Washington and Lee Law Review

Volume 41 | Issue 3 Article 5

Summer 6-1-1984

Oral Misrepresentations at "Roadshows" and In Other Settings: Illusory Liability Under Rule lOb-57

NOTES

ORAL MISREPRESENTATIONS AT "ROADSHOWS" AND IN OTHER SETTINGS: ILLUSORY LIABILITY UNDER RULE 10b-5?

Congress enacted the Securities Act of 1933[1] ('33 Act) and the Securities Exchange Act of 1934[2] ('34 Act) to provide the investing public with adequate information to make informed investment decisions.[3] The '33 and '34 Acts reflect Congress' desire to protect the investor by requiring the effective disclosure of material facts relevant to the sale of a security.[4] Specifically,

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1. 15 U.S.C. §§ 77a-77aa (1982).

2. 15 U.S.C. §§ 78a-78kk (1982).

3. *See* SEC Securities Act Release No. 3844 (Oct. 8, 1957) (basic purpose of Securities Act of 1933 ('33 Act) and Securities Exchange Act of 1934 ('34 Act) is distribution of adequate and accurate information and periodic updating thereof concerning public issuers and securities to create and maintain informed trading market); 1 L. Loss, SECURITIES REGULATION 130-31 (2d ed. 1961) (outlining purposes of '33 and '34 Act); *see also infra* note 4 (legislative history and goals of '33 and '34 Acts).

4. *See* S. REP. No. 47, 73d Cong., 1st Sess. 1 (1933), *reprinted in* 2 J. ELLENBERGER & E. MAHAR, LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934, item 17 (1973) (Congress passed '33 Act to give investor access to all material facts regarding securities offerings); H.R. REP. No. 85, 73d Cong., 1st Sess. 1-5 (1933), *reprinted in* 2 J. ELLENBERGER & E. MAHAR, *supra* item 18 (Congress imposed registration and prospectus requirements under '33 Act to eliminate pressure tactics in securities sales and to inform buyers of material information about issue of security); *see also* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 752-53 (1975) (primary goal of '33 Act is disclosure of essential information about security); 1 L. Loss, *supra* note 3, at 178 (aim of Congress in passing '33 Act was to inform and protect investors while encouraging honest enterprise).

Congress intended the '34 Act to protect the investor by requiring companies that issue securities traded on any national securities exchange to report information the Securities and Exchange Commission (SEC or Commission) deems necessary to safeguard the public interest. *See* Securities Exchange Act of 1934, §§ 9, 10, 15 U.S.C. §§ 78i, 78j (1982); S. REP. No. 792, 73d Cong., 2d Sess. 1-5 (1934), *reprinted in* 5 J. ELLENBERGER & E. MAHAR, *supra*, item 17 [hereinafter cited as S. REP. No. 792]. The '34 Act serves the dual purpose of protecting the investing public and instilling confidence in free and honest securities markets by penalizing unfair transactions. *See* S. REP. No. 792, *supra*, at 1-5; Shores v. Sklar, 647 F.2d 462, 470 (5th Cir. 1981) (en banc), *cert. denied*, 455 U.S. 936 (1982); *see also* Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972) (primary purpose of '34 Act is to replace philosophy of *caveat emptor* with philosophy of complete disclosure to prevent fraud and protect investors). Congress' ultimate goal was the prevention of fraudulent and deceptive practices that might harm the investing public. *See* S. REP. No. 792, *supra*, at 12-13. Since the purpose of the '33 and '34 Acts was to provide information to persons engaging in securities transactions, a subordinate goal that courts infer from the securities laws is that Congress intended the Acts to protect only the careful investor who avails himself of the information mandated by the statutory scheme. *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, 587 (1975) (Congress intended securities laws for protection of careful investor).

the '33 Act requires an issuing company to register with the Securities and Exchange Commission (SEC or Commission) any security that an issuer offers to the public via the means of interstate commerce, unless a registration exemption for the offering exists under the Act.[5] Under the terms of the '33 Act, the issuer of a registered security also must give any purchaser a prospectus containing essential information embodied in the registration statement.[6] The '33 and '34 Acts impose liability for material misrepresentations or omissions made by an individual in the course of a transaction resulting in the acquisition or sale of a security.[7] Most securities are sold through the oral representations of a salesman rather than through a prospectus.[8] Officials of the issuing company, underwriters, or others involved in the distribution of a security, therefore, may face a significant potential for liability under the securities laws for oral misrepresentations made during the course of a "roadshow"[9] or other sales contact with potential purchasers.

One provision of the securities laws that may establish civil liability for

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5. *See* Securities Act of 1933, §§ 3, 4, 5, 15 U.S.C. §§ 77c, 77d, 77e (1982) (registration requirement and statutory exemptions from registration).

6. Securities Act of 1933, § 5(b)(2), 15 U.S.C. § 77e(b)(2) (1982) (unlawful to sell or deliver security unless prospectus accompanies or precedes such security).

7. *See* Securities Act of 1933, §§ 11, 12(2), 15 U.S.C. §§ 77k, 77*l*(2) (1982) (civil liability provisions for material misstatements or omissions); Securities Exchange Act of 1934, § 10(b), 15 U.S.C. § 78j(b) (1982) (unlawful to use any manipulative or deceptive device or contrivance in violation of SEC rules); *see also infra* notes 10-11 (legislative history of § 10(b) and SEC rule 10b-5); Note, *Conflict Resolved: An Implied Remedy Under § 10b of the '34 Act Survives Despite The Existence of Express Remedies*, 40 WASH. & LEE L. REV. 1039, 1067 (1983) (congressional goal of deterring fraud in securities market necessitates continued recognition of implied private right of action under § 10(b) despite express remedies in '33 and '34 Acts).

8. *See* Kripke, *The Myth of the Informed Layman*, 28 BUS. LAW. 631, 635 (1973) (most promotional issues sold by salesmen's oral presentations); *see also* Mann, *Prospectuses: Unreadable or Just Unread?—A Proposal to Reexamine Policies Against Permitting Projections*, 40 GEO. WASH. L. REV. 222, 223 (1971) (investors do not read prospectuses because prospectuses do not contain information investors consider crucial to investment decision); Address by William J. Casey to American Society of Business Writers, *reprinted in* SEC. REG. & L. REP. (BNA) No. 100, at I-3 (May 5, 1971) (disclosure requirements of securities laws unsatisfactory as long as no one really reads prospectuses).

9. Interview with Robert P. Lancaster, Senior Vice President of Institutional Sales, Shearson, American Express, Dallas, Texas (April 10, 1984). A roadshow is a very polished presentation, conducted more or less in the manner of a press conference, in which company officials and/or underwriters promote a new security offering. *Id.* The company officials, usually the Chief Executive Officer and Chief Financial Officer, attempt to give some idea of where the business is headed and what competitive advantages the company has. *Id.* The company officials frequently are accompanied by counsel for the underwriter who is generally very careful about what the company officials may say in their presentation. *Id.* While oral misrepresentations may occur during roadshows, "the risks are inordinate to the benefits—if you misrepresent, you've bought it back." *Id.*; *see* SEC v. Geotek, 426 F. Supp 715, 728 (N.D. Cal. 1976) (oral misrepresentations during sales meetings with wealthy investors); 5A A. JACOBS, LITIGATION AND PRACTICE UNDER RULE 10b-5 § 64.01[b][ii], at 3-309 (2d ed. 1983) (division among courts concerning permissibility of "puffing" in securities sales); 6 L. Loss, *supra* note 3, at 3541-43 (puffing has no place in securities transactions).

oral misrepresentations is section 10(b)[10] of the '34 Act and its appurtenant regulation, SEC rule 10b-5.[11] To maintain a private cause of action for

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10. 15 U.S.C. § 78j(b) (1982). 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.

Id.

