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ELEMENTS OF RECOVERY UNDER RULE 10b-5: SCIENTER, RELIANCE, AND PLAINTIFF'S REASONABLE CONDUCT REQUIREMENT

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I. INTRODUCTION

A comparison of the commentaries on rule 10b-5¹ indicates that uncertainty is widespread in this area of securities law. One area that is needlessly confused is the proper selection and definition of those elements necessary for recovery in a 10b-5 action. The purpose of this article is to consider four distinct elements that continue to be the source of constant litigation and comment and to suggest an approach that clarifies their meaning and use. The four elements are: (1) scienter (the defendant's state of mind), (2) reliance, (3) justifiable reliance, and (4) materiality. This article will analyze the use of these elements in determining liability for violations of rule 10b-5 in the context of four recurring factual patterns: (1) face-to-face misstatement situations, (2)

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1. 17 C.F.R. § 240.10b-5 (1973) rule 10b-5 states:

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.

face-to-face nondisclosure situations, (3) non-privacy misstatement situations, and (4) non-privacy nondisclosure situations.²

The thesis of this article is that the configuration of elements required to establish liability under 10b-5 need not be the same in each factual situation. Rather, the elements of recovery should be selected and defined in a manner that will further such sound policies as the integrity of the securities market and fairness among the parties. Fairness dictates that the loss resulting from a securities transaction should be borne by the more blameworthy party. If the parties are equally blameworthy, the law should not reapportion the loss. The promotion of integrity in the securities market³ requires that the elements be defined in such a way as both to encourage the disclosure of material information needed for an informed investment decision and to discourage the use of misstatements and manipulative devices in stock transactions.⁴ The furtherance of these policies may be thwarted if rigidity of definition is demanded by the courts.

II. FACE-TO-FACE TRANSACTIONS: MISSTATEMENTS AND NONDISCLOSURES

An appropriate starting point is to define the terms "face-to-face misstatement" and "face-to-face nondisclosure." A face-to-face misstatement arises where a seller of securities (defendant) sells a security to a purchaser (plaintiff) and in the course of the transaction makes a misstatement to that purchaser.⁵ This type of transaction is clearly subject to the constraints of rule 10b-5.⁶ The sale of a security by the defendant to the plaintiff where

2. Each factual situation is defined more fully at the beginning of each section.

3. For a discussion of the purposes of the fraud provisions of the securities acts see Fleischer, *Securities Trading and Corporate Information Practices: The Implications of the Texas Gulf Sulphur Proceeding*, 51 VA. L. REV. 1271, 1274-76 (1965). "[I]t must be remembered that the broader concern for the integrity of securities markets is the dominant policy theme." *Id.* at 1275. For a discussion of the purposes of section 10(b), see *Landy v. Federal Deposit Insurance Corp.*, 486 F.2d 139, 157 (3d Cir. 1973) (stating that "[§ 10(b)]'s immediate concern was the protection of the purity of the informational system in the securities market.").

4. See Schwartz, Book Review, 54 VA. L. REV. 569, 571-72 (1968).

5. Included in this category is the "half-truth" situation, as covered in rule 10b-5(b). Subsection 5(b) makes it unlawful "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 . . ." 17 C.F.R. § 240.10b-5(b) (1973).

6. See, e.g., *List v. Fashion Park, Inc.*, 340 F.2d 457 (2d Cir.), cert. denied, 382 U.S. 811, reh. denied, 382 U.S. 933 (1965).

defendant fails to disclose to the plaintiff a fact relevant to the transaction would constitute a face-to-face nondisclosure. This transaction is also subject to the constraints of rule 10b-5.⁷

Although face-to-face misstatements and nondisclosures have been held to be actionable in certain situations, a determination of liability in any given situation must be made with reference to the four elements previously mentioned. The remainder of this section will define those elements and describe how they should affect recovery.

A. *Scienter*

1. Face-To-Face Misstatement

"Scienter" is a term used to describe the state of mind of a defendant in a 10b-5 suit.⁸ Relying primarily on an article by Dean Keeton,⁹ commentators have described five possible types of conduct and states of mind of a defendant in a 10b-5 suit:¹⁰

7. See, e.g., *Stier v. Smith*, 473 F.2d 1205 (5th Cir. 1973).

8. More than any other element, the defendant's state of mind has been the subject of comment by writers. See, e.g., Epstein, *The Scienter Requirement in Actions Under Rule 10b-5*, 48 N.C.L. REV. 482 (1970); Note, *The Role of Scienter and the Need to Limit Damages in Rule 10b-5 Actions—The Texas Gulf Sulphur Litigation*, 59 Ky. L.J. 891 (1971).

9. Keeton, *Fraud: The Necessity for an Intent to Deceive*, 5 U.C.L.A.L. REV. 583 (1958).

10. Epstein, *The Scienter Requirement in Actions Under Rule 10b-5*, 48 N.C.L. REV. 482, 483 (1970) [hereinafter cited as Epstein]; Bucklo, *Scienter and Rule 10b-5*, 67 Nw. U.L. REV. 562, 567-71 (1972) [hereinafter cited as Bucklo].

In her article, Bucklo explains the five levels of conduct with an example. A company that has just acquired a patent on a material similar to fiberglass issues a press release stating that the material is superior to other material used in molded equipment. In fact, it was inferior, and the company goes broke. The author then states:

The defendants' degrees of knowledge and state of mind at the time the shares were sold to the public could be any of the following:

1. They could have been convinced that the material was strong and durable, based on their attorney's statements regarding testing by a market research firm, and on successful first-year production [innocent behavior].
2. They could have believed in the superiority of the material for their uses, but may have known that these beliefs were based solely on the original patentee's statements and their own initial success in experimental production [negligent behavior].
3. They might not have known whether the representations were true, since they had not begun production or testing designed to discover whether the material would be suitable or not [reckless behavior].
4. They could have known of the falsity of the statements but hoped that, with additional experimentation, the material would be suitable for

- (1) Innocent, non-negligent behavior. An example would be the seller of a security making a misstatement based on a reasonable belief that the statement is true.¹¹
- (2) Negligent behavior. An example would be the seller making a misstatement that he negligently or unreasonably believes to be true.
- (3) Reckless behavior. An example would be the seller making a misstatement without any knowledge concerning the truth of the statement.
- (4) Actual knowledge. An example would be the seller making a statement that he knows is false.
- (5) Intent to defraud. An example would be the seller making a statement that he knows is false *and* making it with the intent to induce the buyer to purchase the security.¹²

Although there is no absolute consistency,¹³ commentators have

their purposes [actual knowledge].

5. They could have known of the falsity of their statements and simply intended to create a demand for the stock which would raise its market value quickly, having no intention ever to market any of the products described in the release [intent to defraud].

Id. at 568.

11. Two cases from the Ninth Circuit seemed to indicate that an innocent misstatement could be the basis for recovery under rule 10b-5. *Royal Air Properties, Inc. v. Smith*, 312 F.2d 210 (9th Cir. 1962); *Ellis v. Carter*, 291 F.2d 270 (9th Cir. 1961). A subsequent case, however, made it clear that the Ninth Circuit does not accept the notion that there is liability in 10b-5 cases in the absence of fault. *White v. Abrams*, 495 F.2d 724 (9th Cir. 1974). Other than *Ellis* and *Royal Air Properties*, there is little support for liability without at least negligence. *See, e.g.*, 6 L. LOSS, *SECURITIES REGULATION* 3377 (2d ed. 1960) [hereinafter cited as L. LOSS].

It should be noted, however, that there may be common law remedies available to one who purchases or sells securities in reliance on an *innocent* misrepresentation. Such a plaintiff may be entitled to either rescission or damages. *See* W. PROSSER, *HANDBOOK OF THE LAW OF TORTS* 710-14 (4th ed. 1971) [hereinafter cited as W. PROSSER].

12. There is no discussion in this article of the "intent to defraud" standard as a prerequisite for recovery, since there is little, if any, support for the proposition that this standard is a requisite state of mind for recovery under 10b-5. *See* 2 A. BROMBERG, *SECURITIES LAW* § 8.45 (543), at 204.175 (1971) [hereinafter cited as A. BROMBERG]:

No 10b-5 decision squarely requires 'intent to deceive' or clearly equivalent phrases. There are some dicta, some ambiguous statements and some holdings that intent or knowledge (or recklessness) is necessary. Most of the cases are in the lower courts.

For a good discussion and rejection of the intent to defraud standard, see *Globus v. Law Research Servs., Inc.*, 287 F. Supp. 188 (S.D.N.Y. 1968), *aff'd*, 418 F.2d 1276 (2d Cir. 1969). *See also* *Myzel v. Fields*, 386 F.2d 718 (8th Cir. 1967).

13. *See* L. LOSS, *supra* note 11, at 1432 (2d ed. 1961), wherein the author states that scienter "has been variously defined to mean everything from knowing falsity with an implication of *mens rea*, through the various gradations of recklessness, down to such non-action as is virtually equivalent to negligence or even liability without fault . . ."

generally defined "scienter" with reference to conduct that is reckless, knowing or intentional.¹⁴ Thus, "scienter" has not been used to describe conduct of a defendant that is innocent or merely negligent.

One unresolved issue in the face-to-face misstatement situation is whether scienter, as defined above, is a prerequisite to liability, or whether negligence alone is sufficient for recovery. If scienter is required, a defendant would be liable only if his misstatement was made recklessly, knowingly, or with an intent to defraud. If negligence is sufficient for liability, a defendant who believed that his misstatement was accurate would nevertheless be liable if his belief were unreasonable. Obviously under the negligence standard a misstatement made recklessly, knowingly, or with the intent to defraud would also be actionable. The issue most discussed by courts and commentators is simply whether a defendant should be liable for misstatements negligently made or whether liability should be imposed only when a defendant's state of mind may be characterized as more culpable—that is, reckless, knowing or intentional.¹⁵

A number of cases, primarily from the Second Circuit, have required something more than negligence for the imposition of liability under 10b-5.¹⁶ One reason for this requirement seems to be a desire to avoid nullifying other civil liability sections—primarily sections 11 and 12 of the Securities Act of 1933.¹⁷ This notion is reflected in *Fischman v. Raytheon Manufacturing Co.*,¹⁸ which involved alleged misstatements in a prospectus and registration statement. Both misstatements would have been actionable under section 11 of the Securities Act of 1933. In attempting to distinguish the remedies provided under section 11 from those provided under 10b-5, the court stated that "[a] suit under § 11 of the 1933 Act requires no proof of fraud or deceit. . . . But proof of fraud is required in suits under § 10(b) of

14. See Epstein, *supra* note 10, at 484; Bucklo, *supra* note 10, at 569.

15. For a discussion of the development of the *scienter* requirement in the Second Circuit, see Bucklo, *supra* note 10, at 576-81. But see *Wellington Computer Graphics, Inc. v. Middell*, 315 F. Supp. 24, 26 (S.D.N.Y. 1970): "[S]cienter is not essential to establish a violation of Section 10(b) and rule 10b-5 where it is sufficient merely to show 'lack of diligence, constructive fraud, or unreasonable or negligent conduct.'"

16. *Id.*

17. 15 U.S.C. §§ 77 (k)-(1) (1970). See also Note, *Negligent Misrepresentations Under Rule 10b-5*, 32 U. CHI. L. REV. 824, 832 (1965).

18. 188 F.2d 783 (2d Cir. 1951).

the 1934 Act and Rule X-10b-5. . . .”¹⁹

In a subsequent case, *Weber v. C.M.P. Corp.*,²⁰ a district court stated that 10b-5 liability should be dependent on “something more than mere misstatements which might be innocent or negligent.”²¹ The court’s reasoning again seems based on a desire not to nullify the liability sections of the 1933 Act:

To give a private remedy under Rule 10b-5 . . . is simply to duplicate (without their restrictions) the express liabilities created by Sections 11 and 12 of the 1933 Act *unless* the remedy under . . . Rule 10b-5 be made different. . . . If you wish to avoid those limiting procedures [such as the short statute of limitations], you must allege and prove real fraud, that is, *scienter*.²²

Another basis for the rejection of negligence as the standard for recovery is concern that the language of section 10(b), which speaks of “any manipulative or deceptive device or contrivance,”²³ will not support such an extension. This concern was reflected in *Globus v. Law Research Services, Inc.*²⁴ In *Globus* the plaintiff’s suit was based on an offering circular that prominently referred to a contract with Sperry Rand but which did not mention that the contract was presently being litigated. Sperry Rand had terminated the contract for non-payment of consideration by the defendant. In rejecting negligence as an appropriate standard for liability, the district court stated that “it appears inescapable that an implied civil action under § 10(b) requires the existence of at least ‘manipulative’ or ‘deceptive’ conduct or a ‘contrivance’ in order to fall within the congressional mandate.”²⁵

19. *Id.* at 786.

20. 242 F. Supp. 321 (S.D.N.Y. 1965).

21. *Id.* at 324.

22. *Id.* at 325. See also 2 A. BROMBERG, *supra* note 12, § 8.4 (523), at 204.133-35 and § 8.4 (525(1)), at 204.1137-40. “Some of the authorities treating actual knowledge as sufficient for liability also seem to regard it as necessary. But only a few say so in a direct fashion, and these may be of limited precedent value because of the pleadings before the court.” *Id.* at 204.133.

23. 15 U.S.C. § 78j(b) (1970).

24. 287 F. Supp. 188 (S.D.N.Y. 1968), *aff’d*, 418 F.2d 1278 (2d Cir. 1969). On appeal the Second Circuit did not reach the question of whether negligence would support a 10b-5 claim, since it found the district court had utilized a standard more stringent than negligence and the plaintiff had still prevailed. The Second Circuit voiced the same concern in *Lanza v. Drexel & Co.*, 479 F.2d 1277 (2d Cir. 1973).

25. *Id.* at 197. Professor Loss has noted that it is open to serious question whether liability “without . . . fraud or *scienter* . . . is a permissible implementation of a statu-

The reasoning of *Fischman*, *Weber*, and *Globus* indicates two of the recurring arguments in favor of requiring scienter. First, the finding of liability under 10b-5 based on the defendant's negligence might undermine the carefully framed limitations imposed by section 12(2) of the 1933 Securities Act.²⁶ Furthermore, imposing negligence as a standard of liability could exceed the authority vested in the Securities and Exchange Commission by section 10(b), a section which speaks only of "manipulative or deceptive device or contrivance."²⁷

Recently, the Second Circuit in *Leasco Corp. v. Taussig*²⁸ refused to relax its strict scienter standard and reaffirmed the proposition that something more than mere negligence was required for relief under 10b-5. In that case the plaintiff Leasco sued for specific performance of a contract for the sale of McCreary-Koretsky International, Inc. to the defendant Taussig. Taussig contended that there were misleading representations made in violation of 10b-5. In holding that the defendant did not possess the requisite scienter, the court stated that "mere negligence is insufficient; there must be a showing of knowledge of

tory provision [section 10(b)] that speaks in terms of any manipulative or deceptive device or contrivance." 6 L. Loss, *supra* note 11, at 3884. Other commentators, however, have not been troubled by this problem. See, e.g., Note, *Civil Liability Under Section 10B and Rule 10b-5: A Suggestion for Replacing the Doctrine of Privity*, 74 YALE L.J. 658, 683 (1965): "Section 10b and Rule 10b-5 are susceptible to an interpretation which would allow suits for negligence." See also *Ellis v. Carter*, 291 F.2d 270, 274 (9th Cir. 1961): "It would have been difficult [for Congress] to frame the authority to prescribe regulations [under 10b-5] in broader terms."

