UNITED STATES COURT OF APPEALS
FOR THE TENTH CIRCUIT

No. 75-1144

K. JAY HOLDSWORTH and
DONA S. HOLDSWORTH,

Plaintiffs-Appellees,

v.

KLINE D. STRONG,

Defendant-Appellant.

BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, *AMICUS CURIAE*, ON REHEARING EN BANC

HARVEY L. PITT
General Counsel

PAUL GONSON
Associate General Counsel

DAVID J. ROMANSKI
Assistant General Counsel

VERNON I. ZVOLEFF
Attorney

Securities and Exchange Commission
500 North Capitol Street
Washington, D.C. 20549
(202) 755-1387

INDEX

	Page
CITATIONS	i
PRELIMINARY STATEMENT AND QUESTION ADDRESSED	1
INTEREST OF THE SECURITIES AND EXCHANGE COMMISSION	3
DISCUSSION	6
Sound Policy and the Effectuation of the Purposes Underlying the Establishment of Implied Private Actions Under Securities Exchange Act Rule 10b-5 Make it Appropriate to Hold Intentional Fraudulent Conduct Actionable Under the Federal Securities Laws, Even If the Victims of that Fraud May Have Been Negligent in Failing Timely to Discover the Fraud	6
CONCLUSION	29
APPENDIX	A-1
STATEMENT OF THE CASE	A-1
The Plaintiffs' Allegations	A-1
The Decision of the District Court	A-5
The Panel Decision of the Court of Appeals	A-8

CITATIONS

Cases:

Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972)	6, 17
Andrus v. Saint Louis Smelting & Refining Co., 130 U.S. 643 (1889)	9
A. T. Brod & Co. v. Perlow, 375 F.2d 393 (C.A. 2, 1967)	3
Bird v. Ferry, 497 F.2d 112 (C.A. 5, 1974)	27

Page

Cases: (continued)

Birnbaum v. Newport Steel Corp., 193 F.2d 461 (C.A. 2), certiorari denied, 343 U.S. 956 (1952) 7, 8

Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975) .... 3, 4, 6, passim

Cleaveland v. Richardson, 132 U.S. 318 (1889) 9

Clegg v. Conk, 507 F.2d 1351 (C.A. 10, 1974), certiorari denied, 422 U.S. 1007 (1975) 11, 15

Clement A. Evans & Co. v. McAlpine, 434 F.2d 100 (C.A. 5, 1970), certiorari denied, 402 U.S. 988 (1971) 25, 26, 27

Equitable Life Ins. Co. of Iowa v. Halsey, Stuart & Co., 312 U.S. 410 (1941) 11

Ernst & Ernst v. Hochfelder, 96 S. Ct. 1375 (1976) .... 3, 4, 5, passim

Farrar v. Churchill, 135 U.S. 609 (1890) 9

Financial Industries Fund, Inc. v. McDonnel Douglas Corp., 474 F.2d 514 (C.A. 10, 1973), certiorari denied, 414 U.S. 874 (1974) 25

Fratt v. Robinson, 203 F.2d 627 (C.A. 9, 1953) 8

Gilbert v. Nixon, 429 F.2d 348 (C.A. 10, 1970) 14, 24, 26

Globus v. Law Research Service, Inc., 418 F.2d 1276 (C.A. 2, 1969), certiorari denied, 397 U.S. 913 (1970) 4

Harnett v. Ryan Homes, Inc., 496 F.2d 832 (C.A. 3, 1974) 25

Holdsworth v. Strong, D. Utah, No. C-190-73, December 23, 1974 .... 2, A-2, A-3, passim

Holdsworth v. Strong, [Current] CCH Fed. Sec. L. Rep. ¶95,465 .... 2, 5, 18, passim

Hooper v. Mountain State Securities Corp., 282 F.2d 195 (C.A. 5, 1960), certiorari denied, 365 U.S. 814 (1961) 7

Cases: (continued)

	Page
J. I. Case Co. v. Borak, 377 U.S. 426 (1964)	4, 6
Kardon v. National Gypsum Co., 69 F.Supp. 512 (E.D. Pa., 1946)	3, 4
Kohler v. Kohler Co., 319 F.2d 634 (C.A. 7, 1963)	25
Keuhnert v. Texstar Corp., 412 F.2d 700 (C.A. 5, 1969)	23
Long v. Robinson, 432 F.2d 977 (C.A. 4, 1970)	17
Marsh v. Armada Corp., [Current] CCH Fed. Sec. L. Rep. ¶95,496 (C.A. 6, 1976)	21
Migliaccio v. Continental Mining & Milling Co., 196 F.2d 398 (C.A. 10, 1952)	8, 9, 10
Mills v. Electric Auto-Lite, 396 U.S. 375 (1970)	6, 17, 22
Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90 (C.A. 10, 1971), certiorari denied, 404 U.S. 1004 and 405 U.S. 918 (1972)	8, 15, 24, *passim*
Myzel v. Fields, 386 F.2d 718 (C.A. 8, 1967), certiorari denied, 390 U.S. 951 (1968)	25, 28, 29
Robert W. Stark, Jr., Inc. v. New York Stock Exchange, Inc., 346 F.Supp. 217 (S.D.N.Y.), affirmed per curiam, 466 F.2d 743 (C.A. 2, 1972)	17
Securities and Exchange Commission v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963)	5, 6, 8, *passim*
Securities and Exchange Commission v. Manor Nursing Centers, Inc., 458 F.2d 1082 (C.A. 2, 1972)	4
Smith v. Richards, 13 Peters 26, 38 U.S. 22 (1839)	8, 9, 10
Stein v. Treger, 182 F.2d 696 (C.A.D.C., 1950)	8, 10, 11
Straub v. Vaisman & Co., Inc., C.A. 3, Nos. 75-1704 and 75-2018 (June 15, 1976)	6, 12, 14, *passim*
Superintendent of Insurance v. Bankers Life & Casualty Co., 404 U.S. 6 (1971)	3, 6

Page

Cases: (continued)

TSC Industries, Inc. v. Northway, Inc., 44 U.S.L.W. 4852, U.S. Sup. Ct. No. 74-1471 (June 14, 1976) 6

Tcherepnin v. Knight, 389 U.S. 332 (1967) 6

Tomera v. Galt, 511 F.2d 504 (C.A. 7, 1975) 15

United States v. Charnay, [Current] CCH Fed. Sec. L. Rep. ¶95,560 (C.A. 9, 1976) 21

Vanderboom v. Sexton, 422 F.2d 1233 (C.A. 8), certiorari denied, 400 U.S. 852 (1970) 15

Statutes and Rules:

Securities Act of 1933, 15 U.S.C. §77a, *et seq.*

Section 11, 15 U.S.C. 77k 7, 22
Section 11(a), 15 U.S.C. 77k(a) 21, 22
Section 12, 15 U.S.C. 77l 7
Section 12(2), 15 U.S.C. 77l(2) 21, 22
Section 13, 15 U.S.C. 77m 7, 22
Section 15, 15 U.S.C. 77o 7, 21, 23
Section 16, 15 U.S.C. 77p 23
Section 17(a), 15 U.S.C. 77q(a) 7

Securities Exchange Act of 1934, 15 U.S.C. §78a, *et seq.*

Section 9, 15 U.S.C. 78i 7, 20
Section 9(e), 15 U.S.C. 78i(e) 21
Section 10(b), 15 U.S.C. 78j(b) .... 2, 3, 4, *passim*
Section 16(b), 15 U.S.C. 78p(b) 7
Section 18, 15 U.S.C. 78r 7, 18, 20
Section 18(a), 15 U.S.C. 78r(a) 21, 22
Section 20, 15 U.S.C. 78t 7
Section 20(a), 15 U.S.C. 78t(a) 21
Section 21(d), 15 U.S.C. 78u(d) 4
Section 28(a), 15 U.S.C. 78bb(a) 23

Rules Under the Securities Exchange Act of 1934

Rule 10b-5, 17 CFR 240.10b-5 .... 2, 3, 4, passim

Miscellaneous:

2 Bromberg, *Securities Law: Fraud SEC Rule 10b-5*, ¶8.4 (1974) 14

Page

Miscellaneous: (continued)

Douglas and Bates, The Federal Securities Act of 1933, 43 Yale L. J. 171 (1933) 4

Harper and James, The Law of Torts, §22.5 (1956) 19

H.R. Rep. No. 85, 73d Cong., 1st Sess. (1933) 5, 12

5 Jacobs, The Impact of Rule 10b-5, §64.01 n. 71 (1974) 19

Restatement of the Law of Torts, 2d, §481 19

Report of Investigation In the Matter of Sterling Homex Corporation Relating to Activities of the Board of Directors of Sterling Homex Corporation, Securities Exchange Act Release No. 11516 (Jul. 2, 1975), 7 SEC Docket 298 (Jul. 15, 1975) 29

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BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, *AMICUS CURIAE*, ON REHEARING EN BANC

PRELIMINARY STATEMENT AND QUESTION ADDRESSED

Pursuant to an order of this Court, the Securities and Exchange Commission respectfully submits this brief, *amicus curiae*, on the question whether an intentional and willful violator of the antifraud provisions of the federal securities laws should be permitted to retain the fruits of his violations, even if it could be shown that the victim of that deliberate fraud may have been negligent in failing to discover the fraud at its incipient stages.[1/]

1/ The Commission does not take any position with respect to the scope and applicability of the law of Utah concerning common law fraud.

