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Relevance of Tort Law Doctrines to Rule 10b-5: Should Careless Plaintiffs Be Denied Recovery

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THE RELEVANCE OF TORT LAW DOCTRINES TO RULE 10b-5: SHOULD CARELESS PLAINTIFFS BE DENIED RECOVERY?

*Margaret V. Sachs**

INTRODUCTION

Private litigation under section 10(b)[1] of the Securities Exchange Act of 1934[2] and rule 10b-5[3] is at present riddled with tort law doctrines.[4] Familiar tort concepts such as aiding and abet-

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1 Section 10(b) 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—
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> . . . .
>
> (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.

15 U.S.C. § 78j(b) (1982) [hereinafter cited as section 10(b)].

2 Securities Exchange Act of 1934, 15 U.S.C. § 78(a)-(kk) (1982) [hereinafter cited as 1934 Act].

3 Rule 10b-5, promulgated by the Securities and Exchange Commission (SEC) in 1942, 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,
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> (a) To employ any device, scheme, or artifice to defraud,
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> (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
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> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
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> in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1985) [hereinafter cited as rule 10b-5].

Neither rule 10b-5 nor § 10(b) expressly provides for a private action. *See supra* notes 1, 3. Beginning with Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946), however, lower federal courts implied a private action for violations of the rule. By 1969 a private action under rule 10b-5 had been upheld by 10 of the 11 United States courts of appeals. *See* 6 L. Loss, SECURITIES REGULATION 3871-73 (2d ed. Supp. 1969) (collecting cases). The Supreme Court first recoguized the private action in Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6 (1971).

4 Tort principles underlay judicial implication of a private action under rule 10b-5.

ting,[5] respondeat superior,[6] plaintiff's duty of care,[7] *in pari delicto*,[8] and contribution[9] have been imported into the rule 10b-5 private

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Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946), the first case to imply a private action under rule 10b-5, was premised on the theory that "[t]he disregard of the command of a statute is . . . a tort." *Id.* at 513. The Supreme Court's subsequent acknowledgements of the private action have failed to address its putative basis in tort law. *See* Herman & MacLean v. Huddleston, 459 U.S. 375, 380-81 & n.10 (1983); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 196 (1976); Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6, 13 n.9 (1971). The Court's rejection of the tort law basis does seem to follow, however, from its recent rulings that implied actions are appropriate only where intended by Congress. *See, e.g.*, Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11, 15-24 (1979) (no implied private action under § 206 of the Investment Advisors Act of 1940, 15 U.S.C. § 80b-6 (1982)); Touche Ross & Co. v. Redington, 442 U.S. 560, 574-79 (no implied action for damages under § 17(a) of the 1934 Act, 15 U.S.C. § 78q(a) (1982)).

5 *E.g.*, Cleary v. Perfectune, Inc., 700 F.2d 774, 777 (1st Cir. 1983); IIT v. Cornfeld, 619 F.2d 909, 922 (2d Cir. 1980); Harmsen v. Smith, 693 F.2d 932, 943-44 (9th Cir. 1982), *cert. denied*, 104 S. Ct. 89 (1983); Walck v. American Stock Exch., Inc., 687 F.2d 778, 790-91 (3d Cir. 1982), *cert. denied*, 461 U.S. 942 (1983); Stokes v. Lokken, 644 F.2d 779, 782-83 (8th Cir. 1981); Woodward v. Metro Bank of Dallas, 522 F.2d 84, 94-97 (5th Cir. 1975).

6 *E.g.*, Paul F. Newton & Co. v. Texas Commerce Bank, 630 F.2d 1111, 1118 (5th Cir. 1980); Marbury Management, Inc. v. Kobn, 629 F.2d 705, 712-16 (2d Cir.), *cert. denied*, 449 U.S. 1011 (1980); Holloway v. Howerdd, 536 F.2d 690, 694 (6th Cir. 1976). *But see* Rochez Bros., Inc. v. Rhoades, 527 F.2d 880, 884-86 (3d Cir. 1975) (liability of employer not based on respondeat superior doctrine; basis for liability was "controlling person" provision of Exchange Act § 20, 15 U.S.C. § 78t(a) (1982)); Zweig v. Hearst Corp., 521 F.2d 1129, 1132-33 (9th Cir.) (same), *cert. denied*, 423 U.S. 1025 (1975).

7 *E.g.*, Zobrist v. Coal-X, Inc., 708 F.2d 1511, 1515-19 (10th Cir. 1983); White v. Sanders, 689 F.2d 1366, 1369 (11th Cir. 1982) (per curiam); Mallis v. Bankers Trust Co., 615 F.2d 68, 78-79 (2d Cir. 1980), *cert. denied*, 449 U.S. 1123 (1981); Nye v. Blyth Eastman Dillon & Co., 588 F.2d 1189, 1196-97 (8th Cir. 1978); Holmes v. Bateson, 583 F.2d 542, 559 & n.21 (1st Cir. 1978); Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1048 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977); Dupuy v. Dupuy, 551 F.2d 1005 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977); Straub v. Vaisman & Co., 540 F.2d 591, 596-98 (3d Cir. 1976). *See also* National Bank v. Whitehead & Kales Co., 528 F. Supp. 940, 949 (E.D. Mich. 1981) (action could not be maintained where plaintiffs failed to exercise minimal degree of care and due diligence required by 1934 Act, §§ 10(b), 20(a), 15 U.S.C. §§ 78j(b), 78t(a) (1982)), *aff'd mem.*, 732 F.2d 155 (6th Cir. 1984); McDaniel v. Compania Minera Mar de Cortes, 528 F. Supp. 152, 166-67 (D. Ariz. 1981) (plaintiff must establish that he assessed available information as would reasonable person in his position possessed with similar business experience, and that he was unaware of any untruth or omission of fact).

8 *E.g.*, Mallis v. Bankers Trust Co., 615 F.2d 68, 76-77 (2d Cir. 1980), *cert. denied*, 449 U.S. 1123 (1981); Tarasi v. Pittsburgh Nat'l Bank, 555 F.2d 1152 (3d Cir.), *cert. denied*, 434 U.S. 965 (1977); James v. Du Breuil, 500 F.2d 155 (5th Cir. 1974); Grnmet v. Shearson/American Express, Inc., 564 F. Supp. 336 (D.N.J. 1983). *But see* Natbanson v. Weis, Voisin, Cannon, Inc., 325 F. Supp. 50 (S.D.N.Y. 1971) (*in pari delicto* defense not available to insiders in suit brought by purchasers).

In Bateman Eichler, Hill Richards, Inc. v. Berner, 105 S. Ct. 2622 (1985), the Supreme Court rejected the *in pari delicto* defense of securities professionals in a suit brought by their tippees. The Court based its rejection of the defense on enforcement considerations. For a discussion of the circumstances in which an *in pari delicto* defense may still be valid, see *infra* note 293.

9 *E.g.*, Tucker v. Arthur Andersen & Co., 646 F.2d 721, 727 (2d Cir. 1981); Heizer Corp. v. Ross, 601 F.2d 330, 332-34 (7th Cir. 1979); Globus, Inc. v. Law Research Serv.,

action by a number of lower federal courts.[10] The United States Supreme Court had not addressed the relevance of any of these doctrines[11] until its decision this year in *Bateman Eichler, Hill Richards, Inc. v. Berner*.[12] By disallowing a defense of *in pari delicto* on statutory enforcement grounds, *Bateman* plainly signals the now precarious status of tort law doctrines in rule 10b-5 private actions.

Bateman is the most recent of a series of decisions over the past decade in which the Court has indicated that the intent of Congress governs the elements of the rule 10b-5 action.[13] The Supreme Court has enumerated several factors that must be considered in determining congressional intent: the langnage and history of section 10(b) and rule 10b-5; the structure of the 1934 Act and the Securities Act of 1933;[14] the policies underlying both the 1933 and

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Inc., 318 F. Supp. 955 (S.D.N.Y. 1970), *aff'd on opinion below*, 442 F.2d 1346 (2d Cir.), *cert. denied*, 404 U.S. 941 (1971).

At least one court has questioned the status of contribution under rule 10b-5 following the Supreme Court's decisions in Northwest Airlines, Inc. v. Transportation Workers Union, 451 U.S. 77 (1981) (rejecting contribution under Equal Pay Act, 29 U.S.C. § 206(d) (1982), and title VII of Civil Rights Act of 1964, 42 U.S.C. § 2000e-2 (1982)) and Texas Indus., Inc. v. Radcliff Materials, Inc., 451 U.S. 630 (1981) (rejecting contribution under Clayton Act, 15 U.S.C. § 15 (1982)). *See* Fogel v. Chestnutt, 668 F.2d 100, 119 n.17 (2d Cir. 1981), *cert. denied*, 459 U.S. 828 (1982). *But cf.* Noonan v. Granville-Smith, 532 F. Supp. 1007 (S.D.N.Y.) (distinguishing *Northwest Airlines* and *Texas Industries* and upholding right of contribution under rule 10b-5), *certificate for interlocutory appeal granted*, 535 F. Supp. 333 (S.D.N.Y. 1982).

10 *See* cases cited *supra* notes 5-9. Lower court decisions on whether recklessness may be a basis for liability also illustrate the prominence of tort law in rule 10b-5 actions. Several lower courts have accepted recklessness as a basis for liability because of its sufficiency under common law deceit. *See* McLean v. Alexander, 599 F.2d 1190, 1198 (3d Cir. 1979); Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017, 1024 (6th Cir. 1979); Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 45-46 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978); Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1044 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977). *See generally infra* note 17 (discussing elements of rule 10b-5 private action).

11 The Supreme Court has expressly left open the relevance of aiding and abetting and contribution under rule 10b-5. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 191 n.7 (1976) (aiding and abetting); Texas Indus., Inc. v. Radcliff Materials, Inc., 451 U.S. 630, 640 n.11 (1981) (contribution); Northwest Airlines, Inc. v. Transportation Workers Union, 451 U.S. 77, 91-92 n.24 (1981) (same).

Although the Court has never addressed the plaintiff's duty of care, Justice White dissented in 1977 from the denial of certiorari in a duty of care case. *See* Dupuy v. Dupuy, 434 U.S. 911 (1977) (White, J., dissenting from denial of certiorari). He maintained that "[t]he Court should take this opportunity to clarify the standard of care expected of plaintiffs in litigation under Rule 10b-5." *Id.* at 912.

12 105 S. Ct. 2622 (1985).

13 *See also* Dirks v. SEC, 463 U.S. 646, 655 (1983); Chiarella v. United States, 445 U.S. 222, 233 (1980); Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 472, 479 (1977); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 200 (1976); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737 (1975).

14 Securities Act of 1933, 15 U.S.C. § 77(a)-(mm) (1982) [hereinafter cited as 1933 Act].

1934 Acts; and the elements of deceit under the common law.[15]

This Article has two objectives: first, to examine the Court's jurisprudence for the rule 10b-5 action;[16] second, to apply the Court's jurisprudence to the duty of care, a rule 10b-5 doctrine of common law origin.[17] The duty of care requires that the court dis-

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15 In Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975), for example, the Court held that a private plaintiff under rule 10b-5 must have purchased or sold the security in question. The holding was premised on the language of § 10(b), statutory structure, and statutory policy.

In Erust & Ernst v. Hochfelder, 425 U.S. 185 (1976), the Court held that rule 10b-5 does not encompass liability for negligence. The holding was premised on the language of § 10(b), statutory structure, and legislative history.

In Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977), the Court held that rule 10b-5 liability requires misrepresentation or nondisclosure. The holding was premised on the language of § 10(b), legislative history, and statutory policy.

In Chiarella v. United States, 445 U.S. 222 (1980), the Court held that under rule 10b-5, silence was actionable only if the defendant had a duty to disclose. The Court premised its holding on common law deceit after finding that the language and history of § 10(b), as well as statutory policy, were not helpful.

16 A substantially different reading of the Court's jurisprudence has been offered by Professor Daniel R. Fischel, who claims that the appropriate factors are limited to the language, structure, and history of § 10(b). *See* Fischel, *Secondary Liability Under Section 10(b) of the Securities Act of 1934,* 69 CALIF. L. REV. 80, 94 (1981). He specifically rejects both policy, *id.* at 100-02, and common law deceit, *id.* at 94, as relevant factors.

17 *See generally* W. PROSSER & W. KEETON, PROSSER AND KEETON ON TORTS § 108 (5th ed. 1984). *See also infra* notes 318-29 and accompanying text (discussing status of duty of care under common law deceit).

The duty of care has repeatedly been held irrelevant to actions brought by the SEC. *See, e.g.,* Dupuy v. Dupuy, 551 F.2d 1005, 1015 (5th Cir.), *cert. denied,* 434 U.S. 911 (1977); SEC v. Dolnick, 501 F.2d 1279, 1283 (7th Cir. 1974); SEC v. North Am. Research & Dev. Corp., 424 F.2d 63, 84 (2d Cir. 1970); Hanly v. SEC, 415 F.2d 589, 596 (2d Cir. 1969). *Cf.* 5C A. JACOBS, LITIGATION AND PRACTICE UNDER RULE 10b-5 § 238.02, at 10-84 (rev. 2d ed. 1985) (defense of *in pari delicto* irrelevant to actions brought by SEC). *But see* SEC v. Coffey, 493 F.2d 1304, 1313 (6th Cir. 1974) (victim's knowledge held sufficient to defeat action by SEC), *cert. denied,* 420 U.S. 908 (1975).

Under rule 10b-5 a private plaintiff must plead and prove the following elements:

(1) *PURCHASER/SELLER REQUIREMENT.* The plaintiff must be a purchaser or seller of a security. *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 754-55 (1975).

(2) *MATERIALITY.* The fact omitted or misrepresented must have been material. A fact is material "if there is a substantial likelihood that a reasonable . . . [investor] would consider it important. . . ." TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976). Although the *TSC Industries* standard was propounded in the context of § 14(a) of the 1934 Act, 15 U.S.C.§ 78n(a) (1982), and rule 14a-9, 17 C.F.R. § 240.14a-9 (1985), it also applies to actions brought under § 10(b) and rule 10b-5. *See* Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 474 n.14 (1977) (*TSC Industries* cited as sole authority for finding of lack of materiality under rule 10b-5); S.D. Cohn & Co. v. Woolf, 426 U.S. 944 (1976) (rule 10b-5 action remanded for reconsideration in light of *TSC Industries*). *See also* Abrams v. Oppenheimer Gov't Sec., Inc., 737 F.2d 582, 593 (7th Cir. 1984) (*TSC Industries* standard applied to rule 10b-5 action); Madison Consultants v. FDIC, 710 F.2d 57, 62 (2d Cir. 1983) (same); Simpson v. Southeastern Inv. Trust, 697 F.2d 1257, 1259 (5th Cir. 1983) (same); Austin v. Loftsgaarden, 675 F.2d 168, 176 & n.17 (8th Cir. 1982) (same).

(3) *SCIENTER.* Defendant must have acted with scienter, defined as an intent to deceive, manipulate, or defraud. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976).

miss a rule 10b-5 private action when the plaintiff has carelessly ignored information,[18] relied upon suspicious information,[19] or failed to seek warranted additional information.[20] Every circuit that has

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The Supreme Court has not determined whether recklessness is sufficient for liability. *Id.* at 194 n.12; Herman & MacLean v. Huddleston, 459 U.S. 375, 378 n.4 (1983). Lower courts after *Hochfelder* have held recklessness to be sufficient for liability. *E.g.*, Pegasus Fund, Inc. v. Laraneta, 617 F.2d 1335, 1340 (9th Cir. 1980); Healey v. Catalyst Recovery, Inc., 616 F.2d 641, 649 (3d Cir. 1980); Broad v. Rockwell Int'l Corp., 614 F.2d 418, 440 (5th Cir. 1980). *See also* cases cited *supra* note 10.

(4) *"IN CONNECTION WITH" REQUIREMENT.* The fraud must have occurred "in connection with" the purchase or sale of a security. See the texts of § 10(b), *supra* note 1, and rule 10b-5, *supra* note 3. *See also* Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6 (1971) (addressing scope of "in connection with" requirement).

(5) *RELIANCE.* Plaintiff must have relied on the fact that was omitted or misrepresented. Where the fact was omitted, plaintiff's reliance is presumed. Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-54 (1972). *See* Huddleston v. Herman & MacLean, 640 F.2d 534, 548 (5th Cir. 1981), *rev'd in part on other grounds,* 459 U.S. 375 (1983); Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1048 (7th Cir.), *cert. denied,* 434 U.S. 875 (1977). *Cf.* Sharp v. Coopers & Lybrand, 649 F.2d 175, 188-89 (3d Cir. 1981) ("flexible approach" adopted with respect to presumption of reliance), *cert. denied,* 455 U.S. 938 (1982). Courts have relaxed the reliance element when the claim involves "fraud on the market." *See generally* Black, *Fraud on the Market: A Criticism of Dispensing with Reliance Requirements in Certain Open Market Transactions,* 62 N.C.L. REV. 435 (1984).

(6) *CAUSATION.* The injury to the plaintiff must have resulted from the omission or misrepresentation. Bloor v. Carro, Spanbock, Londin, Rodman & Fass, 754 F.2d 57, 61 (2d Cir. 1985); Huddleston v. Herman & MacLean, 640 F.2d 534, 549 (5th Cir. 1981), *rev'd in part on other grounds,* 459 U.S. 375 (1983); St. Louis Union Trust Co. v. Merrill Lynch Pierce Fenner & Smith, Inc., 562 F.2d 1040, 1048 (8th Cir. 1977), *cert. denied,* 435 U.S. 925 (1978); Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374, 380-81 (2d Cir. 1974), *cert. denied,* 421 U.S. 976 (1975). The causation element is also relaxed when the claim involves "fraud on the market." *See generally* Black, *supra.*

(7) *JURISDICTIONAL MEANS REQUIREMENT.* The defendant must have used interstate commerce, the mails, or a facility of a national securities exchange. *See supra* notes 1, 3. *Cf.* Affiliated Ute Citizens v. United States, 406 U.S. 128, 148 (1972) (affirming district court's holding that defendants made use of jurisdictional means).

18 *See, e.g.*, Thompson v. Smith Barney, Harris Upham & Co., 709 F.2d 1413, 1418 (11th Cir. 1983) (failure to read contract); Frigitemp Corp. v. Financial Dynamics Fund, Inc., 524 F.2d 275, 282 (2d Cir. 1975) (failure to examine transfer sheets); Financial Indus. Fund, Inc. v. McDonnell Douglas Corp., 474 F.2d 514, 521 (10th Cir.) (inattention to earnings statement), *cert. denied,* 414 U.S. 874 (1973); Lucas v. Florida Power & Light Co., 575 F. Supp. 552, 570 (S.D. Fla. 1983) (inattention to prospectus); McDaniel v. Compania Minera Mar de Cortes, 528 F. Supp. 152, 167 (D. Ariz. 1981) (inattention to available records and information); Kaplan v. Vornado, Inc., 341 F. Supp. 212, 215 (N.D. Ill. 1971) (failure to read debenture).

