. Fields*, 386 F.2d 718, 734-35 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968); *Kohler v. Kohler Co.*, 319 F.2d 634, 637, 642 (7th Cir. 1963) (*dicta*). See Bueklo, *The Supreme Court Attempts to Define Scienter Under Rule 10b-5: Ernst & Ernst v. Hochfelder*, 29 STAN. L. REV. 213, 231 (1977).

17. See notes 28-31 *infra* and accompanying text.

18. See notes 83-150 *infra* and accompanying text.

courts have been divided since *Hochfelder*, the majority have continued to recognize some standard of care for plaintiffs in private 10b-5 actions.¹⁹ The decisions indicate that, for policy reasons, victims of securities fraud will continue to be required to show they did not act with reckless disregard in the circumstances before recovery is allowed.²⁰

I. HISTORICAL BACKGROUND OF THE DUE CARE REQUIREMENT: THEORETICAL JUSTIFICATIONS

A. *Common Law Analysis*

Because the courts have often turned to the common law as a guide to interpreting rule 10b-5,²¹ it is a logical place to start an analysis of the theoretical support for the due care requirement. Common law tort theory distinguished intentional misrepresentations made with a specific intent to harm²² from negligent misrepresentations made without intent to deceive or knowledge of their falsity.²³ Where a defendant was merely negligent in misrepresenting or in omitting relevant facts, any corresponding negligence of the claimant would bar recovery under contributory negligence concepts.²⁴ However, where a defendant intentionally

19. *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033 (7th Cir.), *cert. denied*, 98 S. Ct. 225 (1977) (due care defense held unavailable to bar an intentional tort, but plaintiff's due care used to determine nonreliance); *Dupuy v. Dupuy*, 551 F.2d 1005 (5th Cir.), *cert. denied*, 98 S. Ct. 312 (1977); *Holdsworth v. Strong*, 545 F.2d 687 (10th Cir. 1976), *cert. denied*, 97 S. Ct. 1600 (1977) (dicta) (plaintiff's gross conduct may bar recovery); *Straub v. Vaisman & Co.*, 540 F.2d 591 (3d Cir. 1976); *NBI Mortgage Inv. Corp. v. Chemical Bank*, [Current Binder] FED. SEC. L. REP. (CCH) ¶ 96,066 (S.D.N.Y. 1977); *McLean v. Alexander*, 420 F. Supp. 1057 (D. Del. 1976).

20. *Dupuy v. Dupuy*, 551 F.2d 1005 (5th Cir.), *cert. denied*, 98 S. Ct. 312 (1977); *Holdsworth v. Strong*, 545 F.2d 687 (10th Cir. 1976), *cert. denied*, 97 S. Ct. 1600 (1977); *Straub v. Vaisman & Co.*, 540 F.2d 591 (3d Cir. 1976); *McLean v. Alexander*, 420 F. Supp. 1057 (D. Del. 1976).

21. *See Dupuy v. Dupuy*, 551 F.2d 1005 (5th Cir.), *cert. denied*, 98 S. Ct. 312 (1977); *Holdsworth v. Strong*, 545 F.2d 687 (10th Cir. 1976), *cert. denied*, 97 S. Ct. 1600 (1977); *Straub v. Vaisman & Co.*, 540 F.2d 591 (3d Cir. 1976); *List v. Fashion Park, Inc.*, 340 F.2d 457 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965).

22. *See* W. PROSSER, *HANDBOOK OF THE LAW OF TORTS* 699 (4th ed. 1971) [hereinafter cited as PROSSER]; *Wheeler*, *supra* note 2, at 576 & n.44. The tort of intentional misrepresentation was the basis of the common law fraud or deceit action. *See Derry v. Peek*, 14 App. Cas. 337 (H.L. 1889).

23. The tort of negligent misrepresentation, which modified the action of deceit, was a later development of the common law. *See* PROSSER, *supra* note 22, at 705; *Wheeler*, *supra* note 2, at 577.

24. *RESTATEMENT (SECOND) OF TORTS* § 552A (1977). *See Dupuy v. Dupuy*, 551 F.2d 1005 (5th Cir.), *cert. denied*, 98 S. Ct. 312 (1977); *Holdsworth v. Strong*, 545 F.2d 687 (10th Cir. 1976), *cert. denied*, 97 S. Ct. 1600 (1977); *Straub v. Vaisman & Co.*, 540 F.2d 591 (3d Cir. 1976) (dicta); *Wheeler*, *supra* note 2, at 577.

inflicted harm, carelessness by the injured party would be irrelevant to liability.²⁵ But a limited defense would lie at common law where the misrepresentations were patently false, or the claimant had actual knowledge of the truth.²⁶

Such common law distinctions, if directly applied to rule 10b-5 actions, would appear to restrict the availability of a due care defense to cases resting upon a finding of negligence. But motivated by strong policy considerations surrounding the securities laws, the courts have tempered the common law and applied the defense more broadly than in traditional tort actions.

Until recently, only one court had used common law distinctions to hold the plaintiff's lack of due care irrelevant to liability under rule 10b-5 for intentional misrepresentation or fraud.²⁷ Since most circuits prior to *Hochfelder* had required some degree of scienter,²⁸ courts had examined due care in situations which usually were not within the bounds of common law contributory negligence. Due care was not only considered relevant where knowing conduct was found,²⁹ but was also discussed in

25. *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033 (7th Cir.), *cert. denied*, 98 S. Ct. 225 (1977); *Holdsworth v. Strong*, 545 F.2d 687 (10th Cir. 1976), *cert. denied*, 97 S. Ct. 1600 (1977); *Carroll v. First Nat'l Bank*, 413 F.2d 353 (7th Cir. 1969), *cert. denied*, 396 U.S. 1003 (1970) (apparently rejecting due care limitation on rule 10b-5). *See Dupuy v. Dupuy*, 551 F.2d 1005 (5th Cir.), *cert. denied*, 98 S. Ct. 312 (1977). *See also Wheeler*, *supra* note 2, at 577. *Contra*, *Straub v. Vaisman & Co.*, 540 F.2d 591 (3d Cir. 1976); *Rochez Bros. v. Rhoades*, 491 F.2d 402 (3d Cir. 1974), *cert. denied*, 425 U.S. 993 (1976); *Mitchell v. Texas Gulf Sulphur Co.*, 446 F.2d 90 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971); *Clement A. Evans & Co. v. McAlpine*, 434 F.2d 100 (5th Cir. 1970), *cert. denied*, 402 U.S. 988 (1971).

Prosser states that "where there is an intent to mislead . . . , [barring recovery] is clearly inconsistent with the general rule that mere negligence of the plaintiff is not a defense to an intentional tort. The better reasoned cases have rejected contributory negligence as a defense applicable to intentional deceit" PROSSER, *supra* note 22; § 108, at 716. Section 545A of the RESTATEMENT (SECOND) OF TORTS (1977) states, "One who justifiably relies upon a fraudulent misrepresentation is not barred from recovery by his contributory negligence in doing so."

26. *Shappirio v. Goldberg*, 192 U.S. 232, 241-42 (1904); *See generally* RESTATEMENT (SECOND) OF TORTS § 541 (1977); PROSSER, *supra* note 22, at 716; *Wheeler*, *supra* note 2, at 577 n.50, 578 n.52; BROMBERG, *supra* note 6, ¶ 8.4 (652), at 204.248 (1977).

27. *Carroll v. First Nat'l Bank*, 413 F.2d 353 (7th Cir. 1969), *cert. denied*, 396 U.S. 1003 (1970). However in the year and a half following *Hochfelder*, two other cases have used common law distinctions to find due care irrelevant to 10b-5 recovery. *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033 (7th Cir.), *cert. denied*, 98 S. Ct. 225 (1977); *Holdsworth v. Strong*, 545 F.2d 687 (10th Cir. 1976), *cert. denied*, 97 S. Ct. 1600 (1977). *See text* accompanying notes 99-121 *infra* for further discussion.

28. *See note 16 supra*.

29. *Thomas v. Duralite Co.*, 524 F.2d 577 (3d Cir. 1975); *Rochez Bros. v. Rhoades*, 491 F.2d 402 (3d Cir. 1974), *cert. denied*, 425 U.S. 993 (1976); *Mitchell v. Texas Gulf Sulphur Co.*, 446 F.2d 90 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971); *Clement A. Evans & Co. v. McAlpine*, 434 F.2d 100 (5th Cir. 1970), *cert. denied*, 402 U.S. 988 (1971).

circumstances where the court failed to find the defendant liable at all.³⁰ But only rarely has the due care standard been applied to bar recovery where the defendant had the specific intent to harm required for an action in common law fraud.³¹ Thus the defense of lack of due care has heretofore usually been limited to defendants whose conduct falls short of common law fraud.³²

B. Policy Considerations

The Securities Exchange Act of 1934³³ (the Act) was enacted in order to eliminate a wide range of abuses in the securities field by promoting "ethical standards of honesty and fair dealing."³⁴ The Act was part of a comprehensive legislative scheme designed to better protect investors from fraud by requiring full disclosure and honest dealing in both public and private securities transactions.³⁵

