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Plaintiff's Standard of Care After Hochfelder: Toward a Theory of Causation

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Plaintiff's Standard of Care After *Hochfelder*: Toward a Theory of Causation

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I. INTRODUCTION: THE TORT MODEL

Since the recognition of a private right of action under Securities and Exchange Commission rule 10b-5,[1] courts have relied heavily upon the principles governing the tort of deceit to supply the elements essential to recovery.[2] Plaintiffs in rule 10b-5 actions generally must prove, as do victims of deceit at common law, a misrepresentation or omission of a material fact, defendant's scienter, and their own reliance.[3] Certain cases under rule 10b-5 require additionally that a plaintiff must have acted in some way to protect

1. Rule 10b-5, promulgated under the Securities Exchange Act of 1934, § 10(b), 15 U.S.C. § 78j(b) (1976), provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interestate [*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 statement 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). The first decision to recognize a private right of action under rule 10b-5 was Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946). In Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 n.9 (1971), the Supreme Court confirmed that a private right of action is implied in rule 10b-5.

2. The Supreme Court suggested in Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 744 (1975), that tort analogies were not inappropriate in 10b-5 cases.

3. These elements, among others, are necessary in the typical 10b-5 case and correspond closely to a tort cause of action in deceit. *See* Dupuy v. Dupuy, 551 F.2d 1005, 1014 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977); W. PROSSER, HANDBOOK OF THE LAW OF TORTS § 105, at 685-86 (4th ed. 1971).

himself from the defendant's fraud. Judicial descriptions of this notion that investors must look out for themselves range from a requirement that plaintiff's reliance be "justified,"[4] to a notion that the duty of a defendant to disclose facts varies with the knowledge and sophistication of the plaintiff,[5] to a linking of due diligence with the materiality requirement.[6] The Supreme Court's decision in *Ernst & Ernst v. Hochfelder,*[7] which eliminated negligence as a basis for liability under rule 10b-5,[8] has inspired a reevaluation of the requirement that a plaintiff act in some manner to protect himself. Because these cases invariably utilize tort concepts in rule 10b-5 analysis, it is appropriate to examine briefly the common law standard of conduct required of a plaintiff in an action for deceit.

At common law, in order to prove the causal connection between the defendant's misrepresentation and the plaintiff's damage, a victim of deception must show that the misrepresentation induced him to act; that is, that the plaintiff "relied upon it, and believed it to be true."[9] The plaintiff next must demonstrate that his reliance was "justified," a term used in two senses. First, the plaintiff must have been justified in taking action on the basis of the facts represented—the facts must be "material."[10] Second, the plaintiff must have been justified in believing that the facts represented were true. This second requirement is the most troublesome aspect of "justified reliance," generating two difficult questions. May the alleged victim of deceit have ignored indications that the defendant's representations were false? To what extent must the victim have investigated the facts for himself to determine the truth of the defendant's representations?

Professor Prosser, after examining the common law deceit cases in which the defendant's conduct was intentional—those that supply the closest analogues to 10b-5 cases after *Hochfelder*—determined that the plaintiff did have an obligation to protect himself

4. *See* notes 47-59 *infra* and accompanying text.

5. *See* notes 60-66 *infra* and accompanying text.

6. *See* notes 67-69 *infra* and accompanying text.

7. 425 U.S. 185 (1976).

8. The Court in *Hochfelder* determined that a private cause of action for damages would not lie under rule 10b-5 absent an "allegation of 'scienter.' " *Id.* at 193. The Court indicated in a footnote that

> 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. . . . 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.

Id. at 193 n.12.

9. W. PROSSER, *supra* note 3, § 108, at 714.

10. *Id.* at 718-19.

from fraud, but that the obligation did not derive from an objective "reasonable man" standard,[11] and that a breach of the obligation was not "contributory negligence":

> Rather than contributory negligence, the matter seems to turn upon an individual standard of the plaintiff's own capacity and the knowledge which he has, or which may fairly be charged against him from the facts within his observation in the light of his individual case, and so comes closer to the rules which are associated with assumption of risk. . . . The other side of the shield is that one who has special knowledge, experience and competence may not be permitted to rely on statements for which the ordinary man might recover, and that one who has acquired expert knowledge concerning the matter dealt with may be required to form his own judgment, rather than take the word of the defendant.
>
> . . . .
>
> . . . It is only where, under the circumstances, the facts should be apparent to one of his knowledge and intelligence from a cursory glance, *or he has discovered something which should serve as a warning that he is being deceived,* that he is required to make an investigation of his own.[12]

Although this description serves as a useful guide by focusing attention on a particular individual's duty in particular circumstances rather than on what conduct would have been objectively "reasonable," it fails to address the key questions. What knowledge that a plaintiff does not possess may be "fairly charged against him;" what facts "should be apparent to one of his knowledge and intelligence;" and what "should serve as a warning?" In short, how much must he investigate?

In spite of these uncertainties, Professor Prosser attempted in the *Restatement (Second) of Torts* to implement his theory that in certain circumstances even a victim of intentional deceit should be charged with knowledge of facts he could have discovered through investigation. The *Restatement* treatment of deceit begins by defining a representation as a "fraudulent misrepresentation" if the maker knows it is false or knows that he is not as certain of its truth as he implies.[13] To recover, the plaintiff must have relied in fact on the misrepresentation, and his reliance must be "justifiable."[14] The

11. *Id.* at 716-17.

12. *Id.* at 717-18 (footnotes omitted) (emphasis added).

13. RESTATEMENT (SECOND) OF TORTS § 526 (1977), provides:

§ 526. Conditions Under Which Misrepresentation Is Fraudulent (Scienter)

A misrepresentation is fraudulent if the maker

(a) knows or believes that the matter is not as he represents it to be,

(b) does not have the confidence in the accuracy of his representation that he states or implies, or

(c) knows that he does not have the basis for his representation that he states or implies.

14. *Id.* § 537, comments a & b.

Restatement places specific, although not stringent, limits on justifiable reliance. Section 538 provides that reliance is justifiable only if the matter represented is material,[15] and section 541 states that "[t]he recipient of a fraudulent misrepresentation is not justified in relying upon its truth if he knows that it is false or its falsity is obvious to him."[16] The *Restatement* treats the effect of plaintiff's negligence separately: section 545A provides that "[o]ne who justifiably relies upon a fraudulent misrepresentation is not barred from recovery by his contributory negligence in doing so."[17]

The most controversial element in the *Restatement*'s treatment is its handling of the extent to which a plaintiff must investigate. In Tentative Drafts Ten and Eleven, offered to the American Law Institute in 1964 and 1965, Professor Prosser proposed a version of section 540 that under some circumstances would have imposed an obligation on the plaintiff to make an investigation before his reliance would be justifiable. As proposed, the section provided that "[t]he recipient of a fraudulent misrepresentation is justified in relying upon its truth without investigation, unless he knows or has reason to know of facts which make his reliance unreasonable."[18]

---

15. *Id.* § 538(1). Materiality is defined as follows:

> (2) The matter is material if
>
> (a) a reasonable man would attach importance to its existence or nonexistence in determining his choice of action in the transaction in question; or
>
> (b) the maker of the representation knows or has reason to know that its recipient regards or is likely to regard the matter as important in determining his choice of action, although a reasonable man would not so regard it.

Id. § 538(2).

16. *Id.* § 541. The comment to this section states that a plaintiff is "required to use his senses, and cannot recover if he blindly relies upon a misrepresentation the falsity of which would be patent to him if he had utilized his opportunity to make a cursory examination or investigation." *Id.* comment a. "Obvious" is an expandable term, and the *Restatement* does not define its parameters. Is "obviousness" to be tested objectively or subjectively? How much imputed knowledge is considered in determining what is obvious?

17. *Id.* § 545A. The comment to this section explains the conceptual difference between justification and non-negligence:

> 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, judgment or care.

Id. comment b. This formulation corresponds to the usual rule that contributory negligence is no bar to an intentional tort. *See* W. PROSSER, *supra* note 3, § 108, at 716.