19 *See, e.g.*, Zobrist v. Coal-X, Inc., 708 F.2d 1511, 1518 (10th Cir. 1983) (reliance on oral misrepresentations that contradicted memorandum); White v. Sanders, 689 F.2d 1366, 1369 (11th Cir. 1982) (jury might have reasonably believed that plaintiffs were reckless in ignoring evidence that should have made them suspicious); Lane v. Midwest Bancshares Corp., 337 F. Supp. 1200, 1210-11 (E.D. Ark. 1972) (reliance on suspect balance sheet).

20 *See, e.g,* City Nat'l Bank v. Vanderboom, 422 F.2d 221, 231 (8th Cir.) (failure to seek audit report), *cert. denied,* 399 U.S. 905 (1970); Kohler v. Kohler Co., 319 F.2d 634, 641 (7th Cir. 1963) (failure to investigate discrepancy as to earnings); Altschuler v. Cohen, 471 F. Supp. 1372, 1384 (S.D. Tex. 1979) (allegedly material information could

considered the duty of care has upheld it,[21] albeit under a variety of names[22] and burden of proof allocations.[23] This Article concludes, however, that the duty of care is not appropriate to rule 10b-5 litigation and should be rejected.[24]

Part I of this Article traces the development of the duty of care

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have been obtained); Caan v. Kane-Miller Corp., [1975-76 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,446, at 99,242 (S.D.N.Y. Feb. 5, 1976) (failure to make inspection of available documents); Jackson v. Oppenheim, 411 F. Supp. 659, 668-69 (S.D.N.Y. 1974) (failure to conduct warranted additional inquiry), *rev'd in part on other grounds*, 533 F.2d 826 (2d Cir. 1976); Niedermeyer v. Niedermeyer, [1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,123, at 94,500 (D. Ore. Aug. 21, 1973) (failure to conduct thorough examination of available records).

Other types of carelessness may likewise result in a finding of failure to meet the duty of care. *See, e.g.*, Fallani v. American Water Corp., 574 F. Supp. 81, 84 (S.D. Fla. 1983) (failure to have contract translated into Italian); McLean v. Alexander, 420 F. Supp. 1057, 1079 (D. Del. 1976) (failure to retain counsel under other circumstances), *rev'd on other grounds*, 599 F.2d 1190 (3d Cir. 1979); Eichen v. E.F. Hutton & Co., 402 F. Supp. 823, 830-31 (S.D. Cal. 1975) (investigating too quickly); McGraw v. Matthaei, 388 F.Supp. 84, 91 (E.D. Mich. 1972) (investigating minimally).

A plaintiff with knowledge of facts warranting further investigation who fails to investigate does not fulfill his duty of care. This knowledge of facts warranting further investigation is distinct from knowledge of the fraud itself. Plaintiff's actual knowledge of the fraud undermines his cause of action for reasons separate from the duty of care. *See* Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1051 (7th Cir.) (plaintiff's knowledge precludes finding that defendant caused damages), *cert. denied*, 434 U.S. 875 (1977); Straub v. Vaisman & Co., 540 F.2d 591, 596 (3d Cir. 1976) (plaintiff's knowledge precludes finding of materiality); Ply-Gem Indus., Inc. v. Green, 503 F.2d 1362, 1365 (2d Cir. 1974) (plaintiff's knowledge defeats rule 10b-5 claim); Safecard Servs., Inc. v. Dow Jones & Co., 537 F. Supp. 1137, 1143 (E.D. Va. 1982) (plaintiff's knowledge precludes finding of reliance and causation), *aff'd mem.*, 705 F.2d 445 (4th Cir.), *cert. denied*, 464 U.S. 831 (1983). *But see* Stewart v. Bennett, 359 F. Supp. 878, 881 n.9 (D. Mass. 1973) (rule 10b-5 "affords no defense on the grounds of plaintiff's knowledge"). *See generally* 3 A. BROMBERG & L. LOWENFELS, SECURITIES FRAUD AND COMMODITIES FRAUD § 8.4(650-51) (1984) (plaintiff's knowledge of defendant's fraud precludes finding of nondisclosure or misrepresentation).

21 *See* cases cited *supra* note 7.

22 Other names used in referring to the duty of care include: justifiable reliance, reasonable reliance, reasonable diligence, and due diligence. *See infra* notes 31-34 and accompanying text.

23 The circuits disagree as to whether the plaintiff or the defendant bears the burden of proof concerning the duty of care. *See infra* notes 102-11 and accompanying text. A distinction exists among those circuits placing the burden on the plaintiff; some circuits impose the burden of proof on the plaintiff in every case, whereas at least one circuit places the burden of proof on the plaintiff only when the defendant has placed the plaintiff's care in issue. *See infra* notes 102-06 and accompanying text.

24 Commentators generally have approved of the duty of care. *See* Campbell, *Elements of Recovery Under Rule 10b-5: Scienter, Reliance, and Plaintiff's Reasonable Conduct Requirement*, 26 S.C.L. REV. 653 (1975); Wheeler, *Plaintiff's Duty of Due Care Under Rule 10b-5: An Implied Defense to an Implied Remedy*, 70 NW. U.L. REV. 561 (1976); Note, *The Due Diligence Requirement for Plaintiffs Under Rule 10b-5*, 1975 DUKE L.J. 753 (1975); Note, *A Comparative Fault Approach to the Due Diligence Requirement of Rule 10b-5*, 49 FORDHAM L. REV. 561 (1981); Note, *The Due Diligence Defense in Rule 10b-5: The Hochfelder Aftershocks*, 11 IND. L. REV. 727 (1978); Comment, *Plaintiff's Duty of Care After* Ernst & Ernst v. Hochfelder, 73 NW. U.L. REV. 158 (1978); Comment, *A Reevaluation of the Due Diligence Requirement for Plaintiffs in Private Actions under SEC Rule 10b-5*, 1978 WIS. L. REV. 904 (1978). *But see*

under rule 10b-5. The duty of care was first used to restrict the scope of rule 10b-5 and originally was applied in only two types of cases in which the need for limits was especially compelling: claims premised on the defendant's negligence and claims brought by insiders, corporations, and securities professionals. Although the Supreme Court's decisions in *Affiliated Ute Citizens v. United States*[25] and *Ernst & Ernst v. Hochfelder*[26] did not address the duty of care directly, the decisions facilitated expanded application of the doctrine. Part I examines this broader reach and potentially harsher impact of the present duty of care.

Parts II, III, and IV examine the Supreme Court's rule 10b-5 jurisprudence. Part II begins with the language and history of section 10(b) and rule 10b-5, including an exploration of the difficulties in utilizing these factors to determine congressional intent. The analysis of statutory structure in Part II prompts the conclusion that the duty of care cannot be reconciled with section 29(a) of the 1934 Act.[27]

Part III addresses the underlying policies of the 1933 and 1934 Acts and demonstrates their inconsistency with the policies that lower courts have advanced to justify the duty of care. Part III shows that the duty of care is inconsistent with the congressional policy of statutory enforcement and thereby contravenes the Supreme Court's decision in *Bateman Eichler, Hill Richards, Inc. v. Berner*.[28]

Part IV examines common law deceit. In accordance with congressional intent, the relevant deceit standards are those of the most liberal jurisdictions in 1934.[29] In those jurisdictions, a plaintiff's carelessness did not bar recovery.[30] Thus, rule 10b-5's duty of care is inconsistent with the common law as well as with statutory structure and policy. As such, it is contrary to the intent of Congress and should be abandoned.

I

DEVELOPMENT OF THE DUTY OF CARE UNDER RULE 10b-5

Whether discussed in explicit terms or as justifiable reliance,[31]

Note, *Abrogation of Plaintiff's Due Care Requirement in Private Actions Under Rule 10b-5*, 28 CASE W. RES. L. REV. 399 (1978).

25 406 U.S. 128 (1972).

26 425 U.S. 185 (1976).

27 Section 29(a) of the 1934 Act, 15 U.S.C. § 78cc(a) (1982) [hereinafter cited as section 29(a)].

28 105 S. Ct. 2622 (1985).

29 *See infra* note 317 and accompanying text.

30 *See infra* notes 319-29 and accompanying text.

31 *E.g.*, Zobrist v. Coal-X, Inc., 708 F.2d 1511, 1515-19 (10th Cir. 1983); LTV Fed.

reasonable reliance,[32] reasonable diligence,[33] or due diligence,[34] courts have applied the duty of care to rule 10b-5 actions involving both open market[35] and face-to-face[36] transactions. Courts have even extended the duty of care to class actions.[37] Face-to-face transactions, however, provide the more common context for litigation of duty of care issues. Such transactions are more likely to involve inconsistent or otherwise problematical information that a careful investor would be expected to clarify. Accordingly, duty of care issues are especially likely to arise in transactions involving close corporations,[38] private placements,[39] and customer-broker relations.[40]

A. Early Rule 10b-5 Duty of Care Cases

Courts originally applied the duty of care to rule 10b-5 litiga-

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Credit Union v. UMIC Gov't Sec., Inc., 523 F. Supp. 819, 836 (N.D. Tex. 1981), *aff'd*, 704 F.2d 199 (5th Cir.), *cert. denied*, 464 U.S. 852 (1983).

32 *E.g.*, Nye v. Blyth Eastman Dillon & Co., 588 F.2d 1189, 1197 (8th Cir. 1978); Zucker v. Sable, 72 F.R.D. 1, 4 (S.D.N.Y. 1975); Carlisle v. LTV Electrosystems, Inc., 54 F.R.D. 237, 239 (N.D. Tex. 1972).

33 *E.g.*, Clement A. Evans & Co. v. McAlpine, 434 F.2d 100, 104 (5th Cir. 1970), *cert. denied*, 402 U.S. 988 (1971); Meier v. Texas Int'l Drilling Funds, Inc., 441 F. Supp. 1056, 1063 (N.D. Cal. 1977).

34 *E.g.*, White v. Sanders, 689 F.2d 1366, 1369 (11th Cir. 1982); Straub v. Vaisman & Co., 540 F.2d 591, 596 (3d Cir. 1976); Financial Indus. Fund, Inc. v. McDonnell Douglas Corp., 474 F.2d 514, 521 (10th Cir.), *cert. denied*, 414 U.S. 874 (1973).

35 *E.g.*, Financial Indus. Fund, Inc. v. McDonnell Douglas Corp., 474 F.2d 514, 515 (10th Cir.), *cert. denied*, 414 U.S. 874 (1973); Lucas v. Florida Power & Light Co., 575 F. Supp. 552, 554-55 (S.D. Fla. 1983); Kaplan v. Vornado, Inc., 341 F. Supp. 212, 213 (N.D. Ill. 1971).

36 *See infra* notes 38-40 and accompanying text.

37 *E.g.*, Sharp v. Coopers & Lybrand, 649 F.2d 175 (3d Cir. 1981), *cert. denied*, 455 U.S. 938 (1982); Lucas v. Florida Power & Light Co., 575 F. Supp. 552 (S.D. Fla. 1983); Ferland v. Orange Groves, Inc., 377 F. Supp. 690 (M.D. Fla. 1974). *See also* Dura-Bilt Corp. v. Chase Manhattan Corp., 89 F.R.D. 87, 95-96 (S.D.N.Y. 1981) (class certification granted where duty of care regarded as potentially relevant to action); Cohen v. Uniroyal, Inc., 77 F.R.D. 685, 695 (E.D. Pa. 1977) (same).

38 *E.g.*, Swenson v. Engelstad, 626 F.2d 421 (5th Cir. 1980); Dupuy v. Dupuy, 551 F.2d 1005 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977); Holdsworth v. Strong, 545 F.2d 687 (10th Cir. 1976), *cert. denied*, 430 U.S. 955 (1977); Rochez Bros., Inc. v. Rhoades, 491 F.2d 402 (3d Cir. 1974); Arber v. Essex Wire Corp., 490 F.2d 414 (6th Cir.), *cert. denied*, 419 U.S. 830 (1974).

39 *E.g.*, Siebel v. Scott, 725 F.2d 995 (5th Cir.), *cert. denied*, 104 S. Ct. 3515 (1984); Zobrist v. Coal-X, Inc., 708 F.2d 1511 (10th Cir. 1983); Sharp v. Coopers & Lybrand, 649 F.2d 175 (3d Cir. 1981), *cert. denied*, 455 U.S. 938 (1982); Goodman v. Epstein, 582 F.2d 388 (7th Cir. 1978), *cert. denied*, 440 U.S. 939 (1979); Spatz v. Borenstein, 513 F. Supp. 571 (N.D. Ill. 1981); Meier v. Texas Int'l Drilling Funds, Inc., 441 F. Supp. 1056, 1063 (N.D. Cal. 1977); Eichen v. E.F. Hutton & Co., 402 F. Supp. 823, 830-31 (S.D. Cal. 1975).

40 *E.g.*, Thompson v. Smith Barney, Harris Upham & Co., 709 F.2d 1413 (11th Cir. 1983); Nye v. Blyth Eastman Dillon & Co., 588 F.2d 1189 (8th Cir. 1978); Straub v. Vaisman & Co., 540 F.2d 591 (3d Cir. 1976); Weir v. Merrill Lynch Pierce Fenner & Smith, Inc., 586 F. Supp. 63 (S.D. Fla. 1984).

tion as a way to limit liability.[41] The Fifth Circuit Court of Appeals offered an explanation for the perceived necessity of this limitation:

> Considered alone, the sweeping language of Rule 10b-5 creates an almost completely undefined liability. All that the rule requires for its violation is that someone "do something bad" in connection with a purchase or sale of securities. Without further delineation, civil liability is formless . . . . In recognition of this problem, courts have sought to construct workable limits to liability . . . .[42]

The duty of care was among the "workable limits" identified by the Fifth Circuit.[43]

The early duty of care cases measured the plaintiff's carelessness by a negligence standard.[44] Courts were divided, however, on the relation of the duty of care to the other elements of the private action.[45] Some courts regarded the duty of care as a separate element;[46] other courts subsumed it under the elements of causation,[47] reliance,[48] or materiality.[49] Courts also disagreed about whether to

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41 *E.g.*, Herpich v. Wallace, 430 F.2d 792, 804-05 & n.12 (5th Cir. 1970) (citing reasonable reliance as one limitation upon "formless" liability under rule 10b-5); Mutual Shares Corp. v. Genesco, Inc., 384 F.2d 540, 543-44 (2d Cir. 1967) (same); McLean v. Alexander, 420 F. Supp. 1057, 1077 (D. Del. 1976) (duty of care originated "as a defensive response to the increasing number of private actions brought under 10b-5"), *rev'd on other grounds*, 599 F.2d 1190 (3d Cir. 1979). *See also* Straub v. Vaisman & Co., 540 F.2d 591, 597 (3d Cir. 1976) ("where the basis of a 10b-5 recovery began to broaden from intentional to negligent conduct, importation of the tort concept of a plaintiff's contributory negligence was a natural development").

Kohler v. Kohler Co., 319 F.2d 634 (7th Cir. 1963), appears to have been the first rule 10b-5 case to utilize the duty of care concept. In *Kohler* the Seventh Circuit refused to hold the defendant liable, in part on the ground that the plaintiff had access to the information he claimed was misstated. *Id.* at 640. Other early cases utilizing the duty of care concept include Myzel v. Fields, 386 F.2d 718, 736-37 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968), and Phillips v. Reynolds & Co., 294 F. Supp. 1249, 1254 (E.D. Pa. 1969).

42 Herpich v. Wallace, 430 F.2d 792, 804-05 (5th Cir. 1970) (citations omitted).

43 *Id.* at 805 & n.12. Other "limits" were privity, causation, foreseeability, and the purchaser-seller requirement. *Id.*

44 *E.g.*, Rochez Bros. Inc. v. Rhoades, 491 F.2d 402, 409-10 (3d Cir. 1974) (by implication); Clement A. Evans & Co. v. McAlpine, 434 F.2d 100, 103 (5th Cir. 1970) (by implication), *cert. denied*, 402 U.S. 988 (1971); City Nat'l Bank v. Vanderboom, 422 F.2d 221, 230 (8th Cir.) (by implication), *cert. denied*, 399 U.S. 905 (1970).

45 *See supra* note 17 for the elements of a rule 10b-5 private action.

46 *E.g.*, Rochez Bros. Inc. v. Rhoades, 491 F.2d 402, 409 (3d Cir. 1974); Financial Indus. Fund, Inc. v. McDonnell Douglas Corp., 474 F.2d 514, 517 (10th Cir.), *cert. denied*, 414 U.S. 874 (1973); Jackson v. Oppenheim, 411 F. Supp. 659, 665 (S.D.N.Y. 1974), *rev'd in part on other grounds*, 533 F.2d 826 (2d Cir. 1976).

47 *E.g.*, Pollak v. Eastman Dillon, [1974-75 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,987, at 97,408 & n.1 (S.D.N.Y. Feb. 18, 1975); Branham v. Material Sys. Corp., 354 F. Supp. 1048, 1056 (S.D. Fla. 1973); Kaplan v. Varnado, Inc., 341 F. Supp. 212, 215-16 (N.D. Ill. 1971).

48 *E.g.*, Thomas v. Duralite Co., 524 F.2d 577, 585-86 (3d Cir. 1975); City Nat'l

judge the duty of care subjectively or objectively[50] and whether the plaintiff or the defendant had the burden of proof.[51] These differences were of little consequence during the 1960s and early 1970s, however, because at that time courts applied the duty of care in only two categories of rule 10b-5 cases.

The first category of cases applying the duty of care consisted of those purporting to reject a rule 10b-5 scienter requirement. True rejection of the scienter requirement did not occur in any circuit because no court actually imposed liability when scienter was lacking.[52] What may thus far have been overlooked, however, is that in dismissing claims alleging liability without scienter, courts frequently focused on the plaintiff's lack of care.[53] Indeed, the duty of care repeatedly served as a basis for dismissal,[54] affirmance of a defendant's verdict,[55] or reversal of a plaintiff's verdict[56] in cases in

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Bank v. Vanderboom, 422 F.2d 221, 230 (8th Cir.), *cert. denied,* 399 U.S. 905 (1970); Myzel v. Fields, 386 F.2d 718, 735-37 (8th Cir. 1967), *cert. denied,* 390 U.S. 951 (1968).

49 *E.g.,* Taylor v. Smith Barney & Co., 358 F. Supp. 892, 896 n.11 (D. Utah 1973).