26. See Note, *Negligent Misrepresentation Under Rule 10b-5*, 32 U. CHI. L. REV. 824, 837 (1965). Another argument raised by the article against negligence as the standard [d]erives from the tort theory by which civil liability is inferred when no privity between plaintiff and defendant exists. Under this theory only the violation of a criminal statute creates civil liability in the violator. But 10b-5 is not itself a criminal enactment; violation of the rule . . . becomes criminal only when the violation is willful, as provided by section 32. Since a plaintiff must establish a criminal violation to support private recovery, therefore, he must establish the defendant's 'willfulness.'

But see Note, *Scienter and Rule 10b-5*, 69 COLUM. L. REV. 1057, 1062 n.45 (1969): "Contrary to the belief of some commentators, this tort principle does not apply only to breach of a criminal statute." The article goes on to state that the tort theory of recovery merely provides a remedy for a violation of the rule. Whether negligence or some other state of mind is required for a violation of the rule is unimportant for the application of a remedy under this theory. *Id.* at 1062.

27. Although addressing a situation involving a non-privity misstatement, Judge Friendly raises this argument in favor of a rejection of the negligence standard. See *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 864 (2d Cir. 1968) (concurring opinion).

28. 473 F.2d 777 (2d Cir. 1972).

falsity or reckless disregard for the truth.”²⁹

In spite of the decisions of the Second Circuit, there exists substantial authority indicating that negligence is the appropriate standard for recovery in a face-to-face misstatement case.³⁰ *Kohler v. Kohler Co.*³¹ is illustrative of this line of cases. *Kohler* involved a face-to-face transaction that fits into the “half-truth” category, i.e., an omission “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.”³² The plaintiff—a 10% shareholder, former employee, director and secretary of the company—alleged that during negotiations which resulted in the resale of his stock to the company, he had relied on misleading figures of the company’s earnings. Specifically, he claimed that more recent earnings figures were available but were not disclosed, that the figures contained an unusual excess profits tax refund and that some of the accounting procedures may have been misleading. Although the circuit court affirmed the lower court’s decision for the defendant,³³ it adopted a negligence standard for determining liability. After observing that the Securities and Exchange Act of 1934 “was meant to cover more than deliberately and dishonestly misrepresenting or omitting material facts which ordinarily are badges of fraud and deceit,”³⁴ the court concluded that 10b-5 “requires the insider to exercise reasonable and due diligence not only in ascertaining what is material as of the time of the transaction but in disclosing fully these material facts about which the outsider is presumably uninformed and which would, in reasonable anticipation, affect his judgment.”³⁵

29. *Id.* at 785. See also *Shemtob v. Shearson, Hammill & Co.*, 448 F.2d 442 (2d Cir. 1971), which reaffirms the position that at least a reckless disregard for the truth must be shown. In 1973 the Second Circuit, sitting en banc, held that reckless disregard for truth was the appropriate standard for the nondisclosure situation . . . *Lanza v. Drexel & Co.*, 479 F.2d 1277 (2d Cir. 1973).

30. For a compilation of the circuits which have held negligence to be sufficient, see 2 A. BROMBERG, *supra* note 12, § 8.4 (585), at 204.213-18. See also Bucklo, *supra* note 10, at 576-80.

31. 319 F.2d 634 (7th Cir. 1963).

32. Half-truths are generally equated with misstatements, since both are explicitly prohibited by 10b-5(2). See A. BROMBERG, *supra* note 12, § 4.2, at 71. Even in a common law action for fraud, which generally will not support recovery for nondisclosure, recovery was permitted for half-truth situations, as well as misstatement situations. See L. Loss, *supra* note 11, at 1433-35.

33. 208 F. Supp. 808 (E.D. Wis. 1962).

34. *Kohler v. Kohler Co.*, 319 F.2d 634, 637 (7th Cir. 1963).

35. *Id.* at 642. The language of this case indicates that once the appropriate state of

In addition to *Kohler*, numerous cases reflect the acceptance of negligence as an appropriate standard in the face-to-face misstatement situation.³⁶

With regard to the face-to-face misstatement, two powerful arguments may be asserted in favor of adopting negligence as the appropriate standard of liability. First, such a standard would "seem perfectly consistent with the broad Congressional design . . . 'to insure the maintenance of fair and honest markets in *** [sic] *** [sic] [securities] transactions.'" ³⁷ As the Supreme Court expressly recognized in *Superintendent of Insurance v. Bankers Life and Casualty Co.*,³⁸ one purpose of section 10b is the preservation of the integrity of the securities markets.³⁹ A standard which operates more stringently on the defendant will induce him to take additional care with his statements. This additional care will, in turn, protect "the public from any derogation from 'free market conditions,'"⁴⁰ thereby insuring the integrity of the securities markets.

In *J.I. Case Co. v. Borak*,⁴¹ the Supreme Court made it clear that the courts should fashion liability to accommodate the purposes of the securities legislation. In holding that the courts have jurisdiction to grant relief to private citizens for violation of the proxy rules, the Court stated that "it is the duty of the courts to be alert to provide such remedies as are necessary to make effective the congressional purpose"⁴² of the securities laws. In applying the *Borak* reasoning to 10b-5 situations, absent some overrid-

mind is selected, it is then applied to the assessment of other elements. A similar concept was advanced by the court in *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 854 (2d Cir. 1968), with respect to a claim by some of the defendants that they did not know that the ore strike information was not public. The court held that as reasonable men they should have known, thus there was no defense.

36. See, e.g., *City Nat'l Bank v. Vanderboom*, 422 F.2d 221 (8th Cir.), cert. denied, 399 U.S. 905 (1970). With respect to the issue of scienter, any face-to-face nondisclosure case is also authority for the face-to-face misstatement situation. See text accompanying note 49 *infra*. Further, any court that would permit recovery against a negligent defendant in a non-privy situation would also permit recovery in the face-to-face situation. See text accompanying notes 139-56 and 190-96 *infra*.

37. *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 855 (2d Cir. 1968): "The securities laws should be interpreted as an expansion of the common law . . . to effectuate the broad remedial design of Congress. . . ."

38. 404 U.S. 6 (1971).

39. *Id.* at 12.

40. Note, *Scienter and Rule 10b-5*, 69 COLUM. L. REV. 1057, 1068 (1969). The author makes this argument in the context of a situation where privy of contract is removed.

41. 377 U.S. 426 (1964).

42. *Id.* at 433.

ing policy consideration, the Court should select elements which promote the protection of the investor and the integrity of the marketplace.⁴³ The use of negligence as the standard applied to a defendant's action would effect this end.

A second argument favoring adoption of a negligence standard for liability in the face-to-face misstatement situation is the doctrine of fairness. In a situation in which the seller has induced the purchaser to buy securities by negligently misstating a material fact, a decision must be made as to who should be required to absorb the resulting loss on the transaction. It seems indefensible to require an innocent purchaser to absorb this loss; it is only appropriate that the person making the negligent mistake bear the loss.⁴⁴ The *Borak* Court indicated its awareness of the need to do substantial "justice" by stating that "where legal rights have been invaded, and a federal statute provides for a general right to sue for such invasion, federal courts may use any *available remedy* to make good the wrong done."⁴⁵ Furthermore, such an interpretation is not at odds with the language of section 10b which speaks of "the protection of investors."⁴⁶

It is the position of this writer that, in the face-to-face misstatement situation, the negligent defendant should be held liable. This approach will promote the integrity of the securities

43. See text accompanying note 3 *supra*, for a discussion of the primary purposes of rule 10b-5. See Ruder, *Texas Gulf Sulphur—The Second Round: Privy and State of Mind in Rule 10b-5 Purchase and Sale Cases*, 63 Nw. U.L. Rev. 423 (1968) [hereinafter cited as Ruder]. After recognizing that the reasoning of *Borak* "can be expected to be extended to rule 10b-5," Ruder goes on to state that

[i]f the private right of action exists by direct implication from the statute itself, federal courts will be free in interpreting Rule 10b-5 to fashion policy which is not hampered by the logical complications inherent in the doctrines traditionally advanced to support the private right of action under Rule 10b-5, nor by detailed reference to legislative intent. By emphasizing the general purposes of the securities acts and provided with the general and broad language of Rule 10b-5, the federal courts will be able to create law in the securities field almost without restriction.

Id. at 433.

44. This may be dubbed the bathtub theory: if someone must take a "bath," or loss, it should be the party most culpable.

45. 377 U.S. at 433 (emphasis added).

46. 15 U.S.C. § 78j(b) (1970). In discussing the somewhat different situation of corporate liability for inaccurate disclosures, at least two authors seem to agree with the persuasiveness of these arguments by saying "both the deterrence and compensation purposes of rule 10b-5 require the employment of a negligence standard of conduct in damage actions. . . ." Sandler & Conwill, *Texas Gulf Sulphur; Reform in the Securities Marketplace*, 30 OHIO St. L.J. 225, 273 (1969) [hereinafter cited as Sandler & Conwill].

market as well as fairly apportion the loss resulting from the transaction. There seems to be a decided trend in favor of this position, both in the courts⁴⁷ and among the commentators.⁴⁸

2. Face-to-Face Nondisclosure

Once it is agreed that there exists a duty to disclose in certain situations, liability should generally be imposed for a breach of that duty on the same terms as in the misstatement situation.⁴⁹ Thus, in the face-to-face nondisclosure situation, a negligent non-disclosure should subject the defendant to liability. In fact, most courts have dealt with the face-to-face nondisclosure situations in the same manner as with the face-to-face misstatement situations, assuming without discussion that the treatment should be the same. In *Myzel v. Fields*,⁵⁰ for example, the Eighth Circuit stated that "proof of 'scienter,' i.e. knowledge of the falseness of the impression produced by the *statements or omissions* made, is not required."⁵¹ The language of the court in *Kohler*⁵² also indicated that, with respect to the required state of mind of the defendant, face-to-face misstatements and face-to-face non-disclosures should receive similar treatment: "[T]he statute was meant to cover more than deliberately and dishonestly *misrepresenting or omitting* material facts. . . ."⁵³

Those previous arguments supporting the use of negligence as the standard in a face-to-face nondisclosure situation would apply here. Selection of negligence as the appropriate standard would promote the integrity of the market by providing the impetus for disclosure of material facts. Moreover, as a matter of

47. See, e.g., *Mitchell v. Texas Gulf Sulphur Co.*, 446 F.2d 90 (10th Cir. 1971), which accepts negligence as the appropriate standard, even in the non-privy situation. Although one commentator states that in none of the circuits "has a plaintiff recovered damages for conduct which was merely negligent," in four of the five circuits discussed, it seems clear that negligence is the standard which the courts favor. See Bucklo, *supra* note 10, at 575-90.

48. See 2 A. BROMBERG, *supra* note 12, § 8.4 (585), at 204.217-18. But see Note, *The Role of Scienter and Need to Limit Damages in Rule 10b-5 Actions—The Texas Gulf Sulphur Litigation*, 59 Ky. L.J. 891, 911 (1971) (advocating the requirement of scienter).

49. See Ruder, *supra* note 43, at 411: "Once the disclosure obligation has been identified, considerations imposing liability are not significantly different than those existing in misrepresentation cases."

50. 386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968).

51. *Id.* at 734 (emphasis added).

52. *Kohler v. Kohler Co.*, 391 F.2d 634 (7th Cir. 1963).

53. *Id.* at 637 (emphasis added).

fairness between the parties, the loss should be borne by the more culpable individual. As a result, the appropriate standard for recovering in a face-to-face nondisclosure situation should be negligence.

B. Plaintiff's "Reasonable Conduct" Requirement

In either a face-to-face misstatement or nondisclosure situation, the conduct of the *plaintiff* must meet certain standards or he will be denied recovery.⁵⁴ That notion is incorporated in two distinct but related concepts: (1) *the reliance of the plaintiff must have been justifiable*; and (2) the misstatement or nondisclosure the plaintiff relied on must have been material.⁵⁵ Unless the plaintiff's conduct conforms to this standard he should be denied recovery notwithstanding the establishment of the other necessary elements.

1. Justifiable Reliance

In a misstatement situation, a requirement that "a plaintiff's reliance must be justified" probably means that a plaintiff should be "justified in his belief that the representation is true,"⁵⁶ in a nondisclosure situation, justifiable reliance seemingly requires that the plaintiff be justified in his failure to discover an undisclosed fact.

In *Myzel v. Fields*,⁵⁷ the plaintiffs, after selling their stock to defendants, alleged that, in making a sale of stock to defendants, they had relied on misstatements and nondisclosures about the financial condition of the company. In affirming the lower court's decision in favor of the plaintiffs, the court addressed itself to the standard to which the plaintiff's conduct should conform. One of the plaintiffs was a man of some investment sophistication as well as a director of the company. The court stated that if he "had been misled solely by . . . statements or nondisclosures regarding the company's value, and on that basis alone had sold his stock, recovery would be denied."⁵⁸ The court's reasoning was appar-

54. See text accompanying note 56 *infra*.

55. But see Cobine, *Elements of Liability and Actual Damages in Rule 10b-5 Actions*, 1972 U. ILL. L. FORUM 651. The author states that materiality is "best classified as cause in fact. . . ." *Id.* at 656.

56. W. PROSSER, *supra* note 11, at 718.

57. 386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968).

58. *Id.* at 736.

ently based on the rule that "there is no duty to disclose information to one who reasonably should already be aware of it."⁵⁹ The *Myzel* court would apparently deny recovery, in a proper case, to one who unreasonably relied to his own detriment on a misstatement or nondisclosure.⁶⁰

In *City National Bank v. Vanderbloom*⁶¹ the Eighth Circuit discussed the issue of whether unreasonable conduct on the part of a plaintiff would bar his right to recovery. Although the court resolved the case on the issue of standing, it stated that recovery should be conditioned on a finding that "a reasonable investor, in light of the facts existing at the time of the misrepresentation and in the exercise of due care, would have been entitled to rely upon the misrepresentation."⁶² The court applied this reasoning to find that "a reasonable investor would not have relied upon any representations" made in this case, apparently because of the accessibility of the company's books and records. The *Vanderboom* court seemingly adopted a standard based on the conduct of a reasonable man exercising due care.⁶³ In other words, a plaintiff's negligence in failing to discover the misrepresentation will apparently prevent him from recovering.