18. RESTATEMENT (SECOND) OF TORTS § 540 (Tent. Draft No. 11, 1965); *Id.* (Tent. Draft No. 10, 1964). Proposed comment c expanded on what Professor Prosser had in mind:

> It is not enough . . . that the recipient has, in his own mind, some doubts as to the truth

The proposal generated heated debate at the American Law Institute's annual meeting. Professor Prosser initially assured the Institute that contributory negligence in the sense of failure to act as a reasonable man could not bar recovery for intentional deceit.[19] He argued forcefully, however, that between the cases in which a representation is obviously false[20] and the usual cases in which the plaintiff has no idea that he is being deceived, there is a problem area: "What are you to do in the type of situation where the plaintiff has what courts have called notice that the representation made to him is or may be false?"[21] Professor Prosser believed that a person with such notice ought to investigate. Critics of the proposal argued that it allowed contributory negligence as a defense to an intentional tort and suggested that any cases in which a plaintiff's "notice" made his recovery unjust would be covered by section 541's rule on "obvious falsity."[22] Professor Prosser responded[23] that

> It is one thing to say that he may be a gullible fool and believe something in the first instance before he is warned, but after he is warned, is he free to proceed? This is the very narrow issue that we have before us. I don't think "obvious" takes care of it, and I think that we are dealing with a question of limits upon reliance rather than contributory negligence at all.
>
> . . . .
>
> This is an "on notice" section. It means that he knows so much that he cannot reasonably act upon the assumption that the facts are not true.
>
> Now, I submit that that is a different thing from contributory negligence, which is simply failure to act as a reasonable man. This is proceeding after knowledge, after warning, after notice, and is deliberately taking a chance. If I had to characterize it, I would call it not contributory negligence but assumption of risk . . . .[24]

In spite of the Reporter's urgings, the Institute defeated his proposal sixty-seven to thirty-nine.[25]

> of the representation, or that he knows facts which might lead an unduly suspicious person to make inquiry. He must have knowledge of facts, or reason to know of them . . . which would prevent a reasonably careful and cautious man from entering into the transaction without investigation. He must, in other words, have information which would serve as a danger signal and a red light to any normal person of his intelligence and experience.

Id. comment c. The Advisers to the Reporter rejected his proposal and suggested the following: "Failure of the recipient of a fraudulent misrepresentation to investigate it does not prevent his justifiable reliance upon it, although he might have ascertained the falsity of the representation by such investigation." *Id.* § 540.

19. 41 ALI PROCEEDINGS 509 (1964).

20. Reliance is not justifiable in such cases. *See* note 16 *supra* and accompanying text.

21. 41 ALI PROCEEDINGS 509 (1964).

22. *Id.* at 512 (remarks of Mr. Eldredge).

23. The Reporter's responses were made in 1965. Because of the controversy surrounding the proposal, the ALI tabled it for a year. *Id.* at 513.

24. 42 ALI PROCEEDINGS 327, 329 (1965).

25. *Id.* at 331. The final verson of § 540 provides: "The recipient of a fraudulent misre-

The extended debate by the Institute illustrates the logical and even emotional difficulty of dealing with the victim of an admittedly intentional deception who has acted foolishly in his own behalf and does not seem to deserve recovery. The crux of the controversy in the common law deceit cases mirrors that in the 10b-5 cases: should the victim have to investigate, and what might trigger an obligation to investigate? As this discussion demonstrates, tort principles provide some guidance. In deceit cases, the obligations placed on the plaintiff arise from the requirement that his reliance be justified. To the extent that his knowledge makes the falsity of a representation "obvious," his reliance is unjustified. The term "obvious" is expandable, and courts can manipulate it to limit recovery.

Finally, there is authority for the proposition that, wholly apart from the question of plaintiff's culpability, a plaintiff should be charged with the information he would have obtained from an investigation if, in light of his particular sophistication and knowledge, he had notice that he was being deceived, because proceeding in the face of such notice is tantamount to assumption of risk.[26]

With this examination of the common law of deceit as background, this Note undertakes to trace briefly[27] the treatment given the standard of care required of plaintiffs before *Hochfelder*, to analyze the decisions reconsidering this standard of care after *Hochfelder*, and to suggest a synthesis that will permit a continued evaluation of plaintiff's conduct in 10b-5 cases without running afoul of the *Hochfelder* scienter standard.

II. PLAINTIFF'S STANDARD OF CARE BEFORE *Hochfelder*

A. *Introduction*

Of the enormous number[28] of reported decisions under rule 10b-5, relatively few give serious consideration to the standard of conduct required of plaintiffs.[29] Both commentators[30] and some of the

presentation 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 (SECOND) OF TORTS § 540 (1977).

26. *See* W. PROSSER, *supra* note 3, § 108, at 717.

27. This Note does not provide a detailed examination of the pre-*Hochfelder* cases. For such treatment, see Wheeler, *Plaintiff's Duty of Due Care Under Rule 10b-5: An Implied Defense to an Implied Remedy*, 70 Nw. U.L. REV. 561 (1975).

28. One commentator has described the mass of 10b-5 cases as a "seething plethora." Mann, *Rule 10b-5: Evolution of a Continuum of Conduct to Replace the Catch Phrases of Negligence and Scienter*, 45 N.Y.U. L. REV. 1206, 1220 (1970).

29. Commentators have identified approximately 60 such cases.

30. *See generally* Bahlman, *Rule 10b-5: The Case for Its Full Acceptance as Federal Corporation Law*, 37 U. CIN. L. REV. 727 (1968); Campbell, *Elements of Recovery Under Rule*

cases[31] have attempted to categorize the approaches taken in these decisions. Although such categories provide some assistance in analyzing the cases, they imply greater differences in approach than the decisions actually exhibit. Courts have enunciated a variety of formulations of the "duty" imposed on plaintiffs, but the standards actually applied have been more consistent. This underlying consistency is explained by the fact that the cases in which a plaintiff's duty to investigate is a serious factor often arise from similar fact patterns. Although the formulations apply theoretically to any 10b-5 case, the actual decisions have dealt with close corporations and opposing parties who are related or well-known to each other much more often than open-market transactions. Thus, in the surprisingly typical case in which a former director of a close corporation sues a fellow shareholder for nondisclosures or misrepresentations in connection with a buy-out of the plaintiff's stock, the court may characterize the plaintiff's standard of care as a duty to investigate, or in terms of the defendant's lack of an obligation to disclose facts made nonmaterial by what plaintiff knew or should have known, or by some other catch phrase. The characterization, however, is less important than the recognition that courts are quite likely to consider it unfair for a party to complain about nondisclosures or misrepresentations concerning corporations with which they are familiar. Nevertheless, an examination of the various characterizations is useful in understanding the methodology of the post-*Hochfelder* cases.

B. *The Traditional Approaches*

Cases imposing a standard of care on 10b-5 plaintiffs have utilized two approaches, one procedural and one substantive. Procedurally, some decisions have required the plaintiff to demonstrate his proper conduct as an element of his case. Others have allowed defendants to prove a plaintiff's improper conduct as an affirmative defense. Whichever procedural approach is taken, the courts gener-

10b-5: Scienter, Reliance, and Plaintiff's Reasonable Conduct Requirement, 26 S.C. L. REV. 653 (1975); Jacobs, *Affirmative Defenses to Securities Exchange Act Rule 10b-5 Actions,* 61 CORNELL L. REV. 857 (1976); Mann, *supra* note 28; Ruder & Cross, *Limitations on Civil Liability Under Rule 10b-5,* 1972 DUKE L.J. 1125; Wheeler, *supra* note 27; Note, *The Due Diligence Requirement for Plaintiffs Under Rule 10b-5,* 1975 DUKE L.J. 753; Note, *The Reliance Requirement in Private Actions Under SEC Rule 10b-5,* 88 HARV. L. REV. 584 (1975); Note, *Reliance Under Rule 10b-5: Is the "Reasonable Investor" Reasonable?,* 72 COLUM. L. REV. 562 (1972); Comment, *Due Care: Still a Limitation on 10b-5 Recovery?,* 61 MARQ. L. REV. 122 (1977).

