

V. SEC RULE 10b-5

Rule 10b-5,⁶¹² the most comprehensive of the antifraud provisions found in federal securities law, has been described as a proscription of “practically any sin of omission or commission which may be imagined in connection with the purchase or sale of a security.”⁶¹³ While the essence of the rule is that it requires disclosure of material facts, it does not impose strict liability for misrepresentation or omission.⁶¹⁴

The nature and extent of the additional elements of a private action under rule 10b-5 are the subject of this section. It will examine the required state of mind, “scienter,” and compare the standard established by two circuit courts of appeals. Further, it will ascertain the relationships among materiality, causation, and reliance, and assess the burden that proof of these elements places upon a plaintiff alleging fraud in connection with a securities transaction.

A. *Scienter*

Common law fraud, the action for deceit, required proof of the defendant’s scienter.⁶¹⁵ Scienter was defined as the intent to deceive, to

612. 17 C.F.R. § 240.10b-5 (1974):

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,

1) to employ any device, scheme, or artifice to defraud,

2) 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

3) 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.

613. *Courtland v. Walston & Co.*, 340 F. Supp. 1076, 1083 (S.D.N.Y. 1972), citing *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6 (1971), and *Drachman v. Harvey*, 453 F.2d 722 (2d Cir. 1972).

614. See, e.g., A. BROMBERG, *SECURITIES LAW: FRAUD—SEC RULE 10b-5* (1971) [hereinafter cited as BROMBERG]; L. LOSS, *SECURITIES REGULATION* (2d ed. 1961) [hereinafter cited as LOSS]; Anderson, *The Disclosure Process in Federal Securities Regulation: A Brief Review*, 25 HASTINGS L. REV. 311 (1974); Cohen, “*Truth in Securities*”—*Revisited*, 79 HARV. L. REV. 1340 (1966); Knauss, *A Reappraisal of the Role of Disclosure*, 62 MICH. L. REV. 607 (1964); Whitney, *Section 10b-5: From Cady Roberts to Texas Gulf: Matters of Disclosure*, 21 BUS. LAW. 193 (1965); Note, *SEC Rule 10b-5: A Recent Profile*, 13 WM. & MARY L. REV. 860 (1970).

615. 3 LOSS, 1432; W. PROSSER, *HANDBOOK OF THE LAW OF TORTS* 685-86 (4th ed.

mislead, or to convey a false impression.⁶¹⁶ Rule 10b-5 was intended to express and expand the antifraud coverage of both the 1933 and 1934 Acts. Because the legislative history offered no clear guidance concerning substantive elements required for a private action under rule 10b-5, courts have disagreed as to the nature of scienter required in such actions.⁶¹⁷

Initially, the courts promulgated a scienter standard that seemed to require a general intent to defraud.⁶¹⁸ The minimum culpable conduct was conscious or intentional misrepresentation.⁶¹⁹ The vast majority of cases, however, have recognized that the trend is clearly away from enforcing a scienter requirement equivalent to the intent to defraud required for common law fraud.⁶²⁰

1971) [hereinafter cited as PROSSER]; see Note, *Scienter & Rule 10b-5: Development of a New Standard*, 23 CLEV. ST. L. REV. 493, 495-500 (1974).

616. PROSSER 700. RESTATEMENT OF TORTS § 526 (1938) provides:

- A misrepresentation in a business transaction is fraudulent if the maker
- (a) knows or believes the matter to be otherwise than as represented, or
 - (b) knows that he has not the confidence in its existence or non-existence asserted by his statement of knowledge or belief, or
 - (c) knows that he has not the basis for his knowledge or belief professed by his assertion.

See PROSSER 700-02. The problem of maintaining an action in deceit for misrepresentation that falls short of actual intent to defraud has troubled the courts since *Derry v. Peek*, 14 App. Cas. 337 (1889), excluded negligent misrepresentations from the action for deceit. A minority of courts have refused to accept *Derry* and have held that deceit will lie for negligent statements. PROSSER 699, 705 n.23.

617. The disagreement among the courts is reflected in the number of commentators who have attempted to come to grips with the concept of scienter. See Bucklo, *Scienter and Rule 10b-5*, 67 NW. U.L. REV. 562 (1972); Epstein, *The Scienter Requirement in Actions under Rule 10b-5*, 48 N.C.L. REV. 482 (1970); Mann, *Rule 10b-5: Evolution of a Continuum of Conduct to Replace the Catch Phrases of Negligence and Scienter*, 45 N.Y.U.L. REV. 1206 (1970); Note, *supra* note 615; Note, *Proof of Scienter Necessary in a Private Suit Under SEC Anti-Fraud Rule 10b-5*, 63 MICH. L. REV. 1070 (1965); Comment, *Negligent Misrepresentation Under Rule 10b-5*, 32 U. CHI. L. REV. 824 (1965).

618. See *Fishman v. Raytheon, Inc.*, 188 F.2d 783, 787 (2d Cir. 1951) (an ingredient of fraud is necessary).

619. See *Gerstle v. Gamble-Skogmo, Inc.*, 298 F. Supp. 66 (E.D.N.Y. 1969). Loss suggests that the congressional delegation of power in § 10(b) requires some form of knowledge or intent in private actions because of the words "manipulative or deceptive." 3 Loss 1767. See Note, *Proof of Scienter Necessary in a Private Suit Under SEC Anti-Fraud Rule 10b-5*, 63 MICH. L. REV. 1070 (1965).

620. See, e.g., *Hecht v. Harris, Upham, & Co.*, 430 F.2d 1202 (9th Cir. 1970); *Globus v. Law Research Serv., Inc.*, 418 F.2d 1276 (2d Cir. 1968), *cert. denied*, 397 U.S. 993 (1970); *Hanley v. SEC*, 415 F.2d 589 (2d Cir. 1969); *Myzel v. Fields*, 386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968); *Royal Air Properties, Inc. v. Smith*, 312 F.2d 210 (9th Cir. 1962); *Ellis v. Carter*, 291 F.2d 270 (9th Cir. 1961).

As shown in later cases, the courts have differed in formulating a scienter test for private actions under the rule. Second Circuit cases have cited the language in *SEC v. Texas Gulf Sulphur Co.*,⁶²¹ that "some form of scienter is required."⁶²² As a minimum, something more than negligence is necessary before liability will attach.⁶²³ Another line of cases has indicated that scienter is not necessary, but it is not clear whether these cases are merely stating that no specific intent to defraud is necessary or whether they are attaching liability for negligent misrepresentations.⁶²⁴

621. 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

622. *Id.* at 855.

623. See *Shemtob v. Shearson, Hammill & Co.*, 448 F.2d 442 (2d Cir. 1971); *SEC v. North Am. Research & Dev. Corp.*, 424 F.2d 63 (2d Cir. 1970); *Globus v. Law Research Serv., Inc.*, 418 F.2d 1276 (2d Cir. 1968), *cert. denied*, 397 U.S. 993 (1970); *Heit v. Weitzen*, 402 F.2d 909 (2d Cir. 1968), *cert. denied*, 395 U.S. 903 (1969); *SEC v. Great Am. Indus., Inc.*, 407 F.2d 453 (2d Cir. 1968), *cert. denied*, 395 U.S. 920 (1969).

624. See *Mitchell v. Texas Gulf Sulphur Co.*, 446 F.2d 90, 103 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971) (good faith and due diligence constitute defense); *Hecht v. Harris, Upham & Co.*, 430 F.2d 1202, 1209 (9th Cir. 1970) (proof of specific intent to defraud unnecessary); *Gilbert v. Nixon*, 424 F.2d 348, 357 (10th Cir. 1970) (defense exists if defendant did not know, and in exercise of reasonable care could not have known that he made misrepresentation or omission of material fact); *Vanderboom v. Sexton*, 422 F.2d 1233, 1238 (8th Cir.), *cert. denied*, 400 U.S. 852 (1970) (10b-5 applies to negligent as well as intentional misrepresentations); *City Nat'l Bank v. Vanderboom*, 422 F.2d 221, 229-30 (8th Cir.), *cert. denied*, 397 U.S. 1080 (1970); *Myzel v. Fields*, 386 F.2d 718, 734-35 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968) (proof of scienter, *i.e.*, knowledge of falseness of impression produced by statement or omission made, not required); *Stevens v. Vowell*, 343 F.2d 374, 379 (10th Cir. 1965) (necessary only to prove one of prohibited actions such as material misstatement of fact or omission to state material fact); *Kohler v. Kohler Co.*, 319 F.2d 634, 637 (7th Cir. 1963) (knowledge of falsity or misleading character of statement not required); *Royal Air Properties, Inc. v. Smith*, 312 F.2d 210, 212 (9th Cir. 1962) (10b-5 requires only proof of material misstatement or omission of fact to establish *prima facie* case); *Ellis v. Carter*, 291 F.2d 270, 274 (9th Cir. 1961) (if Congress intended to limit authority to create regulations to those proscribing common law fraud, it would have said so); *Bachelor v. Legg & Co.*, 52 F.R.D. 545 (D. Md. 1971) (need merely to show lack of due diligence or unreasonable or negligent conduct by defendant). See also 3 Loss 1430-44. But see *Bucklo*, *supra* note 617, at 590 (footnotes omitted):

Language embracing a negligence standard, or a standard less stringent than one of actual knowledge or reckless disregard for the truth, has in every instance been used in cases where the defendant's conduct was clearly violative of a higher standard, in cases arising on a motion to dismiss or in cases in which the court found an alternative reason to find no liability. In those few cases where defendant's conduct might be said to constitute negligent behavior, but not knowing or reckless behavior, no liability has been found.

1. *The Second Circuit Approach*

As recent cases indicate, the majority of the Second Circuit has followed the dictum enunciated in *Shemtob v. Shearson, Hammill & Co.*⁶²⁵ that knowledge of falsity or reckless disregard for the truth is sufficient to satisfy the scienter requirement in private actions while a mere negligence is insufficient.⁶²⁶ In *Chris-Craft Industries, Inc. v. Piper Aircraft Corp.*⁶²⁷ the court stated that it is unnecessary to allege specific intent in order to state an action under rule 10b-5, but that mere negligence is insufficient to meet the scienter requirement.⁶²⁸ *Chris-Craft* sets out the standard which has been followed in later Second Circuit cases: The scienter requirement is met if the defendant either knew the essential facts and failed to disclose them or failed and refused, after being put on notice of a possible material failure in disclosure, to apprise himself of the facts under the circumstances where he could reasonably ascertain them without any extraordinary effort.⁶²⁹ Thus, liability attaches either for what the defendant knew or, in certain situations, what he should have known.