The reasonable investor standard apparently was also adopted by the Fifth Circuit in *Clement A. Evans & Co. v. McAlpine*.⁶⁴ McAlpine had purportedly created a facade of financial responsibility that permitted him to trade a large volume of securities with the plaintiff. His checks were dishonored for insufficient funds, causing the plaintiff to sustain a loss in excess of \$300,000. Despite the dishonored checks, the plaintiff continued to transact business with McAlpine and accepted his personal checks although the normal procedure would have been to freeze a customer's account for 90 days. In affirming the lower court's denial of recovery, the circuit court commented extensively on its conception of the plaintiff's duty in a 10b-5 case.⁶⁵ Stating that

59. *Id.*, citing *Kohler v. Kohler Co.*, 319 F.2d 634 (7th Cir. 1963).

60. The court went on, "although not without great difficulty," to find sufficient proof of reasonable reliance because of misstatements concerning the proposed conduct of a trusted friend and advisor of the plaintiff, as well as the nondisclosure of the true purchaser. *Id.* at 737.

61. 422 F.2d 221 (8th Cir.), cert. denied, 399 U.S. 905 (1970).

62. *Id.* at 230 (emphasis added).

63. *Id.* at 231.

64. 434 F.2d 100 (5th Cir. 1970).

65. This author would argue that 10b-5 is not applicable to the facts of this case since the fraud concerned the financial position of the defendant, i.e., the sufficiency of funds

the applicable standard for the plaintiff's conduct was "the objective standard of a reasonable investor exercising due care in light of all facts . . . ," the court added to that standard "a duty of reasonable investigation" ⁶⁶ This language clearly set up a reasonable investor standard to which the conduct of the plaintiff must conform. ⁶⁷

The *McAlpine* court was confronted, however, with a misrepresentation which was allegedly intentional, rather than negligent. Thus the possibility existed that a knowing misrepresentation, or even a misrepresentation made with the intent to defraud, would not be actionable simply because the plaintiff was negligent in not discovering the misrepresentation. The court addressed this problem by stating that

plaintiff's duty above espoused is not altered merely because the misrepresentations are alleged to be intentional rather than negligent. Surely plaintiff would not contend that a purchaser or seller could justifiably rely on a fraudulent misrepresentation, no matter how willfully and intentionally made, if that misrepresentation would tax even the most credulous mind. ⁶⁸

McAlpine demonstrates one of the difficulties in demanding that a plaintiff's reliance on the misstatement or nondisclosure be justifiable. The problem is the standard to which the plaintiff's conduct must conform. Will the plaintiff be denied recovery if his reliance is negligent, or will recovery be denied only if the reliance on the misstatement or nondisclosure "would tax even the most credulous mind?" These are clearly different tests, although the court seemingly uses them interchangeably.

The Fifth Circuit subsequently added to the existing confusion in *Stier v. Smith*. ⁶⁹ In *Stier* the plaintiff sued under 10b-5,

to cover the purchase of the securities, rather than a fraud "in connection with" the actual securities transaction. As a result this case could have been treated as either a contract action or an action for deceit rather than a 10b-5 violation. But see *Superintendent of Ins. v. Banker's Life & Cas. Co.*, 404 U.S. 6 (1971).

66. 434 F.2d at 104, quoting *City Nat'l Bank v. Vanderboom*, 422 F.2d 221, 230 n.10 (8th Cir. 1970).

67. This concept, obviously, is not unlike the concept of contributory negligence in tort law which bars the plaintiff's recovery for his own negligence. It is based on a reasonable man standard: "The plaintiff is required to conform to the same broad standard of conduct, that of the reasonable man of ordinary prudence under like circumstances." W. PROSSER, *supra* note 11, at 419.

68. 434 F.2d at 104.

69. 473 F.2d 1205 (5th Cir. 1973).

alleging a nondisclosure of information in a disastrous public offering undertaken by the issuer, Mickey Mantle's Country Cookin', Inc. The district court denied the plaintiff relief because his investment sophistication should have led to his discovery of the undisclosed facts from accessible information. In reversing and holding for the plaintiff, the Fifth Circuit characterized this case as one in which the defendant "*knew* that he [plaintiff] was purchasing in reliance on this fact [a successful public offering] and there was [none]."⁷⁰ In this situation, where the nondisclosure was *knowingly* made, the court was understandably reluctant to deny the plaintiff relief because of contributory negligence: "We should always be wary of holding that a purchaser of securities could have found out omitted material facts by examining the corporate books or undertaking other extensive investigations."⁷¹ Although the court concentrated its efforts on finding reliance within the meaning of *List v. Fashion Park, Inc.*,⁷² it seems clear that the court would hesitate to deny a plaintiff relief for mere negligent reliance. Nonetheless, the court again failed to define the standard that should bar relief to a plaintiff when the defendant had knowledge of both the nondisclosure and the plaintiff's reliance thereon.

Most courts that have faced the issue have used reasonable care as the standard to which the plaintiff's reliance must conform.⁷³ Cases such as *McAlpine* and *Stier*, however, demonstrate the imprecise analysis often employed by courts when confronted with an allegation that the *defendant's* misstatement or nondisclosure is more culpable than the *plaintiff's* negligence.

When a defendant's misrepresentation or nondisclosure is negligently made, as opposed to being made recklessly, knowingly or with the intent to defraud, reasonable care as the required standard of conduct for the plaintiff appears unobjectionable.⁷⁴ The notion that it is proper to bar a negligent plaintiff from

70. *Id.* at 1210 (emphasis added).

71. *Id.* at 1208.

72. 340 F.2d 457 (2d Cir. 1965). See also text accompanying note 134 *infra*.

73. See generally Comment, *Reliance Under Rule 10b-5: Is the 'Reasonable Investor' Reasonable?*, 72 COLUM. L. REV. 562 (1972), in which the author states that, although the test is phrased in terms of reasonableness, the standard may be subjective in some situations with the court lowering or raising the norm because of the qualifications of the plaintiff.

74. See Comment, *Negligent Misrepresentations Under Rule 10b-5*, 32 U. CHI. L. REV. 824, 841-44 (1965). The author advocates that negligence on the part of the *defendant* should be actionable under 10b-5 and that reasonable reliance should be required.

recovery when the defendant's act was merely negligent receives substantial support from tort law.⁷⁵ Under the law of torts, recovery may be sought either on the theory that a common law action for deceit will lie for negligent misstatement, or on the theory that recovery for negligence should be extended beyond compensation for personal injury and property damage to compensate for pecuniary loss.⁷⁶ In cases that raise the issue, the courts have held that contributory negligence on the part of the plaintiff bars his recovery.⁷⁷

When a plaintiff's cause of action is based on the more traditional notions of deceit involving an intent to mislead, negligence on the part of the plaintiff is not grounds to bar his cause of action. As Professor Prosser views the required standard, a plaintiff will be barred from recovery only when his conduct is "so utterly unreasonable, in light of the information open to him, that the law may properly say that his loss is his own responsibility."⁷⁸ This "utterly unreasonable" test seems to fall somewhere between negligence and knowledge. Thus, Prosser appears to say that a plaintiff who acts in reckless disregard of the truth will be barred from recovery.

This test is a logical expression of the standard of conduct to which the plaintiff in a 10b-5 suit must conform. It seems fair that negligent reliance on the part of a plaintiff should bar his recovery when the defendant's omission or misstatement is merely negligent. This approach would be consistent with the tort doctrine of not reapportioning loss when both parties are negligent.⁷⁹ It seems unfair, however, to deny the negligent plaintiff

75. The most elementary example is the concept of contributory negligence. See generally W. PROSSER, *supra* note 11, at 416-27.

76. *Id.* at 705. See also *Gediman v. Anheuser Busch Co.*, 299 F.2d 537 (2d Cir. 1962) (negligent advice given to an employee concerning how to exercise rights under a pension plan); *Anderson v. Tway*, 143 F.2d 95, 99 (6th Cir. 1944) (negligence with respect to nondisclosures about the financial status of a company); *Brown v. Underwriters at Lloyd's*, 53 Wash. 2d 142, 146, 332 P.2d 228, 230 (1958) ("A representation of fact believed to be true but which proves to be false is actionable, and our law as of right ought to and does afford a remedy for the damage sustained by the representee . . ."); *Gould v. Flato*, 170 Misc. 378, 10 N.Y.S.2d 361 (Sup. Ct. 1938) (recognizing liability for negligent misstatement only where as a matter of good faith and general social policy the defendant should exercise diligence, but finding such a relationship in a purchaser-seller situation).

77. See, e.g., *Gould v. Flato*, 170 Misc. 378, 10 N.Y.S.2d 361 (Sup. Ct. 1938) (contributory negligence on the part of a purchaser of an expensive string of pearls barred her recovery from the seller when her cause of action was based on negligent misrepresentation); *Vartan Garapedian, Inc. v. Anderson*, 92 N.H. 390, 31 A.2d 371 (1943).

78. W. PROSSER, *supra* note 11, at 715.

79. See text accompanying note 74 *infra*.

recovery when the defendant's state of mind is either reckless, knowing or intentional. In that situation the denial of recovery to the plaintiff would require the less blameworthy party to bear the loss. Where the defendant's misstatement or omission is made recklessly, knowingly or intentionally, the plaintiff should be barred from recovery only if his reliance was "utterly unreasonable" or in reckless disregard of the truth.⁸⁰

The selection and definition of the elements of recovery should be made to promote fairness among the parties and to further the purposes of the securities legislation.⁸¹ The confusion that has crept into this area, as exemplified by *McAlpine*⁸² and *Stier*,⁸³ has resulted from analyses which are imprecise and which fail to apply the sound policy considerations vital to a definition of the elements of recovery. The courts must avoid both the mistake made in *McAlpine*, simply confusing the standard to which the plaintiff's conduct must conform,⁸⁴ and the imprecise analysis of the *Stier v. Smith* approach in dismissing the reliance issue with the statement that "[w]e should always be wary of holding that a purchaser of securities could have found out omitted material facts by examining the corporate books or undertaking other extensive investigation."⁸⁵ Both approaches demonstrate the absence of a critical, policy-oriented analysis that will avoid needless confusion.

2. Materiality

a. In General

Even if his reliance is justifiable, a plaintiff in the face-to-face misstatement or nondisclosure situation will be barred from recovery unless the misstatement or nondisclosure involved is "material." This element is unequivocally expressed by the 10b-5 prohibition of "any untrue statement of a *material* fact."⁸⁶

80. For a similar analysis, see Cobine, *Elements of Liability and Actual Damages in Rule 10b-5 Actions*, 1972 U. ILL. L. F. 651, 658-67.

As a logical extension of the notion that the plaintiff should be barred from recovery only if he is as culpable or more culpable than the defendant, it may be appropriate, when the defendant's misstatement or omission is knowingly or intentionally made, to bar the plaintiff only when he has knowledge of the untruth.

81. See text accompanying note 3 *supra*.

82. 434 F.2d 100 (5th Cir. 1970).

83. 473 F.2d 1205 (5th Cir. 1973).

84. 434 F.2d at 104 (5th Cir. 1970).

85. 473 F.2d at 1208 (5th Cir. 1973).

86. 17 C.F.R. § 240.10b-5(b) (1973) (emphasis added).

Thus, without distinguishing between the nondisclosure and misstatement cases, Professor Bromberg refers to materiality as "one common law element that is still going strong under 10b-5."⁸⁷

The formulation of a test of materiality has been less than successful.⁸⁸ At present, however, it appears settled that the materiality of any fact is determined with reference to the reasonable man standard. A material fact must be one which would have an effect on a reasonable man's investment decision with respect to the security in question. One definition of materiality which has gained substantial acceptance is derived from *List v. Fashion Park, Inc.*⁸⁹ In that case, involving a face-to-face nondisclosure, the court defined the test of materiality to be whether "a reasonable man would attach importance [to the undisclosed fact] in determining his choice of action in the transaction in question."⁹⁰ The court elaborated by stating that this test "'encompasses those facts which in reasonable and objective contemplation might affect the value of the corporation's stock or securities'"⁹¹ This formulation of the test of materiality has been utilized by later 10b-5 cases, including the now famous *Texas Gulf Sulphur* case.⁹²

87. 2 A. BROMBERG, *supra* note 12, § 8.3, at 199. See also Cobine, *Elements of Liability and Actual Damages of Rule 10b-5 Actions*, 1972 U. ILL. L.F. 651, 655: "One of the best established elements of rule 10b-5 liability is that any misstatement or omission must be material to be actionable."

88. See *Kardon v. National Gypsum Co.*, 73 F. Supp. 798 (E.D. Pa. 1947). The court discussed materiality in terms of a fact that "would materially affect the judgment of the other party to the transaction." *Id.* at 800. In *Kohler v. Kohler Co.*, 319 F.2d 634 (7th Cir. 1963), the court defined materiality in terms of "[f]acts . . . which in reasonable and objective contemplation might affect the value of the corporation's stock or securities" *Id.* at 642.

A number of commentators have also expressed opinions about the appropriate formulation of materiality. See Fleischer, *Controls on Insider Trading*, 34 U. Mo. K.C.L. REV. 210, 217 (1966) ("facts which . . . can reasonably be expected to have a significant impact on the market"); Ferber, *Duties of Disclosure of Corporate Insiders*, 34 U. Mo. K.C.L. REV. 222, 224 (1966) (fact which "might reasonably be expected to have a substantial effect on the price of the company's securities . . ."); Cary, *Symposium—Insider Trading in Stocks*, 21 BUS. LAW. 1009, 1014 (1966) (facts which "would have a significant effect on the marketprice of the stock").

For a discussion of the various formulations of materiality by courts and commentators see Wiesen, *Disclosure of Inside Information—Materiality and Texas Gulf Sulphur*, 28 MD. L. REV. 189, 204-11 (1968). See also Annot., 22 A.L.R.3d 973, 800 (1968).

89. 340 F.2d 457 (2d Cir. 1965).

90. *Id.* at 462, quoting RESTATEMENT OF TORTS § 538(2)(a) (1938).

91. *Id.*, quoting *Kohler v. Kohler Co.*, 319 F.2d 634, 642 (7th Cir. 1963).

92. SEC v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968). In *Myzel v. Fields*, 386 F.2d 718 (8th Cir. 1967), the court cited *List* approvingly, and defined material-

b. Misstatements

If the defendant is to be held liable under 10b-5 for negligent misstatements, the requirement of materiality is unobjectionable if defined in terms of the reasonable man, since reliance on a non-material fact would seem tantamount to negligence on the part of the plaintiff. If a plaintiff's investment judgment is affected by a non-material fact that a reasonable man would not deem important, the plaintiff would seem to be contributorily negligent and should be barred from recovery against a merely negligent defendant. If, however, a particular defendant's misstatement is made with a more blameworthy state of mind (*i.e.*, recklessly, knowingly or intentionally), to bar the recovery of a plaintiff who relied on a non-material misstatement seems improper. To deny recovery would be to reject the notion that the more blameworthy party should bear the loss. Thus, a plaintiff who was merely negligent would be barred from recovery from a defendant whose actions were either reckless, knowing or intentional.⁹³ The unfairness of this result can be illustrated by the following example:

ity to mean "facts 'which in reasonable and objective contemplation might affect the value of a corporation's stock or securities to the seller.'" *Id.* at 734. See also *Rogen v. Ilikon Corp.*, 361 F.2d 260, 266 (1st Cir. 1968); *Kohler v. Kohler Co.*, 319 F.2d 634, 642 (7th Cir. 1963).

