Due Care: Still a Limitation on 10b-5 Recovery?

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DUE CARE: STILL A LIMITATION ON 10b-5 RECOVERY?

From the time of its promulgation by the Securities and Exchange Commission, Rule 10b-5 has offered investors only as much protection as the courts have considered necessary. The scope of private actions for securities fraud has been controlled in a number of ways. Because the civil remedy is a creature of judicial implication the courts have broad latitude to infer elements and defenses. Additionally, the courts have retained the discretion to determine liability on a case by case basis, since a flexible rule is necessary to accommodate a diverse investing public. The due care limitation is one important exercise of this discretionary power. Recognition of the due care limitation on plaintiff's recovery has served to counter a sudden increase in litigation under the Rule. Simply stated, the due care limitation bars recovery where the plaintiff has not acted reasonably to prevent the loss.

1. 17 C.F.R. § 240.10b-5 (1977) provides as follows:
   It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
   (a) To employ any device, scheme, or artifice to defraud,
   (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
   (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
   in connection with the purchase or sale of any security.


[The duty of reasonable diligence is an obligation imposed by law solely under the peculiar circumstances of each case, including existence of a fiduciary relationship, concealment of the fraud, opportunity to detect it, position in the industry, sophistication and expertise in the financial community, and knowledge of related proceedings.

Id. at 103.

5. Id. at 103; Kohler v. Kohler Co., 319 F.2d 634, 642 (7th Cir. 1963).


7. See Wheeler, supra note 2, at 568 and cases cited at 563 n.7.
In addition to the due care requirement, the United States Supreme Court recently imposed a second major limitation on 10b-5 recovery. In *Ernst & Ernst v. Hochfelder*, the Court held that allegations of negligent misrepresentation did not state a cause of action for securities fraud under 10b-5. As a result, there are now concurrent limitations on 10b-5 recovery: the requirements of due care on the part of the plaintiff and wilful conduct on the part of the defendant.

This article will consider the dual limitations of due care and *Ernst* and examine whether both limitations should be imposed on 10b-5 claims.

I. DEVELOPMENT OF THE DUE CARE DEFENSE

Neither Section 10(b) of the Securities Act of 1934, nor Rule 10b-5 explicitly provide for a private cause of action for securities fraud. Instead, the courts have read the civil remedy into the rule, acting on the premise that a private enforcement mechanism is in tune with the purposes of the Securities Act. Defrauded investors are considered to be more likely to proceed on a civil basis than to pass their claims to the SEC for criminal action.

Initially, litigants in civil actions brought under Rule 10b-5 were handicapped by the lack of a clear statement of the elements needed to establish a cause of action. To fill this void, the courts established a standard patterned after the common law torts of misrepresentation and deceit. However, the circuits have not agreed on which of the elements of deceit are necessary to state a 10b-5 claim.

For a time, the courts differed on the question of whether the plaintiff was required to show scienter on the part of the

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9. See Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 749 (1975); But as we have pointed out, we are not dealing here with any private right created by the express language of § 10(b) or of Rule 10b-5. No language in either of those provisions speaks at all to the contours of a private cause of action for their violation... We are dealing with a private cause of action which has been judicially found to exist, and will have to be judicially delimited one way or another unless and until Congress addresses the question.
11. See, e.g., Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 744 (1975); Landy v. Federal Deposit Ins. Corp., 486 F.2d 139, 169 (3rd Cir. 1973), cert. denied, 416 U.S. 960 (1974); Wheeler, supra note 2, at 575 n.43. Essentially the rule is that courts may draw analogies to tort concepts but are not to consider them controlling.
defendant. At common law, plaintiffs were allowed to recover only in cases where intentional or reckless misrepresentation or omission was proved. However, once scienter was shown, the plaintiff's fault in causing his loss became irrelevant. No duty of due care was imposed on the claimant. Instead, the plaintiff only had to prove that his reliance was justified and that the misrepresentations were not palpably false. Recovery was denied only where it was shown that, as a matter of law, the plaintiff's reliance was so foolish that it caused the loss. If a plaintiff was denied recovery, it was because he could not prove scienter, not because of any notion of contributory fault.

In comparison, some circuit courts of appeal did not require a showing of scienter in order to recover under Rule 10b-5. Since recovery was allowed in cases of negligent misconduct, the scope of 10b-5 recovery was considerably broadened. To restrict the scope of this liability, a number of courts denied recovery where it was shown that the claimant failed to exercise due care in the transaction. The rationale behind the rule was that a negligent plaintiff should not be allowed to recover from a defendant whose liability was predicated solely on negligence.

