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# A COMPARATIVE FAULT APPROACH TO THE DUE DILIGENCE REQUIREMENT OF RULE 10b-5

## INTRODUCTION

Promulgated pursuant to the comprehensive antifraud mandate established by section 10(b)<sup>1</sup> of the Securities Exchange Act of 1934,<sup>2</sup> rule 10b-5<sup>3</sup> prohibits the commission of any fraudulent act and the issuance of any false or materially misleading statement in connection with the purchase or sale of any security. Since the implication of a private action under this section,<sup>4</sup> courts have exercised considerable

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1. Section 10b of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1976), provides that "[i]t 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 . . . (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

2. 15 U.S.C. §§ 78a-78kk (1976) (1934 Act). The federal securities laws were enacted during a period of economic and political upheaval marked by rampant speculation in the securities markets. The 1934 Act was directed primarily at the national trading markets, as distinguished from the new issue markets, and was intended to shield investors from unscrupulous price manipulation. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195 (1976); 1 A. Bromberg & L. Lowenfels, *Securities Fraud & Commodities Fraud* § 2.2, at 2.16 (1979).

3. 17 C.F.R. § 240.10b-5 (1980). The rule provides that "[i]t 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." *Id.*

4. A private right of action under 10b-5 was first recognized in *Kardon v. National Gypsum Co.*, 69 F. Supp. 512, 513-14 (E.D. Pa. 1946); see *Fischman v. Raytheon Mfg. Co.*, 188 F.2d 783, 786-87 (2d Cir. 1951) (recognition of buyer's implied cause of action when "fraud" is shown). The Supreme Court expressly recognized the private right of action in *Superintendent of Ins. v. Banker's Life & Cas. Co.*, 404 U.S. 6, 13 n.9 (1971). A properly stated cause of action under rule 10b-5 must allege the scier of the defendant, *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976), the materiality of any omission or misrepresentation by the defendant, *Arber v. Essex Wire Corp.*, 490 F.2d 414, 418 (6th Cir.), *cert. denied*, 419 U.S. 830 (1974); *Rogen v. Iikon Corp.*, 361 F.2d 260, 266 (1st Cir. 1966), and the extent of actual reliance by the plaintiff on the defendant's statements. *Holdsworth v. Strong*, 545 F.2d 687, 695-97 (10th Cir. 1976), *cert. denied*, 430 U.S. 955 (1977); *Titan Group, Inc. v. Faggen*, 513 F.2d 234, 238-39 (2d Cir.), *cert. denied*, 423 U.S. 840 (1975); *Rochez Bros. v. Rhoades*, 491 F.2d 402, 410 (3d Cir. 1973).

latitude<sup>5</sup> in formulating elements of the cause of action as well as its defenses.<sup>6</sup> One such defense, the failure of the plaintiff to exercise

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Proof of actual reliance is not required when defendants have omitted, rather than misrepresented, information. *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153-54 (1972). Reliance on the omission will be presumed when the omission is material. *E.g.*, *Competitive Assoc. v. Laventhol, Krekstein, Horwath & Horwath*, 516 F.2d 811, 814 (2d Cir. 1975). When reliance must be proven, it must also be justifiable. *Holdsworth v. Strong*, 545 F.2d 687, 695-97 (10th Cir. 1976), *cert. denied*, 430 U.S. 955 (1977); *Clement A. Evans & Co. v. McAlpine*, 434 F.2d 100, 103-04 (5th Cir. 1970), *cert. denied*, 402 U.S. 988 (1971); *see* *Straub v. Vaisman & Co.*, 540 F.2d 591, 595-98 (3d Cir. 1976); *Rochez Bros. v. Rhoades*, 491 F.2d 402, 410-11 (3d Cir. 1973). Although the justifiability of plaintiff's reliance is often translated into a due diligence requirement, the two can be distinguished for analytical purposes. "Reliance considers whether the plaintiff was in fact influenced in his investment decision by the untrue statements or omission of the defendant." *Wheeler, Plaintiff's Duty of Due Care Under Rule 10b-5: An Implied Defense to an Implied Remedy*, 70 Nw. U.L. Rev. 561, 592 (1975) (footnote omitted); *see* *Rogen v. Ilikon Corp.*, 361 F.2d 260, 267-68 (1st Cir. 1966); *List v. Fashion Park, Inc.*, 340 F.2d 457, 462-63 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965). On the other hand, due diligence considers whether the plaintiff was influenced in his investment decision by defendant's untrue statements or omissions because plaintiff failed to conduct a reasonable investigation to discover additional information. *See Wheeler, supra*, at 598.

5. It has been stated that rule 10b-5 was a deliberate effort by the Securities and Exchange Commission (SEC) to make the prohibitions contained in § 17(a) of the Securities Act of 1933, 15 U.S.C. § 77m (1976), applicable to purchasers as well as to sellers of securities. 1 A. Bromberg & L. Lowenfels, *supra* note 2, § 2.2, at 2.28. Because the rule was not intended to be enforced by private parties, *id.* § 2.3, at 2.52, the elements and defenses of the private 10b-5 action are largely judicial creations without direct statutory basis. *Id.*

6. A number of defenses to rule 10b-5 actions have gradually been established on an *ad hoc* basis. Among these are laches, waiver, estoppel, *see* *Mihara v. Dean Witter & Co.*, 619 F.2d 814, 822 (9th Cir. 1980); *Nemkov v. O'Hare Chicago Corp.*, 592 F.2d 351, 354 (7th Cir. 1979); *Bosse v. Crowell Collier & MacMillan*, 565 F.2d 602, 611 n.15 (9th Cir. 1977); *Fey v. Walston & Co.*, 493 F.2d 1036, 1049 (7th Cir. 1974); *Landry v. Hemphill, Noyes & Co.*, 473 F.2d 365, 374 (1st Cir.), *cert. denied*, 414 U.S. 1002 (1973); *Hecht v. Harris, Upham & Co.*, 430 F.2d 1202, 1207 (9th Cir. 1970); *Royal Air Properties, Inc. v. Smith*, 312 F.2d 210, 213-14 (9th Cir. 1962); *Collins v. Ruskin*, 342 F. Supp. 1282, 1291 (D. Mass. 1972); *Marth v. Industrial Incomes, Inc.*, 290 F. Supp. 755, 758-59 (S.D.N.Y. 1968), *in pari delicto*, *Wolfson v. Baker*, 623 F.2d 1074, 1081-83 (5th Cir. 1980); *Gordon v. duPont Glove Forgan, Inc.*, 487 F.2d 1260, 1262-63 (5th Cir. 1973), *cert. denied*, 417 U.S. 946 (1974); *Hogan v. Teledyne, Inc.*, 328 F. Supp. 1043, 1047 (N.D. Ill. 1971); *Wohl v. Blair & Co.*, 50 F.R.D. 89, 91-93 (S.D.N.Y. 1970); *Kuehnert v. Texstar Corp.*, 286 F. Supp. 340, 345 (S.D. Tex. 1968), *aff'd*, 412 F.2d 700 (5th Cir. 1969), and the statute of limitations. *Roberts v. Magnetic Metals Co.*, 611 F.2d 450, 452 (3d Cir. 1979); *Jones v. Ford Motor Co.*, 599 F.2d 394, 398-99 (10th Cir. 1979); *Williams v. Sinclair*, 529 F.2d 1383, 1387-88 (9th Cir. 1975), *cert. denied*, 426 U.S. 936 (1976); *Berry Petroleum Co. v. Adams & Peck*, 518 F.2d 402, 406-09 (2d Cir. 1975); *Schaefer v. First Nat'l Bank*, 509 F.2d 1287, 1293-95 (7th Cir. 1975), *cert. denied*, 425 U.S. 943 (1976); *Parrent v. Midwest Rug Mills, Inc.*, 455 F.2d 123, 127 (7th Cir. 1972); *Mitchell v. Texas Gulf Sulphur Co.*, 446 F.2d 90, 103-04 (10th Cir. 1971), *cert. denied*,

due care<sup>7</sup> or due diligence<sup>8</sup> precludes recovery when a plaintiff has failed to inquire or confirm the truthfulness of defendant's misrepresentations or omissions in a manner calculated to avert the commission of a fraud.<sup>9</sup>

Due diligence reflects the notion that rule 10b-5 does not remedy private losses that are partially or wholly attributable to plaintiffs'

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405 U.S. 918 (1972); *Janigan v. Taylor*, 344 F.2d 781, 783-84 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965).

7. *See, e.g.*, *Holdsworth v. Strong*, 545 F.2d 687, 692 (10th Cir. 1976), *cert. denied*, 430 U.S. 955 (1977); *Rochez Bros. v. Rhoades*, 491 F.2d 402, 409 (3d Cir. 1973); *McLean v. Alexander*, 420 F. Supp. 1057, 1077-78 (D. Del. 1976).

8. *See, e.g.*, *Mallis v. Bankers Trust Co.*, 615 F.2d 68, 78 (2d Cir. 1980); *Bird v. Ferry*, 497 F.2d 112, 118-19 (5th Cir. 1974); *Mitchell v. Texas Gulf Sulphur Co.*, 446 F.2d 90, 102 (10th Cir. 1971), *cert. denied*, 405 U.S. 918 (1972); *Clement A. Evans & Co. v. McAlpine*, 434 F.2d 100, 103 (5th Cir. 1970), *cert. denied*, 402 U.S. 988 (1971). This Note will refer to the due care or due diligence requirements as due diligence.

9. *E.g.*, *Clegg v. Conk*, 507 F.2d 1351, 1360 (10th Cir. 1974), *cert. denied*, 422 U.S. 1007 (1975); *Vohs v. Dickson*, 495 F.2d 607, 623 (5th Cir. 1974); *Rochez Bros. v. Rhoades*, 491 F.2d 402, 409 (3d Cir. 1973); *Financial Indus. Fund, Inc. v. McDonnell Douglas Corp.*, 474 F.2d 514, 517, 521 (10th Cir.), *cert. denied*, 414 U.S. 874 (1973); *Mitchell v. Texas Gulf Sulphur Co.*, 446 F.2d 90, 103 (10th Cir. 1971), *cert. denied*, 405 U.S. 918 (1972); *Clement A. Evans & Co. v. McAlpine*, 434 F.2d 100, 103-04 (5th Cir. 1970), *cert. denied*, 402 U.S. 988 (1971); *City Nat'l Bank v. Vanderboom*, 422 F.2d 221, 230 n.10, 231 (8th Cir.), *cert. denied*, 399 U.S. 905 (1970); *Myzel v. Fields*, 386 F.2d 718, 736 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968); *Harnett v. Ryan Homes, Inc.*, 360 F. Supp. 878, 886-87 (W.D. Pa. 1973), *aff'd*, 496 F.2d 832 (1974); *Lane v. Midwest Bancshares Corp.*, 337 F. Supp. 1200, 1209 (E.D. Ark. 1972); *Kaplan v. Vornado, Inc.*, 341 F. Supp. 212, 216 (N.D. Ill. 1971); *Chris-Craft Indus. v. Piper Aircraft Corp.*, 337 F. Supp. 1128, 1135 (S.D.N.Y. 1971), *aff'd in part, rev'd in part and remanded*, 480 F.2d 341 (2d Cir.), *cert. denied*, 414 U.S. 910 (1973); *Rogen v. Ilikon Corp.*, 250 F. Supp. 112, 117 (D. Mass.), *rev'd*, 361 F.2d 260 (1st Cir. 1966); 5 A. Jacobs, *The Impact of Rule 10b-5*, § 64.01 [b] [ii], at 3-248 (rev. ed. 1980). The due diligence defense under rule 10b-5 should not be confused with the due diligence defense available to defendants under § 11 of the Securities Act of 1933, 15 U.S.C. § 77k (1976). Under that section, liability may be avoided for the issuance of a false or misleading registration statement when it is established that the defendant "had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading." 15 U.S.C. § 77k(b)(3) (1976) (emphasis added). The due diligence defense created under § 11 is available to all signers of a registration statement except the issuer. 15 U.S.C. § 77k(b)(3)(A) (1976). As to any portion issued on the authority of an expert, the expert may resort to the defense as to that portion of the registration statement based on his authority as an expert. 15 U.S.C. § 77k(b)(3)(B) (1976). A non-expert may rely on these portions if he has no reasonable ground to believe and does not believe that any of the statements are untrue. 15 U.S.C. § 77k(b)(3)(C) (1976). *See generally* *Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544, 575-83 (E.D.N.Y. 1971); *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643, 682-703 (S.D.N.Y. 1968).

culpable conduct.<sup>10</sup> Although the Supreme Court has not expressly recognized the due diligence requirement,<sup>11</sup> a majority of federal courts<sup>12</sup> and commentators<sup>13</sup> have equated the Court's silence with approval and have recognized the validity of the requirement. This

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10. Wheeler, *supra* note 4, at 563. See also, Comment, *Due Diligence Defense in Rule 10b-5: The Hochfelder Aftershocks*, 11 Ind. L. Rev. 727, 727 (1978) [hereinafter cited as *Aftershocks*].