31. *See, e.g.,* Dupuy v. Dupuy, 551 F.2d 1005, 1014-15 (5th Cir.), *cert. denied,* 434 U.S. 911 (1977).

ally describe the conduct expected of plaintiff in one of three ways. Under the first approach, a plaintiff's reliance on defendant's misrepresentation is not justified or reasonable unless he makes a reasonable investigation to ascertain the truth—the justified reliance approach. Second, some decisions have stated that a defendant has no duty to disclose facts that a plaintiff could have discovered on his own through reasonable investigation—the variable duty approach. Finally, some courts have suggested that facts that a plaintiff reasonably could have discovered are not material.

The clearest expression of the notion that a plaintiff must demonstrate due care as an element of his case occurs in *City National Bank v. Vanderboom.*[32] The Eighth Circuit framed the issue before it in procedural terms. According to the court, unless, in the case of misrepresentations, "a reasonable investor, in light of the facts existing at the time of the misrepresentation *and in the exercise of due care,* would have been entitled to rely upon the misrepresentation," or, in the case of nondisclosures, "a reasonable investor, in light of the facts existing at the time of the nondisclosure *and in the exercise of due care,* would have been entitled to receive full disclosure from the party charged and would have acted differently had the alleged nondisclosure not occurred,"[33] then defendant's misdeeds were not made in connection with the purchase or sale of a security.[34] Having taken this procedural approach, the court, not atypically, applied two of the substantive notions: "we find a reasonable investor would not have relied upon any representations made by [one codefendant] and that [the other codefendant] did not owe a duty of full disclosure to the investors."[35] To support both conclusions, the court noted that plaintiffs "had access to all the books and records" of the corporation whose securities had been traded. Although *Vanderboom* employed the unusual notion that deceptive conduct is not covered by section 10(b) unless a victim exercising due care would be entitled to rely on it, subsequent decisions regularly cite the case without analysis for the proposition that plaintiffs have an affirmative duty of due diligence.[36] The decision also marks a clear departure from the traditional tort notion that mere access to the truth does not automatically bar recovery for deceit.[37] Under the

32. 422 F.2d 221 (8th Cir.), *cert. denied,* 399 U.S. 905 (1970).
33. *Id.* at 230 (emphasis added).
34. *Id.* at 229-31.
35. *Id.* at 231.
36. *See, e.g.,* Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90, 103 (10th Cir.), *cert. denied,* 404 U.S. 1004 (1971); Clement A. Evans & Co. v. McAlpine, 434 F.2d 100, 104 (5th Cir. 1970), *cert. denied,* 402 U.S. 988 (1971).
37. *See* 41 ALI PROCEEDINGS 509-10 (1964).

Vanderboom analysis, whether the test is couched in terms of reasonable reliance or lack of duty to disclose is immaterial. In either case, what the plaintiff could have discovered will be charged to him.

The Fifth Circuit's decision in *Clement A. Evans & Co. v. McAlpine*[38] typifies those cases that have permitted defendants to raise plaintiff's lack of due care as an affirmative defense. The court in *McAlpine* approved a jury instruction that directed the jurors to find for the defendant if they concluded that "the plaintiff had knowledge of facts sufficient to excite . . . inquiry," that the particular circumstances of the case imposed on the plaintiff "a duty of reasonable diligence, and that the plaintiff failed to exercise this duty."[39] The facts of *McAlpine*[40] are analogous to those that troubled Professor Prosser in the common law deceit field:[41] a plaintiff who has been warned that his reliance is not reasonable nonetheless relies and seeks to recover. The court in *McAlpine* imposed a "duty of reasonable diligence"[42] in such circumstances, citing *Vanderboom* in describing the duty as an "objective standard of a reasonable investor exercising due care . . . ."[43] Despite this language, examination of the jury instruction reveals that the court did not in fact employ a negligence standard, which would entail conformity to a general community standard of conduct. Rather, the trial court in *McAlpine* instructed the jury that "the duty of a 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."[44] Confusion of this test with a negligence test stems from the use of the term "reasonable." A negligence standard asks what a reasonable person would do in similar circumstances, while the *McAlpine* test asks what was reasonable for a particular individual to do, given all the details of his peculiar circumstances. More significant than

38. 434 F.2d 100 (5th Cir. 1970), *cert. denied*, 402 U.S. 988 (1971). In *McAlpine* defendant brokers allegedly created a facade of financial responsibility around individual defendant McAlpine, allowing him to trade a large volume of securities with plaintiff broker. Plaintiff's loss came from several worthless checks McAlpine used in payment. Defendant demonstrated that over a three- to four-month period several of McAlpine's checks were dishonored, yet plaintiff continued to accept them. *Id.* at 101-02.

39. *Id.* at 102.

40. *See* note 38 *supra*.

41. *See* notes 21-24 *supra* and accompanying text.

42. 434 F.2d at 102.

43. *Id.* at 104.

44. *Id.* at 102.

McAlpine's use of plaintiff's lack of care as an affirmative defense, therefore, is its reliance on an analysis similar to Prosser's "assumption of risk"[45] notion requiring a plaintiff to act reasonably but not imposing a negligence standard on him. Moreover, because the underlying rationale of *McAlpine* is not negligence, the court's refusal to consider whether defendant's conduct was negligent or intentional[46] in establishing the standard of care imposed on plaintiffs is neither surprising nor improper.

The most common substantive approach asks whether plaintiff's reliance was "justified." In *Mitchell v. Texas Gulf Sulphur Co.*,[47] for example, plaintiffs sold their shares allegedly in reliance on an excessively gloomy press release, several days after the company issued a curative release.[48] The court denied recovery, arguing that

> [a]t some point in time after the publication of a curative statement . . . stockholders should no longer be able to claim reliance on the deceptive release, sell, and then sue for damages. . . . This is but a requirement that stockholders too act in good faith and with due diligence in purchasing and selling stock.
>
> . . . We conclude that by [the dates plaintiff sold], the reasonable investor would have become informed of the [curative] release and could no longer rely on the earlier release in selling TGS stock.[49]

Mitchell clearly imposed on the plaintiff a duty to investigate, even in the absence of a specific warning that something was amiss. Moreover, the court used the negligence terminology of "reasonable investor" and did in fact employ that standard. Although *Mitchell* dealt with open-market transactions, similar analyses surface in close corporation, face-to-face settings. In *Niedermeyer v. Niedermeyer*,[50] a district court decision, a corporate officer sold stock to his brother and fellow officer at an allegedly excessive price.[51] The court denied recovery, stating that plaintiff's "lack of business acumen" did not obviate his duty to demonstrate

45. *See* text accompanying notes 11-12 & 23-24 *supra*.

46. The court stated that:

> [W]e are of the view that plaintiff's duty . . . is not altered merely because the misrepresentations are alleged to be intentional rather than negligent. Surely plaintiff would not contend that a purchaser or seller could justifiably rely on a fraudulent misrepresentation, no matter how willfully and intentionally made, if that misrepresentation would tax even the most credulous mind.

434 F.2d at 104.

47. 446 F.2d 90 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971).

48. *Id.* at 96. The court observed that the curative release had been given "saturation coverage." *Id.* at 103.

49. *Id.*

50. [1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,123 (D. Ore. 1973).

51. *Id.* at 94,494.