The due care limitation was later applied to plaintiffs whose claims were based on intentional and reckless misrepresentation. However, defendants who raised the issue in these

13. Holdsworth v. Strong, 545 F.2d 687, 693-95 (10th Cir. 1976); Prosser, supra note 12, at 716.
16. Id.
cases were seldom successful.\textsuperscript{21} The courts which held due care could be raised in the cases alleging intentional misconduct barred plaintiff’s recovery on policy grounds.\textsuperscript{22} This approach afforded courts wide discretion\textsuperscript{23} to grant relief after considering all the equities of the parties.\textsuperscript{24}

II. THE NATURE OF THE PLAINTIFF’S DUTY

The due care requirement mandates that an investor act reasonably when he purchases or sells securities. The duty is one of affirmative action to prevent the perpetration of a fraudulent scheme.\textsuperscript{25} It might entail making inquiries or checking records. Rather than being a uniform standard, like the duty of reasonable care in negligence cases, the due care duty is subjective.\textsuperscript{26} That is, the standard of care varies with each individual investor under the circumstances.\textsuperscript{27} Personal characteristics, as well as external factors, determine the level of care demanded. A party’s sophistication, business acumen, and the situational context are all relevant.\textsuperscript{28} As a result, the level of care required of plaintiffs has varied substantially. This discretionary power to determine the duty of care required, coupled with the freedom to define the elements of the 10b-5 claim, has given the federal courts broad latitude to determine whether a specific plaintiff should be allowed to recover.

The circuits have utilized at least three methods of raising plaintiff’s due care in the 10b-5 context. But these differing procedural references have not varied the principle behind the

\textsuperscript{21} Dupuy v. Dupuy, 551 F.2d at 1019; Wheeler, supra note 2, at 581.
\textsuperscript{23} See Wheeler, supra note 2, at 584.
\textsuperscript{24} See generally Clement A. Evans & Co. v. McAlpine, 434 F.2d 100, 104 (5th Cir. 1970), cert. denied, 402 U.S. 988 (1971).
\textsuperscript{25} See, e.g., Bird v. Ferry, 497 F.2d 112, 114 (5th Cir. 1974); Wheeler, supra note 2, cases cited at 563 n.7.
\textsuperscript{27} For example, a plaintiff’s status as a corporate insider substantially raises the level of which care must be exercised in the transaction. See, e.g., Holdsworth v. Strong, 545 F.2d 687, 696-97 (10th Cir. 1976); Bird v. Ferry, 497 F.2d 112, 114 (5th Cir. 1974); Myzel v. Fields, 386 F.2d 718, 736 (8th Cir. 1967).
\textsuperscript{28} Clement A. Evans & Co. v. McAlpine, 434 F.2d 100, 104 (5th Cir. 1970), cert. denied, 402 U.S. 988 (1971).
due care requirement. An investor still has a duty to protect himself from loss.

One procedure for raising the due care limitation is the justifiable or reasonable reliance approach.\textsuperscript{29} To recover for securities fraud where this approach is followed, a plaintiff must first prove that the purchase or sale was made because of the misrepresentations.\textsuperscript{30} The plaintiff must also prove his reliance was reasonable, given his access to sources of information, his relationship to the other party, and other circumstances of the case.\textsuperscript{31} This approach is a modification of the justifiable reliance requirement of common law. Despite this procedural similarity, the due care requirement is an active duty that did not exist at common law.

A second procedure for raising the due care limitation is the variable duty approach.\textsuperscript{32} This standard imposes a duty on the defendant to disclose only material facts.\textsuperscript{33} By implication, all other facts must be discovered by the plaintiff, creating his duty of care. Whether facts are considered material depends on the plaintiff's sophistication, experience and access to information.\textsuperscript{34} It is a variable duty in that the duty to disclose varies with the individual investor. The plaintiff must prove the materiality of the facts withheld.\textsuperscript{35}

The last approach allows the defendant to raise the plaintiff's lack of care as an affirmative defense.\textsuperscript{36} The defendant has the burden of proving that the investor, through the exercise of reasonable diligence, should have ascertained the true facts.

\textsuperscript{29} Vohs v. Dickson, 495 F.2d 607, 622-23 (5th Cir. 1974); White v. Abrams, 495 F.2d 724, 736 (9th Cir. 1974); Rochez Bros. v. Rhinoes, 491 F.2d 402, 410 (3rd Cir. 1974); Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90 (10th Cir. 1970), \textit{cert. denied}, 404 U.S. 1004 (1971); Myzel v. Fields, 386 F.2d 718, 735-36 (8th Cir. 1967), \textit{cert. denied}, 390 U.S. 951 (1968); Kohler v. Kohler Co., 319 F.2d 634, 642 (7th Cir. 1963).