Congress intended to grant the SEC board rule-making powers under § 10 to prevent future abuses that Congress specifically did not prohibit. *See* S. REP. No. 792, *supra* note 4, at 18; Wheeler, *supra* note 4, at 565 (drafters of '34 Act gave Commission broad rule-making power to combat unforseen deleterious practices). The drafters intended § 10(b) to serve as a "catchall clause" to give the Commission authority to deal with new manipulative or fraudulent devices. *Hearings on H.R. 7852 and H.R. 8720 Before the House Comm. on Interstate and Foreign Commerce*, 73d Cong., 2d Sess. 115 (1934), *reprinted in* 8 J. ELLENBERGER & E. MAHAR, *supra* note 4, item 23 (testimony of Thomas G. Corcoran on behalf of drafters of § 10(b)). The House of Representatives initially passed a bill giving the SEC power to regulate specific practices that the bill proscribed, but delegating no authority to the Commission to regulate manipulative or deceptive practices generally. *See* H.R. 9323, 73d Cong., 2d Sess. § 9 (1934), *reprinted in* 10 J. ELLENBERGER & E. MAHAR, *supra* note 4, item 31. The Senate amended the bill and a conference committee agreed to the language now in § 10 of the '34 Act. *See* H.R. REP. No. 1838, 73d Cong., 2d Sess. 32-33 (1934), *reprinted in* 5 J. ELLENBERGER & E. MAHAR, *supra* note 4, item 20 (conference report). The legislative history discusses neither the reasons for the change in the statutory language of § 10(b) nor the scope of § 10(b)'s "catchall" function. *See* S. REP. No. 792, *supra* note 4, at 1-5; H.R. REP. No. 1383, 73d Cong., 2d Sess. 20-21 (1934), *reprinted in* 5 J. ELLENBERGER & E. MAHAR, *supra* note 4, item 18 [hereinafter cited as H.R. REP. No. 1383]; Ernst & Ernst v. Hochfelder, 425 U.S. 185, 202-04 (1976). Thus, courts should determine the scope of § 10(b) by reference to the overall congressional intent in the '34 Act to prevent manipulative or deceptive practices serving no useful purpose. *See* S. REP. No. 792, *supra* note 4, at 12-13; H.R. REP. No. 1383, *supra*, at 10-11, 20-21; *see also* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 206 (1976).

11. 17 C.F.R. § 240.10b-5 (1983). In 1942, the SEC exercised the authority that Congress granted the Commission under the '34 Act and promulgated rule 10b-5. *See id; supra* note 10 (congressional intent). Rule 10b-5 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, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1983). Misrepresentations are actionable under rule 10b-5(b) which forbids any person to make any untrue statement of a material fact in connection with the purchase or sale of a security. *See id.* § 240.10b-5(b).

misrepresentation under section 10(b) and rule 10b-5,[12] a plaintiff must establish that the defendant, acting with scienter,[13] made a false representation of a

12. *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730 (1975) (25 years of precedent support maintaining private right of action under rule 10b-5). Congress probably did not contemplate the creation of a substantive civil remedy under the '34 Act but rather intended that the SEC handle violations of the statute and regulations through administrative disciplinary actions. *See* Ruder, *Civil Liability Under Rule 10b-5: Judicial Revision of Legislative Intent?*, 57 NW. U. L. REV. 627, 642-60 (1963) (legislative history and statutory construction indicate Congress did not intend implied right of action under § 10(b)); Note, *Reliance Under Rule 10b-5: Is The "Reasonable Investor" Reasonable?*, 72 COLUM. L. REV. 562, 564 (1972) (Congress did not intend to create private right of action under § 10(b)). *But see* S. REP. No. 792, *supra* note 4, at 6 (committee report includes § 10 in discussion of civil remedies). Nevertheless, the federal courts have inferred a private cause of action under rule 10b-5 and that right now is well settled. *See* Herman & MacLean v. Huddleston, 103 S. Ct. 683, 687 (1983); *see also* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 206 (1976) (recognizing private right of action); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730 (1975) (25 years of precedent support maintaining private right of action under rule 10b-5); Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6, 13 n.9 (1971) (affirming private right of action); Kardon v. National Gypsum Co., 69 F. Supp. 512, 514 (E.D. Pa. 1946). Courts have inferred a private right of action under rule 10b-5 to compensate persons injured by violations of the rule and to enhance the rule's corrective purposes. *See* Note, *The Reliance Requirement In Private Actions Under SEC Rule 10b-5*, 88 HARV. L. REV. 584, 585, 606 (1975) [hereinafter cited as *Reliance Requirement*]; Wheeler, *supra* note 4, at 585-86. Accordingly, courts intend private actions under rule 10b-5 to prevent fraud rather than to serve as an "insurance policy for foolish investors." *Reliance Requirement*, *supra*, at 606; *see* Wheeler, *supra* note 4, at 585 (courts promote anti-fraud policies of securities laws and encourage market stability by requiring plaintiffs to invest carefully).

Courts fashioned the elements of a rule 10b-5 private cause of action by referring to the elements necessary to establish a common-law action for misrepresentation or deceit. *See* 1 A. BROMBERG & L. LOWENFELS, SECURITIES FRAUD & COMMODITIES FRAUD, § 2.7(1), at 55 (1982); 3 L. LOSS, *supra* note 3, at 1430-44. A common-law action for deceit requires a false representation of a material fact with knowledge or belief on the part of the defendant that the representation is false. *See* W. PROSSER, HANDBOOK OF THE LAW OF TORTS § 105, at 685-86 (4th ed. 1971). A plaintiff also must show that the defendant intended to induce the plaintiff to act or not to act on the basis of the defendant's misrepresentation and that damage resulted from his justifiable reliance on the defendant's misrepresentation. *See id.; see also* RESTATEMENT (SECOND) OF TORTS §§ 525 (liability for fraudulent misrepresentation), 526 (scienter), 531 (intent to induce conduct), 537 (justifiable reliance), 538 (materiality) (1977); *see generally* Whalen, *Causation and Reliance in Private Actions Under SEC Rule 10b-5*, 13 PAC. L.J. 1003, 1007-15 (1982) (extensive analysis of relationship between common law misrepresentation action and rule 10b-5 action). One commentator notes that the courts have not restricted the scope of a private action under rule 10b-5 to the analogous common law proceeding but instead have used policy considerations to define the action. Wheeler, *supra* note 4, at 583.

13. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976) (liability under rule 10b-5 requires scienter rather than merely negligent conduct). In *Ernst & Ernst v. Hochfelder* the Court held that § 10(b) requires a showing of the defendant's "scienter," a mental state that the Court defined as including "intent to deceive, manipulate, or defraud." *Id.* at 193-94 n.12. The *Hochfelder* Court reserved the question of whether recklessness was sufficient to meet the scienter requirement under the statute. *Id.* Several federal courts of appeal, however, have held that recklessness is a sufficiently culpable state of mind to satisfy the scienter requirement of § 10(b). *See, e.g.*, White v. Sanders, 689 F.2d 1366, 1369 (11th Cir. 1982) (recklessness satisfied *Hochfelder* scienter requirement under § 10(b)); Hackbart v. Holmes, 675 F.2d 1114, 1117 (10th Cir. 1982) (same); G. A. Thompson & Co. v. Partridge, 636 F.2d 945, 961-62 (5th Cir. 1981) (same); Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017, 1023 (6th Cir. 1979) (same); Rolf v. Blyth, Eastman

material fact[14] in connection with the purchase or sale of a security.[15] In addition, a plaintiff generally must show that he relied upon the misrepresentation[16]

Dillon & Co., 570 F.2d 38, 44 (2d Cir.) (same), *cert. denied*, 439 U.S. 1039 (1978); Coleco Indus. v. Berman, 567 F.2d 569, 574 (3d Cir. 1977) (same), *cert. denied*, 439 U.S. 830 (1978); Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1039-40 (7th Cir.) (same), *cert. denied*, 434 U.S. 875 (1977). Several courts have noted that reckless conduct under rule 10b-5 must involve an extreme deviation from the ordinary standard of care. *See* Broad v. Rockwell Int'l Corp., 642 F.2d 929, 961 (5th Cir.) (en banc) (only "severe recklessness" meets scienter standard under rule 10b-5), *cert. denied*, 454 U.S. 965 (1981); Huddleston v. Herman & MacLean, 640 F.2d 534, 545 (5th Cir. 1981) (extreme departure from ordinary standards of care), *aff'd in part and rev'd in part on other grounds*, 103 S. Ct. 683 (1983), *citing* SEC v. Southwest Coal & Energy Co., 624 F.2d 1312, 1321 n.17 (5th Cir. 1980); McLean v. Alexander, 599 F.2d 1190, 1197 (3d Cir. 1979) (same); Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1039-40 (7th Cir.) (same), *cert. denied*, 434 U.S. 875 (1977).

14. *See* TSC Indus. v. Northway, 426 U.S. 438, 449-50 (1976) (defining materiality). In *TSC Indus. v. Northway*, the Supreme Court provided a definition of materiality in construing § 14(a) of the '34 Act. *Id.* The Court stated that a fact is material if a reasonable man would find that fact important in determining whether or not to enter into a transaction. *Id.* at 445. Courts have applied the materiality standard in *Northway* to rule 10b-5 actions as well. *See, e.g.*, SEC v. Carriba Air, Inc., 681 F.2d 1318, 1323 (11th Cir. 1982) (applying *Northway* definition of materiality in rule 10b-5 action); McGrath v. Zenith Radio Corp., 651 F.2d 458, 466 (7th Cir.) (same), *cert. denied*, 454 U.S. 835 (1981); Dower v. Mosser Indus., 648 F.2d 183, 187 (3d Cir. 1981) (same); James v. Gerber Prods. Co., 587 F.2d 324,, 327 (6th Cir. 1978) (same); Harkavy v. Apparel Indus., Inc., 571 F.2d 737, 740-41 (2d Cir. 1978) (same). If a defendant fails to disclose information already actually known by the plaintiff, courts may treat that information as not material. *See* Straub v. Vaisman & Co., 540 F.2d 591, 596 (3d Cir. 1976).