30. *Frigitemp Corp. v. Financial Dynamics Fund, Inc.*, 524 F.2d 275 (2d Cir. 1975); *Vohs v. Dickson*, 495 F.2d 607 (5th Cir. 1974); *Arber v. Essex Wire Corp.*, 490 F.2d 414 (6th Cir.), *cert. denied*, 419 U.S. 830 (1974); *Financial Indus. Fund, Inc. v. McDonnell Douglas Corp.*, 474 F.2d 514 (10th Cir.), *cert. denied*, 414 U.S. 874 (1973); *City Nat'l Bank v. Vanderboom*, 422 F.2d 221 (8th Cir.), *cert. denied*, 399 U.S. 905 (1970); *Rogen v. Ilikon Corp.*, 361 F.2d 260 (1st Cir. 1966); *Hafner v. Forest Laboratories, Inc.*, 345 F.2d 634 (7th Cir. 1965); *Kohler v. Kohler Co.*, 319 F.2d 634 (7th Cir. 1963); *Eichen v. E.F. Hutton & Co.*, 402 F. Supp. 823 (S.D. Cal. 1975); *Jackson v. Oppenheim*, 411 F. Supp. 659 (S.D.N.Y. 1974), *aff'd on other grounds*, 533 F.2d 826 (2d Cir. 1976); *McGraw v. Matthaei*, 388 F. Supp. 84 (E.D. Mich. 1972); *Ferland v. Orange Groves of Fla., Inc.*, 377 F. Supp. 690 (M.D. Fla. 1974); *Chelsea Assocs. v. Rapanos*, 376 F. Supp. 929 (E.D. Mich. 1974), *aff'd*, 527 F.2d 1266 (6th Cir. 1975); *Branham v. Material Sys. Corp.*, 354 F. Supp. 1048 (S.D. Fla. 1973); *Kaplan v. Vornado, Inc.*, 341 F. Supp. 212 (N.D. Ill. 1971).

31. *See Rochez Bros. v. Rhoades*, 491 F.2d 402 (3d Cir. 1974), *cert. denied*, 425 U.S. 993 (1976); *Clement A. Evans & Co. v. McAlpine*, 434 F.2d 100 (5th Cir. 1970), *cert. denied*, 402 U.S. 988 (1971). Specific intent to defraud involves an intent to harm the plaintiff and thus is considered more culpable than conduct carried out knowingly but without any conscious intent to cause injury. In 10b-5 actions courts rarely analyze specific intent to defraud because their analysis stops when knowing conduct sufficient to meet scienter requirements is found.

32. *See Wheeler, supra* note 2, at 581-82.

33. 15 U.S.C. §§ 78a to 80b-17 (1970 & Supp. V 1975).

34. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195 (1976) (citing S. REP. NO. 792, 73d Cong., 2d Sess. 1-5 (1934) and H.R. REP. NO. 85, 73d Cong., 1st Sess. 1-5 (1933)). *Accord, Herpich v. Wallace*, 430 F.2d 792, 800-01 (5th Cir. 1970).

35. *Santa Fe Indus., Inc. v. Green*, 97 S. Ct. 1292, 1302-03 (1977); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195 (1976); *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963). Section 2 of the Act reflects legislative cognizance of the need for regulation:

[T]ransactions in securities as commonly conducted upon securities exchanges and over-the-counter markets are affected with a national public interest which makes it necessary to provide for regulation and control of such transactions and of practices and matters related thereto . . . in order to protect interstate commerce . . . and to insure the maintenance of fair and honest markets in such transactions

In section 10(b) of the Act, Congress vested broad rule-making power in the newly created Securities and Exchange Commission (SEC) to enable the latter to police the investment market and punish any future "manipulative or deceptive" practices.³⁶ Pursuant to section 10(b), the SEC promulgated rule 10b-5, which prohibits fraud in the sale of securities by means of making untrue statements or omitting material facts.³⁷ Although the rule was intended as a mechanism for administrative actions against fraud, the courts have read into it a private cause of action.³⁸ Correspondingly, various common law defenses,³⁹ particularly lack of due care by the victim,⁴⁰ have become available in such private actions.

Since private remedies under rule 10b-5 lack legislative guidance, it has been entirely proper for the courts to define the parameters of such

15 U.S.C. § 78b (Supp. V 1975). In a message to Congress concerning the Act, President Roosevelt saw the need to correct abuses in national security exchange trading:

It is my belief that exchanges for dealing in securities and commodities are necessary and of definite value to our commercial and agricultural life. Nevertheless, it should be our national policy to restrict, as far as possible, the use of these exchanges for purely speculative operations.

I therefore recommend to the Congress the enactment of legislation providing for the regulation by the Federal Government of the operations of exchanges dealing in securities and commodities for the protection of investors, for the safeguarding of values, and, so far as it may be possible, for the elimination of unnecessary, unwise and destructive speculation.

78 CONG. REC. 2264 (1934).

36. 15 U.S.C. § 78j(b) (1970). Section 10(b) states:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Id.

37. See note 1 *supra*.

38. See note 2 *supra*.

39. The defenses judicially implied by rule 10b-5 include: (1) laches, waiver and estoppel, which are usually treated as a group; (2) *in pari delicto*, which arises in the rare situations where both parties are found to be equally at fault, as where the victim actively participated in the defendant's wrongdoing; and (3) statute of limitations. Since occasional judicial examination of a plaintiff's diligence in discovering the fraud focuses upon a victim's care *after* the fraud has been perpetrated, it is easily distinguishable from the duty of care discussed in this comment, which involves diligence to avoid allowing the fraud in the first place. See DUKE, *supra* note 13, at 562 & nn.4-6, for a general discussion of common law defenses to 10b-5 actions.

40. The defense of lack of due care can be distinguished from an *in pari delicto* defense in that the latter involves an affirmative, knowing participation in a 10b-5 violation, while lack of due care is passive inaction by the victim, whose carelessness allows the fraud to be perpetrated under his nose.

recovery.⁴¹ As the Supreme Court recently pointed out, policy considerations play an important role in "flesh[ing] out" the securities laws where congressional guidance is lacking, as it clearly is in private actions under rule 10b-5.⁴²

A common justification for imposing the duty of due care is the need to tighten the requirements for private 10b-5 recovery in order to help reduce the vast number of claims brought under the rule.⁴³ The due care requirement effectively limits potential liability and bars many claimants who have exhibited as much carelessness as the defendant, or who have acted in bad faith. Rule 10b-5 actions must be brought in good faith in order to avoid use of that provision as an "insurance policy" by unsuccessful investors.⁴⁴

Some courts out of a policy of fairness have prevented a careless or incautious victim of securities fraud from recovering damages for injuries of which he was not wholly innocent.⁴⁵ An analogous principle in equity

41. The Supreme Court in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), conceded this when it stated:

[A]s we have pointed out, we are not dealing here with any private right created by the express language of §10(b) or of Rule 10b-5. No language in either of those provisions speaks at all to the contours of a private cause of action for their violation. . . . We are dealing with a private cause of action which has been judicially found to exist, and will have to be judicially delimited one way or another unless and until Congress addresses the question.

Id. at 748-49.

42. *Id.* at 737. *Accord*, *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 151-52 (1972); *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 235 (2d Cir. 1974); *Herpich v. Wallace*, 430 F.2d 792, 800-01 (5th Cir. 1970).

43. *Dupuy v. Dupuy*, 551 F.2d 1005, 1019 (5th Cir.), *cert. denied*, 98 S. Ct. 312 (1977); *Straub v. Vaisman & Co.*, 540 F.2d 591, 597 (3d Cir. 1976); *Clement A. Evans & Co. v. McAlpine*, 434 F.2d 100, 104 (5th Cir. 1970), *cert. denied*, 402 U.S. 988 (1971). This has also been the justification behind the seller-purchaser rule, *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952), and the imposition of the requirement of scienter, *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

44. *McGraw v. Matthaiei*, 388 F. Supp. 84 (E.D. Mich. 1972). There the court stated, "An investor who casually makes investments, and who blindly rides bubbles until they burst, does so at his own risk, and cannot later invoke § 10(b) as a form of 'investor's insurance.'" *Id.* at 92. *Accord*, *Financial Indus. Fund, Inc. v. McDonnell Douglas Corp.*, 474 F.2d 514 (10th Cir.), *cert. denied*, 414 U.S. 874 (1973); *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). In *Royal Air Properties, Inc. v. Smith*, 312 F.2d 210, 213-14 (9th Cir. 1962), the court stated, "The purpose of the Securities Exchange Act is to protect the innocent investor, not one who loses his innocence and then waits to see how his investment turns out before he decides to invoke the provisions of the Act."

45. *See Arber v. Essex Wire Corp.*, 490 F.2d 414 (6th Cir.), *cert. denied*, 419 U.S. 830 (1974); *City Nat'l Bank v. Vanderboom*, 422 F.2d 221 (8th Cir.), *cert. denied*, 399 U.S. 905 (1970); *Hafner v. Forest Laboratories, Inc.*, 345 F.2d 167 (2d Cir. 1965); *Kohler v. Kohler Co.*, 319 F.2d 634 (7th Cir. 1963); *Eichen v. E.F. Hutton & Co.*, 402 F. Supp. 823 (S.D.

is that a party will be denied relief where he himself has not done equity.⁴⁶ Even where a defendant's conduct was intentional, a few courts will still look to the overall fairness of the transaction and bar recovery on the basis of the claimant's own lack of care.⁴⁷

One of the strongest judicial policies behind the securities laws is the promotion of investor carefulness. By requiring that all claimants under rule 10b-5 act cautiously and take reasonable precautions to prevent fraud, the courts not only encourage investor self-protection, but help promote the anti-fraud purposes underlying the Act as well.⁴⁸

Punishment of the defendant only minimally justifies the imposition of private remedies under rule 10b-5.⁴⁹ Since private recovery is based on the amount of injury rather than on the defendant's mental state, it is not suitable as a form of primary punishment for securities fraud.⁵⁰ Instead, private remedies compensate for injuries suffered as a result of a defendant's fraudulent conduct. Thus, the due care requirement furthers these restorative purposes by barring recovery for injuries that were not caused solely by the defendant, but were aided in part by the claimant's own carelessness. The defense of due care would therefore not unjustly affect the interests of the investor who had exercised caution and diligence; it would only bar the careless or bad faith claimant from unfairly profiting from the situation.⁵¹

Cal. 1975); *Jackson v. Oppenheim*, 411 F. Supp. 659 (S.D.N.Y. 1974), *aff'd on other grounds*, 533 F.2d 826 (2d Cir. 1976); *Ferland v. Orange Groves of Fla., Inc.*, 377 F. Supp. 690 (M.D. Fla. 1974); *Chelsea Assocs. v. Rapanos*, 376 F. Supp. 929 (E.D. Mich. 1974), *aff'd*, 527 F.2d 1266 (6th Cir. 1975); *Branham v. Material Sys. Corp.*, 354 F. Supp. 1048 (S.D. Fla. 1973); *Kaplan v. Vornado, Inc.*, 341 F. Supp. 212 (N.D. Ill. 1971).