Professor Bromberg termed this latter possibility "constructive knowledge."⁶³⁰ His suggestion, implicit in the Second Circuit decisions, would require some type of knowledge, implementing a due care criterion through a constructive knowledge standard which requires diligence.⁶³¹ This would be in line with modern developments in the definition of scienter, moving past the traditional standard requiring actual knowledge of the falsity to a standard under which the defendant would be liable if he knew or should have known of the falsity or omission if he had used due care in investigating.⁶³²

Other Second Circuit cases have held that the negligent failure to discover material facts when such facts could have been ascertained with-

625. 448 F.2d 442 (2d Cir. 1971).

626. *Id.* at 445. See *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 353 F. Supp. 264 (S.D.N.Y. 1972) (defendant employees of defendant brokerage house knew or should have known that adverse information concerning corporation, in defendant's possession as managing underwriter, was confidential and could not be used to tip other customers).

627. 480 F.2d 341 (2d Cir.), *cert. denied*, 414 U.S. 910 (1973).

628. *Id.* at 362; see *Republican Technology Fund, Inc. v. Lionel Corp.*, 483 F.2d 540 (2d Cir. 1973), *cert. denied*, 415 U.S. 918 (1974).

629. *Id.* at 398 (Mansfield, J., concurring).

630. 2 BROMBERG § 8.4(531), at 204.161.

631. *Id.* § 8.4(504), at 204.105-106.

632. See 3 LOSS 1771-78; Note, *Proof of Scienter Necessary in a Private Suit Under SEC Anti-Fraud Rule 10b-5*, 63 MICH. L. REV. 1070, 1075 (1965).

out inordinate effort, is not, by itself, sufficient to establish liability in a private action under rule 10b-5.⁶³³ Liability can only arise if such failure to discover material facts is preceded by the defendant's knowledge of the misstatements or omissions,⁶³⁴ notice to the defendant of the misstatements, or omissions, occurrences constituting reasonable grounds to believe that misstatements or omissions existed,⁶³⁵ or a defendant's failure to fulfill a duty to investigate, if the facts could have been uncovered by reasonable investigation.⁶³⁶ Thus, in *Cohen v. Franchard Corp.*,⁶³⁷ rule 10b-5 liability did not arise when the facts indicated that the defendant promoters had no knowledge and were not on notice that a limited partner was diverting corporate funds. Without knowledge or notice, the promoters were not under a duty to investigate even though they had an opportunity to do so and the facts would have been uncovered by reasonable investigation.⁶³⁸

In *Lanza v. Drexel & Co.*,⁶³⁹ the court again refused to impose liability after examining the facts. The court rejected the plaintiffs' argu-

633. *Cohen v. Franchard Corp.*, 478 F.2d 115 (2d Cir. 1973), *cert. denied*, 414 U.S. 857 (1974).

634. *See Lanza v. Drexel & Co.*, 479 F.2d 1277 (2d Cir. 1973) (en banc); *Cohen v. Franchard Corp.*, 478 F.2d 115 (2d Cir. 1973), *cert. denied*, 414 U.S. 857 (1974).

635. *Cohen v. Franchard Corp.*, 478 F.2d 115 (2d Cir. 1973), *cert. denied*, 414 U.S. 857 (1974).

636. *Lanza v. Drexel & Co.*, 479 F.2d 1277 (2d Cir. 1973) (en banc).

637. 478 F.2d 115 (2d Cir. 1973), *cert. denied*, 414 U.S. 857 (1974).

638. Upholding the trial court's charge which required a showing of "actual knowledge or reckless disregard for the truth," the Second Circuit stated the test: "[T]hat defendant either knew the material facts that were misstated . . . and should have realized their significance, or failed or refused to ascertain and disclose such facts when they were readily available to him and he had reasonable grounds to believe that they existed." *Id.* at 123. It has been argued, however, that the holding in *Cohen* centers upon the court's view of whether misstated or omitted facts were "readily available" or "could have been ascertained without inordinate effort" with liability attaching in the case of the former, but not in the latter. Note, *supra* note 615, at 524-26.

The court in *Stewart v. Bennett*, 362 F. Supp. 605 (D. Mass. 1973), in denying the defendant's motion to dismiss the complaint, explained the holding in *Cohen* in terms of an inference of recklessness. The district court stated that in the absence of actual knowledge, notice is the key; thus, the critical element missing in *Cohen* was reasonable grounds to suspect falsity. The court went on to say that a "failure or refusal to discover, and thereafter disclose, misrepresentations and omissions, in the face of notification as to their possible existence, amounts to a wilful and reckless disregard for the truth such as to constitute knowing and intentional conduct. . . . [A]llegations of mere failure to discover and disclose material facts that were omitted or distorted would be nothing more than an assertion of negligence and would not constitute a 10b-5 violation." *Id.* at 607.

639. 479 F.2d 1277 (2d Cir. 1973) (en banc).

ment that the defendant's position as a director by itself imposed a duty to investigate.⁶⁴⁰ The majority affirmed the trial court finding that the defendant, an outside director, neither knew nor should have known of misstatements and omissions about the BarChris business and financial position, and held that the outside director was not liable in failing to advise the plaintiffs of such facts. The court found that the defendant was not aware nor even suspicious of any deceptions practiced upon the plaintiffs, and that the inquiries and investigation he did make were sufficient as a matter of law to satisfy rule 10b-5.⁶⁴¹ The court held that, absent knowledge of or participation by a director in the dissemination of false information, an outside director is under no affirmative duty to insure that all material adverse information is conveyed to prospective purchasers of the company's stock.⁶⁴²

The court refused to apply a negligence standard as the measure of culpability necessary to constitute a violation of rule 10b-5. Such a duty

640. Victor Billiard Company, plaintiff, entered into an agreement with BarChris to exchange all outstanding Victor shares for BarChris shares. During the negotiations BarChris made material misrepresentations and omissions concerning the financial status of BarChris. Defendant Coleman was an outside director and a member of an investment banking firm with interests in BarChris. Coleman did not participate in any of the negotiations. He did gain knowledge of some negative corporate developments and management difficulties after negotiations were completed but before the deal was closed. *Id.* at 1283-86. The court held that no rule 10b-5 violation was stated against Coleman because he had assumed, and had no reason to suspect otherwise, that the Victor shareholders had been made aware of all these developments during negotiations.

641. *Id.* at 1304.

642. *Id.* at 1302. The duty to which the court referred was the duty to investigate rather than the duty to disclose, which was also considered in the opinion. *See id.* at 1281:

[N]either the language nor intent of Section 10(b) or Rule 10b-5 would justify a holding (1) that a director is an insurer of the honesty of individual officers of the corporation in their negotiations which involve the purchase or sale of the corporation's stock or (2) that, although he does not conduct the negotiations, participate therein, or have knowledge thereof, he is under a duty to investigate each such transaction and to inquire as to what representations had been made, by whom and to whom, and then independently check on the truth or falsity of every statement made and document presented.

Were a contrary result to be reached it would, in effect, place an affirmative duty on Coleman (and all other directors) to intervene personally in every transaction involving the sale or exchange of his corporation's stock and would amount to a holding that a director's vote of approval for any such transaction negotiated and concluded by others, without his knowledge or participation, would be a representation to such purchasers that the director personally had inquired as to the facts upon which the negotiations were based and that he was satisfied that all representations were correct.

See also Note, *supra* note 615, at 577 (confusion resulted in case because court disregarded separate duties to investigate and to disclose, referring to them as duty to convey).

would have required the director to ascertain whether BarChris' financial status had been fully and adequately disclosed even though the director had no notice that disclosure was incomplete or inaccurate.⁶⁴³ Where the outside director maintained an awareness of significant corporate developments and considered any adverse material developments coming to his attention, he met his responsibility even though he knew disquieting facts about the corporation.⁶⁴⁴ The majority held that liability under rule 10b-5 could arise only upon proof of a willful or reckless disregard of the truth.⁶⁴⁵

One judge, dissenting, disagreed with the finding that the director exercised due care in the investigation which he undertook.⁶⁴⁶ Where his knowledge and experience required further inquiry, the director should be held liable, if, had he investigated the sources of information to which he had ready access, he would have been apprised that the material facts had not been disclosed.⁶⁴⁷ Another dissenter, Judge Timbers, agreed that a failure by the director to inform himself of the progress of negotiations after being put on notice of their existence was a breach of duty.⁶⁴⁸ This dissent took the position rejected by the majority, that the director owed a duty to investigate solely by reason of his position as a director and that negligent failure to do so was adequate basis for liability.⁶⁴⁹

643. 479 F.2d at 1305.

644. *Id.* at 1306. The court justified the scienter requirement on the ground that liability for mere negligence would deter competent individuals from serving on corporate boards. *Id.* at 1307.

645. *Id.*

646. 479 F.2d at 1320-22. Judge Timbers pointed out that because Coleman's reckless disregard for the truth was clearly demonstrated, it was not necessary to reach the question of negligent liability in a private action under rule 10b-5, though he specified that he did not necessarily disagree with a negligence standard.

647. *Id.* at 1321.

648. *Id.* at 1318 (Hays, J., joined by J. Smith, Oakes, and Timbers, J.J., dissenting in part).

649. *Id.*:

As a director, Coleman had a duty to keep himself adequately informed as to the activities of the corporation. He could no more close his eyes to the purchase of Victor than he could to other important corporate developments. . . .

Although Coleman knew that BarChris's condition had worsened considerably, he made no effort to ascertain whether [that information had been conveyed] to the Victor shareholders. Coleman's vote to approve the exchange of shares was a representation to plaintiff purchasers that he had sufficiently inquired as to the facts upon which the negotiations were based and that he was satisfied with the correctness of those facts. The representation was false.

The dissent also pointed out that previous Second Circuit cases rejecting negligence as insufficient to meet the requirement of scienter did so *in dicta*, and thus the Second Circuit had not yet decided the scienter-negligence issue. *Id.* at 1319.

As can be seen in *Lanza*, semantic confusion has arisen because the constructive knowledge standard embodies the tort-derived concepts of recklessness and negligence. The constructive knowledge standard relates both to the knowledge of the facts stimulating inquiry and to the failure to fulfill a duty of acquiring information.⁶⁵⁰ As Professor Bromberg has pointed out, where the defendant does not use reasonable diligence in learning the facts, the existence of which he has reasonable grounds to believe, and is therefore negligent in a tort sense, the effect is the same as constructive knowledge—holding the defendant liable for what he should have known.⁶⁵¹ If the facts cannot be learned in the exercise of reasonable diligence, even though the defendant is on notice, the defendant is not held liable for constructive knowledge.