11. To date, the Supreme Court has refused to entertain the issue. In dissenting from the denial of certiorari in Dupuy v. Dupuy, Justice White stated that "[t]he Court should take this opportunity to clarify the standard of care expected of plaintiffs in litigation under Rule 10b-5. Business can be transacted more freely and efficiently if the responsibility for verifying underlying facts is clearly allocated. Because securities litigation can be complex and expensive, it [should] be avoided to the maximum extent by early clarification of the ground rules. This Court should thus promptly resolve the existing uncertainty as to the proper standard of care required of plaintiffs after *Ernst & Ernst*." Dupuy v. Dupuy, 434 U.S. 911, 912 (White, J., dissenting), *denying cert. to* 551 F.2d 1005 (5th Cir. 1977).

12. See note 9 *supra* and accompanying text. Nearly all circuits presently recognize the necessity of a due diligence requirement. *E.g.*, Mallis v. Bankers Trust Co., 615 F.2d 68, 78-79 (2d Cir. 1980); Holmes v. Bateson, 583 F.2d 542, 559 & n.21 (1st Cir. 1978); Sundstrand Corp. v. Sun Chem. Co., 553 F.2d 1033, 1048-49 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977); Dupuy v. Dupuy, 551 F.2d 1005, 1013-20 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977); Holdsworth v. Strong, 545 F.2d 687, 693-95 (10th Cir. 1976), *cert. denied*, 430 U.S. 955 (1977); Straub v. Vaisman & Co., 540 F.2d 591, 596-98 (3d Cir. 1976); White v. Abrams, 495 F.2d 724, 732-33 (9th Cir. 1974); Arber v. Essex Wire Corp., 490 F.2d 414, 420-21 (6th Cir.), *cert. denied*, 419 U.S. 830 (1974); City Nat'l Bank v. Vanderboom, 422 F.2d 221, 230-31 (8th Cir.), *cert. denied*, 399 U.S. 905 (1970). Although the Fourth Circuit has yet to express its position with regard to due diligence, a Virginia District Court has recognized that a threshold due diligence requirement exists in the Fourth Circuit. See *American Gen. Ins. Co. v. Equitable Gen. Corp.*, 493 F. Supp. 721, 746-47 (E.D. Va. 1980). Additionally, the D.C. Circuit has not yet formulated a due diligence standard. The proposed Federal Securities Code has expressly adopted a defense based on a plaintiff's failure to exercise due diligence. See ALI Fed. Sec. Code § 1703(e) (1978) ("Defense of Plaintiff's Knowledge").

13. The most thoughtful and provocative endorsement of the requirement is presented in Wheeler, *supra* note 4. The field is rife with commentaries. *E.g.*, Campbell, *Elements of Recovery Under Rule 10b-5: Scienter, Reliance and Plaintiff's Reasonable Conduct Requirement*, 26 S.C.L. Rev. 653 (1975); Comment, *Abrogation of Plaintiff's Due Care Requirement in Private Actions Under Rule 10b-5*, 28 Case W. L. Rev. 399 (1978) [hereinafter cited as *Abrogation of Due Care*]; *Aftershocks supra* note 10, at 727; Comment, *Due Care: Still a Limitation on 10b-5 Recovery?*, 61 Marq. L. Rev. 122 (1977) [hereinafter cited as *Still a Limitation*]; Comment, *Plaintiff's Duty of Care After Ernst & Ernst v. Hochfelder*, 73 Nw. U.L. Rev. 158 (1978); Comment, *Plaintiff's Standard of Care After Hochfelder: Toward a Theory of Causation*, 31 Vand. L. Rev. 1225 (1978) [hereinafter cited as *Causation*]; Comment, *A Reevaluation of the Due Diligence Requirement for Plaintiffs in Private Actions Under SEC Rule 10b-5*, 1978 Wis. L. Rev. 904; Note, *The Due Diligence Requirement for Plaintiffs Under Rule 10b-5*, 1975 Duke L.J. 753 [hereinafter cited as *Due Diligence*]; Note, *Negligent Misrepresentations Under Rule 10b-5*, 32 U. Chi. L. Rev. 824 (1965); 12 Ga. L. Rev. 112 (1977); 50 Temp. L.Q. 124 (1976).

Note examines the use of the due diligence requirement as a means of reducing, rather than barring, 10b-5 recoveries. Part I will present the relevant historical background of the due diligence requirement. Part II will suggest that due diligence can be reformulated as a liability-reducing rule rather than a liability-denying rule without blunting the rule's deterrent effect and will offer a liability-reducing formulation drawn from the evolving notion of comparative fault in tort.

### I. DUE DILIGENCE HISTORICALLY CONSIDERED

Prior to the Supreme Court's decision in *Ernst & Ernst v. Hochfelder*,<sup>14</sup> federal courts were free to premise civil liability for violations of rule 10b-5 on negligent misconduct.<sup>15</sup> In this context,

14. 425 U.S. 185 (1976).

15. See, e.g., *Hughes v. Dempsey-Tegeler & Co.*, 534 F.2d 156, 176 (9th Cir.), cert. denied, 429 U.S. 896 (1976); *Woodward v. Metro Bank*, 522 F.2d 84, 93 (5th Cir. 1975); *Robinson v. Cupples Container Co.*, 513 F.2d 1274, 1278 (9th Cir. 1975); *Hochfelder v. Ernst & Ernst*, 503 F.2d 1100, 1107-09 (7th Cir. 1974), rev'd., 425 U.S. 185 (1976); *Hudak v. Economic Research Analysts, Inc.*, 499 F.2d 996, 1000 (5th Cir. 1974), cert. denied, 419 U.S. 1122 (1975); *White v. Abrams*, 495 F.2d 724, 730-31 (9th Cir. 1974); *Vohs v. Dickson*, 495 F.2d 607, 622 (5th Cir. 1974); *Sargent v. Genesco, Inc.*, 492 F.2d 750, 761 (5th Cir. 1974); *Financial Indus. Fund, Inc. v. McDonnell Douglas Corp.*, 474 F.2d 514, 517 (10th Cir.), cert. denied, 414 U.S. 874 (1973); *Parrent v. Midwest Rug Mills, Inc.*, 455 F.2d 123, 126 (7th Cir. 1972); *Clement A. Evans & Co. v. McAlpine*, 434 F.2d 100, 103-04 (5th Cir. 1970), cert. denied, 402 U.S. 988 (1971); *Vanderboom v. Sexton*, 422 F.2d 1233, 1239 (8th Cir.), cert. denied, 400 U.S. 852 (1970); *City Nat'l Bank v. Vanderboom*, 422 F.2d 221, 229-30 & n.9 (8th Cir.), cert. denied, 399 U.S. 905 (1970); *Texasgulf, Inc. v. Canada Dev. Corp.*, 366 F. Supp. 374, 420-21 (S.D. Tex. 1973); *Blakely v. Lisac*, 357 F. Supp. 255, 262, 264-67 (D. Or. 1972); *Lane v. Midwest Bancshares Corp.*, 337 F. Supp. 1200, 1210 (E.D. Ark. 1972); *Drake v. Thor Power Tool Co.*, 282 F. Supp. 94, 105 (N.D. Ill. 1967). A substantial number of courts, however, had required that the conduct of defendants exceed mere negligence. Compare *Clegg v. Conk*, 507 F.2d 1351, 1361-62 (10th Cir. 1974) (scienter required to maintain a private damage action under rule 10b-5), cert. denied, 422 U.S. 1007 (1975) and *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579, 606 (5th Cir.) (same), cert. denied, 419 U.S. 873 (1974) and *Lanza v. Drexel & Co.*, 479 F.2d 1277, 1306 (2d Cir. 1973) (same) and *Shemtob v. Shearson, Hammill & Co.*, 448 F.2d 442, 445 (2d Cir. 1971) (same) and *Hornblower & Weeks-Hemphill, Noyes v. Burchfield*, 366 F. Supp. 1364, 1366 (S.D.N.Y. 1973) (same) and *Gerstle v. Gamble-Skogmo, Inc.*, 298 F. Supp. 66, 97 (E.D.N.Y. 1969) (same), aff'd and modified, 478 F.2d 1281 (2d Cir. 1973) with *Carras v. Burns*, 516 F.2d 251, 256 (4th Cir. 1975) (conduct equivalent to scienter probably required) and *SEC v. Coffey*, 493 F.2d 1304, 1314, 1316 n.30 (6th Cir. 1974) (same), cert. denied, 420 U.S. 908 (1975) and *Rochez Bros. v. Rhoades*, 491 F.2d 402, 407-08 (3d Cir. 1973) (same), cert. denied, 425 U.S. 993 (1976) and *Leasco Corp. v. Taussig*, 473 F.2d 777, 785 (2d Cir. 1972) (same) and *Gordon v. Burr*, 366 F. Supp. 156, 167 (S.D.N.Y. 1973) (same), aff'd in part, rev'd in part and remanded, 506 F.2d 1030 (2d Cir. 1974).

the absence of plaintiff's due diligence attained prominence as an absolute defense<sup>16</sup> analogous to contributory negligence at common law.<sup>17</sup> The generally accepted rationale for this rule was that, if a defendant were potentially liable for statements or omissions made without specific fraudulent intent, equity dictated that a comparable standard govern plaintiff's dealings.<sup>18</sup>

Although federal courts consistently used the lack of due diligence to bar certain plaintiffs, the procedural treatment of the requirement was not uniform. Courts recognized it as either an element of plaintiff's case,<sup>19</sup> a component of plaintiff's justifiable reliance,<sup>20</sup> an affirmative defense to be pleaded by defendant,<sup>21</sup> or one factor to be considered in determining what information a defendant was required to disclose to a particular buyer or seller.<sup>22</sup> Regardless of the differ-

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16. In practice, the due diligence requirement operates as a defense, although it has been raised under a number of divergent rationales. See note 19-22 *infra* and accompanying text.

17. Contributory negligence has been defined as an "act or omission amounting to the want of ordinary care on the part of the complaining party, which, concurring with the negligence of the defendant, is the proximate cause of the injury." *Honaker v. Crutchfield*, 247 Ky. 495, 501, 57 S.W.2d 502, 504 (1933). If a plaintiff is held to be contributorily negligent he will be barred from recovery. See H. Woods, *Comparative Fault* § 1:3, at 7 (1978).

18. See *Dupuy v. Dupuy*, 551 F.2d 1005, 1014 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977); *Holdsworth v. Strong*, 545 F.2d 687, 692-93 (10th Cir. 1976), *cert. denied*, 430 U.S. 955 (1977); *Straub v. Vaisman & Co.*, 540 F.2d 591, 597 (3d Cir. 1976); *McLean v. Alexander*, 420 F. Supp. 1057, 1078 (D. Del. 1976). Professor Bromberg has noted "that the circuits which have most clearly charged defendant with constructive knowledge or diligence are, by and large, the same courts that have similarly charged plaintiff. There is a logic and a balance in this. A high standard of conduct for defendant justifies a high standard for plaintiff. Stated a little differently, the price plaintiff pays for being relieved of . . . proving defendant's intent or actual knowledge, is that plaintiff himself must show some diligence." 3 A. Bromberg & L. Lowenfels, *supra* note 2, § 8.4, at 204.248.

19. *E.g.*, *Dupuy v. Dupuy*, 551 F.2d 1005, 1014, 1016 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977); *Clement A. Evans & Co. v. McAlpine*, 434 F.2d 100, 104 (5th Cir. 1970), *cert. denied*, 402 U.S. 988 (1971).

20. *E.g.*, *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1048-49 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977); *Holdsworth v. Strong*, 545 F.2d 687, 695 (10th Cir. 1976), *cert. denied*, 430 U.S. 955 (1977); *White v. Abrams*, 495 F.2d 724, 736 (9th Cir. 1974); *Vohs v. Dickson*, 495 F.2d 607, 622-23 (5th Cir. 1974); *Rochez Bros. v. Rhoades*, 491 F.2d 402, 410 (3d Cir. 1973); *Myzel v. Fields*, 386 F.2d 718, 735-36 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968); *Kohler v. Kohler Co.*, 319 F.2d 634, 642 (7th Cir. 1963).