Many courts confuse the concepts of reliance and materiality. *See* 5A A. JACOBS, *supra* note 9, at § 64.01[a], at 3-279 n.3 (confusion between reliance and materiality). Reliance concerns whether a particular plaintiff believed and acted upon a misrepresentation while materiality involves whether a reasonable man would have acted upon the basis of a misrepresentation. *See* List v. Fashion Park, Inc., 340 F.2d 457, 462-63 (2d Cir.) (materiality involves reasonable man but reliance is subjective concept), *cert. denied*, 382 U.S. 811 (1965); 5A A. JACOBS, *supra* note 9, § 64.01[a], at 3-279 & n.3 (same).

15. *See* Birnbaum v. Newport Steel Corp., 193 F.2d 461, 463-64 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952) (court formulated *Birnbaum* doctrine which provides that only actual purchasers or sellers may maintain action under rule 10b-5). The Supreme Court explicitly affirmed the *Birnbaum* doctrine in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 731 (1975). The *Blue Chip Stamps* court noted that the *Birnbaum* doctrine bars three classes of potential plaintiffs. *Id.* at 737-38. These three classes include potential, but not actual, purchasers of shares; shareholders who do not sell because of a misrepresentation; and shareholders, creditors, or others related to an issuer who suffer a decrease in the value of their investment because of activities in connection with the purchase or sale of securities that violate rule 10b-5. *Id.* Since the *Birnbaum* doctrine limits actions under rule 10b-5 to actual purchasers or sellers, courts should construe the statutory definitions of purchase and sale broadly to effectuate the antifraud purposes of the '34 Act. *See* 5 A. JACOBS, *supra* note 9, § 38.02[a], at 2-84. *See generally id.* § 38.02[2] (discussing transactions constituting purchase or sale).

16. *See, e.g.*, Vervaecke v. Chiles, Heider & Co., 578 F.2d 713, 718 (8th Cir. 1978) (plaintiff must prove reliance); Chelsea Assocs. v. Rapanos, 527 F.2d 1266, 1271 (6th Cir. 1975) (same); List v. Fashion Park, Inc., 340 F.2d 457, 462-63 (2d Cir.) (same), *cert denied*, 382 U.S. 811 (1965); Issen v. GSC Enterprises, 508 F. Supp. 1278, 1287 (N.D. Ill. 1981) (same); *see also Reliance Requirement, supra* note 12, at 589 (no need to presume reliance in affirmative misrepresentation cases). The nature of the reliance requirement varies depending upon whether the fraudulent action is a misrepresentation or a failure to disclose and upon the context of the transaction. *See* R.

and that his reliance was the cause of the harm.[17]

Courts dealing with misrepresentations under rule 10b-5 have applied several different standards to measure a plaintiff's reliance.[18] Most courts recognize that reliance under rule 10b-5 encompasses both a plaintiff's actual

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JENNINGS & H. MARSH, SECURITIES REGULATION—CASES AND MATERIALS 1063 (4th ed. 1977) (analysis of reliance necessitates distinguishing between affirmative misrepresentations and nondisclosure, private transactions and transactions in public market, and individual investment decisions and collective action).

When a failure to disclose is the principal fraud, positive proof of reliance is not necessary. Affiliated Ute Citizens v. United States, 406 U.S. 128, 143-54 (1972). In a failure to disclose case, a plaintiff must show only that a reasonable investor would have considered the facts important in determining whether to invest. *Id.* Nonreliance is an affirmative defense in nondisclosure cases, however, since *Affiliated Ute Citizens* only creates a presumption of reliance. *See* Dwoskin v. Rollins, Inc., 634 F.2d 285, 291-92 n.4 (5th Cir. 1981). Defendants may rebut evidence of reliance by showing either that the plaintiff knew the representation was untrue at the time of the transaction or that the plaintiff entered the transaction for other reasons. *See* R. JENNINGS & H. MARSH, *supra*, at 1063-64.

17. *See, e.g.*, Shores v. Sklar, 610 F.2d 235, 239 (5th Cir. 1980) (courts require proof of causation in 10b-5 actions); St. Louis Union Trust Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 562 F.2d 1040, 1048 (8th Cir. 1977) (same), *cert. denied*, 435 U.S. 925 (1978); Titan Group, Inc. v. Faggen, 513 F.2d 234, 239 (2d Cir.) (same), *cert. denied*, 423 U.S. 840 (1975). Materiality, reliance, and causation are related but different concepts. *See* 5A A. JACOBS, *supra* note 9, § 64.02, at 3-324. The reason for the reliance requirement is to prove that the defendant's conduct was the cause of a plaintiff's injury. *See* List v. Fashion Park, Inc., 340 F.2d 457, 462-63 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965). If the misrepresentation is a "substantial factor" in determining the plaintiff's course of conduct, that is a sufficient degree of reliance under the subjective tests. *See id.* Thus, a misrepresentation may cause a plaintiff's harm even if the misrepresentation is not the only or most important factor in determining his actions. *See* Herzfeld v. Laventhol, Krekstein, Horwath & Horwath, 540 F.2d 27, 33-34 (2d Cir. 1976) (sufficient for plaintiff to show misrepresentation was substantial or significant cause even if not sole cause); Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90, 102-03 (10th Cir.) (substantial factor satisfies causal requirement), *cert. denied*, 405 U.S. 918 (1972); 5A A. JACOBS, *supra* note 9, § 64.01[b][ii], at 3-294 & n.18 (courts and commentators have addressed degree of reliance necessary). Plaintiffs should have no difficulty demonstrating in face-to-face transactions that a misrepresentation induced the investment decision. *See* R. JENNINGS & H. MARSH, *supra* note 16, at 1063. Materiality involves whether a reasonable man would be justified in acting upon the representation. *See* 5A A. JACOBS, *supra* note 9, § 64.02, at 3-324. Therefore, whether a plaintiff may show causation rests upon a conclusion that the fact misrepresented was relevant to the investment decision. *See id.* Once a plaintiff demonstrates that he relied on a material misrepresentation, he only need show that the securities transaction rather than a general market decline or some other factor was the cause of his economic loss. *See* Whalen, *supra* note 12, at 1016-17; *cf.* Holdsworth v. Strong, 545 F.2d 687, 695 (10th Cir. 1976) (proof of reliance establishes chain of causation in affirmative misrepresentation cases).

18. *See* 5A A. JACOBS, *supra* note 9, § 64.01[b], at 3-281 (courts use constructive, subjective, and justifiable reliance standards). Constructive reliance applies in nondisclosure cases, *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153-54 (1972), and many lower courts have held that constructive reliance also is appropriate in misrepresentation cases involving a large class of plaintiffs. *See* Selk v. St. Paul Ammonia Prod., Inc., 597 F.2d 635, 638-39 (8th Cir. 1979) (separate showing of reliance in proxy solicitation materials unnecessary); Herbst v. International Tel. & Tel. Corp., 495 F.2d 1308, 1315-16 (2d Cir. 1974) (proof of individual reliance unnecessary in class action); 5A A. JACOBS, *supra* note 9, § 64.01[b][i], at 3-288 (constructive reliance appropriate when misrepresentations involve large class). When constructive reliance is available, some courts allow a defendant to show only that the plaintiffs as a class could not

reliance and the justifiability of that reliance.[19] Actual reliance involves a subjective determination of whether a particular plaintiff in fact believed that a misleading statement was true.[20] A majority of courts dealing with misrepresentations under rule 10b-5 also have employed a subjective standard in determining the justifiability of a plaintiff's reliance.[21] Although the circuits have not been consistent in their analysis of the justifiability of a plaintiff's reliance,[22] the courts have indicated that a plaintiff has some level of duty whether phrased in terms of "justifiable reliance"[23] or due diligence.[24]

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rely on the misrepresentation because of sophistication or other factors. *See* Kohn v. American Metal Climax, Inc., 458 F.2d 255, 265, 269 (3d Cir.) (fact that class representative may have had knowledge is no defense), *cert. denied*, 409 U.S. 874 (1972); 5A A. JACOBS *supra* note 9, § 64.01[b][i], at 3-286-87. Other courts, however, permit a defendant to disprove the reliance of any or all plaintiffs. *See, e.g.*, Keirnan v. Homeland, Inc., 611 F.2d 785, 788-90 (9th Cir. 1980) (court permits defendant to disprove reliance of one plaintiff); Little v. First Cal. Co., 532 F.2d 1302, 1304-05 & n.3 (9th Cir. 1976) (defendant may rebut reliance in open market situation); Carrus v. Burns, 516 F.2d 251, 257 (4th Cir. 1975) (broker may prove lack of reliance).

