Rudder-Brug

UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 79-3712

RALPH E. HUDDLESTON and CHESTER E.
BRADLEY, JR., Individually and as
designated Class Representatives,

Plaintiffs-Appellees,

v.

HERMAN & MACLEAN, etc., *et al.*,

Defendants,

HERMAN & MACLEAN, Certified Public
Accountants, a partnership, and
LAWRENCE A. LOPATIN, LESLIE SHARE,

Defendants-Appellants.

MEMORANDUM OF THE SECURITIES AND EXCHANGE COMMISSION, *AMICUS CURIAE*, ON PETITION FOR REHEARING AND REHEARING *EN BANC*

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MEMORANDUM OF THE SECURITIES AND EXCHANGE COMMISSION, AMICUS CURIAE, ON PETITION FOR REHEARING AND REHEARING EN BANC

INTEREST OF THE SECURITIES AND EXCHANGE COMMISSION

The Securities and Exchange Commission, the agency primarily responsible for the administration and enforcement of the federal securities laws, submits this memorandum, amicus curiae, on the pending petition for rehearing and rehearing en banc of this Court's decision of March 9, 1981. While the Commission has no interest in the outcome of this litigation between private parties and thus takes no position on the ultimate resolution of this appeal, the Commission is concerned that the panel's treatment of certain legal issues may have a significant adverse impact

on the goal of investor protection embodied in the federal securities laws.

The panel decision in this private damage action alleging violations of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b-5 thereunder, 17 CFR 240.10b-5, as well as of state law, comprehensively treats the procedural and substantive requirements of the federal cause of action. In their petition, plaintiffs-appellees seek rehearing on six separate grounds. In this memorandum the Commission addresses two of those grounds: the appropriate standard of proof in a Rule 10b-5 action (an issue which was not briefed prior to the panel decision) and the treatment of reliance as an element in such an action. The Commission believes that the panel's determination that a plaintiff in a Rule 10b-5 action must prove his case by clear and convincing evidence, rather than by a preponderance of the evidence, and its articulation of the legal standards relating to proof of the plaintiff's reliance as well as its failure to recognize alternative means of proving causation-in-fact represent an erroneous and unduly restrictive view of the protections afforded by the antifraud prohibitions of Rule 10b-5.

The Commission is concerned that the legal standards articulated in this decision, if applied in future cases, could have serious adverse effects on the enforcement of the federal securities laws through actions brought by private parties. Such private actions, particularly class actions such as the present case, serve as a "necessary supplement" to the Commission's own enforcement activities and provide an essential means of redress for injured investors. Mills v. Electric Auto-Lite Co., 396 U.S. 375, 382 (1970); J. I. Case Co. v. Borak, 377 U.S. 426, 432 (1964). Moreover, this

Court's reconsideration of the panel's statements regarding reliance could provide an invaluable precedent in future actions in which questions are raised concerning causation-in-fact and the distinct concept of proximate cause (or legal causation), with which it is "often hopelessly confused * * *." W. Prosser, Handbook of the Law of Facts § 42, at 244 (4th ed. 1971). Reconsideration is further warranted because, if the requirement of proof by clear and convincing evidence adopted by the panel should be extended to actions brought by the Commission, it could have serious ramifications for the Commission's own enforcement program. 1/

STATEMENT 2/

Plaintiffs, the appellees in this class action, are purchasers of the securities of Texas International Speedway, Inc. ("TIS"), an entity formed to build and operate an automobile race track. TIS first publicly offered securities in October, 1969. The class plaintiffs include those persons who purchased TIS securities, having received a prospectus, either in the initial offering or in the over-the-counter market, between October 30, 1969 and January 28, 1970. In November, 1970, TIS filed a petition under Chapter X of the Bankruptcy Act. The appellants in this case, defendants below, include Lawrence LoPatin, the former president, treasurer, and a director of TIS; Leslie Share, the former executive vice-president and a director of TIS; and Herman & MacLean, the accountants who certified the financial statements contained in the prospectus.

1/ Of course, neither causation-in-fact nor proximate causation is an element of a Commission injunctive action.

2/ This statement is taken from the panel's opinion of March 9, 1981, reported at 640 F.2d 534.