"reasonable reliance" in order to recover under rule 10b-5.[52] The *Niedermeyer* court also tested reasonable reliance by a negligence standard:

> The question to be decided is whether [plaintiff], as a *reasonable* investor, in light of the facts existing at the time of the nondisclosures and in the exercise of due care, would have been entitled to receive full disclosure from the defendants. . . . The objective standard of a reasonable investor . . . imposes a duty of "reasonable investigation," limiting the class of protected investors to conscientious buyers and sellers in good faith.[53]

To temper the harsh impact of this negligence standard on 10b-5 plaintiffs, most courts requiring reasonable reliance have recognized that the circumstances of particular cases may prevent a party from obtaining the information that a reasonable investor would have before entering a transaction. For example, in *Rochez Bros. v. Rhoades,*[54] also arising in a close corporation setting, the Third Circuit held that although a plaintiff "must fulfill a duty of due care in seeking to ascertain for himself the facts relevant to a transaction,"[55] he "cannot fail in his duty of due care if he lacked any opportunity to detect the fraud."[56] Because the undisclosed facts were within defendant's personal knowledge or in his private files, plaintiff's "status as an insider, his financial expertise, and his business acumen" were deemed irrelevant; plaintiff "had no access to the critical information or any opportunity to discover the nondisclosed facts."[57] The emphasis on access to information in *Rochez,* like the analysis in *McAlpine,*[58] indicates that some courts using the justified reliance approach are not applying, in spite of their verbal formulations, a negligence standard. A negligence standard would require of an investor, first, that he investigate, and second, if he discovers during his investigation that he did not have access to some kinds of information that prudence dictated he should examine, that he not complete the transaction. The standard applied in cases such as *Rochez,* however, is more subjective and less stringent than negligence because it excuses a plaintiff from further investigation if such would be futile.[59]

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52. *Id.* at 94,500.
53. *Id.* (emphasis by the court).
54. 491 F.2d 402 (3d Cir. 1974).
55. *Id.* at 409.
56. *Id.*
57. *Id.* at 410.
58. *See* text accompanying notes 44-46 *supra.*
59. If access were blocked to information of a kind that no one would expect to exist, such as secret plans for business expansion, then under both a negligence standard and the less stringent *Rochez* test it would be reasonable not to attempt to ferret out the deception. But if access were blocked to information such as a company's books and records, a negligence

Under the second approach—the "flexible duty standard"[60]—the defendant's duty to disclose varies with the extent of a plaintiff's knowledge of the corporate information or his access to such knowledge. In *Arber v. Essex Wire Corp.*,[61] which involved the sale of stock in a close corporation that subsequently appreciated in value, the Sixth Circuit defined the defendant's duty as follows:

> We hold that an insider has no affirmative duty to direct a seller's attention to all routine data commonly found in the statements and books of the corporation, at least where that information is readily available; the outsider has knowledge that it is available and makes no inquiry; and the information thus available is not of an unusual or extraordinary nature.[62]

Because this test limits the defendant's duty to disclose when the particular plaintiff has access to the material facts, it is theoretically distinct from the reasonable reliance test. The test focuses upon the particular plaintiff and the duty owed him rather than upon the "reasonable" investor. *White v. Abrams*,[63] a Ninth Circuit decision, clearly demonstrates that the variable duty approach does not address the plaintiff's negligence, producing results similar to those under Prosser's assumption of risk analysis. In *White* the court argued that the "proper analysis, . . . is not only to focus on the duty of the defendant, but to allow a flexible standard to meet the varied factual contexts."[64] In determining the extent of a defendant's duty in a particular case, the *White* court urged that future decisions "focus on the goals of the securities fraud legislation by considering a number of factors that have been found to be significant in securities transactions,"[65] including the relationship between plaintiff and defendant, their comparative access to information, the benefit defendant receives from the relationship, the defendant's awareness of the plaintiff's reliance, and the defendant's activity in initiating the transaction.[66] Such factors would direct a court's attention to the particular transaction in question. Consequently, the hypothetical, reasonable investor is meaningless in the flexible duty approach. Thus the second approach corresponds closely to that used in those cases under the reasonable reliance

standard undoubtedly would require that a party refrain from investing, while the test in *Rochez* suggests that he could invest without violating his duty of "due care."

60. White v. Abrams, 495 F.2d 724, 736 (9th Cir. 1974).

61. 490 F.2d 414 (6th Cir.), *cert. denied*, 419 U.S. 830 (1974).

62. *Id.* at 420; *accord*, Frigitemp Corp. v. Financial Dynamics Fund, 524 F.2d 275, 282 (2d Cir. 1975).

63. 495 F.2d 724 (9th Cir. 1974).

64. *Id.* at 734.

65. *Id.* at 735.

66. *Id.* at 735-36.

approach that interpreted "reasonable" to mean reasonable for a particular individual in a peculiar set of circumstances.

The third approach, which links the plaintiff's knowledge to the materiality requirement, is generally used in conjunction with one of the other two approaches. In *Arber,* for example, although the court stated a variable duty test, its holding that defendants were not liable was based specifically on the finding that no material facts were withheld;[67] in essence, any information to which the plaintiff had access was not material.[68] This approach is theoretically suspect, however, because virtually all courts and commentators define materiality in objective terms.[69]

However courts in the pre-*Hochfelder* era formulated the test, they commonly made some inquiry into the extent to which a plaintiff should have acted to protect himself. The key analytical lesson of these cases is that, although they generally voice concern over the reasonableness of the plaintiff's conduct, they often pay such close attention to the knowledge and sophistication of the individual plaintiffs and to the peculiarities of the factual contexts, that the resulting standard evaluates a subjective assumption of risk rather than an objective failure to conform to a community norm. The unarticulated rationale underlying this approach may be the conclusion that, in the policy-oriented proximate cause sense, the conduct of the plaintiff rather than of the defendant caused the loss.

III. THE IMPACT OF *Hochfelder*

A. *Introduction*

The Supreme Court in *Hochfelder* did not address directly the issue of plaintiff's standard of care. Nevertheless, aside from its substantive holding, which eliminated defendant's negligence as a possible basis for liability and provoked a reevaluation of decisions perceived to hold plaintiffs to a standard of contributory negligence, the analytical technique used by the Court may foreshadow its ultimate decision on this issue.[70] The *Hochfelder* Court's approach to

67. 490 F.2d at 421.

68. A post-*Hochfelder* case, Straub v. Vaisman & Co., 540 F.2d 591 (3d Cir. 1976), may have employed a similar notion when it stated that "[i]f a plaintiff has actual knowledge of material facts, defendant's failure to disclose the same information will not create a cause of action under 10b-5 since there would be a lack of materiality." *Id.* at 596. This analysis errs in not recognizing that materiality is an objectively determined concept. What actual knowledge by the plaintiff would do is vitiate reliance in fact.

69. *See* note 15 *supra;* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 445 (1976).

70. The Court probably will feel compelled to make some resolution of the plaintiff's standard of care issue. Although the Court denied certiorari in Dupuy v. Dupuy, 551 F.2d 1005 (5th Cir.), *cert. denied,* 434 U.S. 911 (1977), Justice White registered a strong dissent:

the scienter question was one of narrowly focused statutory construction. Its examination of the precise words of the rule and the legislative history of the statute provided no basis for the inference that either intended to hold a defendant liable for negligence. Consequently, the Court conceivably could resolve the standard of care issue simply by concluding that neither the statute nor the rule by its terms uses plaintiff's conduct to limit defendant's liability. The lower court decisions following *Hochfelder*, however, have painted with a broader brush. These decisions have reevaluated the theoretical bases of the pre-*Hochfelder* decisions imposing a standard of care on plaintiffs, returned to the rule's common law analogues for guidance, and examined the relevant policy considerations. Although the sophistication of analysis varies considerably among the post-*Hochfelder* cases, the decisions typically divide into those that continue to articulate a due diligence requirement and those that perceive *Hochfelder* as requiring its elimination.

B. *Decisions Retaining a Due Diligence Approach*

The earliest decision to reevaluate plaintiff's standard of care after *Hochfelder* is also one of the most closely reasoned. In *Straub v. Vaisman & Co.*[71] the Third Circuit examined what it termed "flagrantly fraudulent conduct."[72] Plaintiff, acting on the recommendation of an employee of defendant broker-dealer, purchased shares in Mark I Offset, which then went bankrupt less than a month later. The trial court found that defendants had both omitted and misrepresented material information in connection with plaintiff's purchase.[73] On appeal, defendant argued that plaintiff's

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> The Court should take this opportunity to clarify the standard of care expected of plaintiffs in litigation under Rule 10b-5. Business can be transacted more freely and efficiently if the responsibility for verifying underlying facts is clearly allocated. Because securities litigation can be complex and expensive, it should be avoided to the maximum extent by early clarification of the ground rules. This Court should thus promptly resolve the existing uncertainty as to the proper standard of care required of plaintiffs after *Ernst & Ernst.*

434 U.S. at 912. The securities bar also has expressed concern about the confusion over plaintiff's standard of care following *Hochfelder*, suggesting that if the "no due diligence" defense is eliminated the Supreme Court may have taken away with one hand what it gave defendants with the other by imposing the scienter requirement. PRACTISING LAW INSTITUTE, EIGHTH ANNUAL INSTITUTE ON SECURITIES REGULATION 329 (R.H. Mundheim, A. Fleischer, Jr., & B.M. Vandegrift eds. 1977).