21. See *Clement A. Evans & Co. v. McAlpine*, 434 F.2d 100, 103 (5th Cir. 1970), *cert. denied*, 402 U.S. 988 (1971).

22. *E.g.*, *White v. Abrams*, 495 F.2d 724, 736 (9th Cir. 1974) (the variable duty of disclosure depends on the sophistication and status of the buyer or seller); *Arber v. Essex Wire Corp.*, 490 F.2d 414, 418 (6th Cir.) (same), *cert. denied*, 419 U.S. 830 (1974); *Kohler v. Kohler Co.*, 319 F.2d 634, 642 (7th Cir. 1963) (same).

ent procedural classifications, however, the test of plaintiff's conduct was inevitably subjective,<sup>23</sup> varying in response to the status and business acumen of the individual plaintiff.<sup>24</sup> Thus, the early due diligence standard did not correspond exactly to the common law concept of contributory negligence, which considered a plaintiff's conduct according to an objective test of due care.<sup>25</sup> Moreover, due diligence was more limited than a duty of reasonable care because plaintiffs were never required to investigate beyond the corporation, its officers, and its business records.<sup>26</sup>

*Hochfelder* did not directly address the issue of due diligence.<sup>27</sup> The Supreme Court held only that no private action for damages under section 10b and rule 10b-5<sup>28</sup> may lie "in the absence of any

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23. *E.g.*, *Dupuy v. Dupuy*, 551 F.2d 1005, 1023 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977); *McLean v. Alexander*, 420 F. Supp. 1057, 1077-79 (D. Del. 1976); *Franklin Sav. Bank v. Levy*, 406 F. Supp. 40, 46 (S.D.N.Y. 1975), *rev'd and remanded*, 551 F.2d 521 (2d Cir. 1977); *see Still a Limitation, supra* note 13, at 125; Note, *Reliance Under Rule 10b-5: Is the "Reasonable Investor" Reasonable?*, 72 Colum. L. Rev. 562, 565-66 (1972).

24. *E.g.*, *Dupuy v. Dupuy*, 551 F.2d 1005, 1016 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977); *Holdsworth v. Strong*, 545 F.2d 687, 696-97 (10th Cir. 1976), *cert. denied*, 430 U.S. 955 (1977); *Bird v. Ferry*, 497 F.2d 112, 114 (5th Cir. 1974); *Myzel v. Fields*, 386 F.2d 718, 736 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968). As the court stated in *Dupuy*, "[t]he role model for a plaintiff, then, is an investor with the attributes of the plaintiff, rather than the average investor." 551 F.2d at 1016. In determining the plaintiff's duty of due diligence, a court will examine circumstances such as the existence of a fiduciary relationship, concealment of the fraud, opportunity for detection of the fraud, and plaintiff's sophistication and position in the investment community. *Id.*

25. Restatement (Second) of Torts § 464 (1965).

26. *See Dupuy v. Dupuy*, 551 F.2d 1005, 1023 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977); *Rogen v. Ilikon Corp.*, 361 F.2d 260, 266-67 (1st Cir. 1966); *Kohler v. Kohler Co.*, 319 F.2d 634, 641-42 (7th Cir. 1963); *Jackson v. Oppenheim*, 411 F. Supp. 659, 668 (S.D.N.Y. 1974).

27. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976). The Court rejected a finding of liability for an accounting firm's certification of a negligent audit that failed to disclose a fraudulent securities scheme. *Id.*

28. The Supreme Court did not address the degree of defendant's culpable conduct that must be alleged in an injunctive action by the SEC. That issue was raised and resolved in *Aaron v. SEC*, 100 S. Ct. 1945, 1952-53 (1980), which required scienter. *Aaron* is the latest in a series of Supreme Court decisions that have tended to restrict the 10b-5 cause of action. *E.g.*, *Chiarella v. United States*, 100 S. Ct. 1108, 1116-18 (1980) (nondisclosure by a non-fiduciary not actionable under rule 10b-5); *International Bhd. of Teamsters v. Daniel*, 439 U.S. 551, 563-69 (1979) (employee interests in non-compulsory union pension plan are not "securities" for 10b-5 purposes); *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 474-77 (1977) ("short-form Delaware merger" with full disclosure subsequent to the merger is not actionable under rule 10b-5); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197-206 (1976) (establishment of "scienter" as a necessary element of the 10b-5 private cause of action); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 731-32 (1975) (affirming requirement that plaintiffs in 10b-5 actions be either "buyers" or "sellers" of secur-



allegation of 'scienter'—intent to deceive, manipulate, or defraud."<sup>29</sup> The Court expressly considered and rejected liability for "negligent

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ities). This limiting trend in 10b-5 litigation parallels a limiting trend in related areas of securities litigation. See *Touche Ross & Co. v. Redington*, 442 U.S. 560, 568-71 (1979) (denial of implied cause of action under § 17(a) of the Securities Exchange Act of 1934); *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 445-49 (1976) (establishment of strict standard respecting "materiality" in proxy issuances); *Cort v. Ash*, 422 U.S. 66, 77-85 (1975) (refusal to recognize implied cause of action with respect to shareholders' grievances against corporate directors involved in illegal political campaign contributions).

29. 425 U.S. at 193 (footnote and citation omitted). By ruling that clearly fraudulent conduct is proscribed by the Act, the Court disallowed negligence as a basis for liability. It failed, however, to indicate whether any points on the "wide spectrum of prohibited behavior between negligence and specific intent to defraud," *McLean v. Alexander*, 420 F. Supp. 1057, 1078 (D. Del. 1976), could give rise to liability. See Bucklo, *The Supreme Court Attempts to Define Scienter Under Rule 10b-5*: Ernst & Ernst v. Hochfelder, 29 Stan. L. Rev. 213, 214-15 (1977). At first glance, the Court's definition of scienter connotes the narrowest interpretation of common law fraud, which requires a specific intent to deceive the person to whom the speaker conveys information. *Id.* at 218; see Restatement of Torts § 531 (1934). Nevertheless, the Court refused to decide whether recklessness is sufficient to impose 10b-5 liability. This appears to indicate that *Hochfelder* did little more than reject negligence as a basis for liability. Bucklo, *supra*, at 219. *Hochfelder's* recourse to the legislative history of the 1934 Act is of equally limited value in establishing a defendant's threshold of prohibited conduct. Although the Court conceded that "the extensive legislative history of the 1934 Act is bereft of any explicit explanation of Congress' intent," it reasoned that the "relevant portions of that history support our conclusion that § 10(b) was addressed to practices that involve some element of scienter and cannot be read to impose liability for negligent conduct alone." 425 U.S. at 201. In its decision, the Court relied on language drawn from legislative hearings preceding the Act's passage, indicating that § 10(b) was intended as a "'catch-all clause to prevent manipulative devices.'" 425 U.S. at 202. This language, the Court suggested, eliminated negligence from consideration as a basis for liability. 425 U.S. at 199 n.21, 203. The Court garnered additional support for its position from a Senate Report that indicated that § 10(b) was directed at manipulative and deceptive practices that had been demonstrated to "fulfill no useful function." 425 U.S. at 204-05. These practices in turn were illustrated in the Senate Report by fraudulent transactions that had been traditionally associated with an intent to deceive. 425 U.S. at 206. As a result of the Court's failure to provide adequate guidelines with respect to defendant's culpable conduct, divergent formulations of scienter have been proposed by federal courts. *E.g.*, *Rolf v. Blyth Eastman Dillon & Co., Inc.*, 570 F.2d 38, 47 (2d Cir.) (the necessity of alleging a specific intent to deceive or defraud would "disembowel the private cause of action"), *cert. denied*, 439 U.S. 1039 (1978); *Abrahamson v. Fleschner*, 568 F.2d 862, 878 n.27 (2d Cir. 1977) (scienter does not require a showing of intent to cause a loss to plaintiff), *cert. denied*, 436 U.S. 905 (1978); *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1045 (7th Cir.) (recklessness is equivalent to the employment of a deceptive device), *cert. denied*, 434 U.S. 875 (1977); *Utah State Univ. v. Bear, Stearns & Co.*, 549 F.2d 164, 169 (10th Cir.) (willful or intentional misconduct, or the equivalent thereof, is sufficient to constitute scienter), *cert. denied*, 434 U.S. 890 (1977); *Arthur Lipper Corp. v. SEC*, 547 F.2d 171, 181 (2d Cir. 1976) (specific intent to violate the law is not required to establish scienter), *cert. denied*, 434 U.S. 1009 (1978).

conduct alone;”<sup>30</sup> faultless conduct and conduct resulting from an entirely innocent mistake was also rejected as a basis for liability.<sup>31</sup> Nevertheless, by premising 10b-5 liability on a finding of scienter, *Hochfelder* cast doubt on the viability of a defense that barred a claimant from a damage award by weighing his negligent behavior against the intentional or reckless<sup>32</sup> conduct of a defendant.<sup>33</sup> In response to this problem, post-*Hochfelder* cases have rejected the negligence formulation of due diligence<sup>34</sup> by analogizing the requirement to the tort law concept that contributory negligence may bar

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30. 425 U.S. at 201.

31. *Id.* at 198, 207.

32. The Court noted that “[i]n certain areas of the law recklessness is considered to be a form of intentional conduct.” *Id.* at 193 n.12. It declined, however, to define recklessness or to state whether it conforms to the scienter requirement. *Id.* Prior to *Hochfelder*, a majority of courts regarded recklessness as sufficient to constitute scienter. *E.g.*, *Clegg v. Conk*, 507 F.2d 1351, 1361-62 (10th Cir. 1974), *cert. denied*, 422 U.S. 1007 (1975); *Rochez Bros. v. Rhoades*, 491 F.2d 402, 407 (3d Cir. 1973); *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579, 606 (5th Cir.), *cert. denied*, 419 U.S. 873 (1974); *Lanza v. Drexel & Co.*, 479 F.2d 1277, 1306 (2d Cir. 1973); *Kohn v. American Metal Climax, Inc.*, 458 F.2d 255, 279-88 (3d Cir.), *cert. denied*, 409 U.S. 874 (1972); *Shemtob v. Shearson, Hammill & Co.*, 448 F.2d 442, 445 (2d Cir. 1971). Subsequent to *Hochfelder*, a significant number of courts have agreed that recklessness suffices to establish defendants’ liability. *E.g.*, *McLean v. Alexander*, 599 F.2d 1190, 1197-98 (3d Cir. 1979); *Mansbach v. Prescott, Ball & Turben*, 593 F.2d 1017, 1023 (6th Cir. 1979); *Edward J. Mawod & Co. v. SEC*, 591 F.2d 588, 596 (10th Cir. 1979); *Hoffman v. Estabrook & Co.*, 587 F.2d 509, 516 (1st Cir. 1978); *Sanders v. John Nuveen & Co.*, 554 F.2d 790, 793 (7th Cir. 1977); *Dupuy v. Dupuy*, 551 F.2d 1005, 1019-20 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977); *Peltz v. Northern Ohio Bank*, 430 F. Supp. 382, 383-84 (N.D. Ohio 1976); *Rolf v. Blyth Eastman Dillon & Co.*, 424 F. Supp. 1021, 1042 (S.D.N.Y. 1977), *aff’d in part, remanded in part*, 570 F.2d 38 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978); *see Note, Recklessness and the Rule 10b-5 Scienter Standard After Hochfelder*, 48 *Fordham L. Rev.* 817, 817-22 (1980); *Note, Scienter’s Scope and Application in Rule 10b-5 Actions: An Analysis in Light of Hochfelder*, 52 *Notre Dame Law.* 925 (1977).

33. *See Holmes v. Bateson*, 583 F.2d 542, 559 n.21 (1st Cir. 1978); *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1048-49 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977); *Dupuy v. Dupuy*, 551 F.2d 1005, 1017-18 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977); *Holdsworth v. Strong*, 545 F.2d 687, 693 (10th Cir. 1976), *cert. denied*, 430 U.S. 955 (1977); *Straub v. Vaisman & Co.*, 540 F.2d 591, 597 (3d Cir. 1976); *McLean v. Alexander*, 420 F. Supp. 1057, 1078 (D. Del. 1976). *But see Meier v. Texas Int’l Drilling Funds, Inc.*, 441 F. Supp. 1056, 1063 (N.D. Cal. 1977) (plaintiff’s diligence considered without regard to defendant’s scienter); *Alton Box Board Co. v. Goldman, Sachs & Co.*, 418 F. Supp. 1149, 1158 (E.D. Mo. 1976) (same), *rev’d on other grounds*, 560 F.2d 916 (8th Cir. 1977). *See also Wheeler, supra* note 4, at 583; *Still a Limitation, supra* note 13, at 139.