The concept of notice, however, requires some type of knowledge by the defendant. Thus, the majority and the Timbers dissent in *Lanza* did not differ in finding the requisite notice gave rise to a duty of the director to inquire into the facts. But once the defendant has the requisite knowledge of the facts that would put him on notice, he “could not avoid liability by pleading ignorance where his knowledge and experience tell him that certain events or circumstances known to him require that further inquiry be made.”⁶⁵²

The Hays dissent, with which three members of the Second Circuit concurred, would have imposed a duty to investigate because of the defendant's position as a director rather than because the defendant was placed on notice.⁶⁵³ Using this standard, knowledge of the facts would not be required to trigger the duty to investigate.⁶⁵⁴ The dissent reasoned that “as a director, the outside director had a duty to keep himself adequately informed as to the activities of the corporation,” and a negligent failure to investigate reasonably, with the resulting failure to ascertain the facts required to be disclosed to the plaintiff, should make the defendant liable under rule 10b-5 under a negligence standard. If the courts followed this standard, any corporate carelessness would satisfy the scienter requirement, thus justifying the broad lan-

650. 2 BROMBERG § 8.4(432), at 204.162.

651. *Id.*; see *Heit v. Weitzen*, 402 F.2d 909 (2d Cir. 1968), *cert. denied*, 395 U.S. 903 (1969).

652. *Lanza v. Drexel & Co.*, 479 F.2d 1277, 1321 (2d Cir. 1973) (en banc).

653. *Id.* at 1318.

654. See *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 868 (2d Cir. 1968) (Friendly, J., concurring), *cert. denied sub nom.*, *Kline v. SEC*, 394 U.S. 976 (1969).

guage in *Texas Gulf* that included negligence in its definition of "some form of scienter."⁶⁵⁵

While the Second Circuit has required more than mere negligence in private actions under rule 10b-5, *SEC v. Manor Nursing Centers, Inc.*⁶⁵⁶ held that mere negligence is a sufficient basis for liability in an SEC enforcement proceeding for equitable or prophylactic relief.⁶⁵⁷ In upholding the district court's finding of liability, the court held that even if there were no evidence that the selling shareholder-defendants acted in bad faith, they should have been put on notice that the progress of the offering did not comport with the arrangement described in the prospectus.⁶⁵⁸ Nevertheless, the court did not find it necessary to clarify "[w]hether their conduct be termed lack of due diligence or negligence"⁶⁵⁹

By failing to clarify whether negligence or lack of due diligence provided the basis for the injunction, the court did not provide an answer for the hypothetical situation in which the defendant's negligence results in his not being placed on notice. As the Second Circuit has held, liability attaches for failure to investigate reasonably only after notice has triggered the duty to investigate; the question of negligent liability in a private suit arises once again. The test set down in *Cohen*⁶⁶⁰ has left open the possibility that if the defendant had reasonable grounds to believe that facts existed that would put him on notice, he is held to a duty of reasonable investigation. Thus, for example, if the defendant director negligently fails to open the mail containing the corporate minutes and thus negligently fails to put himself on notice, liability would arise. The liability here, though, would be for merely negligent conduct since there was no notice to trigger the duty to investigate. To hold a defendant liable under the constructive knowledge rationale in such a situation would be to impose rule 10b-5 liability for mere negligence.

2. *The Ninth Circuit Approach*

While two later cases outside the Second Circuit have rejected the

655. *Id.* at 855.

656. 458 F.2d 1082 (2d Cir. 1972).

657. *But cf.* *SEC v. Coffey*, 493 F.2d 1304, 1314 (6th Cir. 1974), where the court in remanding to the district court, stated that "the reasoning of the Second Circuit in *Lanza* fully supports our conclusion that the SEC's proof in an injunctive suit must meet the standard of showing 'wilful or reckless disregard for the truth.'"

658. 458 F.2d at 1097.

659. *Id.*

660. *See* note 758 *supra*.

need for scienter without reinforcing the reasoning used to justify a negligence standard in earlier cases,⁶⁶¹ the Ninth Circuit has rejected all standards based solely upon state of mind. Thus, *White v. Abrams*⁶⁶² represents another attempt by the federal courts to move away from the elements of common law fraud in cases involving rule 10b-5.⁶⁶³ The *White* court called for a case-by-case analysis, investigating the duty imposed upon the defendant by rule 10b-5 in the specific factual context rather than using the traditional fault analysis of common law fraud.⁶⁶⁴ In reviewing the framework of analysis used by the Second Circuit, the *White* court approved the initial inquiry as to the duty of disclosure that the law should impose upon the defendant. The court, however, disapproved of overlaying this inquiry with a scienter or culpability requirement.⁶⁶⁵

The *White* court moved away from a rigid compartmentalization of common law fraud requirements toward a sliding scale of various factors used to determine the appropriate duty of the defendant toward the

661. *Swanson v. American Consumers Indus., Inc.*, 475 F.2d 516, 525 (7th Cir. 1973) (Sprecher, J., concurring) (scienter not an element of proof); *Lane v. Midwest Bancshares Corp.*, 347 F. Supp. 1200 (E.D. Ark. 1973) (scienter need not be shown).

662. 495 F.2d 724 (9th Cir. 1974).

663. 495 F.2d at 728. In rejecting a trial court instruction imposing strict liability for material misrepresentations by the defendant, the court cited the earlier Ninth Circuit opinions in *Royal Air Properties, Inc. v. Smith*, 312 F.2d 210 (9th Cir. 1962), and *Ellis v. Carter*, 291 F.2d 270 (9th Cir. 1961), as early indications, and *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972), as the logical culmination of the current trend to modify or eliminate common law elements of fraud as applied to claims brought under rule 10b-5.

664. 495 F.2d at 731. The court went on to say that

[a]lthough the [*Ute*] Court did not discuss the scope of the duty imposed by clause (b) of [rule 10b-5], we believe it is significant that it considered a number of factors such as the defendant's relationship to the plaintiffs, the benefit the defendants derived from the sale of the stock, the access the defendants had to the undisclosed information as compared with the access of the plaintiffs, and the activity of the defendants in encouraging the plaintiffs to sell their stock.

Id. (footnotes omitted).

665. *Id.* at 732. While the *White* court acknowledged that the standard in *Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 480 F.2d 341 (2d Cir. 1973), accurately reflected the various courts' decisions as to the state of mind sufficient for recovery under rule 10b-5, it recognized the anomaly of this result. The Second Circuit enunciated a standard that imposed no liability for mere negligence, but simultaneously set forth a negligence standard for those persons on notice and thus invested with a special duty to investigate. In criticizing both *Chris-Craft* and *Lanza*, the *White* court deemed the Second Circuit's requirement of some degree of scienter or culpability to be an unfortunate limitation upon the duty of disclosure imposed by rule 10b-5. 495 F.2d at 732-33. The court went on to approve the position taken in the *Hays* dissent (and rejected

plaintiff.⁶⁶⁶ In addition to providing a flexible standard to meet varying factual contexts, such a sliding scale focused upon the duty of the defendant without clouding the issue with fault concepts traditionally used in 10b-5 cases.⁶⁶⁷ In so deciding, the Ninth Circuit consciously rejected any state of mind requirement as a necessary and separate element of a rule 10b-5 action⁶⁶⁸ and thus rejected any set formula for the determination of 10b-5 liability in favor of a loose set of guidelines gleaned from earlier rule 10b-5 actions.⁶⁶⁹

While the *White* court emphasized that the rejection of the scienter standard as a separate element did not eliminate it as an important factor in determining the scope of duty imposed by rule 10b-5,⁶⁷⁰ the Ninth Circuit's new standard is actually no standard at all. A sliding

by the *Lanza* majority) that the duty to investigate and inform arises solely from the duty inherent in the position of a director and controlling person without considering if there was any negligence in the investigation following notice to that individual. *Id.* at 733.

666. 495 F.2d at 734; see Mann, *supra* note 617.

667. 495 F.2d at 734.

668. *Id.* at 734-35 (footnote omitted):

In this circuit, we have never adhered to the requirement of scienter in the common law fraud sense. While we did not apply liability without fault, our language in *Ellis* and *Royal Air* was apparently construed by the district court to create such a standard. Such a construction is erroneous. It is also erroneous to construe those cases as imposing a negligence standard or any other standard that focuses solely upon state of mind and its various compartmentalizations. 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. Consequently, we reject scienter or any other discussion of state of mind as a necessary and separate element of a 10b-5 action. The proper standard to be applied is the extent of the duty that rule 10b-5 imposes on this particular defendant. In making this determination the court should focus on the goals of the securities fraud legislation by considering a number of factors that have been found to be significant in securities transactions.

669. *Id.* at 735. While the *White* court states that it would be inappropriate to list all the factors to be considered in determining the defendant's duty under rule 10b-5, it did give a partial list, emphasizing that the list was not exhaustive and that a court is not precluded from making additions or adaptations in a particular case:

[W]e feel the court should, in instructing on a defendant's duty under rule 10b-5, require the jury to consider the relationship of the defendant to the plaintiff, . . . 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. (footnotes omitted). The *White* factors and adaptations therefrom were applied in *Jackson v. Bache & Co., Inc.*, 381 F. Supp. 71 (S.D.N.Y. 1974) (investigation by defendant broker was adequate).

670. 495 F.2d at 736.

scale of liability gives no guidance regarding mental state and culpability,⁶⁷¹ and raises the dangers of judicial Monday-morning quarterbacking in which culpability in the plaintiff-defendant relationship may be determined in light of the outcome. In making state of mind one of the factors to be considered, the Ninth Circuit combined it with other factors that involve the relationship between parties in securities transactions. The notion of scienter does not fit into a conceptual framework dealing with duties imposed by the parties' relationship. The standard laid down in *White* would allow liability to be imposed upon a defendant based upon his status alone, a sharp break from the long line of cases that imposed liability only upon a finding of culpability based upon the individual's state of mind.⁶⁷²

3. Conclusion

Recent Second Circuit cases illustrate that court's reluctance to relax the scienter requirement in private actions under rule 10b-5. By requiring that a defendant be "to some extent cognizant" of misrepresentations or omissions, the Second Circuit has resisted the general trend toward relaxation of the elements of proof with respect to reliance, causation, and materiality. This trend has been recognized and applied by the Ninth Circuit. That court has rejected state of mind as a separate element of a rule 10b-5 case and has accepted in its stead a sliding scale of factors to determine the duty owed by the defendant to the plaintiff.

