The Due Diligence Defense in Rule 10b-5: The *Hochfelder* Aftershocks

The private remedy under rule 10b-5[1] is entirely a creation of judicial decisions. The district court decision in *Kardon v. National Gypsum Co.*[2] started the judicial discussion concerning the formation of requirements for recovery in a private action under rule 10b-5. With limited legislative guidelines, the burden of defining the requirements for private enforcement of securities laws has been left to the courts.[3] The development of a private recovery under rule 10b-5 has focused primarily on the elements of the defendant's conduct and the prerequisites for recovery.[4] Courts have held some traditional equitable defenses applicable to rule 10b-5 cases.[5] However, frequently the courts have imposed on the plaintiff a duty of due care or diligence. This duty is sometimes described as requiring the plaintiff to demonstrate that his reliance was reasonable or justifiable.[6] A more general and applicable definition is that where the plaintiff's conduct was unreasonable and contributed to his own harm, he will not be allowed to recover. Various courts have used

---

[1]Securities and Exchange Commission Rule 10b-5, 17 C.F.R. § 240.10b-5 (1977), states:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interestate [sic] commerce, or of the mails or any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Rule 10b-5 was promulgated pursuant to § 10(b) of the Securities and Exchange Act, 15 U.S.C. § 78j(b) (1976).

[2]69 F. Supp. 512 (E.D. Pa. 1946), *addressing merits*, 73 F. Supp. 798 (E.D. Pa. 1947). The private remedy under rule 10b-5 was implied under RESTATEMENT (SECOND) OF TORTS § 286 (1965), which deals with the implied right of action for negligence.

[3]Dupuy v. Dupuy, 551 F.2d 1005, 1013 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977).

[4]Generally, the requirements for recovery in rule 10b-5 are as follows: A material misrepresentation or omission by the defendant, a showing of scienter, reliance, and some form of due diligence by the plaintiff. *Id.* at 1014.

[5]Ocrant v. Dean Witter & Co., 502 F.2d 854 (10th Cir. 1974) (latches and estoppel used as a defense); James v. DuBreuil, 500 F.2d 155 (5th Cir. 1974) (*in pari delicto* defense); Landry v. Hemphill, Noyes & Co., 473 F.2d 365 (1st Cir.), *cert. denied*, 414 U.S. 1002 (1973), *reh. denied*, 415 U.S. 960 (1974) (waiver used as a defense).

[6]Dupuy v. Dupuy, 551 F.2d 1005, 1014 (5th Cir.), *cert. denied*, 434 U.S. 411 (1977). *See* Wheeler, *Plaintiff's Duty of Due Care Under Rule 10b-5: An Implied Defense to an Implied Remedy*, 70 NW. U.L. REV. 561, 563 (1975).

different rationales and standards in dealing with the due diligence issue, but the majority of jurisdictions require some showing of due diligence.[7] While once well established, the duty of due diligence is presently being questioned. This Note will trace the judicial development of due diligence, assess its theoretical validity, and discuss its applications.

I. Early Judicial Development of the Duty of Due Diligence

Courts have generally dealt with the due diligence issue in the context of a flexible duty standard (variable disclosure),[8] reliance,[9] materiality,[10] general equitable considerations,[11] and as a separate element in rule 10b-5 actions.[12] Despite these diverse approaches, the plaintiff's failure to exercise due diligence will preclude his 10b-5 recovery.

The flexible duty approach incorpates the plaintiff's duty of due care into the scope of the defendant's duty to disclose. This approach was used by the court in *Arber v. Essex Wire Corp.*[13] when the president-purchaser of corporate stock did not reveal the book value of the corporate stock to the sellers. The book value of the stock and other financial information was easily obtainable from the records of the corporation. The court held there was no duty for a corporate insider to reveal routine, easily obtained corporate data.[14] The sellers of the stock were not permitted to recover because they were charged with constructive knowledge of the contents of the corporate records.[15] The narrow holding in *Arber* is of limited value

---

[7]The following circuits have recognized some form of due diligence defense: Rogen v. Ilikon Corp., 361 F.2d 260 (1st Cir. 1966); Frigitemp Corp. v. Financial Dynamics Fund, Inc., 524 F.2d 275 (2nd Cir. 1975); Rochez Bros., Inc. v. Rhoades, 491 F.2d 402 (3d Cir. 1975), *cert. denied,* 425 U.S. 993 (1976); Clement A. Evans & Co. v. McAlpine, 434 F.2d 100 (5th Cir. 1970), *cert. denied,* 402 U.S. 988 (1971), *reh. denied,* 404 U.S. 874 (1971); Arber v. Essex Wire Corp., 490 F.2d 414 (6th Cir.), *cert. denied,* 419 U.S. 830 (1974); Kohler v. Kohler Co., 319 F.2d 634 (7th Cir. 1963); City Nat'l Bank v. Vanderboom, 422 F.2d 221 (8th Cir.), *cert. denied,* 399 U.S. 905 (1970); White v. Abrams, 495 F.2d 724 (9th Cir. 1974); Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90 (10th Cir.), *cert. denied,* 404 U.S. 1004 (1971), *reh. denied,* 404 U.S. 1064 (1972) (Mitchell), *cert. denied,* 405 U.S. 918 (1972) (Reynolds).

[8]White v. Abrams, 495 F.2d 724 (9th Cir. 1974); Arber v. Essex Wire Corp., 490 F.2d 414 (6th Cir.), *cert. denied,* 419 U.S. 830 (1974).

[9]City Nat'l Bank v. Vanderboom, 422 F.2d 221 (8th Cir.), *cert. denied,* 399 U.S. 905 (1970); Kohler v. Kohler Co., 319 F.2d 634 (7th Cir. 1963).

[10]Taylor v. Smith, Barney & Co., 358 F. Supp. 892 (D. Utah 1973).

[11]Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90 (10th Cir.), *cert. denied,* 404 U.S. 1004 (1971); Kohler v. Kohler Co., 319 F.2d 634 (7th Cir. 1963).

[12]Clement A. Evans & Co. v. McAlpine, 434 F.2d 100 (5th Cir. 1970), *cert. denied,* 402 U.S. 988 (1971).

[13]490 F.2d 414 (6th Cir.), *cert. denied,* 419 U.S. 830 (1974).

[14]*Id.* at 420.

[15]*Id.*

when trying to develop a workable standard under the flexible duty rationale, because the court did not further define what information a defendant must reveal beyond that which is routinely available in corporate records.

A more extensive discussion of the flexible duty approach was undertaken by the court in *White v. Abrams.*[16] In *White*, the plaintiff was advised by the defendant, a long time friend and advisor, to invest a considerable sum in several companies. The defendant misrepresented the financial condition of the companies, and the plaintiff invested his money based upon these false representations. After learning the true facts, the plaintiff sued under rule 10b-5, and the trial court imposed absolute liability on the defendant for his mispresentations. The Ninth Circuit Court of Appeals reversed and adopted the flexible duty rationale as a gauge for the defendant's conduct.[17] The court outlined a variable disclosure standard based on the relationship between the plaintiff and the defendant, the defendant's access to information, the benefit the defendant derived from the relationship, the defendant's awareness of the plaintiff's reliance upon the relationship in making the investment decision, and representations made by the defendant for the purpose of inducing the plaintiff to enter the transaction.[18]

Under the *White* test, the defendant's duty to disclose information varies depending on the particular fact situation.[19] The defendant's duty is to disclose *only* that material information to which the plaintiff has no access, and consequently, the plaintiff's duty of due diligence is derived from what the defendant does not reveal. The plaintiff's status and the particular circumstances of each case determine whether he has exercised due diligence. If a defendant omits or misrepresents information to which the plaintiff has no reasonable access, he will be liable. On the otherhand, if the omission or misrepresentation involves facts to which the plaintiff has reasonable access, the plaintiff will not recover.[20]

The most significant aspect of the flexible duty approach is that it does not always require a full and accurate disclosure. The level

---

[16]495 F.2d 724 (9th Cir. 1974).

[17]*Id.* at 734.

[18]*Id.* at 735-36.

[19]*Id.* at 736.