71. 540 F.2d 591 (3d Cir. 1976).

72. *Id.* at 593.

73. Defendants had represented the stock to be a new issue, which it was not. They neglected to inform the plaintiff that they had inside information of the imminence of the bankruptcy, that they were purchasing the shares from a company in which they had a controlling interest, and that the price they charged plaintiff was above the current market

failure to exercise due diligence by not demanding a prospectus or conducting any investigation of Mark I Offset should bar his recovery.[74]

In the Third Circuit's view, the imposition of a standard of care on 10b-5 plaintiffs derived from a concern over the rapidly expanding scope of liability under the rule.[75] Especially in those courts that imposed 10b-5 liability for negligence, "importation of the tort concept of a plaintiff's contributory negligence was a natural development."[76] Because *Hochfelder* sharply limited the scope of defendant's liability, however, the court reasoned that the need for a due diligence defense to perform that function was less compelling.[77] To determine how much diligence should be required of plaintiffs, the court looked to two considerations: "common law derivations and deterrence of investor carelessness."[78] In the court's view, common law precedent dictated elimination of a due diligence requirement in the negligence sense, because lack of care generally is irrelevant in intentional tort cases and because tort law is shifting toward comparative negligence and away from using plaintiff's conduct as a complete bar.[79] Against this, the court balanced the policies underlying the federal securities laws, which it perceived as encouraging "watchfulness in the market place" by all parties.[80] The court was satisfied neither with making plaintiff's lack of due diligence a complete bar nor with making it irrelevant. The former would provide rule 10b-5 plaintiffs with less protection than does the common law, and the latter would fail to encourage investor caution.[81] In an attempt to compromise, the court concluded that the "obligation of due care must be a flexible one, dependent upon the circumstances of each case. We require only that the plaintiff act reasonably."[82] The court listed a number of factors that would determine the extent of a plaintiff's duty in a particular case: "fiduciary relationship, opportunity to detect the fraud, sophistication of the plaintiff, the existence of long standing business or personal relationships, and access to the relevant information."[83] In *Straub* the court considered

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price. The trial court based its holding on the omissions rather than the misrepresentation. *Id.* at 594.

74. *Id.* at 596.
75. *Id.* at 597.
76. *Id.*
77. *Id.*
78. *Id.*
79. *Id.*
80. *Id.*
81. *Id.* at 598.
82. *Id.*
83. *Id.*

the trusting relationship that had evolved between plaintiff and defendants, plaintiff's lack of access to information about the imminency of bankruptcy, and the occurrence of the transaction during the holiday season when plaintiff had little opportunity to investigate.[84] This combination of circumstances placed the "plaintiff['s] conduct within the permissible zone and fully justified the district court's rejection of the lack of diligence defense."[85]

Without articulating its standard precisely, the Third Circuit in *Straub* retained in large measure the analysis it used in *Rochez.*[86] Although the court required reasonableness on the part of the plaintiff, its emphasis on a series of factors keyed to the individual plaintiff and his particular factual context demonstrates that it did not employ a negligence standard, but rather applied the notion, albeit implicit, that because of their sophistication and access to information, certain plaintiffs assume the risk of their loss. Under this approach there is no compulsion to bar plaintiff's claim once "some" negligence, however slight, is found. To bar recovery, the combination of factors must add up to a level of carelessness indicating a conscious assumption of risk. This analysis is consistent with *Hochfelder* and is true to the common law system. More important, it breaks away from obeisance to common law analogues by recognizing a strong policy basis for encouraging investors to be watchful as an additional safeguard to an orderly market.

A district court decision following *Straub* in the Third Circuit illustrates a similar approach. *McLean v. Alexander*[87] arose in the context of what the court termed a "prototypical sophisticated investor."[88] McLean had purchased a one hundred percent interest in Technidyne, Inc., which had a negative net worth, on the basis of recommendations by the shareholders and an accountant that the company's accounts receivable were fully collectible.[89] McLean sent an associate to investigate the company and made at least one personal visit.[90] After McLean purchased the company, his newly appointed president discovered that the bulk of the sales on which the accounts receivable were based were not "hard" sales but had been

84. *Id.*
85. *Id.*
86. *See* notes 54-59 *supra* and accompanying text.
87. 420 F. Supp. 1057 (D. Del. 1976).
88. *Id.* at 1063. McLean, the plaintiff, was founder of McLean Trucking and Sea-Land Services. He had a personal net worth of about $50,000,000 and served on several boards of directors. *Id.* at 1062.
89. *Id.* at 1074.
90. *Id.* at 1064-65.

made on a consignment basis.[91] The court determined that an alleged lack of diligence on McLean's part did not bar his recovery.[92]

As had the Third Circuit in *Straub,* the *McLean* court suggested that the due diligence requirement was intended to check the increasing volume of litigation under 10b-5.[93] Although the court stated that "[d]ue diligence imposes on the plaintiff the duty to act with the caution expected of a reasonable person in his position,"[94] it retreated from this negligence language by noting that the duty to investigate varied with the sophistication of the investor.[95] The function of the duty to investigate was, in the court's view, to raise a presumption of knowledge commensurate with what an investigation would have revealed if conducted by one of plaintiff's level of sophistication. Noting that *Hochfelder* rendered the validity of a due diligence defense based on negligence suspect, the court nonetheless concluded that when defendant's conduct lay in the "wide spectrum of prohibited behavior between negligence and specific intent to defraud . . . that uncharted land of knowing and reckless misconduct," he should be able to contest liability by raising a due diligence defense.

Testing McLean's conduct by this standard, the court observed initially that the assessment should be made on the assumption that " 'integrity is the mainstay of commerce.' "[96] The court concluded that McLean should not be charged with information discoverable from an examination of the sales records underlying the accountant's report because the accountant was charged with fairly representing the records, and because such an investigation by an outsider "would represent an unwise, unnecessary and unwarranted intrusion into ongoing affairs."[97]

The *McLean* court's analytical approach is less sound than that taken by *Straub.* Although apparently recognizing that a true negligence standard is not the proper test, the court unnecessarily narrows the examination of the plaintiff's conduct to those cases, which may or may not be actionable after *Hochfelder,* in which defendant's conduct is reckless. As established above, defendant's culpability should be irrelevant to an examination of plaintiff's conduct.

91. *Id.* at 1067.

92. *Id.* at 1079.

93. *Id.* at 1077.

94. *Id.*

95. *Id.* at 1078.

96. *Id.* at 1079 (citing Straub v. Vaisman & Co., 540 F.2d at 598). This assumption should be made with caution. To the extent that it suggests that business adversaries should always be trusted, it injects a fiduciary-like element into the most commonplace transactions.

97. 420 F. Supp. at 1079.

Moreover, the high standard imposed on accountants to present fairly the records of a company should not affect the assessment of McLean's diligence. Such inquiries can only distract a court from the necessarily individualized examination of the propriety of the investor's total conduct.

Except for *Straub* and *McLean,* post-*Hochfelder* decisions that have continued to impose some duty of care upon plaintiffs in 10b-5 cases have done so with a minimum of analysis. In *Meier v. Texas International Drilling Funds, Inc.*[98] the court considered allegations of deceit practiced on a doctor, who had considerable investment experience, in connection with his purchases of limited partnership interests in speculative oil drilling ventures.[99] The court undertook no reevaluation in light of *Hochfelder,* but stated that a "duty of reasonable diligence"[100] exists only if an investor has experience in investment and access to appropriate sources of information. The court also applied the variable duty approach, relying on *White v. Abrams,*[101] and concluded that "[d]efendants breached no duty with respect to plaintiff, considering the relationship of the parties, access to necessary information, and related factors."[102] Although the court's reasoning is abbreviated and incorrect in that it apparently would consider plaintiff's conduct only if his sophistication reached a certain level, the result comports with the ideal analysis of *Straub* by relying on a standard of care that varies with the relationship of the parties and the sophistication of the investor.