B. Materiality, Reliance, and Causation

1. Introduction

By adopting rule 10b-5, the SEC expanded the common law tort action of deceit⁶⁷³ to encompass fraud in securities transactions.⁶⁷⁴ At

671. While the *White* court gave polar extremes concerning liability, *id.*, it did not give any shape to the vast gray area between the two extremes.

672. See Note, *Intent to Deceive and the Outside Director's Duty to Disclose Under Rule 10b-5*, 25 SYRACUSE L. REV. 575, 578-80, 595 (1974). See generally Bucklo, *supra* note 617.

673. See *Stevens v. Vowell*, 343 F.2d 374, 379 (10th Cir. 1965): "It is not necessary to allege or prove common law fraud to make out a case under the statute and rule. It is only necessary to prove one of the prohibited actions such as the material misstatement of fact or the omission to state a material fact." See also *Mitchell v. Texas Gulf Sulphur Co.*, 446 F.2d 90 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971); *Hooper v. Mountain States Sec. Corp.*, 282 F.2d 195, 201 (5th Cir. 1960), *cert. denied*, 365 U.S. 814 (1961).

For a discussion of common law deceit, see generally PROSSER 683-736.

674. Shulman, *Civil Liability and the Securities Act*, 43 YALE L.J. 227, 227 (1933):

common law a plaintiff must show, along with scienter and some evidence of privity,⁶⁷⁵ that a fact has been misrepresented,⁶⁷⁶ that the fact was material,⁶⁷⁷ that the plaintiff has relied upon the misrepresented fact,⁶⁷⁸ and that in so relying the plaintiff has been caused injury.⁶⁷⁹ It has been held that the common law elements were incorporated by reference into rule 10b-5.⁶⁸⁰

This section will discuss the metamorphosis of the materiality, reliance, and causation elements, with the Supreme Court case of *Affiliated Ute Citizens v. United States*⁶⁸¹ as the focal point. Concentration will be placed primarily on lower court treatment of the Supreme Court decision.

[T]he common-law liability was not consciously and especially moulded for the flotation of securities. Instead, general tort and contract law, developed largely in connection with other transactions, was applied piecemeal to securities cases as they came before the courts.

675. Unlike equitable rescission, there is no requirement of absolute privity in an action for deceit. 3 Loss 1628.

676. Complete failure to disclose a material fact (a "pure omission") does not give rise to an action for deceit unless the nondisclosing party prevents the other party from obtaining the information or the two parties are in a fiduciary or similar relationship. 3 Loss 1433-35.

677. RESTATEMENT OF TORTS § 538(2) (1938):

A fact is material if

- (a) its existence or nonexistence is a matter to which a reasonable man would attach importance in determining his choice of action in the transaction in question,

. . . .

See 3 LOSS 1431; PROSSER 718-20.

678. 3 LOSS 1432; RESTATEMENT OF TORTS §§ 525, 546 (1938). Reliance serves as a limiter of liability. It would be unjust to grant recovery to one who would believe in statements that are clearly contrary to fact in light of the information available to him. See PROSSER 715-18.

679. Reasonable reliance raises a necessary inference of causation since it is the material inducement that would lead plaintiff to act or forbear to his detriment. Note that reliance supplies causation for entering into the transaction, and, in the absence of any intervening factors not germane to the transaction, causation of the loss will necessarily follow. PROSSER 732. Cases under rule 10b-5 have not discussed the cause-of-transaction and cause-of-loss distinction. See 2 BROMBERG § 8.7(2). This discussion may not be necessary, given the Supreme Court's interpretation of the "in connection with" language in rule 10b-5. *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 12-13 (1971).

680. See *List v. Fashion Park, Inc.*, 340 F.2d 457, 462 (2d Cir.), cert. denied, 382 U.S. 811 (1965). Professor Loss argues that "[b]ecause of the legislative background [of the federal securities laws] it seems reasonable to assume at the very least that the most liberal common law views on these questions should govern . . ." 3 Loss 1435.

681. 406 U.S. 128 (1972).

2. *The Law Before Affiliated Ute*

Although rule 10b-5 requires a finding of "materiality," it does not define the term.⁶⁸² The courts, however, have fashioned a definition: A material fact is one to which a reasonable investor would attach importance.⁶⁸³ The term "reasonable investor" includes both unsophisticated⁶⁸⁴ and professional investors.⁶⁸⁵ The test of materiality is an objective one.⁶⁸⁶

While the text of rule 10b-5 does not mention reliance, it has been included by the courts since it is a basic element of the tort upon which the rule is based. Reliance is measured by both an objective and a subjective standard. Objectively, the plaintiff must have acted as a reasonable investor would have acted when confronted by the misrepresentation or omission.⁶⁸⁷ Subjectively, the plaintiff must have in fact relied.⁶⁸⁸ The

682. The only promulgated definition of the term "materiality" is in rule 405 of Regulation C of the 1933 Act, which provides:

The term "material," when used to qualify a requirement for the furnishing of information as to a subject, limits the information required to those matters as to which an average prudent investor ought reasonably to be informed before purchasing the security registered.

17 C.F.R. § 230.405(1) (1974). The SEC has not followed this definition in 10b-5 actions. See *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 911 (1962) (material facts are those which if known would affect investment judgment of person with whom insider deals).

683. *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849-50 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969); *List v. Fashion Park, Inc.*, 340 F.2d 457, 462 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965). One variation of this definition emphasized what "might affect the value of the corporation's stock or securities." *Kohler v. Kohler Co.*, 319 F.2d 634, 642 (7th Cir. 1963) (dictum). *List* and *Texas Gulf Sulphur* both incorporate this criterion as something to which the investor would attach importance.

684. *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191 (1963).

685. *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

686. See *List v. Fashion Park, Inc.*, 340 F.2d 457, 462 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965); 6 Loss 3876-80.

687. "[T]he test of 'reliance' is whether 'the misrepresentation is a substantial factor in determining the course of conduct which results in [the recipient's] loss.'" *List v. Fashion Park, Inc.*, 340 F.2d 457, 462 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965), quoting RESTATEMENT OF TORTS § 546 (1938). See Note, *The Nature and Scope of the Reliance Requirement in Private Actions Under SEC Rule 10b-5*, 24 CASE W. RES. L. REV. 363, 368 (1973) (footnotes omitted):

The element of reliance operates to establish the causal connection between the defendant's fraud and the plaintiff's actions. Causation is the ultimate fact that must be proved, and reliance is the only acknowledged way to prove causation in misrepresentation cases.

Under the objective reliance standard the court will look only to how the reasonable investor would have acted under the circumstances. Thus, if no investor would have be-

Second Circuit summarized these requirements:

Thus to the requirement that the *individual plaintiff* must have acted upon the fact misrepresented, is added the parallel requirement that a *reasonable man* would also have acted upon the fact misrepresented.⁶⁸⁹

Although causation plays a central role in tort law,⁶⁹⁰ it has received little treatment in rule 10b-5 cases.⁶⁹¹ Most courts have adopted a causation-in-fact test⁶⁹² that is merely a restatement of the objective test of reliance.⁶⁹³ Another possible test of causation can be found in the "in connection with" language of the rule.⁶⁹⁴ In this context the question is one of proximity between the fraudulent scheme and the loss.⁶⁹⁵ The Supreme Court has held that this proximate relation need

lieved the misrepresented fact, plaintiff could not have relied—that is, the reliance was not reasonably justified. See Jacobs, *What is a Misleading Statement or Omission Under Rule 10b-5?*, 42 *FORD. L. REV.* 243, 249 (1973).

688. *List v. Fashion Park, Inc.*, 340 F.2d 457, 462 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965). Recovery will be defeated if the plaintiff had constructive or actual knowledge of the truth or could have discovered the truth through a reasonable investigation. See, e.g., *Clement A. Evans & Co. v. McAlpine*, 434 F.2d 100, 104 (5th Cir. 1970), *cert. denied*, 402 U.S. 988 (1971) (plaintiff's familiarity with business matters is constructive knowledge); *Myzel v. Fields*, 386 F.2d 718, 736 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968) (reasonable investigation would have revealed truth), *citing Kohler v. Kohler Co.*, 319 F.2d 634, 641-42 (7th Cir. 1963) (plaintiff's knowledge of corporation's internal workings is constructive knowledge). In each of the cases cited it could be said that the plaintiff did not "reasonably rely." Note, *Reliance Under Rule 10b-5: Is the "Reasonable Investor" Reasonable?*, 72 *COLUM. L. REV.* 562 (1972), lists five categories of cases in which unreasonable reliance can arise: (1) the plaintiff has general business experience or expertise; (2) the plaintiff is acquainted with the affairs of the corporation; (3) the plaintiff has access to the information misrepresented; (4) the plaintiff initiated the transaction; (5) the defendant owes plaintiff a fiduciary duty. *Id.* at 567-75.

689. *List v. Fashion Park, Inc.*, 340 F.2d 457, 462 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965) (emphasis original).

690. 6 *LOSS* 3882, *QUOTING RESTATEMENT OF TORTS* § 286 (1934): "a violation must be 'a legal cause of the invasion' of another's interest."

691. 2 *BROMBERG* § 8.7(1).

692. *Chasins v. Smith, Barney & Co.*, 438 F.2d 1167, 1172 (2d Cir. 1970). See *Mitchell v. Texas Gulf Sulphur Co.*, 446 F.2d 90, 102 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971).

693. 2 *BROMBERG* § 8.7(1).

694. Professor Bromberg has noted that the causation requirement must be "squeezed out." *Id.*

695. The notion of proximity is not, however, used as it is in tort law as a limitation of liability. Rather, the phrase is keyed towards the scope of investor protection, and must be broadly construed:

[I]t seems clear from the legislative purpose Congress expressed in the Act, and the legislative history of Section 10(b) that Congress when it used the phrase "in connection with the purchase or sale of any security" intended only

be no more than a "touching" of the securities transaction that ultimately led to the loss.⁶⁹⁶

In cases where individual plaintiffs allege fraud, the problems of proving reliance or its absence do not appear to be too onerous. In class actions, however, determining whether each plaintiff in fact relied under the circumstances becomes judicially unworkable, for example, when the plaintiff class is composed of a thousand or more members.⁶⁹⁷ Courts have recognized, however, the important role Rule 23 of the Federal Rules of Civil Procedure⁶⁹⁸ plays in effectuating the policies of the securities laws,⁶⁹⁹ and have adjusted the reliance requirement accordingly.⁷⁰⁰ These adjustments have resulted in a transformation or elimination of the reliance requirement in class actions.⁷⁰¹ Reliance remains relevant to the threshold determination of common questions of fact⁷⁰²

that the device employed, whatever it might be, be of a sort that would cause reasonable investors to rely thereon, and, in connection therewith, so relying, cause them to purchase or sell a corporation's securities.