46. See *Wheeler*, *supra* note 2, at 584.

47. *Straub v. Vaisman & Co.*, 540 F.2d 591 (3d Cir. 1976); *Mitchell v. Texas Gulf Sulphur Co.*, 446 F.2d 90 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971); *Clement A. Evans & Co. v. McAlpine*, 434 F.2d 100 (5th Cir. 1970), *cert. denied*, 402 U.S. 988 (1971). *Contra*, *Holdsworth v. Strong*, 545 F.2d 687 (10th Cir. 1976), *cert. denied*, 97 S. Ct. 1600 (1977); *Carroll v. First Nat'l Bank*, 413 F.2d 353 (7th Cir. 1969), *cert. denied*, 396 U.S. 1003 (1970).

48. *Dupuy v. Dupuy*, 551 F.2d 1005, 1014 (5th Cir.), *cert. denied*, 98 S. Ct. 312 (1977).

49. See *Herpich v. Wallace*, 430 F.2d 792 (5th Cir. 1970); *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946).

50. See *Wheeler*, *supra* note 2, at 585 & n.75. *Wheeler* notes that "relatively minimal involvement [by a defendant] might nevertheless lead to tremendous damage exposure." A further indication of the purposes behind rule 10b-5 is the refusal of the courts to award punitive damages in private 10b-5 actions. See, e.g., *Carras v. Burns*, 516 F.2d 251, 259-60 (4th Cir. 1975). Section 28 of the Act restricts recovery under the Act to actual damages. 15 U.S.C. § 78bb (1970).

51. Compare *Dupuy v. Dupuy*, 551 F.2d 1005 (5th Cir.), *cert. denied*, 98 S. Ct. 312 (1977), and *McLean v. Alexander*, 420 F. Supp. 1057 (D. Del. 1976) with *Jackson v. Oppenheim*, 411 F. Supp. 659 (S.D.N.Y. 1974), *aff'd on other grounds*, 533 F.2d 826 (2d Cir. 1976) and *Branham v. Material Sys. Corp.*, 354 F. Supp. 1048 (S.D. Fla. 1973).

While promoting these restorative purposes, the courts that permit the defense are not ignoring the culpability of the defendant or letting him go unpunished.⁵² Criminal penalties and injunctive relief are specifically covered elsewhere in the securities laws, providing adequate mechanisms for the punishment and deterrence of fraudulent conduct.⁵³ To bar a private claimant's recovery because of a failure to exercise due care is not to say that the defendant did not violate rule 10b-5—just that whatever violations occurred cannot be compensated for because of the claimant's own culpability.⁵⁴ The ultimate responsibility for punishment of such a defendant can then be left up to criminal or administrative agencies.⁵⁵

C. Early Judicial Application of Due Care

Although the duty of due care has been applied to public transactions carried out through stock exchanges,⁵⁶ the majority of cases imposing the duty have involved private, face-to-face transactions,⁵⁷ where there is usually a greater opportunity to exercise care to avoid being defrauded.⁵⁸ Since the plaintiff is often charged with knowledge of all information to which he had access—either because it was readily available or because it could have been discovered by reasonable investigation⁵⁹—the circum-

52. See Wheeler, *supra* note 2, at 585-86.

53. See §§ 21, 32 of the Act (15 U.S.C. §§ 78u, 78ff (1970)).

54. The SEC has stated that civil remedies will not always follow from 10b-5 violations. See Wheeler, *supra* note 2, at 586 n.77 (citing Brief for SEC as Amicus Curiae, Ernst & Ernst v. Hochfelder, *cert. granted*, 421 U.S. 909 (1975)).

55. Wheeler notes that as a practical matter public officials have only limited manpower available to police and punish all 10b-5 violations and thus reliance upon the judicial system is often necessary as well as helpful. Consequently, the possibility of private actions for damages is an important factor in the enforcement of the anti-fraud provisions. Wheeler, *supra* note 2, at 586 & n.79; see Herpich v. Wallace, 430 F.2d 792, 804 (5th Cir. 1970).

56. See Financial Indus. Fund, Inc. v. McDonnell Douglas Corp., 474 F.2d 514 (10th Cir.), *cert. denied*, 414 U.S. 874 (1973); Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971).

57. See, e.g., Vohs v. Dickson, 495 F.2d 607 (5th Cir. 1974); Rochez Bros. v. Rhoades, 491 F.2d 402 (3d Cir. 1974), *cert. denied*, 425 U.S. 933 (1976); Jackson v. Oppenheim, 411 F. Supp. 659 (S.D.N.Y. 1974), *aff'd on other grounds*, 533 F.2d 826 (2d Cir. 1976).

58. See Wheeler, *supra* note 2, at 596-97.

59. See *id.* at 598; notes 8-9 *supra* and accompanying text. One recent case determined the point at which the duty to investigate will end. Hutto v. Texas Income Properties Corp., 416 F. Supp. 478 (S.D. Texas 1976). Even though the plaintiff had failed to adequately investigate before the agreement was reached, the court found that the fraud could not have been detected at that time, since it appeared only later during the prolonged negotiations prior to the actual transfer. The court held that in such instances of prolonged negotiations following an initial agreement, the plaintiff's duty to investigate will begin at the "initial contact between buyer and seller and continu[e] only until such time as an agreement to purchase is reached . . ." *Id.* at 483. It would not be necessary for a

stances surrounding the transaction play an important part in the success or failure of the defense.

1. Use of Due Care to Determine the Defendant's Duty to Disclose

The courts have taken various approaches to the requirement of due care in private 10b-5 actions. One approach ties the plaintiff's conduct to the threshold question of the defendant's duty to disclose, and the exposure of the conduct to 10b-5 liability.⁶⁰ In such cases, liability is conditioned upon the claimant's lack of knowledge of the relevant information. Where the exercise of a reasonable amount of care should have led the plaintiff to the true facts, the defendant has no duty under rule 10b-5 to disclose the information.⁶¹ Under such an approach, the plaintiff's sophistication in financial affairs, or his position as an insider to a company's business, will play an important role in determining what information he should have been aware of without its specific disclosure.⁶²

One of the problems with this approach is that it fails to separate the defendant's liability from the plaintiff's right to recover.⁶³ Liability under rule 10b-5 should be independently based upon the defendant's culpability; avoidance of that liability being a separate determination based upon the availability of several defenses. When the issue of a plaintiff's due care affects the determination of liability, the result is often that a

plaintiff to continue investigating throughout the negotiation period unless circumstances arise to put a reasonable person on notice of a need for further inquiry. *Id.*

60. *Frigitemp Corp. v. Financial Dynamics Fund, Inc.*, 524 F.2d 275 (2d Cir. 1975); *Arber v. Essex Wire Corp.*, 490 F.2d 414 (6th Cir.), *cert. denied*, 419 U.S. 830 (1974); *City Nat'l Bank v. Vanderboom*, 422 F.2d 221 (8th Cir.), *cert. denied*, 399 U.S. 905 (1970); *Myzel v. Fields*, 386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968); *Hafner v. Forest Laboratories, Inc.*, 345 F.2d 167 (2d Cir. 1965); *Kohler v. Kohler Co.*, 319 F.2d 634 (7th Cir. 1963); *Chelsea Assocs. v. Rapanos*, 376 F. Supp. 929 (E.D. Mich. 1974), *aff'd*, 527 F.2d 1266 (6th Cir. 1975); *McGraw v. Matthaei*, 388 F. Supp. 84 (E.D. Mich. 1972); *Kaplan v. Vornado, Inc.*, 341 F. Supp. 212 (N.D. Ill. 1971).

61. *See, e.g., Frigitemp Corp. v. Financial Dynamics Fund, Inc.*, 524 F.2d 275 (2d Cir. 1975) (no duty to disclose information which the defendants knew plaintiffs could have found out from available transfer sheets); *City Nat'l Bank v. Vanderboom*, 422 F.2d 221 (8th Cir.), *cert. denied*, 399 U.S. 905 (1970) (no duty to disclose an audit report of the company books and records to which the plaintiff had unimpeded access); *Chelsea Assocs. v. Rapanos*, 376 F. Supp. 929 (E.D. Mich. 1974), *aff'd*, 527 F.2d 1266 (6th Cir. 1975) (no duty to inform plaintiff of facts of which its representative was already aware).

62. *See City Nat'l Bank v. Vanderboom*, 422 F.2d 221 (8th Cir.), *cert. denied*, 399 U.S. 905 (1970); *Myzel v. Fields*, 386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968); *Kohler v. Kohler Co.*, 319 F.2d 634 (7th Cir. 1963).