50 *Compare* City Nat'l Bank v. Vanderboom, 422 F.2d 221, 230 n.10 (8th Cir.) (objective), *cert. denied,* 399 U.S. 905 (1970) *and* Niedermeyer v. Niedermeyer, [1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,123, at 94,500 (D. Ore. Aug. 21, 1973) (same) *with* Bird v. Ferry, 497 F.2d 112, 114 (5th Cir. 1974) (subjective) *and* Clement A. Evans & Co. v. McAlpine, 434 F.2d 100, 104 (5th Cir. 1970) (same), *cert. denied,* 402 U.S. 988 (1971) *and* Myzel v. Fields, 386 F.2d 718, 737 (8th Cir. 1967) (same), *cert. denied,* 390 U.S. 951 (1968).

51 Early cases placing the burden of proof on defendant include Clement A. Evans & Co. v. McAlpine, 434 F.2d 100, 104 (5th Cir. 1970), *cert. denied,* 402 U.S. 988 (1971); Reilly v. Frederick, [1975-76 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,417, at 99,111 (N.D. Ala. Jan. 12, 1976); Branham v. Material Sys. Corp., 354 F. Supp. 1048, 1056 (S.D. Fla. 1973). *See also* Colvin v. Dempsey-Tegeler & Co., 477 F.2d 1283, 1291 n.12 (5th Cir. 1973) (explicitly reserving question whether plaintiff or defendant had burden of proof).

For cases placing the burden of proof on plaintiff, see *supra* note 46.

52 *E.g.,* Smallwood v. Pearl Brewing Co., 489 F.2d 579, 606 (5th Cir.), *cert. denied,* 419 U.S. 873 (1974); Kohn v. American Metal Climax, Inc., 458 F.2d 255, 286 (3d Cir.) (Adams, J., concurring and dissenting), *cert. denied,* 409 U.S. 874 (1972); Bucklo, *Scienter and Rule 10b-5,* 67 NW. U.L. REV. 562, 563 (1972); Cox, Ernst & Ernst v. Hochfelder: *A Critique and an Evaluation of its Impact upon the Scheme of the Federal Securities Laws,* 28 HASTINGS L.J. 569, 570-71 & nn. 5-13 (1977). *See also* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194 n.12 (1976) (noting that intentional conduct was in fact at issue in most cases sanctioning negligent liability).

53 Courts have recognized that the duty of care arose to curb liability for nonintentional conduct. *See, e.g.,* Dupuy v. Dupuy, 551 F.2d 1005, 1019 (5th Cir.), *cert. denied,* 434 U.S. 911 (1977); Straub v. Vaisman & Co., 450 F.2d 591, 597 (3d Cir. 1976). What has not been recognized, however, is the duty of care's role in insuring that liability for unintentional conduct was never imposed.

54 *E.g.,* Branham v. Material Sys. Corp., 354 F. Supp. 1048, 1056-57 (S.D. Fla. 1973); McGraw v. Matthaei, 388 F. Supp. 84, 91 (E.D. Mich. 1972); Kaplan v. Vornado, Inc., 341 F. Supp. 212, 215-16 (N.D. Ill. 1971).

55 *E.g.,* Arber v. Essex Wire Corp., 490 F.2d 414, 420 (6th Cir.), *cert. denied,* 419 U.S. 830 (1974); Kohler v. Kohler Co., 319 F.2d 634, 640 (7th Cir. 1963).

56 *E.g.,* Financial Indus. Fund, Inc. v. McDonnell Douglas Corp., 474 F.2d 514, 521 (10th Cir.), *cert. denied,* 414 U.S. 874 (1973). *See also* Colvin v. Dempsey-Tegeler & Co.,

which scienter was at least formally not required.

The second category of cases applying the duty of care was a limited subgroup of cases in which scienter was expressly at issue:[57] those in which the plaintiff was a securities professional,[58] a corporation,[59] or an insider.[60] The Second Circuit explained the rationale for applying the duty of care in these cases:[61]

> The securities laws were not enacted to protect sophisticated

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477 F.2d 1283, 1287-88 (5th Cir. 1973) (plaintiff's verdict reversed because jury gave inconsistent answers to questions involving duty of care); White v. Abrams, 495 F.2d 724, 734-36 (9th Cir. 1974) (plaintiff's verdict reversed and remanded for reconsideration in light of new rule 10b-5 standards, which include duty of care).

57 Scienter might be at issue either because the court regarded it as an essential element or because the plaintiff alleged it. *Compare* Jackson v. Oppenheim, 411 F. Supp. 659, 665 (S.D.N.Y. 1974) (circuit requirement), *rev'd in part on other grounds,* 533 F.2d 826 (2d Cir. 1976), *with* Clement A. Evans & Co. v. McAlpine, 434 F.2d 100 (5th Cir. 1970) (scienter alleged by plaintiff), *cert. denied,* 402 U.S. 988 (1971).

58 *E.g.,* Edwards & Hanley v. Wells Fargo Sec. Clearance Corp., 602 F.2d 478 (2d Cir. 1979) (brokerage firm), *cert. denied,* 444 U.S. 1045 (1980); Clement A. Evans & Co. v. McAlpine, 434 F.2d 100 (5th Cir. 1970) (same), *cert. denied,* 402 U.S. 988 (1971).

59 *E.g.,* Rodman v. Grant Found., 460 F. Supp. 1028 (S.D.N.Y. 1978) (bankruptcy trustee for mercantile chain), *aff'd,* 608 F.2d 64 (2d Cir. 1979); NBI Mortgage Inv. Corp. v. Chemical Bank, [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,066 (S.D.N.Y. May 24, 1977) (corporation); Caan v. Kane-Miller Corp., [1975-76 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,446 (S.D.N.Y. Feb. 5, 1976) (counterclaim of conglomerate).

60 *E.g.,* Pittsburgh Coke & Chem. Co. v. Bollo, 560 F.2d 1089, 1091-92 (2d Cir. 1977) (insider is corporation); Jackson v. Oppenheim, 411 F. Supp. 659 (S.D.N.Y. 1974) (insider is officer and director), *rev'd in part on other grounds,* 533 F.2d 826 (2d Cir. 1976).

61 Early cases did not explicitly acknowledge the application of the duty of care to scienter cases involving insiders, corporations, and securities professionals. Some did, however, implicitly acknowledge it. For example, in Rochez Bros., Inc. v. Rhoades, 491 F.2d 402 (3d Cir. 1974), the court held that "before *an insider* may claim reliance on a material misrepresentation or nondisclosure, he must fulfill a duty of due care." *Id.* at 409 (emphasis added). Similarly, in Thomas v. Duralite Co., 524 F.2d 577 (3d Cir. 1975), the court held that the "plaintiff, as *an 'insider,'* had the duty of using due care to ascertain the relevant facts." *Id.* at 585-86 (emphasis added). In Frigitemp Corp. v. Financial Dynamics Fund, Inc., 524 F.2d 275 (2d Cir. 1975), the court imputed constructive knowledge to the corporate plaintiff but then noted that "[w]hether 'constructive knowledge,' or 'ready access to the information involved,' is always a bar to the plaintiff we need not decide." *Id.* at 282 (citation omitted; emphasis deleted). In Myzel v. Fields, 386 F.2d 718 (8th Cir. 1967), *cert. denied,* 390 U.S. 951 (1968), the court assessed the justifiable reliance of the insider plaintiff, but not that of the ordinary plaintiff. *Id.* at 735-37.

Moreover, recent cases have erroneously assumed that the duty of care previously had no application to scienter cases. *See, e.g.,* Mallis v. Bankers Trust Co., 615 F.2d 68, 78 (2d Cir. 1980), *cert. denied,* 449 U.S. 1123 (1981); Dupuy v. Dupuy, 551 F.2d 1005, 1019 (5th Cir.), *cert. denied,* 434 U.S. 911 (1977). This error has created interpretative problems. For example, in Dupuy v. Dupuy, 551 F.2d 1005 (5th Cir.), *cert. denied,* 434 U.S. 911 (1977), the court had difficulty explaining why the duty of care had been invoked in Clement A. Evans & Co. v. McAlpine, 434 F.2d 100 (5th Cir. 1970), *cert. denied,* 402 U.S. 988 (1971), because the *McAlpine* plaintiff had alleged scienter. 551 F.2d at 1019 n.26. The *Dupuy* court failed to recognize the significance of the plaintiff's status as a brokerage firm in *McAlpine,* preferring instead to cast *McAlpine* aside as an "exception." *Id.*

> businessmen from their own errors of judgment. Such investors must, if they wish to recover under federal law, investigate the information available to them with the care and prudence expected from people blessed with full access to information.[62]

Accordingly, in many of these cases, courts based their dismissals on the plaintiff's failure to meet his duty of care.[63] Not all courts accepted the application of the duty of care in these circumstances, however. Some courts appeared to regard the duty of care as inapplicable to scienter cases, regardless of the plaintiff's identity.[64] They reasoned that carelessness, even where the plaintiff was sophisticated, would not expurgate the defendant's fraud, because "sophisticated investors, like all others, are entitled to the truth."[65]

In cases involving scienter and an unsophisticated plaintiff, lack of care did not defeat recovery, even when the plaintiff had been on notice of the need for further inquiry. The Tenth Circuit's decision in *Zabriskie v. Lewis*[66] illustrates this view. In *Zabriskie,* the defendants allegedly orally misrepresented the negotiability of certain stock. The defendants argued that the legend on the face of the stock certificate had given the plaintiff notice of the stock's non-negotiability.[67] The Tenth Circuit refused to impose a duty of care, reasoning that

> [the plaintiff's] reliance on the statements of these two men would not seem to indicate a lack of diligence but rather a justifiable reliance. As to her alleged receipt of actual notice from the legend, the oral statement indicating the stock was negotiable could easily have satisfied any question the legend raised in the mind of this unsophisticated investor.[68]

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62 Hirsch v. Du Pont, 553 F.2d 750, 763 (2d Cir. 1977). In Mallis v. Bankers Trust Co., 615 F.2d 68 (2d Cir. 1980), *cert. denied,* 449 U.S. 1123 (1981), the court limited the application of the quoted statement to situations like *Hirsch* where the plaintiff's actions are "far beyond negligence." *Id.* at 79.

63 *See* cases cited *supra* notes 58-60.

64 In Metro-Goldwyn-Mayer, Inc. v. Ross, 509 F.2d 930 (2d Cir. 1975), the court upheld the omissions claim of a corporate plaintiff that had access to documents containing the allegedly omitted information. *Id.* at 933.

In Franklin Sav. Bank v. Levy, 406 F. Supp. 40 (S.D.N.Y. 1975), *rev'd on other grounds,* 551 F.2d 521 (2d Cir. 1977), the court entered judgment for the plaintiff bank despite its president's awareness of the problematic nature of the investment in question. 406 F. Supp. at 46.

65 Stier v. Smith, 473 F.2d 1205, 1207 (5th Cir. 1973).

66 507 F.2d 546 (10th Cir. 1974).

67 The legend read:

> The shares of Stock represented by this certificate are held for investment and not for distribution, and cannot be presented for transfer until compliance with the Securities Act of 1933 as amended.

Id. at 552 n.12.

68 *Id.* at 552-53. *See also* Myzel v. Fields, 386 F.2d 718, 735-37 (8th Cir. 1967) (issue of justifiable reliance adjudicated as to insider plaintiff, but not as to noninsider plaintiff), *cert. denied,* 390 U.S. 951 (1968). *Cf.* Bird v. Ferry, 497 F.2d 112, 114 (5th Cir. 1974)

Thus, courts invoked the duty of care as a means of curbing the application of rule 10b-5[69] only when the need for a curb seemed especially acute. Such situations involved claims premised on the defendant's negligence[70] and claims brought by certain privileged or sophisticated plaintiffs.[71]

B. The Supreme Court Speaks By Indirection: *Affiliated Ute* and *Hochfelder*

Prior to *Affiliated Ute Citizens v. United States,*[72] courts often subsumed the duty of care under the element of reliance.[73] In *Affiliated Ute,* the Supreme Court refused to dismiss the plaintiff's claim merely because the plaintiff had failed to prove reliance upon material factual omissions:

> Under the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material . . . . This obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact.[74]

Affiliated Ute thus recognized the difficulty of establishing reliance upon omitted information.[75] The Court relieved the plaintiff of this burden by placing the burden on the defendant to establish that the plaintiff had not relied upon the omitted information.[76] The plaintiff retained the burden of establishing reliance, however, if he alleged misrepresentations rather than omissions.[77]

By eliminating the plaintiff's burden of proving reliance in omissions cases, the *Affiliated Ute* Court further complicated the uncertain relationship between reliance and the duty of care. If reli-

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(verdict against broker affirmed despite plaintiff's failure to request receipts or audit account).

69 *See supra* notes 41-43 and accompanying text.

70 *See supra* notes 52-56 and accompanying text.

71 *See supra* notes 57-63 and accompanying text.

72 406 U.S. 128 (1972).

73 *See supra* note 48 and accompanying text.

74 406 U.S. at 153-54 (citations omitted).

75 *See, e.g.,* Lipton v. Documation, Inc., 734 F.2d 740, 742 (11th Cir. 1984), *cert. denied,* 105 S.Ct. 814 (1985); Dupuy v. Dupuy, 551 F.2d 1005, 1015 (5th Cir.), *cert. denied,* 434 U.S. 911 (1977).

76 *E.g.,* Huddleston v. Herman & MacLean, 640 F.2d 534, 548 (5th Cir. 1981), *rev'd in part on other grounds,* 459 U.S. 375 (1983). *See generally* Note, *The Reliance Requirement in Private Actions Under SEC Rule 10b-5,* 88 HARV. L. REV. 584 (1975).

77 Where the plaintiff claims an omission as well as a misrepresentation, courts sometimes presume reliance as to both claims to avoid the necessity of giving two sets of instructions on reliance. *See, e.g.,* Austin v. Loftsgaarden, 675 F.2d 168, 178 n.21 (8th Cir. 1982); Sharp v. Coopers & Lybrand, 649 F.2d 175, 188-89 (3d Cir. 1981), *cert. denied,* 455 U.S. 938 (1982). *But cf.* Huddleston v. Herman & MacLean, 640 F.2d 534, 548 (5th Cir. 1981) (plaintiffs not entitled to presumption), *rev'd in part on other grounds,* 459 U.S. 375 (1983).

ance subsumed the duty of care,[78] the burden of proof allocations applicable to reliance would also apply to the duty of care. Thus, after *Affiliated Ute,* a plaintiff would have had to prove that he had met his duty of care in a misrepresentation case but not in an omissions case.[79] Courts could not justify this allocation, however, because proof of the duty of care is not inherently more difficult in omissions cases than in misrepresentation cases.[80] Consequently, most courts after *Affiliated Ute* separated reliance from the duty of care.[81]

Affiliated Ute thus systematized the relationship between the duty of care and the other elements of the rule 10b-5 action. The previous uncertainty regarding this relationship probably contributed to the selective application of the duty of care.[82] By systematizing this relationship, *Affiliated Ute* also facilitated the eventual extension of the duty of care to all private rule 10b-5 actions.[83]

Ernst & Ernst v. Hochfelder[84] further enhanced the status of the duty of care in rule 10b-5 cases. The *Hochfelder* Court held that rule 10b-5 did not encompass liability for mere negligence.[85] The Court held that liability under rule 10b-5 requires scienter, defined as an intent to deceive, manipulate, or defraud.[86] The Court expressly left open the question of whether scienter embraces recklessness.[87]

By eliminating liability based on the defendant's negligence, *Hochfelder* prompted courts to reconsider the relevance of the plaintiff's negligence.[88] Every circuit to reconsider the issue, however, has reaffirmed the duty of care,[89] at least in modified form,[90] after

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78 *See supra* note 48 and accompanying text.

79 *See* Dupuy v. Dupuy, 551 F.2d 1005, 1015-16 (5th Cir.), *cert. denied,* 434 U.S. 911 (1977).

80 Courts were unable to identify any other policy that would allocate proof of the duty of care in accordance with whether the plaintiff's allegations involved omissions or misrepresentations. *See id.* at 1016.

81 *E.g., id.* at 1015-16.

82 *E.g.,* Thompson v. Smith Barney, Harris Upham & Co., 709 F.2d 1413, 1418 (11th Cir. 1983) (reliance is a separate element of plaintiff's case). *But cf.* Holdsworth v. Strong, 545 F.2d 687, 695-97 (10th Cir. 1976) (not clearly separating plaintiff's due diligence from reliance), *cert. denied,* 430 U.S. 955 (1977).

83 *See infra* notes 114-17 and accompanying text.

84 425 U.S. 185 (1976).

85 Plaintiffs had specifically conceded defendants' lack of scienter. *Id.* at 190 n.5.

86 *Id.* at 193.

87 *See id.* at 194 n.12. *See also* Herman & MacLean v. Huddleston, 459 U.S. 375, 378 n.4 (1983) (question again left open). Lower courts after *Hochfelder* have upheld the sufficiency of recklessness. *See supra* note 17.

88 *E.g.,* Mallis v. Bankers Trust Co., 615 F.2d 68, 78 (2d Cir. 1980), *cert. denied,* 449 U.S. 1123 (1981); Holmes v. Bateson, 583 F.2d 542, 559 n.21 (1st Cir. 1978).

89 *See* cases cited *supra* note 7. For a discussion of the modified duty of care, see *infra* notes 99-124 and accompanying text. As will be shown, most circuits have equated the modified duty of care with avoidance of recklessness, making the phrase "duty of

conceding that the preclusion of negligent liability rendered the duty of care less necessary.[91] Courts have premised this reaffirmation on five new justifications for the duty of care: deterrence of investor carelessness,[92] promotion of anti-fraud policies,[93] promotion of market stabilization,[94] "fairness,"[95] and provision of a causal link[96] between the defendant's wrong and the plaintiff's injury.[97] By precipitating recognition of these five new justifications, *Hochfelder* fostered the entrenchment of the duty of care under rule 10b-5.[98]

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care" something of a misnomer. Nevertheless, this Article uses the "duty of care" phraseology throughout.

90 Courts advanced three reasons for modifying the duty of care rather than retaining it intact. First, its necessity diminished after the Supreme Court eliminated liability for negligence in Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976). See *supra* notes 85-86 and accompanying text.

Second, courts did not perceive the duty of care as a defense to traditional common law fraud, which they analogized to rule 10b-5. *See, e.g.*, Dupuy v. Dupuy, 551 F.2d 1005, 1018-19 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977); Holdsworth v. Strong, 545 F.2d 687, 694 (10th Cir. 1976), *cert. denied*, 430 U.S. 955 (1977). *But cf.* Frigitemp Corp. v. Financial Dynamics Fund, Inc., 524 F.2d 275, 282 (2d Cir. 1975) (duty of care had been defense to common law fraud). As Part IV of this Article shows, a split of authority existed among common law courts in 1934 concerning the relevance of the plaintiff's carelessness to deceit actions.