SEC v. Texas Gulf Sulphur, Co., 401 F.2d 833, 860 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

696. Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 12-13 (1972): "The crux of the present case is that Manhattan suffered an injury as a result of deceptive practices touching its sale of securities as an investor." See Cooper v. North Jersey Trust Co., 226 F. Supp. 972, 978 (S.D.N.Y. 1964): "[T]he outlawed activity is not limited to the portion of the transaction involving an exchange of consideration by the purchaser for the stock."

697. Mills v. Electric Auto-Lite Co., 396 U.S. 375, 382 n.5 (1970). See generally Comment, *The Impact of Class Actions on Rule 10b-5*, 38 U. CHI. L. REV. 337 (1971).

698. FED. R. CIV. P. 23.

699. See, e.g., Escott v. BarChris Constr. Corp., 340 F.2d 731, 733 (2d Cir.), *cert. denied*, 382 U.S. 816 (1965): "In our complex modern economic system where a single harmful act may result in damages to a great many people there is a particular need for the representative action as a device for vindicating claims which, taken individually, are too small to justify legal action but which are of significant size if taken as a group." See also 3 Loss 1819: "The ultimate effectiveness of the federal remedies . . . may depend in large measure on the applicability of the class action device."

700. In response to defendant's argument that all the plaintiffs (at least 1200) might not have relied on the misrepresentations, one court said: "List [a case calling for proof of objective and subjective reliance] was not a class suit. It involved only one plaintiff." Mader v. Armel, 402 F.2d 158, 162 (6th Cir. 1968), *cert. denied*, 394 U.S. 930 (1969).

701. "[P]rocedure's very function is to modify the substantive law." Hazard, *The Effect of the Class Action Device Upon the Substantive Law*, 58 F.R.D. 299, 307 (1973).

702. FED. R. CIV. P. 23(a) (emphasis added) requires:

One or more members of a class may sue or be sued as representative parties on behalf of all only if (1) the class is so numerous that joinder of all members is impractical, (2) there are questions of law or fact common to the class, (3)

and the requirement that the common questions predominate over questions affecting individuals.⁷⁰³ If either of these requirements is not met, the motion to proceed as a class will be denied.⁷⁰⁴

One solution to the problem of reliance in class actions is to proceed with the merits of the plaintiffs' claim and, in a second trial, deal with the individual reliance questions.⁷⁰⁵ This solution may be appealing logically, but it does not solve the problem of bringing thousands of class members into court.⁷⁰⁶ A variation of the split-trial device is to subclassify the plaintiff class according to degrees and kinds of reliance.⁷⁰⁷ This procedure, however, would be as unworkable as the split-trial, since the varying degrees of reliance would have to be identified by examining each class member. The optimal solution, for convenience of judicial administration, would be to eliminate reliance as an element of rule 10b-5. In *Kahan v. Rosenstiel*,⁷⁰⁸ the Third Circuit held that "[p]roof of reliance is not an independent element which must be alleged to establish a cause of action."⁷⁰⁹ The court, relying on *Mills v. Electric Auto-Lite Co.*,⁷¹⁰ reasoned that proof of materiality established reliance by inference.⁷¹¹ In *Kohn v. American Metal Climax, Inc.*⁷¹² the Third Circuit retreated from its position in *Kahan* and

the claims or defenses of the representative parties are typical of the claims or defenses of the class, and (4) the representative parties will fairly and adequately protect the interests of the class.

703. FED. R. CIV. P. 23(b) provides:

An action may be maintained as a class action if the prerequisites of subdivision (a) are satisfied, and in addition:

. . . .
(3) the court finds that the questions of law or fact common to all the members of the class predominate over any questions affecting only individual members

704. See *Hirsch v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 311 F. Supp. 1283 (S.D.N.Y. 1970); *Jacobs v. Paul Hardeman, Inc.*, 42 F.R.D. 595 (S.D.N.Y. 1967).

705. *Green v. Wolf Corp.*, 406 F.2d 291 (2d Cir. 1968), *cert. denied*, 395 U.S. 977 (1969).

706. See *Morris v. Burchard*, 51 F.R.D. 530, 536 (S.D.N.Y. 1971) (referring to the split trial device as a "harrowing experience" that could "transform a litigation into a gigantic burden on the Court's resources beyond its capacity to manage or effectively control").

707. *Kroneberg v. Hotel Governor Clinton, Inc.*, 41 F.R.D. 42, 45-46 (S.D.N.Y. 1966).

708. 424 F.2d 161 (3d Cir.), *cert. denied*, 398 U.S. 950 (1970).

709. *Id.* at 173.

710. 396 U.S. 375 (1970).

711. 424 F.2d at 173-74.

712. 458 F.2d 255 (3d Cir. 1972).

held that reliance was a necessary element, but that it could be "presumed" from a showing of materiality.⁷¹³ This is consistent with the approach taken by other courts that reliance exists a priori in certain securities transactions.⁷¹⁴ While the courts have not developed a single formula for elimination of reliance in class actions, it is apparent that individual reliance will not be required.

3. Affiliated Ute Citizens

In *Affiliated Ute Citizens v. United States*⁷¹⁵ the Supreme Court modified the standards for determining materiality and reliance under rule 10b-5. The case involved the making of a secondary market for shares⁷¹⁶ in the Ute Development Corporation (UDC)⁷¹⁷ by two employees of the bank designated as transfer agent for UDC. The employees purchased shares for non-Indian buyers and sold at prices generally higher than were paid to the Indians.⁷¹⁸ The Court affirmed the district court's holding that failure to disclose the market-making activities violated rule 10b-5⁷¹⁹ and thus reversed the court of appeals holding that there was no violation of the rule unless the record disclosed evidence of reliance on material fact representations by the employees.⁷²⁰ The Court held:

Under the circumstances of this case, involving primarily a failure to disclose, *positive proof of reliance is not a prerequisite to recovery.* All

713. *Id.* at 269.

714. *See, e.g.*, *Mader v. Armel*, 402 F.2d 158, 162-63 (6th Cir. 1968), *cert. denied*, 394 U.S. 930 (1969) (shareholders rely on honesty and fair dealing of management); *Weisman v. M.C.A., Inc.*, 45 F.R.D. 258, 259-60 (D. Del. 1968) (same).

715. 406 U.S. 128 (1972).

716. The stock involved represented half-blood Ute Indians' interests in the tribal assets, the distribution of which was provided for by the Ute Partition Act of 1954, 25 U.S.C. §§ 677-77aa (1970). Each certificate bore a legend which advised the holder about the interests represented by the share and stated that the certificate should be retained for the benefit of the shareholder and his family. 406 U.S. at 137-38.

717. UDC was incorporated in 1958 to manage jointly with the Tribal Business Committee, representing the full-blooded Utes, the distribution of the tribal assets. 406 U.S. at 136.

718. UDC shares were purchased by the employees, on their own account and for others, at prices ranging from \$300 to \$700 per share and were resold in the secondary market for \$500 to \$700 per share.

719. *Reyos v. First Security Bank*, Civil No. 39-65 (D. Utah, filed April 18, 1969), *reprinted in* Petitioner's Brief for Certiorari at App. A, *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972).

720. *Reyos v. United States*, 431 F.2d 1337 (10th Cir. 1970), *aff'd in part and rev'd in part sub nom.* *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972).

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.⁷²¹

This holding was significant in two respects. First, the standard of materiality was gauged by what the reasonable investor "might" do rather than what he "would" do. The "might" standard was taken from the Court's decision in *Mills v. Electric Auto-Lite Co.*,⁷²² which involved rule 14a-9⁷²³ and not rule 10b-5. The "would" standard has been taken from *SEC v. Texas Gulf Sulphur Co.*⁷²⁴ The distinction between "might" and "would" is crucial because the former denotes possibility and the latter denotes probability.⁷²⁵ Consequently, what "might" affect the reasonable investor encompasses a wider range of information than what "would" affect him. Apparently, the Court applied the former standard to effect what it conceived to be the policy of the 1934 Act.⁷²⁶ Secondly, proof of reliance was eliminated as a necessary ele-

721. 406 U.S. at 153-54 (emphasis added). The Court made no specific mention of any misstatements or half-truths by the bank's employees, although this fact was suggested by allusion:

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.

Id. at 153. The Court was obviously more concerned with the defendants' silent deceit, and it is reasonable to hypothesize that the Court found all plaintiffs to be injured by the nondisclosures. See 1973 UTAH L. REV. 119, 133.

722. 396 U.S. 375, 384 (1970) (footnote omitted):

Where the misstatement or omission in a proxy statement has been shown to be "material," as it was found to be here, that determination itself indubitably embodies a conclusion that the defect was of such a character that it might have been considered important by a reasonable shareholder who was in the process of deciding how to vote.

723. 17 C.F.R. § 240.14a-9(a) (1974) provides in part:

No solicitation subject to this regulation shall be made by means of any proxy statement . . . containing any statement which, at the time and in light of the circumstances under which it was made, 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

724. 401 F.2d 833, 849 (2d Cir. 1968), *cert. denied*, 394 U.S. 967 (1969).

725. *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1302 (2d Cir. 1973). See sources cited in notes 733-39 *infra* and accompanying text.