On this *en banc* rehearing[2] of an appeal from a judgment of the United States District Court for the District of Utah, entered on December 23, 1974, it is not seriously disputed that the defendant deliberately defrauded the plaintiffs into selling securities they held in Sans-Copy, Inc. -- a joint venture between the plaintiffs, the defendant and others. Upon making such a finding, the district court directed the defendant to return to the plaintiffs the shares the defendant fraudulently had induced the plaintiffs to sell to him, in violation of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b-5 promulgated thereunder, 17 CFR 240.10b-5.[3]

In an opinion filed February 17, 1976, a divided panel of this Court reversed the district court's judgment on the ground that, notwithstanding the defendant's intentional misconduct, the failure of the plaintiffs to have exercised due diligence in detecting the defendant's fraud precluded rescission of that transaction. The panel also held that the plaintiffs had failed to establish either injury or detriment, as required under Utah law to recover for common law fraud.[4]

2/ This Court granted rehearing, *en banc*, on May 14, 1976.

3/ See the district court's findings of fact and conclusions of law in *Holdsworth v. Strong*, D. Utah, No. C-190-73, dated December 23, 1974, at page 16. Hereinafter, references to the district court's findings of fact and conclusions of law will be made to the separate paragraphs of that document.

Although the plaintiffs also alleged in their complaint that the defendant's action constituted common law fraud, the district court did not explicitly rule on that contention.

4/ The Panel's decision in this case is reported at [Current] CCH Fed. Sec. L. Rep. ¶95,465.

The Commission files this brief to express its general view that an intentional violation of the federal securities laws, once established, should, but for exceptional conduct on the part of the plaintiff, result in the divestiture of the defrauder's ill-gotten gains. We have set forth in an Appendix to this brief a summary of the allegations of the complaint, the district court's findings of fact and conclusions of law, and the panel decision of this Court.

INTEREST OF THE SECURITIES AND EXCHANGE COMMISSION

The complaint in this action alleges a "garden-type variety" securities fraud.[5/] Plaintiffs allege that the defendant induced them to sell their securities in Sans-Copy, Inc., to him on the basis of misrepresentations and omissions of material facts. Notwithstanding that the district court found, and the majority panel of this Court did not dispute, that those misrepresentations and omissions were intentionally made by the defendant, the panel of this Court held that the plaintiffs cannot rescind that stock transaction.

Since 1946, the federal courts have implied the existence of private rights of action for violations of the antifraud provisions of the federal securities laws, including Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder. Kardon v. National Gypsum Co., 69 F. Supp. 512, 514 (E.D. Pa., 1946). And, as the Supreme Court stated in Superintendent of Insurance v. Bankers Life & Casualty Co., 404 U.S. 6, 13 n. 9 (1971), "[i]t is now established that a private right of action is implied under §10(b)" of the Securities Exchange Act. Accord, Ernst & Ernst v. Hochfelder, 96 S. Ct. 1375 (1976); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730 (1975).

5/ See Superintendent of Insurance v. Bankers Life & Casualty Co., 404 U.S. 6, 11 n. 7 (1971); A. T. Brod & Co. v. Perlow, 375 F.2d 393, 397 (C.A. 2, 1967).

The basic rationale underlying the recognition of an implied private right of action for violations of Rule 10b-5 is that persons who are injured by the actions of another in violation of that Rule -- and who were the intended beneficiaries of the Rule -- should be allowed to recover against the wrongdoer. Kardon v. National Gypsum Co., supra, 69 F. Supp. at 513-514. Another, equally important, consideration is that "private enforcement of Commission rules may '[provide] a necessary supplement to Commission action.'" Blue Chip Stamps v. Manor Drug Stores, supra, 421 U.S. at 730, citing J. I. Case Co. v. Borak, 377 U.S. 426, 432 (1964).[6/] The Commission, of course, can sue to enjoin violations of Section 10(b) and Rule 10b-5,[7/] and, in appropriate cases, may obtain ancillary relief. See, e.g., Securities and Exchange Commission v. Manor Nursing Centers, Inc., 458 F.2d 1082 (C.A. 2, 1972). But, the Commission's resources are limited and, as a result, investors usually can obtain relief only through private actions for damages or, as in this case, for equitable relief.

Whatever other conduct is actionable in implied private actions under the federal securities laws, the Supreme Court recently has made clear the fact that intentional wrongdoing is the precise type of conduct for which private remedies under Rule 10b-5 are to be encouraged and fostered. Ernst & Ernst v. Hochfelder, 96 S. Ct. 1375 (1976). It is in this area of conduct, therefore, that the courts have the most important function of insuring that the implied private right

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6/ The express civil liability provisions in the first federal securities legislation -- the Securities Act of 1933, 15 U.S.C. 77a, et seq., were intended by Congress to have an "in terrorem" effect. Globus v. Law Research Service, Inc., 418 F.2d 1276, 1288 (C.A. 2, 1969), certiorari denied, 397 U.S. 913 (1970). See Douglas and Bates, The Federal Securities Act of 1933, 43 Yale L. J. 171, 173 (1933).

7/ Section 21(d) of the Securities Exchange Act of 1934, 15 U.S.C. 78u(d).

of action under Rule 10b-5 remains as a strong and effective deterrent against securities law abuses. The Commission is concerned that, if the panel's decision is so construed, a defendant who intentionally misrepresents material facts can escape responsibilty for his deliberate acts simply by showing that the plaintiff had not exercised "due diligence."[8/] Concomitantly, intentional wrongdoing will scarcely be deterred, and, perhaps, could be encouraged on the part of those would-be malfeasors who might find it profitable to chance securities fraud, on the possibility that, even if caught, they may nonetheless be able to keep their victim's money or securities if the victim of the fraud was sufficiently trusting or gullible so as not to have exercised "due diligence." We believe that such a standard would undercut the remedial purposes of the securities laws, restoring the rule of caveat emptor, which has been expressly discredited for those securities transactions governed by the federal securities laws.[9/]

Although a plaintiff's conduct may be relevant in determining whether a violation of Rule 10b-5 has been made out, and although the panel decision suggested that the defense of a plaintiff's lack of due diligence in intentional misconduct cases should be a "rarity,"[10/] sound policy suggests, in our

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8/ Although the term "due diligence" is not defined or otherwise explained in the panel's opinion, it is a term used to describe merely negligent conduct. See Ernst & Ernst v. Hochfelder, supra, 96 S. Ct. at 1388.

9/ Securities and Exchange Commission v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963). See also, H. R. Rep. No. 85, 73d Cong., 1st Sess. 2 (1933).

10/ [Current] CCH Fed. Sec. L. Rep. ¶95,465 at p. 99,363.

view, that in implied private actions under Section 10(b) and Rule 10b-5, the so-called due diligence defense should not serve to deny relief to a merely negligent victim of intentional fraud.[11/]

DISCUSSION

Sound Policy and the Effectuation of the Purposes Underlying the Establishment of Implied Private Actions under Securities Exchange Act Rule 10b-5 Make it Appropriate to Hold Intentional Fraudulent Conduct Actionable under the Federal Securities Laws, Even if the Victims of that Fraud May Have Been Negligent in Failing Timely to Discover the Fraud

In establishing, recognizing, and fostering implied private actions under the antifraud provisions of the federal securities laws,[12/] the Supreme Court has given content to its basic canon of construction for these antifraud provisions -- that such legislation be construed "not technically and restrictively, but flexibly to effectuate [their] remedial purposes." Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972); Superintendent of Insurance v. Bankers Life & Casualty Co., supra, 404 U.S. at 12; Tcherepnin v. Knight, 389 U.S. 332, 336 (1967); Securities and Exchange Commission v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 195, (1962). This principle of statutory construction is applicable to Rule 10b-5.[13/]

11/ As discussed, infra, pp. 17-18, there are situations where a plaintiff's conduct may properly preclude recovery under Rule 10b-5, even where the defendant had engaged in intentional misconduct. And see Straub v. Vaisman & Co., Inc., C.A. 3, Nos. 75-1704 and 75-2018 (June 15, 1976).