Justifiable reliance measures a plaintiff's conduct using a reasonable man standard. *See* 5A A. JACOBS, *supra* note 9, § 64.01[b] [iii], at 3-319. To show justifiable reliance on a misrepresentation, a plaintiff must establish that a reasonable man would have believed the misrepresentation. *Id.* Courts frequently use the term "justifiable reliance" when they really mean materiality or due diligence. *Id.* at 3-320-21. Justifiable reliance as a reasonable man standard probably does not survive the *Hochfelder* decision. *See id.* at 3-321-22; *supra* note 13 (discussing *Hochfelder*); *see also infra* note 25 and accompanying text ("justifiable reliance" is subjective concept).

19. *See* Dupuy v. Dupuy, 551 F.2d 1005, 1014 (5th Cir.) (plaintiff must show both actual reliance and justifiability of reliance to recover under rule 10b-5), *cert. denied*, 434 U.S. 911 (1977); Gaskins v. Grosse, [Current] FED. SEC. L. REP. (CCH) ¶ 99,105, at 95,277 (S.D. Ga. 1983) (reliance aspect includes extent of actual reliance by plaintiff and justifiability of reliance in rule 10b-5 case).

20. *See* Gaskins v. Grosse, [Current] FED. SEC. L. REP. (CCH) ¶ 99,105, at 95,277 (S.D. Ga. 1983) (actual reliance means plaintiff would not have invested if he had known truth); 5A A. JACOBS, *supra* note 9, § 64.01[b][ii], at 3-292 (whether plaintiff actually believed statement was true).

21. *See* 5A A. JACOBS, *supra* note 9, § 64.01[b][ii], at 3-291 (subjective reliance appropriate when constructive reliance not applicable); *see also* Nye v. Blyth Eastman Dillon & Co., 588 F.2d 1189, 1197 (8th Cir. 1978) ("reasonable reliance"); Holdsworth v. Strong, 545 F.2d 687, 695 (10th Cir. 1976) ("justifiable reliance").

22. *See* Dupuy v. Dupuy, 551 F.2d 1005, 1014 (5th Cir.) (treatment of justifiability of plaintiff's reliance varies greatly among circuits), *cert. denied* 434 U.S. 911 (1977); L. LOSS, FUNDAMENTALS OF SECURITIES REGULATION 1127 (1983) (courts impose some sort of duty on plaintiff but use different labels) [hereinafter cited as FUNDAMENTALS]; Wheeler, *supra* note 4, at 563 n.7 (courts employ different terminology in requiring plaintiff to show his "due care").

23. *See* Zobrist v. Coal-X, Inc., 708 F.2d 1511, 1516 (10th Cir. 1983) (justifiable reliance); Sunstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1048 (7th Cir. 1977) (same), *cert. denied*, 434 U.S. 875 (1977); Holdsworth v. Strong, 545 F.2d 687, 694 (10th Cir. 1976) (same), *cert. denied*, 430 U.S. 955 (1977); FUNDAMENTALS, *supra* note 22, at 1127 (courts speak of justifiable reliance to show plaintiff's duty).

24. *See* First Va. Bankshares v. Benson, 559 F.2d 1307, 1314 (5th Cir. 1977) (due diligence requires plaintiff to examine available information), *cert. denied*, 435 U.S. 952 (1978); Hirsch v. duPont, 553 F.2d 750, 763 (2d Cir. 1977) (sophisticated investor must investigate to satisfy due diligence standard); Dupuy v. Dupuy, 551 F.2d 1005, 1022 (5th Cir. 1977) (plaintiff's principal duty is to seek available information to uncover fraud); Straub v. Vaisman & Co., 540 F.2d 591, 598 (3d Cir. 1976) (flexible due diligence standard requires only that plaintiff act

Justifiable reliance concerns whether a plaintiff's reliance on a defendant's misrepresentations was reasonable and justifiable given the relationship of the parties and the particular factual climate of each case.[25] The due diligence concept, on the other hand, is simply a judicially imposed limitation on a plaintiff's ability to recover that requires a plaintiff to investigate to some extent the truthfulness of a defendant's statements.[26] Since a private plaintiff

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reasonably); E.H. Boerth Co. v. LAD Properties, 82 F.R.D. 635, 642 (D. Minn. 1979) (same). *But see* Mallis v. Bankers Trust Co., 615 F.2d 68, 78-79 (2d Cir. 1980) (recklessness may bar plaintiff's recovery, but due diligence not applicable after *Hochfelder*), *cert. denied*, 449 U.S. 1123 (1981); Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1040, 1048 (7th Cir.) (no due diligence defense), *cert. denied*, 434 U.S. 875 (1977); Holdsworth v. Strong, 545 F.2d 687, 692-94 (10th Cir. 1976) (recklessness or gross conduct bar plaintiff's recovery, but due diligence no longer exists after *Hochfelder*), *cert. denied*, 430 U.S. 955 (1977). Some courts address the plaintiff's requirement of due diligence as an element of the plaintiff's prima facie case, but other courts treat due diligence as an affirmative defense for the defendant to raise. *See* Note, *A Reevaluation Of The Due Diligence Requirement For Plaintiffs In Private Actions Under SEC Rule 10b-5*, 1978 WISC. L. REV. 904, 905-06 (1978). Some courts, however, treat due diligence as part of the proof of other elements of a plaintiff's case, such as reliance. *See id.*; Huddleston v. Herman & MacLean, 640 F.2d 534, 548 (5th Cir. 1981) (reasonable reliance contemplates subjective reliance tempered by plaintiff's due diligence), *aff'd in part and rev'd in part on other grounds*, 103 S. Ct. 683 (1983).

A due diligence requirement promotes two distinct policies. First, general principles of equity should bar those who have not pursued their own interests with care and good faith. *See* Dupuy v. Dupuy, 551 F.2d 1005, 1014 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977). Second, courts promote market stability and the anti-fraud aspects of the securities laws by requiring plaintiffs to exercise care in investing. *See id.; see also Reliance Requirement, supra* note 12, at 604 (purpose of due diligence is to deter investor carelessness in securities transactions).

25. *See* Zobrist v. Coal-X, Inc., 708 F.2d 1511, 1516 (10th Cir. 1983) (courts examine all relevant factors to determine whether reliance justifiable in factual situation); Holdsworth v. Strong, 545 F.2d 687, 697 (10th Cir. 1976) (reliance on misrepresentations reasonable and justifiable given facts of case). Courts determine the justifiability of a plaintiff's reliance by examining, *inter alia*, the plaintiff's sophistication and expertise in securities transactions, the relationship between the parties, access of the parties to the relevant information, and the general or specific nature of the misrepresentations. *See* Zobrist v. Coal-X, Inc., 708 F.2d at 1516 (citing factors relevant in determining whether plaintiff's reliance was justifiable); G.A. Thompson & Co. v. Partridge, 636 F.2d 945, 955 (5th Cir. 1981) (plaintiff's due diligence evaluated in light of fiduciary relationships, concealment or ability to detect fraud, and plaintiff's sophistication and financial expertise); Nye v. Blyth Eastman Dillon & Co., 588 F.2d 1189, 1197 (8th Cir. 1978) (availability of information and plaintiff's knowledge and experience are factors to consider in determining reasonableness of plaintiff's reliance); Straub v. Vaisman & Co., 540 F.2d 591, 598 (3d Cir. 1976) (plaintiff's sophistication and opportunity to uncover fraud, fiduciary or long-standing relationships, and access to relevant information worthy of court's consideration); Hughes v. Dempsey-Tegeler & Co., 534 F.2d 156, 176-77 (9th Cir.) (general or specific nature of representation is consideration in assessing plaintiff's reliance on information), *cert. denied*, 429 U.S. 896 (1976).