726. 406 U.S. at 151, quoting *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963): "The Court has said that the 1934 Act and its companion legislative enactments embrace a 'fundamental purpose . . . to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry.'"

ment of rule 10b-5 for private damage suits alleging nondisclosure. This was an advance beyond the common law and prior 10b-5 cases.⁷²⁷ More specifically, this holding eliminated a fictional reliance requirement, that plaintiff rely on the absence of information.⁷²⁸

The Court closed its discussion of rule 10b-5 with a reference to the causation requirement: "This obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact."⁷²⁹ By itself, this statement was not a significant departure from the prior law. With the elimination of reliance, however, the Court changed the context of causation-in-fact. As noted above, objective reliance was used to establish causation. The Court appears to have by-passed the reliance-causation criterion and substituted a materiality-causation criterion. As precedent for its causation statement, the Court cited the holding of *Chasins v. Smith, Barney & Co.*:

To the extent that reliance is necessary for a finding of a 10b-5 violation in a non-disclosure case such as this, the test is properly one of tort "causation in fact." . . . Chasins relied upon Smith, Barney's recommendations of purchase made without the disclosure of a material fact, purchased the securities recommended, and suffered a loss in their resale. Causation in fact or adequate reliance was sufficiently shown by Chasins.⁷³⁰

Affiliated Ute went beyond this statement. The question of "adequate" reliance in nondisclosure cases is meaningless. Causation, and ultimately liability, are established by a duty to disclose a material fact and subsequent nondisclosure. As a result, the importance of a particular plaintiff's actual or constructive knowledge of undisclosed material facts is questionable.⁷³¹

4. *The Law After Affiliated Ute*

Lower court interpretations of *Affiliated Ute* have not been uniform.

727. See notes 682-714 *supra* and accompanying text. In *List v. Fashion Park, Inc.*, 340 F.2d 457, 463 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965), the court said that the proper test for reliance in nondisclosure cases was "whether the plaintiff would have been influenced to act differently than he did act if the defendant had disclosed to him the undisclosed fact." *But cf.* *Crane Co. v. Westinghouse Air Brake Co.*, 419 F.2d 787, 797 (2d Cir. 1969), *cert. denied*, 400 U.S. 822 (1970); *Vine v. Beneficial Fin. Corp.*, 374 F.2d 627, 635 (2d Cir. 1967).

728. The requirement of reliance in nondisclosure cases is fictional because it necessitates proof of a negative. See 2 BROMBERG § 8.6(1).

729. 406 U.S. at 154.

730. 438 F.2d 1167, 1172 (2d Cir. 1970) (emphasis added).

731. See *The Supreme Court, 1971 Term*, 86 HARV. L. REV. 52, 270 (1972).

The seemingly clear language in which the Court expressed the materiality test and the rejection of reliance in nondisclosure cases has been interpreted and applied in various ways.

a. *Materiality*

Affiliated Ute changed the test of materiality from what "would" affect the reasonable investor to what "might" affect him.⁷³² The Second Circuit, however, has declined to follow the Supreme Court. In *Gerstle v. Gamble-Skogmo, Inc.*⁷³³ Chief Judge Friendly, writing for the court, applied the "would" test to proxy statements contested under rule 14a-9.⁷³⁴ The court distinguished the "might" test in *Mills* on the ground that the issue presented in *Mills* was causation. Therefore, the definition of materiality "must . . . be read as a characterization of the minimum that all would agree was 'embodied' in the district court's conclusion that the defect was material"⁷³⁵ *Affiliated Ute*, on the other hand, dealt with reliance, and thus that definition of materiality was not controlling.⁷³⁶ The court further noted that the majority opinion in *Mills* modified its "might" standard to include material facts that "have a significant propensity to affect the voting process"⁷³⁷ What is especially striking about the *Gamble-Skogmo* decision is the court's concern for the consequences accruing to the defendant. "When account is taken of the heavy damages that may be imposed, a standard tending toward probability rather than toward mere possibility is more appropriate."⁷³⁸ This position is inconsistent with the Supreme Court's practice of construing the securities laws flexibly to effectuate their broad remedial purpose.⁷³⁹

732. See *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228 (2d Cir. 1974); *SEC v. Lum's, Inc.*, 365 F. Supp. 1046 (S.D.N.Y. 1973); *Allen Organ Co. v. North Am. Rockwell Corp.*, 363 F. Supp. 1117 (E.D. Pa. 1973). See generally *The Supreme Court, 1971 Term, supra* note 731, at 269; 1973 UTAH L. REV. 119, 121.

733. 478 F.2d 1281 (2d Cir. 1973).

734. See text quoted note 823 *supra*.

735. 478 F.2d at 1301; accord, *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579 (5th Cir. 1974); R. JENNINGS & H. MARSH, *SECURITIES REGULATION: CASES & MATERIALS* 1354-55 (3d ed. 1972).

736. 478 F.2d at 1302 n.21. See *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579 (5th Cir.), cert. denied, 419 U.S. 873 (1974).

737. 478 F.2d at 1302, quoting *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 384 (1970) (emphasis original).

738. 478 F.2d at 1302.

739. *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972); Superintendent

In *Broder v. Dane*,⁷⁴⁰ the "might" and "would" standards were further confused. The court, faced with the question of the proper materiality standard to be applied under the anti-fraud provision of the Williams Act,⁷⁴¹ held:

[I]t is this Court's judgment that the instant case calls for the standard of materiality tending more toward a reasonable possibility than toward probability, thus requiring something more than mere possibility, but something less than probability.⁷⁴²

If "mere possibility" is interpreted as de minimus materiality, the court's decision can be justified. Clearly rule 10b-5 is not a strict liability provision. A standard of probability would seem to exclude that class of plaintiffs who lack sufficient understanding of securities markets to make sophisticated investment decisions. A standard of reasonable possibility, on the other hand, would assure some connection between misrepresented or undisclosed facts and an investment decision⁷⁴³ without excluding unsophisticated plaintiffs.

b. *Reliance*

Although the Supreme Court has clearly rejected reliance as an element of rule 10b-5, the requirement has nonetheless survived in various contexts. Three basic themes have been pursued by the lower courts: reliance has been eliminated; reliance can be presumed from materiality; and reliance of some kind is a necessary element.

(i) *Reliance Has Been Eliminated. In Swanson v. American Con-*

of *Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6 (1971); *SEC v. National Sec. Co.*, 393 U.S. 453 (1969); *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963).
740. 384 F. Supp. 1312 (S.D.N.Y. 1974).

741. 1934 Act § 14(e), 15 U.S.C. § 78n(e) (1970). It has been held that the proper standards for finding a violation of § 14(e) are the same as those applied under rule 10b-5. *Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 480 F.2d 341, 362 (2d Cir.), *cert. denied*, 414 U.S. 910 (1973).

742. 384 F. Supp. at 1321 (emphasis original; footnote omitted).

743. This connection is important in that a finding of materiality of an undisclosed fact gives rise to a finding of causation-in-fact. See text accompanying notes 730-31 *supra*. It is one of the goals of the securities laws to protect the unsophisticated investor. See text accompanying note 684 *supra*. If the level at which certain information becomes actionable rises above the level of those the law seeks to protect, causation might never be found for the unsophisticated. It is to be remembered that certain investors will believe anything they are told.

sumers Industries, Inc.,⁷⁴⁴ the Seventh Circuit applied *Affiliated Ute* to a shareholders' derivative action challenging a merger. Plaintiffs asserted injuries caused by a merger that was effectuated by allegedly misleading proxy statements, and sued for rescission of the merger and for damages for loss of statutory appraisal rights. The court upheld the merger as fair,⁷⁴⁵ assuming, but not deciding, that causation between the proxy materials and the merger had been established by the materiality of the omissions in the proxy statements.⁷⁴⁶ Regarding the loss of appraisal rights, the court noted that it had previously remanded the case

for a factual determination of whether a causal relationship existed between the deficiency in the proxy statement and the loss of statutory appraisal rights. Under the Supreme Court's decision in *Mills*, causation and reliance are no longer factually-to-be-proven predicates to recovery.⁷⁴⁷

The *Swanson* court followed this statement with a quotation from *Affiliated Ute*.⁷⁴⁸ This decision highlights the proposition that reliance and causation are not factual matters, and that causation arises by operation of law. Judge Sprecher's concurring opinion stated the case more forcefully:

[T]he district court erred as a matter of law in requiring proof of causal connection under the circumstances of this case.

. . . .

Under the "obligation to disclose" standard of *Affiliated Ute Citizens*, the withholding of a material fact or facts, as here, established the requisite elements of causation in fact.⁷⁴⁹

744. 475 F.2d 516 (7th Cir. 1973).

745. The court held the district court's finding of the fairness of the merger terms not clearly erroneous. In addition, the unscrambling of the merger would work injustice to other shareholders. *Id.* at 519.

746. By assuming that causation did not have to be shown, the court avoided a direct holding on the question left open by *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 385 n.7 (1970): whether causation could be shown where the management controls a sufficient number of votes to effect the transaction without any minority approval. 475 F.2d at 518-19.

747. 475 F.2d at 520.

748. *Id.* at 520-21, quoting 406 U.S. at 153-54.

749. *Swanson v. American Consumers Indus., Inc.*, 475 F.2d 516, 523 (7th Cir. 1973) (Sprecher, J., concurring); *accord*, *Davis v. Avco Corp.*, 371 F. Supp. 782 (N.D. Ohio 1974); *Jenkins v. Fidelity Bank*, 365 F. Supp. 1391 (E.D. Pa. 1973); *SEC v. Lum's, Inc.*, 365 F. Supp. 1046 (S.D.N.Y. 1973); *Allen Organ Co. v. North Am. Rockwell Corp.*, 363 F. Supp. 1117 (E.D. Pa. 1973); *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith*, 353 F. Supp. 264, 275 (S.D.N.Y. 1972), *aff'd*, 495 F.2d 228 (2d Cir. 1974).

Several rule 10b-5 class action cases, decided before *Affiliated Ute*,⁷⁵⁰ anticipated the Supreme Court's reasoning. In approving settlement of a non-disclosure case, one court stated: "[P]roof of reliance no longer appears to be a serious problem in securities cases such as this."⁷⁵¹ Another court noted that the defense of non-reliance "no longer has any substantial merit."⁷⁵² As a result, the question of factual commonality required by Rule 23(a)(2) will be limited to the materiality of the misrepresentation or omission.⁷⁵³

(ii) *Reliance Can Be Presumed from Materiality.* In *Chris-Craft Industries, Inc. v. Piper Aircraft Corp.*⁷⁵⁴ the Second Circuit applied the reasoning of *Affiliated Ute* to a suit brought under the antifraud provisions of the Williams Act⁷⁵⁵ and rule 10b-5.⁷⁵⁶ The decision was the court's second arising out of the tender-offer battle between Chris-Craft and Bangor Punta Corp. for control of Piper Aircraft.⁷⁵⁷ One of the questions presented concerned the district court's conclusion that there was no causal connection between the alleged violations⁷⁵⁸ and the defeat of Chris-Craft's tender offer.⁷⁵⁹ The circuit court began its

750. See notes 697-714 *supra* and accompanying text.

751. *In re Brown Co. Sec. Litigation*, 355 F. Supp. 574, 583 (S.D.N.Y. 1973).