34. *See Dupuy v. Dupuy*, 551 F.2d 1005, 1018 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977); *Holdsworth v. Strong*, 545 F.2d 687, 693-95 (10th Cir. 1976), *cert. denied*, 430 U.S. 955 (1977); *Straub v. Vaisman & Co.*, 540 F.2d 591, 597 (3d Cir. 1976); *Wheeler, supra* note 4, at 575.

recovery for negligent misrepresentations, but not for intentional misrepresentations.<sup>35</sup> Thus, courts have attempted to eliminate the similarity between due diligence and contributory negligence by changing the standard of care for plaintiffs. No court, however, has attempted to justify the use of a due diligence standard as a complete bar to recovery.

The first decision to reconsider the viability of due diligence was *Straub v. Vaisman & Co.*<sup>36</sup> Addressing *Hochfelder's* scienter requirement, the Third Circuit acknowledged the difficulty inherent in recognizing a negligence defense to an intentional tort by analogy to the common law tort of deceit.<sup>37</sup> The court observed that, "[u]nder the common law, once the right to recover for intentional misrepresentation has been established, lack of care on the part of the recipient in accepting the representations as true becomes irrelevant so long as the misrepresentation is not patently false."<sup>38</sup> *Straub*, however, refrained from abrogating the due diligence requirement. It held, in effect, that a claimant's qualitatively lesser fault could offset a defendant's intentional misconduct and bar recovery when the claimant failed to act reasonably.<sup>39</sup> Although this formulation is inconsistent with *Straub's* rejection of a negligence standard,<sup>40</sup> the case is significant because the court justified retention of a due diligence require-

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35. *Dupuy v. Dupuy*, 551 F.2d 1005, 1018 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977).

36. 540 F.2d 591 (3d Cir. 1976). In *Straub*, the plaintiff, manager of a European portfolio management firm, purchased 10,000 shares in Mark I Offset at the recommendation of defendant Vaisman & Co., a broker. *Id.* at 594. Less than a month following the stock purchase, Mark I Offset filed for bankruptcy. *Id.* The trial court found that defendant had access to "inside" information regarding the imminence of Mark I's bankruptcy. *Id.* On appeal, defendants urged that plaintiff should be barred from recovery because of his failure to inquire into the financial status of the troubled company prior to purchase. *Id.* at 596.

37. *Id.* at 597. Common law torts, although not determinative, have been found relevant in interpreting rule 10b-5. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 744-45 (1975); *Landy v. Federal Deposit Ins. Co.*, 486 F.2d 139, 169 (3d Cir. 1973), *cert. denied*, 416 U.S. 960 (1974). At common law, the tort of deceit requires misrepresentation, reliance, scienter, deception, and injury. W. Prosser, *Handbook of the Law of Torts* § 105, at 685-86 (4th ed. 1971); *Restatement (Second) of Torts* §§ 526-48 (1965).

38. 540 F.2d at 597; see W. Prosser, *supra* note 37, § 108; *Restatement (Second) of Torts* §§ 540, 541 (1965). When plaintiff is misled by a patent falsity, he would be denied a recovery under common law principles. See *Seeger v. Odell*, 18 Cal. 2d 409, 415, 115 P.2d 977, 981 (1941); *Bean v. Bickley*, 187 Iowa 689, 709, 174 N.W. 675, 683 (1919).

39. 540 F.2d at 598.

40. The court's due diligence standard conflicts with its seeming disregard of a plaintiff's negligence inasmuch as negligence is defined as the failure to exercise that degree of care that a reasonably careful person would exercise under like circumstances. *Restatement (Second) of Torts* § 282 (1965). The *Straub* court did not consider

ment on the policy ground of promoting investor diligence in the securities markets.<sup>41</sup>

The Tenth Circuit disparate result in *Holdsworth v. Strong*.<sup>42</sup> The decision initially noted that, before *Hochfelder*, a duty of due diligence had barred recovery only in those cases involving negligent misrepresentations.<sup>43</sup> The court reasoned that, "[i]f the negligence standard were being applied it might be appropriate to allow due diligence to be exacted from the victim, but where liability of the defendant requires proof of intentional misconduct, the exaction of a due diligence standard from the plaintiff becomes irrational and unrelated."<sup>44</sup> The court resolved this analytical obstacle by limiting the due diligence defense to instances in which the plaintiff has engaged in "gross conduct somewhat comparable to that of defendant,"<sup>45</sup> and by subsuming the notion of a standard of care in the claimant's requirement of justifiable reliance.<sup>46</sup>

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this issue. It did note, however, that in determining plaintiff's reasonableness, the court should consider plaintiff's sophistication, access to relevant information, and whether a fiduciary or other settled business relationship is shown to exist. 540 F.2d at 598. Sophistication itself, however, would not preclude recovery when a fiduciary relationship exists. *Id.*; cf. *Stier v. Smith*, 473 F.2d 1205, 1207 & n.4 (5th Cir. 1973) ("sophisticated investors, like all others, are entitled to the truth"); *Lehigh Valley Trust Co. v. Central Bank of Jacksonville*, 409 F.2d 989, 992 (5th Cir. 1969) ("[T]he protections and remedies of the Securities Act are not accorded only to those who fail a battery of information and intelligence tests, but are simply conditioned upon the misrepresentation of material facts.").

41. 540 F.2d at 597.

42. 545 F.2d 687 (10th Cir. 1976), *cert. denied*, 430 U.S. 955 (1977). The case arose when the Holdsworths sold their shares in a closely-held corporation to Strong, who held a majority of the corporation's stock. The sale was prompted by Strong's misrepresentation of the company's financial future and by his assertions that the company would be unable to pay dividends. *Id.* at 689. In response to plaintiff's 10b-5 claim, Strong contended that Mr. Holdsworth, a corporate "insider", an attorney, and an accountant, had a duty to ascertain the corporation's financial status prior to selling his stock. *Id.* at 692.

43. *Id.* at 692-93; see *Frigitemp Corp. v. Financial Dynamics Fund, Inc.*, 524 F.2d 275, 282 (2d Cir. 1975); *White v. Abrams*, 495 F.2d 724, 730 (9th Cir. 1974); *Arber v. Essex Wire Corp.*, 490 F.2d 414, 419-21 (6th Cir.), *cert. denied*, 419 U.S. 830 (1974); *Myzel v. Fields*, 386 F.2d 718, 734-35 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968).

44. 545 F.2d at 692. The court also noted that, when plaintiff must establish a defendant's scienter and defendant is permitted to raise a plaintiff's negligence as an absolute defense, "the [10b-5] action lies only in an extraordinary case." *Id.* at 693.

45. *Id.* at 693.

46. The court, following the common law principle that a plaintiff may not justifiably rely on a palpably false representation, ruled that the Holdsworths' reliance was justified because their relationship with the defendant was "quasi-fiduciary" in nature, giving them no reason to doubt his honesty. *Id.* at 696-97. Subsequent to the publication of its decision, the Tenth Circuit's reasoning in *Holdsworth* was endorsed

Yet another analytic thread is to be found in the Fifth Circuit's decision in *Dupuy v. Dupuy*.<sup>47</sup> Rejecting classification of due diligence in the context of materiality,<sup>48</sup> reliance,<sup>49</sup> or defendant's variable duty of disclosure,<sup>50</sup> the *Dupuy* court commenced its analysis by considering due diligence as a separate element of plaintiff's case.<sup>51</sup> The court then rejected the negligence standard as a bar to recovery based on the tort analogy, concluding that, subsequent to *Hochfelder*, there was less need for a limit on a defendant's liability.<sup>52</sup> In support of the tort analogy,<sup>53</sup> the court cited two principles. First, the "policy

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by the Seventh Circuit in *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1048 (7th Cir.), cert. denied, 434 U.S. 875 (1977). Other cases have also followed this reasoning. *E.g.*, *Alton Box Board Co. v. Goldman, Sachs & Co.*, 418 F. Supp. 1149, 1158 (E.D. Mo. 1976); *Carr v. New York Stock Exch., Inc.*, 414 F. Supp. 1292, 1301-02 (N.D. Cal. 1976).

47. 551 F.2d 1005 (5th Cir.), cert. denied, 434 U.S. 911 (1977). In *Dupuy*, two brothers, Clarence and Milton Dupuy, each held 47% of the stock in a closely-held corporation. Clarence had gradually restricted his ailing younger brother, Milton, to a position of ignorance and dependence. *Id.* at 1008-10. Milton averred that Clarence had induced him to sell his 47% share for \$10,000 when its real value was \$500,000. *Id.* at 1011. At trial, the jury found for the plaintiff. The trial judge, however, entered judgment *n.o.v.*, finding no basis for the jury's determination that the plaintiff had exercised due diligence. *Id.* at 1008.

48. *Id.* at 1014-16.

49. 551 F.2d at 1014-16; see note 20 *supra* and accompanying text.

50. 551 F.2d at 1014-16; see note 22 *supra* and accompanying text.

51. 551 F.2d at 1014.

52. *Id.* at 1017, 1020.

53. The tort analogy rests on two tenuous premises. The first premise is that *Hochfelder* allows for recovery exclusively in cases of intentional misconduct. The Court, however, expressly declined to consider whether recklessness would suffice for the imposition of liability. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 & n.12 (1976). The second premise is the purportedly determinative character of the tort analogy itself. *E.g.*, *Dupuy v. Dupuy*, 551 F.2d 1005, 1018 (5th Cir.), cert. denied, 434 U.S. 911 (1977); *Holdsworth v. Strong*, 545 F.2d 687, 693-95 (10th Cir. 1976), cert. denied, 430 U.S. 955 (1977); *Straub v. Vaisman & Co.*, 540 F.2d 591, 597 (3d Cir. 1976); see *Wheeler*, *supra* note 4, at 575; *Still a Limitation*, *supra* note 13, at 134-35. Tort analogies, although instructive in fashioning the contours of 10b-5 liability are not determinative. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 744-45 (1975) ("[T]he typical fact situation in which the classic tort of misrepresentation and deceit evolved was light years away from the world of commercial transactions to which Rule 10b-5 is applicable."). Notwithstanding, were these premises to be accepted *arguendo*, it would not be improper to support the imposition of some due care burden. Dean Prosser reached a similar conclusion when he provided in several tentative drafts of the Second Restatement of Torts that, even in cases of intentional misrepresentation, a claimant could be barred from recovery when he is "on notice" of the falsity of a misrepresentation and blindly disregards such notice. Restatement (Second) of Torts § 540 (Tent. Draft No. 11, 1965); *id.* (Tent. Draft No. 10, 1964); 42 ALI Proceedings 327, 329 (1965); 41 ALI Proceedings 509 (1964); *Causation supra* note 13, at 1226-30. Although Dean Prosser's proposal was ultimately rejected by the American Law Institute after considerable debate, see 42 ALI Proceedings 331 (1965), a due care requirement has been effectively included in the Second Restatement's requirement that a claimant's reliance on a fraudulent misrep-

of deterring intentional misconduct outweighs that of deterring negligent behavior."<sup>54</sup> Second, comparative culpability influences the determination of who should bear the loss occasioned by a fraud and, thus, dictates a shift of the loss from the victim.<sup>55</sup> The court buttressed these considerations with a reading of the Securities Acts that favored the deterrence of fraudulent conduct over the promotion of investor diligence.<sup>56</sup> Accordingly, the court held that a plaintiff may not recover only when he fails to exercise care "in disregard of a risk known to him or so obvious that he must be taken to have been aware of it, and so great as to make it highly probable that harm would follow."<sup>57</sup> Ultimately, the standard established by *Dupuy* is one of recklessness.<sup>58</sup>

Until recently, the Second Circuit was the only court to retain a duty of due diligence premised on plaintiff's negligence. The leading case, *Hirsch v. du Pont*,<sup>59</sup> stated in dicta that a sophisticated plaintiff would be estopped from asserting a 10b-5 claim when he failed to ascertain available material facts.<sup>60</sup> A recent decision, however, *Mal-*

resentation be "justifiable" as a prerequisite to recovery. Restatement (Second) of Torts § 537 (1965). Thus, "[t]he recipient of a fraudulent misrepresentation is not justified in relying upon its truth if he knows that it is false or its falsity is obvious to him." *Id.* § 541. These comments, however, need not suggest the incorporation of a due diligence element into the requirement of plaintiff's reliance in private 10b-5 actions. Such an approach, as *Dupuy* correctly maintains, is problematic in application. *Dupuy v. Dupuy*, 551 F.2d 1005, 1014-16 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977). The foregoing commends the consideration of some due diligence requirement as an element in determining the relative culpability of the parties for the litigated transaction without "slavish judicial adherence to verbal formulations and scant attention to [the] underlying reality." *Causation, supra* note 13, at 1252.