63. *See Dupuy v. Dupuy*, 551 F.2d 1005, 1015 (5th Cir.), *cert. denied*, 98 S. Ct. 312 (1977).

defendant escapes all liability rather than merely avoiding the burden of rectifying the losses suffered.

Another problem with this approach is that it fails to impose a uniform standard of culpability upon defendants, since a defendant's duty will vary according to the status of the plaintiff and the circumstances of the transaction. Thus, where the plaintiff is a sophisticated investor or corporate insider, the defendant's duty to disclose the relevant facts will be much lower than it would be were the plaintiff unsophisticated or the action part of an SEC proceeding.⁶⁴ However, the policy of furthering high ethical standards in the securities field indicates that the duty of full disclosure is owed to the public as a whole, not to any particular investor.⁶⁵ It follows that the status of a claimant should not alter the duty of disclosure mandated by rule 10b-5. Imposing the due care requirement to alter a defendant's duty according to the type of proceeding brought or the status of the victim, will inevitably produce confusion and inconsistency, and will allow defendants to engage in "gamesmanship" in carrying out their obligation to disclose.⁶⁶

2. Infusion of Due Care into the Reliance Requirement

A second approach employed by the courts has been to intertwine due care with the requirements of reliance and materiality.⁶⁷ Some courts have thus confused the finding of reliance on misstatements or omissions—the fact which establishes causation⁶⁸—with the determination of

64. See *City Nat'l Bank v. Vanderboom*, 422 F.2d 221 (8th Cir.), *cert. denied*, 399 U.S. 905 (1970); *Myzel v. Fields*, 386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968); *Kohler v. Kohler Co.*, 319 F.2d 634 (7th Cir. 1963).

Recently, in *Dupuy v. Dupuy*, 551 F.2d 1005 (5th Cir.), *cert. denied*, 98 S. Ct. 312 (1977), the Fifth Circuit noted this inherent inconsistency between the standards imposed upon defendants in private actions under rule 10b-5, and those imposed upon defendants in SEC enforcement proceedings:

Because the private 10b-5 cause of action derives from a prohibitory SEC rule, the standard of conduct for defendants logically should be the same whether the SEC or a private litigant enforces the duty. In an SEC enforcement proceeding, the due care of the victim generally does not receive consideration.

Id. at 1015. See also *SEC v. Dolnick*, 501 F.2d 1279 (7th Cir. 1974) (victim's status as a knowledgeable investor disregarded); *Hanley v. SEC*, 415 F.2d 589 (2d Cir. 1967) (victim's sophistication disregarded).

65. *Dupuy v. Dupuy*, 551 F.2d 1005, 1015 (5th Cir.), *cert. denied*, 98 S. Ct. 312 (1977).

66. *Id.* See *Wheeler*, *supra* note 2, at 591.

67. See *Mitchell v. Texas Gulf Sulphur Co.*, 446 F.2d 90 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971); *Rogen v. Ilikon Corp.*, 361 F.2d 260 (1st Cir. 1966); *Ferland v. Orange Groves of Fla. Inc.*, 377 F. Supp. 690 (M.D. Fla. 1974); *Taylor v. Smith, Barney & Co.*, 358 F. Supp. 892 (D. Utah 1973); *Branham v. Material Sys. Corp.*, 354 F. Supp. 1048 (S.D. Fla. 1973). See generally Note, *The Reliance Requirement in Private Actions Under SEC Rule 10b-5*, 88 HARV. L. REV. 584 (1975).

68. See citations note 6 *supra*.

whether the plaintiff *should have* relied on defendant's actions—something that is more properly a policy decision.⁶⁹ The two inherently separate questions of due care and reliance have been merged by some courts into the single requirement of “reasonable reliance.”⁷⁰ Where a plaintiff fails to take the care which his background and the immediate circumstances call for, the reliance is deemed unreasonable and proof of causal connection fails.⁷¹

The difficulty with applying this approach lies not only in its obfuscation of the difference between reliance and due care, but in the inconsistencies which result. In *Affiliated Ute Citizens v. United States*,⁷² the Supreme Court ruled that where omissions are alleged under rule 10b-5, individual reliance need no longer be proved once it is shown that the omissions were material.⁷³ As a result, in omissions cases those courts tying due care to reliance will avoid assessing the plaintiff's degree of

69. Comment b of § 545A of the RESTATEMENT (SECOND) OF TORTS makes an important distinction between “justifiableness” of the plaintiff's reliance on a particular misrepresentation or omission, and his contributory negligence (lack of due care) in doing so:

Although the plaintiff's reliance on the misrepresentation must be justifiable, . . . this does not mean that his conduct must conform to the standard of the reasonable man. Justification is a matter of the qualities and characteristics of the particular plaintiff, and the circumstances of the particular case, rather than of the application of a community standard of conduct to all cases. Negligent reliance and action sometimes will not be justifiable, and the recovery will be barred accordingly; but this is not always the case. There will be cases in which a plaintiff may be justified in relying upon the representation, even though his conduct in doing so does not conform to the community standard of knowledge, intelligence, judgement or care. Thus, under the rule stated in § 540, the recipient of a fraudulent misrepresentation is not required to investigate its truth, even when a reasonable man of ordinary caution would do so before taking action; and it is only when he knows of the falsity or it is obvious to him that his reliance is not justified.

RESTATEMENT (SECOND) OF TORTS § 545A, Comment b (1977). See generally Wheeler, *supra* note 2, at 592-93.

70. See Taylor v. Smith, Barney & Co., 358 F. Supp. 892 (D. Utah 1973); Branham v. Material Sys. Corp., 354 F. Supp. 1048 (S.D. Fla. 1973). See generally Comment, *Reliance Under Rule 10b-5: Is the “Reasonable Investor” Reasonable?*, 72 COLUM. L. REV. 562 (1972).

71. See, e.g., Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971) (reliance on a deceptive press release unjustified when a subsequent truthful one had since been issued); Branham v. Material Sys. Corp., 354 F. Supp. 212 (N.D. Ill. 1971) (plaintiff's reliance unreasonable since as an experienced investor making a large investment he should have exercised greater care in discovering the true facts).

72. 406 U.S. 128 (1972).

73. *Id.* at 153. See also Blackie v. Barrack, 524 F.2d 891 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976).

Some commentators contend that proof of materiality raises a presumption of reliance which is rebuttable by a showing that the plaintiff would not have appreciated the importance of the information even if disclosure was made. See Ruder & Cross, *Limitations on Civil Liability under Rule 10b-5*, 1972 DUKE L.J. 1125, 1134-38.

care altogether.⁷⁴ However, due care would continue to be applied in misrepresentation cases, which in fact have no greater policy reasons for the requirement of due care than omission cases do.⁷⁵ Such inconsistency would allow a claimant to escape his duty of care merely by alleging an omission. This situation can be alleviated only by treating due care as a completely separate requirement, producing a clear and constant duty of care by the plaintiff regardless of the nature of the allegations.⁷⁶

3. Use of Due Care as a Separate Element

A third approach to the due care requirement is to regard it as a separate element of recovery under rule 10b-5, entirely independent from proof of reliance or a determination of defendant liability.⁷⁷ Commentators argue that this is the far superior approach.⁷⁸ Since the issue of liability is settled prior to an examination of the plaintiff's conduct, the defendant's duty to disclose remains unaltered by the status or knowledge of the claimant. Rather than dispute the legality of the defendant's acts, a successful defense would bar recovery because of the claimant's own carelessness in helping to bring about the harm. This approach more clearly aligns the use of the due care requirement with policy considerations stressing investor watchfulness and the use of rule 10b-5 privately for primarily restorative purposes.

Unfortunately, it is unclear which party will have the burden of proving or disproving the plaintiff's due care. While a few courts have treated the duty of due care as an affirmative defense to be raised by the defendant,⁷⁹ in one case it was held to be part of the plaintiff's case.⁸⁰

74. See *Dupuy v. Dupuy*, 551 F.2d 1005, 1015-16 (5th Cir.), *cert. denied*, 98 S. Ct. 312 (1977).

75. *Id.*

76. See *McLean v. Alexander*, 420 F. Supp. 1057, 1078 & n.112 (D. Del. 1976); *Wheeler*, *supra* note 2, at 594.

77. See *Thomas v. Duralite Co.*, 524 F.2d 577 (3d Cir. 1975); *Bird v. Ferry*, 497 F.2d 112 (5th Cir. 1974); *Rochez Bros. v. Rhoades*, 491 F.2d 402 (3d Cir. 1974), *cert. denied*, 425 U.S. 993 (1976); *Financial Indus. Fund, Inc. v. McDonnell Douglas Corp.*, 474 F.2d 514 (10th Cir. 1973); *Clement A. Evans & Co. v. McAlpine*, 434 F.2d 100 (5th Cir. 1970), *cert. denied*, 402 U.S. 988 (1971); *Jackson v. Oppenheim*, 411 F. Supp. 659 (S.D.N.Y. 1974), *aff'd on other grounds*, 533 F.2d 826 (2d Cir. 1976).

78. See *Wheeler*, *supra* note 2, at 594; *DUKE*, *supra* note 13, at 760 (approach called "theoretically impeccable").

79. *Clement A. Evans & Co. v. McAlpine*, 434 F.2d 100 (5th Cir. 1970), *cert. denied*, 402 U.S. 988 (1971) (affirmative defenses—presumably due care—held available in 10b-5 actions); *Branham v. Material Sys. Corp.*, 354 F. Supp. 1048 (S.D. Fla. 1973) (due care raised as an affirmative defense, though court also tied due care to reliance).