12/ TSC Industries, Inc. v. Northway, Inc., 44 U.S.L.W. 4852 (U.S. Sup. Ct., No. 74-1471) (June 4, 1976); Ernst & Ernst v. Hochfelder, supra, 96 S. Ct. at 1382; Blue Chip Stamps v. Manor Drug Stores, supra, 421 U.S. at 730; Affiliated Ute Citizens v. United States, 406 U.S. 128, 150-154 (1972); Superintendent of Insurance v. Bankers Life & Casualty Co., supra, 404 U.S. at 13 n. 9 (1971); Mills v. Electric Auto-Lite, 396 U.S. 375 (1970); J. I. Case Co. v. Borak, 377 U.S. 426 (1964).

13/ Affiliated Ute Citizens v. United States, supra, 406 U.S. at 150-154; Superintendent of Insurance v. Bankers Life & Casualty Co., supra, 404 U.S. at 12.

But, the Supreme Court also has recognized that implied remedies are not, as is true of the express remedies under the federal securities laws,[14/] without the need for some limiting doctrine.[15/] These recent decisions, following upon older lower court decisions,[16/] make clear that (1) an appreciation of the underlying purposes of the federal securities laws, (2) sound policy, and (3) reference to the express remedies set forth in those laws, are the guide-posts by which the courts should determine whether, and how, it is appropriate to construct limitations on the scope of such private actions.[17/] These standards, we believe, militate against the establishment of a plaintiff's lack of due diligence in timely detecting intentional fraud as a defense to an implied private antifraud action.

I.

Section 10(b) was adopted to make unlawful the defrauding of *sellers,* as well as the defauding of purchasers, of securities.[18/] *Hooper* v. *Mountain State*

14/ See, *e.g.*, Sections 11, 12, 13 and 15 of the Securities Act of 1933, 15 U.S.C. 77k, 77*l*, 77m and 77*o*; Sections 9, 16(b), 18 and 20 of the Securities Exchange Act of 1934, 15 U.S.C. 78i, 78p(b), 78r and 78t.

15/ See *Ernst & Ernst* v. *Hochfelder*, *supra* ("scienter" on the part of the defendant must be shown in private action for damages under Rule 10b-5); *Blue Chip Stamps* v. *Manor Drug Stores*, *supra* (plaintiff in an action under Rule 10b-5 must be an actual purchaser or seller of securities).

16/ See, *e.g.*, *Birnbaum* v. *Newport Steel Corp.*, 193 F. 2d 461 (C.A. 2), *certiorari denied*, 343 U.S. 956 (1952).

17/ See *Ernst & Ernst* v. *Hochfelder*, *supra*, 96 S. Ct. at 1384-1390; *Blue Chip Stamps* v. *Manor Drug Stores*, *supra*, 421 U.S. at 730, 748-749.

18/ Rule 10b-5 was patterned after Section 17(a) of the Securities Act, 15 U.S.C. 77q(a), which makes unlawful the defrauding of purchasers of securities. See *Ernst & Ernst*, *supra*, 96 S. Ct. at 1390 n. 32. See also, *Blue Chip Stamps* v. *Manor Drug Stores*, *supra*, 421 U.S. at 733.

Securities Corp., 282 F. 2d 195, 201 (C.A. 5, 1960), certiorari denied, 365 U.S. 814 (1961); Fratt v. Robinson, 203 F. 2d 627 (C.A. 9, 1953); Birnbaum v. Newport Steel Corp., 193 F. 2d 461 (C. A. 2), certiorari denied, 343 U.S. 956 (1952).

In Securities and Exchange Commission v. Capital Gains Research Bureau, Inc., 375 U.S. 185 (1963), the Supreme Court pointed out that a fundamental purpose, common to all of the federal securities laws, was to "substitute a philosophy of full disclosure for the philosophy of caveat emptor. . . ." Id., at 186.[19/] In light of this Congressional purpose, the Court held in that case that the principles of common law fraud and deceit did not apply "in their technical sense" in an action under the Investment Advisers Act of 1940. Ibid.[20/]

Even decisions at common law, dealing with the obligation of a buyer of merchandise or property to make an inspection or otherwise act to protect himself, did not always reflect a vigorous and rigid application of caveat emptor. Generally, a person who misrepresented a material fact was liable, for fraud, to another who relied upon the misrepresentation to his detriment, whether or not the misrepresentation was based on an innocent mistake. Smith v. Richards, 13 Peters 26, 36, 38 U.S. 22, 31 (1839); Stein v. Treger, 182 F. 2d 696, 698-699 (C.A. D.C., 1950). As this Court stated in Migliaccio v. Continential Mining & Milling Co., 196 F. 2d 398 (1952):

19/ The fact that the victims in the present case are defrauded sellers of securities, rather than defrauded buyers, is irrelevant. The "philosophy of full disclosure" is, of course, equally applicable. See, e.g., Mitchell v. Texas Gulf Sulphur Co., 446 F. 2d 90 (C.A. 10, 1971), certiorari denied, 404 U.S. 1004 and 405 U.S. 918 (1972).

20/ The Court held that, in an action to enforce the antifraud provisions of the Investment Advisers Act, the Commission did not have to show, as a prerequisite for injunctive relief, that the defendant intended to cause injury or in fact did cause injury.

> "one has a right to rely on statements of material facts or on positive statements, essentially connected with the substance of the transaction, where they are not mere general commendations or expressions of opinion, and are as to matters within the knowledge of the person making them, as to matters which he assumes to assert as of his knowledge, or as to matters which from their nature or situation are peculiarly within his knowledge."

Such liability, however, is not absolute. "[W]here the subject of the sale is open to the inspection and examination of the buyer, it is his own folly and negligence not to examine." Smith v. Richards, supra, 13 Peters at 42, 38 U.S. at 36. Referring to Chancellor Kent's Commentaries, the Supreme Court stated that "the law does not go to romantic length of giving indemnity against the consequences of indolence and folly, or a careless indifference to the ordinary and accessible means of information." Ibid. And see Andrus v. St. Louis Smelting & Refining Co., 130 U.S. 643, 647 (1889); Cleaveland v. Richardson, 132 U.S. 318, 329 (1889). Thus, as the Court pointed out in Farrar v. Churchill, 135 U.S. 609, 616 (1890):

> ". . . if the means of investigation and verification be at hand, and the attention of the party receiving the representations be drawn to them, the circumstances of the case may be such, as to make it incumbent on a court of justice to impute to him a knowledge of the result, which, upon due inquiry, he ought to have obtained, and thus the notion of reliance on the representations made to him may be excluded." 21/

21/ See also, Migliaccio v. Continental Mining & Milling Co., supra.

On the other hand, the circumstances of a case may not impose an affirmative duty to investigate the representations made by the defendant. In Smith v. Richards, supra, 13 Peters at 41-42, 38 U.S. at 35-36, the Supreme Court held that the plaintiff did not have to inspect "remote" property as to which the defendant had made representations; and this Court has suggested that, when the misrepresented fact is within the particular knowledge of the person stating it and not otherwise easily verifiable by the person relying on it, the former will be liable in fraud. Migliaccio v. Continental Mining & Milling Co., supra, 196 F.2d at 403-404.

In Stein v. Treger, supra, the defendants, who were whiskey brokers, were held liable for misrepresenting the financial responsibility of the supplier and the availability of whiskey supplies to plaintiff, even though the defendants had believed that what they had told the plaintiff was true. On appeal, defendants asserted, among other things, that the district judge had erred in not instructing the jury that the plaintiff had a duty to investigate. The court of appeals rejected this argument, stating:

> "However, even though Treger [the plaintiff] could have investigated the matter, there was no obligation upon him to do so at his peril, unless the circumstances were such as to put him on notice. As a retail purchaser, he was entitled to rely upon the representations of the broker concerning their principal's financial standing, especially after they had gone to Chicago and made the representaion to Treger that they had investigated that particular matter; and he was also entitled to rely on the broker's assurance that the whiskey was all in Chicago and immediately available to anyone who would sign the order and make the required payment. Treger could not be said to be guilty of voluntary blindness in not

> seeing matters before him, for these matters were not before him. He could, of course, have made an investigation himself, but so could almost everyone else who has ever been defrauded by fraudulent representations. One does not generally rely upon such representations, at his own risk." 182 F.2d at 699. 22/

But, the common law, while providing a useful framework for consideration, is not determinative. 23/ Whatever limitations may exist on the right to recover for fraudulent misrepresentation in an action at common law, the Supreme Court in Securities and Exchange Commission v. Capital Gains Research Bureau, Inc., supra, held, as we noted, that common law doctrines do not, necessarily, limit the right of a plaintiff to obtain relief for violations of the federal securities laws. 24/ In reaching this conclusion, the Court pointed out that the common law doctrines of fraud and deceit, which had developed around transactions involving land and

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22/ See also, Equitable Life Ins. Co. of Iowa v. Halsey, Stuart & Co., 312 U.S. 410, 420 (1941), where the Court, citing Iowa law, stated:

> "If, as the jury found, petitioner relied on these representations to its injury, it is immaterial . . . that petitioner did not make its own investigation to ascertain whether they were true."