Although it is beyond the scope of this article to examine in depth the myriad of facts deemed by the courts to be material, some examples may prove instructive. In *Kardon v. National Gypsum Co.*, 83 F. Supp. 613 (E.D. Pa. 1947), the act of selling substantially all the corporate assets was termed a material fact. In *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), a rich mineral strike was deemed material. In *SEC v. Shattuck Denn Mining Corp.*, 297 F. Supp. 470 (S.D.N.Y. 1968), the reopening of negotiations of a previously announced agreement to purchase an oil refinery was held to be a material fact. In *Speed v. Transamerica Corp.*, 99 F. Supp. 808 (D. Del. 1951), the nondisclosure of appreciation of assets coupled with an intent to liquidate the company was held to be material. Professor Loss questions, however, whether the undisclosed intent to liquidate in *Transamerica* was necessary to establish materiality. 3 L. Loss, *supra* note 11, at 1460-62.

Although a determination of whether a fact is material will often be uncertain, it has been argued that "a careful analysis of the facts involved, together with the application of honest judgment and common sense will generally produce the right answer." Kennedy & Wander, *Texas Gulf Sulphur, A Most Unusual Case*, 20 BUS. LAW. 1057, 1067 (1965). For an in depth discussion of cases dealing with the issue of materiality, see 3 L. Loss, *supra* note 11, at 1457-65, supplemented by 6 L. Loss, *supra* note 11, at 3577-3601.

93. In the chapter of the RESTATEMENT OF TORTS dealing with misrepresentation, materiality is first defined as an element "to whose existence or nonexistence a reasonable man would attach importance in determining his choice of action . . ." The second section, however, enlarges the definition to include the situation when "the maker of the representation knows that its recipient regards or is likely to regard the matter as important, although a reasonable man would not so regard it." RESTATEMENT (SECOND) OF TORTS § 538 (Tent. Draft No. 10, 1964) (emphasis added).

Assume that Seller (*S*) was a shareholder in *X* Airways, and, in the course of selling his stock to Purchaser (*P*), *S* incorrectly told *P* that *X* was going to paint its planes a number of different colors. Assume further that *S* gave *P* this information in an attempt to induce *P* to purchase the stock, but without any knowledge of its truth or falsity. Finally, assume that, although a reasonable man would attach no importance to this information, *P* believed it to be significant. If materiality is defined with reference to a reasonable man, *P* would be denied recovery because he did not respond reasonably to the misstated information. This result seems unfair since *S*'s statement appears to have been made in reckless disregard of the truth. When the defendant's misstatement is made recklessly, knowingly, or intentionally, the plaintiff should be denied recovery only when his conduct is "utterly unreasonable" or reckless. Thus, in the preceding hypothetical, *P* should be denied recovery only if his judgment of the importance of the misstated fact was "utterly unreasonable."

To apportion the loss fairly in a situation where the conduct of a defendant has been reckless, knowing or intentional, therefore, materiality should be defined in terms of "recklessness." Under this standard, a plaintiff would be barred from recovery only when the misstated fact was so insignificant as to make his reliance on it "utterly unreasonable."

c. Nondisclosures

If the other elements of recovery are met, a defendant who negligently fails to disclose a fact to a plaintiff should be held liable under rule 10b-5.⁹⁴ Where liability in the face-to-face nondisclosure situation is predicated on such simple negligence, it is appropriate to define materiality with reference to a reasonable man. If the undisclosed fact was one that would *not* have been important to a reasonable man, therefore, the negligent defendant should not be held liable. Even if the plaintiff can show that *he* would have deemed the undisclosed fact important, recovery should be denied since a plaintiff who would place importance on such a trivial fact would be responding unreasonably or negligently. Thus, his own unreasonable conduct would render his loss as much his fault as the fault of the negligent defendant. To deny the plaintiff a recovery in this situation would be consistent with

94. See text accompanying note 37 *supra*.

the notion, expressed above, that the law should not reapportion loss if the parties are equally blameworthy.

If the defendant's failure to disclose is reckless, knowing or intentional, however, should the law define materiality in terms of a reasonable man standard or in terms of recklessness, thus denying liability only if the undisclosed fact was so trivial that to deem it important would be reckless conduct? Although this altered standard of materiality would be consistent with the approach suggested for the face-to-face misstatement situation, it should nevertheless not be generally applied in the case of a reckless, knowing or intentional nondisclosure by a defendant. The test of materiality should be defined in all cases with reference to a reasonable man. Although such a rule may sometimes result in the less blameworthy party bearing the loss, this result is necessitated by the inherent nature of the nondisclosure situation, which involves a step absent from the misstatement situation. Since materiality is the primary factor in determining whether a nondisclosure violates 10b-5, a potential defendant is forced to review those facts within his knowledge to make a judgment as to what facts must be revealed. This determination requires the potential defendant to apply some standard to those facts. If the standard is the objective, reasonable man standard, then the difficulty in determining what facts should be revealed is minimized. If the definition of materiality were altered, however, to include all facts that affect the investment judgment of non-reckless investors, the potential defendant would be confronted with the Solomonic task of determining which facts would be deemed material in the subjective perception of an unreasonable investor.

Assume that *S* was a shareholder in *X Airways* and, in the course of selling his stock to *P*, *S* did not reveal the inside information that one of the vice-presidents of *X* was about to resign. Unless that information were deemed material (*i.e.*, one to which a reasonable man would attach importance in determining whether to purchase the stock), *S* should not be held liable, even though there was nondisclosure of a *known* fact. This result is necessitated because *S* needs a workable standard by which to ascertain those disclosures that must be made. To require the disclosure of all information that some *unreasonable person* may perceive to be important is impracticable since it would be impossible to determine what facts must be disclosed. Liability in this situation would seem clearly unfair to a corporate insider who

wanted to sell his stock.⁹⁵

The defendant must be given a workable standard to ascertain those facts that must be revealed in a face-to-face transaction. This standard can fairly be provided only with reference to the reasonable man. For this reason, plaintiffs should be barred from recovery unless the nondisclosure involves a fact that would affect the investment judgment of a reasonable man. Any less stringent standard gives inadequate guidance to the defendant regarding his required course of conduct.⁹⁶

C. Reliance

1. Face-to-Face Misstatement

Prior to *Mills v. Electric Auto-Lite Co.*,⁹⁷ it was assumed that reliance⁹⁸ was a prerequisite for recovery under rule 10b-5.⁹⁹ Reliance is a subjective element implying that the particular plaintiff's investment decision was influenced by the misstated fact. Accordingly, for a plaintiff in a face-to-face misstatement situation to recover, the particular misstatement must have been a substantial factor in his investment decision.¹⁰⁰ Thus, for exam-

95. Comparing this to the misstatement situation, if *P* asked *S* if the vice-president had been fired and *S*, although knowing the contrary to be true, told *P* that the vice-president had not been fired, *P* should not be barred from recovery *unless* the misstated fact were so insignificant as to make his reliance on it utterly unreasonable. Arguably the purchaser should be barred only if he knew the statements were false.

96. The one possible exception may be where the seller knows that the purchaser would deem the fact important and thus intends to "defraud" the purchaser. In that situation, it would seem that non-disclosure of the fact should be actionable, even though it was not a fact which would influence the judgment of a reasonable man.

97. 396 U.S. 375 (1970).

98. One point concerning the definition of reliance deserves emphasis. Reliance exists under a 10b-5 analysis if the plaintiff relies on the defendant's misstatement in his decision to purchase or in his decision as to the proper purchase price of the security involved. If, for example, the defendant-seller makes a misstatement to the plaintiff-purchaser regarding the earnings of the company, and this misstatement does not persuade the plaintiff to purchase, but does persuade him that the stock is worth \$15 per share rather than \$10, reliance is established as required for a 10b-5 cause of action.

99. See generally 6 L. Loss, *supra* note 11, at 3876-80; 2 A. BROMBERG, *supra* note 12, § 8.6(1), at 289; Dykstra, *The Battle Grounds of 10b-5*, 1971 UTAH L. REV. 297. "In face-to-face transactions the reliance approach . . . continues, in all probability, to have validity." *Id.* at 305.

The requirement of reliance in 10b-5 causes of action was not clear in the early cases. For example, in *Kardon v. National Gypsum Co.*, 83 F. Supp. 613, 614 (E.D. Pa. 1947), the judge found that representations of the defendants "were relied upon, although the result would be the same if they had not been."

100. This tort concept is borrowed from the law of misrepresentation which requires that a defendant's action be only a substantial factor in causing the plaintiff's conduct

ple, if Seller (S), in the course of negotiations with Purchaser (P) for the sale of X corporation stock, incorrectly states that Mr. Adams has just been appointed president of X, P will be permitted recovery only if the misstated fact was a substantial factor in his investment decision. If, however, P's decision was made for a different reason, *e.g.*, X was to manufacture a new product, P would not recover because he did not rely on the misstatement. That reliance was a necessary element of recovery, prior to *Mills*, is exemplified by *Janifan v. Taylor*.¹⁰¹ Here, the plaintiff, a shareholder of Boston Electric Steel Casting, Inc., sold his stock to the defendant, who was the president, general manager and a director of the company. During the sale negotiations, the defendant was asked if he knew of any material change in the affairs of the company. The defendant falsely responded in the negative. In affirming the liability of the defendant,¹⁰² the court stated that reliance was a requirement for establishing liability.¹⁰³

Mills, however, raised serious questions about the continued viability of reliance as a requisite element of recovery.¹⁰⁴ There the plaintiff alleged a violation of the 1934 Securities Exchange Act rule 14a-9, which forbids the solicitation of proxies by the use of any statement that is "false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading"¹⁰⁵ The plaintiff complained that the material used to solicit proxies for a proposed merger between his company, Electric Auto-Lite, and Mergenthaler Linotype Company was defi-

and not the sole or even paramount inducement. *Neuman v. Corn Exch. Nat'l Bank & Trust Co.*, 356 Pa. 442, 51 A.2d 759 (1947). See generally *W. PROSSER, supra* note 11, at 714-20.

101. 344 F.2d 781 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965).

102. The court affirmed the lower court's decision for the plaintiff, but remanded the case on the issue of damages.

103. 344 F.2d at 786: "[U]nder any interpretation of the Act, [reliance] is a necessary condition." See also *Rogen v. Ilikon Corp.*, 361 F.2d 260, (1st Cir. 1966). Judgment should be rendered for the defendant "if it has been demonstrated as a matter of law that plaintiff in no way relied on such possible nondisclosure of material facts." *Id.* at 267.

104. Some cases have dismissed the need for reliance altogether. See, *e.g.*, *Vine v. Beneficial Fin. Co.*, 374 F.2d 627 (2d Cir. 1967). *Vine*, however, represents a special fact situation. The plaintiff was a nonacceptor of a tender offer, and the defendant, after its alleged deception in making a tender offer, effected a short form merger, thus forcing the plaintiff to accept cash for his shares. Since the plaintiff was forced to "sell" his shares, a showing of reliance was held to be unnecessary "in the limited instance when no volitional act is required." *Id.* at 635.

105. 17 C.F.R. § 240.14a-9 (1973). An interpretation of rule 14a-9 is especially relevant to rule 10b-5(2) since the language of the two rules is essentially identical.

cient in stating that Auto-Lite recommended the merger without revealing that all the directors were nominees of Mergenthaler. Apparently sensitive to the seventh circuit's concern that "reliance by thousands of individuals . . . can scarcely be inquired into,"¹⁰⁶ the Supreme Court seemingly relieved the plaintiff of the burden of establishing reliance on the misstatement as a prerequisite for recovery. Once materiality had been established, the Court stated,

There is no need to supplement this requirement . . . with a requirement of proof of whether the defect actually had a decisive effect on the voting. Where there has been a finding of materiality, a shareholder has made a sufficient showing of causal relationship between the violation and the injury for which he seeks redress if, as here, he proves that the proxy solicitation itself, rather than the particular defect in the solicitation materials, was an essential link in the accomplishment of the transaction. This objective test will avoid the impracticalities of determining how many votes were affected, and, by resolving doubts in favor of those the statute is designed to protect, will effectuate the congressional policy of ensuring that the shareholders are able to make an informed choice when they are consulted on corporate transactions.¹⁰⁷

*Johns Hopkins University v. Hutton*¹⁰⁸ exemplified the uncertainty of the status of reliance after *Mills*. In the course of negotiations which ultimately led to the university's purchase of oil and gas production payments, misstatements of the estimated revenues from the oil wells were made. In granting a summary judgment for the plaintiff,¹⁰⁹ the court addressed itself to the element of reliance. Recognizing that "in 10b actions, 'most of the authorities require *some* reliance by the plaintiff upon the data that was furnished,'" ¹¹⁰ the court discussed *Mills*, but refused to

106. *Mills v. Electric Auto-Lite Co.*, 403 F.2d 429, 436 n.10 (7th Cir. 1968). The Seventh Circuit determined the existence of reliance by reference to the fairness of the terms of the merger. The court held that if the merger was fair in its terms, the defendants would have satisfied the court that the merger would have been approved even without the misleading statements, thereby establishing the absence of reliance or causation. The Supreme Court, however, rejected this approach, stating that such a formulation "would allow the stockholders to be bypassed . . ." 396 U.S. 375, 381 (1970).

107. 396 U.S. at 384-85.

108. 326 F. Supp. 250 (D. Md. 1971).

109. The court had presented the plaintiff with the choice of opting for damages after refusing to grant summary judgment for rescission.

110. 326 F. Supp. at 257.

construe that case as eliminating the need for reliance. Instead, the court stated that "in this case, *inquiry into the fact of reliance is not impractical* and such inquiry undisputedly establishes . . . reliance" ¹¹¹

In another post-*Mills* case, *Kohn v. American Metal Climax, Inc.*,¹¹² the Third Circuit was less than unanimous in determining the necessity for establishing reliance in a 10-5 recovery. *Kohn* grew out of an amalgamation between American Metal Climax, Inc. (AMAX) and Roan Selection Trust Limited (RST). The operating assets of RST were to be turned over to the government of Zambia and the non-operating assets would either be distributed to the shareholders of RST or amalgamated into AMAX. In return AMAX was to give the non-AMAX shareholders of RST \$76 million in 8% subordinated debentures with common stock warrants attached and \$6.3 million in cash. Kohn filed a derivative action against AMAX on behalf of RST and all non-AMAX shareholders of RST. In finding a violation of 10b-5 because of material misrepresentations in the proxy solicitation material, the majority apparently rejected the notion that reliance is a prerequisite to establishing a cause of action under 10b-5:

We think those alleging a violation of Rule 10b-5 have an obligation to show a fraudulent and material misrepresentation and that to the extent a reliance factor is required, in the present context it is encompassed by the finding that the misrepresentation was material.¹¹³

In a separate opinion, Judge Adams disagreed with the idea that reliance is no longer important in a 10b-5 private action. Although conceding that both section 10b and rule 10b-5 are silent on the subject of any reliance requirement, he concluded that

Congress clearly intended that as part of a plaintiff's case he prove that he relied on the particular misleading statement of which he complains [and that] most cases discussing the matter hold that reliance is an essential element in an action for damages under the securities laws.¹¹⁴

111. *Id.* at 260 (emphasis added).