80. *Financial Indus. Fund, Inc. v. McDonnell Douglas Corp.*, 474 F.2d 514 (10th Cir.), *cert. denied*, 414 U.S. 874 (1973).

Most courts, however, do not state whether they are looking at the plaintiff's conduct in the context of his case, or at proof raised by the defendant.⁸¹ With increased recognition of the due care requirement, courts can be expected to define more clearly the procedural aspects of its implementation.⁸² Applying due care as an affirmative defense may assure its isolation from the issue of the plaintiff's reliance or the liability of the defendant, and thus allow its use to bar recovery under rule 10b-5 much like the defenses of estoppel and waiver.

II. JUDICIAL APPLICATIONS OF DUE CARE FOLLOWING *Hochfelder*

In early 1976, the Supreme Court announced in *Ernst & Ernst v. Hochfelder*⁸³ that negligence would not be a valid basis for 10b-5 recovery, and that in order to establish liability, a defendant must be shown to have had an "intent to deceive, manipulate or defraud."⁸⁴ The Court expressly left open the question of whether reckless disregard⁸⁵ would satisfy the scienter requirement, although it noted that "[i]n certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act."⁸⁶

Despite ambiguities in the Court's definition of "scienter," commentators and courts have generally agreed that the *Hochfelder* standard embraces more than specific intent to deceive, and that mere knowledge of falsity⁸⁷ or reckless disregard for the truth⁸⁸ will be enough for

81. See, e.g., *Bird v. Ferry*, 497 F.2d 112 (5th Cir. 1974); *Rochez Bros. v. Rhoades*, 491 F.2d 402 (3d Cir. 1974), cert. denied, 425 U.S. 993 (1975); *City Nat'l Bank v. Vanderboom*, 422 F.2d 221 (8th Cir.), cert. denied, 399 U.S. 905 (1970); *Jackson v. Oppenheim*, 411 F. Supp. 659 (S.D.N.Y. 1974), aff'd on other grounds, 533 F.2d 826 (2d Cir. 1976).

82. There is some indication that the duty of due care may have ramifications on the scope of discovery in securities cases. In *Zucker v. Sable*, 72 F.R.D. 1 (S.D.N.Y. 1975), the court held that a plaintiff's investment history is "clearly relevant" to the defendant's case since, where sophisticated investors are seeking recovery, such information can establish a lack of due care on the plaintiff's part. *Id.* at 4.

83. 425 U.S. 185 (1976).

84. *Id.* at 193.

85. "Recklessness" in the securities field is defined by David Ruder as "acts in conscious disregard of, or indifference to, the risk that [victims of a misrepresentation or omission] will be misled." Ruder, *Texas Gulf Sulphur—The Second Round: Privity and State of Mind in Rule 10b-5 Purchase and Sales Cases*, 63 NW. U.L. REV. 423, 436 (1968). Recklessness generally connotes a type of aggravated negligence which differs in quality rather than degree from ordinary negligence. The actor has intentionally disregarded a known risk from which it was highly probable that harm would follow. See PROSSER, *supra* note 22, at 184-85. See generally 3 BROMBERG, *supra* note 6, ¶ 8.4(570), at 204.208.

86. 425 U.S. at 193-94 n.12.

87. See Bucklo, *The Supreme Court Attempts to Define Scienter Under Rule 10b-5: Ernst & Ernst v. Hochfelder*, 29 STAN. L. REV. 213, 226-27, 235 (1977).

88. *Saunders v. John Nuveen & Co.*, 554 F.2d 790, 792-93 (7th Cir. 1977); Sundstrand

liability. Several cases following *Hochfelder* have grappled with the effect of the scienter standard upon the requirement of due care.

The first such case was *Straub v. Vaisman & Co.*,⁸⁹ decided by the Third Circuit shortly after *Hochfelder*. Suit under rule 10b-5 had been brought by several foreign nationals against a securities broker which had allegedly failed to disclose material facts during a stock transfer.⁹⁰ The district court found specific intent to defraud, but the defendants argued that the plaintiffs' failure to investigate the financial conditions of the company adequately before investing should bar recovery.⁹¹

The Third Circuit held that after *Hochfelder* a plaintiff still must exercise due care in the particular circumstances in order to recover under rule 10b-5.⁹² The court recognized that by analogy to the common law, the *Hochfelder* requirement of scienter should severely limit the use of lack of due care as a defense.⁹³ The court also noted that the rise of the doctrine of comparative negligence has raised doubts as to the validity of a policy which "den[ies] all recovery to a defrauded plaintiff who was only somewhat careless or understandably trusting."⁹⁴

Despite these doubts, the court found the legislative and judicial policies underlying the defense—encouraging investor caution and integrity—too strong to be overruled.⁹⁵ As a result, the court imposed a "flexible duty" standard of care on plaintiffs, to be measured by the circumstances of each case, such as the relationship between the parties, the sophistication of the plaintiff, and the plaintiff's opportunity to discover the fraud or obtain access to the truth.⁹⁶ The court expressly placed the burden of showing lack of due care upon the defendants, to be raised as an affirmative defense rather than as part of the plaintiff's case.⁹⁷ The court concluded that, under the circumstances shown, the

Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1040 (7th Cir.), cert. denied, 98 S. Ct. 225 (1977); Dupuy v. Dupuy, 551 F.2d 1005, 1017 & n.23 (5th Cir.), cert. denied 98 S. Ct. 312 (1977); Bailey v. Meister Brau, Inc., 535 F.2d 982, 993-94 (7th Cir. 1976); McLean v. Alexander, 420 F. Supp. 1057, 1080-81 (D. Del. 1976). See also Bucklo, *The Supreme Court Attempts to Define Scienter Under Rule 10b-5: Ernst & Ernst v. Hochfelder*, 29 STAN. L. REV. 213, 235-36 (1977).

89. 540 F.2d 591 (3d Cir. 1976).

90. *Id.* at 594.

91. *Id.* at 596.

92. *Id.* at 598.

93. *Id.* at 597. See notes 24-25 *supra* and accompanying text.

94. 540 F.2d at 597.

95. *Id.* at 597-98.

96. *Id.* at 598.

97. *Id.*

plaintiffs had acted with reasonable care and that lack of diligence had not been established.⁹⁸

A few months after *Straub* was decided, the Tenth Circuit in *Holdsworth v. Strong*⁹⁹ held that in light of the requirement of scienter imposed by *Hochfelder*, due care would no longer be available as a defense in private 10b-5 actions.¹⁰⁰ The suit was brought by one corporate insider against another, who had allegedly misrepresented the financial position of a close corporation in order to induce the plaintiff to sell his stock.¹⁰¹ The trial court had little trouble finding that the defendant had knowingly and intentionally misrepresented the facts to the plaintiff.¹⁰²

Examining common law distinctions between negligence as a defense to negligent misrepresentation and its availability against intentional misrepresentation, the court held that a plaintiff's lack of due care would be "irrational and unrelated" to 10b-5 actions based on fraud.¹⁰³ The court noted that "[s]ince the plaintiff must prove his case in terms of the standard of scienter, doubts are cast on its usefulness where it allows the fraudulent actor to escape liability by saying that if the plaintiff had been diligent, he would not have allowed himself to be cheated."¹⁰⁴ The court found nothing in either the language of rule 10b-5 or the *Hochfelder* decision to indicate that the defense should continue to be applied in the face of intentional conduct.¹⁰⁵ Only where the intentional misrepresentation was patently false would a plaintiff have the duty to investigate before relying on it.¹⁰⁶ Nevertheless, the actions of the plaintiff might be a defense if they were "gross conduct somewhat comparable to that of

98. *Id.* The court found that the transaction had been specifically timed during a holiday season to afford the plaintiffs only a short opportunity to investigate. The defendants had also exploited the plaintiffs' confidence in the defendant representative in order to further the fraud.

99. 545 F.2d 687 (10th Cir. 1976) (en banc), *cert. denied*, 97 S. Ct. 1600 (1977).

100. *Id.*, at 694. The Tenth Circuit had written a prior opinion five months earlier which was withdrawn following the *Hochfelder* decision. See [1975-76 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,465 (Feb. 27, 1976). In the withdrawn opinion, the court had held that the plaintiff was barred from recovery by his lack of due diligence in not investigating the financial status of the company. While recognizing the rarity of the due care defense in intentional conduct situations, the court felt that since the plaintiff was a sophisticated investor, his failure to investigate could not be overlooked. *Id.* at 99,363.

101. 545 F.2d at 689.

102. *Id.* at 691.

103. *Id.* at 692, 694. The court said that "[j]ust as contributory negligence is not a defense to an intentional tort case of fraud, similarly due diligence is totally inapposite in the context of intentional conduct required to be proved under Rule 10b-5." *Id.* at 694.

104. *Id.* at 693.

105. *Id.* at 694.

106. *Id.* See note 26 *supra* and accompanying text.

defendant.”¹⁰⁷ While not stating a basis for this apparent undercutting of the strength of its holding, the court implied that it would modify its position in extreme situations where the plaintiff’s conduct was shown to have been as flagrant as defendant’s.