23/ The Supreme Court in Blue Chip Stamps v. Manor Drug Stores, supra, 421 U.S. at 744-745, recognized that the

> "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."

24/ See n. 23, supra. And see, Clegg v. Conk, 507 F. 2d 1351, 1361 (C.A. 10, 1974), certiorari denied, 422 U.S. 1007 (1975) ("the federal securities acts are not frozen into the old common law patterns").

other tangible items, "are ill-suited to the sale of such intangibles as . . . securities, and . . . accordingly, the doctrines must be adopted to the merchandise in issue." Id., at 194. 25/ The Court went on to state that:

> "even if we were to agree . . . that Congress had intended, in effect, to codify the common law of fraud in the Investment Advisers Act of 1940, it would be logical to conclude that Congress codified the common law 'remedially' as the courts had adapted it to the prevention of fraudulent securities transactions by fiduciaries, not 'technically' as it has traditionally been applied in damage suits between parties to arm's-length transactions involving land and ordinary chattels." Id., at 195. 26/

In Ernst & Ernst v. Hochfelder, supra, 96 S. Ct. at 1382-1383, the Supreme Court emphasized that the protection afforded by implied private remedies under Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder extend, at least, to intentional misconduct. 27/ Given the broad purposes of Section 10(b)

25/ In enacting laws to regulate interstate transactions in securities, Congress recognized securities to be "intricate merchandise." H. R. Rep. No. 85, 73d Cong., 1st Sess. 8 (1933).

26/ See Straub v. Vaisman & Co., Inc., supra, slip op. at 10, where the court of appeals noted, in an action involving Section 10(b) and Rule 10b-5, that

> "tort concepts must be balanced against the policies underlying the federal securities laws and the judicially created causes of action, where encouragement of watchfulness in the market place has obvious benefits."

27/ The Court left open questions concerning (1) the existence of and standard for violations of aiding and abetting securities violations, Ernst & Ernst v. Hochfelder, supra, 96 S. Ct. at 1380 n. 7; (2) whether recklessness would constitute such intentional fraudulent behavior, id., at 1381 n. 12; and (3) whether, given the public interest inherent in Commission lawsuits for equitable relief, a showing of intentional conduct would ever be necessary in a Commission action, ibid.

and Rule 10b-5 as set forth above, and the peculiarly pertinent applicabilty of an implied private action under those proscriptions to intentional fraudulent schemes, we believe it would be inconsistent with the Congressional intent and the teachings of the Supreme Court to impose a due diligence burden on the victim of intentional deceptive conduct.

II.

Nor do we believe that sound policy reasons, particularly in light of recent judicial interpretations of the federal securities laws, support the imposition of a due diligence defense in intentional fraud cases.

The requirement -- that a plaintiff, in an action under Rule 10b-5, based upon misrepresentations of material facts, must establish due diligence -- appears to have evolved, in turn, from the requirement, at common law, that a plaintiff must have reasonably relied on a misrepresentation in order to obtain relief for fraud. But the difference between a "due diligence" requirement and a requirement of "reasonable reliance" is not, as the panel decision in this case demonstrates, merely one of semantics. Due diligence, although most often equated with simple negligence,[28/] implies more than reasonable reliance; it implies some affirmative action, such as the duty to make an investigation of books and records which the panel decision would require in the instant case. Reasonable reliance, on the other hand, properly focuses on the individual plaintiff and the reasonableness of his conduct

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28/ See n. 8, p. 5, *supra*.

in light of the facts involved in the transaction in question.[29/] This latter standard of the reasonableness of a plaintiff's conduct, we respectfully submit, should be the proper test.

The establishment of a plaintiff's due diligence in federal securities actions certainly had its derivation in attempts by this Court as well as others to counterbalance the low burden on plaintiffs to show only either negligent conduct, or constructive knowledge, on the defendant's part, of the violation charged, as a basis for recovering damages under Rule 10b-5. The panel decision in this case cited with approval the statement of Professor Bromberg, a noted commentator on Rule 10b-5, articulating this rationale for requiring the showing of due diligence by plaintiffs as a condition to obtaining relief under that Rule. Professor Bromberg had stated:

> "It is noteworthy that the circuits which have most clearly charged defendant with constructive knowledge or diligence [the 8th, 9th and 10th] are, by and large, the same courts that have similarly charged plaintiff. There is a logic and balance in this. A high standard of conduct for defendant justifies a high standard for plaintiff. Stated a little differently, the price plaintiff pays of being relieved of the burden of proving defendant's intent or actual knowledge is that plaintiff himself must show some diligence." 30/

29/ The Court of Appeals for the Third Circuit recently stated that a plaintiff's obligation of due care "must be a flexible one, dependent upon the circumstances of each case." Straub v. Vaisman & Co., Inc., supra, slip op. at 10.

30/ 2 Bromberg, Securities Law: Fraud SEC Rule 10b-5, ¶8.4(652) (1974). The principal Tenth Circuit case cited by Bromberg was Gilbert v. Nixon, 429 F.2d 348 (C.A. 10, 1970), which applied a constructive knowledge test. Id., at ¶8.4(575). Compare

(footnote continued)

But, that rationale no longer seems viable in light of the Supreme Court's recent decision in Ernst & Ernst v. Hochfelder, supra.

In Ernst & Ernst, the Court held that, in order to recover in a private action for damages under Section 10(b) and Rule 10b-5, a plaintiff must establish that the defendant acted with "scienter." 31/ The Court rejected the argument that an implied private recovery under Rule 10b-5 could be based on a showing of a lack of due diligence on the part of a defendant -- that is, that the defendant had acted only negligently. If, as the panel of this Court seemingly held, therefore, the concept of a balancing of the burdens between plaintiff and defendant was the policy basis for imposing a due diligence burden on plaintiffs, that basis has been eroded. Thus, in Straub v. Vaisman & Co., Inc., supra, the Court of Appeals for the Third Circuit recognized that

> "since Ernst & Ernst v. Hochfelder has limited 10b-5 actions to those in which the defendant has a mental state 'embracing intent to deceive, manipulate, or defraud,' the desirability of a 'contributory

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30/ (footnote continued)

Clegg v. Conk, supra, 507 F.2d at 1361-1362; Mitchell v. Texas Gulf Sulphur, 446 F.2d 90 (C.A. 10, 1971), certiorari denied, 404 U.S. 1004 and 405 U.S. 918 (1972).

The Seventh and Eighth Circuits already had, prior to Ernst & Ernst v. Hochfelder, supra, established a constructive knowledge test. See, e.g., Tomera v. Galt, 511 F.2d 504, 508 (C.A. 7, 1975); Vanderboom v. Sexton, 422 F.2d 1233, 1239 (C.A. 8), certiorari denied, 400 U.S. 852 (1970).

31/ The Court defined the term "scienter" to mean a "mental state embracing an intent to deceive, manipulate, or defraud." 96 S. Ct. at 1381 n. 12. The Court did not determine whether, in some circumstances, reckless behavior might constitute the requisite element of scienter, and thus be a sufficient basis for civil liability under Section 10(b) and Rule 10b-5. Ibid.

> negligence' defense becomes less compelling." Slip op. at 9.

In that Court's view, with which we agree, "[t]he obligation of due care must be a flexible one, dependent upon the circumstances of each case . . . [requiring] only that the plaintiff act reasonably." Slip op. at 10.[32/]

The sole policy reason which once may have been thought to justify the due diligence defense -- an effort by the courts to preclude potentially large recoveries by plaintiffs who had clearly contributed to their own difficulties against persons or entities whose violations of the law may have occurred through inadvertence or lack of care in the pursuit of legitimate corporate and investment activities -- no longer exists. It seems to us to be far more important, and consonant with the redefined scope of Rule 10b-5, to preclude intentional wrongdoers from reaping the benefits of their unlawful conduct except, of course, where the plaintiff wantonly acts in disregard of the defendant's fraudulent

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32/ Just as reckless behavior by a defendant may be a sufficient basis for the imposition of liability under Rule 10b-5 (see nn. 27 and 31, *supra*), reckless behavior by a plaintiff may be enough to bar recovery. In this context, we agree with the Third Circuit that "[s]ince the failure to meet that standard is in the nature of an affirmative defense the burden of proof rests upon the defendant." Slip op. at pp. 10-11.

or deceptive conduct of which the plaintiff is aware or to which the plaintiff unquestionably is alerted.[33/]

We do not believe the the mere possibility of access to books and records, standing alone, warrants an imputation to a plaintiff of constructive knowledge of their contents. To do so would jump an important step. That step is whether there was anything in the _transaction itself_

33/ A plaintiff who has actual knowledge of a material misrepresentation prior to the transaction should not recover under Rule 10b-5. _Straub_ v. _Vaisman & Co., Inc._, _supra_, slip op. at 8. And see the discussion, _infra_, at part III., pp. 20-24.