[20]Arber v. Essex Wire Corp., 490 F.2d 414 (6th Cir.), *cert. denied*, 419 U.S. 830 (1974). An illustration of a typical flexible duty analysis is one in which the plaintiff is an insider and thus has access to most information. The defendant's duty to disclose is then limited to that information which the plaintiff cannot reasonably obtain, and the plaintiff is charged with the constructive knowledge of the omitted information he could have easily obtained. With a less sophisticated insider the defendant must correspondingly increase his level of disclosure.

of disclosure is dependent upon the particular plaintiff and the particular factors that are present. With a multitude of fact situations and differing levels of sophistication among plaintiffs, defendants' duties of disclosure can vary significantly.[21] The variable disclosure approach is inconsistent with SEC enforcement procedures where the defendant is found guilty whenever he fails to make a complete and accurate disclosure.[22] When the SEC attempts to deter fraudulent conduct it is not relevant "that [claimant] might have been a knowledgeable investor."[23] A flexible duty analysis that allows the defendant's duty to disclose to be determined by the particular circumstances of the case encourages inconsistent standards of conduct. If the defendant is already required to make a complete disclosure, it seems reasonable that the plaintiff, despite his investment status, should also gain from the benefits of the disclosure. If an SEC enforcement procedure were made contingent upon a violation of a flexible duty disclosure, it would have limited availability. An additional difficulty with the flexible duty approach is that it imposes a tremendous burden upon the defendant. Before instituting any transaction, the defendant must first determine what is to be disclosed to the plaintiff. A large scale securities broker with many clients is hard pressed to make his disclosure decisions in an efficient and accurate manner. He must first collect and categorize all the available information and then parcel it out depending upon the client with whom he is dealing. As a result, the defendant is able to define his own liability. There is no consistency in this approach, and it provides no identifiable standard of conduct.[24] With no identifiable set of standards by which the defendant's disclosure duty may be gauged, the only practical method by which the potentially defrauded plaintiff may assess the validity of his claim is to bring a rule 10b-5 suit. This situation invites spurious claims and an unwarranted expansion of rule 10b-5 litigation.

One of the most popular treatments of the due diligence issue is to link the due care question to the plaintiff's reliance.[25] Under the reliance approach, the plaintiff's conduct is analyzed in view of the particular fact situation to determine whether his reliance on the

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

[22]*See* SEC v. Dolnick, 501 F.2d 1279 (7th Cir. 1974); Hanly v. SEC, 415 F.2d 589 (2d Cir. 1969). *But see* SEC v. Coffey, 493 F.2d 1304 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975).

[23]SEC v. Dolnick, 501 F.2d 1279, 1283 (7th Cir. 1974).

[24]The flexible duty standard has been roundly criticized. In Haimoff, *Holmes Looks at Hochfelder and 10b-5*, 32 Bus. Law. 147 (1976), the author accurately characterized the flexible duty standard as "hopelessly indefinable." *Id.* at 147.

[25]Holdsworth v. Strong, 545 F.2d 687 (10th Cir. 1976), *cert. denied*, 430 U.S. 955 (1977); City Nat'l Bank v. Vanderboom, 422 F.2d 221 (8th Cir.), *cert. denied*, 399 U.S. 905 (1970); Rogen v. Ilikon Corp., 361 F.2d 260 (1st Cir. 1966).

defendant's misrepresentations or omissions was justified.[26] In *City National Bank v. Vanderboom*,[27] an Eighth Circuit Court of Appeals decision, a consortium of investors obtained an option to purchase a corporation. The corporation owned a financial institution whose aquisition, the investors believed, would aid their own construction business. During the negotiations, the sellers misreresented the financial condition of the companies and a bank with actual knowledge of the shaky financial condition of the companies loaned the investors the money to acquire the corporation. For the four month duration of the option, the investors had access to the corporation books and records but never investigated. The bank later filed suit on the investor's outstanding notes, and the investors counterclaimed under rule 10b-5, alleging that the bank failed to reveal the actual financial condition of the companies. The court dismissed the counterclaim, because a reasonable investigation would have provided the investors with the omitted information.[28] The court developed a test by which the plaintiff's reasonable reliance could be determined: Where there is misrepresentation, reasonable reliance is conditioned upon the plaintiff's exercise of due care in light of the particular circumstances existing at the time the misrepresentation is made. In the non-disclosure situation, reasonable reliance is also dependent upon an exercise of due care, but in addition, the plaintiff must also demonstrate that he is entitled to receive a full disclosure and that he would have acted differently had the alleged omission not occurred.[29] The *Vanderboom* court held that reliance could not be justified unless there had been some investigation by the plaintiff.[30] Thus, *Vanderboom* imposed a positive duty of reasonable investigation on the plaintiff prior to recovery.[31]

The reliance approach is logical in that the plaintiff must investigate the prospective transaction, and the approach is flexible enough to correlate with the particular fact situation. However, the validity of a link between due care and reliance is in jeopardy and has been questioned in the Supreme Court's decision in *Affiliated Ute Citizens v. United States*.[32] In *Affiliated Ute Citizens*, a bank purchased securities from a group of Ute Indians who were un-

---

[26] 545 F.2d at 697.

[27] 422 F.2d 221 (8th Cir.), *cert. denied*, 399 U.S. 905 (1970).

[28] *Id.* at 230-31.

[29] *Id.* at 230. The test also provides that once the court is satisfied that the plaintiff has discharged his duty of due diligence, the defendant's conduct must be examined to see whether it was intentional or negligent.

[30] *Id.* at 230-31.

[31] *Id.* at 230 n.10. The court held that the investigation would have to be reasonable under the circumstances of the individual case.

[32] 406 U.S. 128, *reh. denied*, 407 U.S. 916, *reh. denied*, 408 U.S. 931 (1972).

familiar with investment practices. Without telling the plaintiffs, the bank sold the securities in an artificially inflated market, which the bank was able to manipulate. The Court of Appeals denied recovery, because the plaintiffs were unable to prove that had the omitted information been revealed, they would not have consented to the sale.[33] The Supreme Court reversed the decision and held: "All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision."[34] In cases prior to *Affiliated Ute Citizens*, the plaintiff was required to prove that the omitted information would have been instrumental in their investment decision. With the multitude of potential factors that can influence an investment decision, *Affiliated Ute Citizens* relieved the plaintiff of an almost impossible burden of proof.[35] The Supreme Court in *Affiliated Ute Citizens* created a distinction between acts of affirmative misrepresentation and omission. If misrepresentation occurs, the plaintiff must still demonstrate his reliance on the defendant's statements, whereas with omissions, proof of reliance is not required. When this distinction is carried through to a due diligence analysis, the plaintiff's burden of due care may be eliminated in omissions cases. If reliance is presumed, once materiality has been demonstrated, the court will no longer be in a position to determine if the reliance is reasonable. Thus, if reliance does not become an issue, any discussion in which reliance and due diligence are linked will also vanish.[36] This misrepresentation/omission distinction is an unwarranted limitation when applied to due diligence. The courts have used the due diligence defense to limit recovery to those plaintiffs who have exercised due care in the marketplace,[37] and this policy is not modified merely because the particular case is based on an omission. If imposing a duty of due care promotes efficiency and fair dealing in the marketplace,[38] it should apply to both omission and misrepresentation cases. If the plaintiff's due diligence can

---

[33]Reyos v. United States, 431 F.2d 1337, 1348 (10th Cir. 1970).

[34]406 U.S. at 153-54.

[35]*See, e.g.*, Holdsworth v. Strong, 545 F.2d 687 (10th Cir. 1976), *cert. denied*, 430 U.S. 955 (1977); Jackson v. Oppenheim, 411 F. Supp. 659 (S.D.N.Y. 1974), *aff'd on other grounds*, 533 F.2d 826 (3d Cir. 1976).

[36]Although *Affiliated Ute Citizens* eliminates the proof of reliance, there is some suggestion by the court in Rochez Bros. v. Rhoades, 491 F.2d 402, 410 (3d Cir. 1975), *cert. denied*, 425 U.S. 993 (1976), that the defendant may be able to put reliance in issue for due diligence purposes. While this procedure has never been attempted, it seems probable that since the proof of reliance was eliminated to avoid the complicated analysis and burden of proof problems that accompany reliance in omission cases, the court would be unwilling to resurrect the problems they sought to eliminate.

[37]Dupuy v. Dupuy, 551 F.2d 1005, 1016 (5th Cir.), *cert. denied*, 434 U.S. 411 (1977).

[38]*Id. See also* Straub v. Vaisman & Co., 540 F.2d 591 (3d Cir. 1976).

reveal misrepresentations, it can also turn up material omissions. By imposing a duty of due diligence in both omission and misrepresentation cases, one of the primary policy objectives of rule 10b-5, which is to encourage careful investment conduct by all parties, is furthered.

One court has used materiality in an attempt to define the scope of due diligence.[39] Materiality is generally defined as whether a reasonable investor might consider the fact important to his investment decision.[40] Using materiality to define the scope of due diligence, different levels of due care are imposed to correspond to each investor's level of sophistication. Presumably, a corporate insider could only consider a representation to be material after he has made an extensive investigation. The unsophisticated investor would have a correspondingly lower threshold of materiality for the same information. If a defendant misrepresents or omits information and the plaintiff ascertains the nature of the information, the plaintiff is not permitted to recover, because the facts are no longer material.[41] This reasoning is an extension of the traditional concept of materiality. The question of when an investor *would* be influenced by a fact and when he *should* be influenced by the same fact are far different concepts. A plaintiff with special expertise might consider information important to his investment decision and thus material, but at the same time he might realize that the information is false. Little is done to promote the policies of rule 10b-5 if investors are allowed to recover when their expertise would indicate that their reliance on the information has been unreasonable.