Third, courts believed Congress had attached greater importance to the defendant's intentional fraud than to the plaintiff's negligence. *E.g.*, Dupuy v. Dupuy, 551 F.2d 1005, 1019 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977). As Parts II and III of this Article demonstrate, the issue of the plaintiff's negligence did not concern Congress, and it is therefore an inappropriate determinant of the scope of rule 10b-5.

91 *See, e.g.*, Dupuy v. Dupuy, 551 F.2d 1005, 1019 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977); Straub v. Vaisman & Co., 540 F.2d 591, 597 (3d Cir. 1976).

92 *E.g.*, Straub v. Vaisman & Co., 540 F.2d 591, 597 (3d Cir. 1976).

93 *E.g.*, Dupuy v. Dupuy, 551 F.2d 1005, 1014 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977). The theory seems to be that fraud will fail when investors are careful. *See id.* (by implication).

94 *E.g., id.* Apparently, the theory is that greater investor caution will create fewer market swings. *See id.* (by implication).

95 *E.g., id.* The court explained that "fairness" limits access to rule 10b-5 to "those who have pursued their own interests with care and good faith." *Id. See also* Weir v. Merrill Lynch Pierce Fenner & Smith, Inc., 586 F. Supp. 63, 65 (S.D. Fla. 1984).

96 For the elements of a rule 10b-5 private action, see *supra* note 17.

97 Courts adopting this theory maintain that the injury to a careless plaintiff results from his own lack of diligence, not from the defendant's fraud. *E.g.*, Dupuy v. Dupuy, 551 F.2d 1005, 1016 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977); Holdsworth v. Strong, 545 F.2d 687, 695-97 (10th Cir. 1976), *cert. denied*, 430 U.S. 955 (1977).

For a discussion of the justifications advanced by lower courts to support the duty of care, see *infra* notes 259-77 and accompanying text.

98 The perceived anti-plaintiff trend in the Supreme Court's recent rule 10b-5 decisions may have been an unstated justification for retaining the duty of care. Reconsideration of the duty of care in light of *Affiliated Ute* and *Hochfelder* occurred principally between 1976 and 1980, see *supra* note 7, a time when the Supreme Court was restricting the scope of rnle 10b-5. *E.g.*, Chiarella v. United States, 445 U.S. 222 (1980) (silence actionable only where defendant has duty to disclose); Sante Fe Indus., Inc. v. Green, 430 U.S. 462 (1977) (liability requires manipulation or deception); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975) (private plaintiff must be purchaser or seller of security). *But cf.* Bateman Eichler, Hill Richards, Inc. v. Berner, 105 S. Ct. 2622 (1985)

C. Duty of Care Cases After *Affiliated Ute* and *Hochfelder*

Duty of care cases after *Affiliated Ute* and *Hochfelder* have attempted to relax the pre-*Hochfelder* negligence standard.[99] The relaxed standards, all of which are applied subjectively,[100] have taken several forms.[101] The Second,[102] Fifth,[103] Tenth,[104] and Eleventh[105] Circuits measure the duty of care by a recklessness standard, with the burden of proof on the plaintiff.[106] The Seventh Circuit also uses a recklessness standard,[107] but the burden of proof ap-

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(rejecting *in pari delicto* defense of securities professionals in rule 10b-5 action brought by their tippees); Herman & MacLean v. Huddleston, 459 U.S. 375, 380-87 (1983) (rule 10b-5 and § 11 of 1933 Act, 15 U.S.C. § 77k (1982) are cumulative remedies).

99 For why the standard was relaxed rather than retained intact, see *supra* note 90.

100 *E.g.*, Nye v. Blyth Eastman Dillon & Co., 588 F.2d 1189, 1197 (8th Cir. 1978); Dupuy v. Dupuy, 551 F.2d 1005, 1016 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977); Holdsworth v. Strong, 545 F.2d 687, 696-97 (10th Cir. 1976), *cert. denied*, 430 U.S. 955 (1977); Straub v. Vaisman & Co., 540 F.2d 591, 598 (3d Cir. 1976). None of these cases acknowledged that previously some courts had applied the duty of care objectively. *See supra* note 50 and accompanying text.

101 At least one district court has puzzled over whether the standards are interchangeable. *See* American Gen. Ins. Co. v. Equitable Gen. Corp., 493 F. Supp. 721, 746-47 (E.D. Va. 1980).

102 *E.g.*, Mallis v. Bankers Trust Co., 615 F.2d 68, 79 (2d Cir. 1980), *cert. denied*, 449 U.S. 1123 (1981); Fund of Funds, Ltd. v. Arthur Andersen & Co., 545 F. Supp. 1314, 1368 (S.D.N.Y. 1982).

103 *E.g.*, Gower v. Cohn, 643 F.2d 1146, 1156 (5th Cir. 1981); Paul F. Newton & Co. v. Texas Commerce Bank, 630 F.2d 1111, 1122 (5th Cir. 1980); Dupuy v. Dupuy, 551 F.2d 1005, 1020 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977).

The First Circuit has indicated its approval of the Fifth Circuit standard but has not itself addressed the appropriate standard for the duty of care. *See* Xaphes v. Merrill Lynch Pierce Fenner & Smith, Inc., 600 F. Supp. 692, 694-95 (D. Me. 1985). One district court in the Ninth Circuit also has endorsed the Fifth Circuit standard. *See* Sullivan v. Chase Inv. Servs., Inc., 79 F.R.D. 246, 262 n.6 (N.D. Cal. 1978).

104 *E.g.*, Zobrist v. Coal-X, Inc., 708 F.2d 1511, 1516 (10th Cir. 1983) (recklessness standard); Holdsworth v. Strong, 545 F.2d 687, 696 (10th Cir. 1976) (burden of proof on plaintiff), *cert. denied*, 430 U.S. 955 (1977).

105 *E.g.*, Friedlander v. Nims, 571 F. Supp. 1188, 1197 (N.D. Ga. 1983), *aff'd*, 755 F.2d 810 (11th Cir. 1985); Gaskins v. Grosse, [1982-83 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 99,105, at 95,277 (S.D. Ga. Jan. 31, 1983).

106 *See* cases cited *supra* notes 102-05. None of these cases explains why the plaintiff should carry the burden of proving the duty of care rather than the defendant.

In the Second Circuit, the plaintiff must prove that he exercised due care only if the defendant places the plaintiff's care in issue. Mallis v. Bankers Trust Co., 615 F.2d 68, 79 (2d Cir. 1980), *cert. denied*, 449 U.S. 1123 (1981). In the Fifth and Eleventh Circuits, however, the plaintiff must meet this burden of proof in every case. Dupuy v. Dupuy, 551 F.2d 1005, 1014 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977); White v. Sanders, 689 F.2d 1366, 1369 (11th Cir. 1982). This difference is significant. *Compare* Fallani v. American Water Corp., 574 F. Supp. 81, 84 (S.D. Fla. 1983) (granting motion to dismiss for failure to allege plaintiff's lack of recklessness) *with* Savino v. E.F. Hutton & Co., 507 F. Supp. 1225, 1234 n.6 (S.D.N.Y. 1981) (denying motion to dismiss for failure to allege lack of recklessness).

107 Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1048 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977). Although the *Sundstrand* court stated that nonfulfillment of the duty of care requires " 'gross conduct somewhat comparable to that of defendant,' " *id.* (quoting Holdsworth v. Strong, 545 F.2d 687, 693 (10th Cir. 1976), *cert. denied*, 430

pears to be on the defendant.[108] The standard of care in the Third Circuit is reasonableness,[109] and the defendant bears the burden of proof.[110] Although the Third Circuit standard resembles negligence, it is more lenient than those pre-*Hochfelder* cases that required the plaintiff to prove a lack of negligence.[111]

Despite these modifications, the post-*Hochfelder* duty of care potentially has a much harsher impact on plaintiffs than its predecessor. First, the post-*Hochfelder* duty of care has a much wider scope. Before *Hochfelder*, courts ordinarily applied the duty of care only when the defendant lacked scienter[112] or when the plaintiff was a securities professional, corporation, or insider.[113] After *Hochfelder*, the duty of care applies to the claims of all types of investors.[114] For

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U.S. 955 (1977)), the court equated this standard with recklessness in the next paragraph. *Id.* The rationale for this equation appears to be that a plaintiff's recklessness makes him comparable to the defendant because the defendant can be found liable for reckless conduct. *Id.* at 1047-48. *See also* Spatz v. Borenstein, 513 F. Supp. 571, 585 (N.D. Ill. 1981) (equating lack of care with recklessness).

When a particular defendant acts intentionally, however, the question arises as to whether he is comparable to a plaintiff who acts recklessly. *Compare* Zobrist v. Coal-X, Inc., 708 F.2d 1511 (10th Cir. 1983) (reversing judgment in favor of a reckless plaintiff and against defendant who acted intentionally) *with id.* at 1520 (Holloway, J., dissenting) (reckless plaintiff should be entitled to recover from defendant who acts intentionally).

108 *See, e.g.*, J.H. Cohn & Co. v. American Appraisal Assocs., 628 F.2d 994, 998 (7th Cir. 1980); Goodman v. Epstein, 582 F.2d 388, 405 & n.47 (7th Cir. 1978), *cert. denied*, 440 U.S. 939 (1979); Bruce v. Rosenberg, 468 F. Supp. 777, 779 (E.D. Wis. 1979). None of these cases addresses the reasons for placing the burden on the defendant rather than on the plaintiff.

109 *E.g.*, Sharp v. Coopers & Lybrand, 649 F.2d 175, 194 (3d Cir. 1981), *cert. denied*, 455 U.S. 938 (1982); Straub v. Vaisman & Co., 540 F.2d 591, 598 (3d Cir. 1976).

110 *E.g.*, Straub v. Vaisman & Co., 540 F.2d 591, 598 (3d Cir. 1976). The Third Circuit offered the following conclusory justification for placing the burden of proof on the defendant: "the failure to meet . . . [the duty of care] standard is in the nature of an affirmative defense." *Id.* at 598.

111 *See supra* note 46 and accompanying text; *see also* Dupuy v. Dupuy, 551 F.2d 1005, 1017-18 (5th Cir.) (explaining Third Circuit's action in shifting burden of proof from plaintiff to defendant as relaxation of duty of care standard), *cert. denied*, 434 U.S. 911 (1977).

112 *See supra* notes 52-56 and accompanying text.

113 *See supra* notes 57-63 and accompanying text.

114 Claims of insiders, corporations, and securities professionals that have been dismissed for nonfulfillment of the duty of care include Landry v. All Am. Assurance Co., 688 F.2d 381 (5th Cir. 1982) (insiders) and McDaniel v. Compania Minera Mar de Cortes, 528 F. Supp. 152 (D. Ariz. 1981) (same). *See also* Hendrickson v. Westland Mineral Corp., 463 F. Supp. 826 (S.D. Fla. 1978) (failure to allege care by liquidator of business entities). *Cf.* Paul F. Newton & Co. v. Texas Commerce Bank, 630 F.2d 1111, 1121-22 (5th Cir. 1980) (duty of care of plaintiff broker to be decided upon retrial).

Nonfulfillment of the duty of care also has resulted in the dismissal of the claims of plaintiffs who were not insiders, corporations, or securities professionals. *See, e.g.*, Thompson v. Smith Barney, Harris Upham & Co., 709 F.2d 1413 (11th Cir. 1983); Zobrist v. Coal-X, Inc., 708 F.2d 1511, 1516 (10th Cir. 1983); White v. Sanders, 689 F.2d 1366 (11th Cir. 1982). *Cf.* Goodman v. Epstein, 582 F.2d 388, 405-06 (7th Cir. 1978) (duty of care to be decided at trial), *cert. denied*, 440 U.S. 939 (1979). *See also* Siebel v.

example, courts have recently dismissed claims of a businessman,[115] a physician,[116] and citizens of Italy[117] for failing to satisfy the duty of care.

The post-*Hochfelder* duty of care also has a harsher impact than its predecessor when the plaintiff has notice of the need for further inquiry. Before *Hochfelder,* notice did not defeat the claim of an ordinary investor if the defendant acted with scienter.[118] After *Hochfelder,* notice is sufficient to defeat an ordinary investor's claim, as the Tenth Circuit's decision in *Zobrist v. Coal-X, Inc.*[119] illustrates. In *Zobrist* a purchaser of an interest in a limited partnership claimed that he was given oral assurances that the investment was "no risk"[120] after he challenged the defendants' assertions that the investment was a "sure thing" and "couldn't miss."[121] The trial court entered judgment against the defendants. The Tenth Circuit reversed, imputing to the plaintiff knowledge of a private placement memorandum which contained a statement of risks.[122] The court concluded that even if the plaintiff had not read the memorandum before investing,[123] the plaintiff had been reckless to rely on the defendants' oral assurances given their inconsistency with the memorandum.[124]

The reach and impact of the duty of care in rule 10b-5 litigation

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Scott, 725 F.2d 995, 1000 (5th Cir.) (district court's finding of sufficient care not clearly erroneous, although a "close" question), *cert. denied,* 104 S. Ct. 3515 (1984).

A few of the foregoing cases were brought by individual plaintiffs with financial sophistication. *See, e.g.,* Zobrist v. Coal-X, Inc., 708 F.2d 1511, 1517 (10th Cir. 1983). Such cases illustrate the duty of care's expansion because they were not brought by insiders, securities professionals, or corporations.

115 Thompson v. Smith Barney, Harris Upham & Co., 709 F.2d 1413 (11th Cir. 1983).

116 Meier v. Texas Drilling Funds, Inc., 441 F. Supp. 1056 (N.D. Cal. 1977).

117 Fallani v. American Water Corp., 574 F. Supp. 81 (S.D. Fla. 1983).

118 *See supra* notes 66-68 and accompanying text.

119 708 F.2d 1511 (10th Cir. 1983). *See also* White v. Sanders, 689 F.2d 1366 (11th Cir. 1982). In *White* plaintiffs were purchasers of corporate notes that subsequently became worthless. They alleged that the defendant had misrepresented the safety of the notes as well as his own impartiality. The trial court entered judgment notwithstanding the verdict for the plaintiff. The Eleventh Circuit reversed, concluding that the jury reasonably might have found the plaintiffs "reckless in ignoring certain circumstantial evidence that should have made them suspicious." *Id.* at 1369. *Cf.* Siebel v. Scott, 725 F.2d 995, 1001 n.5 (5th Cir.) (court declined to charge plaintiffs with knowledge of statement contained in their prospectuses because defendant's testimony called into question truth of statement), *cert. denied,* 104 S. Ct. 3515 (1984).

120 708 F.2d at 1516.

121 *Id.* at 1514.

122 *Id.* at 1518.

123 *Id.* at 1514. The plaintiff had, however, signed an agreement acknowledging that the investment was subject to risks set forth in the memorandum. *Id.*

124 The court held that the plaintiff should not have relied on the defendants' oral assurances without "further inquiry." *Id.* at 1519.

has expanded enormously after *Hochfelder*. Parts II, III, and IV of this Article offer a framework for evaluating this expanded doctrine.

II
THE ELEMENTS OF RULE 10b-5: LANGUAGE, HISTORY, AND STATUTORY STRUCTURE

The Supreme Court has repeatedly emphasized that the intent of Congress governs the elements of the rule 10b-5 action. The Court measures this intent by the following factors: the language and history of section 10(b) and rule 10b-5, the structure of the 1933 and 1934 Acts, the policies underlying both those Acts, and the elements of deceit under the common law.[125] The duty of care must be evaluated in accordance with this framework.

A. The Language of Section 10(b)

The Supreme Court's rule 10b-5 analysis begins with the language of section 10(b):[126] "[W]e turn first to the language of [section] 10(b), for '[t]he starting point in every case involving construction of a statute is the language itself.' "[127] Statutory language has nevertheless been of limited usefulness to the Court. The language of section 10(b) has provided partial support for some elements, such as scienter[128] and the purchaser-seller requirement.[129] Statutory language fails, however, to offer a basis for other elements, such as a duty to disclose in cases challenging the defendant's silence.[130]

Three principal difficulties arise in inferring the elements of rule 10b-5 from the language of section 10(b). First, the wording of

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125 *See supra* notes 13-15 and accompanying text.

126 For the text of § 10(b), see *supra* note 1.

127 Ernst & Ernst v. Hochfelder, 425 U.S. 185, 197 (1976) (quoting Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 756 (1975) (Powell, J., concurring)). *See also* Chiarella v. United States, 445 U.S. 222, 226 (1980) (analysis of rule 10b-5 action should begin with language of § 10(b)).

128 *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) (deriving scienter requirement from language and history of § 10(b) and also from statutory structure).

129 *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975) (deriving purchaser-seller requirement from language of § 10(b), statutory structure, and statutory policy).

130 *See* Chiarella v. United States, 445 U.S. 222, 228 n.9, 233 (1980) (reversing conviction because duty to disclose, as developed under common law and incorporated into § 10(b), does not exist outside fiduciary relationship). Chief Justice Burger dissented in *Chiarella* because he considered the duty to disclose requirement to be consistent with the language of § 10(b), which encompasses "*any* person engaged in *any* fraudulent scheme." *Id.* at 240 (Burger, C.J., dissenting) (emphasis in original).

Other rule 10b-5 decisions not predicated upon the language of § 10(b) include Dirks v. SEC, 463 U.S. 646 (1983) (tippee liability) and Herman & MacLean v. Huddleston, 459 U.S. 375, 389 (1983) (establishing appropriate standard of proof in private action).

section 10(b) is imprecise and susceptible to alternative readings. The Court's analysis in *Hochfelder*[131] is illustrative. In holding that rule 10b-5 requires scienter, the Court relied upon the words " 'manipulative or deceptive' . . . in conjunction with 'device or contrivance.' "[132] The Court first attempted to infer the intent of Congress from the 1934 dictionary definitions of "manipulative," "device," and "contrivance."[133] The Court failed to note, however, that in the history of the 1934 Act, "device" was used synonymously with "practice," a word that does not necessarily support an inference of scienter.[134] The Court also attempted to confer special importance upon the word "manipulative," which it deemed "a term of art [in the securities field] . . . connot[ing] intentional or willful conduct."[135] In doing so, the Court apparently overlooked the fact that the words "manipulative" and "deceptive" are "expressed in the disjunctive, and each should be given its separate meaning."[136]

Indeed, the *Hochfelder* Court appeared to concede that it could not ground the scienter requirement solely on the language of section 10(b). After announcing that the clarity of the language made "further inquiry . . . unnecessary,"[137] the Court nonetheless sought additional support for its conclusion in the legislative history of the 1934 Act.[138] The Court made a similar concession in *Santa Fe Industries, Inc. v. Green*.[139] After deeming the language of section 10(b) to be "dispositive" of the matter at issue,[140] the *Sante Fe* Court proceeded to examine policy considerations.[141]

Another difficulty in drawing inferences from the language of section 10(b) is uncertainty over whether this language reflects the intent of Congress in the prima facie case only or in affirmative de-

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131 425 U.S. 185 (1976).