26. *See* Note, *The Due Diligence Requirement For Plaintiffs Under Rule 10b-5*, 1975 DUKE L.J. 753, 754-55 (1975) (plaintiff must investigate advisability of transaction and use common sense in evaluating available information) [hereinafter cited as *Due Diligence*]. Due diligence is a subjective standard and the degree of investigation necessary therefore varies according to the individual characteristics of a particular plaintiff. *See* Dupuy v. Dupuy, 551 F.2d 1005, 1023 (5th Cir.) (court should examine plaintiff's physical and mental condition and other commitments), *cert. denied*, 434 U.S. 911 (1977). Since the Supreme Court in *Hochfelder*, 425 U.S. 185, 193 (1976), held that a defendant could not be liable for merely negligent conduct, many courts have

after *Ernst & Ernst v. Hochfelder*[27] must show that a defendant acted with scienter to establish a rule 10b-5 claim,[28] most courts will not bar a plaintiff's recovery for mere negligence but rather will bar a plaintiff's recovery only if he acted in a reckless manner or intentionally disregarded risks he knew or should have known in entering into the securities transaction.[29]

Conceptually, an oral misrepresentation is indistinguishable from other misrepresentations under rule 10b-5. As a practical matter, the requirements of reliance and due diligence on the part of the plaintiff are the most difficult to establish in a rule 10b-5 action for an oral misrepresentation because of the subjective nature of those requirements.[30] Courts have addressed the reliance and due diligence requirements in two analytically distinct situations in which oral misrepresentations may create a potential for liability on the part of those persons engaging in securities transactions. First, an individual who makes an oral misrepresentation may be liable even when a potential plaintiff has access to accurate information when he invests or sells.[31] Alternatively, an individual who makes an oral misrepresentation also may be liable when accurate information is not otherwise available to an investor or seller at the time of his investment or sale.[32]

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reconsidered the circumstances under which a plaintiff should be barred from recovery. *See* Mallis v. Bankers Trust Co., 615 F.2d 68, 78 (2d Cir. 1980), *cert. denied*, 449 U.S. 1123 (1981); Holdsworth v. Strong, 545 F.2d 687, 693-94 (10th Cir. 1976), *cert. denied*, 430 U.S. 955 (1977). The effect of *Hochfelder* is to bring rule 10b-5 actions closer to an intentional tort action. *See* 545 F.2d at 693. As in the case of tort law, the securities laws are intended to deter intentional misconduct. *See supra* note 4 (legislative goals of '33 and '34 Acts). Lack of care on the part of a person injured by an intentional misrepresentation is irrelevant at common law so long as the representation is not patently false. *See* W. PROSSER, *supra* note 12, § 108. Consequently, the courts, by analogy, have concluded that the mere negligence of a plaintiff is not a defense to a rule 10b-5 action since the negligence of a plaintiff is not a defense to an intentional tort. *See* Mallis v. Bankers Trust Co., 615 F.2d 68, 78 (2d Cir. 1980) (recklessness but not negligence may bar plaintiff's recovery under rule 10b-5), *cert. denied*, 449 U.S. 1123 (1981); Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1048-49 (7th Cir.) (negligent conduct will not bar recovery for intentional actions), *cert. denied*, 434 U.S. 875 (1977); Dupuy v. Dupuy, 551 F.2d 1005, 1013-24 (5th Cir.) (same), *cert. denied*, 434 U.S. 911 (1977); Holdsworth v. Strong, 545 F.2d 687, 693 (10th Cir. 1976) (same), *cert. denied*, 430 U.S. 955 (1977). *But see* Straub v. Vaisman & Co., 540 F.2d 591, 596-98 (3d Cir. 1976) (plaintiff must act "reasonably" under circumstances).

27. 425 U.S. 185 (1976).

28. *See supra* note 13 (analysis of *Hochfelder* scienter standard).

29. *See* Zobrist v. Coal-X, Inc., 708 F.2d 1511, 1517 (10th Cir. 1983) (most courts hold that plaintiff must not intentionally or recklessly disregard known or obvious risks); Gower v. Cohn, 643 F.2d 1146, 1156 (5th Cir. 1981) (same); *supra* note 26 (recklessness but not negligence may bar plaintiff's recovery).

30. *See Due Diligence, supra* note 26, at 754-57 (bars to plaintiff's recovery under rule 10b-5); *supra* notes 18-29 and accompanying text (discussion of reliance and due diligence). In addition to reliance and due diligence, courts also have used the concepts of waiver, laches, and estoppel to deny recovery to a plaintiff. *Due Diligence, supra* note 26, at 755.

31. *See* Holdsworth v. Strong, 545 F.2d 687, 689 (10th Cir. 1976) (defendant liable despite plaintiff's access to information). *But see* Zobrist v. Coal-X, Inc., 708 F.2d 1511, 1518 (10th Cir. 1983) (plaintiff barred from recovery because no justifiable reliance).

32. *See infra* notes 86-90 and accompanying text (oral misrepresentations without access to accurate information).

When a plaintiff has access to accurate information, a court may bar a plaintiff's recovery because of his failure to act in a justifiable manner or to exercise due diligence.[33] Thus, a plaintiff must read or investigate to some extent the information available to him.[34] Even in an environment of complete disclosure, however, an oral misrepresentation may cause a person to discount the other information available to him and instead cause him to rely subjectively upon the oral misrepresentation.[35] That accurate information was available and known to a plaintiff should not necessarily bar his recovery if he relied justifiably on the oral misrepresentation because of his relationship with the defendant or because of other factual circumstances rendering his reliance reasonable.[36]

In contrast, a plaintiff also may rely solely upon a defendant's oral misrepresentation and not investigate or avail himself of the correct information open to him. In some situations in which a plaintiff fails to utilize available information, a court may consider that plaintiff to have constructive knowledge of the information.[37] Thus, considering the plaintiff's constructive knowledge of the available information for purposes of determining the justifiability of the plaintiff's reliance, a court may preclude the plaintiff from recovery under rule 10b-5.[38] The parameters within which a court will impute knowledge to a plaintiff under rule 10b-5 are not clear.[39]

In *Holdsworth v. Strong*,[40] for example, the plaintiffs relied on a defendant's oral misrepresentations while failing to use accurate information available to them.[41] The plaintiffs in *Holdsworth* sold their shares in a closely held corporation to the defendant, another shareholder, on the basis of the defendant's oral misrepresentations.[42] The defendant represented that the corporation's financial condition was declining when in fact the company was increasing

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33. *See supra* notes 18-29 and accompanying text (justifiable reliance and due diligence as bars to plaintiff's recovery).

34. *See* 5A A. JACOBS, *supra* note 9, § 64.01[b][ii], at 3-319 (plaintiff must investigate).

35. *See* 3 A. BROMBERG & L. LOWENFELS, *supra* note 12, § 8.4 (651) (2), at 204.246 (plaintiff may rely an oral misrepresentation even with complete disclosure).

36. *See id.; cf.* Zobrist v. Coal-X, Inc., 708 F.2d 1511, 1518 (10th Cir. 1983). In *Zobrist*, the plaintiff relied on the defendant's oral misrepresentations despite specific contrary warnings in a private placement memorandum. *See id.* at 1514. The *Zobrist* court, however, correctly determined that the court should not bar the plaintiff's recovery if the plaintiff had a valid reason for relying on the defendant. *See id.* at 1518. The court concluded that the plaintiff's reliance was not justifiable. *Id.*

37. *See* Zobrist v. Coal-X, Inc., 708 F.2d 1511, 1518 (10th Cir. 1983) (court will impute knowledge of materials required by statute or regulations); *infra* notes 76-81 and accompanying text (discussion of constructive notice). Constructive knowledge is knowledge that a person should know rather than what he actually does know. *See* 2 A. BROMBERG & L. LOWENFELS, *supra* note 12, § 8.4 (531).

38. *See* Zobrist v. Coal-X, Inc., 708 F.2d at 1518 (only consequences of imputing knowledge is that court considers information imputed in determining justifiability of plaintiff's reliance).

39. *See infra* notes 76-81 and accompanying text (discussion of constructive notice).

40. 545 F.2d 687 (10th Cir. 1976), *cert. denied*, 430 U.S. 955 (1977).

41. *Id.* at 692.

42. *Id.* at 689-90.

its earning capability.[43] The plaintiffs sought recission of the sale, but the defendant claimed that the plaintiffs, as corporate insiders, did not exercise due diligence because they had access to the corporate books and records but did not investigate.[44]

The Tenth Circuit in *Holdsworth* rejected the practice of requiring a plaintiff to exercise due diligence.[45] Noting the similarity between the common law torts of intentional misrepresentation or deceit and a private claim under rule 10-5 after *Hochfelder*,[46] the *Holdsworth* court held that an intentional actor should not escape liability because of a plaintiff's failure to exercise due diligence.[47] The court stated that application of the due diligence standard to a plaintiff was roughly equivalent to contributory negligence, and therefore a plaintiff's lack of due diligence should not be a defense to an intentional wrong.[48] The *Holdsworth* court concluded that only gross misconduct on the part of a plaintiff, similar in nature to that of the defendant, will bar a plaintiff's recovery under rule 10b-5.[49]

Despite rejecting the due diligence concept, the *Holdsworth* court nevertheless held that a plaintiff must establish that his reliance on a misrepresentation was justifiable.[50] The court in *Holdsworth* reasoned that the plaintiffs' reliance on the defendant's misrepresentations was justifiable because of the long personal and business association between the parties which amounted to a quasi-fiduciary relationship.[51] In addition, the court found that the plaintiffs were preoccupied with other pursuits and lacked any notice that the defendant was not dealing with them honestly.[52] Thus, the court concluded that the plaintiffs could rely justifiably on the defendant's misrepresentations given the particular factual circumstances, despite the plaintiff's access to the corporate books and records.[53]

Although the *Holdsworth* court did not charge the plaintiffs with constructive knowledge of the contents of the corporate books and records, the

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43. *Id.*

44. *Id.* at 692.