54. 551 F.2d at 1018.

55. *Id.*

56. *Id.*; see *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195, 206 (1976); note 29 *supra* and accompanying text.

57. 551 F.2d at 1020.

58. *Id.*; accord, *Paul F. Newton & Co. v. Texas Commerce Bank*, 630 F.2d 1111, 1121-22 (5th Cir. 1980); *Meyers v. Moody*, 475 F. Supp. 232, 246-47 (N.D. Tex. 1979). See also *Croy v. Campbell*, 624 F.2d 709, 716 (5th Cir. 1980) (*Dupuy* cited with approval). In *Altschuler v. Cohen*, 471 F. Supp. 1372 (S.D. Tex. 1979), however, the court held a sophisticated investor to what appears to be a negligence standard when he failed to uncover a highly complex fraudulent commission scheme. *Id.* at 1376-77, 1384.

59. 553 F.2d 750 (2d Cir. 1977). *Hirsch* concerned a 10b-5 action brought by *Hirsch & Co.* against *F.I. du Pont* for misrepresentations about *du Pont's* financial well-being made during a merger. *Id.* at 754.

60. *Id.* at 762. The court did not expressly reach the issue of investor diligence because it considered the undisclosed information immaterial to the litigation. *Id.* The court stated that "[t]he securities laws were not enacted to protect sophisticated businessmen from their own errors of judgment." *Id.* at 763. Because the *Hirsch* court did not analyze *Hochfelder* and mentioned due diligence in dicta, the case's precedential value is questionable. A subsequent case, however, *Edwards & Hanly v. Wells Fargo Sec. Clearance Corp.*, 458 F. Supp. 1110, 1123 (S.D.N.Y. 1978),

*lis v. Bankers Trust Co.*,<sup>61</sup> has seemingly aligned the Second Circuit with the Fifth by concluding that a claimant's burden in a section 10(b) action should be "simply to negate recklessness when the defendant puts that in issue, not to establish [his own] due care."<sup>62</sup> The court, however, declined to overrule *Hirsch*. Although maintaining that the case should be limited to its facts, Judge Friendly stated that he had "no quarrel whatever" with its result.<sup>63</sup>

The wide divergence of the post-*Hochfelder* standards<sup>64</sup> underscores the insufficiency of any attempt to establish an arbitrary demarcation of prohibited behavior that results in dismissal of a plaintiff's claim. Regardless of which standard is applied, the use of

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*rev'd on other grounds*, 602 F.2d 478 (2d Cir. 1979), *cert. denied*, 444 U.S. 1045 (1980), cited *Hirsh* with approval. See also *Greene v. Emersons, Ltd.*, [1979-80 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,266, at 96,868 (S.D.N.Y. 1980) (*Edwards & Hanly* cited with approval); *Bradford Sec. Processing Servs., Inc. v. County Fed. Sav. & Loan*, 474 F. Supp. 957, 965 (S.D.N.Y. 1979) (plaintiff's "negligence" sufficient to bar recovery because he is in the "best position to know what was happening"); *Rice v. Baron*, [1979-80 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,200, at 96,583 (S.D.N.Y. 1979) (plaintiff was negligent because he ignored financial statements that gave him notice of a possible fraud).

61. 615 F.2d 68 (2d Cir. 1980). *Mallis* involved a complex securities transaction in which the plaintiff purchased shares in Equity National Industries, Inc. and subsequently learned that they contained transfer restrictions that rendered them valueless. *Id.* at 71-74.

62. *Id.* at 79 (footnote omitted). Although the court's language appears to indicate that the plaintiff's failure to exercise due care is an affirmative defense to be raised and proved by the defendant, the court adopted *Dupuy's* approach, concluding that the plaintiff must negate his own recklessness as an element of the cause of action. *Id.* at 79 n.10.

63. *Id.* at 79. The court characterized the plaintiff's conduct in *Hirsch* as going "far beyond negligence." *Id.* It acknowledged in a footnote, however, that the "facts in *Edwards & Hanly* would have led to dismissal under the *Dupuy* standard." *Id.* at 79 n.9. *Mallis'* reasoning has been endorsed in *Greenfield v. Flying Diamond Oil Corp.*, [1979-80 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,298, at 97,043 (S.D.N.Y. 1980). *But see Verace v. New York Stock Exch., Inc.*, [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,575, at 98,043 (S.D.N.Y. 1980) (*Edwards & Hanly*, not *Mallis*, cited with respect to plaintiff's diligence).

64. The divergent formulations of due diligence present formidable analytical difficulties. See *Dupuy v. Dupuy*, 551 F.2d 1005, 1014-18 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977). For instance, the Fifth Circuit noted that a variable duty standard, which varies the defendant's duty to disclose in relation to the status of the plaintiff, may lead to "gamesmanship" by defendants as they adjust their degree of disclosure to the status of the victim. *Id.* at 1015; *Wheeler*, *supra* note 4, at 591. Similarly, the *Dupuy* court assailed the "materiality-reliance approach" of the First and Tenth Circuits as presenting a problem of "consistency of application." 551 F.2d at 1015. Because the Supreme Court held that proof of reliance in 10b-5 actions is unnecessary in cases involving omissions, *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972), an approach that subsumes the due diligence element into the plaintiff's reliance requirement would "remove from plaintiffs the responsibility of exercising due care to protect their interests in omission cases." 551 F.2d at 1015-16.

due diligence as a liability-denying rule is at cross purposes with the policies that the requirement is intended to promote.

## II. A PROPOSED DUE DILIGENCE REQUIREMENT

### A. *Due Diligence as a Liability-Reducing Rule*

The notion of a due diligence requirement is a sensible one. It promotes stability in the securities markets through reasoned investment-making<sup>65</sup> and reflects the equitable notion that only those who have pursued their own interests with care and good faith should qualify for the judicially created 10b-5 remedy.<sup>66</sup> Due diligence need not, however, be formulated in a manner that denies all liability for a defendant's intentional misconduct when the plaintiff recklessly or intentionally misbehaves. Such a formulation fails to recognize the lack of moral parity between litigants with respect to securities fraud.<sup>67</sup> The conduct of a defrauding defendant is "egoistical" and "antisocial" in character;<sup>68</sup> his conduct is directed at the infliction of injury on ascertainable victims in the marketplace.<sup>69</sup> In contrast, a claimant's behavior is conduct that "runs an unjustified risk to the actor himself, rather than to others."<sup>70</sup> Accordingly, it is specious to weigh the claimant's fault with that of the defendant without regard for the

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65. See *Dupuy v. Dupuy*, 551 F.2d 1005, 1014 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977); *Wheeler*, *supra* note 4, at 564-65; *Due Diligence*, *supra* note 13, at 760-61.

66. See *Dupuy v. Dupuy*, 551 F.2d 1005, 1014 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977); *Clement A. Evans & Co. v. McAlpine*, 434 F.2d 100, 104 (5th Cir. 1970), *cert. denied*, 402 U.S. 988 (1971); *City Nat'l. Bank v. Vanderboom*, 422 F.2d 221, 230 n.10 (8th Cir.), *cert. denied*, 399 U.S. 905 (1970); *Wheeler*, *supra* note 4, at 568-72.

67. See, e.g., *Mallis v. Bankers Trust Co.*, 615 F.2d 68, 78-79 (2d Cir. 1980); *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1048 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977); *Holdsworth v. Strong*, 545 F.2d 687, 692-95 (10th Cir. 1976), *cert. denied*, 430 U.S. 955 (1977).

68. Schwartz, *Contributory and Comparative Negligence: A Reappraisal*, 87 Yale L.J. 697, 722 (1978).

69. This is the basis of intentionally tortious conduct. See W. Prosser, *supra* note 37, § 8, at 31-34 ("intent to bring about a result which will invade the interests of another in a way that the law will not sanction.").

70. Schwartz, *supra* note 68, at 722. In support of the abrogation of contributory negligence-like formulations such as the due diligence rule, Professor Schwartz has argued that the "foolish" or "stupid" behavior of plaintiffs should not preclude a negligence judgment against an antisocial defendant. *Id.* at 722-26. This rationale is all the more applicable to cases involving intentional wrongdoing such as 10b-5 violations. Additionally, certain non-diligent investor behavior may be beneficial to the market. For example, Professor Posner regards the behavior of speculators as beneficial because it "serves the salutary purpose of enabling rapid adjustments of prices to current values." R. Posner, *Economic Analysis of Law* 333-34 (2d ed. 1977). The information that speculators uncover diffuses rapidly throughout the market enabling other traders to adjust as rapidly as possible to the changed conditions unearthed by



qualitative differences involved. Moreover, a liability-denying rule is equally suspect from the perspective of securities policy. Rule 10b-5, by compensating defrauded claimants, creates a deterrent effect<sup>71</sup> by making violations unprofitable for defendants.<sup>72</sup> The imposition of a liability-denying rule "undercuts this deterrent effect because fewer violators are forced to return their fraudulent gains."<sup>73</sup>

The present rule unnecessarily phrases liability in antipodal terms: a claimant is either victorious or vanquished; a defendant is either absolved or condemned.<sup>74</sup> The notion of due diligence would be neither "impaired [n]or compromised were it deployed in support of a liability-reducing rule rather than a liability-denying rule."<sup>75</sup> Such a result would be consistent with jurisprudential principles and common sense.<sup>76</sup> As one commentator has observed, when possible "the

the speculator. *Id.* Professor Posner maintains that "society buys this important social service at a low price." *Id.* at 334 n.4. *See also* H. Manne, *Economic Policy and the Regulation of Corporate Securities*, 202-04 (1969); H. Manne, *Insider Trading and the Stock Market*, 107, 108 (1966). John Maynard Keynes observed whimsically that "[t]he game of professional investment is intolerably boring and overexacting to anyone who is entirely exempt from the gambling instinct." J. M. Keynes, *The General Theory of Employment, Interest and Money* 157 (1949).

71. *See* *Globus v. Law Research Serv., Inc.*, 418 F.2d 1276, 1288 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970). Deterrence, not punishment, is the basis of the rule. The Securities Exchange Act of 1934 specifically precludes an award of punitive damages. Securities Exchange Act of 1934, § 28, 15 U.S.C. § 78 bb (1976) (limitation on amount recoverable to actual damages sustained). Courts also have refrained from awarding punitive damages. *See* *deHaas v. Empire Petroleum Co.*, 435 F.2d 1223, 1230 (10th Cir. 1970); *Green v. Wolf Corp.*, 406 F.2d 291, 302 (2d Cir. 1968), *cert. denied*, 395 U.S. 977 (1969). The reticence of courts with respect to the award of punitive damages may be rooted in the notion that, in certain instances, "relatively minimal involvement might nevertheless lead to tremendous damage exposure." Wheeler, *supra* note 4, at 585. One commentator has suggested that there is no intrinsic connection between the private enforcement action and the deterrence of fraudulent conduct because other specific SEC provisions were legislatively enacted to deter fraudulent conduct. Wheeler, *supra* note 4, at 585-86. Sections 21 and 32 of the 1934 Act provide for injunctions and criminal penalties to combat violations of the Act. *See* Securities Exchange Act of 1934, §§ 21, 32, 15 U.S.C. §§ 78(u), 78(ff) (1976). It would be unwise, however, to assume that the prospect of exacting a large damage recovery in a private action with the zeal characteristic of an aggrieved plaintiff is not, in practice, a substantial deterrent.

72. *Abrogation of Due Care*, *supra* note 13, at 421-22.

73. *Id.* at 432. "A due care requirement [that bars a recovery by plaintiff] might even encourage intentional wrongdoing since potential defrauders may find it profitable to perpetrate securities fraud, realizing that mere negligence on the part of the plaintiff will allow them to retain the fruits of the fraudulent transaction." *Id.*

74. In so doing, the rule risks compounding the unfairness by permitting the "break point" of recovery to turn on the questionable judgment of a lay jury. Schwartz, *supra* note 68, at 727; *see* W. Prosser, *supra* note 37, § 67, at 438; A. Strick, *Injustice for All* 97 (1977).

75. Schwartz, *supra* note 68, at 725.

76. *See id.* at 725-26.

law's preferred course is to seek an accommodating rule or result that is able to reduce, or if possible to resolve, the original tension" between the underlying policy and its expression.<sup>77</sup> A preferable due diligence formulation is one that distributes liability in proportion to the responsibility of each actor for the tortious injury.<sup>78</sup> The basis for such a formulation may be drawn from the emerging doctrine of comparative fault in tort.