Another district court decision, *Alton Box Board Co. v. Goldman, Sachs & Co.,*[103] also demonstrates that after *Hochfelder* some courts continue to apply a varying duty of investigation approach without apparent concern that they might be using a negligence standard. Plaintiff in *Alton Box* had purchased Penn Central commercial paper, allegedly in reliance on Goldman, Sachs' rating Penn Central's credit as "prime."[104] Although Penn Central's credit proved to be something short of prime, recovery was denied on the ground that plaintiff's purchasing agent had access to the same information possessed by defendant about the financial condition of Penn Central.[105] The court's analysis shows that Alton Box Board

98. [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,132 (N.D. Cal. 1977).

99. *Id.* at 92,089-90.

100. *Id.* at 92,094.

101. *See* text accompanying notes 63-66 *supra.*

102. [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) at 92,095.

103. 418 F. Supp. 1149 (E.D. Mo. 1976), *rev'd on other grounds,* 560 F.2d 916 (8th Cir. 1977).

104. *Id.* at 1152.

105. *Id.* at 1153.

did not lose its claim because it failed to act as should a reasonable investor. The implicit holding is that because plaintiff and its agent were "highly sophisticated investors with large amounts of financial resources available to them,"[106] they should be considered as having taken a deliberate risk.

The Second Circuit also has retained some requirement of plaintiff's due diligence in spite of *Hochfelder*. In *Hirsch v. DuPont*[107] plaintiffs alleged that defendant New York Stock Exchange, conspiring to facilitate the merger of plaintiff with the brokerage house F.I. DuPont, had concealed the imaginative techniques by which DuPont was attempting to comply with the Exchange's net capital rules.[108] The court mixed the three traditional approaches, finding that the Exchange had no duty to disclose DuPont's machinations, either because the information was not material, or "if material, should have been discovered by the exercise of due diligence."[109] The court supported both conclusions by noting plaintiff's "exhaustive and unrestricted" investigation of DuPont.[110] The conclusion that the information was not material apparently derives from the observation that in spite of the information available to plaintiffs, they proceeded with the transaction—an erroneous analysis because it applies a nonobjective standard of materiality. The due diligence portion of the *Hirsch* court's analysis conforms precisely to Professor Prosser's category of cases in which plaintiff has received a warning that something is amiss: "given the information they possessed [regarding DuPont's back office problems and difficulty with raising capital], we believe any reasonable investor of appellants' sophistication would have made a further inquiry."[111] The court's use of the word "reasonable" does not obscure its emphasis on the individual plaintiff in determining the proper extent of the duty to investigate. After *Hirsch*, district courts in the Second Circuit have continued to examine plaintiff's conduct for the appropriate measure of due diligence. In *NBI Mortgage Investment Corp. v. Chemical Bank*[112] the court considered a claim of fraud in connection with the sale of a participation in a mortgage loan. Although the court found that a disclaimer of reliance signed by plaintiff effectively barred his claim,[113] it argued in the alterna-

106. *Id.* at 1158.
107. 553 F.2d 750 (2d Cir. 1977).
108. *Id.* at 755.
109. *Id.* at 762.
110. *Id.*
111. *Id.* at 762-63.
112. [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,066 (S.D.N.Y. 1977).
113. *Id.* at 91,801.

tive that even if the disclaimer had not been effective, plaintiff had failed to exercise the requisite due diligence. Plaintiff reasoned that a due diligence defense was no longer applicable in light of *Hochfelder,* but the court cited *Hirsch* for the proposition that "the standard of diligence is still viable and accepted in this circuit."[114] In holding that plaintiff had not met the requirement of due diligence, the court did not utilize an abstract negligence standard, but instead focused on two specific factors that led it to charge plaintiff with the knowledge that would have been discovered through investigation. Plaintiff was a sophisticated investor that had advertised its willingness to participate in loans on the basis of its peculiar expertise in the field, and plaintiff had contracted for the right to examine defendant's books and records but had never done so.[115]

In spite of *Hochfelder,* therefore, a substantial number of courts continue to require that plaintiffs in 10b-5 actions act in some way to protect themselves. Some of these decisions have carefully examined the policy bases supporting the imposition of a standard of care on plaintiffs; others have simply recognized that plaintiffs in a position to protect themselves who ignore warnings and proceed with dubious transactions should not recover.

C. Decisions Purporting To Reject a Due Diligence Approach

The most extensive and influential decision of the post-*Hochfelder* era is the Fifth Circuit case *Dupuy v. Dupuy.*[116] Defendant bought out his brother's share of a jointly owned corporation after misrepresenting the venture's substantially appreciated value. The brothers had formed a corporation to exploit a long-term lease for a valuable parcel of real estate on which they intended to build a hotel.[117] Initially, plaintiff supervised the day-to-day development of the property and received a management fee for his services, but defendant abruptly terminated plaintiff's fee and severed all direct contacts plaintiff had with the corporation.[118] Plaintiff, experiencing financial difficulties, requested that defendant buy him out.[119] During the next five months, defendant conducted extensive negotiations that led to a partnership agreement and construction financing for the hotel, disclosing nothing of this to plaintiff.[120] Defendant

114. *Id.*

115. *Id.*

116. 551 F.2d 1005 (5th Cir. 1977), *cert. denied,* 434 U.S. 911 (1977) (commented upon in 12 GA. L. REV. 112 (1977)).

117. 551 F.2d at 1008.

118. *Id.* at 1009.

119. *Id.*

120. *Id.* at 1010.

executed agreements with the partnership on behalf of the board of directors of the original corporation, but never informed his brother of board meetings.[121] Plaintiff requested explanations of expenses paid for with corporation funds by checks he countersigned, but defendant did not reply. Finally, plaintiff sold his interest to defendant for $10,000.[122] The jury found, in response to special interrogatories, that defendant had knowingly or recklessly failed to disclose or had misrepresented material facts to plaintiff, that plaintiff relied on the misrepresentations or would have attached importance to the omissions, and that plaintiff "exercised 'due diligence' for his protection."[123] The trial court granted defendant's motion for a judgment notwithstanding the verdict, however, finding that there was no evidence from which the jury could have inferred any diligence on plaintiff's part.

The Fifth Circuit embarked on its extensive analysis by citing the four elements of any 10b-5 case: "the scienter of the defendant, the materiality of any misrepresentation or omission . . . the extent of actual reliance by the plaintiff . . . and the justifiability of the reliance, frequently translated into a requirement of due diligence by the plaintiff."[124] The court argued that the question of plaintiff's due diligence merited the separate treatment given it in the Fifth Circuit since *McAlpine*[125] because "considering independently whether the carelessness of a plaintiff should preclude his recovery"[126] served two policies: only those who have pursued their own interests with "care and good faith" would benefit from the judicially created 10b-5 remedy, and requiring careful investment would help prevent fraud and promote market stability.[127] The court then attacked the alternate methodologies used by other circuits. Citing *White v. Abrams*[128] as an example, the court argued that the variable duty approach produced inconsistent standards of conduct. In the court's view, the duty of disclosure was owed to the public, not to any particular investor, and a determination that an individual plaintiff does not deserve recovery should "not alter the distinct consideration whether a defendant has violated duties imposed by

121. *Id.*

122. *Id.* at 1011. Estimates of the actual value of plaintiff's interest ranged from $500,000 to $1,200,000. *Id.*

123. *Id.* at 1007 n.2.

124. *Id.* at 1014.

125. *See* notes 38-46 *supra* and accompanying text.

126. 551 F.2d at 1014.