Several courts, in exercising their equitable discretion, have ruled that a duty of due care should be imposed.[42] Often these courts do not attempt an extended analysis, but simply state their conclusion supported by citation to other cases where a due diligence standard has been imposed.[43] Courts often use wide latitude in exercising their equitable discretion; such as in *Kohler v. Kohler Co.*,[44] where the court imposed a due care burden on both parties. In *Kohler*, the plaintiff sold common stock to the corporation for less than the true market value and then brought suit alleging that he

---

[39]Taylor v. Smith, Barney & Co., 358 F. Supp. 892 (D. Utah 1973).

[40]SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968), *cert. denied*, 404 U.S. 1004 (1971); List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir.), *cert. denied*, 382 U.S. 811, *reh. denied*, 382 U.S. 933 (1965).

[41]Straub v. Vaisman & Co., 540 F.2d 591, 596 (3d Cir. 1976).

[42]*See, e.g.*, Frigitemp Corp. v. Financial Dynamics Fund, 524 F.2d 275 (2d Cir. 1975); Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971); Kaplan v. Vornado, 341 F. Supp. 212 (N.D. Ill. 1971).

[43]*See* Wheeler, *supra* note 6, at 588.

[44]319 F.2d 634 (7th Cir. 1963).

was induced to sell the stock by the misrepresentations, half truths, and omissions of the defendant. The plaintiff sued under rule 10b-5, contending that the defendant's conduct breached the corporate insider's duty to fully and accurately disclose all facts pertaining to the value of the stock.[45] Even though the plaintiff accused the defendant of violating his insider duties, both parties could probably have been classified as insiders.[46] The *Kohler* court discussed the duty of insiders to disclose material information and framed the disclosure requirement in terms of a flexible duty:

> On one hand, the corporate insiders must scrupulously disclose to outsiders those material facts about a corporation's business which in reasonable and objective contemplation might affect the value of the corporation's stock or securities and which insiders should reasonably believe are unknown to the outsider. On the other hand they are not required to search out details that presumably would not influence the person's judgment with whom they are dealing.[47]

The court was prompted by an overriding concern to promote an equitable result between the parties and thus held that where the plaintiff had the means available to discover the information and made no effort to do so, he could not recover.[48]

A final approach has been to characterize due diligence as a separate element of the rule 10b-5 action. In *Clement A. Evans & Co. v. McAlpine*,[49] the defendant was able to create an appearance of financial solvency by obtaining bank loans with non-existent securities pledged as collateral. Under this guise, the defendant was able to trade large amounts of securities with the plaintiff and paid for the purchased securities with checks drawn on his personal account. Throughout the four months of trading, several of the defendant's checks were dishonored for insufficient funds. Despite the earlier bad checks, the plaintiff continued to trade securities with the defendant. This procedure was contrary to accepted industry practice and was also prohibited under federal guidelines, which require a customer's account to be frozen for ninety days when irregularities appear.[50] The plaintiff institued suit under rule 10b-5 to

---

[45]*Id.* at 636.

[46]The plaintiff owned 21,415 shares of the 200,000 outstanding shares of Kohler Co. stock, had been employed by the corporation for 22 years, had been a director of the company for 11 years, and had been an officer (secretary) for another 10 years.

[47]319 F.2d at 642.

[48]*Id.* at 641.

[49]434 F.2d 100 (5th Cir. 1970), *cert. denied*, 402 U.S. 988 (1971), *reh. denied*, 404 U.S. 874 (1971).

[50]Federal Reserve Board Regulation T, 12 C.F.R. § 220.4(c)(8) (1977), requires that any irregularity in a customer's account be investigated by the brokerage firm. The

recover the proceeds of the last five checks. The Fifth Circuit Court of Appeals affirmed the trial court's decision to deny recovery, because the plaintiff had not exercised due diligence.[51] The court's jury instruction imposed the following duty of due diligence on the plaintiff:

> If you find from the evidence in this case that the plaintiff had knowledge of facts sufficient to excite its inquiry, and the peculiar circumstances of this case were sufficient to impose upon the plaintiff a duty of reasonable diligence, and that the plaintiff failed to exercise this duty, then you should return a verdict for the defendants.[52]

In *McAlpine*, the court separated due diligence from the concepts of variable disclosure or reliance and reasoned that the due diligence issue should be treated in the nature of an affirmative defense.[53] The plaintiff was required to exercise that degree of diligence which was reasonable under the particular facts.[54] The court listed several factors that influenced the level of diligence which is required: Existence of a fiduciary relationship, concealment of the fraud, opportunity to detect the fraud, position in the industry, sophistication and expertise in the financial business community, and knowledge of the related proceedings.[55] These duty conditioning factors are similar to the duty disclosing considerations of the flexible duty standard.[56] However, under the *McAlpine* approach, the defendant must give a full and accurate disclosure of his available information regardless of the sophistication of the plaintiff. This full disclosure requirement is more equitable and compatible with SEC enforcement actions than a variable standard. When due care is treated as an affirmative defense, the due diligence analysis is removed from the defendant's causation, and the defendant's prima facie liability is established before due diligence becomes an issue. This policy promotes flexibility, because the defendant's fraudulent conduct can be punished in an SEC enforcement action,[57]

---

brokers are allowed 90 days to investigate the irregularities, and during that time, the customer's trading account is to be frozen.

[51]434 F.2d at 104.

[52]*Id.* at 102.

[53]*Id.* at 104. The court noted the decision in Kuehnert v. Texstar Corp., 412 F.2d 700 (5th Cir. 1969), which held that affirmative defenses, such as *in pari delicto*, are available in rule 10b-5 actions and rest within the sound discretion of the court.

[54]*Id.* at 102-03.

[55]*Id.* at 102.

[56]*See* text accompanying note 18 *supra*.

[57]The court in Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974), recognized the possibility of separate public and private actions where different results could be reached.

but if the plaintiff's conduct also contributed to his injury, he will be denied recovery.

The only remaining aspect of the separate element approach to due diligence is to determine what level of due diligence will be required of the plaintiff. The *McAlpine* court concluded that a negligence standard would best serve the policy interests of rule 10b-5[58] and extended this duty to all aspects of the defendant's conduct. If the plaintiff's investigation was not reasonable, he would be denied recovery regardless of whether there had been misrepresentation or omission, negligent conduct by the defendant, or intentional misconduct.[59] This reasoning is interesting when compared with traditional tort law concepts where contributory negligence is a bar to recovery for a negligent but not an intentional misrepresentation.[60] By allowing a plaintiff's lack of due diligence to bar recovery where the defendant's conduct is intentional, the potential class of plaintiffs in rule 10b-5 actions will be more restricted than in common law deceit actions.

Some support for the *McAlpine* position can be found in *Rochez Bros. v. Rhoades*[61] in which the plaintiff-seller investigated the circumstances surrounding the purchase of his interest by his co-owner, the defendant. Despite a reasonable investigation, the plaintiff did not discover the facts that were intentionally omitted by the defendant.[62] The Third Circuit Court of Appeals required that the plaintiff must "fulfill a duty of due care in seeking to ascertain for himself the facts relevant to a transaction."[63] Under this particular fact situation, the court concluded that the plaintiff discharged his duty, but the court still discussed the due diligence issue notwithstanding the intentional conduct by the defendant.[64] This analysis suggests that the court would hold the duty of due diligence applicable to both intentional and negligent conduct.

In *Mitchell v. Texas Gulf Sulphur Co.*,[65] the court concluded that the defendants made intentional misrepresentations and knowingly omitted material facts.[66] The *Mitchell* court did not allow the plaintiff an unlimited amount of time to rely on the intentional misrepresentations and barred the plaintiff's recovery, because he

---

[58]434 F.2d at 104.

[59]*Id.*

[60]RESTATEMENT (FIRST) OF TORTS § 540 (1938); W. PROSSER, HANDBOOK OF THE LAW OF TORTS § 108 at 716 (4th ed. 1971).

[61]491 F.2d 402 (3d Cir. 1974), *cert. denied*, 425 U.S. 993 (1976).

[62]*Id.* at 408 n. 8.

[63]*Id.* at 409.

[64]*Id.* at 407-08.

[65]446 F.2d 90 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971).

[66]*Id.* at 102.

could not demonstrate due diligence.[67] Some courts do make the intentional/negligent distinction, and the court in *Carrol v. First National Bank of Lincolnwood*[68] strictly followed the tort analogy. In *Carroll*, a rule 10b-5 claim was based on the defendant-bank's alleged fraudulent conspiracy for failing to make expedient payments and settlements of securities transactions. The delay in settlement enabled other participants in the scheme an opportunity to engage in short term speculation, using the plaintiff's funds. Through a motion to dismiss, the defendant attempted to assert the defense of contributory negligence based upon the plaintiff's careless handling of the securities sales. The court held that the defense of contributory negligence was not available where the complaint was founded on fraud rather than negligence.[69] These cases show the two extremes of the intentional/negligent distinction. Most courts have refused to explicitly discuss the intentional/negligent distinction, and consequently, decisions can often by interpreted as falling somewhere between the two extremes.[70]

The various approaches and standards used to implement the due diligence duty reflect the latitude the courts have used in rule 10b-5 cases. While the different theoretical approaches generally conclude that some duty of due diligence should exist, the recent Supreme Court case of *Ernst & Ernst v. Hochfelder*[71] has prompted a complete re-examination of the due diligence issue.