132 *Id.* at 197. The Court also inferred a scienter requirement from the words "[t]o use or employ." *Id.* at 199 n.20.

133 *Id.* at 199 nn.20-21 (quoting WEBSTER'S INTERNATIONAL DICTIONARY (2d ed. 1934)). The Court did not seek a dictionary definition for "deceptive," a word that characterizes the consequences of the defendant's acts, not his state of mind. Cox, *supra* note 52, at 575.

134 Aaron v. SEC, 446 U.S. 680, 707 (1980) (Blackmun, J., concurring in part and dissenting in part) (citing S. REP. No. 792, 73d Cong., 2d Sess. 18 (1934)).

135 425 U.S. at 199.

136 Aaron v. SEC, 446 U.S. 680, 707 (1980) (Blackmun, J., concurring in part and dissenting in part).

137 425 U.S. at 201.

138 *Id.* at 201-06.

139 430 U.S. 462 (1977).

140 *Id.* at 477. The issue in *Santa Fe* was whether liability under rule 10b-5 could be premised on conduct not involving misrepresentation or nondisclosure. The Court held that misrepresentation or nondisclosure was essential to liability under rule 10b-5. *Id.* at 474-77. *See also* Schreiber v. Burlington Northern, Inc., 105 S. Ct. 2458 (1985) (misrepresentation or nondisclosure held essential to liability under § 14(e) of the 1934 Act).

141 430 U.S. at 477-80.

fenses as well. Even in the wake of *Bateman Eichler, Hill Richards, Inc. v. Berner,*[142] the Court's first rule 10b-5 decision involving an affirmative defense,[143] this difficulty remains unresolved. In *Bateman* the Court does not address the lack of support for the *in pari delicto* defense in the language of section 10(b).[144] Possibly, the Court chose not to refer to the language of section 10(b) because it regarded this language as relevant to the prima facie case only.

A third difficulty pertains solely to the private action. Inferring from section 10(b)'s language elements unique to private actions may be inappropriate because Congress in 1934 did not consider private actions under section 10(b).[145] The *Bateman* Court may have failed to look to the language of section 10(b) since the affirmative defense at issue pertains only to private actions.[146] This private action difficulty also may account for the Court's reasoning in *Blue Chip Stamps v. Manor Drug Stores,*[147] which held that under rule 10b-5 private plaintiffs must be either purchasers or sellers. Although the Court found support for the purchaser-seller requirement in the words "in connection with the purchase or sale,"[148] as well as in the defeat in 1957 and 1959 of proposed amendments which would have added the phrase "*any attempt to purchase or sell,*" statutory language did not provide the ultimate basis for its decision:[149]

> [W]e would by no means be understood as suggesting that we are able to divine from the language of [section] 10(b) the express

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142 105 S. Ct. 2622 (1985).

143 The Court's major rule 10b-5 decisions are Dirks v. SEC, 463 U.S. 646 (1983) (tippee liability); Herman & MacLean v. Huddleston, 459 U.S. 375 (1983) (right to cumulative remedies under rule 10b-5 and § 11, 15 U.S.C. § 77k (1982), and appropriate standard of proof in rule 10b-5 private action); Aaron v. SEC, 446 U.S. 680 (1980) (SEC must prove scienter as element of rule 10b-5 action); Chiarella v. United States, 445 U.S. 222 (1980) (defendant lacking duty to disclose does not violate rule 10b-5 by his silence); Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977) (conduct not actionable under rule 10b-5 absent misrepresentation or nondisclosure); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) (scienter required in rule 10b-5 private action); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975) (private plaintiff must have purchased or sold securities to recover under rule 10b-5); Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972)(plaintiff alleging omissions need not prove reliance); Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6 (1971) (scope of "in connection with" requirement).

144 *Cf.* Kuehnert v. Texstar Corp. 412 F.2d 700, 705 (5th Cir. 1969) (Godbold, J., dissenting) (rejecting defenses of *in pari delicto* and unclean hands partly because they are not set out in language of § 10(b) and rule 10b-5).

145 *See infra* notes 159-61 and accompanying text.

146 *See* 5C A. JACOBS, *supra* note 17, § 238.02, at 10-84.

147 421 U.S. 723 (1975).

148 *Id.* at 733.

149 *Id.* at 732-33 (emphasis in original) (quoting S. 2545, 85th Cong., 1st Sess., 103 CONG. REC. 11,636 (1957); S. 1179, 86th Cong., 1st Sess., *reprinted in SEC Legislation: Hearings on S. 1178, S. 1179, S. 1180, S. 1181, and S. 1182 Before a Subcomm. of the Senate Comm. on Banking and Currency,* 86th Cong., 1st Sess. 367-68 (1959)).

> "intent of Congress" as to the contours of a private cause of action under Rule 10b-5 . . . . [I]t would be disingenuous to suggest that either Congress in 1934 or the Securities and Exchange Commission in 1942 foreordained the present state of the law with respect to Rule 10b-5.[150]

The Court was somewhat more reluctant in *Blue Chip* than in *Hochfelder*[151] or *Sante Fe*[152] to rely upon statutory language because only in *Blue Chip* did the questioned element pertain exclusively to the private action.

The above analysis supports the conclusion that the Court regards the language of section 10(b) as an important starting point but not the sole factor in interpreting rule 10b-5. Other factors become especially important if the questioned element involves either the private action or an affirmative defense.

Determining the appropriateness of the duty of care must, therefore, begin with the language of section 10(b). Even allowing for the imprecision of that language, nothing in section 10(b) suggests that a defendant might avoid liability because of the victim's carelessness. On the contrary, the entire provision is directed at the defendant's fraudulent activity; the possibility that the plaintiff might have averted the fraud is not discussed.

The duty of care should not be rejected, however, for lack of a basis in the language of section 10(b) because that language alone does not reliably indicate congressional intent about the duty of care. First, the duty of care is an element unique to private actions,[153] which were not considered by Congress in 1934.[154] Second, the duty of care is just as plausibly an affirmative defense as an element of the plaintiff's case.[155] If Congress intended section 10(b) to convey only the elements of the prima facie case, and if Congress intended the duty of care to be an affirmative defense, one would not expect to find the duty of care in section 10(b).

B. History of Section 10(b)

The Supreme Court has consistently identified section 10(b)'s

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150 *Id.* at 737. Statutory policy was the ultimate basis for the decision. *See id.* at 737-49. Justice Powell concurred "to emphasize the significance of the texts of the Acts of 1933 and 1934 and especially the language of § 10(b) and Rule 10b-5." *Id.* at 755 (Powell, J., concurring).

151 *See supra* notes 137-38 and accompanying text.

152 *See supra* notes 140-41 and accompanying text.

153 *See supra* note 17.

154 *See infra* notes 159-61 and accompanying text.

155 The disagreement between the circuits supports the fact that this ambiguity exists. *See supra* notes 102-11 and accompanying text.

history as an appropriate basis for interpreting rule 10b-5.[156] As the Court has acknowledged,[157] however, that history is extremely limited. Indeed, Congress gave scant attention to section 10(b)[158] and completely failed to consider section 10(b) private actions.[159] Only two substantive references to section 10(b) appear in the legislative history. One is a statement from the Senate Report that section 10(b) is "aimed at those manipulative and deceptive practices which have been demonstrated to fulfill no useful function."[160] The other is a statement from the House Hearings by Thomas Corcoran, speaking for the drafters:

> Subsection (c) [later section 10(b)] says, "Thou shalt not devise any . . . cunning devices."
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> . . . .
>
> . . . Of course subsection (c) is a catch-all clause to prevent manipulative devices [sic] I do not think there is any objection to that kind of a clause. The Commission should have the authority to deal with new manipulative devices.[161]

Section 10(b)'s history has, consequently, seldom provided a basis for the Court's rule 10b-5 decisions.[162] Although the Court attempted to rely upon this history in *Ernst & Ernst v. Hochfelder*,[163] the attempt was not persuasive. To uphold the scienter requirement, the Court purported to find support in Corcoran's references

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156 *E.g.*, Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 473 & n.13 (1977); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 202 (1976).

157 *See, e.g*, Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 473 n.13 (1977); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 201-06 (1976).

158 Only two substantive references to § 10(b) appear in the legislative history of the 1934 Act. *See infra* notes 160-61 and accompanying text.

The legislative history of the 1933 and 1934 Acts is assembled in LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934 (J. Ellenberger & E. Mahar eds. 1973) [hereinafter cited as LEGISLATIVE HISTORY].

159 The Supreme Court has recognized that Congress did not contemplate private actions under section 10(b). *E.g.*, Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 729 (1975).

160 S. REP. No. 792, 73d Cong., 2d Sess. 6 (1934), *reprinted in* 5 LEGISLATIVE HISTORY, *supra* note 158, item 17, at 6.

161 *"Stock Exchange Regulation," Hearings on H.R. 7852 & H.R. 8720 Before the House Interstate & Foreign Commerce Comm.*, 73d Cong., 2d Sess. 115 (1934), *reprinted in* 8 LEGISLATIVE HISTORY, *supra* note 158, item 23, at 115.

162 *E.g.*, Herman & MacLean v. Huddleston, 459 U.S. 375, 389-90 (1983) (legislative history provided no specific basis for determining standard of proof in rule 10b-5 private action); Chiarella v. United States, 445 U.S. 222, 226 (1980) (legislative history provided no direct help in determining whether silence is actionable absent duty to disclose); Sante Fe Indus., Inc. v. Green, 430 U.S. 462, 473 & n.13 (1977) (legislative history did not specifically address whether conduct can be actionable absent misrepresentation, deception, or nondisclosure). *But cf.* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 732-33 (1975) (support for purchaser-seller requirement inferred from defeat in 1957 and 1959 of amendments that would have added to § 10(b) the words "attempts to purchase or sell").

163 425 U.S. 185, 201-06 (1976).

to "manipulative" and "cunning" devices.[164] The Court then relied upon portions of congressional reports that are of questionable relevance[165] because they are not directed at section 10(b).[166] Indeed, the Court underscored the probable irrelevance of these reports when it observed that "Congress fashioned standards of fault . . . on a particularized basis"[167] and "[a]scertainment of congressional intent with respect to the standard of liability created by a particular section . . . rest[s] primarily on the language of that section."[168]

Although analyzing legislative history is an obvious means of discovering congressional intent, the history of section 10(b) is so limited as to be virtually useless in most instances. This history perhaps is least useful when the questioned element is unique to the private action and therefore not even contemplated by Congress.[169] Thus, for example, legislative history provided no basis for determining the appropriateness of the *in pari delicto* defense in *Bateman Eichler, Hill Richards, Inc. v. Berner*.[170]

Nothing in the history of section 10(b) suggests that Congress was concerned about investor carelessness.[171] This lack of concern is an insufficient basis for rejecting the duty of care, however, because it may have resulted from Congress's failure to consider private actions.

C. The Language and History of Rule 10b-5

The Court has repeatedly sigualed that rule 10b-5 is governed not only by the language[172] and history[173] of section 10(b), but also

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164 *Id.* at 203. *See supra* note 161 and accompanying text.

165 Cox, *supra* note 52, at 581.

166 425 U.S. at 204-06. The Court conceded that the portions relied upon had not been directed specifically at section 10(b). *See id.* at 204.

167 *Id.* at 200.

168 *Id.* Chief Justice Burger's dissent in Chiarella v. United States, 445 U.S. 222, 239 (1980) (Burger, C.J., dissenting) illustrates the limited usefulness of § 10(b)'s history. The Chief Justice relied upon the statement from the Senate Report that § 10(b) was aimed at "practices which . . . fulfill no useful function," see *supra* note 160 and accompanying text, in concluding that the silence of someone with material inside information should be actionable without a duty to speak because such silence "serves no useful function." *Id.* at 241. This reasoning fails to recognize that conduct serving no useful function is impossible to identify with specificity.

169 *See supra* notes 159-61 and accompanying text.

170 105 S. Ct. 2622 (1985).

171 *See generally* S. REP. No. 792, 73d Cong., 2d Sess. 2-13 (1934), *reprinted in* 5 LEGISLATIVE HISTORY, *supra* note 158, item 17, at 2-13; H.R. REP. No. 1383, 73d Cong., 2d Sess. 2-16 (1934), *reprinted in* 5 LEGISLATIVE HISTORY, *supra* note 158, item 18, at 2-16.

At least one case upholding the duty of care has acknowledged that the legislative history offers no affirmative support for the duty of care. *See* Dupuy v. Dupuy, 551 F.2d 1005, 1019 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977).

172 *See supra* notes 126-27 and accompanying text.

173 *See supra* note 156 and accompanying text.

by the language[174] and history[175] of the rule itself. Although reliance upon administrative interpretation of statutes is widely accepted,[176] such reliance is particularly appropriate here because Congress expressly provided in section 10(b) for the promulgation of rules by the SEC.[177] Unfortunately, the language and history of rule 10b-5 are not especially informative. The brief history consists of a short release,[178] a paragraph in the SEC's 1942 annual report,[179] and the subsequent recollections of an SEC staff attorney.[180] Moreover, issues unique to private actions cannot be meaningfully inferred from the rule's language and history because the SEC gave no consideration to private actions.[181]

The language and history of rule 10b-5 can help only if they do not expand the scope of section 10(b) in ways prohibited by Con-

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174 *See, e.g.*, Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 748-49 (1975); Affiliated Ute Citizens v. United States, 406 U.S. 128, 152-53 (1972). *See also* Chiarella v. United States, 445 U.S. 222, 240-41 (1980) (Burger, C.J., dissenting) (language of rule 10b-5 supports broad scope of application). For the text of rule 10b-5, see *supra* note 3.

175 *E.g.*, Chiarella v. United States, 445 U.S. 222, 226 & n.7 (1980); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 212 & n.32 (1976); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 736 n.8 (1975).

176 *See, e.g.*, Udall v. Tallman, 380 U.S. 1, 16 (1965).

177 For the text of § 10(b), see *supra* note 1.

178 SEC Securities Exchange Act Release No. 3230 (May 21, 1942), *reprinted in* 5 A. JACOBS, THE IMPACT OF RULE 10b-5 § 5.02, at 1-128 (1980). The release prefaces the text of the rule as follows:

> The Securities and Exchange Commission today announced the adoption of a rule prohibiting fraud by any person in connection with the purchase of securities. The previously existing rules against fraud in the purchase of securities applied only to brokers and dealers. The new rule closes a loophole in the protections against fraud administered by the Commission by prohibiting individuals or companies from buying securities if they engage in fraud in their purchase. The text of the Commission's action follows:
>
> The Securities and Exchange Commission, deeming it necessary for the exercise of the functions vested in it and necessary and appropriate in the public interest and for the protection of investors so to do, pursuant to authority conferred upon it by the Securities Exchange Act of 1934, particularly Sections 10(b) and 23(a) thereof, hereby adopts the following Rule X-10B-5 . . . .

Id.

179 8 SEC ANN. REP. 10 (1942). Entitled "[r]ule for additional protection to investors," the paragraph states only as follows:

> During the fiscal year the Commission adopted Rule X-10B-5 as an additional protection to investors. The new rule prohibits fraud by any person in connection with the purchase of securities, while the previously existing rules against fraud in the purchase of securities applied only to brokers and dealers.

Id.

180 *See Conference on Codification of the Federal Securities Laws*, 22 BUS. LAW. 793, 921-22 (1967) (remarks of Milton Freeman). Freeman explained that the commissioners upon approving rule 10b-5 simply commented, "[W]e are against fraud, aren't we?" *Id.* at 922.

181 *See supra* notes 178-80 and accompanying text.

gress. In *Ernst & Ernst v. Hochfelder*,[182] for example, the Court rejected an argument against scienter predicated on subsections (b) and (c) of the rule.[183] After conceding that these subsections might by themselves embrace liability without scienter,[184] the Court ruled that the scope of rule 10b-5 "cannot exceed the power granted the Commission by Congress under [section] 10(b)."[185] The *Hochfelder* Court did not foreclose the possibility, however, that the scope of rule 10b-5 could be narrower than that of section 10(b).

Neither the language[186] nor the history[187] of rule 10b-5 provides support for the duty of care. The language of the rule, like that of the statute under which it was promulgated,[188] exclusively addresses the defendant's fraud, not the possibility that under different circumstances the fraud might have been averted.[189] Moreover, nothing in the history of rule 10b-5 demonstrates that the SEC was concerned about investor carelessness.[190] The remaining factors require further investigation because the absence of support from the administrative language and history may be attributable to SEC inattention to private actions.

D. Statutory Structure

The Supreme Court has identified statutory structure as a basis for interpreting rule 10b-5.[191] The Court's concern with statutory structure has three aspects: (1) language, (2) express remedies, and (3) other sections providing inferences about section 10(b).

1. *Language*

The Court has interpreted section 10(b) by contrasting its language with the language of other sections of the 1933 and 1934

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182 425 U.S. 185 (1976).

183 *Id.* at 212-14.

184 *Id.* at 212.

185 *Id.* at 214.

186 *Cf.* Mutual Shares Corp. v. Genesco, Inc., 384 F.2d 540, 543-44 (2d Cir. 1967) (conceding that language of rule does not require reasonable reliance); Herpich v. Wallace, 430 F.2d 792, 804-05 (5th Cir. 1970) (same).

187 *See supra* notes 178-80 and accompanying text.

188 For the text of § 10(b), see *supra* note 1.

189 If rule 10b-5 did provide for a duty of care, its scope would he narrower than that of § 10(b). This result would be consistent with the Court's decision in Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976). *See supra* notes 182-85 and accompanying text.

190 *See supra* notes 178-80 and accompanying text.

191 *E.g.*, Ernst & Ernst v. Hochfelder, 425 U.S. 185, 206 (1976); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 733 (1975). *See also* Dirks v. SEC, 463 U.S. 646, 659 (1983) (interpreting § 10(b) by reference to § 20(b) of 1934 Act, 15 U.S.C. § 78t(b) (1982)).

Acts.[192] The Court has, however, failed to recognize that these contrasts sometimes lack meaning, as the Court's decision in *Blue Chip Stamps v. Manor Drug Stores* illustrates.[193]

In *Blue Chip Stamps* the Court upheld the purchaser-seller requirement in private actions under rule 10b-5, based in part on the contrasting language of section 16(b),[194] which expressly authorizes private actions by plaintiffs who have neither purchased nor sold.[195] The Court noted that section 10(b) contains no comparable authorization for private actions and concluded that "[w]hen Congress wished to provide a remedy to those who neither purchase nor sell securities, it had little trouble in doing so expressly."[196] The Court thus implied that section 10(b) reflected an affirmative congressional decision to deny standing to those who were not purchasers or sellers.