45. *Id.* at 694.

46. *See supra* notes 13 & 26 (relationship of private action under rule 10b-5 and common-law fraud after *Hochfelder*).

47. 545 F.2d at 693-94. The court in *Holdworth v. Strong* observed that neither the language in § 10(b) nor in rule 10b-5 suggests the applicability of due diligence to any greater extent than in a common-law fraud action. *Id.* at 694.

48. *Id.*

49. *Id.* at 693; *see supra* note 29 and accompanying text (most courts only bar plaintiff's recovery for intentional or reckless behavior).

50. 545 F.2d at 695. In addressing the issue of due diligence, the Tenth Circuit in *Holdsworth* stated that *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976), necessitated a reevaluation of the standard. 545 F.2d at 693. The court noted that if a plaintiff's contributory fault is to bar recovery for a defendant's intentional conduct, the plaintiff's conduct should be gross conduct comparable to that of the defendant. *Id.*

51. *Id.* at 697.

52. *Id.*

53. *Id.*

Tenth Circuit in *Zobrist v. Coal-X, Inc.*[54] did impute knowledge of a private placement memorandum to the plaintiffs.[55] The defendants in *Zobrist* offered interests in a limited partnership venture to "sophisticated" investors.[56] Each plaintiff signed a statement indicating that he had read a memorandum detailing the risks involved in the investment although in reality none of the plaintiffs ever actually read the memorandum.[57]

On appeal, the defendants argued that the plaintiffs' reliance on the oral misrepresentations could not be justifiable as a matter of law because the memorandum expressly warned of the risks involved in the investment.[58] The plaintiffs contended, however, that the court should not allow the defendants to mitigate the effect of their misrepresentations by using "boiler plate" warnings as a shield while making fraudulent representations to potential investors.[59]

The Tenth Circuit stated in *Zobrist* that a court should determine whether reliance is justifiable on the basis of all relevant factors.[60] The court held that it would charge investors who fail to read documents mandated by statute or regulation with constructive knowledge of the contents of those documents.[61] The *Zobrist* court reasoned that once it imputed knowledge of the information in the memorandum to the plaintiffs, the plaintiffs' reliance on the defendants' oral misrepresentations could not be justified as a matter of law.[62] Noting that the memorandum expressly contradicted the defendants' oral representations, the court stated that the plaintiffs would have to show compelling reasons to justify their reliance on the representations without further investigation.[63]

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54. 708 F.2d 1511 (10th Cir. 1983).

55. *Id.* at 1518. In *Zobrist v. Coal-X, Inc.*, the defendant offered interests in the limited partnership pursuant to § 4(2) of the '33 Act, exempting transactions not involving a public offering from the registration requirements of the '33 Act. *Id.* at 1514; *see* 15 U.S.C. § 77d(2) (1982). Rule 146 of the SEC, promulgated under § 4(2) of the '33 Act, required that each offeree in an exempt offering receive the same type of information that an investor would receive in a prospectus in a non-exempt offering. *See* 17 C.F.R. § 230.146 (1981) (rescinded at 47 Fed. Reg. 11261 (1982)). The private placement memorandum in *Zobrist* thus was the equivalent of a prospectus, except that the SEC had not reviewed the memorandum as they would a prospectus. 708 F.2d at 1514 n.3.

56. 708 F.2d at 1514.

57. *Id.* The jury in *Zobrist* found that the two officers of the defendant company knowingly violated rule 10b-5 by making oral misrepresentations to one of the plaintiffs. *Id* at 1515. The jury further determined that the plaintiff justifiably relied on the defendants' misrepresentations and therefore found the defendants liable. *Id.*

58. *Id.* at 1516.

59. *Id.*

60. *Id.* at 1517; *see supra* note 25 (listing several factors courts consider relevant in determining plaintiff's justifiable reliance).

61. 708 F.2d at 1518.

62. *Id.*

63. *Id.* In *SEC v. Geotek*, 426 F. Supp. 715, 728 (N.D. Cal. 1976), the defendant made various oral misrepresentations concerning tax advantages and prospective profits during sales meetings with wealthy investors. The court held that the defendant's statements were merely "puffing" upon which the investors could not and obviously did not rely. *Id.* The court based its conclusion on the grounds that the defendant's offering circulars and prospectuses explicitly warned of the investment risks. *Id.*

As an example of a possible justification, the court cited the existence of a longstanding business or personal association with the defendant which, the court observed, did not exist in *Zobrist*.[64] The *Zobrist* court concluded that the plaintiffs had no valid reason for relying on the defendants' general misrepresentations of risk in light of the specific warnings in the memorandum.[65]

While the Tenth Circuit rejected the concept of requiring a plaintiff to exercise due diligence in *Holdsworth* and *Zobrist*,[66] the court merely applied a virtually identical requirement under the rubric of justifiable reliance.[67] In both *Holdsworth* and *Zobrist* the court examined the actions of the plaintiffs in light of the particular circumstances of the case and the characteristics of each plaintiff.[68] The *Zobrist* court also specifically observed that a plaintiff may have to engage in further investigation or inquiry to justify his reliance on a defendant's representations.[69] The Tenth Circuit's subjective approach to justifiable reliance is practically indistinguishable from that of other courts that continue to employ a due diligence test after *Hochfelder* to measure a plaintiff's conduct.[70]

Under either the justifiable reliance or the due diligence caption, the courts almost uniformly bar a plaintiff's recovery under rule 10b-5 only if he recklessly or intentionally ignores factors that indicate he should not rely on the defendant's representations.[71] Using the "reckless or intentional" standard to limit

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64. 708 F.2d at 1518.

65. *Id.*

66. *See supra* notes 45 & 63 and accompanying text (*Holdsworth* and *Zobrist* courts rejected due diligence requirement for plaintiffs under rule 10b-5).

67. *See* 5A A. JACOBS, *supra* note 9, § 64.01[b][iii], at 3-320 (courts use term "justifiable reliance" to describe due diligence standard).

68. *See supra* notes 40-65 and accompanying text (description and analysis of *Holdsworth* and *Zobrist* decisions).

69. 708 F.2d at 1518.

70. *See* Dupuy v. Dupuy, 551 F.2d 1005, 1020-23 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977). In *Dupuy v. Dupuy*, the Fifth Circuit found that the plaintiff satisfied the due diligence requirement despite being a corporate insider. *Id.* at 1020. The plaintiff relied on the oral misrepresentations of the defendant, his brother, concerning the financial worth of stock in a closely held corporation. *Id.* at 1021. Assessing the due diligence of the plaintiff, the court relied on the plaintiff's repeated discussions about the stock with his brother before selling to him, the plaintiff's limited time and access to information, and the plaintiff's increasing physical debilitation. *Id.* at 1023. Under these circumstances, the court concluded that "a jury could find justification" for the plaintiff's conduct. *Id.*

71. *See supra* note 29 and accompanying text (most courts only bar plaintiff's recovery if he recklessly or intentionally disregards known or obvious risks). In *Hirsch v. Du Pont*, 553 F.2d 750, 763 (2d Cir. 1977), the Second Circuit barred the plaintiffs from recovery under rule 10b-5 because the plaintiffs failed to exercise due diligence to obtain the magnitude of the defendant company's capital deficiency. The court stated that the plaintiffs received all requested information from the defendant and that a reasonable investor of the plaintiffs' level of sophistication would have made further inquiries. *Id.* at 762-63. However, the *Hirsch* court based its decision on the determination that neither the defendant stock exchange nor the defendant accounting firm had a duty to disclose information to the plaintiffs. *Id.* at 762.

The *Hirsch* decision's treatment of a plaintiff's due diligence runs contrary to the vast majority

a plaintiff's ability to recover comports with the purposes of section 10(b) as expressed by Congress and of rule 10b-5 as interpreted by the courts.[72] Although the courts effectively insulate some defendants from liability by employing the "reckless or intentional" standard to measure a plaintiff's conduct, the possibility that the SEC will initiate civil or criminal proceedings against those who violate rule 10b-5 should be sufficient to deter fraudulent conduct in these types of securities transactions.[73] Moreover, investor carelessness is discouraged by the "reckless or intentional" limitation under the justifiable reliance or due diligence requirements.[74] Thus, in the context of oral misrepresentations, a plaintiff may demonstrate the justifiability of his reliance as long as the factual circumstances do not reveal that the plaintiff recklessly or intentionally ignored indications that he should not rely on the defendant's representations.[75]

A plaintiff may have difficulty demonstrating the justifiability of his reliance, however, if a court imputes knowledge of available information to him.[76] The *Zobrist* court specifically limited the circumstances in which it would impute knowledge of the contents of documents to a plaintiff to those situations in which an investor fails to read material mandated by statute or regulation.[77] Thus, the failure of the *Holdsworth* court to impute knowledge of the contents of corporate books and records to the plaintiffs is in accord with the treatment of constructive notice delineated in *Zobrist*.[78] Other courts, however, have charged investors with knowledge of any publicly available information.[79] This extension of constructive notice is reasonable in the con-

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of authority after *Hochfelder*. *See supra* note 29 and accompanying text. The Second Circuit subsequently limited *Hirsch* to its facts and instead stated that a plaintiff need not establish due care but only negate recklessness when a defendant places the matter in issue. *See* Mallis v. Bankers Trust Co., 615 F.2d 68, 79 (2d Cir. 1980).