\textsuperscript{30} Holdsworth v. Strong, 545 F.2d 687, 695 (10th Cir. 1976).


\textsuperscript{33} White v. Abrams, 495 F.2d 724, 728 (9th Cir. 1974).

\textsuperscript{34} Id. at 735. See Wheeler, \textit{supra} note 2, at 572-74.


\textsuperscript{36} Clement A. Evans & Co. v. McAlpine, 434 F.2d 100, 103 (5th Cir. 1970), \textit{cert. denied}, 402 U.S. 988 (1971).
As with the other approaches, the peculiar circumstances of the investor dictate the standard of care that is required.\textsuperscript{37} Each of these procedures provides a bar to recovery in situations where a plaintiff contributes to his loss. Each was developed to restrict the virtually unlimited liability existing under Rule 10b-5. However, these procedures have been criticized for being inadequate to deal with the wide variety of fraud cases that have arisen under the securities laws.

The reasonable reliance approach to due care has been criticized because it cannot be utilized in cases of omission.\textsuperscript{38} In \textit{Affiliated Ute Citizens v. United States},\textsuperscript{39} the Supreme Court ruled that proof of reliance was not necessary where a 10b-5 claim is based on omissions of fact. In such cases, proving reliance is nearly impossible. Eliminating this requirement removes the need to prove that the plaintiff's reliance was reasonable.\textsuperscript{40} Thus, in circuits which follow the reasonable reliance standard, the issue of the plaintiff's lack of due care cannot be raised. This creates an unfounded distinction between 10b-5 cases based upon misrepresentation and those based on omissions. If the plaintiff is required to exercise due care, the duty of investigation should not be limited solely to the facts represented.

Since the variable duty standard modifies the duty to disclose with each litigant, conduct which may violate 10b-5 in one instance may not be actionable in another.\textsuperscript{41} However, 10b-5 is a rule of prohibition and the question of whether it has been violated should be determined with regard to the general public, not the particular individual.\textsuperscript{42} Consequently, this approach undermines the regulatory effect of Rule 10b-5. There is no precedent for comparing the fault of the parties to determine whether there has been a statutory violation.

The affirmative defense notion of due care escapes these criticisms. Theoretically, the consideration of whether a defendant has violated Rule 10b-5 is separate and distinct from the

\textsuperscript{37} Id.

\textsuperscript{38} See Wheeler, supra note 2, at 580-81; Note, The Due Diligence Requirement for Plaintiffs Under Rule 10b-5, 1975 \textit{Duke L.J.} 753, 759.

\textsuperscript{39} 406 U.S. 128, 151-52 (1972).

\textsuperscript{40} McLean v. Alexander, [1976-1977 Transfer Binder], \textit{Fed. Sec. L. Rep.} (CCH) \textsuperscript{\textcopyright}95,725, at 90,548 (S.D. N.Y. 1976).

\textsuperscript{41} White v. Abrams, 495 F.2d 724, 735 (9th Cir. 1974).

\textsuperscript{42} Dupuy v. Dupuy, 551 F.2d 1005, 1015 (5th Cir. 1977).
consideration of whether the plaintiff has exercised due care. If the approach is to be criticized, it is because it was entirely fashioned by judicial implication. The other approaches are drawn from common law concepts, while the due care affirmative defense is based solely on judicial interpretations of public policy.

Clement A. Evans & Co. v. McAlpine is the leading case on the use of the due care affirmative defense. In McAlpine, a brokerage firm sued another firm and an investor who had collusively traded securities through the Evans Company. The defendants were not the rightful owners of the securities traded. When the scheme collapsed, the Evans Company possessed $300,000 in worthless checks. The Fifth Circuit Court denied the plaintiff firm recovery, holding that the protections of Rule 10b-5 extend only to "conscientious buyers and sellers in good faith." Although it noted that other courts relied on common law precedents to impose the duty of due care on plaintiffs, the McAlpine court asserted that the limitation best serves the purposes of the Securities Acts when raised as an affirmative defense. The court also favored the approach because it affords the courts wide discretion in deciding 10b-5 cases.

The McAlpine court also ruled that the due care affirmative defense may be raised by a defendant charged with intentional misconduct. Thus, under this approach, recovery is dependent upon a balancing of the equities by the trier of fact, regardless of the character of the parties' conduct. McAlpine illustrates the broad power of the federal courts to formulate standards for 10b-5 recovery and enforce the rule on a discretionary basis.