This reasoning fails to consider the most plausible explanation for the difference between section 16(b) and section 10(b). Under section 16(b) Congress expressly provided for private actions and therefore had to identify the appropriate private plaintiff. In contrast, Congress did not contemplate private actions under section 10(b);[197] hence, Congress had no occasion to identify the appropriate private plaintiff. The purpose of contrasting the language of section 10(b) with the language of other sections is to clarify Congress's choice of words in section 10(b). These contrasts are least valuable when they involve matters not considered by Congress in drafting section 10(b): elements unique to the private action[198] or not a part of the prima facie case.[199]

In contrast to section 10(b), three sections of the 1933 Act expressly impose a "duty of care." One imposes the duty on the plain-

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192 *See, e.g.*, Ernst & Ernst v. Hochfelder, 425 U.S. 185, 206-11 (1976); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 733-36 (1975).

193 421 U.S. 723 (1975).

194 15 U.S.C. § 78p(b) (1982) [hereinafter cited as section 16(b)].

195 Section 16(b) provides in relevant part:

> [A]ny profit realized by [a beneficial owner, director, or officer] from any purchase and sale, or any sale and purchase, of any equity security of such issuer . . . within any period of less than six months, . . . shall inure to and be recoverable by the issuer . . . . Suit to recover such profit may be instituted . . . by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer. . . .

Id.

196 421 U.S. at 734. The Court also gave weight to the contrast between the " 'in connection with the purchase or sale' of securities" language from § 10(b) and the " 'in the offer or sale' of securities" language from § 17(a) of the 1933 Act, 15 U.S.C. § 77q (1982). *Id.* at 733-34.

197 *See supra* notes 159-61 and accompanying text.

198 *See supra* notes 145-52 and accompanying text.

199 *See supra* notes 142-44 and accompanying text.

tiff,[200] and two impose it on the defendant.[201] Section 11,[202] an express remedy for fraud in a registration statement, provides the defendant with a defense if he "had, after reasonable investigation, reasonable ground to believe and did believe . . . that the statements therein were true."[203] Similarly, section 12(2),[204] an express remedy for fraud in prospectuses and communications, provides the defendant with a defense if he "did not know, and in the exercise of reasonable care could not have known of [the fraud]."[205] Section 13,[206] the statute of limitations for actions under section 11 and section 12(2), allows actions to be brought within one year after discovery of the fraud "should have been made by the exercise of reasonable diligence."[207] These three sections indicate that Con-

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200 *See infra* note 206 and accompanying text.

201 *See infra* notes 202-05 and accompanying text. Imposing a duty of care manifests Congress's willingness to penalize carelessness expressly, regardless of whether the duty is imposed on the plaintiff or the defendant.

202 Section 11 of the 1933 Act, 15 U.S.C. § 77k (1982) [hereinafter cited as section 11].

203 Section 11(b) provides a defense for a nonexpert defendant concerning the portion of the registration statement not prepared by an expert. It reads as follows:

> [N]o person, other than the issuer, shall be liable as provided therein who shall sustain the burden of proof—
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> . . .
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> (3) that (A) as regards any part of the registration statement not purporting to be made on the authority of an expert, and not purporting to be a copy of or extract from a report or valuation of an expert, and not purporting to be made on the authority of a public official document or statement, he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading . . . .

Id.

204 1933 Act § 12(2), 15 U.S.C. § 771(2) (1982) [hereinafter cited as section 12(2)]. Section 12(2) reads as follows:

> Any person who—
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> . . . .
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> (2) offers or sells a security . . . by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable to the person purchasing such security from him
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> . . . .

Id.

205 *Id.*

206 1933 Act § 13, 15 U.S.C. § 77m (1982) [hereinafter cited as section 13]. Section 13 reads in pertinent part: "No action shall be maintained to enforce any liability created under [§ 11] or [§ 12(2)] of this title unless brought within one year after the discovery of the untrue statement or the omission, or after such discovery should have been made by the exercise of reasonable diligence . . . ." *Id.*

207 *Id.*

gress did not hesitate to penalize carelessness expressly, and therefore, it is arguable that its failure to do so in section 10(b) was intentional.

The problem with this argument is that the language of section 10(b) may not reliably reflect congressional intentions concerning the duty of care. The duty of care is unique to private actions, which Congress did not consider.[208] In addition, the duty of care may be an affirmative defense rather than a part of the prima facie case.[209] Section 10(b) may be exclusively addressed to the prima facie case.[210] The absence of a duty of care from section 10(b), therefore, may imply nothing about congressional intent. Given this possibility, it would seem imprudent to attach significance to contrasts between section 10(b) and sections 11, 12, and 13.

Sectional comparisons as to the duty of care, however, are far from meaningless. The express remedies[211] do not impose a duty of care on the plaintiff.[212] The absence of a plaintiff's duty of care from the express remedies indicates that Congress did not regard the duty of care as an inevitable component of a private action.

2. *Express Remedies*

The Court has sought to avoid interpretations of rule 10b-5 that would nullify the express remedies and thereby ostensibly violate congressional intent.[213] The Court's decisions in *Ernst & Ernst*

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208 *See supra* notes 159-61 and accompanying text.

209 The circuits presently are divided on whether the duty of care is a defense or an element of the plaintiff's case. *See supra* notes 102-10 and accompanying text.

210 *See supra* notes 142-44 and accompanying text.

211 Section 11 and § 12(2) are the express remedies for fraud under the 1933 Act. Section 9(e), 15 U.S.C. § 78i(e) (1982) [hereinafter cited as section 9(e)], and section 18, 15 U.S.C. § 78r (1982) [hereinafter cited as section 18], are the express remedies for fraud under the 1934 Act.

212 Section 11 merely provides a defense that the plaintiff had actual knowledge of fraud. *See, e.g,* Martin v. Hull, 92 F.2d 208, 210 (D.C. Cir.), *cert. denied,* 302 U.S. 726 (1937); McFarland v. Memorex Corp., 96 F.R.D. 357, 362 (N.D. Cal. 1982). *See generally* A. BROMBERG & L. LOWENFELS, *supra* note 20, at 327 (actual knowledge must be shown to establish defense of plaintiff's knowledge under § 11).

Similarly, there is no duty of care under § 12(2). *See, e.g.,* Sanders v. John Nuveen & Co., 619 F.2d 1222, 1229 (7th Cir. 1980), *cert. denied,* 450 U.S. 1005 (1981); Hill York Corp. v. American Int'l Franchises, Inc., 448 F.2d 680, 696 (5th Cir. 1971). Instead, the plaintiff need only establish lack of actual knowledge of the fraud. *See, e.g.,* Junker v. Crory, 650 F.2d 1349, 1361 (5th Cir. 1981).

Section 18 merely requires that the plaintiff establish a lack of actual knowledge. *See generally* A. BROMBERG & L. LOWENFELS, *supra* note 20, at 464.

Section 9(e) does not prohibit an action even where the plaintiff has actual knowledge of the defendant's fraud. *See* L. LOSS, FUNDAMENTALS OF SECURITIES REGULATION 1053 (1983).

213 *See, e.g.,* Herman & MacLean v. Huddleston, 459 U.S. 375, 383-84 (1983); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 208-11 (1976); Blue Chip Stamps v. Manor Drng Stores, 421 U.S. 723, 736 (1975).

v. Hochfelder[214] and *Blue Chip Stamps v. Manor Drug Stores*[215] illustrate this analysis. In *Hochfelder* the Court focused on the absence of a scienter requirement in sections 11 and 12(2) in holding that rule 10b-5 requires scienter.[216] The *Hochfelder* Court observed that sections 11 and 12 contain procedural barriers not present in section 10(b).[217] The Court reasoned that if rule 10b-5 did not require scienter, plaintiffs would cease using sections 11 and 12(2), thereby nullifying those causes of action and their accompanying procedural barriers.[218] Similarly, in *Blue Chip Stamps,* the Court upheld the purchaser-seller requirement in part because all of the express remedies were limited to purchasers and sellers: "It would indeed be anomalous to impute to Congress an intention to expand the plaintiff class for a judicially implied cause of action beyond the bounds it delineated for comparable express causes of action."[219]

Although the impact on the express remedies is a factor to consider when interpreting rule 10b-5, the Court has indicated that a marginal negative impact on the express remedies that is short of nullification ought not to affect interpretation of the rule. In *Herman & MacLean v. Huddleston*[220] the Court held that conduct actionable under section 11 could be actionable under rule 10b-5 because there was no risk of section 11's nullification.[221] The Court offered no objection to possible reduced utilization of section 11 resulting from giving plaintiffs a choice between section 11 and rule 10b-5.

Eliminating the duty of care under rule 10b-5 would not nullify the express remedies. Eliminating rule 10b-5's duty of care would merely achieve equalization because none of the express remedies imposes a duty of care on the plaintiff.[222] Rule 10b-5 and the express remedies would still retain virtually all their present advantages and disadvantages. For example, unlike sections 11 and 12(2), rule 10b-5 would still require scienter, but it would lack the proce-

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214 425 U.S. 185 (1976).

215 421 U.S. 723 (1975).

216 *See* 425 U.S. at 208-09.

217 *Id.* at 209-10. These procedural barriers, set forth in § 11(e), apply at the district court's discretion and include the posting of a bond at the start of the action and assessment of costs at the end of the action. *See id.*

218 *Id.* at 210-11.

219 421 U.S. at 736.

220 459 U.S. 375 (1983).

221 *Id.* at 382-84. Another reason that the *Huddleston* Court held § 11 and rule 10b-5 to be cumulative remedies was that "the two provisions involve distinct causes of action and were intended to address different types of wrongdoing." *Id.* at 381. Section 11 "was designed to assure compliance with the disclosure provisions of the Act by imposing a stringent standard of liability on the parties who play a direct role in a registered offering." *Id.* at 381-82 (footnotes omitted). Rule 10b-5, in contrast, is a "catchall" fraud provision requiring scienter. *Id.* at 382.

222 *See supra* note 212 and accompanying text.

dural barriers of those sections.[223] Elimination of the duty of care might increase the use of rule 10b-5 and concomitantly decrease utilization of the express remedies. This possibility, however, is highly speculative and by no means constitutes nullification.

3. *Other Sections Providing Inferences About Section 10(b)*

The Supreme Court has examined other statutory sections capable of providing inferences about section 10(b).[224] In *Blue Chip Stamps v. Manor Drug Stores,*[225] for example, the Court assessed the purchaser-seller requirement in light of section 28(a),[226] which limits its recovery in any 1934 Act private action to "actual damages."[227] The Court found the purchaser-seller requirement consistent with section 28(a) on the ground that a purchaser or seller would more easily establish actual damages than would a person who is neither.[228] Similarly, in *Dirks v. SEC*[229] the Court held a ban on tippee trading consistent with section 20(b).[230] Because section 20(b) makes illegal violations of the 1934 Act committed "through or by means of any other person,"[231] the Court reasoned that it outlawed trades by tippees that benefit insiders.[232]

The duty of care cannot be reconciled with section 29(a) of the 1934 Act.[233] In recognition of the weak relative bargaining position of investors,[234] section 29(a) voids "[a]ny condition, stipulation, or

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223 *See supra* note 217 and accompanying text. Nor does it appear likely that eliminating the duty of care under rule 10b-5 would significantly affect the largely ignored § 9(e), described by Professor Loss as "no bargain." *See* L. Loss, *supra* note 212, at 1052. Nor would it affect the likewise ignored § 18, described as no better than common law deceit. *See id.* at 1055.

224 *See infra* notes 225-32 and accompanying text.

225 421 U.S. 723 (1975).

226 Section 28(a) of the 1934 Act, 15 U.S.C. § 78bb(a) (1982) [hereinafter cited as section 28(a)]. Section 28(a) reads in pertinent part: "no person permitted to maintain a suit for damages under the provisions of this chapter shall recover . . . a total amount in excess of his actual damages on account of the act complained of." *Id.*

227 *Id.*

228 421 U.S. at 734-35. The Court also found the purchaser-seller requirement consistent with § 29(b) of the 1934 Act, 15 U.S.C. § 78cc(b) (1982) [hereinafter cited as section 29(b)]. The Court noted that § 29(b), which makes contracts in violation of the 1934 Act voidable, is sometimes mentioned as a justification for implying a private action under § 10(b), "[b]ut that justification is absent when there is no actual purchase or sale of securities, or a contract to purchase or sell . . . ." 421 U.S. at 735.

229 463 U.S. 646 (1983).

230 Section 20(b) of the 1934 Act, 15 U.S.C. § 78t(b) (1982) [hereinafter cited as section 20(b)]. Section 20(b) reads as follows: "It shall be unlawful for any person, directly or indirectly, to do any act or thing which it would be unlawful for such person to do under the provisions of this chapter or any rule or regulation thereunder through or by means of any other person." *Id.*

231 *Id.*

232 463 U.S. at 659.

233 Section 29(a), *supra* note 27.

234 Even sophisticated investors are protected by § 29(a). *Cf.* Esposito v. Sweeney,

provision binding any person to waive compliance with any provision of this chapter or of any rule or regulation thereunder."[235] As the Supreme Court explained in connection with the parallel 1933 Act provision:[236]

> [T]he Securities Act was drafted with an eye to the disadvantages under which buyers labor. Issuers of and dealers in securities have better opportunities to investigate and appraise the prospective earnings and business plans affecting securities than buyers. It is therefore reasonable for Congress to put buyers of securities covered by that Act on a different basis from other purchasers.[237]

Section 29(a) reflects the judgment that penalizing investors for their own mistakes is less important than prosecuting the Act's violators. Under section 29(a), for example, an investor retains his 1934 Act rights if a purchase contract provision[238] has waived them,

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No. 80 C 2861 (N.D. Ill. May 13, 1982) (available on LEXIS, Genfed library, Dist. file) (voiding under § 29(a) a contractual provision of nonreliance notwithstanding plaintiff's alleged sophistication); Brown v. Gilligan, Will & Co., 287 F. Supp. 766, 772 (S.D.N.Y. 1968) (noting that broker-dealers are protected by 1933 Act provision that parallels § 29(a)).

235 Section 29(a), *supra* note 27. Justice White has suggested that the words "waive compliance with any *provision of this chapter*" in § 29(a) are "literally inapplicable" to private rule 10b-5 actions, because such actions were judicially implied rather than created by Congress. *See* Dean Witter Reynolds, Inc. v. Byrd, 105 S. Ct. 1238, 1244 (1985) (White, J., concurring) (emphasis in original). Lower courts have not adopted Justice White's position. *See, e.g.*, cases cited *supra* note 234. Assuming that Justice White's position were adopted someday by the Court, assessment of the duty of care by reference to § 29(a) would remain appropriate. Section 29(a) would still reflect the intent of Congress and thereby provide a basis for inferring the sort of private action Congress might have constructed under § 10(b) had it considered such actions. A contrary conclusion would suggest that statutory structure is irrelevant to interpreting rule 10b-5 private actions.

236 The parallel 1933 Act provision is § 14 of the 1933 Act, 15 U.S.C. § 77n (1982) [hereinafter cited as section 14]. Section 14 reads as follows: "Any condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this subchapter or of the rules and regulations of the Commission shall be void." *Id.*

237 Wilko v. Swan, 346 U.S. 427, 435 (1953). In *Wilko* an agreement to require arbitration was voided pursuant to § 14.

The only substantive comment in the legislative history concerning § 29(a) was that the section was "taken verbatim out of the Securities Act." *Stock Exchange Practices: Hearings on S. Res. 84 (72d Cong.), S. Res. 56 & S. Res. 97 (73d Cong.) Before the Senate Banking and Currency Comm.*, 73d Cong., 2d Sess. 6578 (1934), *reprinted in* 6 LEGISLATIVE HISTORY, *supra* note 158, item 22, at 6578 (statement of Thomas Corcoran, spokesman for drafters). The history of the 1933 Act, however, is silent concerning the scope of § 14. *See generally Federal Securities Act 1933: Hearings on H. 4314 Before the House Comm. of Interstate and Foreign Commerce*, 73d Cong., 1st Sess. (1933), *reprinted in* 2 LEGISLATIVE HISTORY, *supra* note 158, item 20, at 17-19, 110, 147-48, 170, 222; *Securities Act 1933: Hearings on S. 875 Before the Senate Comm. on Banking & Currency*, 73d Cong., 1st Sess. (1933), *reprinted in* 2 LEGISLATIVE HISTORY, *supra* note 158, item 21, at 86-87, 175, 277.

238 *E.g.*, Thomas v. Duralite Co., 386 F. Supp. 698, 730 n.13 (D.N.J. 1974), *aff'd mem.*, 559 F.2d 1209 (3d Cir. 1977); Special Transp. Servs., Inc. v. Balto, 325 F. Supp. 1185, 1187 (D. Minn. 1971).

even if the waiver was intentional.[239]

Section 29(a) is not, however, limited to waivers of the right to sue. Investors who contractually acknowledge nonreliance are nonetheless entitled to prove reliance in court. In *Rogen v. Ilikon Corp.*,[240] for example, a sales contract acknowledged that the plaintiff and his father were "fully familiar with the business and prospects of the corporation, [were] not relying on any representations or obligations to make full disclosure with respect thereto, and [had] made such investigation thereof as they deem[ed] necessary."[241] The defendant argued that this acknowledgment established nonreliance as a matter of law. The First Circuit rejected the argument:

> [W]e see no fundamental difference between saying, for example, "I waive any rights I might have because of your representations or obligations to make full disclosure" and "I am not relying on your representations or obligations to make full disclosure." Were we to hold that the existence of this provision constituted the basis (or a substantial part of the basis) for finding non-reliance as a matter of law, we would have gone far toward eviscerating Section 29(a).[242]

Thus, Congress effectively has eliminated waiver of unmatured claims in order to maximize the efficacy of the securities acts.[243]

Although section 29(a) does not by its terms prohibit the duty of care and duty of care determinations typically do not involve waivers,[244] section 29(a) and the duty of care nonetheless have antithetical underlying philosophies. By safeguarding even deliberately waived claims, section 29(a) recognizes the informational advantage of securities defendants over securities plaintiffs and places the highest value upon enforcement of violations. The duty of care, on the other hand, compromises enforcement in order to penalize in-

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239 *E.g.*, Pearlstein v. Scudder & German, 429 F.2d 1136, 1143 (2d Cir. 1970) (dictum), *cert. denied*, 401 U.S. 1013 (1971); Special Transp. Servs., Inc. v. Balto, 325 F. Supp. 1185, 1187 (D. Minn. 1971); Perfect Photo, Inc. v. Grabb, 205 F. Supp. 569, 572 (E.D. Pa. 1962); Jefferson Lake Sulphur Co. v. Walet, 104 F. Supp. 20, 24 (E.D. La. 1952), *aff'd*, 202 F.2d 433, 435 (5th Cir.), *cert. denied*, 346 U.S. 820 (1953).