72. *See supra* notes 10 & 12 (congressional intent regarding § 10(b) and goals of courts interpreting rule 10b-5).

73. *See* Wheeler, *supra* note 4, at 586-88 (criminal and administrative sanctions pursued by SEC deter fraudulent conduct in securities transactions).

74. *Cf. id.* (existence of due diligence defense encourages investor care); *see infra* note 77 (failure to impute knowledge of documents required by securities statutes would defeat legislative purpose and create insurance for foolish investors).

75. *See supra* notes 66-74 and accompanying text (analysis of justifiability of plaintiff's reliance).

76. *See* Zobrist v. Coal-X, Inc., 708 F.2d at 1518 (10th Cir. 1983); *supra* notes 54-65 and accompanying text (discussion of *Zobrist* decision).

77. 708 F.2d at 1518. The failure of a court to impute knowledge of statutory documents provided to a plaintiff would defeat the subordinate goal of ensuring investor care in regard to a securities offering. *See supra* note 4 (courts infer subordinate goal of securities laws of protecting only careful investors). Rather than placing the investor and the person offering the security for sale on an equal footing, allowing a plaintiff to rely on oral representations while ignoring accurate information in statutorily mandated documents merely would create an insurance policy for foolish investors. *See Reliance Requirement, supra* note 12, at 606.

78. *See* Zobrist v. Coal-X, Inc., 708 F.2d 1511, 1518 (10th Cir. 1983) (court will only charge plaintiffs with constructive knowledge of documents required by statute or regulation under securities laws). *But see infra* note 79 and accompanying text.

79. *See* Scarfarotti v. Bache & Co., 438 F. Supp. 199, 203 (S.D.N.Y. 1977) (plaintiff must use any information available to him or court will impute knowledge of that information to him).

text of rule 10b-5 only if the policy of imputing knowledge of the information serves to deter investor carelessness.[80] While the *Zobrist* decision's limitation of constructive notice to those documents mandated by statute or regulation provides a sound guideline, the courts nevertheless may wish to leave some latitude for special circumstances in which imputing knowledge to a plaintiff is necessary to prevent the securities laws from becoming an insurance scheme for careless investors.[81]

Once a court imputes knowledge of available information to a plaintiff, the court then must determine whether the plaintiff's reliance was justifiable in light of that knowledge.[82] A plaintiff claiming reliance on an oral misrepresentation may have an almost insurmountable burden to prove the justifiability of that reliance when a court imputes knowledge of other information available to him.[83] Absent particular circumstances creating a special relationship or some other reason to rely on a defendant's oral representations, constructive knowledge of mandated documents or other available information will preclude recovery under rule 10b-5 on the basis of the oral misrepresentations.[84]

On the other hand, a plaintiff who did not have access to accurate information faces a substantially lighter burden in proving the justifiability of his reliance than a plaintiff that had access to accurate information at the time of his investment or sale.[85] A plaintiff may not have had access to correct information either because a prospectus or other written document also contained misrepresentations[86] or because the information was not ascertainable.[87]

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80. *See supra* note 4 (courts have established subordinate goal under rule 10b-5 of deterring investor carelessness). Obviously, imputing knowledge to a plaintiff would not serve to deter fraudulent practices by defendants. Therefore, if constructive notice is to serve any purpose other than limiting private actions, constructive notice must serve to deter investor carelessness to relate to the goals of the securities laws. *See supra* note 4 (legislative and judicial purposes under § 10(b) and rule 10b-5).

81. *See supra* note 80 (purpose of imputing knowledge to plaintiffs); *see also* Jackson v. Oppenheim, 411 F. Supp. 659, 668 (S.D.N.Y. 1974) (corporate "insider" normally can not recover against other insiders since both have equal access to information); 5A A. JACOBS, *supra* note 9, § 64.01[b][ii], at 3-316 n.106 (same). *Jackson v. Oppenheim* suggests that the court should have charged the plaintiffs in *Holdsworth* with constructive knowledge of the corporate books since the plaintiffs did not show that the books were unavailable. *See* 545 F.2d at 696. The *Holdsworth* court notes, however, that the corporate books would not have revealed the defendant's false representations. *Id.* at 697. Thus, accurate information was not available to the plaintiffs which indicates that the court should not have barred the plaintiffs' recovery on that basis alone. *See infra* note 90 (court should not bar recovery if falsity of representation unascertainable).

82. *See* Zobrist v. Coal-X, Inc., 708 F.2d 1511, 1518 (10th Cir. 1983).

83. *See id.*

84. *See id.*

85. *See infra* notes 86-90 and accompanying text (analysis of situations when plaintiffs do not have access to accurate information).

86. *See* Nye v. Blyth Eastman Dillon & Co., 588 F.2d 1189, 1197 (8th Cir. 1978) (defendant's oral misrepresentations affirmed by later oral and written misrepresentations made by others).

87. Holmes v. Bateson, 434 F. Supp. 1365, 1383 (D. R.I. 1977) (plaintiffs lacked effective access to information about fraud), *modified*, 583 F.2d 542 (1st Cir. 1978); *see also* Hackbart v. Holmes, 675 F.2d 1114, 1121 (10th Cir. 1982) (plaintiff could not have learned true nature of affairs until too late to affect investment decision).

Thus, because the information is either inaccurate or unavailable, courts do not charge plaintiffs with constructive notice of that information.[88] Regardless of the reason a plaintiff does not have access to accurate information, most courts hold that a plaintiff is not required to investigate sources from outside the corporation[89] and should not be barred from recovery if the falsity of the representation is unascertainable.[90]

In addressing a situation in which information was not available to a plaintiff, the Third Circuit in *Straub v. Vaisman & Co.*[91] held that the plaintiffs satisfied their obligation of due diligence despite the plaintiffs' sophistication and experience in the securities industry.[92] Relying on the defendants' misrepresentations and omissions, the plaintiffs purchased a substantial number of shares of a particular stock.[93] Less than a month later, the issuing company filed bankruptcy proceedings.[94] Noting that the plaintiffs neither requested a prospectus nor investigated the status of the issuer, the defendants contended that the plaintiffs failed to exercise due diligence before purchasing the securities and therefore should be barred from recovery.[95]

In addressing the due diligence issue, the *Straub* court decided that a plaintiff's lack of diligence by failing to investigate or inquire about a defendant's representations in a securities transaction was only one element in analyzing a plaintiff's conduct under rule 10b-5.[96] The court noted that a plaintiff's duty of care requires simply that the plaintiff act reasonably under the circumstances.[97] Therefore, the Third Circuit concluded that courts should

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88. *See supra* notes 86-88 and accompanying text (information inaccurate or unascertainable).

89. *See* Dupuy v. Dupuy, 551 F.2d 1005, 1023 (5th Cir.) (plaintiff need not investigate sources outside corporation), *cert. denied*, 434 U.S. 911 (1977); 5A A. JACOBS, *supra* note 9, § 64.01[b][ii], at 3-316 & n.102 (due diligence does not require investigation outside of corporation).

90. *See* Rochez Bros. Inc. v. Rhoades, 491 F.2d 402, 409 (3d Cir. 1974) (inability to ascertain truth of statement does not preclude recovery under rule 10b-5); Holmes v. Bateson, 434 F. Supp. 1365, 1383 (D. R.I. 1977) (lack of access to information about fraud does not bar action), *modified*, 583 F.2d 542 (1st Cir. 1978); 5A A. JACOBS, *supra* note 9, § 64.01[b][ii], at 3-315 & n.100 (lack of any diligence should not preclude recovery if information unascertainable).

91. 540 F.2d 591 (3d Cir. 1976).

92. *Id.* at 598.

93. *Id.* at 594.

94. *Id.*

95. *Id.* at 596. The defendants in *Straub* asserted that a minimal inquiry by the plaintiffs would have revealed that the security was not a new issue and indicated the security's actual market price. *Id.*

96. *Id.* at 597. *See* Nye v. Blyth Eastman Dillon & Co., 588 F.2d 1189, 1197 (8th Cir. 1978) (courts must consider all factors); Holdsworth v. Strong, 545 F.2d 687, 696-97 (10th Cir. 1976) (no one factor is determinative). The Third Circuit in *Straub v. Vaisman & Co.*, 540 F.2d 591, 597 (3d Cir. 1976), stated that courts should balance the common law notion that a negligent plaintiff nevertheless may recover for an intentional tort against the underlying policies of the securities laws in preventing fraud and investor carelessness. *Id.; see supra* note 4 (legislative intent behind '33 and '34 Acts).