II. Recent Judicial Development of Due Diligence

The duty of due diligence is premised on reasonable investor conduct. The reasonable conduct concept is, in essence, a negligence standard.[72] Recently courts have started questioning the availability

---

[67] *Id.* at 103.

[68] 413 F.2d 353 (7th Cir. 1969), *cert. denied*, 396 U.S. 1003 (1970).

[69] *Id.* at 358. The court did not discuss the possible relevancy that a contributory negligence (due diligence) defense could have at trial. The court's narrow holding was that such a defense was not proper when asserted in a motion to dismiss. This court expressed a general unwillingness to accept a due diligence defense in fraud cases especially where the court could find no legislative mandate for such a limitation and the defendant offered no supporting case law.

[70] Before the Supreme Court's decision in Ernst & Ernst v. Hochfelder, 425 U.S. 185, *reh. denied*, 425 U.S. 986 (1976), liability in rule 10b-5 actions could be imposed on the defendant for negligent or intentional conduct. Therefore, there was little reason for courts to specifically decide if the defendant's conduct was, in fact, intentional. Complaints under rule 10b-5 that may have alleged intentional conduct were often decided in favor of liability once the court concluded that the conduct was at least negligent. Any due diligence discussion under these circumstances would not indicate whether the court indeed felt that due diligence and intentional conduct were compatible. *See* text accompanying notes 76-77 *infra* for a discussion of the scienter standard now required in rule 10b-5 cases.

[71] 425 U.S. 185, *reh. denied*, 425 U.S. 986 (1976).

[72] *See* note 70 *supra*.

of a negligence based due diligence defense where the defendant's liability cannot be imposed for mere negligence.

In *Hochfelder*, the Supreme Court eliminated the imposition of rule 10b-5 liability based on negligence.[73] The accounting firm of Ernst & Ernst contracted with the First Securities Company of Chicago to audit the firm's books and records. The president of First Securities perpetrated an intentional fraud by converting customers' escrow funds to his own use. In connection with their auditing function, Ernst & Ernst was required to file reports with the Securities and Exchange Commission.[74] The rule 10b-5 charge alleged that Ernst & Ernst aided and abetted the fraud be failing to utilize "appropriate auditing procedures."[75] Ernst & Ernst was charged with negligent conduct, and the plaintiffs conceded that there was no "existence of fraud or intentional misconduct on the part of Ernst & Ernst."[76] The Supreme Court held that the alleged negligent conduct by Ernst & Ernst was insufficient to maintain a rule 10b-5 action and established scienter as the appropriate standard for rule 10b-5 liability.[77] The Supreme Court characterized scienter as a mental state embracing an intent to deceive, manipulate, or defraud.[78] With scienter or intentional conduct now required in rule 10b-5 cases, several jurisdictions have reassessed their due diligence standards.

In *Straub v. Vaisman & Co.*,[79] the Third Circuit Court of Appeals became one of the first courts to reconsider the due diligence issue. The plaintiff, a sophisticated manager of a Eurpoean investment firm, purchased securities from the firm of Vaisman & Co. Vaisman and an employee, Charles Erb, had previous dealings with the plaintiff, and knowing of the plaintiff's desire to purchase a new stock issue, recommended the purchase of Loren Industry's Mark I offset

---

[73]425 U.S. at 193.

[74]SEC rule 17a-5, 17 C.F.R. § 240.17a-5 (1975), required that First Securities file annual reports of financial condition together with an accountant's opinion expressing that the reports were prepared under generally accepted auditing standards. Specifically included under "generally accepted auditing standards" is no authority to allow omissions of any procedures that independent accountants would ordinarily employ in the preparation of a similar audit. *Id.*

[75]425 U.S. at 190. The president of First Securities implemented a "mail rule," which provided that under any circumstances only he could open mail addressed to him at the firm. Such a procedure was an irregularity and should have been disclosed. The plaintiffs charged Ernst & Ernst with negligence for never having discovered this procedure. For a complete look at the fraudulent scheme at First Securities, *see* SEC v. First Securities Co., 463 F.2d 981 (7th Cir.), *cert. denied*, 409 U.S. 880 (1972).

[76]425 U.S. at 190.

[77]*Id.* at 193 n.12. The Supreme Court left open the possibility of reckless conduct being sufficient for civil liability under rule 10b-5. *See* text accompanying note 108 *infra*, for an illustration of reckless conduct sufficient to sustain rule 10b-5 liability.

[78]425 U.S. at 190.

[79]540 F.2d 591 (3d Cir. 1976).

stock. Vaisman and Erb told the plaintiff that the new stock issue would be offered at a price of four dollars per share. The purchased stock was not of new issue, and its market value per share was considerably less than four dollars. Vaisman and Erb also had inside information of the precarious financial condition and imminent bankruptcy of Loren, which they never revealed to the plaintiff. The plaintiff sued for relief under rule 10b-5, and the defendants pleaded lack of due diligence as a defense.[80] The *Straub* court first decided to treat due diligence as a separate element of the rule 10b-5 cause of action.[81] The court concluded that the *Hochfelder* decision prompted a change in the standard of due diligence and attempted to analyze due diligence using the common law tort analogy and public policy considerations.[82] The tort law similarity prompted the court to reason "that since intent to defraud is a necessary element of a 10b-5 action, the due care defense should be narrowly circumscribed."[83] The *Straub* court did not treat the tort law similarity as conclusive but instead "balanced the tort concepts with the public policies underlying the federal securities laws."[84] The court identified the applicable public policy as encouraging investor care in the marketplace and promoting an efficient market where fair dealing is encouraged.[85] The court balanced the competing tort concepts and policy considerations and imposed a burden on the plaintiff to act reasonably.[86] Presumably, this standard is somewhere between allowing a due diligence defense based on negligence to bar recovery and treating due care considerations as irrelevant. The *Straub* court held that the duty of due care should be flexible and allowed to vary with the particular circumstances of each case.[87] In a concession to tort law, the court narrowed the availability of the due diligence defense by reversing their previous burden of proof for due care.[88] The plaintiff was relieved of his affirmative duty to plead and prove due diligence, and the burden shifted to the defendant, who was required to raise the lack of due diligence as an affirmative defense and carry the corresponding burden of proof.[89] The flexible duty allows the plaintiff's standard of due diligence to vary with

---

[80] *Id.* at 596.

[81] *Id.* at 596-97. This approach is consistent with the earlier Third Circuit opinion in Rochez Bros. v. Rhoades, 491 F.2d 402 (3d Cir. 1974), *cert. denied*, 425 U.S. 993 (1976), where the court treated the duty of due care as a distinct element of rule 10b-5.

[82] 540 F.2d at 597.

[83] *Id.*

[84] *Id.*

[85] *Id.* at 598.

[86] *Id.* at 597.

[87] *Id.* at 597-98.

[88] *Id.* at 598.

[89] *Id.*

both the investor's status and the particular fact situation. Thus, a sophisticated investor may not be denied recovery based on a lack of due diligence if the particular circumstances were such that his access advantages were negated.[90] It is unclear exactly what standard is imposed by the *Straub* court. The court rejected a negligence standard[91] yet still required the plaintiff to act reasonably.[92] This subjective approach is somewhat confusing, but it gives the Third Circuit a workable standard by which to assess due diligence. In a typcial case, the defendant would be required to put due diligence in issue, then looking at all the available facts, the defendant would have to prove the plaintiff's conduct was unreasonable. It will be interesting to see how future Third Circuit decisions deal with this reasonableness requirement. The Third Circuit has limited the availability of the due diligence defense but is still willing to impose a duty of due diligence even where the defendant's conduct is clearly intentional.[93]

After the decision in *Straub*, the district court in *McLean v. Alexander*[94] apparently relaxed the availability of the due diligence defense. In *McLean*, the court charged the plaintiff with a duty of due diligence commensurate with his investor sophistication.[95] The court concluded that the scope of the inquiry should be what a similarly situated plaintiff "reasonably could or should have done under the circumstances."[96] The court's use of the "could or should have done" language seemed to suggest a negligence standard.[97]

The Tenth Circuit Court of Appeals drastically reduced the availability of the due diligence defense in *Holdsworth v. Strong*.[98]

---

[90]*Id. See, e.g.*, Holdsworth v. Strong, 545 F.2d 687 (10th Cir. 1976), *cert. denied*, 430 U.S. 955 (1977); Rochez Bros. v. Rhoades, 491 F.2d 402 (3d Cir. 1974), *cert. denied*, 425 U.S. 993 (1976); Stier v. Smith, 473 F.2d 1205 (5th Cir. 1973).