While Section 10(b) and Rule 10b-5 contemplate that any person who omits or misrepresents a material fact violates the law, and may be subject to an injunction at the behest of the Commission, suing to vindicate the public interest and safeguard the integrity of the securities markets generally, there are sound reasons for denying relief to a private party who knew the omitted or misrepresented facts in such circumstances.

For one thing, the plaintiff would fail to show reliance and causation -- essential elements of an implied private action under Rule 10b-5, but not required to be proved as separate elements of such a cause of action by a plaintiff who was _unaware_ of the omissions or misrepresentations of material facts, _Mills_ v. _Electric Auto-Lite_, _supra_; _Affiliated Ute Citizens_ v. _United States_, _supra_. Similarly, it has long been held contrary to public policy to allow a plaintiff, in effect, to buy into a lawsuit. See, _e.g._, _Robert W. Stark, Jr., Inc._ v. _New York Stock Exchange, Inc._, 346 F.Supp. 217, 231 (S.D. N.Y.), _affirmed per curiam_, 466 F.2d 743 (C.A. 2, 1972); _Long_ v. _Robinson_, 423 F.2d 977 (C.A. 4, 1970). It would, in our view, contravene this important public policy if a plaintiff, suing on his own behalf, and not derivatively, as in _Mills_ v. _Electric Auto-Lite_, _supra_, were permitted to bring a private suit for his purchase or sale of securities after becoming aware of the false or misleading statements or omissions.

which would have led a person of the particular plaintiff's ability, intelligence and experience, to raise a serious doubt and seek to take advantage of that access.[34/] Naturally, if this Court should conclude that there were specific "red flags" flying, alerting the plaintiffs to the defendant's fraud, a failure to take steps to protect themselves (such as checking available records) might be cause for denying relief.

In contrast to the view we posit, however, the panel decision in this case would appear to require, at least as to those plaintiffs who have some official connection with a corporation, no matter how nominal that connection might prove, that they conduct an independent investigation of the corporation's books and records to verify facts, even if there should be nothing in the transaction itself to alert them of the possibility of fraud.

But, if it be established that there has been "a palpable fraud and direct profiting from the defrauder's own misrepresentations,"[35/] a

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34/ In Straub v. Vaisman & Co., Inc., supra, the court of appeals rejected the defendant's argument that the plaintiff's knowledge of, and experience with, the securities industry should preclude recovery, stating that

> "a sophisticated investor is not barred by reliance upon the honesty of those with whom he deals in the absence of knowledge that the trust is misplaced. Integrity is still the mainstay of commerce and makes it possible for an almost limitless number of transactions to take place without resort to the courts."

Slip op. at 11.

35/ [Current] CCH Fed. Sec. L. Rep. ¶95,465 at p. 99,365 (dissenting opinion).

plaintiff's mere negligence should not, consistent with the remedial nature of the federal securities laws, be held to bar appropriate relief. This is because, as Judge Doyle stated in dissenting from the panel decision, "no legal relationship exists between intentional harm and contributory negligence." 36/

The broader rule suggested by the panel decision in this case could permit unscrupulous manipulators and "fraud artists" to reap the rewards of their own illegal conduct simply by showing that a plaintiff "should have known" that the facts in issue had been misrepresented. Anomalously, the greater and more successful the intentional fraud, the less likely it is that plaintiffs will be able to recover under the panel's formulation.

36/ [Current] CCH Fed. Sec. L. Rep. ¶95,465 at p. 99,365. The concepts of contributory or comparative negligence are, of course, well established in tort law. But, even in tort law, it is recognized that "plaintiffs' contributory negligence does not bar recovery against a defendant for harm caused by conduct by the defendant which is wrongful because it is intended to cause harm to some legally protected interest. . . . " Restatement of the Law of Torts, 2d, §481 (emphasis supplied). Accord, Harper and James, The Law of Torts, §22.5 (1956). If a plaintiff cannot recover for intentional misconduct because of his own negligence, regardless of degree, "Rule 10b-5 would provide less assistance to the trusting or gullible than does the common law." Straub v. Vaisman & Co., Inc., supra, slip op. at 10.

Although the majority relied on Arnold Jacobs, a commentator on Rule 10b-5, in support of its analysis, Mr. Jacobs, in fact has stated that

> "[t]he application of due diligence principles is particularly suspect if applied to intentional statements. It has little enough merit when used in negligent misrepresentation cases, where it can at least be justified on some sort of contributory negligence principle."

5 Jacobs, The Impact of Rule 10b-5, §64.01 n. 71 (1974).

Although the panel opinion indicates that a plaintiff's lack of due diligence will preclude relief only "rarely," there is nothing in the opinion marking the outer boundaries of such a rule. In any event, as we have already discussed, we see no remaining policy reason to support the view that a plaintiff's merely negligent behavior should bar relief against an intentionally fraudulent defendant.

III

Similarly, reference to the express private remedies provided in the federal securities laws -- an approach the Supreme Court, in Ernst & Ernst v. Hochfelder, supra, 96 S. Ct. at 1387-1389, suggested might be helpful in developing sound limitations on implied antifraud private actions under Rule 10b-5 -- demonstrates the inappropriateness of the rule adopted by the panel decision.

There are eight sections of the Securities Act and the Securities Exchange Act which create or condition express private remedies for fraudulent conduct.[37/] The standard of conduct in these sections varies from a negligence standard to intentional or reckless conduct.[38/]

37/ See n. 14, supra.

38/ Compare, for example, Section 9 of the Securities Exchange Act of 1934, 15 U.S.C. 78i, imposing liability for willful manipulation, with Section 18 of the Act, 15 U.S.C. 78r, imposing liability for misstatements or omissions of material facts in documents filed with the Commission, "unless the person sued shall prove that he acted in good faith and had no knowledge that such a statement was false and misleading."

Limitations based on the plaintiff's conduct are very narrowly set forth. Thus, Section 11(a) of the Securities Act, which creates an express civil remedy for false or misleading registration statements, excludes from the class of plaintiffs who may take advantage of the remedy created

> "any person acquiring [the] security [covered by the false registration statement if] . . . it is proved that at the time of such acquisition [the purchaser] knew of such untruth or omission. . . ." (Emphasis supplied.)

A comparable limitation is incorporated into the private remedies created by Section 12(2) of the Securities Act (false or misleading prospectus or oral statement liability), and Section 18(a) of the Securities Exchange Act (liability for false or misleading statements in filings made with the Commission).[39/] As we have suggested above, in such a circumstance, we believe an implied private action under Rule 10b-5 also should not lie.

39/ The plaintiff's knowledge of the false or misleading statement also would be a defense in private actions against controlling persons pursuant to Section 15 of the Securities Act and Section 20(a) of the Securities Exchange Act, for violations of the same sections discussed in the text, since the latter two sections impose such controlling person liability "to the same extent . . ." as applies to the controlled person.

In contrast, Section 9(e) of the Securities Exchange Act (establishing a private action for manipulative conduct or unlawful conduct in connection with puts, calls, options or straddles) does not establish the plaintiff's knowledge as a defense. This, presumably, is a reflection of Congress' intention that manipulative conduct is actionable whether or not the victim of the manipulation also was aware that the manipulative conduct was occurring. Accord, United States v. Charnay, [Current] CCH Fed. Sec. L. Rep. ¶95,560 (C.A. 9, 1976). But see, Marsh v. Armada Corp., [Current] CCH Fed. Sec. L. Rep. ¶95,496 (C.A. 6, 1976).

But, apart from those situations where the plaintiff's knowledge is a bar to a private suit, and apart from requirements, in some cases, of reliance [40/] or damage causation in fact, [41/] the Congress did not impose any due diligence requirements on plaintiffs in order to recover for intentional wrongdoing, even though it is clear that Congress in fact focused on the concept of a plaintiff's "reasonable diligence" in establishing private remedies and the limitations on plaintiffs who may seek to avail themselves of such remedies. [42/]

40/ See Section 11(a) of the Securities Act.

Instructively, after the expiration of at least twelve months from the effective date of a registration statement, if the issuer has made a one-year earnings statement available to its shareholders, the plaintiff, although required, as noted above in text, to show reliance upon the untrue statement in the registration statement, expressly is relieved of the obligation of showing that he read the registration statement. This would serve to reflect a Congressional intent to negate any due diligence requirement on plaintiffs, for the effect of a false or misleading statement in one part of a registration statement may be diminished by disclosures elsewhere in a document that, traditionally, can be quite lengthy. *Cf. Mills* v. *Electric Auto-Lite*, *supra*, 396 U.S. at 384-385.

41/ See Section 18(a) of the Securities Exchange Act.

42/ Thus, in Section 13 of the Securities Act, Congress established a statute of limitations for express remedies pursuant to Sections 11 or 12(2) of the Securities Act. The period established was one year after the discovery of the untrue statement or the omission, or one year

> "after such discovery should have been made by the exercise of *reasonable diligence* * * *" (emphasis supplied).