III. A NECESSARY EXCURSUS — Ernst & Ernst v. Hochfelder

Although Ernst & Ernst v. Hochfelder did not deal with the plaintiff's duty of due care, the Court engaged in a broad dis-

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44. Most often courts state that the defense is necessary to encourage investor caution. Straub v. Vaisman & Co., 540 F.2d 591, 598 (3rd Cir. 1976). For a further discussion of policy, see note 86, infra.
45. 434 F.2d 100 (5th Cir. 1970), cert. denied, 402 U.S. 988 (1971).
47. 434 F.2d at 104.
cussion of the scope of recovery under Rule 10b-5.48 It is evident that the Court's conception of Rule 10b-5 differs substantially from that utilized by the circuits. It would appear that liberal application of the due care standard, as in the McAlpine case, will be severely restricted by the Ernst decision. In fact, the decision may have sounded the death knell for the due care defense.

If the reasoning behind the imposition of the scienter requirement49 applies to defenses under Rule 10b-5, then plaintiffs will find it easier to recover once they have stated their claim. The opinion stresses that courts should strictly adhere to the language of Section 10b-5.50 The Court reasoned that, since the other sections of the Securities Act of 1934 are specific in describing the circumstances to which they are to be applied, Section 10b is similarly limited by its language.51 As a result, the privilege of "reading into" Section 10(b), and therefore, Rule 10b-5, has been curtailed. While the federal judiciary should limit its interpretation to the language of the section, some amount of interpretation must be allowed since the elements of a claim are not specified in either the section or the Rule. Admittedly, this interpretation might recognize a duty of due care. Nonetheless, on the basis of Ernst, it may be strongly argued that the absence of language in the section and rule supporting implication of a plaintiff's duty of care, precludes a defendant from asserting that a plaintiff's conduct is relevant.

Those who would eliminate the due care requirement can find support for their position in the Court's discussion of "knowing or intentional" misconduct. The Court held that the congressional intent, manifest in the Act, was to prohibit certain illicit practices,52 where the purchaser or seller has acted

48. By limiting 10b-5 recovery to circumstances where scienter is proved, the Court eliminated a cause of action for negligent misrepresentation under the Rule.
50. Id. at 201.
51. Id. at 200-03.
52. Id. at 199. There the Court discussed section 10(b):
The argument simply ignores the use of the words "manipulative," "device," and "contrivance" — terms that make unmistakable a congressional intent to proscribe a type of conduct quite different from negligence. Use of the word "manipulative" is especially significant. . . . It connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities.
Id. (footnotes omitted).
knowingly and intentionally. It would appear to follow that liability under 10b-5 should be determined solely on the basis of the defendant's actions without regard to the conduct of the other party to the transaction.

When a statute speaks so specifically in terms of manipulation and deception, and of implementing devices and contrivances — the commonly understood terminology of intentional wrongdoing — and when its history reflects no more expansive intent, we are quite unwilling to extend the scope of the statute to negligent conduct.53

Thus, if one limits his analysis of 10b-5 as the Court did in Ernst, it may be persuasively argued that any limitation on 10b-5 recovery is founded solely upon the defendant's conduct. Ernst also reflects the Supreme Court's willingness to align the 10b-5 remedy with the common law tort of deceit.54 This is apparent from the Court's use of common law principles to define the scope of 10b-5 liability. The lower courts have also looked to the common law to define the 10b-5 claim.55 The circuit courts have adopted the common law definition of scienter in actions brought under the securities laws.56

The Supreme Court in Ernst did not decide whether allegations of reckless conduct are sufficient to state a 10b-5 claim. Consequently, a strict reading of Ernst would limit 10b-5 to situations of intentional misrepresentations. However, one could argue that the Supreme Court could not have intended to restrict scienter to something less than it was at common

53. Id. at 214.
56. McLean v. Alexander, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶95,725, at 90,550 (S.D. N.Y. 1976). At common law, scienter involves more than intentional conduct alone, for it includes a state of mind evidencing a knowing of the falsity or of the probability of falsity of one's representations and a desire to induce the other to act on account of them. A knowing misrepresentation includes one made with such a measure of assurance as to make another believe the actor knows the representation is true when he does not actually know whether it is true or not. The actor, in this circumstance, misrepresents what he does know. Similarly, scienter exists if, from the circumstances, the actor must know he does not have sufficient information to assert the fact as true. But if the actor believes the fact to be true, in all honesty and good faith, then, he does not have the state of mind necessary to be held liable for deceit. See generally PROSSER, supra note 12, at § 107.
A narrow definition of scienter would result in deceit being a broader remedy than 10b-5 and thus, frustrate the explicit purpose of the Securities Acts of regulating illicit securities transactions. If due care is recognized as a defense to a 10b-5 action, this imposes a further limitation on recovery which is not applicable to common law deceit.