127. *Id.*

128. *See* notes 63-66 *supra* and accompanying text.

the Act."[129] The *Dupuy* court next analyzed those cases that determined due diligence by considering whether "reliance by plaintiffs on misrepresentations was reasonable or justifiable."[130] The court suggested that this approach tied due diligence to materiality[131] and thus became logically inconsistent in light of *Affiliated Ute Citizens v. United States.*[132] In the court's view, *Affiliated Ute* removed plaintiff's burden of proving reliance in omission cases because reliance is presumed from materiality.[133] Thus, the court argued, a justifiable reliance approach is left with nothing to analyze in omission cases, although the policies behind encouraging careful investment are as strong in omission cases as in misrepresentation cases.[134]

Having justified its own approach of considering plaintiff's care separately from other 10b-5 elements, the court embarked on a reevaluation of the due diligence standard in light of *Hochfelder.* Although the court noted correctly at the outset that the "diligence of the plaintiff in 10b-5 cases is judged subjectively" and that the "role model for a plaintiff . . . is an investor with the attributes of the plaintiff, rather than the average investor,"[135] the court inexplicably described this standard, which was set up in *McAlpine,*[136] as "in effect, a negligence standard."[137] *Hochfelder,* the court noted, had provoked "an important reexamination . . . of the appropriateness of applying a negligence standard to the conduct of plaintiff when the Supreme Court has forbidden a similar standard to be applied to the conduct of defendants."[138] Responding to *Hochfelder,* the court examined the theoretical justifications for changing the due diligence standard.

Looking first to tort theory, the court noted the distinction between negligent and intentional misrepresentations, recognizing that contributory negligence does not bar recovery for the latter.[139] Tbe court reasoned that two theories provide support for this distinction. First, the law is more firmly committed to deterring intentional misconduct than negligent behavior. Second, although there is no good reason to shift a loss when the conduct of both parties is

129. 551 F.2d at 1015.
130. *Id.*
131. *Id.*
132. 406 U.S. 128 (1972).
133. 551 F.2d at 1015.
134. *Id.* at 1016. The court noted that "[as] diligence can reveal misrepresentations, it can also reveal omissions." *Id.*
135. *Id.*
136. *See* text accompanying notes 38-46 *supra.*
137. 551 F.2d at 1017.
138. *Id.*
139. *Id.* at 1018.

equally culpable, social policy demands such a shift when one party acts intentionally and the other is merely negligent.[140] The court next examined the policies behind the securities acts that suggested the due diligence standard be altered. Because *Hochfelder* had emphasized so strongly that the purpose of the Act was to deter intentional misconduct, the court reasoned that this policy must outweigh any intent to deter negligent conduct.[141] The final argument posed by the court for modifying the due diligence standard was that after *Hochfelder,* due diligence was not needed to curb the almost limitless scope of 10b-5 liability. The court concluded, therefore, that a plaintiff's conduct could bar his recovery only if it matched defendant's level of culpability:

> The question should not be whether Milton acted unreasonably by failing to investigate the condition of Lori corporation. Instead, the court should ask whether Milton 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."[142]

After creating this lax standard for plaintiff's conduct, the court evaluated the defrauded brother's conduct by more traditional measures. The court noted that plaintiff had no effective access to the vital information and suggested that "due diligence analysis should not react reflexively to the titles of apparent insiders. The principle consideration should be whether the plaintiff, by virtue of his position, has access in fact to the particular information needed to uncover the fraud."[143] Furthermore, plaintiff had made inquiries of his brother, the person most likely to have material information about this particular corporation, had little time to investigate because he was looking for a job, and was limited in his ability to investigate by illness.[144] In light of all this, the court concluded that there was evidence to support the jury's due diligence finding in light of the post-*Hochfelder* standard.

Dupuy typifies cases in which courts do what they have done, though they may not say what they have said.[145] The court initially erred in describing the pre-*Hochfelder* test set out in *McAlpine* as a negligence standard. As has been demonstrated,[146] the *McAlpine* court may have used the term "reasonable investor," but by endowing that paragon with all the qualities of the particular plaintiff, it

140. *Id.*
141. *Id.* at 1019.
142. *Id.* at 1020 (quoting W. PROSSER, *supra* note 3, § 34, at 185).
143. *Id.* at 1022.
144. *Id.* at 1023.
145. Lecture by Harold Maier, Conflicts Class, Vanderbilt Law School (Spring 1978).
146. *See* text accompanying notes 38-46 *supra.*

applied something other than a negligence test. Perceiving the prior test as one of negligence, the *Dupuy* court was understandably reluctant to describe the new test in those terms after *Hochfelder* eliminated negligent defendants. Nevertheless, the factors actually examined by the court track closely those used by pre-*Hochfelder* decisions: access to information, the relationship between the parties, and limitations on the ability to investigate that are peculiar to the plaintiff. The *Dupuy* court should have recognized that a plaintiff's conduct can be analyzed without classifying him as negligent, reckless, or intentionally duped. The proper inquiry is whether a particular plaintiff, no matter how deceitful the defendant, proceeded in a business transaction in which he was aware or should have been aware of the risk involved.

The *Dupuy* analysis heavily influenced the district court decision in *Holmes v. Bateson.*[147] *Holmes* concerned the buy-out of a decedent's interest in a corporation and its predecessor partnership. During the negotiations for a purchase price, the remaining shareholders failed to disclose that arrangements were being made for a merger that would vastly increase the value of the stock.[148] Following the *McAlpine/Dupuy* analysis, the court considered the claim that plaintiffs were remiss in not investigating the corporation as an issue separate from materiality and reliance.[149] The court acknowledged *Dupuy*'s liberalization of the *McAlpine* negligence test, but went on to consider the factors that consistently have determined the effect of plaintiff's conduct in both pre- and post-*Hochfelder* cases: the close personal relationships between the estate representatives and the individual defendants, and the lack of effective access to the crucial information. The court concluded that the combination of these factors "justified the level of care which the pliantiffs exercised."[150]

The most difficult plaintiff's standard of care case in the post-*Hochfelder* era is *Holdsworth v. Strong.*[151] Both plaintiff and defendant in *Holdsworth* were attorneys who had formed, with a third party, a company that marketed time recording systems used by law offices.[152] Almost from inception, defendant exercised exclusive management control over the company, and he also obtained a con-

147. 434 F. Supp. 1365 (D.R.I. 1977).

148. *Id.* at 1373-76.

149. *Id.* at 1382.

150. *Id.* at 1383.

151. 545 F.2d 687 (10th Cir. 1976)(en banc), *rev'g* Holdsworth v. Strong, [1975-1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,465 (10th Cir. 1976).

152. 545 F.2d at 689.

trolling interest. Plaintiff alleged that defendant repeatedly represented that the company was in financial trouble and would never pay dividends. In reliance, plaintiff sold his shares for $1500, only to learn that the company was doing quite well, with gross annual receipts of over $100,000. The trial court found intentional violations of 10b-5 and granted plaintiff a recission.[153]

The appeal was heard first by a panel of the Tenth Circuit, which reversed the trial court. The court pointed to earlier decisions such as *Mitchell v. Texas Gulf Sulphur Co.*[154] as creating a duty of due diligence and found that plaintiffs had failed to satisfy that duty. While agreeing that plaintiff had no duty to examine the corporation's books if such investigation would not have revealed the truth, the court found that "the trial court was clearly erroneous in determining the records did not contain enough detail to enable a person examining them to learn of the falsity of appellant's representations. . . . [The records] would certainly excite a person with reasonable business prudence to make this inquiry."[155] The court recognized that lack of due diligence in a negligence sense rarely barred recovery for intentional deceit, but nonetheless held that plaintiff's sophistication, his close association with the corporation, and his easy access to the key information justified the result.[156] Thus, the panel in *Holdsworth* applied a classic pre-*Hochfelder* analysis: an examination of the particular plaintiff's access and sophistication to determine what information should be charged to his knowledge.

Sitting en banc, the Tenth Circuit reversed. The court framed the issue as

> whether in an intentional fraud case . . . the victim is barred from relief if he does not exercise due care to avoid being deceived, due diligence being generally defined as the requirement that an insider "must fulfill a duty of due care in seeking to ascertain for himself the facts relevant to a transaction" before he may claim reliance on a material misrepresentation or omission.[157]

The court concluded, using three separate lines of analysis, that a negligence standard could not be applied to 10b-5 plaintiffs. First, the court concluded that the only courts imposing a due diligence requirement in the negligence sense on the plaintiff did so "in the context of the application to the *defendant* of a *negligence* standard."[158] Agreeing that negligence was an appropriate standard in

153. *Id.* at 689-91.