112. 458 F.2d 255 (3d Cir. 1972).

113. *Id.* at 269. One commentator has read this statement as "establishing a presumption of reasonable reliance where it is reasonable to suppose that reliance in fact existed." Comment, *Reliance Under 10b-5: Is the "Reasonable Investor" Reasonable?*, 72 COLUM. L. REV. 562 (1972).

114. 458 F.2d at 288. See also Latty, *The Aggrieved Buyer or Seller or Holder of*

With respect to *Mills*' relaxation of the reliance requirement, he distinguished the decision as "a class action under Section 14 and the proxy rules—provisions serving a different purpose from Section 10(b) and Rule 10b-5, and having substantially different standards."¹¹⁵ Beyond this, Judge Adams was apparently willing to accept *Mills*' relaxed reliance requirement because it was a class action. He viewed 10b-5 cases as falling within two categories with respect to the requirement of reliance: class or injunctive actions¹¹⁶ and individual damage suits. In the former, he found no need for a reliance element because of the administrative impossibility of each individual plaintiff in a class suit proving his individual reliance. Recognizing that "in *Mills*, the objective test was primarily adopted to obviate the need to prove reliance on the part of each member of the class,"¹¹⁷ Judge Adams felt that demanding such a showing would negate the effectiveness of class actions but believed that proof of reliance was still required in individual damage suits.

In 1972, the Supreme Court in *Affiliated Ute Citizens v. United States*¹¹⁸ may have further weakened the reliance require-

Shares in a Close Corporation Under the S.E.C. Statutes, 18 LAW & CONTEMP. PROB. 505, 526-27 (1953). "There is nothing in [rule 10b-5] to indicate that 'reliance' . . . on the untruth or omission is dispensed with."

115. 458 F.2d at 289.

The thrust of the proxy rules is to ensure that shareholders receive accurate information by enabling objectors to a proxy statement to enjoin the distribution or voting of proxies, or action taken pursuant to the vote, early in the process, while it is still relatively easy to correct the defect. Accordingly, it is appropriate that reliance and culpability not be essential independent elements of a Section 14 action. While the main thrust of Section 10b is to achieve the same goal, it does so by the significantly different method of prescribing penalties, civil and criminal, for the dissemination of false and misleading statements. In such case, reliance and culpability form crucial ingredients in the cause of action, and the equation in *Mills* of materiality with causation and reliance becomes inapplicable.

Id.

116. In the injunctive situation, Professor Loss points out:

Civil actions differ from administrative proceedings under the rule, whose aim is to deter misconduct by insiders rather than to compensate their victims. There the fact that no harm actually results from the misconduct . . . is ordinarily irrelevant to the preventive purposes.

6 L. Loss, *supra* 11, at 3877.

117. 458 F.2d at 290.

118. 406 U.S. 128 (1972). Although *Ute* was decided as a nondisclosure case, it is appropriate to discuss the case in the misstatement situation, since it is the only one in which the Supreme Court discusses its concept of the element of "reliance" in a 10b-5 action.

ment as the pillar of a 10b-5 cause of action. The plaintiffs in *Ute* claimed that the defendants had made misstatements and non-disclosures violative of Rule 10b-5 in connection with a sale of shares in the Ute Development Corporation. The Supreme Court found that the defendants failed to disclose that they were market makers in the securities and that the price the plaintiffs were to receive was below the market price.¹¹⁹ The court then rejected reliance as a prerequisite for recovery:

Under the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision. [Citing *inter alia*, *Mills v. Electric Auto-Lite Co.*] This obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact.¹²⁰

Thus, do *Mills* and *Ute* indicate that reliance is no longer required in the face-to-face misstatement situations? From the standpoint of policy considerations, arguments can be marshalled favoring the deletion of reliance as a prerequisite for recovery.¹²¹ Since the plaintiff's reliance is a subjective factor often established by self-serving testimony, one might argue that to require reliance in a face-to-face misstatement case may relegate the element to an empty ritual of pleading and testifying.¹²² A more

119. *Id.* at 153.

The individual defendants . . . were market makers. . . . This being so, they possessed the affirmative duty under the Rule to disclose this fact to the mixed-blood sellers. [Citations omitted]. It is no answer to urge that, as to some of the petitioners, these defendants may have made no positive representation or recommendation. The defendants may not stand mute while they facilitate the mixed-bloods' sales to those seeking to profit in the non-Indian market the defendants had developed and encouraged and with which they were fully familiar. The sellers had the right to know that the defendants were in a position to gain financially from their sales and that their shares were selling for a higher price in that market.

Id.

120. *Id.* at 153-54.

121. See, e.g., Bucklo, *supra* note 10, at 592, where the author opines that the element of reliance will probably be eliminated.

122. 2 A. BROMBERG, *supra* note 12, § 8.6(2), at 210: "Requiring reliance is likely to produce only a ritual of pleading followed by 'I relied' testimony from the plaintiff. This is true if the alleged offense is misrepresentation. . . ." Professor Loss seems to worry about the same problem, although he addresses himself to the nondisclosure situation. 3 L. LOSS, *supra* note 11, at 1766. In the supplement to that section, Loss softens his

persuasive argument in favor of eliminating reliance as a prerequisite to recovery under 10b-5 is that the *in terrorem* effect of deleting reliance may result in fewer misleading statements being made.¹²³ In *J.I. Case Co. v. Borak*,¹²⁴ the Supreme Court, in affirming the existence of a private remedy for a violation of rule 14a-9 of the proxy rules, indicated that the courts had substantial flexibility in fashioning remedies to promote the goals of the securities acts. It could be argued that relaxation of the reliance requirement would promote the goal of truthful information, and thus logically extend the *Borak* analysis by providing greater deterrence against the type of conduct which rule 10b-5 attempts to proscribe.

An examination of the cases suggests, however, that neither policy considerations nor the language of *Mills* and *Ute* demand the deletion of reliance as a prerequisite for a recovery under 10b-5. In *Mills* the Court stated that “[w]here there has been a finding of materiality, a shareholder has made a sufficient showing of causal relationship between the violation and the injury for which he seeks redress. . . .”¹²⁵ The Court continued by stating that “[t]his objective test will avoid the impracticalities of determining how many votes were affected [and will resolve] doubts in favor of those the statute is designed to protect. . . .”¹²⁶ In *Ute* the Court stated that in

the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. . . . This obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact.¹²⁷

The language of both cases indicates that *causation-in-fact*, a causal connection between the wrong and harm suffered by the

position: “The author may have been a bit *too* relaxed, however, in suggesting . . . that reliance, if required in a case of alleged violation by silence, ‘may mean little more than the inclusion of the word in the complaint.’” 6 L. LOSS, *supra* note 11, at 3878.

123. In discussing *List* one author favored the court’s use of a relaxed reliance test, apparently because the easier recovery would encourage suits, thereby deterring the type of conduct which the section and rule were intended to prevent. Comment, *Securities Regulation: Reliance on Material Misrepresentation or Nondisclosure Essential to Sustain 10b-5 Action*, 50 MINN. L. REV. 759, 764 (1966).

124. 377 U.S. 426 (1964).

125. 396 U.S. at 385.

126. *Id.*

127. 406 U.S. at 153-54.

plaintiff, is essential to recovery. In a face-to-face misstatement situation, there can be no causation-in-fact unless the plaintiff relied on the misstatement.¹²⁸ Absent reliance by the plaintiff in this situation, the misstatement by the defendant simply would not be a substantial factor in bringing about the plaintiff's injury,¹²⁹ and, consequently, there would be no harm in fact caused by defendant's misstatement. To illustrate, assume that defendant, an X corporation shareholder who wishes to sell his stock, makes an offer to sell to plaintiff. In the course of negotiations, defendant tells plaintiff falsely that the company has just signed a large contract to supply goods to the government. Plaintiff's decision to purchase at the price he was willing to pay is not, however, based on defendant's misstatement. Instead, plaintiff relied on the high liquidation value of the assets of the corporation and his own assessment of a new product developed by X corporation. In this case, there is no harm caused by defendant's misstatement, since plaintiff's purchase was determined by other factors.

Mills and *Ute* should not be interpreted as permitting plaintiff to recover in the foregoing illustration, since the requisite element of causation-in-fact is absent. Rather, *Mills* and *Ute* should be construed as explicating the method by which plaintiff can prove causation-in-fact or reliance. Plaintiff can meet his burden of proof with respect to subjective reliance and causation-in-fact by a showing of materiality—that a reasonable man would attach importance to the misstated fact in determining his choice of action in the transaction in question. Thus when the *Mills* Court found a “sufficient showing of causal relationship” by a finding of materiality, and when the Court in *Ute* found that the “withholding of a material fact establish[ed] the requisite ele-

128. Analytically, causation-in-fact and reliance are not necessarily identical because a finding of reliance in the face-to-face misstatement does not answer the question of *how much* damage was in fact caused by the misstatement. See Painter, *Insider Information: Growing Pains for the Development of Federal Corporation Law Under Rule 10b-5*, 65 COLUM. L. REV. 1361 (1965); Comment, *Civil Liability Under Section 10B and Rule 10B-5: A Suggestion for Replacing the Doctrine of Privity*, 74 YALE L.J. 658, 671-72 (1965). The absence of any reliance, however, seems to result in no causation-in-fact in the face-to-face misstatement situation.

129. “The reason for this requirement [of reliance] as explained by the authorities cited is to certify that the conduct of the defendant actually caused the plaintiff's injury.” *List v. Fashion Park, Inc.*, 340 F.2d 457 (2d Cir. 1965). See also Comment, 32 U. CHI. L. REV., *supra* note 74, at 841; the author bases his opinion that reliance is required for recovery on the need to limit the class of persons recovering to those the legislation was intended to protect—“conscientious buyers and sellers.”

ment of causation-in-fact," the Court was presuming subjective reliance from a finding of materiality.

A finding of materiality, however, should not be taken as a conclusive presumption of causation-in-fact. The presumption would be rebuttable, allowing the defendant the opportunity to show that the plaintiff did not rely on the misstatement in assessing his course of conduct. If the defendant can meet this burden, the plaintiff should be denied recovery because he suffered no harm caused by the misstatement.¹³⁰ This interpretation of *Mills* and *Ute* would be consistent with the compensatory nature of civil actions under 10b-5. As Professor Loss has stated: "Civil actions differ from administrative proceedings under the rule, whose aim is to deter misconduct by insiders rather than to compensate their victims."¹³¹ Moreover, this remedial function of the rule has been recognized by the Supreme Court in *SEC v. Capital Gains Research Bureau*,¹³² where the Court said that the rule should be construed "not technically and restrictively, but flexibly to effectuate its remedial purposes."¹³³

2. Face-to-Face Nondisclosure

As in the face-to-face misstatement situation, reliance seemed firmly established as a prerequisite to recovery in the face-to-face nondisclosure situation, at least prior to *Mills*. The significance of the reliance factor, however, becomes less apparent in the face-to-face nondisclosure situation. The question which arises is: How does one rely on a fact not disclosed? In *List v. Fashion Park, Inc.*,¹³⁴ the Second Circuit explained how the element of reliance fits in the face-to-face nondisclosure situation. After affirming that reliance was a prerequisite to liability

130. Although not necessarily advocating this position, Bromberg suggests the presumption of release from materiality as one which "makes sense," but he makes it clear that "the presumption would, of course, be rebuttable by appropriate evidence." 2 A. BROMBERG, *supra* note 12, § 8.6(2), at 212. Bromberg views this method as having the advantage of eliminating the "empty pleading" of reliance. *Id.* Another commentator advocates a similar interpretation of *Mills* and the pre-*Ute* cases. Comment, *Reliance Under Rule 10b-5: Is the "Reasonable Investor" Reasonable?*, 72 COLUM. L. REV. 562, 565 (1972).

131. 6 L. Loss, *supra* note 11, at 3887. See also Sandler & Conwill, *supra* note 46, at 273 (1964), where the authors speak of "both the deterrence and compensation purposes of Rule 10b-5."

132. 375 U.S. 180 (1963).

133. *Id.* at 186, quoted in *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 151 (1972).

134. 340 F.2d 457 (2d Cir. 1965).

under rule 10b-5, "to certify that the conduct of the defendant actually caused the plaintiff's injury,"¹³⁵ the court defined reliance in the nondisclosure situation: "The proper test is whether the plaintiff would have been influenced to act differently than he did act if the defendant had disclosed to him the undisclosed fact."¹³⁶ Thus, as in the misstatement situation, reliance is a subjective element, established only if the *particular plaintiff* would have been influenced to act differently had the fact been disclosed.

The Supreme Court characterized the fact pattern in *Ute* as "involving primarily a failure to disclose."¹³⁷ As previously discussed, *Ute* should be read as establishing in the nondisclosure situation a presumption of reliance from a showing of materiality, affording the defendant an opportunity to rebut the presumption by showing that the undisclosed fact would not have influenced that particular plaintiff to act differently. As in the face-to-face misstatement situation, the elimination of reliance as an element of recovery in the face-to-face nondisclosure situation would be contrary to the remedial nature of 10b-5 because this would allow a plaintiff who has suffered no injury from the nondisclosure to recover. Reliance is thus made an element to be presumed from materiality, with the defendant having the opportunity to rebut the presumption of reliance. Once materiality is shown, "the reasonably prudent investor would be expected to rely. This is more straightforward than requiring an empty pleading and proof, or playing word games with nondisclosure."¹³⁸

135. *Id.* at 462. Although courts regularly state that reliance by the defrauded party is necessary for recovery under 10b-5, closer analysis suggests this view to be an oversimplification. "More accurately, reliance and causation are no longer clearly distinguishable requirements *inter se* or relative to . . . materiality. Rather, they have become partially interchangeable and various combinations . . . suffice in different situations." 2 A. BROMBERG, *supra* note 12, § 8.6(1), at 209. Consequently, causation-in-fact is sometimes absorbed into the element of reliance and *vice versa* in deciding whether there has been a violation of 10b-5.

136. 340 F.2d at 463. In *List*, the court found that the undisclosed fact, the identity of the purchaser, was not relied on by the plaintiff and was of no concern to him. With respect to the other alleged nondisclosure, the possible merger of the corporation, the court could not find clearly erroneous the lower court's holding that at the time of the sale the undisclosed fact was not material. *Id.* at 464.