Although this Section is not dispositive of Congressional intent with respect to barring a suit outright where a plaintiff fails

(footnote continued)

It should be noted, however, that Congress did provide, in both the Securities Act of 1933 [43/] and the Securities Exchange Act of 1934, [44/] that "[t]he rights and remedies provided . . ." were in addition "to any and all other . . ." legal and equitable remedies. In seeking equitable or other relief, a plaintiff may, therefore, be subject to appropriate defenses traditionally recognized, such as the defense that the plaintiff acted *in pari delicto* with the defendant. [45/]

42/ (footnote continued)

to exercise reasonable diligence in ascertaining a written *or oral* false or misleading statement or the written *or oral* omission of a material fact, it does evidence that Congress chose only to apply a stricter statute of limitations to plaintiffs who were not reasonably diligent in detecting fraud, at the same time that Congress did not entirely bar such plaintiffs from bringing such suits. And, in any event, this Section suggests that Congress perceived a plaintiff's duty of care in detecting fraud, if any, as a duty of reasonable diligence, not one of due diligence, as the panel decision suggests.

43/ Section 16 of the Securities Act, 15 U.S.C. 77p.

44/ Section 28(a) of the Securities Exchange Act, 15 U..C. 78bb.

45/ Thus, for example, in *Keuhnert* v. *Texstar Corp.*, 412 F.2d 700 (C.A. 5, 1969), the court of appeals affirmed the district court's grant of summary judgment in favor of the defendants in a suit to recover damages for losses in securities transactions resulting from the plaintiff's reliance on information obtained from the defendants, which turned out to be untrue. Since the plaintiff knew that the information given by the defendants was nonpublic, material information, in violation of Rule 10b-5, he was a "tippee" also subject to Rule 10b-5 and, concomitantly, was required to disclose the information to the seller. Although the plaintiff did not actually "know" material facts, since the facts given him were untrue, he

(footnote continued)

IV.

In holding that, in an action for equitable rescission premised on Rule 10b-5, due diligence on the part of the plaintiff must be shown in order for the plaintiff to obtain relief, even where the defendant admittedly engaged in intentional misconduct, the panel noted that this Court "has often indicated that a plaintiff must act with due diligence in the transaction relevant to the 10b-5 claim." 46/ But, as discussed above, that decision was, of course, rendered before the Supreme Court's decision in Ernst & Ernst v. Hochfelder, supra, and, in any event, the authorities cited by the panel do not compel such a conclusion.

Of the cases cited by the majority as support for its application of a due diligence standard to the victim of intentional securities fraud, four -- Mitchell v. Texas Gulf Sulphur Co., 47/ Gilbert v. Nixon, 48/

45/ (footnote continued)

nonetheless attempted to take advantage of innocent vendors. Under these circumstances, the court denied relief to the plaintiff, stating (412 F.2d at 705):

> "the better choice is to leave upon persons believing themselves tippees the restraint arising from the fear of irretrievable loss should they act upon a tip which proves to have been untrue. Hence the loss must lie where it falls."

46/ [Current] CCH Fed. Sec. L. Rep. ¶95,465, at p. 99,361 (citations omitted).

47/ 446 F.2d 90 (C.A. 10, 1971), certiorari denied, 404 U.S. 1004 and 405 U.S. 918 (1972).

48/ 429 F.2d 348 (C.A. 10, 1970).

Clement A. Evans & Co. v. McAlpine,[49/] and Myzel v. Fields[50/] involved defendants who had intentionally violated the federal securities laws.[51/]

In Mitchell, the defendant had attempted to remedy an intentional misrepresentation by publishing a corrective press release. The plaintiffs had sold their stock in the marketplace six or seven days after the corrective press release was published. In denying relief to these plaintiffs, this Court held that, at some point after publication of the corrective release, which had received extraordinarily wide publicity, stockholders should no longer be permitted to claim reliance on the previous, misleading release. To allow plaintiffs to recover under these circumstances, this Court appropriately held, would encourage plaintiffs to gamble on the movement of the market after a misrepresentation and then sue only if it should have moved against them. Such a situation, this Court held, would "unjustifiably extend . . . [the corporation's] liability to intolerable limits." 446 F.2d at 103.[52/] It was in these unique circumstances that

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49/ 434 F.2d 100 (C.A. 5, 1970), certiorari denied, 402 U.S. 988 (1971).

50/ 386 F.2d 718 (C.A. 8, 1967), certiorari denied, 390 U.S. 951 (1968).

51/ The other three cases relied upon by the panel, Financial Industries Fund, Inc. v. McDonnel Douglas Corp., 474 F.2d 514 (C.A. 10, 1973), certiorari denied, 414 U.S. 874 (1974); Harnett v. Ryan Homes, Inc., 496 F.2d 832 (C.A. 3, 1974); and Kohler v. Kohler Co., 319 F.2d 634 (C.A. 7, 1963), did not involve intentional fraud and may otherwise be distinguished.

52/ The breadth of potential liability in private actions under Rule 10b-5 has been an important consideration for the Supreme Court in imposing some limitations on such actions. See Ernst & Ernst, supra, 96 S.Ct. at 1391 n. 33; Blue Chip Stamps v. Manor Drug Stores, supra.

this Court noted that "stockholders too [must] act in good faith and with due diligence in purchasing and selling stock." Ibid. But this Court did not purport to establish any particular rule of due diligence.

Thus, plaintiffs who had sold their securities immediately after the corrective release was published were allowed to recover, while those who waited -- for what the Court considered to be an inordinate amount of time -- could not. This Court, in Mitchell, did not establish any requirement that plaintiffs had to inspect a corporation's books or take other extraordinary measures to satisfy themselves that the original press release was not false or misleading. Rather, the Court held that a plaintiff could not ignore widely-circulated public facts affecting his investment.

Gilbert v. Nixon, supra, also involved intentional fraud, but this Court there focused on whether the plaintiffs had actual knowledge of the misrepresentations. Interestingly, in remanding a portion of the plaintiff's claim, this Court stated that, in determining whether the plaintiffs had such knowledge, the district court

> "should keep in mind that appellants cannot be charged with the obligation to make independent investigations to verify the accuracy of Nixon's [the defendant's] misrepresentations."

429 F.2d at 361.

Neither does the decision of the Court of Appeals for the Fifth Circuit, in Clement A. Evans & Co. v. McAlpine, supra, support the broad rule suggested by the majority of the panel here. In McAlpine, the defendants devised and participated in a scheme that was designed to create the false

appearance that a particular investor had substantial resources. Thereafter, the investor executed trades through the plaintiff brokerage firm, paying for those transactions by personal check. The brokerage firm allowed the investor to continue trading, notwithstanding that, over a three-to-four month period, several of his checks were dishonored, a situation that, under the normal policy of the plaintiff, should have resulted in a ninety-day freeze on the investor's account. The plaintiff, however, did not invoke that policy and sustained losses as a result of dishonored checks.

In denying plaintiff recovery, the court there pointed to the failure of the plaintiff to take any action that could have prevented its loss. The court stated:

> "Surely plaintiff would not contend that a plaintiff or seller could justifiably rely on the fraudulent misrepresentation no matter how willfully and intentionally made if that misrepresentation would tax even the most credulous mind." 434 F.2d at 104.

At most, the court held that a plaintiff could not ignore what had in that case become incredible, a standard consistent with the views we have set forth above. There was no suggestion in the opinion that otherwise credible statements require independent verification. 53/

53/ Indeed, in Bird v. Ferry, 497 F.2d 112 (C.A. 5, 1974), the same court rejected the defendants' argument that the McAlpine decision precluded the plaintiffs from recovering since they had not shown the requisite due diligence by, among other things, reviewing the confirmations and receipts with respect to securities transactions ostensibly effected on their behalf by an investment club. One of the defendants was the adviser to the club, and the other was his employer. The court noted the relationship between the persons

(footnote continued)

The panel decision also relied on Myzel v. Fields, supra. Quoting from the Myzel opinion, the panel stated that a director of a corporation "is chargeable with a degree of notice of those acts which the corporate books . . . would fairly disclose." 54/ The panel then posited this statement as a general rule and held that a director is to be charged with the knowledge of all matters contained in the corporate books, and that, if those books contained information that would "incite a person with reasonable business prudence to make further inquiry," 55/ a director, such as plaintiff here, could not recover for even an intentional violation of Rule 10b-5.

53/ (footnote continued)

involved -- the adviser had day-to-day control over the club's investments -- and held that he was a "quasi-fiduciary." Id., at 114. Under these circumstances, the court of appeals held the district court's finding that the plaintiffs had exercised due diligence was not clearly erroneous.

54/ [Current] CCH Fed. Sec. L. Rep. ¶95,465 at p. 99,363. The complete statement of the court in Myzel is that a director of a corporation

> "is chargeable with a degree of notice of those facts which the corporate books and the director's meetings would fairly disclose." 386 F.2d at 736 (emphasis supplied).