[91]540 F.2d at 597. The court rejects the neglience standard that was used in *McAlpine*, because it provides less remedial relief to the trusting investor than does the common law.

[92]*Id.* In deciding whether the plaintiff has acted reasonably, the court considers the following: The existence of a fiduciary relationship, the opportunity to detect the fraud, the sophistication of the plaintiff, the existence of long standing business or personal relationships, and the access to relevant information as all being worthy of discussion.

[93]The court characterized Vaisman's conduct as "wilful, wanton and reprehensible." *Id.* at 595.

[94]420 F. Supp. 1057 (D. Del. 1976).

[95]*Id.* at 1078.

[96]*Id.* at 1079.

[97]*Id.* The negligence standard was rejected in the Third Circuit by the *Straub* court. The *McLeon* court found it difficult to settle on a specific due diligence standard but still concluded that "in that uncharted land of knowing and reckless misconduct, defendant should be entitled to contest liability by asserting a due diligence defense." *Id.* at 1078.

[98]545 F.2d 687 (10th Cir. 1976), *cert. denied*, 430 U.S. 955 (1977).

There, the plaintiff sold his shares of a closely held corporation to the defendant. The plaintiff was a corporate insider, attorney, and accountant who had complete access to the corporate records and possessed a high degree of business expertise, but because of his trust in the defendant, rarely engaged in any management activities. The defendant intentionally misrepresented the financial condition of the company and indicated that the corporation would be unable to pay any dividends. Based on these misrepresentations, the plaintiff offered to sell his interest to the defendant. After learning the true condition of the corporation, the plaintiff filed suit under rule 10b-5, and the defendant's principal defense was that the plaintiff failed to exercise due diligence.[99] The *Holdsworth* court denied the application of due diligence and held that "where the liability of the defendant requires proof of intentional misconduct, the extraction of a due diligence standard becomes irrational and unrelated."[100] The court placed primary emphasis on the tort law analogy and reasoned that the *Hochfelder* decision brought the standards for rule 10b-5 liability very close to the standards applicable to the tort law offenses of deceit or intentional misrepresentation.[101] The *Holdsworth* court was also concerned that the use of a due diligence defense would unnecessarily limit the availability of the rule 10b-5 remedy. The court went so far as to suggest that if a plaintiff is required to prove that the defendant acted with scienter and at the same time prove that he acted with due diligence, recovery would only be possible in "extraordinary" cases.[102] The court was also concerned that the defendant could use the due diligence defense to shift the focus of blame from his own conduct to an innocent plaintiff and preclude recovery, because "the defendant would likely be able to demonstrate some lack of diligence on the part of the plaintiff."[103] This criticism of the due diligence defense may be unwarranted, because even in its most permissive application, the due diligence defense will only bar recovery for unreasonable conduct. Certainly some lack of due diligence will not bar recovery unless, under the totality of the circumstances, the plaintiff's conduct was unreasonable. The *Holdsworth* decision requires that the plaintiff use justifiable reliance.[104] However, this concept is tied up with notions of materiality and is designed to insure that the defendant's conduct was the proximate cause of the plaintiff's harm;[105] it is not the imposition of a duty of due care. The court concluded that if the

[99]*Id.* at 691.
[100]*Id.* at 692.
[101]*Id.* at 693.
[102]*Id.*
[103]*Id.*
[104]*Id.* at 694.
[105]*Id.* at 698.

plaintiff's conduct is to bar recovery, it should be gross conduct, somewhat comparable to that of the defendant.[106] Carrying through with the tort law standards, the *Holdsworth* case has all but eliminated a distinct due diligence defense in 10b-5 cases.

The Seventh Circuit Court of Appeals in *Sundstand Corp. v. Sun Chemical*[107] followed the *Holdsworth* logic and also limited the use of the due diligence defense. In *Sundstand*, the plaintiff brought a rule 10b-5 claim against the defendant, alleging "intentional or reckless" omissions and misrepresentations.[108] The court recognized that *Hochfelder* permitted a rule 10b-5 claim to be raised on recklessness.[109] The defendant attempted to avoid liability by asserting a lack of due diligence on the part of the plaintiff. The court responded by holding that the due diligence defense is not available in an intentional fraud case.[110] The *Sundstand* court apparently was secure in the *Holdsworth* reasoning and attempted no further independent due diligence analysis. The court also supported the *Holdsworth* reasoning that once reliance is shown based on the misrepresentations, that is sufficient to show a causal connection between the misrepresentations and the defendant's injury.[111] Apparently this is the extent of the plaintiff's duty unless his conduct is as culpable as that of the defendant.[112]

The Fifth Circuit Court of Appeals decided the *Hochfelder* decision was sufficient justification to modify their often-cited opinion in *Clement A. Evans & Co. v. McAlpine.*[113] In *Dupuy v. Dupuy,*[114] the court was faced with the classic insider case, as the parties were both brothers and partners in a joint real estate venture. The plaintiff was originally an active participant in the project but later became disenchanted and offered to sell his interest to his brother. During the subsequent negotiations, the defendant intentionally misrepresented the success prospects of the venture. Relying upon

---

[106]*Id.* at 693. Presumably, the due diligence defense would only be available as a *pari delicto* defense where the plaintiff knew the misrepresentation was false and still relied. *In pari delicto* is a common law equitable doctrine that prohibits recovery where a party substantially contributes to his own loss. Generally, the *in pari delicto* defense is given a narrow interpretation and precludes recovery only where the plaintiff's conduct is as culpable as that of the defendant. *See* Tarasi v. Pittsburgh Nat'l Bank, 555 F.2d 1152, 1156-57 (3d Cir. 1977).

[107]553 F.2d 1033 (7th Cir.), *cert. denied*, 98 S.Ct. 225 (1977).

[108]*Id.* at 1039.

[109]*Id.* at 1039-40. *See, e.g.*, Sanders v. John Nuveen & Co., Inc., 554 F.2d 790 (7th Cir. 1977); Herzfeld v. Laventhol, Krekstein, Horwath & Horwath, 540 F.2d 27 (2d Cir. 1976).

[110]553 F.2d at 1040.

[111]*Id.*

[112]*Id.* at 1048 (quoting Holdsworth v. Strong, 545 F.2d at 693).

[113]434 F.2d 100 (5th Cir.), *cert. denied*, 402 U.S. 988 (1970).

[114]551 F.2d 1005 (5th Cir.), *cert. denied*, 98 S.Ct. 312 (1977).

these misrepresentations, the plaintiff sold his interest to the defendant at a shockingly low price.[115] The plaintiff sued for damages under rule 10b-5, and the defendant denied liability partially based on the plaintiff's failure to exercise due care.[116]

The trial court jury followed the *McAlpine* procedure and examined the due diligence issue as a separate element in rule 10b-5 and concluded that the plaintiff had exercised due diligence. The trial judge granted the defendant's motion for a judgment notwithstanding the verdict and held that there was no evidence of due care on the part of the plaintiff.[117] The Fifth Circuit Court of Appeals overturned the trial court and examined the due diligence issue. The court first discussed how the due diligence analysis was to be structured. The court affirmed the methodology of keeping the due diligence issue as a separate element in rule 10b-5 cases.[118] The court identified the policy that a due diligence requirement promoted the general equitable principle that only those who have pursued their own interests in good faith should qualify for a rule 10b-5 remedy.[119] The court also reasoned that to require plaintiffs to exercise due care in the investment market promotes the anti-fraud policies of rule 10b-5.[120] The due diligence approach was to be judged subjectively,[121] and the duty was also to be imposed on the basis of particular plaintiff's attributes rather than conditioning the duty on the abilities of the reasonable investor.[122] The court noted that the *McAlpine* reasonableness/negligence standard was set out prior to the *Hochfelder* decision, and concluded that the new standard for due diligence imposed on the plaintiff should be no more rigorous than that which is imposed on the rule 10b-5 defendant.[123] Since recklessness is the minimum level of culpability that imposes liability on a rule 10b-5 defendant, the due diligence standard should also be conditioned on recklessness.

Under this post-*Hochfelder* due diligence framework, the plaintiff's conduct must be examined to determine whether he "intentionally refused to investigate in disregard of a risk known to him or

---

[115]The plaintiff sold his interest for $10,000 and the court awarded damages based on an appraised value of his interest of $905,000.

[116]*Id.* at 1007.

[117]*Id.*

[118]*Id.* at 1014.

[119]*Id. See, e.g.*, Clement A. Evans & Co. v. McAlpine, 434 F.2d 100, 104 (5th Cir.), *cert. denied*, 402 U.S. 988 (1970); City Nat'l Bank v. Vanderboom, 422 F.2d 221, 230 (8th Cir.), *cert. denied*, 399 U.S. 905 (1970).

[120]551 F.2d at 1016.