137. See text accompanying note 118 *supra*. As one commentator has stated: "Reliance established the element of causation, without which the defendant becomes the guarantor, even if the plaintiff's loss was in no way induced by the misrepresentation or omission of which he now complains." Comment, *Reliance Under Rule 10b-5: Is the "Reasonable Investor" Reasonable?*, 72 COLUM. L. REV. 562, 565 (1972).

138. 2 A. BROMBERG, *supra* note 12, § 8.6(2), at 212. In 1961, four years prior to *List*,

D. Summary

In the face-to-face misstatement and nondisclosure situations either negligence or scienter on the part of the defendant should support a recovery by the plaintiff. If, however, the plaintiff has not acted reasonably, he should be barred from recovery. Where the defendant's nondisclosure or misstatement is *negligently* made, the conduct required of the plaintiff is simply that he act reasonably (or, nonnegligently) in assessing the importance of the misstated or undisclosed fact. In addition to this requirement of "materiality," the plaintiff must be reasonable in both believing that the misrepresentation is true and in not discovering the undisclosed fact. Thus, a negligent plaintiff should be denied recovery from a negligent defendant.

If the defendant's misstatement or nondisclosure is made recklessly, knowingly or intentionally, his conduct should be actionable *a fortiori*. Negligence on the part of the plaintiff, either in assessing or investigating the importance of the fact, should not bar recovery. The plaintiff should be denied recovery only if his actions were reckless. The exception to this analysis arises in the nondisclosure situation. A defendant who objectively assesses the significance of a fact in terms of a reasonable man standard and concludes that the information is not material, should prevail over a non-reckless plaintiff even if the plaintiff subjectively would have attached importance to the information. This distinction is necessary to provide an insider with a workable standard for assessing which facts are significant enough to be disclosed.

In both the face-to-face nondisclosure and misstatement sit-

Professor Loss had voiced concern about whether the element of reliance was of any practical significance in the nondisclosure situation. Although stating that "it is difficult not to think in terms of reliance as inherent in the very theory of the action when there is . . . a breach of a duty to speak," he goes on to state that "reliance if required in such a case may mean little more than the inclusion of the word in the complaint." 3 L. Loss, *supra* note 11, at 1766.

Since *Ute*, the lower courts have been predictably confused with respect to the necessity of reliance as an element of recovery under 10b-5. Some courts have indicated that reliance is still an element of recovery under 10b-5. *See, e.g.,* Landy v. Federal Deposit Ins. Corp. 486 F.2d 139, 170 (3d Cir. 1973). More typically, however, the courts have avoided the issue by finding it unnecessary to interpret *Ute*. *See, e.g.,* Cohen v. Franchard Corp. 478 F.2d 115, 124 n.12 (2d Cir. 1973) ("The fullest implications of those decisions [*i.e., Ute* and *Mills*] have not yet been determined."); Johns Hopkins Univ. v. Hutton, 488 F.2d 912, 914-15 (4th Cir. 1973); *In re Penn Cent. Secs. Litigation*, 347 F. Supp. 1327 (E.D. Pa. 1972); Clegg v. Conk, 507 F.2d 1351, 1359 (10th Cir. 1974) ("the implication of the Supreme Court's opinion was that the element of causation in some form remained . . .").

uations, reliance or causation-in-fact should be required. It may be appropriate, however, to presume reliance from a finding that the undisclosed or misstated fact was one which a reasonable man would deem important in assessing his investment decision.

III. NON-PRIVITY MISSTATEMENT

A third factual pattern giving rise to a private action under 10b-5 is the non-privity misstatement situation. If, for example, X corporation (defendant) makes a false statement and Y (plaintiff) purchases X corporation's securities from a third party after learning of the statement, Y may then sue X corporation for a violation of rule 10b-5.

Removing privity from the transaction, however, requires alterations in the elements necessary for 10b-5 recovery. Achieving fairness among the parties and promoting the integrity of the securities market may not be possible under the same configuration of elements as was appropriate in the face-to-face situation. The most obvious non-privity characteristic is the increased number of potential plaintiffs. Thus, if X corporation in the above example is held to have violated 10b-5 for making a public misstatement, its liability would no longer be confined to a single transaction, but instead might extend to a plethora of purchasers or sellers whose transactions were affected. A re-examination of the elements of recovery is necessary in light of this changed circumstance.

A. *Scienter*

In the face-to-face nondisclosure and misstatement cases, even the negligent defendant should be held liable. A negligence standard produces the fairest result by allocating the loss to the more blameworthy party and would promote the integrity of the marketplace by providing an impetus to potential defendants to exercise greater care. When the element of privity is removed from the transaction, however, it seems more appropriate to hold the defendant liable only when the misstatement was made recklessly, with knowledge of its falsity, or with an intent to defraud.¹³⁹ The concept of fairness and the furtherance of the integ-

139. For a discussion of non-privity misstatement cases see Note, *Scienter and Rule 10b-5*, 69 COLUM. L. REV. 1057, 1077-82 (1969); Fleischer, *Securities Trading and Corporate Information Practices: The Implications of the Texas Gulf Sulphur Proceeding*, 51 VA. L. REV. 1271, 1292-94 (1965).

urity of the securities market may necessitate the imposition of liability only if the defendant's state of mind is more blameworthy.

In *Astor v. Texas Gulf Sulphur Co.*,¹⁴⁰ one of the private damage suits arising from the *Texas Gulf Sulphur* litigation,¹⁴¹ Texas Gulf was sued by plaintiffs, who had sold their stock after the deceptively gloomy April 12th press release. In this non-privity misstatement situation, the court held that "plaintiffs must show more than that the April 12 press release was negligently prepared. They must show some degree of scienter."¹⁴² The court went on to recognize that "fraudulent motives, in the traditional common law fraud sense, need not be shown. . . . *Heit* and *Globus* indicate that knowledge of the falsity of statements may be sufficient."¹⁴³

In another case, *Mitchell v. Texas Gulf Sulphur Co.*,¹⁴⁴ plaintiffs again alleged a violation of 10b-5 because they sold their stock after learning of the April 12th press release. After rejecting the defendant's contention that trading by the defendant was a prerequisite for recovery by the plaintiffs,¹⁴⁵ the court grappled with the problem of whether mere negligence on the part of the defendant making the misstatement should be actionable. Although recognizing that the Second Circuit required some degree of scienter, the *Mitchell* court rejected that approach and apparently adopted negligence as the appropriate standard for recovery:

One is not to be held liable *** because of his misleading misrepresentation or omission of material fact . . . if the party responsible for the misrepresentation or omission sustains the burden of proving that he did not know, and in the exercise of reasonable care could not have known that it was a misrepresentation or omission.¹⁴⁶

140. 306 F. Supp. 1333 (S.D.N.Y. 1969).

141. 401 F.2d 833 (2d Cir. 1968).

142. 306 F. Supp. at 1344.

143. *Id.*

144. 446 F.2d 90 (10th Cir. 1971).

145. *Id.* at 102.

The result which we here support is that insider trading is not a requisite for 10b-5 violation by misrepresentation. As appropriately stated by the Second Circuit, "a corporation's misleading material statement may injure an investor irrespective of whether the corporation itself, or those individuals managing it, are contemporaneously buying or selling the stock of the corporation."

146. *Id.*, quoting from *Gilbert v. Nixon*, 429 F.2d 348, 357 (10th Cir. 1970). There are

The notion that liability, absent privity, is appropriate only where the defendant's state of mind can be characterized as reckless, knowing or intentional has been most persuasively advocated by Professor Ruder.¹⁴⁷ Although Ruder finds it acceptable to impose liability for negligence in a privity situation,¹⁴⁸ he balks at imposing liability for negligence in the non-privity misstatement situation: "Under such circumstances, massive liability for negligent misrepresentation or nondisclosure . . . seems unfair."¹⁴⁹ Ruder's unfairness argument is based on the disparity between the potential liability of the defendant and the offensiveness of his conduct. In his opinion the saddling of the defendant with so massive a potential liability for a misstatement made in good faith, albeit negligently, stretches the notion of fairness beyond the point of tolerance.

Beyond the notion of fairness, however, there are other persuasive arguments that negligence should not result in liability in the non-privity misstatement situation. Judge Friendly, in his concurring opinion in *Texas Gulf*, feared that imposing a negligence standard would result in drying up the sources of corporate information:

If the only choices open to a corporation are either to remain silent and let false rumors do their work, or to make a communication, not legally required, at the risk that a slip of the pen or failure properly to amass or weigh the facts . . . will lead to

a number of unresolved problems with the court's statement. First, the authority for the statement, the *Gilbert* case, involved section 12(2) of the Securities Act of 1933, as well as a violation of 10b-5. Second, the court reallocated the burden of proof, requiring the defendant to bear the burden of showing his due diligence. In subsequent cases, however, the Tenth Circuit has retreated from the position stated in text. In *Financial Indus. Fund, Inc. v. McDonnell Douglas Corp.*, 474 F.2d 514, 522 (10th Cir.), cert. denied, 414 U.S. 874 (1973), the court stated that the "burden of showing lack of due care in such circumstances is part of the plaintiff's case." More significantly, the tenth circuit has recently stated that mere negligence on the part of the defendant is not sufficient for recovery under rule 10b-5. *Clegg v. Conk*, 507 F.2d 1351 (10th Cir. 1974). Although the Third Circuit has indicated that recovery in the non-privity misstatement situation does not depend upon establishing an intent to mislead, it has also indicated that mere negligence is not sufficient for recovery. What is not clear, however, is whether knowledge or recklessness is the standard. See *Landy v. Federal Deposit Ins. Corp.*, 486 F.2d 139, 169 (3d Cir. 1973).

147. See Ruder, *supra* note 43.

148. *Id.*

149. *Id.* at 442. But see Sandler & Conwill, *supra* note 46, at 278 (1969), which rejects Ruder's notion because of "the substantial diminution in deterrent force" which is likely to result.

large judgments . . . most corporations would opt for the former.¹⁵⁰

Consequently, subjecting a corporation to non-privy liability would undercut a primary purpose for all securities legislation—guaranteeing a continuing stream of information to public investors.¹⁵¹

The courts should be guided by sound policy reasons in selecting and defining the elements of a 10b-5 cause of action and it is desirable for courts to modify the requisite state of mind in order to promote the integrity of the securities market and fairness among the parties.¹⁵² Allowing non-privy recovery for a negligent misstatement creates an intolerable disparity between the offensiveness of the act and the liability which may be sustained by the defendant.¹⁵³ If one adds to this resulting unfairness the possibility that a negligence standard may in fact result in less information being made available, it becomes difficult to justify the *Mitchell* result.¹⁵⁴ In the non-privy misstatement situation, liability should be predicated on recklessness, knowledge of the falsity or intent to deceive. Although open to attack because it might result in a “substantial diminution in deterrent force,”¹⁵⁵

150. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 867 (2d Cir. 1968).

151. This problem has been discussed by a number of commentators. See, e.g., Note, *Scienter and Rule 10b-5*, 69 COLUM. L. REV. 1057, 1081 (1969). See also Cary, *Symposium—Insider Trading in Stocks*, 21 BUS. LAW. 1009, 1012-13 (1966); 82 HARV. L. REV. 938, 948-51 (1969) (rejecting negligence as the appropriate standard because it would discourage disclosure of information; the author is ready, however, to place the burden of proving good faith on the corporation making the misstatement); Fleischer, *Securities Trading and Corporate Information Practices: The Implications of the Texas Gulf Sulphur Proceeding*, 51 VA. L. REV. 1271, 1292-95 (1965) (accepting liability for non-privy misstatements made by corporations where the misstatement was “knowingly” made, “at least where reliance . . . is intended by the company,” but advocating care in presuming the requisite intent, because “[s]uch a policy . . . might tend to cut off an important source of information for investors and would frustrate the policy of the securities laws of encouraging disclosures.”

The merit of Judge Friendly’s argument is dependent on a rule that there would be no liability against the corporation for nondisclosure of material facts. See text accompanying note 179 *infra*.

152. Although not necessarily in this context, a number of commentators have advocated varying the elements of recovery in different situations. See, e.g., Note, *Scienter and Rule 10b-5*, 69 COLUM. L. REV. 1057, 1070-73 (1969), in which the author advocates negligence as a standard applicable to a tipper while a tippee would be liable only if “reckless indifference” were present.

153. See Ruder, *supra* note 43, at 442.

154. 446 F.2d at 102.

155. Sandler & Conwill, *supra* note 46, at 268.

this possibility must be accepted in order to assure fair treatment of the parties involved.¹⁵⁶

B. Plaintiff's "Reasonable Conduct" Requirement

1. Justifiable Reliance

In the face-to-face situation the plaintiff should be barred from recovery under rule 10b-5 for negligent misstatements and nondisclosures if his conduct was negligent. But, in the case of a misstatement or nondisclosure made recklessly, knowingly or with an intent to defraud, recovery should be denied only if the plaintiff's conduct was "so utterly unreasonable . . . that the law may properly say that his loss is his own responsibility."¹⁵⁷ It is questionable, however, whether the same standards should be applied in a non-privy misstatement situation.

In *Mitchell v. Texas Gulf Sulphur Co.*,¹⁵⁸ a case which involved a non-privy misstatement, the defendants argued that the plaintiff's reliance on the April 12th press release was unreasonable and thus recovery should be denied. The court held that in order to recover, the purchasing plaintiffs must have acted "in good faith and with due diligence."¹⁵⁹ With respect to the sales made by plaintiff Reynolds on April 16th and sales made by plaintiff Mitchell on April 17th, the court allowed recovery, concluding that "good faith and due diligence were exercised in the sale of these shares."¹⁶⁰ In regard to a later sale of shares, however, the court found that reliance on the April 12th press release, in light of the curative press release of April 16th, was unreasonable.

A possible interpretation of *Mitchell* is that a plaintiff may be denied recovery for *negligent* reliance on a misstatement knowingly made by a defendant. One commentator has referred to the April 12th press release as "misleading, intentionally deceptive, inaccurate, and knowingly deficient in material facts"¹⁶¹ The Tenth Circuit, in a subsequent case, stated that the April 12th press release "was obviously and intentionally mis-

156. At least one court has already indicated that the state of mind of the defendant may vary according to the fact pattern involved. *White v. Abrams*, 495 F.2d 724 (9th Cir. 1974).

157. W. PROSSER, *supra* note 11 at 715. See also text accompanying notes 56-85 *supra*.

158. 446 F.2d 90 (10th Cir. 1971).

159. *Id.* at 103.

160. *Id.*

161. Cobine, *Elements of Liability and Actual Damages in Rule 10b-5 Actions*, 1972 U. ILL. L.F. 651, 658 [hereinafter cited as Cobine].

leading.”¹⁶² With respect to the standard to which the plaintiff must conform it is hard to construe “due diligence” (the *Mitchell* Court’s standard) to mean anything other than freedom from negligence.¹⁶³

In discussing the face-to-face misstatement situation, this author suggested that the denial of recovery for negligent reliance on a reckless, knowing or intentional misstatement was unsound because the loss should be absorbed by the more blameworthy party. In a non-privity situation, however, the desire to allocate loss fairly may require a different result.