In Myzel, it appears that the director who was seeking recovery was actively involved in corporate affairs and attended all directors' meetings. No meetings of the board of directors of Sans-Copy were held since 1962. See p. A-2, infra.

55/ [Current] CCH Fed. Sec. L. Rep. ¶95,465 at p. 99,363.

But, Myzel is not as broad, in our view, as the panel here viewed it. While the court of appeals in Myzel did hold that directors can, in appropriate cases, be charged with knowledge of certain facts -- a standard with which the Commission not only does not disagree, but which it has employed in its own enforcement cases [56/] -- Myzel did not purport to, and in fact does not, establish an absolute standard for all directors who, as investors, seek to avail themselves of the protections of the federal securities laws, as the panel decision here seems to suggest. [57/] In fact, the court in Myzel noted that

> ". . . such a generalization does not apply where, for example, one director has exclusive knowledge of facts affecting the value of stock."

386 F.2d at 736 n. 10.

CONCLUSION

In the only appellate decision, of which we are aware, considering a plaintiff's obligations in an implied private action under Rule 10b-5 involving intentional misconduct since the Supreme Court decided Ernst & Ernst v. Hochfelder, supra, the Court of Appeals for the Third Circuit rejected a rule that would bar a plaintiff from obtaining relief because of a lack of due diligence. Straub v. Vaisman & Co., Inc., supra,

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56/ See, e.g., Report of Investigation In the Matter of Sterling Homex Corporation Relating To Activities of the Board of Directors of Sterling Homex Corporation, Securities Exchange Act Release No. 11516 (Jul. 2, 1975), 7 SEC Docket 298 (Jul. 15, 1975).

57/ In Myzel, the court pointed out, for example, that an "improvident sale by an insider to a stranger or even another insider, based upon non-disclosed facts equally known or available to both parties, ordinarily would not be considered within the protective basis of Rule 10b-5." 386 F.2d at 736.

slip op. at pp. 10-11. Rather, as noted above, that Court adopted a flexible approach, focusing on the circumstances of each case, to determine whether a plaintiff had acted reasonably. Id., at 10. This approach, that court of appeals concluded, was most consistent with the intent and effect of the Ernst & Ernst decision. See page 25, supra.

We urge this Court to adopt a similar approach in determining the defendant's liability, if any, in the instant case.

Respectfully submitted,

HARVEY L. PITT
General Counsel

PAUL GONSON
Associate General Counsel

DAVID J. ROMANSKI
Assistant General Counsel

VERNON I. ZVOLEFF
Attorney

Securities and Exchange Commission
Washington, D.C. 20549

July, 1976

A P P E N D I X

APPENDIX

STATEMENT OF THE CASE

The Plaintiffs' Allegations

In their complaint, plaintiffs, K. Jay Holdsworth and his wife, Dona S. Holdsworth, alleged that the defendant, Kline D. Strong, violated Section 10(b) of the Securities Exchange Act and Rule 10b-5 and engaged in common law fraud, in connection with his purchase of their holdings of Sans-Copy common stock.

It appears that Jay Holdsworth and Mr. Strong, both of whom are attorneys, were very good friends who had engaged in a number of business transactions together over a period of years.[1/] One of those transactions involved establishing a corporation, known as Sans-Copy, Inc., to develop and market a time-keeping system to be utilized by law firms. Sans-Copy, which was formed in 1959, originally issued 60 shares of capital common stock -- 20 shares to Strong, 20 shares to the Holdsworths, and 20 shares to another individual named Tanner (and his wife) who had participated in the formation of that corporation. Subsequently, Sans-Copy issued an additional 40 shares of common capital stock, of which Strong and his wife received 32 shares, the Holdsworths and the Tanners 2 shares each, and the remaining 4 shares were allocated to an individual named

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1/ The description of the plaintiffs' complaint that follows is based upon the various briefs filed by the parties as well as the opinion of the district court and the initial, panel decision rendered by this Court.

Robert Shirley who was employed by Tanner[2/] and who apparently had some responsibility for Sans-Copy's books and records.[3/]

Three years later, in 1962, Sans-Copy issued a new class of non-voting stock which was designed to compensate Holdsworth and Tanner (who were not engaged in the corporation's work, as was Strong) by giving them a non-cumulative dividend preference over the ordinary common stock.[4/] The Holdsworths and the Tanners each received 30 shares of this new stock. At that time, the Board of Directors of Sans-Copy, which was composed of Strong, Holdsworth[5/] and Tanner, also passed a resolution to compensate Strong for his services at an appropriate rate. It appears that this resolution was based in part on the fact that Strong was going to take a more active role in the operations of Sans-Copy. In this connection, in 1962, all of the bookkeeping and recordkeeping functions, as well as the responsibilities for the receipt and disbursement of the funds of Sans-Copy, were transferred from Shirley to Strong.[6/]

Although regular financial reports had been supplied to the shareholders between 1959 and 1962, no financial reports were furnished after 1962 when Strong became more active in the operations of Sans-Copy. Moreover, no meetings of the Board of Directors were held for eleven years -- from 1962 until after this action was filed in May, 1973. From at least 1962, Strong has been in effective control of the day-to-day operations

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2/ District Court's findings of fact, ¶5.

3/ Id., at ¶7.

4/ Id., at ¶8.

5/ During periods relevant to the complaint herein, Holdsworth also was the Secretary of Sans-Copy.

6/ Id., at ¶7.

of Sans-Copy, and the Holdsworths and the Tanners have not substantially involved themselves in those activities since that time.[7/]

In January, 1971, Strong wrote to the Holdsworths and the Tanners, advising them that Sans-Copy had declared more in dividends in 1970 than it had funds in surplus and, therefore, that the funds which had been used to pay dividends had been charged to Sans-Copy's capital. The letter stated further that, because of this situation, Sans-Copy would not declare any dividends "for a month or two."[8/] However, Sans-Copy did not pay any dividends during the entire year of 1971.[9/]

In January, 1972, Strong orally stated to Holdsworth that Sans-Copy had not been able to pay any dividends during 1971 because it had no income and that it probably would not be able to pay any dividends in the future. During that conversation, Strong offered to purchase all of the Sans-Copy stock held by the Holdsworths for $1,500.[10/] That oral proposal was shortly confirmed in a letter, dated January 21, 1972. In that letter Strong indicated that he had already made a similar purchase offer to the Tanners and reiterated his doubts that Sans-Copy would be able to pay any dividends on the stock in the future.[11/]

7/ *Ibid*.

8/ *Id*., at ¶18.

9/ *Id*., at ¶23.

10/ *Id*., at ¶24. The Holdsworths' interests were comprised of the twenty-two shares of ordinary common stock that they had acquired about the time that Sans-Copy was formed, as well as reversionary interests in thirty shares of the nonvoting common stock which were held in trust for their children.

11/ *Id*., at ¶25.

The plaintiffs decided to accept Strong's offer, and sold all of their stock interests in Sans-Copy to him.[12/]

In May, 1973, the plaintiffs learned that Strong had misrepresented the condition of Sans-Copy to them, and they demanded the return of their stock, but Strong refused. On May 31, 1973, the plaintiffs filed this action against Strong, alleging that he had violated Section 10(b) of the Act and Rule 10b-5, and had committed common law fraud by intentionally misrepresenting to them the following material facts:

(1) that it would be unlikely that Sans-Copy would pay any dividends in the future;

(2) that Sans-Copy was not able to pay any current dividends on the preference stock; and

(3) that Sans-Copy would not be able to pay any dividends on the preference stock in the future.

The plaintiffs also alleged that Strong had omitted to state certain material facts, including:

(1) that Sans-Copy had substantial gross receipts for the year 1971;

(2) that certain deductions and expenses taken against gross receipts for 1971 and prior years were "unnecessary, unreasonable and excessive";

(3) that many of the deductions constituted payments to or for Strong or his relatives;

(4) that the price paid to the Holdsworths for their stock was not a fair price in light of the actual earnings of Sans-Copy, its history of growth and its future prospects; and

(5) that Strong had personally borrowed funds from Sans-Copy, a substantial amount of which had not been repaid.

12/ Id., at ¶26.

The plaintiffs also asserted that Strong had breached his fiduciary responsibilities to them based upon the special relationship of trust and confidence which existed between them.[13/]

The Decision of the District Court

The case was tried before the district judge, sitting without a jury. At the conclusion of the proceedings, the district judge announced that the plaintiffs had made out their case and were entitled to rescind their transaction with Strong. In finding for the plaintiffs, the district court concluded, based upon the evidence before it, that Strong's 1971 letter to the Holdsworths and the Tanners, concerning the inability of Sans-Copy to pay dividends in the future, was false and misleading.[14/] Contrary to the representation in that letter that dividends paid in 1970 had to be paid out of capital since they exceeded surplus, the court found that there "was in fact a surplus for the year 1970 . . . [and that there was] no impairment of capital."[15/] The district court found that the statements contained in that letter were known by Strong to be false at the time they were made. The court also concluded that those statements "were part of a device, scheme and artifice to defraud and were acts, practices and a course of dealing which operated and would operate as a fraud or deceit upon the plaintiffs."[16/]

In addition, the district court found that the oral statement by the defendant to Holdsworth in January, 1972 -- to the effect that Sans-Copy

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13/ Panel decision, Holdsworth v. Strong, [Current] CCH Fed. Sec. L. Rep. ¶95,465 at pp. 99,360-99, 361.