IV. LIMITING DUE CARE

The various circuits that have discussed due care after Ernst agree that the Supreme Court's decision calls for a reconsideration of the duty of due care. However, they disagree on its place in the law of securities fraud. The question of whether a due care limitation can concurrently exist with the scienter limitation is partially answered by the court's approach to the problem.

If a justifiable reliance approach is utilized a court is logically constrained to abrogate the requirement, unless the representations are palpably false. This was the result reached in Holdsworth v. Strong. Strong, the manager and co-owner of a close corporation, induced Holdsworth to sell his interests by convincing him that his stock was practically worthless. When

57. The Ernst Court held that "knowing or intentional" misconduct is necessary to state a 10b-5 claim. 425 U.S. at 199. Taken literally, this means that scienter is limited to circumstances where the defendant is aware of the falsity of his representations, a result much more restrictive than at common law where scienter exists if defendant has constructive knowledge of the falsity of his statements. See note 56, supra. The varying definitions of scienter are well discussed in White v. Abrams, 495 F.2d 724, 728 n.3 (9th Cir. 1974).


59. See Wheeler, supra note 2, at 583.

60. 545 F.2d 687 (10th Cir. 1976). The case was heard en banc after a petition for rehearing from the decision of a three judge panel, pursuant to Fed. R. App. P. 35, and 28 U.S.C. § 46(c) (1970). The panel had held that Holdsworth's failure to diligently examine the corporate records "does not approach the due diligence requirement consistently articulated by this Court." [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶95,465, at 99,363 (10th Cir. 1976). Using a subjective standard, the panel concluded the defense was nonetheless properly invoked in the face of intentional misrepresentations. Id. at 99,361-63. Judge Doyle argued in his dissent that "no legal relationship exists between intentional harm and contributory negligence" and, on the facts, "the close relationship of trust and confidence" made the plaintiff's conduct "irrelevant." Id. at 99,365.

Judge Doyle, writing for the court, rejected the subjective approach. 545 F.2d at 695.
Holdsworth learned that the company was making record profits, he sued for rescission and damages. Strong raised the question of the plaintiff's lack of care, relying on Holdsworth's business experience, legal and business education, and access to corporate records. The Tenth Circuit Court of Appeals held that the due care limitation is "irrational and unrelated" to the action where a defendant has acted with scienter. The court adhered to the scienter limitation on 10b-5 recovery, and due care was discussed in terms of justifiable reliance. This result is in accord with the strict construction approach of Ernst and common law precedents.

The court went on to consider whether reliance was shown and, if so, whether such reliance was justifiable. It responded to the reliance problem which frequently arises in omissions cases by interpreting Affiliated Ute to restrict the reliance requirement to misrepresentation cases, and not to eliminate it altogether. The court held that the materiality of the omitted facts must still be shown, in effect, requiring the plaintiff to prove reliance. Since the court's holding merely imposed the materiality requirement, the court indulged in a measure of judicial circumlocution. The materiality approach to due care cannot validate the justifiable reliance approach to the limitation.

In order to discern whether the plaintiff's reliance was justifiable, the Holdsworth court looked to the usual factors considered in discussions of due care. It held that the plaintiff's reliance was justifiable in light of the trusting relationship between the parties and the absence of pertinent information in the corporate records. Despite the court's specific language abolishing the due care limitation, it may be possible to formulate circumstances where due care would still be a bar to recovery due to the absence of factors making reliance justifiable. Consequently, the Tenth Circuit might find that a sophisti-

61. Id. at 692.
64. 545 F.2d at 695.
65. The court considered the plaintiff's sophistication, his access to information, and the fiduciary relationship between the parties. Id. at 696-97.
cated investor's purchase of close corporation stock without investigation is unreasonable. The court's statement that "[i]f contributory fault of plaintiff is to cancel out wanton or intentional fraud, it ought to be gross conduct somewhat comparable to that of defendant," has been interpreted to mean that the due care limitation is available in such circumstances. It should be noted, however, that the common law test was whether the representation was palpably false, not whether the circumstances revealed justification for the reliance.

The effect of the *Ernst* case on the due care limitation was also discussed in *McLean v. Alexander*. There, the District Court for the Southern District of New York considered whether reasonable reliance could be raised when a defendant is accused of reckless misconduct. McLean's claim was based on an allegedly reckless misrepresentation that appeared in a bond solicitation. What was represented to be the accounts receivable figure was actually the consignments listing. Claiming he had relied on the corporation's apparent financial stability, as represented in the solicitation, McLean sued the accountants responsible for its preparation. At the time, his $1.7 million investment in the technological products concern had a negative net worth of $66,000.