The issue seems to be whether, in a non-privity misstatement situation, the need to limit the potential class of plaintiffs justifies denying a negligent plaintiff a remedy for a reckless, knowing or intentional misstatement. This author feels that it does not. When the defendant’s state of mind is reckless, knowing or intentional, rather than merely negligent, the possibility of extensive liability is less offensive. There is nothing unfair about holding liable a defendant who recklessly, knowingly or intentionally makes a misstatement that is relied on by non-privity plaintiffs who negligently fail to discover its falsity. In such a situation a plaintiff should be denied recovery only if his conduct is reckless or utterly unreasonable. An accommodation to the tremendous potential liability is properly made by shifting the standard applicable to the *defendant* from negligence to recklessness.

On the other hand, *Mitchell* might be interpreted as barring recovery because of a plaintiff’s negligence in a situation where the defendant’s misstatement was merely negligent. This author believes that liability should be imposed in a non-privity situation only for conduct by a defendant that is more blameworthy than negligent. If, however, courts are determined to hold a non-privity defendant liable for negligent misstatements, then clearly the justifiable reliance requirement should be manipulated to limit the class of potential plaintiffs. Such a constraint on recov-

162. *Financial Indus. Fund, Inc. v. McDonnell Douglas Corp.*, 474 F.2d 514, 522 (10th Cir. 1973). It seems clear, however, that liability in *Mitchell* would have been predicated on the absence of due diligence by the defendant. *Mitchell v. Texas Gulf Sulphur Co.*, 446 F.2d 90, 102 (10th Cir. 1973).

163. *Accord*, Bucklo, *supra* note 10, at 579 (“[D]ue diligence . . . clearly implies a negligence standard.”); 2 A. BROMBERG, *supra* note 12, § 7.2(4)(d), at 154.2. (“The diligence test plainly contemplates that negligent conduct may be a 10b-5 violation.”); *But see* Cobine, *supra* note 161, at 659 (“The justifiable reliance or due diligence standard applied by the *Mitchell* Court should not be mistaken for a contributory negligence theory . . .”).

ery would not only be fair to the plaintiff, but would also be fair to the defendant in helping alleviate the disproportionate liability that he may suffer for a mere negligent misstatement.

2. Materiality

The concept of materiality as a prerequisite for recovery in a face-to-face misstatement case is well established.¹⁶⁴ Although the definition of materiality should be altered in situations involving reckless, knowing or intentional misstatements by the defendant, courts have generally defined materiality as information to which "a reasonable man would attach importance . . . in determining his choice of action. . . ."¹⁶⁵ The important issue, however, is whether materiality should be redefined in the non-privacy misstatement situation.

In *Mitchell v. Texas Gulf Sulphur Co.*,¹⁶⁶ a non-privacy misstatement situation, the Tenth Circuit found the necessary materiality to hold Texas Gulf liable for misstatements made in its April 12th press release. After defining the test for materiality in familiar terms—whether "considering the complaining parties as reasonable investors, the disclosure of the undisclosed facts . . . would affect their trading judgment,"¹⁶⁷—the court assessed the discrepancy between the disclosed facts and the truth. It concluded that "the known size and quality of the ore body was material information; that is, the trading judgment of reasonable investors would not have been left untouched upon receipt of such information."¹⁶⁸

The *Mitchell* case, therefore, indicates that the concept of materiality has not been relaxed in the non-privacy cases since the test is still based on the response of a reasonable man. But was the *Mitchell* court correct in using the same standard for materiality in a non-privacy misstatement situation as is used in the face-to-face situation? Professor Bromberg has suggested that "materiality needs to be more pronounced and more carefully measured in open-market transactions because of potential massive liability to hordes of investors. . . ."¹⁶⁹ Finding some judicial

164. See text accompanying note 86 *supra*.

165. *List v. Fashion Park, Inc.*, 340 F.2d 457, 462 (2d Cir. 1965).

166. 446 F.2d 90 (10th Cir. 1971).

167. *Id.* at 97.

168. *Id.* at 99-100.

169. 2 A. BROMBERG, *supra* note 12, § 8.3, at 199. Another author has been willing to alter the materiality requirement for other reasons. He believes that there should be a

support for a stricter test for materiality,¹⁷⁰ he maintains that courts *as a matter of attitude* should look more carefully at the issue of materiality in the non-privacy situation. Superficially Bromberg's formulation seems to conform with the notion that policy considerations should shape the definition of the elements of recovery. If there is to be liability in the non-privacy situation for misstatements negligently made (a result that this author does not advocate), Bromberg's analysis seems sound. If a plaintiff's investment judgment is affected by the misstatement of a non-material fact (that is, a fact that a reasonable man would not deem important), then his subsequent actions would seem tantamount to negligence. Such conduct should bar a plaintiff's recovery if the defendant's misstatement was negligently made. Furthermore, Professor Bromberg's notion, that in a non-privacy situation the courts should more closely scrutinize the materiality of the misstatement, seems proper in light of the massive liability that may accompany a negligently made statement.

This author, however, rejects the idea that liability ought to be imposed in a non-privacy misstatement situation when the defendant's state of mind is merely negligent. Liability should instead be conditioned on a finding of reckless conduct by the defendant. If the defendant's conduct is reckless (or even more blameworthy) the definition of materiality should change. It is unfair to deny recovery to a plaintiff who relied on a non-material misstatement which was recklessly, knowingly or intentionally made, solely because a reasonable man would not have attached importance to the misstated fact. The plaintiff should instead be barred from recovery only if the misstated fact was so insignificant as to make his reliance on it reckless or utterly unreasonable.

C. Reliance

There is a trend to de-emphasize the importance of reliance in 10b-5 causes of action.¹⁷¹ Much of the pressure to de-emphasize

stricter standard for materiality (*i.e.*, requiring more proof to establish materiality) in the case of insiders who trade on the open-market than in the case of those who merely tip. His reasoning is that, in the open-market situation, there is a legitimate interest served by requiring that managers have a stake in the corporation which they manage. With respect to tipping, however, no such interest exists, thus a looser standard of materiality would suffice. Wiesen, *Disclosure of Inside Information—Materiality and Texas Gulf Sulphur*, 28 MD. L. REV. 189, 208-11, (1968).

170. 2 A. BROMBERG, *supra* note 12, § 8.3, at 199-200.

171. See *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972); *Mills v. Elec-*

the element of reliance apparently stems from the mechanical difficulties in handling suits involving large numbers of plaintiffs. This concern is demonstrated by both the Seventh Circuit and the Supreme Court in the *Mills* litigation. As the Seventh Circuit stated, "Reliance by thousands of individuals, as here, can scarcely be inquired into."¹⁷² Since this factor is more often associated with non-privy situations, the Seventh Circuit favors not requiring each plaintiff in a non-privy suit to prove reliance—especially in class actions.

Should the element of reliance be *completely* eliminated as a requirement in non-privy situations? Although the elimination of reliance as a necessary element would simplify the mechanics of a successful 10b-5 suit, the result would be unacceptable for at least two reasons. First, if a plaintiff has not relied on the defendant's misstatement, causation-in-fact is absent. A recovery in a case where causation-in-fact was not established is impossible to justify. Second, the elimination of privity in the transaction greatly increases the likelihood of numerous suits against a defendant who has made a misstatement. The possibility of extensive liability, coupled with an absence of causation-in-fact, makes recovery by a plaintiff even more unfair. Such a result would permit a suit by a non-privy plaintiff who sold his stock to a third party, when neither the plaintiff-seller nor the third party purchaser was even aware of the defendant's misstatement. It would therefore seem proper to establish a rebuttable presumption of reliance after a showing of materiality. Thus, the element of causation-in-fact would be maintained, but the mechanical difficulties of multiple-party suits would be obviated.

D. Summary

In the non-privy misstatement situation, recovery for a 10b-5 violation should be predicated on a showing that the defendant's misstatement was made with reckless disregard for the

tric Auto-Lite Co., 396 U.S. 375 (1970); *Kohn v. American Metal Climax, Inc.*, 458 F.2d 255 (3d Cir. 1972).

It has been suggested, however, that these cases should not be read as eliminating the requirement of reliance but rather read as establishing a presumption of subjective reliance from a showing of materiality, leaving open to defendants the opportunity to rebut the presumption by evidence of the plaintiff's nonreliance.

172. *Mills v. Electric Auto-Lite Co.*, 403 F.2d 429, 436 n.10 (7th Cir. 1968).

truth, with knowledge of the falsity of the misrepresentation, or with an intent to defraud. The plaintiff's conduct must have involved reliance on a material fact. Materiality should be redefined to bar a plaintiff's recovery only if the misstated fact was so insignificant as to make his reliance on it either reckless or utterly unreasonable. Correspondingly, a plaintiff's reliance should be considered justifiable even if he acts negligently, since the defendant's state of mind is more blameworthy. His reliance on the misstatement should be presumed from a showing that the misstatement was one which would influence the investment decision of a reasonable man. The defendant in the non-privacy misstatement situation, however, should have the opportunity to rebut this presumption by showing that the plaintiff did not in fact rely on the misstatement.

IV. NON-PRIVITY NONDISCLOSURE

The final fact pattern to be discussed is the non-privacy nondisclosure situation. Assume X Corporation learns of some important development that will adversely affect the price of its stock, but fails to disclose this development to the general public. During the time after the discovery of the development by X but before its disclosure, Purchaser buys a share of X stock from Seller, a third party. The result is a non-privacy nondisclosure situation and the issue raised is whether Purchaser can sue X Corporation or X's inside management under rule 10b-5 for failing to disclose the information.¹⁷³ In contrast to discussed fact patterns, it is not clear from the cases that liability exists under any combination of elements. An appropriate starting point for discussion is a determination of whether such a fact pattern should ever be actionable under rule 10b-5.

173. One issue which has been deliberately omitted from this discussion is whether anyone other than the corporation and its high ranking officials has a duty to make a disclosure of inside information in the non-privacy situation. For example, would an accountant who learns of adverse inside information incur liability to market purchasers if he did not make a public disclosure of the information? The courts have generally been reluctant to extend the duty to disclose at least where there is no special relationship between the nondisclosing party and the plaintiff. See *Slade v. Sherson, Hammill & Co.*, 240 Sec. Reg. L. Reps. D-1 (D.N.Y. 1974) (liability of nondisclosing broker to broker's customers for continuing to recommend after learning of adverse inside information); *Landy v. Federal Deposit Ins. Corp.*, 486 F.2d 136 (3d Cir. 1973) (refusal to hold broker liable for nondisclosure where he had no dealings with the plaintiff). But see *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 535 F. Supp. 264 (S.D.N.Y. 1972) (tippees who traded without disclosing held liable to non-privacy purchasers).

A. *Liability Without Regard to Market Activity*

In a recent case the Tenth Circuit apparently accepted the idea that liability may exist in the nondisclosure non-privity situation, without regard to whether or not the defendant is in the market. In that case, *Financial Industrial Fund, Inc. v. McDonnell Douglas Corp.*,¹⁷⁴ the plaintiff had purchased a total of 80,000 shares of McDonnell Douglas stock on June 22 and 23, 1966. On June 24, 1966, the plaintiff learned of a press release by McDonnell Douglas disclosing that its earnings for the last six months were far below the estimates of independent market analysts and brokers. Subsequently, the plaintiff sold the stock at a substantial loss and brought a 10b-5 action to recover his losses.

Financial Industrial Fund was not litigated as a misstatement case. Rather, the case turned on whether liability should result from McDonnell Douglas' nondisclosure on the date when the plaintiff purchased the stock.¹⁷⁵ Although remanding the case with directions to enter a judgment for the defendant notwithstanding the verdict,¹⁷⁶ the court made it clear that non-privity nondisclosure by a corporation may be actionable in certain situations: "It is . . . obvious that an undue delay not in good faith, in revealing facts, can be deceptive, misleading, or a device to defraud under rule 10b-5."¹⁷⁷ It appears that the absence of any market transaction by the defendant would have been of no importance to the court's decision.¹⁷⁸

The commentators are not in agreement that there should be liability for nondisclosure when no privity exists between the plaintiff and defendant—especially when the defendant himself is not exploiting the nondisclosure by engaging in the purchase or sale of securities. As Professor Loss has stated, "[I]t has not yet been established (and should not be) that either the company or its insiders are liable to market buyers or sellers for non-

174. 474 F.2d 514 (10th Cir. 1973).

175. *Id.* at 517-18: "[T]he issue becomes whether the silence of defendant at the date or dates of the stock purchases by plaintiff here gives rise to a cause of action under rule 10b-5."

176. The court found that McDonnell Douglas exercised good faith and due diligence, and that the plaintiff had not shown "the reliance required nor facts to meet the standard of due diligence on his part." *Id.* at 521.

177. *Id.* at 519.

178. There was some market activity by McDonnell Douglas during this period, although the court does not appear to make that a prerequisite for recovery. Specifically, there had been a conversion by a number of debenture holders, who exercised the right to convert in response to a call of the debentures by McDonnell Douglas. *Id.* at 516, 520-21.

disclosure when there is no inside trading.”¹⁷⁹ Professor Ruder likewise rejects the idea that a non-trading defendant should be liable for a failure to disclose information. Ruder views the act that gives rise to 10b-5 liability as the *use* of the information.¹⁸⁰ Other commentators, however, are not as certain that the non-trading defendant will avoid liability in the non-privity nondisclosure situation.¹⁸¹

If the defendant is engaged in market transactions, commentators generally accept the imposition of liability for nondisclosure to plaintiffs who have made purchases from third parties, although even this position is not unanimous.¹⁸² An example of the lack of unanimity is demonstrated by two cases growing out of the *Texas Gulf* litigation. In *Astor v. Texas Gulf Sulphur Co.*,¹⁸³ the plaintiffs had sold their stock after the initial discovery of the mineral deposit on November 12, 1963, but before the public disclosure of the strike. Plaintiffs sued the defendant corporate insiders, who had made purchases from third parties during that period, for not disclosing the mineral discovery. In response to the defendant’s motion for a summary judgment, the court held that the plaintiffs had “stated claims under Rule 10b-5.”¹⁸⁴ In

179. 6 L. Loss, *supra* note 11, at 3597. Professor Cary also agrees that there should be no liability absent market activity by the corporation. Cary, *Symposium—Insider Trading in Stocks*, 21 Bus. Law. 1009, 1014 (1966).

180. Ruder, *supra* note 43, at 442. Professor Ruder admits that, although “affirmative disclosure obligations may be justified from an administrative viewpoint, imposition of large liability on the corporation for failure to make such disclosure when it is not engaged in a transaction does not seem warranted. . . .” *Id.* at 443.