14/ See ¶19 of the district court's findings of fact.

15/ Id., at ¶18.

16/ Id., at ¶19.

could not have paid any dividends in the past and would not be able to pay any dividends in the future -- was false and misleading. Similar statements in the letter from the defendant Strong to plaintiffs, dated January 21, 1972, also were found by the district court to be false and misleading. As in the case of the January, 1971, statement, the court found that the representations made in January, 1972, "were false and were known by defendant to be false and were made by defendant as part of device, scheme and artifice to defraud plaintiffs by inducing the plaintiffs to sell their stock and were acts, practices and a course of dealing which operated as a fraud or deceipt upon the plaintiffs." 17/

In determining that the plaintiffs were entitled to rescind the transaction, the district court rejected the argument, apparently made by Strong, that the plaintiffs' failure to exercise due diligence with respect to the sale of their stock precluded rescission. 18/ The Court further stated that, although Holdsworth was a director and secretary of Sans-Copy at the time he had agreed to sell his stock to the defendant and made no demand to examine the books and records of Sans-Copy before selling his stock, "his failure to do so was excusable under the facts and circumstances of this particular case and in view of the relationship of the parties." 19/ In this connection, the court pointed out that Holdsworth and Strong were the "best of friends," and that they were engaged in another business transaction which was supervised by Holdsworth. 20/

17/ Id., at ¶27.

18/ The district court, however, apparently assumed the view that the plaintiffs' lack of due diligence, if it could be proven, would constitute a defense to the plaintiffs' cause of action under the federal securities laws.

19/ Id., at ¶29.

20/ Ibid.

The court held that, in any event, the books and records of Sans-Copy were of such a nature that "they did not reflect the true financial condition of the company or its ability to pay dividends." 21/ According to the court, those books "were incomplete . . . were adjusted and revised by defendant from time to time . . . [and they] did not contain detail or description sufficient to enable a person examining them to learn of the falsity of defendant's representations." 22/

The court found that Strong knew, at the time he misrepresented the ability of Sans-Copy to pay dividends, that the books and records of the corporation did not reflect the actual ability of Sans-Copy to pay dividends and that Sans-Copy could pay dividends but for his misappropriation of the assets of the corporation. 23/

The district court concluded that:

> "The evidence is clear and convincing that false representations were made concerning present existing material facts which representations defendant knew to be false and which representations were made for the purpose of inducing the plaintiff to sell their stock and that the plaintiffs did sell their stock, acting reasonably under the circumstances and in ignorance of the falsity of said representations and that the plaintiffs in fact relied upon said representations and were thereby induced to sell their stock." 24/

21/ *Id.*, at ¶30.

22/ *Ibid.*

23/ *Id.*, at ¶31.

24/ *Id.*, at ¶33.

The district court also found that the defendant had omitted to state material facts that were necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading.

The court found, for example, that, from 1961 through 1972, the gross receipts of Sans-Copy had increased significantly each year

(footnote continued)

In addition to the material misrepresentations and omissions of material facts it found, the district court concluded that the defendant had engaged in other acts and practices which operated as a fraud or deceit upon the plaintiffs. Thus, the court found that the defendant had appropriated the assets of the corporation to his own use, caused false entries to be made in the books and records of the corporation in such a way as to make it appear that the shares ot stock of Sans-Copy corporation were of little value, and, subsequent to 1969, the defendant

> "systematically and totally excluded plaintiffs from any information about the true financial and economic condition of Sans-Copy by not holding Shareholders or Directors meetings, by not supplying to plaintiffs any copies of tax returns or other financial reports, by not consulting with plaintiffs on any major business decisions of Sans-Copy and by otherwise failing to disclose material facts about Sans-Copy." 25/

The Panel Decision of the Court of Appeals

On appeal to this Court, the judgment of the district court granting rescission to the plaintiffs was reversed. The majority of the panel

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24/ (footnote continued)

and that these gross receipts were more than sufficient to pay all legitimate expenses and dividends at the level paid in the past or at higher levels; that Strong had not complied with the terms of his employment agreement and, instead, increased his compensation contrary to the terms of that agreement through various devices; that the termination of dividends in 1971 was for the purpose of inducing plaintiffs to believe that Sans-Copy was unable to pay dividends; and that Strong did not consider that loans he had made to himself through the funds of Sans-Copy were an obligation that he was required to repay. Id., at ¶35.

25/ Id., at ¶36.

hearing the appeal did not dispute the district court's conclusion that the defendant's misrepresentations and omissions were intentional.[26/] Rather, the majority concluded that, if the plaintiffs had reviewed the books and records of Sans-Copy prior to selling Strong their stock, those books would have reflected certain information that would have placed a reasonable person on notice that further inquiry was required.[27/] The majority held that this failure of the plaintiffs to have exercised "due diligence" to review the books and records of Sans-Copy precluded rescission of the stock transaction pursuant to Rule 10b-5, notwithstanding the intentional misconduct of defendant.

Although the panel decision recognized "the rarity in which due diligence has been allowed as a defense in intentional conduct situations,"[28/] it held that the facts of the case presented a situation requiring its application. In this connection, the Court pointed out that the relationship of the parties could not excuse the plaintiffs' failure to make an investigation prior to the stock transaction. Holdsworth was an attorney and a sophisticiated investor, and he had served as an officer and director of the corporation for many years. The Court concluded that the plaintiff had "apparently acquiesced in, and certainly was aware of the informal manner in which corporate affairs were handled"

26/ [Current] CCH Fed. Sec. L. Rep. ¶95,465 at p. 99,363.

27/ The majority of the panel in this case cited certain findings of fact made by the district court to support its conclusion in this regard. Id. at p. 99,362 n. 6.

28/ Id., at p. 99,363.

by Strong. [29/] Under these circumstances, the majority concluded that the plaintiffs' inaction did not satisfy the standard of due diligence it believed was required for relief based on Rule 10b-5. [30/]

In dissenting from the majority's conclusion that the failure of the plaintiff to have exercised due diligence precluded rescission pursuant to Rule 10b-5, Judge Doyle pointed out that, when analyzed, the cases relied on by the majority, for the proposition that due diligence is required on the part of the plaintiff in a 10b-5 action, did not provide support for that result. [31/] He further pointed out that, whatever may be the applicability of a due diligence standard in other actions under Rule 10b-5, it is not applicable where the misrepresentations are shown to have been intentional. In such situations, Judge Doyle stated,

> "there seems little point in allowing the defendant to escape merely because the plaintiff was a negligent victim. The reason for this conclusion is that no legal relationship exists between intentional harm and contributory negligence." [32/]

He further stated that, even if a due diligence standard were applicable in this case, "the close relationship of trust and confidence between Holdsworth and Strong renders the negligence irrelevant." [33/]

29/ Ibid. We are unaware of any district court finding on which this factual conclusion is based.

30/ As already noted (p. 2, *supra*), the Court also concluded that the plaintiffs had failed to bear the burden under Utah law of establishing that they had suffered injury or detriment.

31/ [Current] CCH Fed. Sec. L. Rep. ¶95,465 at p. 99, 364.

32/ Id., at p. 99,365.

33/ Ibid. Judge Doyle also disagreed with the majority's application of Utah law relating to common law fraud. In his view, all that a plaintiff need show is fraud together with an injury. He concluded that the plaintiffs were certainly injured by the misdeeds of the managing officer of the corporation in which they had purchased stock. Such injury was sufficient, in his view, to obtain the equitable relief requested.

CERTIFICATE OF SERVICE

I hereby certify that, on this 6th day of July, 1976, I caused copies of the Brief of the Securities and Exchange Commission, Amicus Curiae, on Rehearing En Banc to be mailed, postage paid to Counsel for Appellant and Counsel for Appellees as follows:

Harold G. Christensen
Worsley, Snow & Christensen
700 Continental Bank Building
Salt Lake City, Utah 84101
Attorneys for Appellees

Clifford L. Ashton
Brent M. Stevenson
Van Cott, Bagley, Cornwall & McCarthy
Suite 300, 141 East First South
Salt Lake City, Utah 84111
Attorneys for Appellant

Edwin S. Kahn
Holland & Hart
500 Equitable Building
Denver, Colorado 80202

Of Counsel for Appellant

____
Vernon I. Zvoleff