[121]*Id.*; Straub v. Vaisman & Co., 540 F.2d 591, 598 (3d Cir. 1976); Clement A. Evans & Co. v. McAlpine, 434 F.2d 100, 102 (5th Cir. 1970), *cert. denied*, 402 U.S. 988 (1970).

[122]551 F.2d at 1014.

[123]*Id.* at 1020.

so obvious that he must be taken to have been aware of it, and so great as to make it highly probable that harm would follow."[124] This standard falls between the reasonable standard imposed in *Straub v. Vaisman*[125] and the strict limitation which was imposed in *Holdsworth v. Strong*.[126] The *Dupuy* court discussed the tort analogy and noticed the similarities between the policies underlying the common law and the policies applicable to rule 10b-5. Tort law seeks to prevent intentional misconduct and rule 10b-5 specifically seeks to deter manipulative and deceptive practices in the securities market.[127] The lack of legislative history on the policy of promoting investor care is used by the court to conclude that the policy to deter fraudulent conduct is paramount.[128] This reasoning is not conclusive, because rule 10b-5 was enacted as an enforcement procedure[129] and thus the bulk of legislative discussion would naturally be centered on that topic. In addition, under the *Dupuy* approach, a defendant could be liable under an SEC enforcement proceeding and still not be subject to civil liability. The policy of deterring fraudulent conduct does not exclude the policy of promoting investor care because of the unique two step availability of both public and private applications of rule 10b-5. The *Dupuy* court also concluded that the need for further limiting of the rule 10b-5 remedy after *Hochfelder* is questionable.[130] As a final argument, the court reasoned that the history of rule 10b-5 cases is consistent with the distinction between negligent and intentional misrepresentations.[131] This argument is not persuasive when viewed with the early rule 10b-5 cases.[132] The *Dupuy* standard of due diligence represents a compromise between tort law analysis and the public policies underlying rule 10b-5. This compromise limits the availability of the due diligence defense but still holds plaintiffs accountable for their conduct when they have acted recklessly.

---

[124]*Id.* (quoting W. PROSSER, HANDBOOK OF THE LAW OF TORTS, § 34 at 185 (4th ed. 1971)).

[125]540 F.2d 591 (3d Cir. 1976) (reasonableness standard used).

[126]545 F.2d 687 (10th Cir. 1976), *cert. denied*, 430 U.S. 955 (1977) (gross or intentional standard used).

[127]551 F.2d at 1019; Ernst & Ernst v. Hochfelder, 425 U.S. at 206.

[128]551 F.2d at 1019.

[129]*Id.* at 1013; Rochez Bros., Inc. v. Rhoades, 491 F.2d 402, 406 (3d Cir. 1973), *cert. denied*, 425 U.S. 993 (1976).

[130]551 F.2d at 1019.

[131]*Id.*

[132]The only two cases that specifically recognize the distinction are Carroll v. First Nat'l Bank, 413 F.2d 353 (7th Cir. 1969), *cert. denied*, 396 U.S. 1003 (1970), and Fershtman v. Schectman, 450 F.2d 1357 (2d Cir. 1971), *cert. denied*, 405 U.S. 1066 (1972) (recognized that common law limits would probably apply to rule 10b-5). *See* text accompanying notes 58-67 *supra* for a discussion of cases that do not make the negligent/intentional distinction.

The Second Circuit has not been compelled to follow the lead of the other circuits in limiting the due diligence defense. The court in *Hirsch v. du Pont*[133] was concerned that the elimination of the due diligence defense would allow rule 10b-5 to become an insurance policy for defrauded investors. In *Hirsch*, the plaintiffs were engaged in a series of complex negotiations that eventually led to the merger of the brokerage house of Hirsch & Co. with F.I. du Pont. During these merger discussions, F.I. du Pont was already in serious financial trouble.[134] A surprise audit by du Pont's accountants revealed that du Pont had not complied with the net capital rule[135] that was required by the New York Stock Exchange.[136] This distressing financial information was available from public records of the SEC. The plaintiffs charged that the accountants and the New York Stock Exchange had violated rule 10b-5 by not revealing this information. The court found no liability, holding that there was no duty to

---

[133]553 F.2d 750 (2d Cir. 1977).

[134]In the late 1960's and early 1970's, many brokerage houses experienced some degree of financial difficulty. The tremendous trading of securities in the mid-1960's bull market created a large backlog of paperwork and many improperly recorded transactions. Many brokerage houses found themselves with large short and long security count differences. Against this disorganized framework, the market began a steady decline in 1969, which caused large losses and subsequent withdrawals of capital. As brokerage houses found themselves unable to cover their short term capital requirements, they often attempted to merge with other brokerage houses to provide a new influx of capital. *See Study of the Securities Industry Crisis in the Securities Industry, A Chronology - 1967-1970* (N.Y.S.E. Report), *reprinted in Hearings before the Subcomm. on Commerce and Finance*, 92d. Cong., 1st Sess. 14 (1971).

[135]The "net capital rule," 17 C.F.R. § 240.15c3-1(a) (1976), was designed to insure brokers and dealers maintained a sufficient amount of liquid assets to protect customers' accounts. This is accomplished by requiring the broker's aggregate indebtedness not to exceed 2,000% of net capital. Aggregate indebtedness is the broker's total monetary liabilities adjusted for any liabilities specifically excluded. Net capital is the net worth adjusted downward by subtracting out those fixed liabilities that cannot become an immediate charge on capital. *Id.* at § 240.15c3-1(c)(2). By complying with the "net capital rule," a broker should have sufficient liquid assets to meet any short term charges on capital. *See Guy D. Marianette*, 11 S.E.C. 967 (1942). For a complete discussion of the net capital rules, *see* Wolfson and Guttman, *The Net Capital Rules for Brokers and Dealers*, 24 STAN. L. REV. 603 (1972).

[136]553 F.2d at 754. On September 28, 1969, the accountant's audit of F.I. du Pont indicated that the ratio of aggregate indebtedness to net capital was over 3,000%, which represented a capital deficiency of approximately $6,800,000. Du Pont also had short count differences of $7,000,000 and long count differences of $30,000,000. *Id.* Securities count differences often occur from the improper recording of securities transactions, which then causes a discrepancy between the actual physical inventory of securities and the records. A short count difference occurs where the broker is unable to locate securities that are recorded as belonging to a customer. Where there are securities on hand whose owners cannot be determined, a long count difference occurs. The short count differences represent a potential immediate charge on capital. *Id.* at 754 n.5.

disclose the information and that the information was available to the plaintiffs "upon the exercise of due diligence to procure it."[137]

The *Hirsch* court placed more weight on the policy of promoting investor care and concluded that an imposition of a negligence based due diligence standard was justified: "The securities laws were not enacted to protect sophisticated businessmen from their own errors in 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."[138]

The Second Circuit accepts a negligence based duty of due diligence and is not persuaded by the decisions in the other circuits. In *NBI Mortgage Investment Corp. v. Chemical Bank*,[139] the court acknowledged other decisions that have limited due diligence, but reaffirmed the Second Circuit's position: "Despite the Tenth Circuit's decision in *Holdsworth v. Strong*, a post-*Hochfelder* decision, the standard of due diligence is still viable and accepted in this circuit."[140]

The district court in *Holmes v. Bateson*[141] declined to adopt a specified due diligence standard, concluding that the plaintiff's conduct satisfied both the due diligence standard used in *Dupuy* and the justifiable reliance approach that was used in *Rogen v. Ilikon Corp.*,[142] a 1966 vintage case.[143]

III. Justifications for Due Diligence

Before an attempt can be made to define a workable standard for due diligence in post-*Hochfelder* cases, it must be determined to what extent the common law tort distinction between negligent and intentional conduct is applicable to rule 10b-5. If the common law tort analogy is to be given conclusive weight, it is apparent that the due diligence defense must be severely restrained or even eliminated.

The common law has developed a formidable rule that the carelessness of the injured plaintiff is not a defense to the intentional conduct of the defendant.[144] The common law has retained this position of distinction despite some calls for relaxation of the hard

---

[137] *Id.* at 753.

[138] *Id.* at 763.

[139] [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,066 (S.D.N.Y. 1977).

[140] *Id.*

[141] [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,228 (D.R.I. 1977).

[142] 361 F.2d 260 (1st Cir. 1966).

[143] [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,228 (D.R.I. 1977).