The court considered the plaintiff's duty of care as a duty of reasonable reliance. Because of the logical constraints the common law imposes upon this approach, the court did not fully address the issue of whether the plaintiff's lack of due care is a defense to a defendant's allegedly intentional misconduct. Instead, the court noted the need for reevaluation of the limitation in light of *Ernst*, and only discussed the propriety of due care in situations of reckless misconduct. The court concluded that the due care duty exists in such circumstances: "There is, however, a wide spectrum of prohibited behavior between negligence and specific intent to defraud. In that uncharted land of knowing and reckless misconduct, defendant should be entitled to contest liability by asserting a due diligence defense."
This implies that a plaintiff need not exercise due care if the defendant’s fraud was intentional.

The McLean case represents a marked departure from common law precedents. A plaintiff who was damaged by a defendant’s reckless or intentional misrepresentation was barred from recovering only where the representations were palpably false or the plaintiff’s conduct was comparable to that of the defendant. However, under McLean, a plaintiff’s negligence precludes recovery if there is reckless misconduct. In effect, this imposes a higher standard of care on plaintiff than on defendant. The common law approach was that, regardless of whether the defendant acted intentionally or recklessly, the standard of palpable falsity was applied. Furthermore, McLean produces the anomalous result that an investor’s negligent failure to investigate a representation is more reprehensible when the perpetrator of the fraud has acted recklessly than when the misconduct is intentional. Such an approach leaves much to be desired.

The use of the affirmative defense approach to due care is not constrained by common law concepts, as it is purely a product of judicial implication. As a result, the common law notion that the plaintiff’s negligent conduct is not a defense to intentional misrepresentation need not be considered controlling. Courts that utilize the affirmative defense approach are

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71. See Prosser, supra note 12, at 426.
72. Id. To say that a single standard of care is required of a plaintiff whether the defendant acts intentionally or recklessly is not the same as saying there is a single standard of care for all plaintiffs. Even at common law what was considered patently false varied with the individual plaintiff. RESTATEMENT SECOND OF TORTS § 541, Comment a (1977) — Representation Known to Be or Obviously False, states:

a. Although the recipient of a fraudulent misrepresentation is not barred from recovery because he could have discovered its falsity if he had shown his distrust of the maker's honesty by investigating its truth, he is nonetheless required to use his senses, and cannot recover if he blindly relies upon a misrepresentation the falsity of which would be patent to him if he had utilized his opportunity to make a cursory examination or investigation. Thus, if one induces another to buy a horse by representing it to be sound, the purchaser cannot recover even though the horse has but one eye, if the horse is shown to the purchaser before he buys it and the slightest inspection would have disclosed the defect. On the other hand, the rule stated in this Section applies only when the recipient of the misrepresentation is capable of appreciating its falsity at the time by the use of his senses. Thus a defect that any experienced horseman would at once recognize at first glance may not be patent to a person who has had no experience with horses.

73. See, e.g., Clement A. Evans & Co. v. McAlpine, 434 F.2d 100, 104 (5th Cir. 1970), cert. denied, 402 U.S. 988 (1971).
better suited to consider whether scienter and due diligence should be concurrent limitations on 10b-5 recovery.

At first glance, the Ernst decision would appear to eliminate the affirmative defense approach to due care. The Court's strict construction of section 10(b) and close adherence to common law concepts leaves little room for judicial implication of defenses. Nonetheless, the Fifth Circuit Court of Appeals recently discussed the use of due care as an affirmative defense. In Dupuy v. Dupuy, as in McAlpine, the court relied upon policy considerations:

First, general principles of equity suggest that only those who have pursued their own interests with care and good faith should qualify for the judicially created private 10b-5 remedies. . . . Second, by requiring plaintiffs to invest carefully, the Court promotes the anti-fraud policies of the Acts and engenders stability in the markets.

These policy considerations are, of themselves, unconvincing, since countervailing policy arguments are easily suggested. However, the Dupuy court went on to point out the problems inherent in the justifiable reliance and variable duty approaches. If due care is to remain a viable concept, it should be used as an affirmative defense, in view of the limited effectiveness of the other approaches.