Matured claims, however, may be intentionally waived. *E.g.*, Goodman v. Epstein, 582 F.2d 388, 402 (7th Cir. 1978), *cert. denied*, 440 U.S. 939 (1979); Neuman v. Pike, 456 F. Supp. 1192, 1207 (S.D.N.Y. 1978), *rev'd in part on other grounds*, 591 F.2d 191 (2d Cir. 1979). *But cf.* Fox v. Kane-Miller Corp., 398 F. Supp. 609, 624 (D. Md. 1975) (finding section 29(a) to require caution as to waiver defenses to matured securities claims), *aff'd on other grounds*, 542 F.2d 915 (4th Cir. 1976).

240 361 F.2d 260 (1st Cir. 1966).

241 *Id.* at 265.

242 *Id.* at 268 (footnote omitted). *See also* Esposito v. Sweeney, No. 80 C 2861 (N.D. Ill. May 13, 1982) (available on LEXIS, Genfed library, Dist. file) (contractual provision of nonreliance does not establish nonreliance as matter of law).

243 Meyers v. C & M Petroleum Producers, Inc., 476 F.2d 427, 429 (5th Cir.), *cert. denied*, 414 U.S. 829 (1973).

244 *See supra* notes 18-20 and accompanying text.

vestor carelessness. Congress's enactment of section 29(a) strongly suggests that had Congress addressed section 10(b) private actions, it would have decisively rejected the duty of care.

III
ELEMENTS OF RULE 10b-5: STATUTORY POLICY

The Supreme Court has consistently looked to the underlying policies of the 1933 and 1934 Acts in interpreting rule 10b-5.[245] Only once has the Court found language, structure, and history sufficiently dispositive to make considering policy unnecessary.[246] The Court has, moreover, provided guidelines for the identification and application of relevant policies.

The first guideline is that only policies with demonstrable importance to Congress can be used to interpret rule 10b-5. The Court's decision in *Santa Fe Industries, Inc. v. Green*[247] offers an illustration. In limiting rule 10b-5 to conduct involving misrepresentation or nondisclosure, the Court rejected an argument that rule 10b-5 embraced all security-related "unfairuess."[248] Reasoning that the principal purpose of the 1934 Act was " 'to substitute a philosophy of full disclosure for the philosophy of *caveat emptor*,' "[249] the Court concluded that "once full and fair disclosure has occurred, the fairness of the terms of the transaction is at most a tangential concern of the statute."[250] Similarly, in *Blue Chip Stamps v. Manor Drug Stores*,[251] the Court applied the policy of curbing vexatious litigation only after establishing the importance of that policy to Congress.[252]

The Court's second guideline is that conflicting policies must be balanced against each other. In *Blue Chip*, for example, the Court evaluated the purchaser-seller requirement in terms of two conflicting policies: curbing vexatious litigation and protecting worthy plaintiffs. In the Court's view, the purchaser-seller requirement

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245 *E.g.*, Bateman Eichler, Hill Richards, Inc. v. Berner, 105 S. Ct. 2622, 2631 (1985); Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 477-80 (1977); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737, 740-41, 748-49 (1975).

246 *See* Ernst & Ernst v. Hochfelder, 425 U.S. I85, 214 n.33 (1976). In Sante Fe Indus., Inc. v. Green, 430 U.S. 462 (1977), the Court first suggested that policy considerations might be superfluous, *see id.* at 477, but nonetheless proceeded to examine policy, *see id.* at 477-80. In Chiarella v. United States, 445 U.S. 222 (1980), the Court attempted to derive a relevant policy from the legislative history but was unsuccessful. *See id.* at 233 (no evidence of congressional support for general prohibition against trading on inside information).

247 430 U.S. 462 (1977).

248 *Id.* at 477.

249 *Id.* (quoting Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972)).

250 *Id.* at 478.

251 421 U.S. 723 (1975).

252 *Id.* at 740-41.

curbed vexatious litigation by facilitating pre-trial dismissal of all actions except those where the plaintiffs "actually purchased or actually sold, and whose version of the facts is therefore more likely to be believed by the trier of fact."[253] On the other hand, the Court found the purchaser-seller requirement to be at variance with protection of those few plaintiffs who are neither purchasers nor sellers, but are actually injured by fraud.[254] The Court concluded that the value of curbing vexatious litigation outweighed the harm of barring recovery to these plaintiffs.[255]

Finally, the Court has viewed the absence of an identifiable statutory policy as potentially implying congressional endorsement of established legal principles. An illustration is provided by the Court's decision in *Chiarella v. United States,*[256] which held that silence is not actionable absent a duty to speak. The Court reasoned that a contrary holding required "recognizing a general duty between all participants in market transactions to forego actions based on material, nonpublic information."[257] Such a duty, the Court observed, "departs radically from the established [tort] doctrine," and hence "should not be undertaken absent some explicit evidence of congressional intent."[258]

The Court's guidelines for identifying and applying statutory policy supply the appropriate context for examining the policies advanced by lower courts in justification of the duty of care. These guidelines are also helpful in analyzing the conflict between the duty of care and the policy of enforcing section 10(b).

A. Policies Advanced By Lower Courts in Justification of the Duty of Care

Lower courts have attempted to justify the duty of care on the basis of five policies: (1) deterrence of investor carelessness, (2) promotion of anti-fraud policies, (3) fairness, (4) promotion of market stabilization, and (5) provision of a causal link between the defendant's fraud and the plaintiff's injury. An analysis of each of these policies reveals that none survives scrutiny.

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253 *Id.* at 743.

254 *Id.*

255 *See id.* The danger of abuse from oral testimony was an additional reason to avoid vexatious litigation. *Id.* at 743-44.

The duty of care does not further the policy of curbing vexatious litigation. Unlike the question of whether the plaintiff actually bought or sold, the question of the plaintiff's care is a jury question not resolvable by pre-trial motion. Greenwald v. Integrated Energy, Inc., 102 F.R.D. 65, 70 (S.D. Tex. 1984) (collecting cases).

256 445 U.S. 222 (1980).

257 *Id.* at 233.

258 *Id.*

1. *Deterrence of Investor Carelessness*

At least one federal appellate court has asserted that the duty of care is necessary to deter investor carelessness.[259] Nothing in the history of the 1934 Act, however, suggests that Congress intended to penalize careless investors.[260] Congress was concerned with penalizing the perpetrators of fraud, not its victims.[261] The policy of deterring investor carelessness, therefore, does not justify the duty of care. Nor can the duty of care be justified on the ground that it was a firmly entrenched principle of common law deceit in 1934 which Congress endorsed by not affirmatively rejecting. In 1934 common law jurisdictions were divided as to the appropriateness of a duty of care in deceit actions.[262]

2. *Promotion of Anti-Fraud Policies*

A federal appellate court has suggested that the duty of care promotes anti-fraud policies, apparently on the theory that fraud will fail when investors are careful.[263] This suggestion is unsound. The argument assumes that fraud is most appropriately addressed through vigilance by victims of fraud rather than by prosecution of defrauders. The entire thrust of the 1933 and 1934 Acts is contrary to this position. Congress chose to regulate and impose penalties on defrauders as the most effective means of eliminating fraud.[264]

3. *Fairness*

"Fairness" is said to require a duty of care that limits access to rule 10b-5 to "those who have pursued their own interests with care and good faith."[265] This position is without merit. In *Sante Fe Industries, Inc. v. Green,*[266] the Supreme Court specifically rejected fairness as a basis for interpreting rule 10b-5.[267] Even if fairness is relevant, it does not justify the duty of care. Fairness by no means requires absolving blameworthy defendants in order to penalize careless

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259 *See supra* note 92 and accompanying text.

260 *See supra* note 171 and accompanying text.

261 *See generally* S. REP. No. 792, 73d Cong., 2d Sess. 2-4 (1934) (addressing necessity for legislative action), *reprinted in* 5 LEGISLATIVE HISTORY, *supra* note 158, item 17, at 2-4.

262 *See infra* notes 318-25 and accompanying text.

263 *See supra* note 93 and accompanying text.

264 *See generally* S. REP. No. 792, 73d Cong., 2d Sess. (1934), *reprinted in* 5 LEGISLATIVE HISTORY, *supra* note 158, item 17.

265 Dupuy v. Dupuy, 551 F.2d 1005, 1014 (5th Cir.), *cert. denied,* 434 U.S. 911 (1977); *see also* Weir v. Merrill Lynch Pierce Fenner & Smith, Inc., 586 F. Supp. 63, 65 (S.D. Fla. 1984) (denying motion to dismiss because *Dupuy* standard not met).

266 430 U.S. 462 (1977).

267 *See supra* notes 247-50 and accompanying text.

plaintiffs. More plausibly, fairness requires penalizing the wrongdoer, despite the sloppiness of his victim.

4. *Stabilizing the Markets*

The duty of care is said to stabilize the markets, ostensibly on the theory that greater investor caution will result in fewer market swings.[268] This claim is without merit. Imposing a duty of care on investors will have little effect on market stability because the duty of care issue is litigated largely in the context of close corporations[269] and private placements,[270] where no public market exists to be stabilized.

5. *Causation*

Some courts have maintained that the duty of care is necessary to establish causation,[271] on the theory that injury to a careless plaintiff results from his own lack of diligence, not from the defendant's fraud.[272] This position is unsound. Causation is not an absolute concept; rather it "is used . . . to identify those pressure points that are most amenable to the social goals we wish to accomplish."[273] At present, one pressure point is the plaintiff's recklessness.[274] Previously, the analogous pressure point was the plaintiff's negligence.[275] Neither point is fixed; the pressure point is simply the factor in the chain of causation that is most amenable to change and will serve to avoid the unwanted result.[276] Causation might just as easily be limited to actual reliance: as long as the plaintiff in fact relied on the fraudulent misrepresentation or omission, the fraud should be deemed to have caused the plaintiff's injury.[277]

B. The Policy of Enforcing Section 10(b)

In *Bateman Eichler, Hill Richards, Inc. v. Berner,*[278] the Supreme Court held that enforcement considerations constitute a significant policy against which to interpret rule 10b-5. Enforcement considerations, the Court held, are fully applicable to implied private federal

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268 *See supra* note 94 and accompanying text.
269 *See supra* note 38 and accompanying text.
270 *See supra* note 39 and accompanying text.
271 For the elements of a rule 10b-5 private action, see *supra* note 17.
272 *See supra* note 97 and accompanying text.
273 Calabresi, *Concerning Cause and the Law of Torts: An Essay for Harry Kalven, Jr.,* 43 U. CHI. L. REV. 69, 106 (1975).
274 *See supra* notes 102-05, 107 and accompanying text.
275 *See supra* note 44 and accompanying text.
276 *Calabresi, supra* note 273, at 106.
277 The plaintiff still would carry a significant burden of proof. *See infra* notes 330-31 and accompanying text.
278 105 S. Ct. 2622 (1985).

securities actions. Such actions were said to serve as a " 'necessary supplement to Commission action.' "[279] The Court might have noted further that Congress at least implicitly has ratified the enforcement function of private actions by never affirmatively prohibiting them.[280]

Bateman was an action by tippees against their tippers. The plaintiffs, ordinary investors, charged that a corporate insider and a broker deliberately provided them with material nonpublic information that was false. Following losing trades based on this information, the plaintiffs sued under rule 10b-5. The defendants relied upon the *in pari delicto* defense:[281] they argued that by trading on nonpublic information, the plaintiffs had become securities law violators and were therefore not entitled to sue. The Supreme Court rejected the defense because of enforcement considerations and the defendants' greater culpability.[282]

The Court outlined a two-prong test to determine when to permit the defense. The defendant must prove that (i) the plaintiff and the defendant had been equal participants in the violation at issue, and (ii) dismissal of the action "would not siguificantly interfere with the effective enforcement of the securities laws and protection of the investing public."[283] The Court initially sought to determine

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279 *Id.* at 2628 (quoting J.I. Case Co. v. Borak, 377 U.S. 426, 432 (1964)); *see also* Aaron v. SEC, 446 U.S. 680, 689 (1980) ("Another facet of civil enforcement is a private cause of action for money damages."); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730 (1975) (same).

280 *Cf.* Herman & MacLean v. Huddleston, 459 U.S. 375, 384-86 (1983) (inferring congressional approval of cumulative remedies under 1933 and 1934 Acts from Congress's failure to bar those remedies in face of repeated judicial endorsements).

281 *In pari delicto* is Latin for "of equal fault." BLACK'S LAW DICTIONARY 711 (5th ed. 1979).

> The typical pleading situation that gives rise to [such] cases involves receipt of a complaint demanding damages followed by defendant's motion to dismiss on the ground that plaintiff's own conduct bars his recovery. Sometimes the defendant asserts an *in pari delicto* defense, sometimes he claims that the plaintiff has unclean hands, and sometimes he maintains that the plaintiff is contributorily negligent. Regardless of the defendant's description, defendant is claiming that the law will not allow the pot to call the kettle black.

Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification, and Contribution,* 120 U. PA. L. REV. 597, 659 n.282 (1972). *See generally id.* at 659-64.

282 105 S. Ct. at 2628.

283 *Id.* at 2629. Lower courts previously had applied a virtually identical standard for the *in pari delicto* defense in rule 10b-5 actions. *E.g.,* Mallis v. Bankers Trust Co., 615 F.2d 68, 76 (2d Cir. 1980), *cert. denied,* 449 U.S. 1123 (1981); Woolf v. S.D. Cohn & Co., 515 F.2d 591, 604 (5th Cir. 1975), *vacated on other grounds,* 426 U.S. 944 (1976); Schick v. Steiger, 583 F. Supp. 841, 845 (E.D. Mich. 1984).

There were three views as to the appropriate application of the standard. Under one view, the standard could never be met; tippers were precluded as a matter of law from invoking the defense. According to this view, the tipper inevitably is more blame-

the relative culpability of the parties under the first prong. This finding, however, is closely linked to the goal of the second prong because the relative culpability of the parties largely determines whether allowing the defense in a given case furthers effective enforcement of the securities laws.[284] Thus, although enforcement concerns are the express focus of the second prong, they are implied in the first prong as well. Indeed, enforcement is no better served by disallowance of the defense than by allowance when the plaintiff and the defendant are equally culpable.[285]

Applying the first prong, the Court held that insiders and brokers who tip are more culpable than their tippees, at least absent special circumstances. While conceding that the plaintiffs "may well

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worthy than the tippee, because the tipper "is at the fountainhead of the confidential information" and possesses the capacity to wreak greater harm. Nathanson v. Weis, Voisin, Cannon, Inc., 325 F. Supp. 50, 57 (S.D.N.Y. 1971). Moreover, maintaining the action conferred greater benefit to the investing public: "If the prophylactic purpose of the law is to restrict the use of all material inside information until it is made available to the investing public, then the most effective means of carrying out this policy is to nip in the bud the source of the information, the tipper." *Id.* *See* Kuehnert v. Texstar Corp., 412 F.2d 700, 706 (5th Cir. 1969) (Godbold, J., dissenting) ("The best way to stop the misuse of confidential material is to discourage the insider-tipster from making the initial disclosure which is the first step in the chain of dissemination."); Moholt v. Dean Witter Reynolds, Inc., 478 F. Supp. 451 (D.D.C. 1979) (broker's greater culpability bars use of *in pari delicto* defense).

A second view focused upon the particular circumstances, rather than upon tippers and tippees collectively. Under this view, the defense was disallowed when the plaintiff's illegal role was tangential to the conspiracy, *see* Chemetron Corp. v. Business Funds, Inc., 682 F.2d 1149, 1182 (5th Cir. 1982), *vacated on other grounds,* 460 U.S. 1007 (1983), but allowed when tbe plaintiff's role was central to the conspiracy, *see* James v. Du Breuil, 500 F.2d 155, 159 (5th Cir. 1974). Moreover, even when the plaintiff's violations were equal in magnitude to the defendant's, the defense could still be disallowed if to do so were consistent with enforcement considerations specific to the case. For example, the defense was denied to a defendant who issued private placements because "[t]he private action . . . arguably occupies an even more important place in the area of private placements than in other areas of Securities Act enforcement where activities of an issuer must both be reported to and approved by the S.E.C." Woolf v. S.D. Cohn & Co., 521 F.2d 225, 227-28 (5th Cir. 1975), *vacated and remanded on other grounds,* 426 U.S. 944 (1976). *Cf.* James v. Du Breuil, 500 F.2d 155, 160 (5th Cir. 1974) (defense allowed partly because public was not implicated directly in transaction).

Under the third view, tippers apparently could always invoke the defense. Courts adopting this view regarded tippers and tippees as equally blameworthy; the lawsuit between tbem was said to amount to an "accounting between joint conspirators." Kuehnert v. Texstar Corp., 412 F.2d 700, 703 (5th Cir. 1969). Moreover, courts viewed allowing the defense to be more beneficial to the investing public because disallowance provided tippees with a virtual warranty. If the tip was not profitable, the tippee simply could sue the tipper. Tarasi v. Pittsburgh Nat'l Bank, 555 F.2d 1152, 1163-64 (3d Cir.), *cert. denied,* 434 U.S. 965 (1977); Kuehnert v. Texstar Corp., 412 F.2d 700, 705 (5th Cir. 1969).

For a discussion of the status of the *in pari delicto* defense after *Bateman,* see *infra* note 293.

284 105 S. Ct. at 2632.

285 *Cf.* Perma Life Mufflers, Inc. v. International Parts Corp., 392 U.S. 134, 146 (1968) (White, J., concurring).

have violated the securities laws,"[286] the Court noted that "there are important distinctions between the relative culpabilities of tippers, securities professionals, and tippees in these circumstances."[287] First, the Court observed that because a tippee's liability is "solely derivative" from the tipper,[288] the tippee usually is less culpable. Second, the Court noted that insiders and brokers who tip may commit additional offenses not committed by their tippees, such as violating fiduciary duties owed the issuer and defrauding the tippee.[289] Such offenses, according to the Court, are "particularly egregious when committed by a securities professional."[290]

Applying the second prong, the Court held that under the circumstances dismissal of the action would thwart enforcement.[291] Noting the SEC's scarce resources, the Court pointed out that if tippees could not sue tippers for fraud, many violations would remain unprosecuted.[292] The Court reasoned that by permitting tippees' actions against brokers and insiders, the "sources" of inside information, insider trading would be deterred.[293]

Although *Bateman* addressed only the *in pari delicto* defense, the decision applies equally to other common law doctrines. If this defense is subordinate to enforcement considerations, there is no principled basis for preventing subordination of other common law doctrines that are antithetical to enforcement.

Common law doctrines that foster statutory enforcement may be retained. In *American Society of Mechanical Engineers, Inc. v. Hydrolevel Corp.*[294] the Court upheld the defendants' antitrust liability based on a common law "apparent authority" theory.[295]

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286 105 S. Ct. at 2631.

287 *Id.* at 2630.