752. *In re Caesar's Palace Sec. Litigation*, 360 F. Supp. 366, 399 (S.D.N.Y. 1973). See *Robinson v. Penn Cent. Co.*, 58 F.R.D. 436, 442 n.8 (S.D.N.Y. 1973).

753. See *In re United States Financial Sec. Litigation*, 64 F.R.D. 443, 450 (S.D. Cal. 1974) (*dicta*); *Lewis v. Marine Midland Grace Trust Co.*, 63 F.R.D. 39, 42 (S.D.N.Y. 1973).

754. 480 F.2d 341 (2d Cir.), *cert. denied*, 414 U.S. 910 (1973).

755. 1934 Act § 14(e), 15 U.S.C. § 78n(e) (1970).

756. Note the court's discussion of the applicability of the two provisions, 480 F.2d at 359:

Although the fraudulent acts involved in the instant case literally are proscribed by Rule 10b-5, we conclude that § 14(e) is the antifraud provision which more appropriately provides the basis for CCI's standing to sue here.

Apparently, the court did not wish to meet the dilemma of the *Birnbaum* rule, which would require Chris-Craft to prove an injury as a "purchaser or seller" of securities. See *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952).

757. The Second Circuit's first decision is reported at 426 F.2d 569 (2d Cir. 1970) (*en banc*).

758. Specifically, Chris-Craft complained about misrepresentations in the Piper management's press release and letters to Piper shareholders, and Bangor Punta's failure to disclose to the Piper shareholders that it was engaged in negotiations to sell one of its subsidiaries, the Bangor and Aroostock Railroad.

759. *Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 337 F. Supp. 1128 (S.D.N.Y. 1971), *rev'd*, 480 F.2d 341 (2d Cir.), *cert. denied*, 414 U.S. 910 (1973). The district court's reasoning was summarized by Judge Timbers in the instant case: "The court concluded that CCI was seeking damages as a 'defeated contender for control' without show-

causation analysis by noting that reliance was essential to Chris-Craft's case: "CCI must show that there was a misrepresentation upon which the target corporation stockholders relied and that this was in fact the cause of CCI's injury."⁷⁶⁰ The court then added that this reliance was not actual but "constructive," and in impersonal transactions, such as here, prior decisions had spoken in terms of "materiality."⁷⁶¹ This "constructive reliance" was a doctrine, originally set out in *Mills*, which "established a presumption of reasonable reliance in order to avoid an overly difficult burden of proof."⁷⁶² Judge Timbers cited *Affiliated Ute* as a case in which the presumption of reasonable reliance was used,⁷⁶³ and concluded:

In applying the *Mills-Ute* test to the instant action, we *presume* that the Piper shareholders would not have accepted the BPC exchange offer *but for* the misrepresentations to which we have referred above. . . . Piper shareholders had a third option, i.e., to hold their shares, which *presumably* they would have chosen if all material facts had been disclosed.⁷⁶⁴

Judge Mansfield, concurring and dissenting, took issue with Judge Timbers' analysis and pointed out that neither *Mills* nor *Ute* spoke of "presumptions":

Use of that term naturally raises further questions: Is the presumption to be conclusive or rebuttable? If rebuttable, should not BPC be given an opportunity . . . to rebut the presumption by offering proof that the percentage of Piper shareholders who did not rely upon its alleged misrepresentations in tendering their shares was sufficient to enable BPC to achieve control?⁷⁶⁵

ing that 'a single exchanging Piper shareholder would have refrained from the exchange and taken an offer for his shares from Chris-Craft instead of that from Bangor Punta.'"⁷⁶⁰ 480 F.2d at 373, *quoting* 337 F. Supp. at 1139 (emphasis of district court).

760. 480 F.2d at 373.

761. *Id.* at 374.

762. *Id.*

763. *Accord*, *Dorfman v. First Boston Corp.*, BNA SEC. REG. & L. REP. NO. 249, at A-7 (E.D. Pa. April 17, 1974).

764. 480 F.2d at 375 (emphasis added).

765. *Id.* at 400 (Mansfield, J., concurring and dissenting). In *Rochez Bros., Inc. v. Rhoades*, 491 F.2d 402, 410 (3d Cir. 1974), the court said:

We do not read this decision to say that the question of reliance *vel non* may not be considered at all in a non-disclosure case, but only that proof of reliance is not required for recovery. If defendant is able to demonstrate that there was clearly no reliance, that is, that even if the material facts had been disclosed, plaintiff's decision . . . would not have been different from what it was, then the non-disclosure cannot be said to have caused the subsequent loss

The point is that talk of "presumptions" brings the reliance requirement back in after it has been specifically excluded.⁷⁶⁶ Judge Mansfield offered this interpretation of *Affiliated Ute*:

[W]hatever may have been our earlier views as to the necessity of ad-
ducing positive proof of reliance . . . the gravamen of the offense is now
the material misrepresentation itself, from which reliance by a reason-
able investor may be inferred as a matter of law⁷⁶⁷

The strength of the presumption or inference of reliance, and how it may be rebutted, has been developed in subsequent cases. In *Rochez Brothers, Inc. v. Rhoades*,⁷⁶⁸ the Third Circuit Court of Appeals reasoned that if the "defendant is able to demonstrate that there was clearly no reliance, . . . then the non-disclosure cannot be said to have caused the subsequent loss" ⁷⁶⁹ The burden of proof, the court pointed out, "rests squarely upon defendant."⁷⁷⁰ The court also noted that if the plaintiff was an insider, which *Rochez* was,⁷⁷¹ he had to "fulfill a duty of due care in seeking to ascertain for himself the facts relevant to [the] transaction."⁷⁷² This duty of an insider to investigate is equivalent to holding, as a matter of law, that a plaintiff cannot have relied on a defendant's representations of those matters to which he had equal access or knowledge.

In *Harnett v. Ryan Homes, Inc.*,⁷⁷³ the materiality of omitted facts was challenged on appeal. Harnett was a departing employee who sold

. . . . However, in light of the Supreme Court's holding in *Affiliated Ute*, the burden of proof rests squarely upon defendant to establish the "non-reliance" of plaintiff.

766. 480 F.2d at 400.

767. *Id.* at 399.

768. 491 F.2d 402 (3d Cir. 1974).

769. *Id.* at 410. See note 765 *supra*.

770. 491 F.2d at 410.

771. *Rochez* was president of *Rochez Bros., Inc.* and vice-president and a director *MS&R, Inc.* He acted as agent for *Rochez Bros., Inc.*, in its sale of 50% of the issue and outstanding stock of *MS&R, Inc.*, to *Rhoades*. *Id.* at 405.

772. *Id.* at 409, citing *Financial Indus. Fund, Inc. v. McDonnell Douglas Corp.*, 474 F.2d 514 (10th Cir. 1973), *Clement A. Evans & Co. v. McAlpine*, 434 F.2d 100 (5th Cir. 1970), *cert. denied*, 402 U.S. 988 (1971), *City Nat'l Bank v. Vanderboom*, 422 F.2d 221 (8th Cir.), *cert. denied*, 399 U.S. 905 (1970). The court pointed out, though, that "a plaintiff cannot fail in his duty of due care if he lacked any opportunity to detect" the omission. 491 F.2d at 409, citing *Johns Hopkins Univ. v. Hutton*, 422 F.2d 1124 (4th Cir. 1970), *City Nat'l Bank v. Vanderboom*, *supra*, *Lehigh Valley Trust Co. v. Central Nat'l Bank*, 409 F.2d 989 (5th Cir. 1969).

773. 496 F.2d 832 (3d Cir. 1974).

his shares to the corporation.⁷⁷⁴ Affirming the district court's finding that the omitted facts were not material, the Third Circuit reviewed the circumstances of Harnett's particular situation.⁷⁷⁵ The court noted that

when . . . there is single buyer allegedly hiding facts from a single seller it is difficult to divorce consideration of the probable effects of the unrevealed facts from the particular circumstances of the solitary seller. Indeed, it may be argued that the distinction between the objective materiality test and the subjective reliance test breaks down in such circumstances.⁷⁷⁶

The greater the weight given to the particular circumstances and the more atypical the plaintiff, the more subjective the test of materiality becomes. Since materiality and reliance are distinguished by their objective or subjective nature,⁷⁷⁷ reliance may again become a requisite element of a rule 10b-5 action.

A defendant faced with a case of presumed reliance may raise three defenses. Relying on *Rochez Bros.* he may attempt to prove "that there was clearly no reliance,"⁷⁷⁸ or that plaintiff has failed to prove fulfillment of his duty of due diligence,⁷⁷⁹ or, relying on *Harnett* he may emphasize the circumstances of the situation that render the undisclosed facts immaterial.⁷⁸⁰

(iii) *Reliance Has Not Been Eliminated.* The language of *Affiliated Ute* has been construed by some courts in such a manner that reliance has remained a requisite element of a rule 10b-5 action. In *Simon v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*,⁷⁸¹ the Fifth Circuit held, notwithstanding *Affiliated Ute*, that "some element of general reliance"

774. *Id.* at 833-34. Harnett named the closely-held corporation and its chief executive officer as defendants in an action alleging nondisclosure of the officer's thoughts concerning possible employee participation in an impending public offering of the corporation's stock. Employee participation would have permitted Harnett to sell his 1000 shares to the public, rather than to the corporation at book value as required by an agreement covering employees. The district court characterized the officer's thoughts as "speculation." *Harnett v. Ryan Homes, Inc.*, 360 F. Supp. 878, 889 (W.D. Pa. 1973).

775. 496 F.2d at 837-38.

776. *Id.* at 838 n.20.

777. *List v. Fashion Park, Inc.*, 340 F.2d 457, 462 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965). Compare RESTATEMENT OF TORTS § 546 (1934), with *id.* § 538(2)(a).

778. 491 F.2d at 410; see sources cited notes 665-70 *supra* and accompanying text.

779. See notes 891-92 *supra* and accompanying text.

780. 496 F.2d at 837-38; see sources cited notes 675-77 *supra* and accompanying text.

781. 482 F.2d 880 (5th Cir. 1973).

must be shown.⁷⁸² The court distinguished *Affiliated Ute* by noting that it "did not involve, as here, a general lack of reliance by the plaintiffs on the defendant's representations."⁷⁸³ Although it is not clear, the *Simon* court apparently held that a finding of subjective nonreliance by plaintiffs on the general body of defendant's representations was a bar to recovery in nondisclosure cases.