The *Holdsworth* court also noted the distinction the Tenth Circuit has made in the past¹⁰⁸ between holding the plaintiff to a due care standard, and examining the plaintiff’s background in order to determine whether reliance was justified.¹⁰⁹ Thus, even though lack of due care will not be recognized as a separate defense, the plaintiff’s conduct and business acumen will remain relevant to the reasonableness of his reliance.¹¹⁰

In early 1977, the Seventh Circuit in *Sundstrand Corp. v. Sun Chemical Corp.*¹¹¹ examined the due care requirement in the context of recklessness under the scienter requirement. The issue arose in connection with a proposed corporate merger during which the defendants allegedly misrepresented and omitted certain material facts concerning the financial condition of the target company.¹¹² The district court had found that the defendants had “deliberately, or at best, recklessly, misrepresented” the true financial conditions.¹¹³

The Seventh Circuit agreed with the finding of 10b-5 liability, since there was sufficient reckless conduct to meet the scienter requirement of *Hochfelder*.¹¹⁴ But the defendants were not allowed to assert the plaintiff’s lack of due care as a defense.¹¹⁵ At common law, recklessness was sufficient to support a cause of action for fraud or deceit, making a claimant’s negligence as irrelevant to recklessness as it would be to actions carried out with specific intent to deceive.¹¹⁶

Despite adopting common law distinctions to bar the use of due care as a defense, the Seventh Circuit nevertheless considered the plaintiff’s actions when analyzing the separate defense of nonreliance.¹¹⁷ To rebut

107. 545 F.2d at 693.

108. See *Financial Indus. Fund, Inc. v. McDonnell Douglas Corp.*, 474 F.2d 514 (10th Cir.), cert. denied, 414 U.S. 874 (1973).

109. 545 F.2d at 695-96.

110. *Id.* at 697. The court thus perpetuated the confusion between questions of reliance and questions of due care.

111. 553 F.2d 1033 (7th Cir.), cert. denied, 98 S. Ct. 225 (1977).

112. *Id.* at 1037.

113. *Id.* at 1039.

114. *Id.* at 1040. The court cited *Bailey v. Meister Brau, Inc.*, 535 F.2d 982, 993-94 (7th Cir. 1976).

115. 553 F.2d at 1040.

116. *Id.* at 1044.

117. *Id.* at 1049. Thus this court also confuses due care with reliance. In another recent case, due care was confused with causation when the court said that “plaintiff cannot

a presumption of reliance on the omission made, the defendant was required to show that the plaintiff had constructive knowledge of the omitted information. Hinging constructive knowledge upon the plaintiff's ability to have discovered the truth, the court noted that prior to *Hochfelder*, a lack of care under negligence standards would have sufficed to charge the plaintiff with knowledge.¹¹⁸ The court, however, relying on the *Holdsworth* dictum,¹¹⁹ found that following *Hochfelder* a plaintiff must be shown to have exhibited more than mere lack of care: gross or highly unreasonable conduct would be required.¹²⁰ But the court found no recklessness in the plaintiff's investigation of the situation.¹²¹

Thus, the court apparently distinguished the affirmative defense of due care from the use of a claimant's actions to determine justifiable reliance. By using the plaintiff's conduct as a factor in judging the reasonableness of his reliance, the court incorporated due care into its determination of 10b-5 liability while invalidating due care as a separate defense.

A few months after *Sundstrand*, the Fifth Circuit in *Dupuy v. Dupuy*¹²² took the opposite approach, and recognized lack of due care as a separate defense to recklessness if the plaintiff acted not with mere negligence, but with a recklessness comparable to that of the defendant.¹²³ The claimant sued his brother, alleging misrepresentation and omission of material facts concerning the financial condition of a company jointly owned by them in order to induce the plaintiff to sell his stock at an unreasonably low price.¹²⁴ The court held that there was adequate evidence upon which the jury¹²⁵ could have found fraud by the defendant.¹²⁶ Once establishing that the defendant was liable under rule

claim reliance if it failed to exercise the due diligence required of it by law." NBI Mortgage Inv. Corp. v. Chemical Bank, [Current Binder] FED. SEC. L. REP. (CCH) ¶ 96,066, at 91,801 (S.D.N.Y. 1977).

118. 553 F.2d at 1048.

119. *Holdsworth v. Strong*, 545 F.2d 687, 693 (10th Cir. 1976) (en banc), cert. denied, 97 S. Ct. 1600 (1977).

120. 553 F.2d at 1048.

121. *Id.*

122. 551 F.2d 1005 (5th Cir.), cert. denied, 98 S. Ct. 312 (1977).

123. *Id.* at 1020.

124. *Id.* at 1007.

125. At trial, the jury found that the plaintiff had acted with sufficient care to warrant judgment in his favor. However, the trial judge disagreed and gave judgment n.o.v. to the defendant. *Id.* at 1007-08.

126. The defendant, having active management of the company, knew well in advance of his statements to the plaintiff that the company had made a very profitable agreement with a development company, greatly increasing the company's worth. The defendant had hidden the information from his brother and led him to believe that financial arrangements on the deal were at a standstill. The plaintiff, being in ill health, became apprehensive over his investment and asked his brother to buy him out. *Id.* at 1011.

10b-5, the court went on to consider the effect of the plaintiff's lack of care on the recovery.¹²⁷

The court decided to follow the approach it had taken in *Clement A. Evans & Co. v. McAlpine*,¹²⁸ and treated due care as an element separate from the issue of defendant's liability.¹²⁹ The court's choice was influenced by the need to establish consistent standards of conduct for defendants in 10b-5 actions, and to avoid confusion between private 10b-5 proceedings and SEC enforcement proceedings.¹³⁰ Since private actions under rule 10b-5 have the same statutory basis as SEC enforcement proceedings, the same standard of conduct should be imposed upon defendants in both types of action.¹³¹ A victim's conduct should thus be as irrelevant to liability in private actions as it is in SEC proceedings.¹³² Since the duty of full disclosure is theoretically owed to the public rather than to any individual investor, the preclusion of a particular plaintiff from recovery should not affect an independent determination of whether a violation of the Act has occurred.¹³³

The *Dupuy* court was also convinced that tying due care to considerations of materiality and reliance, as some circuits have done,¹³⁴ would bring about inconsistencies between the application of due care in cases involving misrepresentation-induced fraud, and those involving omission-induced fraud.¹³⁵ In omissions cases, relating due care to reliance would result in the courts' ignoring a claimant's responsibility to invest with caution, since after *Affiliated Ute Citizens v. United States*,¹³⁶ reliance need no longer be proven in such cases.¹³⁷ The court argued that policies of promoting investor care and good faith "do not vanish in omissions cases."¹³⁸

Having decided to approach due care as a separate element, the court went on to analyze the effect of the *Hochfelder* scienter requirement upon its continued application in rule 10b-5 actions. Several theories support a continuation of the common law distinction between the effect

127. *Id.* at 1013.

128. 434 F.2d 100 (5th Cir. 1970), *cert. denied*, 402 U.S. 988 (1971). See text accompanying notes 77-78 *supra*.

129. 551 F.2d at 1014-15.

130. *Id.* at 1015.

131. *Id.*

132. *Id.* See note 64 *supra* and accompanying text.

133. 551 F.2d at 1015. See note 64 *supra* and accompanying text.

134. See notes 67-69 *supra* and accompanying text.

135. 551 F.2d at 1016.

136. 406 U.S. 128 (1972).

137. 551 F.2d at 1015-16. See notes 72-75 *supra* and accompanying text.

138. 551 F.2d at 1015-16.

of a plaintiff's negligence in intentional tort actions and in negligent tort actions. First, the policy of discouraging intentional misconduct is much greater than that of discouraging negligent conduct, in light of the judicial shift away from the concept of *caveat emptor* in the securities field.¹³⁹ Second, comparative culpability plays a large part in determining which party should bear the loss.¹⁴⁰ A victim's negligence will be evaluated where it corresponds to the defendant's behavior, but will be disregarded where there is a more culpable intentional act by the defendant.¹⁴¹ The court found that nothing in securities law policy would preclude this judicial allocation of loss.¹⁴²

Until *Hochfelder*, the due care requirement had been an important mechanism for lessening the potential liability of people handling securities transactions.¹⁴³ The requirement of scienter, however, limits the risk of liability to conduct which is in some way intentional, thus decreasing the importance of the due care defense in limiting rule 10b-5 recovery.¹⁴⁴ Since most cases prior to *Hochfelder* did not require the victim to show due care where intentional fraud was found, they can be viewed as consistent with the common law dichotomy.¹⁴⁵

Ultimately, the *Dupuy* court held that following *Hochfelder*, the due care concept would be altered consistent with tort law and the policies of the federal securities laws, so that a successful defense requires proof that the claimant exhibited a lack of care at least as culpable as the defendant's.¹⁴⁶ Thus, since recklessness is the minimum form of conduct recognized under scienter definitions,¹⁴⁷ the defendant must now prove at least reckless conduct by a claimant before recovery can be barred.¹⁴⁸

Using this standard, the Fifth Circuit looked at whether the plaintiff had "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

139. *Id.* at 1018. In *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963), the Supreme Court stated that the 1934 Act and its companion provisions contained a "fundamental purpose . . . 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." *Id.* at 186.

140. 551 F.2d at 1018.

141. *Id.*

142. *Id.* at 1019.

143. *Id.* See note 43 *supra*.

144. 551 F.2d at 1019.

145. *Id.*

146. *Id.* at 1020.

147. *Id.* See notes 87-88 *supra* and accompanying text.