### B. *Due Diligence and Comparative Fault*

The rule of negligence traditionally allocates the entire burden of loss to one party when both parties usually are culpable to some degree.<sup>79</sup> Similarly, contributory negligence operates to bar an injured party's recovery without inquiry into the extent of each party's deviation from a societal norm.<sup>80</sup> Although the common law sought to ameliorate the harsh effect of contributory negligence through the formulation of such judge-made exceptions as the "emergency doctrine"<sup>81</sup> or the "last clear chance doctrine,"<sup>82</sup> these exceptions also were premised on an "all or nothing" approach that granted or denied recovery without regard for the relative fault of the parties.<sup>83</sup>

77. *Id.* at 726. Reluctance to restructure the present due diligence formulation may stem from an inability to distinguish the "rule" of due diligence from the "principle" it represents: the deterrence of negligent investor behavior and equitable limitation on defendant's liability. Rules merely embody principles. They are not principles and they may be reformulated so as to promote desirable behavior. See R. Dworkin, *Taking Rights Seriously* 24-29 (1977) (distinguishing legal "rules" from legal "principles"); H. Hart, *The Concept of Law* 129-30 (1961) (same).

78. See generally W. Hirsch, *Law and Economics* 144 (1979); Schwartz, *supra* note 68, at 727.

79. See W. Prosser, *supra* note 37, § 67, at 433.

80. *Id.* Contributory negligence, as traditionally formulated, bars the plaintiff entirely from recovery even though his fault may be slight in comparison to that of the defendant. See H. Woods, *Comparative Fault* § 1:3, at 7 (1978). This fundamental unfairness is compounded by the plaintiff's relative inability to shoulder the financial burden of the loss. *Hoffman v. Jones*, 280 So. 2d 431, 437 (Fla. 1973); W. Prosser, *supra* note 37, § 67, at 433.

81. The emergency doctrine effectively excuses the contributory negligence of an actor when he is suddenly and unexpectedly deprived of a reasonable opportunity for deliberation and considered decision. Prosser, *supra* note 37, § 33, at 168-70 & n.11. An actor is not excused, however, when the emergency is attributable to his own negligence, *id.* at 170 n.12, or when the emergency should have been anticipated by the actor. *Id.* at 170 nn.16-17.

82. The doctrine of the last clear chance holds that if the defendant has the last opportunity to avoid the harm complained of, the plaintiff's negligence is not a proximate cause of the result and may be disregarded. W. Prosser, *supra* note 37, § 66, at 427. See generally James, *Last Clear Chance: A Transitional Doctrine*, 47 *Yale L.J.* 704 (1938); MacIntyre, *The Rationale of Last Clear Chance*, 53 *Harv. L. Rev.* 1225 (1940).

83. See H. Woods, *Comparative Fault* § 1:8, at 15 (1978); Prosser, *Comparative Negligence*, 51 *Mich. L. Rev.* 465, 474 (1953) ("[T]he real objection to the last clear chance is that it seeks to alleviate the hardships of contributory negligence by shift-

From its origins in civil law jurisdictions and admiralty tribunals, the doctrine of comparative fault<sup>84</sup> arose in reply to the perceived harshness of the contributory negligence formulation.<sup>85</sup> In its simplest form, comparative fault allocates a percentage of fault for tortiously caused injuries to each party and assesses damages in accord with these percentages.<sup>86</sup> Thus, the liability of each actor more accurately reflects his responsibility for the result.

At present, three distinct forms of comparative fault exist.<sup>87</sup> "Pure" comparative fault represents the maximum relaxation of the common law doctrine of contributory negligence.<sup>88</sup> Under a "pure" rule, a claimant may recover from a wrongdoer, regardless of the extent of the claimant's own fault, if the other party's conduct was a cause of the claimant's injury.<sup>89</sup> An alternative formulation, "modified" com-

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ing the entire loss due to the fault of both parties from the plaintiff to the defendant. It is still no more reasonable to charge the defendant with the plaintiff's share of the consequences of his fault than to charge the plaintiff with the defendant's . . .").

84. "'Comparative [fault]' properly refers only to a comparison of the fault of the plaintiff with that of the defendant. It does not necessarily result in any division of damages, but may permit full recovery by the plaintiff notwithstanding his contributory negligence." Prosser, *Comparative Negligence*, 51 Mich. L. Rev. 465, 465 n.2 (1953).

85. See Henry, *Why Not Comparative Negligence in Washington?*, in *Comparative Negligence* 8 (W. Schwartz ed. 1970). "It early developed that hard-headed ship owners recognized the harshness of the rule of contributory negligence. A ship owner whose vessel was sunk, suffering a loss of vessel and cargo of a thousand pounds, in a collision with another vessel whose damage was slight, could not bear to stand the entire loss where both vessels were negligent." *Id.* at 10. See generally W. Prosser, *supra* note 37, § 67, at 433-39; H. Woods, *Comparative Fault* §§ 4:1-4:6 (1978).

86. See Committee on Continuing Legal Education, Chicago Bar Association, *Comparative Negligence* 3-21 (1968); Defense Research Institute, Inc., *Comparative Negligence Primer* 7-10 (1975) [hereinafter cited as *Defense Research*]; W. Prosser, *supra* note 37, § 67 at 434-39; V. Schwartz, *Comparative Negligence* § 3.2, at 46 (1974); H. Woods, *Comparative Fault* § 1.1-11 (1978).

87. *Defense Research*, *supra* note 86, at 9.

88. *Id.*

89. See H. Woods, *Comparative Fault* § 4.1, at 77 (1978). "In other words, a plaintiff damaged in the sum of \$100,000 who is 99% negligent may theoretically recover one thousand dollars on his claim." *Id.* Because of the adoption of the "pure" form of comparative fault in New York, California, and Florida, three of the nation's most populous states, "pure" comparative fault now affects more litigants than any other system. *Id.*; see *Li v. Yellow Cab Co.*, 13 Cal. 3d 804, 810, 119 Cal. Rptr. 858, 862, 532 P.2d 1226, 1230 (1975); *Hoffman v. Jones*, 280 So. 2d 431, 438 (Fla. 1973); N.Y. Civ. Prac. Law § 1411 (McKinney 1976). Other states following the "pure" rule are Alaska, *Kaatz v. Alaska*, 540 P.2d 1037, 1049 (1975); Mississippi, Miss. Code Ann. § 11-7-15 (1972), Rhode Island, R. I. Gen. Laws § 9-20-4 (Supp. 1980), and Washington, Wash. Rev. Code Ann. § 4.22.010 (Supp. 1980). On the federal level, the Federal Employers Liability Act, 45 U.S.C. §§ 51-60 (1976), and the Federal Uniform Comparative Fault Act (1977) both provide for a "pure" form of comparative fault.

parative fault, denotes two distinct systems, each distinguished by the point at which the claimant will be barred from recovery.<sup>90</sup> The "not greater than" or "fifty percent" system allows for the recovery of reduced damages when the fault attributable to the claimant does not exceed fifty percent of the total fault.<sup>91</sup> The "not as great as" system bars a claimant from all recovery when the percentage of fault attributable to his conduct is equal to fifty percent of the total fault.<sup>92</sup> A final formulation of comparative fault, the "slight versus gross" system, exists in a few jurisdictions. This system permits the recovery of damages only when the claimant's fault is determined to be "slight" in comparison with the "gross" culpability of the defendant.<sup>93</sup>

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90. Defense Research, *supra* note 86, at 9; H. Woods, Comparative Fault § 4.3, at 82 (1978).

91. See Defense Research, *supra* note 86, at 9; H. Woods, Comparative Fault § 4.3, at 82 (1978). This system has been adopted by the following jurisdictions: Arkansas, Ark. Stat. Ann. § 27.1765 (1979); Colorado, Colo. Rev. Stat. § 13-21-111 (1973); Idaho, Idaho Code § 6-801 (1979); Kansas, Kan. Stat. Ann. § 60-258(a) (1979); Minnesota, Minn. Stat. Ann. § 604.01 (West Supp. 1980); North Dakota, N.D. Cent. Code § 9-10-07 (1975); Oklahoma, Okla. Stat. Ann. tit. 23, § 13 (West Supp. 1980-1981); Utah, Utah Code Ann. § 78-27-37 (1977); Wyoming, Wyo. Stat. § 1-1-109 (1977).

92. See Defense Research, *supra* note 86, at 10 (1975); H. Woods, Comparative Fault § 4.4, at 84-85 (1978). The following jurisdictions have adopted this approach: Connecticut, Conn. Gen. Stat. Ann. § 52-572h (West Supp. 1980); Hawaii, Hawaii Rev. Stat. § 663-31 (Supp. 1976); Massachusetts, Mass. Gen. Laws Ann. ch. 231 § 85 (West 1974); Montana, Mont. Rev. Codes Ann. § 58-607.1 (Supp. 1977); Nevada, Nev. Rev. Stat. § 41.141 (1979); New Hampshire, N.H. Rev. Stat. Ann. § 507.7a (Supp. 1973); New Jersey, N.J. Stat. Ann. § 2a 15-61 (West Supp. 1973); Texas, Tex. Rev. Civ. Stat. Ann. art. 2212a (Vernon Supp. 1980-1981); Vermont, Vt. Stat. Ann. tit. 12 § 1036 (1970). The difference between the two systems may be illustrated by the following example. Plaintiff's damages arising from an automobile collision with a negligent driver are assessed at \$10,000. Under the "not as great as" system, plaintiff may exact a recovery diminished by his proportion of fault provided that damages attributable to his fault do not exceed \$4,999, 49% of the total damages assessed. Under the "not greater than" system, plaintiff may exact a recovery diminished by his proportion of fault provided that damages attributable to his fault do not exceed \$5,000, 50% of total damages assessed. When damages attributed to plaintiff's fault exceed \$5,000 (or in excess of 50% of total damages assessed), plaintiff would be barred from recovering under either system. The rationale underlying both systems has been criticized as shifting "the lottery aspect of the contributory negligence rule to a different ground." *Li. v. Yellow Cab Co.*, 13 Cal. 3d 804, 827, 532 P.2d 1226, 1242, 119 Cal. Rptr. 858, 874-75 (1975) (footnote omitted).

93. See Defense Research, *supra* note 86, at 10; H. Woods, Comparative Fault § 4.5, at 85 (1978). The following jurisdictions have adopted the "slight versus gross" system: Georgia, Ga. Code Ann. § 105-603 (1968); Nebraska, Neb. Rev. Stat. § 25-1151 (1979); South Dakota, S.D. Comp. Laws Ann. § 20-9-2 (1979); Tennessee, *Bejach v. Colby*, 141 Tenn. 686, 214 S.W. 869, 870 (1919); Louisville & N. R. Co. v. Cheatham, 118 Tenn. 160, 100 S.W. 902, 909 (1907).

Of these systems, "pure" comparative fault offers the only equitable model<sup>94</sup> because it is the only formulation that adequately reflects the basic premise of comparative fault: "the plaintiff should not be barred from recovery by his own negligence; rather, his negligence should serve only to reduce his recovery."<sup>95</sup> Alternative formulations are inconsistent with this idea because a plaintiff's negligence may, if sufficiently great, bar his recovery rather than reduce it.<sup>96</sup> One commentator has observed that

[t]he "pure" form of comparative negligence seems the superior rule of apportionment. It is difficult to justify discriminating between the case in which the plaintiff is a little more negligent than the defendant and the case in which the defendant is a little more negligent than the plaintiff. Apportionment seems a fairer solution in both cases than making one party bear all his own loss. Moreover, in one sense, the more limited form of comparative negligence would only aggravate this unfair discrimination if it really worked according to its theory, because the party a little more negligent would bear all his own loss plus a little more than half the loss flowing from the injury to the other.<sup>97</sup>

Similarly, Dean Prosser has rejected "modified" systems of comparative fault, characterizing them as "more or less obvious [political] compromises . . . remarkable neither for soundness in principle nor success in operation."<sup>98</sup>

Because a "pure" system of comparative fault permits plaintiffs to recover some damages despite bearing some responsibility for their injuries, its extension to 10b-5 cases would transform due diligence from a liability-denying rule to a liability-reducing rule. The introduction of comparative fault into the private 10b-5 action is problematic, however, because of the general resistance by courts to apply comparative fault principles to intentional torts.<sup>99</sup> This resistance may be

94. V. Schwartz, *Comparative Negligence* 349 (1974); Prosser, *Comparative Negligence*, 41 Cal. L. Rev. 1, 21-25 (1953).

95. Pearson, *Apportionment of Losses Under Comparative Fault Laws—An Analysis of the Alternatives*, 40 La. L. Rev. 343, 351 (1980); see Fleming, *Foreword: Comparative Negligence At Last—By Judicial Choice*, 64 Cal. L. Rev. 239, 249 (1976).