Although the Dupuy court held that the plaintiff's lack of care is an affirmative defense, it did not state that it was avail-

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74. 551 F.2d 1005 (5th Cir. 1977).
75. Id. at 1014.
76. The list of contrary policy considerations includes the following: By enacting securities legislation Congress sought to substitute policy of full disclosure for that of caveat emptor. Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972). Actual knowledge of a fact cannot be equated with the opportunity to ascertain that fact. See Blackie v. Barrack, 524 F.2d 891, 907 (9th Cir. 1975). The civil action for securities fraud complements the SEC's criminal enforcement provisions and results in more effective securities control. See J.I. Case Co. v. Borak, 377 U.S. 426, 432 (1964). Rule 10b-5 is a catch-all provision meant to encompass the imaginative scheme and artifice. Wheeler, supra note 2, at 565 n.13.

The purposes of the Securities Act of 1934 are set out in Lanza v. Drexel & Co., 478 F.2d 1277, 1280 n.34 (2nd Cir. 1973):

This report lists six purposes of the proposed legislation: (1) control of credits; (2) control of manipulative stock market practices (e.g., wash sales, matched orders, stock market pools); (3) the provision of adequate and honest reports to security holders by registered corporations; (4) control of unfair practices by corporate insiders; (5) control of exchanges and over-the-counter markets; and (6) administrative reform.

able as a defense in cases of intentional misconduct. The extent of the duty of investigation when a defendant has acted intentionally is entirely a separate question, a question which the court discussed at some length.

Milton Dupuy, the plaintiff, sold his interests in a hotel development corporation to defendant Clarence Dupuy, his brother. Milton sold the stock believing that plans for building a hotel on the corporation's only asset, a valuable lot, had fallen through. Shortly after the sale, Clarence concluded negotiations for a highly profitable corporate partnership for such a hotel. Relying on Milton's position as a corporate insider and the estranged relationship he had with Clarence at the time of the sale, the district court dismissed Milton's 10b-5 claim because of his failure to exercise due care. The court of appeals reversed, holding that negligence is not a defense to intentional fraud.

The court offered four reasons for restricting the due care defense in light of the scienter requirement for defendants. First, since contributory fault is not a defense to deceit, it should not be a defense to 10b-5 violations. Tort concepts should be given particular weight because "the policy of deterring intentional misconduct outweighs that of deterring negligent behavior," and losses should be borne by the person more at fault of two culpable actors. Secondly, the tort concepts produce a result in accord with the policies of the securities acts. The court stated that a strict reading of Rule 10b-5 revealed a greater concern with deterring intentional misconduct than with deterring negligent behavior by investors. For a third reason, the court noted that Ernst diminished the need

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77. 551 F.2d at 1018, citing PROSSER, supra note 12, at 716. Prosser wrote: "where there is an intent to mislead [barring recovery] is clearly inconsistent with the general rule that mere negligence of the plaintiff is not a defense to an intentional tort. The better reasoned cases have rejected contributory negligence as a defense applicable to intentional deceit."

78. 551 F.2d at 1018.

79. Id., citing PROSSER, supra note 12, at 426. Again the author's language is meaningful: "[Intentional] conduct differs from negligence not only in degree but in kind, and in the social condemnation attached to it . . . . It is in reality a rule of comparative fault which is being applied, and the court is refusing to set up the lesser fault against the greater."

80. 551 F.2d at 1019. The court considered the policy of prevention of manipulative and deceptive practices controlling. Id. Compare this to the McAlpine view, supra note 44 and accompanying text.

81. 551 F.2d at 1019.
for limitations on 10b-5 recovery. Scienter adequately serves to limit the scope of liability under the rule. Any further restrictions would excessively limit the situations in which a plaintiff could recover under 10b-5.\textsuperscript{82} Lastly, the court stated that its holding was consistent with prior case law. Early due care cases were said to allow the defense only where the conduct of the parties was of a similar character. For example, a negligent breach of the due care duty was a defense to negligent misrepresentations. In such cases, the courts imposed "on the plaintiff only a standard of care not exceeding that imposed on the defendant."\textsuperscript{84} Since Clarence Dupuy intentionally misrepresented the corporation's financial situation, Milton could only be barred from recovering his loss if he "intentionally refused to investigate 'in disregard of a risk known to him or so obvious that he must be taken to have been aware of it, and so great as to make it highly probable that harm would follow'."\textsuperscript{85} Although Milton's interests in the corporation placed him in a position to discover the negotiations, the court ruled that a jury could conclude that his sale was reasonable. Since the information concerned matters outside the corporate records, Milton might not be expected to discover the fraud from those available to him. If Milton acted reasonably, he acted without the recklessness required to bar recovery in the face of intentional misconduct.