154. *See* text accompanying notes 47-49 *supra.*

155. [1975-1976 Transfer Binder] FED. SEC. L. REP. (CCH), at 99,362-63.

156. *Id.* at 99,363.

157. 545 F.2d at 692.

158. *Id.* (emphasis by the court).

such cases, the court argued that if "liability of the defendant requires proof of intentional misconduct, the exaction of a due diligence standard from the plaintiff becomes irrational and unrelated."[159] Second, the court argued that after *Hochfelder*[160] a fraudulent actor should not be allowed to escape liability by claiming that "if the plaintiff had been diligent, he would not have allowed himself to be cheated."[161] Allowing defendant to make this argument, in the court's view, would limit 10b-5 recovery to the "extraordinary case."[162] Finally, the court looked for analogies in the common law of deceit. Noting the traditional distinctions based on whether the deceit was intentional or negligent, the court concluded that:

> [T]he due diligence standard as applied to 10b-5 suits is about the same as the application of contributory negligence. Just 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.[163]

Having concluded that plaintiff's recovery should not be barred by what it termed contributory negligence, the court nevertheless determined that plaintiff must show that he relied and that his reliance was justified. In explicating "justified reliance," the court first noted, apparently to avoid the *Affiliated Ute* presumed reliance holding,[164] that *Holdsworth* involved misrepresentations and therefore "reliance is the appropriate and decisive way to prove the chain of causation."[165] The court next confronted the language in *Mitchell*[166] that clearly referred to a failure "to exercise due diligence."[167] In the court's view *Mitchell* had not applied a negligence standard but rather had determined that plaintiff's reliance was not

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159. *Id.*

160. The *Holdsworth* court mischaracterized *Hochfelder* as holding that "only intentional conduct of the defendant could give rise to a recovery under Rule 10b-5." *Id.* at 693; *see* note 8 *supra* and accompanying text.

161. 545 F.2d at 693.

162. *Id.*

163. *Id.* at 694.

164. *See* text accompanying notes 132-33 *supra.*

165. 545 F.2d at 695. At this point the court set forth a line of reasoning that is convoluted at best: "Unquestionably the proof of reliance or materiality is essential to the case where it is a positive misrepresentation type of action and justified reliance is the required element." *Id.* Does this mean that justified reliance is a way to prove either reliance or materiality? The court then stated that: "All of this, however, is quite different from superimposing on the plaintiff the standard of due care. Under that standard the plaintiff would not be heard to say that he relied on misrepresentations which were obviously false." *Id.* Without being able to determine with certainty which standard the court meant by "that standard," one assumes that under no standard could a plaintiff claim reliance on obviously false representations. He could not do so at common law. *See* text accompanying note 16 *supra.*

166. *See* text accompanying notes 47-49 *supra.*

167. 545 F.2d at 696.

justified.[168] Applying this standard to Holdsworth's conduct, the court looked to the "quasi-fiduciary"[169] nature of the parties' relationship and to the fact that an examination of the books would not have revealed Strong's misrepresentations, concluding that in the "particular factual climate" of the case "justifiable reliance was a link sufficient to eliminate a need for [Holdsworth] to show lack of contributory fault."[170]

The *Holdsworth* court's analysis is convoluted at best. First, the court misrepresented the *Hochfelder* holding as allowing recovery only for intentional misconduct[171] and incorrectly stated that the only pre-*Hochfelder* cases applying a due diligence standard to plaintiffs had held defendants liable for negligent misconduct.[172] Second, justifiable reliance apparently was utilized as a way to demonstrate either materiality or reliance.[173] Finally, after examining factors consistent with the assumption of risk analysis advocated here, the court apparently reasoned that the particular fact pattern of *Holdsworth* allowed the plaintiff to demonstrate justified reliance as a substitute for showing a lack of contributory fault. By implication, some situations will require a contributory fault standard, but the court provided no insight into the identification of such cases. Thus, while correctly reevaluating *Mitchell*, which clearly applied a true negligence standard to plaintiff's conduct, and properly examining the individualized factors that justified Holdsworth's reliance, the court failed to state its analysis in a comprehensible manner.

Reliance on *Holdsworth* has generated confusion in recent cases. For example, the Seventh Circuit, in *Sundstrand Corp. v. Sun Chemical Corp.*,[174] considered liability for omissions in connection with the purchase of a stock option.[175] The court found that defendant's conduct was reckless and concluded that such behavior could support 10b-5 liability after *Hochfelder*. Relying on *Holdsworth*, the court held that plaintiff's claim would be barred only if he too were reckless.[176] The court then argued that the record

168. *Id.*

169. *Id.* at 697. The court noted that Holdsworth and Strong had been close business associates and family friends for a number of years, and that a relationship of "trust and confidence had been carefully built up over a long period of time." *Id.*

170. *Id.*

171. *See* note 8 *supra.*

172. *See* note 46 *supra* and accompanying text.

173. *See* note 165 *supra.*

174. 553 F.2d 1033 (7th Cir. 1977).

175. *Id.* at 1036.

176. *Id.* at 1048.

did not indicate that plaintiff was reckless in not ferreting out the vital information, but simply showed that even if defendant had disclosed the information, plaintiff would not have acted. This reasoning, however, does not disprove recklessness; it simply demonstrates reliance in fact. The *Sundstrand* court should have examined what plaintiff knew and what his access to information and business acumen could have told him, and determined whether he acted reasonably in proceeding with the transaction. By insisting that plaintiff's conduct have some fault-connoting label such as recklessness attached to it, the court was distracted from the true issue: whether the plaintiff knowingly took a chance.

IV. Conclusion: Toward a Causation Analysis

The better reasoned 10b-5 cases have recognized that there exist strong policy reasons for imposing some obligation on investors to protect themselves in order to combat fraud and promote stable securities markets. Punishing fraudulent conduct is not nearly so effective a preventative tool as is the elimination of potential victims. Although concepts borrowed from the tort law of deceit have provided assistance in defining the elements of a 10b-5 case, they have failed to guide courts toward a proper method of evaluating plaintiffs' conduct, primarily because of slavish judicial adherence to verbal formulations and scant attention to underlying reality. The crux of the problem lies in the unthinking use, in the pre-*Hochfelder* era, of such terms as due diligence, reasonable reliance, and reasonable investor to describe an investor's proper behavior in protecting himself. Stated baldly, courts after *Hochfelder* jumped to the conclusion that these terms connoted a negligence standard and that, in light of traditional tort theory, contributory negligence could not be raised as a defense to an intentional tort. The courts so reasoning labored under two misconceptions. First, within traditional tort theory, as argued by Professor Prosser before the American Law Institute, there is room for testing whether the particular victim of intentional deceit acted reasonably without holding him to a reasonable man standard. Second, many pre-*Hochfelder* cases did precisely that. By considering all the characteristics of the particular plaintiff, the courts determined what was reasonable for that individual in the particular circumstances but did not hold him to a normative standard of negligence. Courts should continue this analysis in the post-*Hochfelder* era. Unlike the test verbally formulated in *Dupuy,* which in the case of intentional defendant misconduct would bar plaintiff only if he acted intentionally to dupe him-

self—a concept verging on nonsense—the proper analysis should avoid attaching a fault-connoting label to plaintiff's conduct at all. If plaintiff's conduct must be labeled, Professor Prosser's suggestion of assumption of risk conveys the proper meaning. Under that standard, no matter how invidiously deceptive the defendant was, it remains appropriate to examine the sophistication and knowledge of the plaintiff to determine whether his risktaking rather than defendant's deception caused his loss. This focus on causation will invoke traditional proximate cause analysis, under which a policy decision is made concerning the appropriateness of recovery. A court's attention, therefore, should focus on whether a plaintiff has been so foolish in his own behalf that he should not be allowed to recover.

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