97. 540 F.2d at 598. The Third Circuit in *Straub* held that the duty of due care is a flexible concept. *Id.* The court considered that such factors as fiduciary relationship, opportunity to detect a misrepresentation, plaintiff's sophistication, length of business or personal relationships, and access to relevant information merit consideration. *Id.*

determine whether a plaintiff's lack of diligence was reasonable given the factual situation.[98] Although one of the plaintiffs in *Straub* was a sophisticated investor, the court explicitly observed that the plaintiffs did not have access to information about the issuer's plans to file for bankruptcy and that the defendants planned the transaction to occur over a holiday season to limit the plaintiffs opportunity to investigate.[99] The court therefore found that the plaintiffs satisfied the requirement of acting reasonably under the circumstances since the information was not available.[100]

Notwithstanding that the *Straub* court based its decision on the individual characteristics of the plaintiffs and gave considerable weight to the plaintiffs' inability to acquire accurate information concerning the transaction,[101] the due diligence requirement that plaintiffs act reasonably under the circumstances provides little guidance to a plaintiff seeking to justify his reliance on a defendant's misrepresentations.[102] The reasonableness standard in *Straub* is one usually associated with negligence and thus seems contrary to the standard in other circuits requiring a plaintiff to act in reckless or intentional disregard of known or obvious risks to bar a plaintiff's recovery under rule 10b-5.[103] If accurate information is not available, the presence or absence of a plaintiff's inquiries concerning a defendant's oral misrepresentations should be irrelevant when the representations are not obviously false and when the plaintiff has no notice of any inaccuracy on the part of the defendant.[104]

Another possibility that a plaintiff relying on a defendant's oral misrepresentations may encounter is when other information is available but also proves inaccurate. In *Gaskins v. Grosse*,[105] the defendant offered employment to one of the plaintiffs subject to the requirement that the plaintiff purchase a specified amount of common stock in the defendant's company.[106] The plaintiff accepted the defendant's offer on the basis of a series of oral misrepresentations by the defendant concerning the financial condition and dividend and salary policies of the company.[107] In investigating the defendant's representations, the plaintiff acquired erroneous financial reports on the company that supported the defendant's position.[108] Further, the plaintiff requested

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98. *Id.*

99. *Id.* The *Straub* court observed that a long standing business relationship between the plaintiff and the defendant allowed the defendant to make the transaction without fear of investigation by the plaintiff. *Id.*

100. *Id.*

101. *See id.*

102. *See infra* note 103 and accompanying text.

103. *See* Note, *supra* note 24, at 912-13 (*Straub* court uses standard of reasonableness which is term usually identified with negligence concepts); *supra* note 29 and accompanying text ("reckless or intentional" standard for due diligence or justifiable reliance predominates).

104. *See* 5A A. JACOBS, *supra* note 9, § 64.01[b][ii], at 3-316-17 & nn. 105-06 (if plaintiff has notice of error or statement is obviously false, plaintiff can not show reliance).

105. [Current] FED. SEC. L. REP. (CCH) ¶ 99,105, at 95, 270 (S.D. Ga. 1983).

106. *Id.* at 95,272.

107. *Id.* at 95,272, 95,276.

108. *Id.* at 95,272.

access to the corporate books but the defendant claimed that the books were with an auditor.[109] After assuming his new position with the company, the plaintiff discovered the defendant's misrepresentations.[110]

The United States District Court for the Southern District of Georgia held that the plaintiff did not recklessly disregard risks that should have been apparent, and therefore, the court did not bar the plaintiff from recovery under rule 10b-5.[111] The *Gaskins* court observed that the financial reports comported with the defendant's misrepresentations.[112] Thus, since the available information also was inaccurate, the court found that the plaintiff made adequate inquiries regarding the defendant and his business to establish the justifiability of his reliance.[113] Furthermore, the court determined that the plaintiff did not have access to inside information from the company such as the corporate books.[114]

Although the inquiries of the plaintiff in *Gaskins* were adequate to establish the justifiability of his reliance, the *Gaskins* decision illustrates the dangers to a plaintiff of failing to engage in any type of inquiry about his investment or sale.[115] While *Straub* indicates that a court will not bar a plaintiff's recovery under rule 10b-5 when accurate information simply is not available,[116] *Gaskins* confirms that a court nevertheless may require a plaintiff to show some reason his reliance on a defendant's oral representations was justifiable.[117] Thus, the plaintiffs' reliance in *Straub*, for example, was justifiable because of their longstanding business relationship with the defendants and because the transaction occurred during a period when investigation was not possible.[118] A plaintiff holds a significant advantage when accurate information is not available since he only must show that he justifiably relied on a defendant's representation rather than that he justifiably relied on a defendant's oral representation over a contrary representation.[119] The approach delineated in the *Straub* and *Gaskins* decisions, therefore, achieves the purpose of the securities laws by deterring fraud without sacrificing the subordinate goal of deterring investor carelessness.[120]

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109. *Id.*

110. *Id.* 95,273.

111. *Id.* at 95,278.

112. *Id.* at 95,272 n.2.

113. *Id.*

114. *Id.*

115. *See infra* notes 116-17 and accompanying text.

116. *See* Straub v. Vaisman & Co., 540 F.2d 591, 598 (3d Cir. 1976) (plaintiff acted reasonably since information not available); *supra* notes 96-104 (holding and analysis of *Straub*).

117. *See* Gaskins, ¶ 99,105, at 95,278; *see also* White v. Sanders, 689 F.2d 1366, 1369 (11th Cir. 1982) (reasonable person could find investor reckless for failing to read any literature before investing).

118. *See supra* note 99 and accompanying text (factors justifying reliance in *Straub*).

119. *Compare* Straub v. Vaisman & Co., 540 F.2d 591, 598 (3d Cir. 1976) (long relationship with defendant and no information available) *with* Zobrist v. Coal-X, Inc., 708 F.2d 1511, 1518 (10th Cir. 1983) (plaintiff's reliance on defendant's oral representations over written contrary representations in private placement memorandum not justified absent special circumstances).

120. *See supra* note 4 (congressional and judicial purposes underlying § 10(b) and rule 10b-5).

Courts have inferred a private right of action under section 10(b) and rule 10b-5 to deter fraudulent misrepresentations and to encourage investor care in securities transactions.[121] Individuals who make oral misrepresentations, therefore, face liability under rule 10b-5 if a plaintiff can establish that his reliance on the misrepresentations was justifiable under all of the circumstances when the other elements of a cause of action under rule 10b-5 are present.[122] If a plaintiff has access to accurate information, a court will not bar his recovery unless he recklessly or intentionally ignores indications that he should not rely on a defendant's oral misrepresentations.[123] However, if a plaintiff should have been aware of other information contrary to a defendant's oral representations, courts under certain circumstances will impute knowledge of that information to the plaintiff thereby defeating his claim of justifiable reliance.[124] On the other hand, when a plaintiff does not have access to accurate information, either because the information is inaccurate or unascertainable, a plaintiff faces a substantially lighter burden of proof.[125] A plaintiff still must demonstrate the justifiability of his reliance but no contrary representation is present for the plaintiff to overcome.[126] Accordingly, any person engaged in securities transactions should be wary that potential liability exists for oral misrepresentations when the factual circumstances provide some basis for a plaintiff's reliance on those misrepresentations. Nevertheless, the inability of a plaintiff to justify his reliance on a defendant's oral misrepresentations frequently, if not usually, will render a defendant immune from liability under rule 10b-5.[127]

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121. *See id.* (courts infer congressional intent to protect only careful investors); *supra* note 10 (§ 10(b) enacted to give SEC power to combat unforseen fraudulent practices); *supra* note 12 (courts have inferred private right of action under § 10(b) and rule 10b-5 to enhance corrective purposes of rule but not to serve as investor's insurance policy).

122. *See supra* notes 12-29 (explaining requirements for private action under rule 10b-5).

123. *See supra* note 29 ("reckless or intentional" standard applies to justifiability of plaintiff's reliance).

124. *See supra* notes 76-84 and accompanying text (when courts will impute knowledge to plaintiffs for purposes of determining justifiability of plaintiffs' reliance).

125. *See supra* notes 85-90 and accompanying text (plaintiff has lighter burden of proof concerning justifiability of reliance when accurate information not available).

126. *See supra* notes 116-19 and accompanying text (even when accurate information is not available, plaintiff still must show reliance was justifiable).

127. *See supra* notes 88 & 117 and accompanying text (courts preclude plaintiffs' recovery absent special circumstances demonstrating justifiable reliance).