148. In *McLean v. Alexander*, 420 F. Supp. 1057, 1078 (D. Del. 1976), the court recognized due care as a defense to reckless misconduct without indicating that anything more than a showing of negligence by the plaintiff was required.

great as to make it highly probable that harm would follow.' ''¹⁴⁹ Under the circumstances, the plaintiff was held to have acted reasonably in selling his stock, and was not reckless.¹⁵⁰

III. FACTORS AFFECTING THE EXTENT OF THE DUE CARE REQUIREMENT

Regardless of the circuits' approach to due care, there are several factual considerations that will affect the extent of an individual claimant's duty of care.¹⁵¹ The courts will hold a claimant to an objective standard of care by requiring that he exercise the degree of care that a person of similar background and depth of knowledge would have exercised in those circumstances.¹⁵² For the average investor, this standard requires the common sense and good judgment of the reasonable person having no particular experience or expertise in the investment field.¹⁵³ Such ordinary investors will be held to an understanding of elementary technical information,¹⁵⁴ and any knowledge contained in easily available current market sheets.¹⁵⁵

Among the factors deemed relevant to the plaintiff's obligation are: access to the information and opportunity to detect the fraud;¹⁵⁶ the way in which the fraud was concealed;¹⁵⁷ the existence of a fiduciary relationship between the parties;¹⁵⁸ the existence of a long standing business or

149. 551 F.2d at 1020 (quoting PROSSER, *supra* note 22, § 34, at 185).

150. *Id.* at 1020-24.

151. The factors most commonly used by the courts were first set down by the Fifth Circuit in *Clement A. Evans & Co. v. McAlpine*, 434 F.2d 100 (5th Cir. 1970), *cert. denied*, 402 U.S. 988 (1971), in the context of the district court's jury instructions:

[I]t is impossible to lay down any general rule as to the amount of evidence or number or nature of evidential facts admitting discovery of fraud. But, facts in the sense of indisputable proof or any proof at all, are different from facts calculated to excite inquiry which impose a duty of reasonable diligence and which, if pursued, would disclose the fraud. Facts calculated to excite inquiry merely constitute objects of direct experience and, as such, may comprise rumors or vague charges if of sufficient substance to arouse suspicion. Thus, the duty of reasonable diligence is an obligation imposed by law solely under the peculiar circumstances of each case, including existence of a fiduciary relationship, concealment of the fraud, opportunity to detect it, position in the industry, sophistication and expertise in the financial community, and knowledge of related proceedings.

Id. at 102.

152. *See McLean v. Alexander*, 420 F. Supp. 1057, 1077 (D. Del. 1976).

153. *See Ferland v. Orange Groves of Fla., Inc.*, 377 F. Supp. 690, 705, 707 (M.D. Fla. 1974). *See generally* DUKE, *supra* note 13, at 775.

154. *Kaplan v. Vornado, Inc.*, 341 F. Supp. 212 (N.D. Ill. 1971).

155. *Hafner v. Forest Laboratories, Inc.*, 345 F.2d 167 (2d Cir. 1965).

156. *See* authorities cited notes 8-9 *supra*.

157. *See Myzel v. Fields*, 386 F.2d 718 (8th Cir.), *cert. denied*, 390 U.S. 951 (1967); *McLean v. Alexander*, 420 F. Supp. 1057 (D. Del. 1976).

158. *See Bird v. Ferry*, 497 F.2d 112 (5th Cir. 1974).

personal relationship between the parties;¹⁵⁹ and whether it was the plaintiff who initiated the sale or sought to rush its progress.¹⁶⁰ Two other factors which have been given considerable importance by the courts are the plaintiff's sophistication and experience in the investment field, and the nature of the plaintiff's position within the industry.¹⁶¹

A. *Sophisticated Investors*

The Securities Exchange Act of 1934 has been interpreted to afford relief not only to the gullible and unsophisticated investor, but to the knowledgeable and experienced one as well.¹⁶² A sophisticated investor is also entitled to reasonable reliance on the honesty of the people he deals with, since "integrity is still the mainstay of commerce"¹⁶³

However, an investor with vast business experience or valuable expertise in the investment field may have constructive knowledge of the risks inherent in certain transactions, regardless of any actual knowledge of the fraud.¹⁶⁴ Such an investor would be held to a greater duty to investigate the truth than a person who lacks such sophistication.¹⁶⁵ An investor who

159. See *Dupuy v. Dupuy*, 551 F.2d 1005 (5th Cir.), *cert. denied*, 98 S. Ct. 312 (1977); *Holdsworth v. Strong*, 545 F.2d 687 (10th Cir. 1976), *cert. denied*, 97 S. Ct. 1600 (1977); *Myzel v. Fields*, 386 F.2d 718 (8th Cir.), *cert. denied*, 390 U.S. 951 (1967).

160. *Dupuy v. Dupuy*, 551 F.2d 1005 (5th Cir.), *cert. denied*, 98 S. Ct. 312 (1977); *Hafner v. Forest Laboratories, Inc.*, 345 F.2d 167 (2d Cir. 1965); *Kohler v. Kohler Co.*, 319 F.2d 634 (7th Cir. 1963).

161. See generally DUKE, *supra* note 13.

162. *Lehigh Valley Trust Co. v. Central Nat'l Bank*, 409 F.2d 989 (5th Cir. 1969). Compare *Zabriskie v. Lewis*, 507 F.2d 546 (10th Cir. 1974) (unsophisticated investor) with *McLean v. Alexander*, 420 F. Supp. 1057 (D. Del. 1976) (sophisticated investor) and *Eichen v. E.F. Hutton & Co.*, 402 F. Supp. 823 (S.D. Cal. 1975) (sophisticated investor).

163. *Straub v. Vaisman & Co.*, 540 F.2d 591, 598 (3d Cir. 1976). *Accord*, *Stier v. Smith*, 473 F.2d 1205 (5th Cir. 1973).

164. *Kohler v. Kohler Co.*, 319 F.2d 634 (7th Cir. 1963); *McLean v. Alexander*, 420 F. Supp. 1057 (D. Del. 1976); *Eichen v. E.F. Hutton & Co.*, 402 F. Supp. 823 (S.D. Cal. 1975); *Jackson v. Oppenheim*, 411 F. Supp. 659 (S.D.N.Y. 1974), *aff'd on other grounds*, 533 F.2d 826 (2d Cir. 1976); *Harnett v. Ryan Homes, Inc.*, 360 F. Supp. 878 (W.D. Pa. 1973), *aff'd*, 496 F.2d 832 (3d Cir. 1974). DUKE, *supra* note 13, at 768, noted that confirmation slips and monthly statements from a brokerage firm have been found sufficient to give a customer-plaintiff of slight sophistication notice of the risks involved in the transactions. See *Ocrant v. Dean Witter & Co.*, 502 F.2d 854 (10th Cir. 1974); *Landry v. Hemphill, Noyes & Co.*, 473 F.2d 365 (1st Cir.), *cert. denied*, 414 U.S. 1002 (1973); *Carr v. Warner*, 137 F. Supp. 611 (D. Mass. 1955).

165. See *Vohs v. Dickson*, 495 F.2d 607 (5th Cir. 1974); *Kohler v. Kohler Co.*, 319 F.2d 634 (7th Cir. 1963); *NBI Mortgage Inv. Corp. v. Chemical Bank*, [Current Binder] FED. SEC. L. REP. (CCH) ¶ 96,066 (S.D.N.Y. 1977); *McLean v. Alexander*, 420 F. Supp. 1057 (D. Del. 1976); *Eichen v. E.F. Hutton & Co.*, 402 F. Supp. 823 (S.D. Cal. 1975); *Jackson v. Oppenheim*, 411 F. Supp. 659 (S.D.N.Y. 1974), *aff'd on other grounds*, 533 F.2d 826 (2d Cir. 1976); DUKE, *supra* note 13, at 768.

has extensive investment experience, or whose occupation gives him relevant business acumen,¹⁶⁶ must take positive and reasonable action to ascertain the true facts.¹⁶⁷ Failure to do so by acting in disregard of the facts or in haste will bar any recovery.¹⁶⁸

Nevertheless, where the sophisticated investor lacks access to the information or the opportunity to discover the fraud, recovery will not be barred.¹⁶⁹ In such a situation, the experience and sophistication of the investor is of little value in preventing the fraud. In *McLean v. Alexander*,¹⁷⁰ an investor experienced in corporate acquisitions and mergers was held to be a sophisticated investor,¹⁷¹ and as such had the duty to make reasonable investigations into the financial status of the company.¹⁷² But the court allowed him to rely on a current certified financial statement without requiring him to "function as a private detective in ferreting out the true facts on which the accountant's representations [were] made."¹⁷³ The court demanded merely that the plaintiff be shown to have acted reasonably in the circumstances.¹⁷⁴

B. Insiders

A plaintiff whose position as a corporate officer, director, or substantial shareholder gives him special access to corporate affairs will have a greater responsibility to discover the true facts surrounding a transfer than would an ordinary investor.¹⁷⁵ Although some courts find that a

166. See *John R. Lewis, Inc. v. Newman*, 446 F.2d 800, 804 (5th Cir. 1971) (recovery by sophisticated investor not barred where his expertise did not relate to the subject of the misrepresentation).

167. See *Vohs v. Dickson*, 495 F.2d 607 (5th Cir. 1974); *Kohler v. Kohler Co.*, 319 F.2d 634 (7th Cir. 1963); *McLean v. Alexander*, 420 F. Supp. 1057 (D. Del. 1976); *Eichen v. E.F. Hutton & Co.*, 402 F. Supp. 823 (S.D. Cal. 1975); *Jackson v. Oppenheim*, 411 F. Supp. 659 (S.D.N.Y. 1974), *aff'd on other grounds*, 533 F.2d 826 (2d Cir. 1976); *Lane v. Midwest Bancshares Corp.*, 337 F. Supp. 1200 (E.D. Ark. 1972) (sophisticated investor should demand most recent financial information reasonably available to him).