181. Halleran, *Symposium—Insider Trading in Stocks*, 21 Bus. Law. 1009, 1025 (1966):

It doesn’t take much of an extension of the SEC position in *Texas Gulf* to say that corporate management which has the power to disseminate material corporate information, (even though the corporation itself is not trading in its own securities) and deliberately withholds it, may be liable to the innocent people who bought or sold at either inflated or deflated prices.

182. See, e.g., Ruder, *supra* note 43, at 441-42. But see Note, *Civil Liability Under Section 10b and Rule 10b-5: A Suggestion for Replacing the Doctrine of Privity*, 74 YALE L.J. 658, 675-76 (1965). The latter article reasons that since there is no liability in the non-privity nondisclosure situation when the corporation is not trading, there should be no liability where the corporation is trading.

In this situation, it would seem absurd to turn a damaged person into a plaintiff merely because of the fortuity that an insider happened to be trading. . . . To impose liability would be to tax the insider with responsibility for an injury which his misconduct did not cause.

Id. at 676.

183. 306 F. Supp. 1333 (S.D.N.Y. 1969).

184. *Id.* at 1342. It should be pointed out, however, that the court stated that “[h]ad

Mitchell v. Texas Gulf Sulphur Co.,¹⁸⁵ however, the Tenth Circuit reached a different result. The plaintiff there had sold his stock on December 11, 1963, after the mineral discovery had been made but before the drilling results had been disclosed. He attempted to hold liable the executive vice-president of the company, Fogarty, who had purchased *Financial* securities on the open-market during that period. The court refused to hold Fogarty liable, because "there was no duty at that time on the part of . . . defendant to disclose the information . . . with respect to drilling results, and [because] Fogarty's violations of the statute and the rule by purchasing TGS stock did not cause any damage to Plaintiff. . . ." ¹⁸⁶

The absence of a purchase or sale by the defendant has no effect on the damage done to the plaintiff. The harm results solely from the fact that the plaintiff did not have all available data when making his investment decision.¹⁸⁷ The decision to extend liability to non-privy plaintiffs¹⁸⁸ for the nondisclosure of information should thus be made without reference to market activity.¹⁸⁹ If one views the imposition of liability in a non-privy nondisclosure situation as a function of the policy considerations of fairness and the purposes of the securities legislation, it seems hard to avoid the conclusion expressed by the Tenth Circuit

[the defendants] neither bought nor recommended TGS securities, there would have been no duty to disclose." *Id.* at 1341.

185. 446 F.2d 90 (10th Cir. 1971), *aff'g on other grounds* Reynolds v. Texas Gulf Sulphur Co., 309 F. Supp. 548 (D. Utah 1970).

186. 309 F. Supp. at 559.

187. See Note, *Civil Liability Under Section 10b and Rule 10b-5: A Suggestion for Replacing the Doctrine of Privity*, 74 YALE L.J. 658, 676 (1965).

It is interesting to note that in the *non-privy misstatement* situation, there is judicial authority for the notion that the absence of insider transactions is irrelevant to recovery. *Mitchell v. Texas Gulf Sulphur Co.*, 446 F.2d 90, 102, *quoting* SEC v. *Texas Gulf Sulphur Co.*, 401 F.2d 833 at 861 (2d Cir. 1968): "[A] corporation's misleading material statement may injure an investor irrespective of whether the corporation itself, or those individuals managing it, are contemporaneously buying or selling the stock of the corporation."

188. Again it should be emphasized that this discussion is limited to liability of the corporation and its top management. It may make sense to restrict liability to persons who trade and to exonerate defendants who are, for example, mere tippees. In the latter situation, a non-trading tippee's nondisclosure may be deemed an act that is not blame-worthy enough to result in his liability.

189. Although my respect for the judgment and analysis of Professor Ruder is evidenced by this article, I am unable to agree with his notion that unfairness, which is a prerequisite for liability, results only from the use of the undisclosed information. Ruder, *supra* note 43, at 442. I would suggest instead that unfairness might result from nondisclosure if the defendant possesses the requisite state of mind.

that, at least under some circumstances, a non-privacy nondisclosure situation should be actionable. First, the imposition of liability in such situations would encourage the disclosure of that material information needed for intelligent investment choice, thereby promoting the integrity of the marketplace. Second, if the nondisclosing defendant's state of mind is sufficiently blameworthy (reckless, knowing or intentional), fairness would seem to dictate that he absorb the loss of the plaintiff's uninformed market transactions. This reasoning, however, serves only to demonstrate that liability in the non-privacy, nondisclosure situation is appropriate in *some* circumstances. The element of recovery must be examined in determining under which circumstances liability is appropriate. It should be emphasized that the non-privacy, nondisclosure situation differs from the non-privacy misstatement situation since a nondisclosure is arguably less offensive than an affirmative misstatement. Furthermore, the non-privacy nondisclosure situation is unlike the face-to-face misstatement and nondisclosure situations in that the non-privacy nondisclosure situation involves potentially massive liability. Consequently, the appropriate elements of recovery should be the subject of close scrutiny in order to avoid treating the nondisclosing defendant unfairly.

B. *Elements of Recovery*

With respect to the requisite *state of mind of the defendant*, the court in *Financial Industrial Fund*¹⁹⁰ was confronted with the *Mitchell* language, which indicated that, in the non-privacy misstatement situation, the failure of the defendant to exercise due diligence would be actionable. The court, however, seemed reluctant to impose this standard on the defendant, and turned instead to a consideration of the "business judgment" rule which bars recovery "for errors or mistakes in judgment . . . when . . . [defendants] have used such judgment and have so acted in good faith."¹⁹¹ Although recognizing that the business judgment rule was generally applicable only in suits against corporate officers and directors for mismanagement of the corporation, the court stated that the same standard should be applied in this case

190. 474 F.2d at 519.

191. *Id.* at 518. The court may be using two different standards in assessing the liability of the corporation. It appears that the corporation owes a duty of "due diligence" in promptly gathering information but only a duty of "good faith" in the timing of the release. *Id.* at 521.

since the "timing of such statement was a matter of discretion."¹⁹² The defendant would therefore be exonerated by a showing of "either good faith or the exercise of good business judgment in its acts or inaction."¹⁹³ The court denied recovery, concluding that "there was exercised good faith and due diligence" in the timing of the release.¹⁹⁴

The court in *Financial Industrial Fund* was attempting to select a standard that would hold the defendant liable only for conduct more blameworthy than mere negligence. In part, the court responded to the fact that disclosure problems involve difficult questions of judgment which are absent from the misstatement situation. In the nondisclosure situation it is necessary for the defendant to judge the significance of facts involved since only material facts need be disclosed.¹⁹⁵ Such a judgment is not required in the misstatement situation, since the defendant may avoid liability by simply telling the truth.

Although it may be appropriate to consider the difficulty of the judgment involved in selecting the standard of conduct applicable to the defendant, the imprecise analysis used by the court in *Financial Industrial Fund* detracts from an opinion that is otherwise lucid. First, it is less than clear that there is any difference between the "business judgment" standard and a due diligence or negligence standard. Professor Lattin has stated that it is "doubtful" whether there is any difference between the reasonable man test and the business judgment rule.¹⁹⁶ Even assuming that a "business judgment" standard is somewhat less stringent than a negligence standard, the concept as defined by the court lacks the precision of a "recklessness" standard, which may, in fact, be the test the court is endorsing. *Financial Industrial Fund* is therefore an example of a case in which the court engaged in the type of analysis appropriate in 10b-5 cases. The court attempted to select a different standard, based on valid policy reasons, by which to measure the defendant's conduct.

192. *Id.* at 518.

193. *Id.* at 521.

194. *Id.*

195. After recognizing that management must evaluate the significance of the information in question, as well as ascertain the details in question with reasonable dispatch, the court stated: "These factors take us so much farther within the corporate decisional processes than do misleading statements actually issued." *Id.* at 518.

196. N. LATTIN, CORPORATIONS 272-74 (2d ed. 1971). See also 3 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS 1 §§ 1039-40 (1947) (liability for want of ordinary prudence and skill under the "business judgment" rule).

If the court in *Financial Industrial Fund* accepted a standard that approximates recklessness as the norm for defendant's conduct, the decision was correct. As in the *non-privy misstatement* situation, the potentially massive liability makes negligence too stringent a standard by which to measure the defendant's conduct. Moreover, the problem sensed by the court in *Financial Industrial Fund*—the difficulty of the disclosure decision—could be properly handled by the use of recklessness as the standard for defendant's conduct. The choice of this less stringent standard would be a concession to the difficulty of the defendant's decision.

Plaintiff's *justifiable reliance* requirement should be measured by the same standard used in the non-privy misstatement situation. Assuming that liability would result only for nondisclosures that were either reckless, knowing, or intentional, the plaintiff would be barred from recovery only if his reliance were reckless. This standard apparently was not followed in *Financial Industrial Fund*. In that case the court, relying on *Mitchell*, accepted the notion that "plaintiff . . . had the burden of proof to establish that it exercised due care in making its stock purchase" ¹⁹⁷ The court found that "there was no showing by plaintiff of . . . facts to meet the standard of due diligence on its part." ¹⁹⁸ Conditioning plaintiff's recovery on a finding that plaintiff acted with due care seems inappropriate in light of the fact that the defendant was apparently held to a lower standard of care. Such a situation could conceivably result in a negligent plaintiff being barred from recovery for a defendant's reckless, knowing or intentional nondisclosure. As stated earlier, this result would seem intolerable. Once it is decided that a fact pattern is actionable, loss should generally be allocated to the more blameworthy party. ¹⁹⁹

Materiality is the only element that should be defined differently here than in the non-privy misstatement situation. In the non-privy nondisclosure situation, a material fact should be defined with reference to a reasonable man standard; that is, any fact which would affect the investment judgment of a reasonable man. The use of a recklessness standard (as was suggested in the non-privy misstatement situation) would not give a defendant

197. 474 F.2d at 521.

198. *Id.*

199. See text accompanying note 170 *supra*.

proper guidance as to what he was expected to disclose since the decision to disclose requires a judgment of what would be material. To define materiality in terms of what may affect the investment decision of even a reckless investor simply does not give the defendant a workable test; only the reasonable man standard can objectively provide proper guidance. Under a recklessness standard, a corporation would have to disclose virtually every fact within its knowledge, no matter how trivial, on the basis that an unreasonable investor might attach importance to it. As a result, the necessity of making such massive disclosures would create an intolerable administrative and financial burden on insiders.

When considering the requirement of *reliance*, the court in *Financial Industrial Fund* omitted any discussion of *Mills* or *Ute*, stating that "the plaintiff [has] the burden of broof to establish that . . . plaintiff relied to its detriment" on the nondisclosure of the defendant.²⁰⁰ The court subsequently found that the plaintiff had not met this requirement. For the same reasons as were discussed in the non-privty misstatement section, reliance should be presumed from a finding of materiality, with the defendant having the opportunity to rebut the presumption by introducing proof of the plaintiff's non-reliance.²⁰¹ This definition of reliance which has emerged from *Mills* and *Ute* seems to offer a logical approach to handling the problem.²⁰²

V. CONCLUSION

In this article the author has attempted to formulate the elements of recovery under rule 10b-5. The basic thesis throughout has been that the elements should be defined so as to promote the integrity of the marketplace and to insure fairness among the parties to a securities transaction. This approach would require courts to recognize that the promotion of these policies requires varying elements of recovery according to the fact patterns involved. Moreover, such an approach would insure maximum fair-

200. 474 F.2d at 521.

201. See text accompanying note 183 *supra*.

202. Courts seem to recognize that there would be no liability for the non-trading insider who failed to make material disclosures if there existed a valid corporate purpose for delay in the disclosure. See *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 850 n.12 (2d Cir. 1968); *Astor v. Texas Gulf Sulphur Co.*, 306 F. Supp. 1333 (S.D.N.Y. 1969). This view was approved in *Financial Industrial Fund*, the court stating that a prerequisite for liability was "that there [be] no valid corporate purpose which dictates the information be not disclosed." 474 F.2d at 519.

ness, promote the integrity of the securities markets and steadily increase predictability, as a rational body of law evolves governing the elements of recovery under 10b-5.

Although this author is convinced that his particular definition of the elements of recovery is the most rational, the acceptance of the definition is not as important as is the acceptance of the overall approach advocated by this paper. To accept the premise that the elements of recovery are interdependent and that their definition should promote fairness and protect the integrity of the market would be a significant advance in bringing order to one area of 10b-5 litigation. It would at least provide an understandable and rational framework in which to analyze 10b-5 problems.

Finally, it should be noted that a Ninth Circuit case has accepted an approach to 10b-5 not unlike that advocated in this article. In *White v. Abrams*²⁰³ the court was faced with a claim that material misstatements and nondisclosures had occurred in connection with stock purchases by White. Apparently relying on *Ellis v. Carter*²⁰⁴ and *Royal Air Properties, Inc. v. Smith*,²⁰⁵ the district court had instructed the jury the defendant would be liable under 10b-5 for any material misstatement he made in connection with the sale of the securities, "even if . . . defendant did not know the falsity of the misrepresentation he made to plaintiffs." In holding this instruction to be improper, the court addressed itself to what state of mind the defendant must have in order to be liable under 10b-5. The court specifically rejected the notion that the state of mind necessary for recovery under 10b-5 must be the same in all fact patterns. Rather, the court advocated a flexible approach to the definition of the requisite state of mind of the defendant, stating:

We believe that the cases and commentators demonstrate that any attempt to limit the scope of duty in all 10b-5 cases by the use of one standard for state of mind or scienter is confusing and unworkable.²⁰⁶

The *White* court further noted that, in selecting the applicable state of mind requirement, "the court should focus on the goals of the securities fraud legislation by considering a number of

203. 495 F.2d 724 (9th Cir. 1974).

204. 291 F.2d 270 (9th Cir. 1961).

205. 312 F.2d 210 (9th Cir. 1962).

206. 495 F.2d at 734.

factors that have been found to be significant in securities transactions.”²⁰⁷

Although there are some problems with the opinion in *White v. Abrams*,²⁰⁸ the attitude it reflects is admirable. The factors explicated by the court as important in the selection of the appropriate state of mind seem to express a concern with promoting fairness among the parties and the integrity of the securities market.²⁰⁹ This approach is a needed change in the analysis of the elements of recovery under rule 10b-5.

207. *Id.* at 735.

208. One glaring problem is that the district court was instructed merely to advise the jury on the factors which are to be considered in selecting the defendant's state of mind. The jury is then to find liability or non-liability. *Id.* The problem is that by allowing each jury to select the appropriate standard in each case, predictability disappears and inconsistent results will follow.

209. The court specifically stated that in making the determination of the requisite state of mind, “the court should focus on the goals of the securities fraud legislation” The court went on to urge the consideration, *inter alia* of “the relationship of the defendant to the plaintiff, the defendant's access to the information as compared to the plaintiff's access, the benefit that the defendant derives from the relationship, the defendant's awareness of whether the plaintiff was relying upon their relationship in making his investment decisions and the defendant's activity in initiating the securities transaction in question.” *Id.* at 735-36.