96. See Pearson, *supra* note 95, at 350-51. "[The adoption of pure comparative fault] is justified because the basic reason for the existence of the doctrine of comparative negligence is social justice and a modified form which denies such justice in some cases produces only modified justice." *Id.*; see *Lawler v. City of Park Falls*, 35 Wis.2d 308, 316, 151 N.W.2d 68, 72 (1967); *Bielski v. Schulze*, 16 Wis.2d 1, 10-11, 114 N.W.2d 105, 109-10 (1962).

97. Keeton, *Comment on Maki v. Frelk*, 21 Vand. L. Rev. 906, 911 (1968).

98. Prosser, *Comparative Negligence*, 51 Mich. L. Rev. 465, 484 (1953).

99. See V. Schwartz, *Comparative Negligence* § 5.2, at 101 (1974 & Supp. 1978); H. Woods, *Comparative Fault* § 7.1, at 159 (1978 & Supp. 1980); *Comment, Com-*

intensified by a rule that diminishes recoveries of negligent plaintiffs. Nevertheless, the rationale for the resistance is unjustified and should be rejected for several reasons. First, contrary to the basic premise of the tort analogy, a plaintiff's negligence and a defendant's intentional wrongdoing can be compared. The two concepts can be viewed as points on a continuum of fault instead of two distinct types of fault.<sup>100</sup> Second, recent developments in the law of contribution and post-*Hochfelder* reformulations of the due diligence standard provide a basis for incorporating comparative fault notions into securities fraud litigation.<sup>101</sup> Finally, application of comparative fault to 10b-5 cases is economically efficient and consistent with the purposes of the private action.<sup>102</sup>

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*parative Fault and Intentional Torts*, 12 Loyola of L. A. L. Rev. 179, 182-84 (1978) [hereinafter cited as *Intentional Torts*]. This unwillingness by the courts is attributed to the inapplicability of contributory negligence, a predecessor concept, to intentional torts, see W. Prosser, *supra* note 37, § 65, at 425-27, and the notion that plaintiff's negligence and defendant's intentional wrongdoing are different types of fault, as opposed to different points on a continuum of fault, and are, therefore, not comparable. W. Prosser, *supra* note 37, § 65, at 426.

100. See note 53 *supra*. Rule 10b-5, however, must be read flexibly to permit the fullest realization of its potential as an enforcement mechanism. Superintendent of Ins. v. Banker's Life & Cas. Co., 404 U.S. 6, 12 (1971). Consequently, the introduction of comparative fault should not be deferred because of the analogization of 10b-5 to the tort of deceit. The tort analogy is limited at best and certainly not determinative. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 731-32 (1975); see note 53 *supra*. The extension of comparative fault to cases alleging strict liability suggests that fault of different types may be compared. See, e.g., Stueve v. American Honda Motors Co., 457 F. Supp. 740, 752 (D. Kan. 1978); Murray v. Beloit Power Sys., Inc., 450 F. Supp. 1145, 1146 (D.V.I. 1978), *aff'd*, 610 F.2d 149 (3d Cir. 1979); Sturm, Ruger & Co. v. Day, 594 P.2d 38, 42 (Alaska 1979); Daly v. General Motors Co., 20 Cal. 3d 725, 734-37, 575 P.2d 1162, 1165-69, 144 Cal. Rptr. 380, 383-84 (1978); Ransome v. Wisconsin Elec. Power Co., 87 Wis. 2d 605, 619-20, 275 N.W.2d 641, 647-48 (1979). See also V. Schwartz, Comparative Negligence § 12.7 (1974); H. Woods, Comparative Fault § 14:49 (1978); *Intentional Torts*, *supra* note 99, at 185-86. See also Homburger, *The 1975 New York Judicial Conference Package: Class Actions and Comparative Negligence*, 25 Buffalo L. Rev. 415, 434 n.69 (1976) ("Under the sweeping language of New York's statute, apportionment of damages appears to be authorized even though defendant is charged with intentional wrongdoing in rare cases where the plaintiff's culpable conduct was a substantial factor in producing the harm."). This view has been hailed as "the wave of the future . . . permitting the decision of the jury to be rendered less on legal niceties and more on a comparison of the total conduct of the litigants." H. Woods, Comparative Fault § 4.6, at 90 (1978).

101. See notes 103-16 *infra* and accompanying text.

102. Deterrence of intentional wrongdoing is enhanced by the application of comparative fault. A defendant is deterred by the heightened availability of a judgment on the merits. Moreover, the reduction of damages possible under a comparative fault formulation equally deters fraudulent defendant conduct by promoting investor diligence and thus depriving defendant of a gullible victim. Furthermore, unlike certain kinds of intentional wrongdoing that cannot be avoided by a watchful plaintiff,

## 1. Contribution

In contrast to indemnification<sup>103</sup> among defendants in 10b-5 litigation, which has been rejected as contrary to public policy,<sup>104</sup> contribution<sup>105</sup> is a viable method of apportioning damages for securities violations among joint tortfeasors without "absolving one at the expense of the other."<sup>106</sup> For some time, pro-rata contribution<sup>107</sup> was regarded as the only acceptable method of contribution.<sup>108</sup> Recent decisions, however, have endorsed, if not effected, alternative means of contribution.<sup>109</sup> One decision, *McLean v. Alexander*,<sup>110</sup> recognized a continuum of "prohibited behavior between negligence and specific intent to defraud" in 10b-5 actions.<sup>111</sup> Thus, because there was a

most securities fraud can be avoided by the diligence of plaintiff. By failing to consider the fault of plaintiff in apportioning damages, the present rule deters fraudulent conduct by punishing the defendant and not by compensating the victim. Compensation, not punishment, is the goal of the private 10b-5 action. *See* 15 U.S.C. § 78b (1976) (actual damages recoverable).

103. Indemnification entails a shift of the loss arising from a tortious event from one tortfeasor who has been compelled to pay to another who, for equitable reasons, should bear it instead. *See* W. Prosser, *supra* note 37, § 51, at 310.

104. *See, e.g.*, *Premier Corp. v. Economic Research Analysts, Inc.*, 578 F.2d 551, 555 (4th Cir. 1978); *Globus v. Law Research Serv., Inc.*, 418 F.2d 1276, 1288 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970); *McLean v. Alexander*, 449 F. Supp. 1251, 1266-67 (D. Del. 1978), *rev'd on other grounds*, 599 F.2d 1190 (3d Cir. 1979); *Odette v. Shearson, Hammill & Co.*, 394 F. Supp. 946, 954-55 (S.D.N.Y. 1975).

105. Contribution entails the distribution of losses among tortfeasors by requiring each to pay his proportionate share for the loss caused. *See* Prosser, *supra* note 37, § 50, at 310.

106. *McLean v. Alexander*, 449 F. Supp. 1251, 1266-67 (D. Del. 1978), *rev'd on other grounds*, 599 F.2d 1190 (3d Cir. 1979). Contribution may be obtained from joint tortfeasors even if one of them is not a defendant. Jacobs, *10b-5 Developments — Who Can Sue and Who Is Liable*, in Tenth Annual Institute on Securities Regulation 477 (A. Fleischer, Jr., M. Lipton, and R. Stevenson, Jr., eds. 1978) [hereinafter cited as *10b-5 Developments*]. *See generally* *Index Fund, Inc. v. Hogo-pian*, 417 F. Supp. 738, 743-44 (S.D.N.Y. 1976); *B & B Investment Club, Inc. v. Kleinert's Inc.*, 391 F. Supp. 720, 724 (E.D. Pa. 1975); *Liggett & Myers, Inc. v. Bloomfield*, 380 F. Supp. 1044, 1046 (S.D.N.Y. 1974).

107. In pro-rata contribution, total liability is determined independently and then divided by the number of tortfeasors to determine each tortfeasor's contribution for the injury. *10b-5 Developments, supra* note 106, at 477-78.

108. *See, e.g.*, *McLean v. Alexander*, 449 F. Supp. 1251, 1272 (D. Del. 1978), *rev'd on other grounds*, 599 F.2d 1190 (3d Cir. 1979); *Herzfeld v. Laventhol, Krekstein, Horwath & Horwath*, 540 F.2d 27, 38-39 (2d Cir. 1976); *Wassel v. Eglowsky*, 399 F. Supp. 1330, 1370 (D. Md. 1975), *aff'd*, 542 F.2d 1235 (4th Cir. 1976).

109. *E.g.*, *Kohr v. Alleghany Airlines, Inc.*, 504 F.2d 400, 405 (7th Cir. 1974), *cert. denied*, 421 U.S. 978 (1975); *Gomes v. Brodhurst*, 394 F.2d 465, 468-70 (3d Cir. 1967); *Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544, 587 (E.D.N.Y. 1971); *deHaas v. Empire Petroleum Co.*, 286 F. Supp. 809, 815-16 (D. Colo. 1968), *aff'd in part and vacated in part*, 435 F.2d 1223 (10th Cir. 1970).

110. 449 F. Supp. 1251 (D. Del. 1978), *rev'd on other grounds*, 599 F.2d 1190 (3d Cir. 1979).

111. *Id.* at 1275.

"vast difference between defendants in the degrees of . . . wrongdoing,"<sup>112</sup> the court believed it more equitable to apportion liability according to the comparative fault of the defendants.<sup>113</sup> In adopting this method of contribution, the court was influenced by the weight of critical opinion favoring use of comparative fault as a flexible tool for the apportionment of damages<sup>114</sup> and by the Supreme Court's adoption of comparative fault in admiralty cases.<sup>115</sup> Ultimately, the court observed that "comparative fault more directly stimulates deterrence, is only minimally more difficult to administer and most importantly best serves justice."<sup>116</sup> There is no ground to restrict *McLean's* reasoning to the apportionment of damages solely among defendants. A comparable system could be applied to apportion culpability among litigants in a 10b-5 action.<sup>117</sup>

## 2. Due Diligence

Post-*Hochfelder* cases have also relied on comparative fault notions in reformulating the due diligence requirement. The *Straub* court implicitly confirmed this when it stated that, "against the background of common law negligence, where the doctrine of comparative negligence is in the ascendency, the policy of denying all recovery to a defrauded plaintiff who was only somewhat careless or understandably trusting may be questioned,"<sup>118</sup> and, accordingly, permitted a recovery despite the claimant's negligence.<sup>119</sup> Similarly, in denying the defendant's assertion of a due diligence defense, the *Dupuy*

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112. *Id.* at 1272.

113. *Id.* at 1274-77.

114. *Id.* at 1274 n.77. A. Bromberg & L. Lowenfels, *supra* note 2, § 8.5, at 208.52; Freund and Hacker, *Cutting Up the Humble Pie: A Practical Approach to Apportioning Litigation Risks Among Underwriters*, 48 St. John's L. Rev. 461, 472 (1974); Note, *Contribution Under the Federal Securities Laws*, 1975 Wash. U.L.Q. 1256, 1308. Contribution among violators of the securities laws based on comparative fault has been adopted by the proposed securities code. ALI Fed. Sec. Code § 1724(f)(2) (1978).

115. See *United States v. Reliable Transfer Co.*, 421 U.S. 397, 401-11 (1975).

116. *McLean v. Alexander*, 449 F. Supp. 1251, 1276 (D. Del. 1978) (footnote omitted), *rev'd on other grounds*, 599 F.2d 1190 (3d Cir. 1979). Two cases have expressed approval of the reasoning in *McLean*, but have declined to follow it. *Heizer Corp. v. Ross*, 601 F.2d 330, 333-34 (7th Cir. 1979); *Marrero v. Abraham*, 473 F. Supp. 1271, 1277-78 (W.D. La. 1979); see *10b-5 Developments*, *supra* note 106, at 478-79.

117. Cf. *Equilease Corp. v. Smith Int'l, Inc.*, 588 F.2d 919, 929 & n.12 (5th Cir. 1979) ("The notion of fault encompasses . . . both the intentional harming of another (*dolus*) and the negligent harming of another (*culpa*)."). See also *Tort Doctrine in Louisiana: The Concept of Fault*, 27 Tul. L. Rev. 1, 8-13 (1952).

118. *Straub v. Vaisman & Co.*, 540 F.2d 591, 597 (3d Cir. 1976).