288 *Id.* (citing Dirks v. SEC, 463 U.S. 646, 659 (1983) and Chiarella v. United States, 445 U.S. 222, 230 n.12 (1980)).

289 *Id.*

290 *Id.*

291 *Id.* at 2631.

292 *Id.* at 2631-32.

293 *Id.* at 2632. The Court also observed that securities professionals were more apt to be cognizant of possible penalties than ordinary investors. Thus, imposing penalties on professionals instead of investors would be more likely to have a deterrent effect. *Id.*

The *Bateman* Court did not foreclose the possibility that the *in pari delicto* defense might be appropriate under different circumstances. *Id.* at 2632. What those circumstances might be, however, is not clear. For example, the Court did not indicate when the tippee and tipper will be deemed to be securities law violators of equal magnitude. Perhaps the most obvious possibility would be a suit by a subtippee against his tippee where neither is a securities professional. It is also uncertain what sorts of other enforcement considerations might warrant disallowance of the defense assuming that the plaintiff's violations were equivalent to the defendant's. *Id.* at 2632 n.30 (question expressly left open).

294 456 U.S. 556 (1982).

295 *Id.* at 570.

Although *American Society* was an antitrust case, it applies to securities cases as well. Indeed, both *American Society*[296] and *Bateman*[297] relied upon *Perma Life Mufflers, Inc. v. International Parts Corp.*,[298] an antitrust decision that the *Bateman* court held "appl[ied] with full force" to implied federal securities actions.[299] In *Perma Life* the Court rejected an *in pari delicto* defense as inconsistent with statutory enforcement.[300] By endorsing application of tort law only so long as it bolsters statutory enforcement, *American Society* provides a corollary to *Perma Life* and *Bateman*. The *American Society* Court explained:

> In the past, the Court has refused to permit broad common-law barriers to relief to constrict the antitrust private right of action. It stated [in *Perma Life*] that "the purposes of the antitrust laws are best served by insuring that the private action will be an ever-present threat" to deter antitrust violations. In *Perma Life* . . . the Court honored that purpose by denying defendants the right to invoke a common-law defense (the doctrine of *in pari*

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296 *Id.* at 569-70.

297 *See infra* note 299 and accompanying text.

298 392 U.S. 134 (1968). Lower courts previously had relied upon *Perma Life* when confronted with an *in pari delicto* defense under rule 10b-5. *See, e.g.*, cases cited *supra* note 283. Regardless of whether these courts accepted or rejected the defense, *Perma Life* was identified as the applicable precedent. *Compare* Tarasi v. Pittsburgh Nat'l Bank, 555 F.2d 1152, 1164 (3d Cir.) (finding *in pari delicto* defense applicable), *cert. denied*, 434 U.S. 965 (1977) *and* James v. Du Breuil, 500 F.2d 155, 160 (5th Cir. 1974) (same) *with* Nathanson v. Weis, Voisin, Cannon, Inc., 325 F. Supp. 50, 56 n.30 (S.D.N.Y. 1971) (rejecting *in pari delicto* defense).

299 105 S. Ct. at 2629. The Court equated the enforcement goals of private securities actions with those of antitrust actions, despite the fact that treble damages are available only in antitrust actions. *Cf.* Nathanson v. Weis, Voisin, Cannon, Inc., 325 F. Supp. 50, 56 (S.D.N.Y. 1971) (noting unavailability of treble damages to private securities plaintiffs). One commentator has dismissed this distinction on the ground that antitrust plaintiffs are accorded treble damages in part to counteract the threat of later retaliation by defendants with whom they often share a market. *See* Note, *The Demise of In Pari Delicto in Private Actions Pursuant to Regulatory Schemes*, 60 CALIF. L. REV. 572, 573 n.6, 590 n.96 (1972).

300 In *Perma Life*, the plaintiff Midas Muffler dealers alleged that their dealership agreements with Midas and its affiliates violated the antitrust laws. Defendants advanced an *in pari delicto* defense, arguing that the plaintiffs were co-participants in the agreements, and were therefore not entitled to recover. In a five opinion decision, the Court rejected the defense. All five opinions stressed the importance of statutory enforcement. *See* 392 U.S. 134, 138-40 (opinion of Court); *id.* at 145 (White, J., concurring); *id.* at 147 (Fortas, J., concurring in result); *id.* at 151 (Marshall, J., concurring in result); *id.* at 154-55 (Harlan, J., concurring in part and dissenting in part). Writing for the Court, Justice Black noted that "fastidious regard for the relative moral worth of the parties would . . . seriously undermin[e] the usefulness of the private action as a bulwark of . . . enforcement." 392 U.S. at 139. He did not, however, endorse rejecting the *in pari delicto* defense in all circumstances. Instead, he reserved judgment as to its appropriate application when the plaintiff's conduct was active and voluntary: "We need not decide . . . whether . . . truly complete involvement and participation in a monopolistic scheme could ever be a basis . . . for barring a plaintiff's cause of action." *Id.* at 140.

> *delicto*) that was inconsistent with the antitrust laws. In this case, we can honor the statutory purpose best by interpreting the antitrust private cause of action to be at least as broad as a plaintiff's right to sue for analogous torts . . . .[301]

Under *Bateman, Perma Life,* and *American Society,* enforcement considerations must govern application of all other rule 10b-5 tort law doctrines, including the duty of care.[302]

Evaluated in light of enforcement considerations, the duty of care doctrine does not withstand scrutiny.[303] The duty of care requires that courts dismiss the claims of careless plaintiffs who have not themselves violated rule 10b-5. Defendants in these actions, however, have violated rule 10b-5. Dismissing suits against violators in order to penalize nonviolators undermines the enforcement of section 10(b), in direct violation of *Bateman, Perma Life,* and *American Society.*

IV
THE ELEMENTS OF RULE 10b-5: COMMON LAW DECEIT

The Supreme Court has accorded common law deceit a limited role in interpreting rule 10b-5. The common law is relevant only when the factors discussed above are inconclusive. The Court has disregarded common law deceit principles where the statute's language, history, structure, or policy are dispositive. In *Blue Chip Stamps v. Manor Drug Stores*[304] the Court adopted the purchaser-seller requirement even though the common law did not require that the aggrieved party in a deceit action be a purchaser or a seller.[305] The Court found that statutory language, structure, and policy gave suf-

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301 456 U.S. at 569 (citations omitted).

302 The principal lower court application of *Perma Life* to rule 10b-5 has involved the *in pari delicto* defense. *See supra* note 283. A few courts, however, have suggested that *Perma Life* may be relevant to all rule 10b-5 common law defenses. *See, e.g.,* Hughes v. Dempsey-Tegeler & Co., 534 F.2d 156, 184 (9th Cir.) (Trask, J., dissenting) ("[T]here is a clear trend in the law today to limit severely, if not abolish altogether, traditional common law defenses in securities and anti-trust actions, where considerations of public policy often outweigh whatever balance in equities the court finds between the individual litigants. . . . Availability of common law defenses, such as *in pari delicto,* assumption of risk, equitable estoppel, and waiver serve to make [the statutory] check upon abuses in the system's internal workings considerably less potent."), *cert. denied,* 429 U.S. 896 (1976); Woolf v. S.D. Cohn & Co., 521 F.2d 225, 227 (5th Cir. 1975) (noting that tension between "traditional equitable defenses" and policies served by private rights of action under federal securities laws have yet to be resolved by the Supreme Court).

303 The circuits presently are split concerning whether the duty of care is a defense or an element of the plaintiff's case. *See supra* notes 102-10 and accompanying text. *Bateman* applies in either instance, however, because the duty of care remains a barrier to relief of common law origin, regardless of the burden of proof.

304 421 U.S. 723 (1975).

305 *Id.* at 744.

ficient affirmative support to the purchaser-seller requirement.[306]

The Court has turned to the common law of deceit, however, when the statutory factors are inconclusive. For example, in *Chiarella v. United States*[307] the Court found statutory language,[308] legislative history,[309] and statutory policy[310] unhelpful in resolving whether silence is actionable absent a duty to speak. Under these circumstances, the Court turned to the common law of deceit,[311] which regarded a duty to speak as a necessary element for silence to be actionable.[312] The Court characterized this common law principle as "established doctrine"[313] and refused to follow the post-1934 trend in the common law identified by the dissent.[314]

The Court's reliance upon common law deceit when other criteria are inconclusive is consistent with congressional intent. Congress intended the federal securities laws to "rectify perceived deficiencies in the available common-law protections."[315] According to the House Report on the 1934 Act:

> If investor confidence is to come back . . . , *the law must advance*. As a complex society so diffuses and differentiates the financial interests of tbe ordinary citizen that he has to trust others and cannot personally watch the managers of all his interests as one horse trader watches another, it becomes a condition of tbe very stability of that society that its rules of law and of business practice recognize and protect that ordinary citizen's dependent position.[316]

Thus, section 10(b) should be interpreted no more restrictively than the common law deceit action of that time period unless Congress has indicated to the contrary. Moreover, Congress's determination that common law protections were deficient suggests that in the face of divided common law opinions, the most liberal common law views of 1934 should govern.[317]

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306 *Id.* at 733-49.

307 445 U.S. 222, 226 (1980) ("[N]either the legislative history nor the statute itself affords specific guidance for the resolution of this case.").

308 *Id.*

309 *Id.* at 233.

310 *Id.*

311 *Id.* at 227-28 & n.9.

312 *Id.* at 228.

313 *Id.* at 233.

314 *Id.* at 247-48 (Blackmun, J., dissenting).

315 Herman & MacLean v. Huddleston, 459 U.S. 375, 389 (1983) (citing SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963)). *See also* 1 A. BROMBERG & L. LOWENFELS, *supra* note 20, § 2.7(1) (concluding that Congress intended rule 10b-5 to be less burdensome than analogous common law causes of action).

316 H.R. REP. No. 1383, 73d Cong., 2d Sess., 5 (1934), *reprinted in* 5 LEGISLATIVE HISTORY, *supra* note 158, item 18, at 5 (emphasis added).

317 This appears to be Professor Loss's view. *See* L. LOSS, *supra* note 212. at 812

Evaluating rule 10b-5's duty of care by reference to the common law deceit action may be superfluous in view of the inferences available from the statute's structure and policy. Nevertheless, the common law deceit action provides yet another ground for rejecting the duty of care. Although some common law deceit cases decided around 1934 imposed a duty of care,[318] a number of others did not.[319] *Buckley v. Buckley*[320] is illustrative of the latter group. In *Buckley* the trial court entered judgment against the defendant for fraud in the sale of stock and refused to instruct the jury that the plaintiff's failure to examine available books and records barred his recovery. The Michigan Supreme Court affirmed, holding that "no duty to use diligence in discovering a fraud is imposed on the injured party."[321]

In the most liberal jurisdictions courts refused to bar the plaintiff from recovery even if he had notice of the need to investigate and had failed to do so. Three types of notice were involved in these cases. First, in several cases, a document in the plaintiff's possession constituted the notice to the plaintiff. In *Albert v. Title Guarantee & Trust Co.*[322] the plaintiff purchased four mortgage participation certificates from the defendant, who had falsely represented to the plaintiff that the mortgages covered only "improved and income producing properties."[323] The trial court instructed the jury to determine whether a legend on the certificates would have "put a reasonable person on inquiry or knowledge that they were not improved by buildings or income-producing property."[324] The New York Court of Appeals held that this instruction was reversible error and stated that "[i]t is no excuse for a culpable misrepresentation that means of probing it were at hand."[325]

("Because of the legislative background it seems reasonable to assume at the very least that the most liberal common law views on these questions should govern under the statutes.").

318 *E.g.*, Troutman v. Stiles, 87 Colo. 597, 290 P. 281 (1930); Clark v. Morrill, 128 Me. 79, 145 A. 744 (1929); Brockton Olympia Realty Co. v. Lee, 266 Mass. 550, 165 N.E. 873 (1929). *See also* Gallon v. Burns, 92 Conn. 39, 101 A. 504 (1917) (describing contrasting judicial views on significance of plaintiff's carelessness).

319 *See infra* notes 320-29 and accompanying text.

320 230 Mich. 504, 202 N.W. 955 (1925).

321 *Id.* at 509, 202 N.W. at 956. *See also* King v. Livingston Mfg. Co., 180 Ala. 118, 127-78, 60 So. 143, 145-46 (1912) ("It would . . . be singular to hold a swindling deceiver exempt from liability because he has swindled only foolishly credulous and trusting persons . . . .").

322 277 N.Y. 421, 14 N.E.2d 625 (1938).

323 *Id.* at 422-23, 14 N.E.2d at 625.

324 *Id.* at 423, 14 N.E.2d at 625.

325 *Id. See also* Martin v. Hughes, 156 Kan. 175, 131 P.2d 682 (1942) (deceit action alleging defendant orally misrepresented that used car was new; fact that age of car was inferable from title certificate held not to bar action); Southern Bldg. & Loan Ass'n v. Dinsmore, 225 Ala. 550, 144 So. 21 (1932) (deceit action alleging oral misrepresenta-

The second type of notice given to plaintiffs in these cases consisted of warnings from others. In *Bell v. Smith,*[326] for example, the plaintiff was warned by her brother-in-law that a car she was about to purchase from the defendant was not a 1924 model, as the defendant had claimed. Plaintiff ignored the warning and purchased the car. The Supreme Court of New Jersey upheld a judgment for the plaintiff, reasoning that the plaintiff "chose to rely rather on the representations made by the defendant than on the warning from her brother-in-law."[327]

The third type of notice case involved something other than a warning or document. In *Steele v. Banninga,*[328] the defendant, a real estate agent, falsely informed the plaintiff that a Mrs. Swenson was the sole owner of certain land. The plaintiff purchased the land with knowledge that a Mr. Stamp possessed and claimed ownership of the property. The Supreme Court of Michigan reversed the lower court's judgment for the defendant and ordered a new trial, after stating that the plaintiff's "[c]onstructive notice of Stamp's rights . . . constitutes no defense to this action."[329]

As the above discussion illustrates, in the more liberal jurisdictions in 1934, the duty of care did not bar recovery in a deceit action. It follows that the duty of care under rule 10b-5 should be rejected, absent contrary indications from Congress. As has been shown, however, no such contrary indications exist; rather, Congress has demonstrated its rejection of the duty of care through statutory structure and policy.

CONCLUSION

The Supreme Court's rule 10b-5 jurisprudence indicates that the elements of the rule 10b-5 action are governed by the intent of Congress, as evidenced by the following factors: the langnage and

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tion in sale of stock; fact that fraud was inferable from stock certificate in plaintiff's possession held not to bar action).

326 6 N.J. Misc. 1079, 143 A. 819 (1928).

327 *Id.* at 1079, 143 A. at 819-20. *See also* Williams v. Bedenbaugh, 215 Ala. 200, 110 So. 286 (1926) (plaintiff ignored her attorney's warnings); Starkweather v. Benjamin, 32 Mich. 305 (1875) (plaintiff ignored rumors in community).

328 225 Mich. 547, 196 N.W. 404 (1923).

329 *Id.* at 553, 196 N.W. at 406. The court added that the "defendant is liable, even if the truth lay elsewhere and plaintiffs might have found it out had they looked beyond defendant in their search for it." *Id.* at 556, 196 N.W. at 407. *See* Carr v. Harnstrom, 207 Ill. App. 31, 35 (1917) (rejecting instruction that recovery will be denied if "there were facts and circumstances present sufficient to put the plaintiff upon his gnard"); Mason v. Thornton, 74 Ark. 46, 54, 84 S.W. 1048, 1049 (1905) (rejecting instruction that recovery should be denied where plaintiff had "notice sufficient to excite the attention of a man of ordinary prudence"). *See also* International Harvester Co. v. Franklin County Hardware Co., 101 Kan. 488, 167 P. 1057 (1917) (constructive knowledge held irrelevant in face of defendant's actual fraud).

history of section 10(b) and rule 10b-5, the structure of the 1933 and 1934 Acts, the policies underlying these Acts, and, where necessary, the views on common law deceit of the most liberal jurisdictions at the time the Acts were enacted. A plaintiff's duty of care in rule 10b-5 cases is manifestly inconsistent with the intent of Congress. The duty of care has no basis in the language or history of either section 10(b) or rule 10b-5. Moreover, it cannot be reconciled with either section 29(a) of the 1934 Act or with the congressional policy regarding enforcement of 1934 Act violations. Finally, the most liberal common law jurisdictions in 1934 did not impose a duty of care. Therefore, the duty of care has no proper place in rule 10b-5 litigation. A plaintiff's carelessness should no longer bar recovery for intentional securities fraud.

Abolishing the duty of care will not unduly expand the scope of rule 10b-5. Plaintiffs will still carry a considerable burden of proof, including scienter, materiality, and reliance.[330] Thus, a plaintiff who carelessly ignored what should have been obvious will still be denied recovery unless he can demonstrate that he relied upon intentional and material omissions or misrepresentations.[331]

The Court's rule 10b-5 jurisprudence applies not only to the duty of care, but also to all other common law doctrines that the rule 10b-5 action has imported. Some factors, however, will be more likely than others to provide affirmative evidence of congressional intent. The language of section 10(b) itself is largely useless as an indicator of congressional intent. It is difficult to discern whether this imprecise statutory language expresses congressional intent only in the prima facie case or in other aspects of the action as well. Relying on section 10(b)'s language is especially dubious with respect to private actions, because Congress never considered them.

The history of section 10(b) also is a largely useless indicator of congressional intent. Congress gave scant attention to section 10(b), leaving a brief and cryptic history of negligible interpretative value. Similarly, inferences regarding congressional intent are unlikely to emerge from the language and history of rule 10b-5 because the rule is the product of the SEC, not Congress. The most liberal views of common law deceit in 1934 also provide little help because they are at best only indirect evidence of congressional intent. The Court has conceded the relative unimportance of com-

330 See *supra* note 17 for the elements of a rule 10b-5 private action.

331 *Cf.* Lucas v. Florida Power & Light Co., 575 F. Supp. 552 (S.D. Fla. 1983) (judgment for defendant for nonfulfillment of duty of care as well as for lack of materiality, scienter, and causation); Lake v. Kidder, Peabody & Co., [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,509 (N.D. Ind. May 22, 1978) (judgment for defendants for nonfulfillment of duty of care as well as for lack of reliance and causation). *See generally supra* note 17 (discussing elements of rule 10b-5 private action).

mon law deceit by deeming it relevant only when the other factors are inconclusive. The most useful factors are the structure of the 1933 and 1934 Acts and the policies underlying those Acts. They provide fertile grounds for inferring what Congress would have done had it actually addressed all aspects of section 10(b).

Each common law doctrine that has found its way into the rule 10b-5 private action must be evaluated separately, because each requires discrete application of the relevant factors outlined above. Lower courts' failure to apply these factors flouts the intent of both the Supreme Court and Congress.