[144] Restatement (First) of Torts § 540 (1930).

and fast rule.[145] While common law analogies are useful in defining the scope of rule 10b-5, they are not determinative.[146] Some courts have expressly rejected the notion that any one aspect of common law fraud controls recovery under rule 10b-5.[147] Although the common law tort of deceit and rule 10b-5 actions do have some similarities, they definitely do not accomplish the same objectives. Rule 10b-5 has two components: Deterrence of fraudulent conduct through SEC enforcement proceedings, and the compensation of defrauded plaintiffs through the private action.[148] Thus, the SEC specifically precludes the plaintiff from recovering punitive damages in rule 10b-5 cases,[149] while at common law, an intentional misrepresentation may give rise to the recovery of punitive damages.[150] The Supreme Court has held that the implied private actions under federal securities laws seek to compensate victims of stock fraud and thereby promote the public objectives of the act.[151] In rule 10b-5 cases, the existence of the private remedy is explicitly tied into the promotion of the applicable rule 10b-5 policies. As previously discussed, one of the principal policies of rule 10b-5 is to promote investor care and thus encourage stability in the marketplace.[152] The imposition of a due diligence defense is one of the best ways to promote investor care in the marketplace. The defendant is constrained by the enforcement potential of rule 10b-5, and the plaintiff realizes he must exercise due diligence if he is ever to be in a position to be compensated under rule 10b-5. If the common law distinction is allowed to remain, the defendant's conduct is constrained while the plaintiff has no such limitation. More importantly, if the common law distinction is given controlling significance, rule 10b-5 will become analogous to the tort of deceit. Thus, the judiciary will have created a statutory federal common law cause of action with all the advantages of nationwide service

---

[145] RESTATEMENT (SECOND) OF TORTS § 540, (Tent. Draft no. 11, 1965), called for a rule that precluded recovery in the intentional misrepresentation case where the plaintiff has either knowledge of the facts or has reason to know of facts that would make his reliance unreasonable. This change was rejected in 42 ALI PROCEEDINGS 331 (1965).

[146] Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, *reh. denied*, 423 U.S. 884 (1975).

[147] White v. Abrams, 495 F.2d 724 (9th Cir. 1974); Clement A. Evans & Co. v. McAlpine, 434 F.2d 100 (5th Cir. 1970), *cert. denied*, 402 U.S. 988 (1971); Carroll v. First Nat'l Bank, 413 F.2d 353 (7th Cir. 1969), *cert. denied*, 396 U.S. 1003 (1970).

[148] J.I. Case Co. v. Borak, 377 U.S. 426 (1964).

[149] The Securities and Exchange Act, 15 U.S.C. § 78(b) (1970), limits the amount recoverable to actual damages.

[150] W. PROSSER, HANDBOOK OF THE LAW OF TORTS, § 110, at 736 (4th ed. 1971).

[151] J.I. Case Co. v. Borak, 377 U.S. 426, 432-35 (1963).

[152] Dupuy v. Dupuy, 551 F.2d 1005 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977); Straub v. Vaisman & Co., 540 F.2d 591 (3d Cir. 1976).

and relaxed federal rules of evidence. If the federal standards of recovery and the common law standards of recovery were to be identical, there appears to be no need to imply the broad federal remedy.

The tort law distinction does not seem so compelling when the compensation of the plaintiff is linked to the public objectives of the federal securities laws. When the tort law is balanced with the public policy considerations, a duty of due care seems justified.

The private right to recover under rule 10b-5 is conditioned on judicial decisions, and thus, the courts should not be hesitant in also defining the limits of permissible recovery. The Supreme Court has said that it is dealing with "a private cause of action [under rule 10b-5] which has been judicially found to exist, and which will have to be judicially delimited one way or another unless and until Congress addresses the question."[153] Courts are free to condition recovery in any manner they wish. Turning to the most basic principle, equity would favor the imposition of a duty of due diligence. The equitable maxim that one must do equity to get equity suggests that we should not permit recovery to a plaintiff whose own conduct has contributed to his injury. The next logical place to look for sources of implied defenses is in the policy objectives behind the legislation. As discussed previously, rule 10b-5 has a two-fold aspect in that it seeks to deter fraudulent conduct and to promote investor care in the marketplace. The SEC enforcement proceeding takes care of the fraudulent conduct, and the requirement of a duty of due care will be the most practical method to insure that all investors are governed by some code of conduct. What must be emphasized is that the imposition of a due diligence duty will not burden the prudent investor. The reasonable investor transacts his business in a way that would never preclude his recovery under rule 10b-5; it was the prudent investor that Congress sought to protect from the manipulative and deceptive practices that are actionable under rule 10b-5.[154] One common objection to the establishment of a due diligence defense is that it would limit the number of plaintiffs entitled to recover under rule 10b-5. One court perceived that the due diligence defense would lead to rule 10b-5 recovery only in extraordinary cases,[155] making the unwarranted assumption that the majority of investors are unreasonable. Under any standard, the reasonable investor will never by prevented from recovering by the due diligence

[153]Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 749, *reh. denied*, 423 U.S. 884 (1975).

[154]Wheeler, *supra* note 6, at 587.

[155]*See* Straub v. Vaisman & Co., 540 F.2d 591 (3d Cir. 1976) discussed in text accompanying notes 79-93 *supra*.

defense. Thus, in a restrictive due diligence framework, a fraudulent defendant could not escape rule 10b-5 liability if a plaintiff was merely negligent, and the supplemental enforcement effect of a private rule 10b-5 remedy would remain viable.[156]

Although rule 10b-5 was enacted as an enforcement procedure and thus does not speak of a policy of due diligence,[157] the Supreme Court has noted that section 10b must be read flexibly and not restrictively.[158] In some private remedies under securities laws, Congress has explicitly defined what conduct by the plaintiff will bar recovery.[159] Section 10b has no such limitation, and in some activities the SEC has often impliedly required an exercise of due care to maintain an acceptable level of conduct and help insure the efficiency of the immense securities marketplace.[160] Finally, if a duty of due care is not imposed, a whole range of conduct which may technically not exclude recovery under rule 10b-5, but which obviously has no place in the securities market, will not be deterred.

The Supreme Court in *Blue Chip Stamps v. Manor Drug Stores*[161] has noted that policy considerations are to be given a good deal of weight in rule 10b-5 cases.[162] With the tort policies not clearly demanding a serious restriction on the availability of a due diligence defense and policy factors weighing heavily in favor of due diligence, it seems reasonable to conclude that some form of due diligence should be required. However, given the impact of the *Hochfelder* decision, the due diligence defense must move beyond a simple negligence standard. The Supreme Court has stated that one of the most important purposes of federal securities laws is to "substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus achieve a high standard of business ethics in the securities industry."[163] Retaining a restrictive due diligence defense is consistent with this objective.

---

[156]The implied private remedy under rule 10b-5 was created to compensate victims and not punish the violators. *See* Herpich v. Wallace, 430 F.2d 792, 804 (5th Cir. 1970). However, the deterrent or *in terrorem* effect of a private rule 10b-5 remedy has long been recognized. *See* Globus v. Law Research Service Inc., 418 F.2d 1276, 1288 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970). Thus, the private rule 10b-5 remedy serves as a necessary supplement to SEC enforcement proceedings. 430 F.2d at 804.

[157]Freeman, *Administrative Procedures*, 22 Bus. Law. 891, 922 (1967).

[158]Superintendant of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 12 (1971).

[159]*See, e.g.*, Securities and Exchange Act of 1934, § 18(a), 15 U.S.C. § 78r (1976); Securities Act of 1933, § 11(a), 15 U.S.C. § 77k (1976), which will deny recovery to a plaintiff who had actual knowledge.

[160]Securities and Exchange Commission Rule 10a-2, 17 C.F.R. § 240, 10a-2 (1977) (due diligence in covering purchases); Securities and Exchange Commission Rule 15b10-9, 17 C.F.R. § 240.15b10-9 (1977) (due diligence required in maintaining broker-dealer distinction in traded securities).

[161]421 U.S. 723 (1975).

[162]*Id.* at 737.

[163]SEC v. Capital Gains Research Bureau, 375 U.S. 180, 186 (1963).

IV. A Workable Due Diligence Application

Once it is accepted that some form of due diligence should be retained, it is necessary to identify a rational standard that can be applied to the diverse fact situations commonly found in rule 10b-5 cases. Consideration has been given to the basic theories courts have used in justifying the imposition of a due diligence defense and found most unsatisfactory. The only workable solution is to treat due diligence as a separate element of the rule 10b-5 cause of action.

The first step in the due diligence analysis is to decide in what manner the standard is to be imposed. This is best accomplished through the use of a two-step process. The first step is to classify the investor according to his particular level of sophistication; thus, it becomes possible to determine the minimum level of due care that will be required. This minimum level of investigation is essential to the due diligence analysis. Investors can best be grouped as corporate insiders, professional investors, sophisticated investors, and unsophisticated investors.

A. *The Corporate Insider*

Logically, the corporate insider should be held to the highest minimum level of due care. The court in *Myzel v. Fields*[164] held that an individual's corporate status could classify him as an insider as a matter of law.[165] However, in general, a corporate insider has special access to information that dictates a greater degree of care.[166] The corporate insider has generally been held accountable for what could be ascertained from the corporate books and records,[167] what transpired at corporate meetings,[168] and any other specific information that was made available because of his insider status.[169] The corporate insider should also demonstrate a familiarity with the workings of the company and a higher degree of business expertise.[170] Finally, the corporate insider must use extreme care when he deals with other individuals of a lesser level of expertise.[171] These criteria

---

[164]386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968). The court in Harnett v. Ryan Homes, 496 F.2d 832 (3d Cir. 1974), went so far as to hold that insiders could not recover from each other.