119. *Id.* at 598.



court observed that "[i]t is in reality a rule of comparative fault which is being applied . . . and the court is refusing to set up the lesser fault [of plaintiff] against the greater [fault of defendant]." <sup>120</sup>

As in a comparative fault analysis, the courts evaluate the relative culpability of the parties and correctly disallow the negligence of the claimant to preclude a recovery. <sup>121</sup> Unlike a comparative fault analysis, however, this same rationale is then used to bestow an undiminished recovery on the foolhardy claimant. <sup>122</sup> The net result is a recovery similar to that under a "modified" comparative fault formulation. <sup>123</sup> Thus, a claimant's negligence will not operate to bar a recovery if it is slight when compared with reckless or intentionally fraudulent conduct. <sup>124</sup> Once a claimant acts "recklessly" <sup>125</sup> or in a manner "comparable to that of defendant," <sup>126</sup> however, his fault is impliedly adjudged to be equal to or greater than that of the defendant, and accordingly, he is barred. <sup>127</sup> Although this "modified" methodology bears all of the vices of a contributory negligence formulation, it is bereft of any of the virtues obtained under a system of "pure" comparative fault. <sup>128</sup>

### 3. Policy Considerations

As a judicially implied cause of action <sup>129</sup> delimited by judicially implied elements and defenses, rule 10b-5 represents a suitable vehicle for the introduction of comparative fault notions into the liability provisions of the securities laws. <sup>130</sup> Because the proposed liability-

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120. *Dupuy v. Dupuy*, 551 F.2d 1005, 1018 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977).

121. *See Dupuy v. Dupuy*, 551 F.2d 1005, 1020 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977); *Holdsworth v. Strong*, 545 F.2d 687, 694 (10th Cir. 1976), *cert. denied*, 430 U.S. 955 (1977); *Straub v. Vaisman & Co.*, 540 F.2d 591, 598 (3d Cir. 1976).

122. *See note 121 supra*.

123. *See notes 90-92 supra* and accompanying text.

124. *Dupuy v. Dupuy*, 551 F.2d 1005, 1020 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977); *Holdsworth v. Strong*, 545 F.2d 687, 694 (10th Cir. 1976), *cert. denied*, 430 U.S. 955 (1977); *Straub v. Vaisman & Co.*, 540 F.2d 591, 596 (3d Cir. 1976); *see Bauer, The Degree of Moral Fault as Affecting Defendant's Liability*, 81 U. Pa. L. Rev. 586, 592-96 (1933) ("Courts have no compassion for defrauders.").

125. *Dupuy v. Dupuy*, 551 F.2d 1005, 1020 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977).

126. *Holdsworth v. Strong*, 545 F.2d 687, 693 (10th Cir. 1976), *cert. denied*, 430 U.S. 955 (1977).

127. *Hirsch v. du Pont*, 553 F.2d 750, 762-63 (2d Cir. 1977); *Dupuy v. Dupuy*, 551 F.2d 1005, 1020 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977); *Holdsworth v. Strong*, 545 F.2d 687, 693 (10th Cir. 1976), *cert. denied*, 430 U.S. 955 (1977).

128. *See notes 94-97 supra* and accompanying text.

129. *See note 4 supra* and accompanying text.

130. 3 A. Bromberg & L. Lowenfels, *supra* note 2, § 8.5, at 204.213; *see Freund & Hacker, supra* note 114, at 472; Note, *Contribution Under the Federal Securities Laws*, 1975 Wash. U.L.Q. 1256, 1308. Because the private 10b-5 cause of action was

reduction rule apportions losses caused by a fraudulent transaction among all the responsible actors, it is inherently equitable.<sup>131</sup> It is also economically efficient and consistent with the underlying purposes of the private 10b-5 damage action.

The present due diligence formulation has been criticized as economically inefficient because it promotes involuntary wealth redistribution by denying a claimant the means of recapturing wealth involuntarily transmitted to a defendant through an "information failure."<sup>132</sup> The crux of this argument is that resources are diverted to wrongdoers through this redistribution.<sup>133</sup> Conversely, the receipt by a reckless claimant of an undiminished award of damages as a result of the abrogation of a due diligence defense is equally inefficient. By redistributing resources to "reckless" claimants, funds that might otherwise compensate the diligent victims whom the Securities Acts were intended to protect are diverted.<sup>134</sup> Alternatively, a comparative fault formulation would recapture resources for defrauded claimants in direct proportion to the assessed fault of the parties, thus permitting a redistribution of wealth commensurate with the value placed on the litigants' conduct by society.<sup>135</sup>

The due diligence requirement also has been criticized because it requires a claimant to expend resources to verify previously available information prior to making an investment.<sup>136</sup> Thus, it is argued that, "[b]ecause the cost of independent verification is greater than the cost of disseminating existing information, the aggregate cost of investor protection rises."<sup>137</sup> Abrogation of a due diligence requirement, however, would discount the value of a diligent claimant's information costs by awarding a "reckless" claimant who may have incurred insignificant or no investigation costs the same recovery received by a diligent claimant. This promotes foolish investment behavior by discouraging the assumption of investigation costs.<sup>138</sup> On the other

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implied by the judiciary, comparative fault may be incorporated into it without a legislative mandate. See notes 4-6 *supra* and accompanying text.

131. See notes 94-97 *supra* and accompanying text.

132. *Abrogation of Due Care*, *supra* note 13, at 430 & nn.158 & 159.

133. *Id.*

134. See *Dupuy v. Dupuy*, 551 F.2d 1005, 1014 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977); *Myzel v. Fields*, 386 F.2d 718, 736 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968).

135. A contrary approach would recompense conduct that runs counter to one of the aims of securities policy, the stabilization of the trading markets, by rewarding non-diligent investment behavior. See *Dupuy v. Dupuy*, 551 F.2d 1005, 1014 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977).

136. *Abrogation of Due Care*, *supra* note 13, at 430.

137. *Id.* at 430-31.

138. For example, A, a diligent plaintiff, spends \$100 on verification and alleges \$1000 in damages arising from a fraudulent transaction procured by D, the defendant. B, reckless plaintiff, expends no sums on verification in a suit against D

hand, a comparative fault formulation would consider a claimant's investigation costs as one element relating to his fault for the resulting injury. Damages would be reduced by the difference between what the claimant spent and what a reasonable claimant should have spent to avoid the injury.<sup>139</sup> Diligent plaintiffs would recover larger awards than foolish ones, thus providing an incentive to diligent behavior.

A reformulation of due diligence based on comparative fault would be consistent with judicial attitudes to the private damage action. By substituting a diminished recovery for the absolute bar presently in place, the reformulated rule would provide an incentive to private enforcement of 10b-5 violations.<sup>140</sup> Additionally, the implementation of a comparative fault approach may promote the deterrence of fraudulent behavior by increasing a court's willingness to impose liability. Justice Cardozo has noted that a court would hesitate to impose liability for deceitful conduct if the resulting hazards would be "so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes [legitimate business] to these consequences."<sup>141</sup> Courts apparently are willing to reinterpret stand-

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arising out of the same transaction. An abrogation of the due diligence requirement would result in A and B each recovering \$1000. In reality, however, A would recover only \$900 because of the expense incurred in verifying information. Accordingly, a reckless plaintiff would recover more than a diligent one.

139. Absent other variables, the recovery of B in note 138 *supra* would be reduced by \$100 as an index of his causative fault in the transaction. This recovery would then equal A's. This hypothetical assumes a direct relationship between investigation costs and diligence. A larger reduction in plaintiff's recoverable damages would follow when it was determined, for example, that plaintiff's unwillingness to spend \$100 in verification signalled a higher degree of fault.

140. The promotion of private enforcement of 10b-5 violations has long been considered a desirable goal because the SEC lacks the resources to police adequately all transactions within the ambit of rule 10b-5. *J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964). *See also* *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730 (1975); *Herpich v. Wallace*, 430 F.2d 792, 804 (5th Cir. 1970); *Wheeler*, *supra* note 4, at 586 n.79. Moreover, the increased availability of a judgment on the merits against defendants would allow for the offensive use of collateral estoppel by similarly situated claimants. The doctrine of collateral estoppel provides that, when an issue necessary to the outcome of a proceeding is litigated therein and is decided by a final judgment on the merits, the party against whom the issue was decided is estopped from relitigating the issue in a subsequent action. *Parklane Hosiery Co. v. Shore*, 439 U.S. 322, 324-33 (1979); 1B J. Moore, *Federal Practice* ¶ 0.405[4.-1], at 634-53 (2d ed. 1976); *see* *Lawlor v. National Screen Serv. Corp.*, 349 U.S. 322, 326 (1955); *Commissioner v. Sunnen*, 333 U.S. 591, 598-99 (1948). Conversely, the retention of a due diligence requirement, as presently formulated, requires diligent plaintiffs in subsequent suits to relitigate, at great expense and needless duplication, the issue of defendant's culpability not addressed in the first suit because of the interposition of a due diligence defense.

141. *Ultramares Corp. v. Touche*, 255 N.Y. 170, 179-80, 174 N.E. 441, 444 (1931); *see* *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 867 (2d Cir. 1968)

ards of culpability to avoid awarding claimants a recovery of devastating proportions to defendant.<sup>142</sup> When liability is diminished in proportion to fault, however, a court may more willingly impose liability for misconduct. Ultimately, the award of damages to a larger class of plaintiffs promotes one of the central aims of the Securities Acts, the deterrence of fraudulent behavior,<sup>143</sup> by making violations more "unprofitable" for defendants.<sup>144</sup>

On the other hand, the present due diligence formulation offers no comparable advantages. Its only attractive feature, economy of administration, may be offset by the salutary effects of the reformulated rule.<sup>145</sup> Sufficient guidelines for a jury, through the use of special verdicts and interrogatories,<sup>146</sup> will suffice to remedy most administrative difficulties.<sup>147</sup>

### CONCLUSION

Rules, whether promulgated by legislatures or established by courts, represent convenient mechanisms for effecting the principles

(Friendly, J. concurring), *cert. denied*, 394 U.S. 976 (1969).

142. See, e.g., *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 761 (1975) ("[A finding of liability] allowing this type of open-ended litigation would itself be an invitation to fraud."); *Fridrich v. Bradford*, 542 F.2d 307, 321 (6th Cir. 1976) ("[A finding of liability] would present a situation wholly lacking in the natural limitations on damages present in cases dealing with face-to-face transactions."), *cert. denied*, 429 U.S. 1053 (1977); *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 242 (2d Cir. 1974) ("[A]n analysis . . . of the nature and character of the Rule 10b-5 violations committed may require limiting the extent of liability imposed . . ."); *Kohn v. American Metal Climax, Inc.*, 458 F.2d 255, 286 (3d Cir.) ("[I]n a suit on behalf of a class composed of thousands of shareholders, damages might well extend into millions of dollars. When faced with such huge potential payments [a lesser degree of disclosure is imposed]."), *cert. denied*, 409 U.S. 874 (1972). The notion is analyzed in Mullaney, *Theories of Measuring Damages in Security Cases and the Effect of Damages on Liability*, 46 *Fordham L. Rev.* 277, 290-94 (1977).

143. See *Dupuy v. Dupuy*, 551 F.2d 1005, 1014-15 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977); *Lanza v. Drexel & Co.*, 479 F.2d 1277, 1290 n.34 (2d Cir. 1973).

144. See *Abrogation of Due Care*, *supra* note 13, at 431-32.

145. See pt. II *supra*; notes 132-45 *supra* and accompanying text.

146. See generally H. Woods, *Comparative Fault* (1978). A special verdict may be defined as "[a] special finding of facts of a case by a jury, leaving to the court the application of the law to the facts thus found." *Black's Law Dictionary* 1731 (Rev. 4th ed. 1968). Special interrogatories are asked "in addition to the instruction to return a general verdict, and as a check on the jury's conclusions." Prosser, *Comparative Negligence*, 51 *Mich. L. Rev.* 465, 497 n.193 (1953).

147. The *McLean* court suggested several factors for consideration when administering the apportionment of damages among defendants. They include "the defendant's extent of involvement, duration of involvement, knowledge of entire scheme to defraud, intent, extent of his contribution toward causation of the losses and benefit received." *McLean v. Alexander*, 449 F. Supp. 1251, 1276 n.84 (D. Del. 1978), *rev'd on other grounds*, 599 F.2d 1190 (3d Cir. 1979) (citation omitted). Similar factors could be used to apportion damages among plaintiffs and defendants.

that underlie them. When a rule may be reformulated to reflect more accurately its underlying principles, the reformulation should not be summarily dismissed merely because it departs radically from existing precedent. A reformulation of the due diligence requirement in privately prosecuted actions under rule 10b-5 based on comparative fault equitably apportions liability among litigants in an economically efficient manner and is consistent with the purposes of the Securities Acts. Moreover, the rationales for incorporating comparative fault into the due diligence requirement need not be restricted to this area alone. Other defenses to violations of the Securities Acts may benefit from a similar reformulation. When fault is the basis of liability, a modern approach to securities regulation commends the consideration of comparative fault.

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