168. See *Kohler v. Kohler Co.*, 319 F.2d 634 (7th Cir. 1963); *Eichen v. E.F. Hutton & Co.*, 402 F. Supp. 823 (S.D. Cal. 1975); *Jackson v. Oppenheim*, 411 F. Supp. 659 (S.D.N.Y. 1974), *aff'd on other grounds*, 533 F.2d 826 (2d Cir. 1976).

169. See *Straub v. Vaisman & Co.*, 540 F.2d 591 (3d Cir. 1976); *Rochez Bros. v. Rhoades*, 491 F.2d 402 (3d Cir. 1974), *cert. denied*, 425 U.S. 993 (1976); *Stier v. Smith*, 473 F.2d 1205 (5th Cir. 1973); *John R. Lewis, Inc. v. Newman*, 446 F.2d 800 (5th Cir. 1971); *McLean v. Alexander*, 420 F. Supp. 1057 (D. Del. 1976).

170. 420 F. Supp. 1057 (D. Del. 1976).

171. *Id.* at 1078.

172. *Id.*

173. *Id.* at 1079.

174. *Id.*

175. See *Thomas v. Duralite Co.*, 524 F.2d 577 (3d Cir. 1975); *Rochez Bros. v. Rhoades*, 491 F.2d 402 (3d Cir. 1974), *cert. denied*, 425 U.S. 993 (1976); *City Nat'l Bank v. Vanderboom*, 422 F.2d 221 (8th Cir.), *cert. denied*, 399 U.S. 905 (1970); *Myzel v. Fields*,

plaintiff's corporate status makes him an "insider" as a matter of law,¹⁷⁶ most look beyond the corporate title and examine the extent of the plaintiff's association with the business affairs of the corporation.¹⁷⁷ An insider who normally has ready access to corporate books, records, and minutes, is chargeable with knowledge of any information which could have been reasonably discovered from those sources.¹⁷⁸ A failure to investigate easily available sources will bar the corporate insider from recovery under rule 10b-5.¹⁷⁹

Normally one insider may not recover from another insider, since under rule 10b-5 persons with equal access to information generally owe no such duty to one another.¹⁸⁰ Where the parties have equal access to the relevant information and there is no attempt to hide or misconstrue the truth, no violation of rule 10b-5 can occur.¹⁸¹ However, recovery cannot be barred if the plaintiff lacked the opportunity to discover the fraud,¹⁸² as where the information was held exclusively by the defendant,¹⁸³ or the nature of the plaintiff's position precluded effective access.¹⁸⁴

386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968); *Kohler v. Kohler Co.*, 319 F.2d 634 (7th Cir. 1963); *Jackson v. Oppenheim*, 411 F. Supp. 659 (S.D.N.Y. 1974), *aff'd on other grounds*, 533 F.2d 826 (2d Cir. 1976); *DUKE*, *supra* note 13, at 762.

176. *Myzel v. Fields*, 386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968).

177. *See Jackson v. Oppenheim*, 411 F. Supp. 659 (S.D.N.Y. 1974), *aff'd on other grounds*, 533 F.2d 826 (2d Cir. 1976); *Harnett v. Ryan Homes, Inc.*, 360 F. Supp. 878 (W.D. Pa. 1973), *aff'd*, 496 F.2d 832 (3d Cir. 1974); *McGraw v. Matthaei*, 388 F. Supp. 84 (E.D. Mich. 1972).

178. *City Nat'l Bank v. Vanderboom*, 422 F.2d 221 (8th Cir.), *cert. denied*, 399 U.S. 905 (1970); *Myzel v. Fields*, 386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968) (*dicta*); *Jackson v. Oppenheim*, 411 F. Supp. 659 (S.D.N.Y. 1974), *aff'd on other grounds*, 533 F.2d 826 (2d Cir. 1976).

179. *See Rochez Bros. v. Rhoades*, 491 F.2d 402 (3d Cir. 1974), *cert. denied*, 425 U.S. 993 (1976) (*dicta*); *Jackson v. Oppenheim*, 411 F. Supp. 659 (S.D.N.Y. 1974), *aff'd on other grounds*, 533 F.2d 826 (2d Cir. 1976); *Myzel v. Fields*, 386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968) (*dicta*).

180. *City Nat'l Bank v. Vanderboom*, 422 F.2d 221 (8th Cir.), *cert. denied*, 399 U.S. 905 (1970).

181. *City Nat'l Bank v. Vanderboom*, 422 F.2d 221 (8th Cir.), *cert. denied*, 399 U.S. 905 (1970); *Myzel v. Fields*, 386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968); *Jackson v. Oppenheim*, 411 F. Supp. 659 (S.D.N.Y. 1974), *aff'd on other grounds*, 533 F.2d 826 (2d Cir. 1976); *Harnett v. Ryan Homes, Inc.*, 360 F. Supp. 878 (W.D. Pa. 1973), *aff'd*, 496 F.2d 832 (3d Cir. 1974).

182. *See Thomas v. Duralite Co.*, 524 F.2d 577 (3d Cir. 1975); *Rochez Bros. v. Rhoades*, 491 F.2d 402 (3d Cir. 1974), *cert. denied*, 425 U.S. 993 (1976); *Myzel v. Fields*, 386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968).

183. *See Rochez Bros. v. Rhoades*, 491 F.2d 402 (3d Cir. 1974), *cert. denied*, 425 U.S. 993 (1976) (information contained in another insider's personal files); *Myzel v. Fields*, 386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968) ("labyrinthine transfers" hidden from plaintiff insider).

184. *In Dupuy v. Dupuy*, 551 F.2d 1005, 1022-23 (5th Cir.), *cert. denied*, 98 S. Ct. 312 (1977), the court refused to raise the plaintiff's duty of care on the basis of his corporate title alone, reasoning that it is not the title that is important, but the access to information

Running against the general trend of the circuits with respect to an insider's duty of care is *Holdsworth v. Strong*,¹⁸⁵ in which one of the plaintiffs, who was both an accountant and an attorney, was found to be a sophisticated insider.¹⁸⁶ It may be assumed that the reasonable close corporate shareholder with such a background would have used his position to check the financial status of the company and to determine its earning capabilities personally before divesting his stock—regardless of personal friendships involved.¹⁸⁷ The court ruled that the failure to exercise due care would no longer be recognized as a defense to fraud, and allowed the plaintiff to recover in spite of his sophistication and experience.¹⁸⁸ The decision ignores the long-standing expectation that this type of investor would more reasonably be aware of the risks to his interests if he failed to re-check what his co-investor told him. This application of common law distinctions to exclude the victim's background seems to ignore the policy of furthering investor caution and the equitable principles of fairness.

IV. CONCLUSION

Overall, in the five circuits which have considered the plaintiff's due care requirement in rule 10b-5 actions since the *Hochfelder* decision, three courts have continued to hold it valid,¹⁸⁹ while two have eliminated it as a separate element, although continuing to tie it to reliance questions.¹⁹⁰ Thus, it can safely be said that the due care requirement will not

that such a position gives the victim. The court found that the plaintiff's failure to investigate properly was due to physical and emotional stress caused by the disease from which he was suffering at the time, and to his faith in his brother's judgment.

185. 545 F.2d 687 (10th Cir. 1976), *cert. denied*, 97 S. Ct. 1600 (1977).

186. *Id.* at 692.

187. *Id.* at 690-91. The trial court had relied on the close friendship between the parties.

188. *Id.* at 689, 692.

189. *Hirsch v. Du Pont*, 553 F.2d 750 (2d Cir. 1977); *Dupuy v. Dupuy*, 551 F.2d 1005 (5th Cir.), *cert. denied*, 98 S. Ct. 312 (1977); *Straub v. Vaisman & Co.*, 540 F.2d 591 (3d Cir. 1976); *NBI Mortgage Inv. Corp. v. Chemical Bank*, [Current Binder] FED. SEC. L. REP. (CCH) ¶ 96,066 (S.D.N.Y. 1977); *McLean v. Alexander*, 420 F. Supp. 1057 (D. Del. 1976).

190. *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033 (7th Cir.), *cert. denied*, 98 S. Ct. 225 (1977); *Holdsworth v. Strong*, 545 F.2d 687 (10th Cir. 1976), *cert. denied*, 97 S. Ct. 1600 (1977).

Recently, in dissent to the denial of certiorari by the Supreme Court in *Dupuy v. Dupuy*, 551 F.2d 1005 (5th Cir.), *cert. denied*, 98 S. Ct. 312 (1977), Justice White recognized the divergence of opinion over the due care requirement following *Hochfelder*. He noted the "existing uncertainty as to the proper standard of care required of plaintiffs after *Ernst & Ernst*," and stressed the need for clarification, saying that "[b]usiness can be transacted more freely and efficiently if the responsibility for verifying underlying facts is clearly allocated." 98 S. Ct. at 313.

vanish with implementation of the *Hochfelder* scienter requirement. Due to the widespread recognition of due care as a defense and the strong policy reasons behind it, the courts will be reluctant to do away with it so quickly. Instead, most courts have relaxed a claimant's standard of conduct such that in order to recover, a victim need only avoid recklessness in investment transactions. Mere negligence by an investor will no longer prevent recovery.

Although the circuits continue to employ due care in diverse ways, its usage as a separate element, independent of reliance and the defendant's duty to disclose, is the more effective and theoretically sound approach. Application of due care in such a way will bring about greater consistency in actions brought under rule 10b-5 and insure its continued value to equitable judicial resolution of securities litigation.

Judith Woodward