[165]386 F.2d at 718. *See also* Kohler v. Kohler Co., 319 F.2d 634 (7th Cir. 1963).

[166]Kohler v. Kohler Co., 319 F.2d 634 (7th Cir. 1963); Jackson v. Oppenheim, 411 F. Supp. 659 (S.D.N.Y. 1974), *aff'd on other grounds*, 533 F.2d 826 (2d Cir. 1976).

[167]Niedermeyer v. Niedermeyer, [1973 Transfer Binder] Fed. Sec. L. Rep. ¶ 94,123, at 501 (D. Ore. 1973).

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

[169]Hirsch v. du Pont, 553 F.2d 750 (2d Cir. 1977).

[170]Kohler v. Kohler Co., 319 F.2d 634 (7th Cir. 1963).

[171]Jackson v. Oppenheim, 411 F. Supp. 659 (S.D.N.Y. 1974), *aff'd on other grounds*, 533 F.2d 826 (2d Cir. 1976).

are useful in establishing the minimum level of care that should be exercised by insiders, but the corporate insider will not automatically be denied recovery where his conduct does not meet this level of care. If there are particular circumstances that diminish the corporate insider's effective access to information, he will not be held accountable. However, when there are no mitigating circumstances the insider should be held to this minimal level of diligence.

B. The Professional Investor

The professional investor can be defined as an individual whose frequent market participation gives him significant knowledge and financial expertise. Professional investors may be stock brokers and other investors who have large portfolios and thus are heavy traders. The professional investor should be held responsible for all published company financial data.[172] A professional investor should also be denied recovery where he "recklessly enters a speculative transaction"[173] or where he disregards accepted business practices.[174] He should have a good working knowledge of the operation of the securities markets[175] and a reasonable knowledge of business and financial matters in general. The court in *Vors v. Dickenson*[176] held that a plaintiff, whose status was that of a professional investor,[177] had discharged her duty of due care by gathering available financial data and discussing the general financial condition of the company with insiders.[178] However, the professional investor should not be held responsible for knowledge that is possessed by insiders, is not revealed, and is not readily ascertainable, or for information that is supplied by insiders that cannot be independently verified with reasonable effort.[179]

C. The Sophisticated Investor

A sophisticated investor can be classified as having some investment experience and an above average knowledge of financial and business matters. The sophisticated investor should also com-

---

[172]Lane v. Midwest Bancshares Corp., 337 F. Supp. 1200, 1210 (E.D. Ark. 1972).

[173]Clement A. Evans & Co. v. McAlpine, 434 F.2d 100 (5th Cir.), *cert. denied*, 402 U.S. 988 (1970).

[174]*Id.*

[175]495 F.2d 607 (5th Cir. 1974).

[176]The plaintiff bought stock in a company where she was employed as an engineer; she had previous banking experience and actively traded a personal stock portfolio with a market value in excess of $200,000.

[177]495 F.2d at 623.

[178]Lehigh Valley Trust Co. v. Central Nat'l Bank, 409 F.2d 989 (5th Cir. 1969).

[179]McCormick v. Esposito, 500 F.2d 620 (5th Cir. 1974), *cert. denied*, 420 U.S. 912 (1975); Gordon v. du Pont Glore Forgan Inc., 487 F.2d 1260 (5th Cir. 1973), *cert. denied*, 417 U.S. 946 (1974).

prehend routine investment procedures and be aware of routinely available information. An investor with experience should be knowledgeable in the operation of declarations of dividends and margin requirements and thus should not be permitted to recover on a claimed lack of knowledge of these procedures.[180] A sophisticated investor has also been held responsible for the terms of a redeemable convertible debenture.[181] A sophisticated investor should be able to attach significance to corporate records and public disclosures and act accordingly.[182]

D. *The Unsophisticated Investor*

Even the unsophisticated investor has a minimum level of due care; however, the duty will be conditioned more heavily on the specific information available rather than the reasonableness or diligence of his conduct. Where information is easily obtainable and the plaintiff knows of its existence, he must act to discover the information.[183] For example, an unsophisticated investor should be able to attach significance to an article that describes the shaky financial condition of a company.[184] While the unsophisticated investor has no special expertise, any individual investing in the stock market should be able to read newspaper price quotations and follow price fluctuations.[185]

The second step in determining the level of care is to scrutinize the particular circumstances that are present. Rarely will an investor fit into one of the neat categories outlined above, but rather, the specific facts dictate elevating or reducing the minimum level of due care. Depending on the significance of the particular facts, the standard of the duty of due care may be altered completely. Some factors that have been considered important are: Special trading expertise,[186] inducement by the defendant to enter the transaction,[187] existence of a fiduciary relationship,[188] concealment of the fraud,[189]

---

[180]Hafner v. Forest Laboratories, Inc., 345 F.2d 167 (2d Cir. 1965).

[181]Kaplan v. Vornado, Inc., 341 F. Supp. 212 (N.D. Ill. 1971).

[182]Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971).

[183]Arber v. Essex Wire Co., 490 F.2d 414 (6th Cir.), *cert. denied*, 419 U.S. 830 (1974).

[184]Phillips v. Reynolds & Co., 294 F. Supp. 1249 (E.D. Pa. 1969).

[185]*See, e.g.*, Hupp v. Gray, 500 F.2d 993 (7th Cir. 1974); Hafner v. Forest Laboratories, Inc., 345 F.2d 167 (2d Cir. 1965); Ferland v. Orange Groves of Florida, Inc., 377 F. Supp. 690 (M.D. Fla. 1974).

[186]Fey v. Walston & Co., 493 F.2d 1036 (7th Cir. 1974).

[187]White v. Abrams, 495 F.2d 724 (9th Cir. 1974); Hafner v. Forest Laboratories, Inc., 345 F.2d 167 (2d Cir. 1965).

[188]Holdsworth v. Strong, 545 F.2d 687 (10th Cir. 1976), *cert. denied*, 430 U.S. 955 (1977); Rogen v. Ilikon Corp., 361 F.2d 260 (1st Cir. 1966).

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

opportunity to detect the fraud[190] and general sophistication and expertise in the financial community.[191]

To illustrate the importance that the particular factors often involve, consider the situation of a corporate insider who relies on the trust of a fiduciary relationship and lacks any opportunity to detect the fraud. The insider should not be held to have violated the duty of due diligence despite his level of sophistication.[192]

With intentional conduct now being required of the defendant to generate rule 10b-5 liability, the particular fact situations are often such that the defendant's conduct has vitiated the plaintiff's opportunity to exercise due diligence. If the court focuses on the particular fact situations, it will limit the availability of the due diligence defense, but the clearly unreasonable plaintiff will be denied recovery. This limitation will bring the due diligence defense in closer harmony with the tort rationale, yet a clear and workable standard of due diligence will survive. Such an approach will give the plaintiff the benefit of the defendant's intentional conduct and still promote general equitable principles, which suggest that the plainitff should act reasonably.

V. Conclusion

The different judicial treatments of due diligence point up the need for uniform standards in this area. The present conflict among the circuits on the applicability of the due diligence defense will cause uncertainty and inefficiency in the investment market. The problem has become more acute as a result of the divergence between the Tenth, Seventh, and Second Circuits. The Fifth and Third Circuits fall somewhere between the two extremes, with the other Circuits remaining free to follow the other circuits or to develop their own standards.

The Supreme Court has recently declined to resolve the issue and denied certiorari in *Dupuy v. Dupuy*.[193] Justice White dissented from the denial of certiorari and outlined some of the conflicts that exist among the circuits. He indicated that securities litigation can be complex and expensive; consequently, there is a need for clarification of the ground rules.[194] This is but one of the reasons why the Supreme Court should resolve this conflict. Perhaps as im-

---

[190]Holdsworth v. Strong, 545 F.2d 687 (10th Cir. 1976), *cert. denied*, 430 U.S. 955 (1977); Straub v. Vaisman & Co., 540 F.2d 591 (3d Cir. 1976); Rochez Bros. v. Rhoades, 491 F.2d 402 (3d Cir. 1974), *cert. denied*, 425 U.S. 993 (1976).

[191]Bird v. Verry, 497 F.2d 112 (5th Cir. 1974).

[192]Holdsworth v. Strong, 545 F.2d 687 (10th Cir. 1976), *cert. denied*, 430 U.S. 955 (1977).

[193]Dupuy v. Dupuy, 551 F.2d 1005 (5th Cir.), *cert. denied*, 434 U.S. 411 (1977).

[194]434 U.S. at 411-12.

portant is the fact that in order for the securities market to run efficiently, there must exist an identifiable code of conduct. If the judiciary is going to imply a private remedy under rule 10b-5, the standards should be clearly enumerated. The availability of a due diligence defense will often determine the outcome of a rule 10b-5 action, and this prospect of success should not be contingent upon the particular circuit in which the law suit is filed.

Lex L. Venditti