The Dupuy decision is a clear departure from the early interpretations of due care in two respects. First, the standard of care imposed on the plaintiff varies with the type of misconduct allegedly perpetrated by the defendant. When the defendant acts intentionally, the common law standard of palpable falsity is applied. However, the plaintiff's standard of care may be higher if his claim alleges reckless misconduct. Thus, another duty, framed in terms of recklessness, may have been created by the Fifth Circuit.

Second, the court's holding marks a clear retreat from the broad powers of implication and judicial discretion recognized in McAlpine. Under Dupuy, courts are constrained to limit their investigation of the plaintiff's conduct according to the

\textsuperscript{82} Id., citing Holdsworth v. Strong, 545 F.2d 687, 693 (10th Cir. 1976).
\textsuperscript{83} 551 F.2d at 1019. See Wheeler, supra note 2, at 582-83.
\textsuperscript{84} 551 F.2d at 1020.
\textsuperscript{85} Id.
character of misconduct proved for the defendant.

A contrary result was reached by the Third Circuit Court
of Appeals in Straub v. Vaisman and Co., where the court
held that a plaintiff must show reasonable action. The case
arose when the plaintiff, a manager of a European portfolio
management firm, purchased stock in Loren Industries. The
purchase was made at the recommendation of the Vaisman
Investment Corporation. The Vaisman Corporation, by coinci-
dence, was solely owned by the majority shareholder of Loren
Industries who knew of Loren's imminent bankruptcy.

In deciding the due care issue, the court considered several
arguments for circumscribing the due care defense. It balanced
the policy of promoting diligence against the equity of the com-
mon law approach and concluded that considerations in favor
of the former predominated. Nonetheless, since the defendant
intentionally timed the transaction to occur when the true facts
would be unknown, the court found the plaintiff had exercised
due care.

The Straub opinion is important because, despite Ernst,
the court concluded the due care limitation on 10b-5 recovery
remains viable. Its rationale is surprisingly simple. Although
Ernst requires a narrow construction of section 10(b), promot-
ing investor caution is more important. The due care require-
ment is a means by which this policy can be achieved. How-
ever, the court's approach is oversimplified. It does not address
the equities of 10b-5 recovery, which are a focal point of discus-
sion in decisions of other circuits. The justification for the
Third Circuit's approach is merely an assertion of policy that
is essentially unsupportable. Countervailing policies are
equally convincing, particularly the consideration that inten-
tional misconduct has historically been considered more repre-
hensible than mere negligence. Because of the court's failure to
discuss pertinent issues in depth, the Straub holding is of ques-
tionable precedential value.

86. 540 F.2d 591, 598 (3rd Cir. 1976).
87. Id. at 597-98.
88. See discussion at note 76, supra.
89. Another post-Ernst court has held that due care is a defense to a 10b-5 action.
In Hirsch v. duPont, [current binder] FED. SEC. L. REP. (CCH) ¶96,011 (2nd Cir. 1977)
the court stated:
The securities laws were not enacted to protect sophisticated businessmen from
their own errors of judgment. Such investors must, if they wish to recover under
V. Conclusion

As the Holdsworth and Dupuy cases reveal, due care has lost much of its effectiveness as a limitation on 10b-5 recovery. The elimination of negligence as a basis for liability under the rule limits recovery to cases where the element of scienter is shown. In actions founded on intentional misconduct, the courts have looked to the common law equities and the language of the Rule and concluded that the plaintiff's failure to exercise due care does not preclude recovery except in unusual circumstances. The common law concept of palpable falsity is equivalent to a "gross" or "intentional" disregard of fact. In short, the Fifth and Tenth Circuit Courts of Appeal have fully addressed the question and accepted the wisdom of the common law answers.

Left unanswered is the question of what measure of care is required of a plaintiff when the defendant's acts are reckless. The answer will depend in part on the court's definition of scienter. If scienter is defined as broadly for 10b-5 purposes as it was at common law, then the Holdsworth and Dupuy cases offer possible answers.

A strict adherence to common law principles would require the application of the palpably false standard of care for plaintiffs in actions grounded on scienter. Such an approach would effectively eliminate the due care limitation.

In those courts where due care is an affirmative defense, the opportunity remains to determine a particular standard of care demanded of plaintiffs when the defendant acts recklessly. Dupuy laid the foundation for setting due care standards by holding that the level of care demanded of a plaintiff cannot exceed that demanded of a defendant. Due care should only be a defense to comparable conduct. This approach is consistent with both 10b-5 policy and principles of equity.

Recent case developments have severely restricted judicial innovation in actions brought under Rule 10b-5. The status of the due care requirement reflects this development. Courts have lost the freedom to allow recovery on the basis of their own perception of each case.

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