The Fifth Circuit elaborated on its *Simon* holding in *Vohs v. Dickinson*.⁷⁸⁴ The court explained that the holding in *Affiliated Ute*

must be confined to making proof of *specific* reliance on particular omissions unnecessary when the circumstances indicate that the plaintiff placed some *general* reliance upon the defendant's disclosing material information.⁷⁸⁵

Since the plaintiffs had sought expert advice in addition to defendant's representations,⁷⁸⁶ and had given no great credence to defendant's statements in making their decision, the defendant's omissions were of little importance. Rather than evaluating this fact pattern as involving facts which were immaterial, the Fifth Circuit employed its notion of "general reliance."

Several courts have barred recovery on the theory that plaintiff was not a "reasonable investor" or that the misrepresented or omitted facts were not material to the particular plaintiff. In *Kohner v. Wechsler*,⁷⁸⁷ the Second Circuit affirmed the dismissal of a complaint based on rule 10b-5. The court quoted the district court: "[T]he plaintiff, an experienced businessman and a sophisticated investor, had many

782. *Id.* at 884 (emphasis added), citing *Clement A. Evans & Co. v. McAlpine*, 434 F.2d 100 (5th Cir. 1970), *cert. denied*, 402 U.S. 988 (1971), *Grumbles v. Times Herald Printing Co.*, 387 F.2d 593 (5th Cir.), *cert. denied*, 390 U.S. 1028 (1968). See *Landy v. FDIC*, 486 F.2d 139 (3d Cir. 1974).

783. 482 F.2d at 884. The Fifth Circuit's stance on reliance is somewhat contrary to the Supreme Court's, *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153 (1972) ("positive proof of reliance is not a prerequisite to recovery"), but can be supported by noting the Supreme Court's language in *Affiliated Ute* that plaintiffs "considered these defendants to be familiar with the market for the shares of stock and relied upon them when they desired to sell their shares." 406 U.S. at 152, cited in *Simon v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 482 F.2d 880, 884 (5th Cir. 1973).

784. 495 F.2d 607 (5th Cir. 1974).

785. *Id.* at 622 (emphasis original).

786. *Id.* at 624: "The record presents a picture of aggressive purchasers who took it upon themselves to ascertain the status of the company and its stock, not persons who passively relied on the knowledge and advice of the seller."

787. 477 F.2d 666 (2d Cir. 1973).

financial advisors to assist him”⁷⁸⁸ In his majority opinion, Judge Moore did not address this statement, but Judge Timbers, concurring, quoted the materiality test from *Affiliated Ute* and concluded:

[T]he testimony of Kohner’s expert witness, an attorney experienced in customs matters, indicated that after successful mitigation of the total potential liability, Wecolite probably would have been subject to an assessment of less than \$4,000. In a sale involving a purchase price of \$650,000 plus extensive additional consideration, the conclusion that \$4,000 would not constitute a factor that a reasonable investor would have deemed important in the purchase decision would seem to be reasonable.⁷⁸⁹

The Fourth Circuit has also resolved the question of reliance by replacing it with materiality. In *Johns Hopkins University v. Hutton*,⁷⁹⁰ the plaintiff sought to rescind its purchase of oil and gas production payments, alleging that the defendant’s employee had misrepresented and omitted material facts concerning the estimated net revenues to be realized from the oil and gas reserves. Rather than applying *Affiliated Ute* to misrepresentations,⁷⁹¹ the court held: “[A]ssuming that in a case such as this some degree of reliance is necessary, we think the essentiality of the tainted information satisfies the accepted criteria of reliance which were delineated in *List*”⁷⁹²

In *Taylor v. Smith, Barney & Co., Inc.*⁷⁹³ a district court applied the “reasonable investor” test⁷⁹⁴ of materiality in denying plaintiff’s motion for summary judgment. Plaintiff brought an action for damages against a broker alleging rules 10b-5 and 15c1-4⁷⁹⁵ violations in the broker’s

788. *Id.* at 667, quoting *Kohner v. Wechsler*, Civil No. 72-1898 (S.D.N.Y., filed June 16, 1972).

789. 477 F.2d at 673-74 (Timbers, J., concurring) (footnote omitted). See *Puma v. Marriott*, 363 F. Supp. 750, 757 (D. Del. 1973): “Materiality cannot be established on the basis of trivial or insignificant defects, or those only tangentially related to the transaction for which the proxy is solicited.”

790. 488 F.2d 912 (4th Cir. 1973), *cert. denied*, 416 U.S. 916 (1974).

791. See *Cutner v. Fried*, 373 F. Supp. 4 (S.D.N.Y. 1974).

792. 488 F.2d at 915. Hutton petitioned for certiorari on January 30, 1974, asserting that the Fourth Circuit had improperly adopted the “materiality causation” standard of *Mills* and *Affiliated Ute*. Hutton argued that since this was a misrepresentation case, specific reliance had to be shown. As authority for its position, Hutton cited *Kohner v. Wechsler*, 477 F.2d 666 (2d Cir. 1973). Hutton’s petition was denied. *Hutton v. Johns Hopkins Univ.*, 416 U.S. 916 (1974).

793. 358 F. Supp. 892 (D. Utah 1973).

794. See source cited note 689 *supra* and accompanying text.

795. 17 C.F.R. § 240.15c1-4 (1974).

failure to disclose its market-making activities. The court noted that while proof of actual reliance was not necessary,⁷⁹⁶ proof that the plaintiff acted as a "reasonable investor" was required to establish materiality:

Judicial pursuit of the "reasonable investor" has led most often to a consideration of the fact constellation of each case including the relationship of the parties, the experience of the investor, the nature of the transaction and the nature of the omitted fact. . . . The reasonable investor of substantial business acumen presumably would more diligently test the reliability and completeness of representations made concerning a proposed transaction before considering them important than would one of lesser acumen.⁷⁹⁷

Although the *Taylor* court recognized that reliance is unnecessary, it permitted a showing of the same evidence that would substantiate subjective non-reliance.⁷⁹⁸ The court distinguished the "reasonable investor" for purposes of a private suit and a suit brought by the SEC.⁷⁹⁹ In the latter, the "reasonable investor" is "prototypal" since the Commission seeks relief on behalf of all investors.⁸⁰⁰

The crux of this group of cases appears to be their consideration of the particular circumstances surrounding the transaction. Whether the court labels the problem as one involving an atypical investor, reliance, or materiality, it may be said of each case that it involved a face-to-face transaction in which the disclosure of the hidden information might or

796. 358 F. Supp. at 895.

797. *Id.*

798. *Id.* at 896. The court also noted that "the application of an objective materiality test usually results in the consideration of surrounding circumstances." *Id.* at 895 n.8.

799. *Id.* at 895 n.9. Compare source cited note 689 *supra* and accompanying text, with *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith*, 495 F.2d 228, 236 (2d Cir. 1974), and *General Host Corp. v. Triumph Am., Inc.*, 359 F. Supp. 749, 753 (S.D.N.Y. 1973).

800. 358 F. Supp. at 895 n.9. Although this position may be attractive in the context of limiting liability under rule 10b-5, with regard to the purposes of the 1934 Act's anti-fraud provisions it is not correct. "[The] policy of vigorous enforcement through private litigation has been the instrument for forging many salutary developments in the securities fraud area, including the broadening of standing to sue and a relaxation of the elements of proof in a private action." *Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 480 F.2d 341, 356 (2d Cir.), *cert. denied*, 414 U.S. 910 (1973) (dictum). See *J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964); *Speed v. Transamerica Corp.*, 235 F.2d 369 (3d Cir. 1956); *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946). The Supreme Court has not set out criteria for the interpretation of the "reasonable investor." *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153-54 (1972).

might not have made a difference. There is really no need to talk about reliance or atypical investors at all—the court should simply find that the undisclosed information was or was not material, *i.e.*, would or would not have been considered important by a person in the same or similar circumstances.

5. Conclusion

In summary, the precise language of *Affiliated Ute* should be recalled: In cases “involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery.”⁸⁰¹ The Court focused on the materiality of the facts withheld. It was sufficient that “a reasonable investor might have considered them important in the making of the decision.”⁸⁰² Rule 10b-5 creates a duty to disclose material facts. If a fact is material, proof of nondisclosure establishes the element of causation and, ultimately, liability.

The language of *Affiliated Ute* has been applied to a myriad of fact patterns. Proof of the materiality of an omission should serve to supply the requisite causation element in class action cases, rather than proof of subjective reliance by each individual plaintiff. In anonymous market transactions, where plaintiff and defendant have no direct contact, again the materiality of the undisclosed information should serve to supply the reliance element. In face-to-face transactions, where material facts are hidden, the mere materiality of those facts coupled with the statutory duty to disclose should be sufficient to establish liability.

In the particularly troublesome cases involving atypical investors, concepts of reliance should not be permitted to confuse the analysis. Courts should simply assess the importance of the undisclosed information to an investor in the same or similar circumstances. These circumstances may include the plaintiff's own knowledge, as in *Harnett*,⁸⁰³ or his recourse to expert advice, as in *Vohs*.⁸⁰⁴ Such a “sliding scale” of

801. *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153-54 (1972).

802. *Id.* (emphasis added).

803. *Harnett v. Ryan Homes, Inc.*, 496 F.2d 832 (3d Cir. 1974); see notes 773-80 *supra* and accompanying text.

804. *Vohs v. Dickinson*, 495 F.2d 607 (5th Cir. 1974); see text accompanying notes 784-85 *supra*. Note also the particular circumstances considered in *Taylor v. Smith, Barney & Co.*, 358 F. Supp. 892 (D. Utah 1973). See notes 793-800 *supra* and accompanying text.

materiality is consistent with the tort theory that underlies rule 10b-5⁸⁰⁵ and with the flexible nature of the securities laws. The crucial issue is the importance of the undisclosed facts; sufficient importance, however defined, coupled with non-disclosure should suffice to yield liability. The seemingly clear language of *Affiliated Ute*, that “[a]ll that is necessary is that the facts withheld be material,”⁸⁰⁶ can be consistently applied only by focusing on the concept of materiality, not reliance. By emphasizing the need to disclose the important facts surrounding a transaction, the disclosure policy of the 1934 Act can be effectuated.

805. See notes 673-80 *supra* and accompanying text.

806. 406 U.S. at 153-54.