The jury in this case found (640 F.2d at 540 n.2)

— that the TIS prospectus was materially misleading as to the land, construction, and start up costs for the speedway track, and TIS' working capital position on October 30, 1969;

— that the defendants failed to make proper disclosures concerning those matters, acting with reckless disregard for the truth;

— that Messrs. LoPatin and Share were responsible for the falsity of the TIS balance sheet employed in the prospectus concerning cash on hand and that they omitted to state that a large loan was obtained from a company affiliated with the principal contractor of the speedway;

— that Mr. Share was responsible for the fact that an engineering firm had permitted the use of its name in the prospectus as an expert when it had not performed due diligence procedures to ascertain the accuracy of cost estimates used in the prospectus; and,

— that Herman & MacLean, the accountants, aided and abetted the unlawful conduct of Messrs. LoPatin and Share.

On appeal from a judgment for the plaintiffs, this Court, in its March 9, 1981 decision, granted the defendants a new trial because it concluded that the trial court had erred in refusing the defendants' request that it submit issues of reliance and proximate causation to the jury. According to the panel, the district court (id. at 548) "confused materiality with reliance" and improperly concluded (id. at 549) that reliance and proximate causation are questions of law, rather than fact. Further, stating that the issue of the appropriate standard of proof would "doubtless arise as an issue in the new trial" (id. at 546 n. 19), the panel addressed that issue sua sponte, concluding that the proper standard is that of clear and convincing evidence (id. at 545-546).

DISCUSSION

A. The Standard of Proof for Rule 10b-5 Actions

The panel in this case ruled that clear and convincing evidence is required to prove each element of a private damage action for violation of Rule 10b-5. This holding is the only authority of which we are aware which imposes that standard of proof for Rule 10b-5 actions; the panel's holding is contrary to well-recognized authority which utilizes a preponderance of the evidence standard of proof for cases arising under the antifraud provisions of the federal securities laws. Further, the panel disregarded the requirement set forth in Addington v. Texas, 441 U.S. 418 (1979), that the determination of the appropriate standard of proof is to be based on a balancing of the interests of the opposing litigants. And, the panel relies on common law fraud cases which have used the clear and convincing standard, while failing to appreciate the differences between Rule 10b-5 and the common law of deceit, and also failing to give any consideration to what we believe are the better reasoned common law authorities, which use the preponderance standard. For these reasons, we urge reconsideration of the panel's holding on this question.

1. The Recognized Standard of Proof in Actions Under the Antifraud Provisions of the Federal Securities Laws is the Preponderance of the Evidence.

The traditional standard of proof in a civil action is the preponderance of the evidence. In one of its first opinions under the federal securities laws, Securities and Exchange Commission v. C.M. Joiner Leasing Corp., 320 U.S. 344, 355 (1943), the Supreme Court held that a preponderance of the evidence was sufficient to show a violation of Section 17(a) of the Securities Act, 15 U.S.C. 77q(a) -- a provision that is virtually identical to Rule

10b-5. 3/ In response to an argument that the potential for criminal application of the federal securities laws compelled strict construction of those laws even when suits were brought in a civil context, the Supreme Court held that those statutes must be liberally construed, and that

> "Where this proof [of the existence of a security within the meaning of the Act] is offered in a civil action, as here, a preponderance of the evidence will establish the case * * *."

Id. (emphasis supplied).

In keeping with the Supreme Court's holding in Joiner, the federal courts have traditionally applied the preponderance standard to proof of the various elements in causes of action under antifraud provisions of the federal securities laws. For example, in Miley v. Oppenheimer & Co., Inc., 637 F.2d 318, 328 (5th Cir. 1981), a private suit under Rule 10b-5 against a broker-dealer for "churning" a customer's account, the appellant challenged the jury instructions on damages. The instruction directed the jury to find the facts relevant to damages "by a preponderance of the evidence." Id. Faced with a challenge to the adequacy of the instruction, this Court, although not specifically addressing the question of the appropriate standard of proof, concluded that "Judge Mahon's instructions on compensatory damages were not only unobjectionable, but deserving of praise." Id. at 329. Similarly, in Mihara v. Dean Witter & Co., Inc., 619 F.2d 814, 824-825 (9th Cir. 1980), the Ninth Circuit upheld the "standard jury instructions" 4/ on churning -- instructions which call for the

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3/ See Aaron v. Securities and Exchange Commission, 446 U.S. 680, 696 (1980) (comparing Rule 10b-5(b) and Section 17(a)(2)).

4/ Those instructions were taken from DeVitt & Blackmar, Federal Jury Practice and Instructions, § 98.13 (3d ed. 1977). 619 F.2d at 824. This Circuit's own Pattern Jury Instructions for Civil Cases, published as a 1980 supplement to that treatise, state that in an action brought under Section 10(b) of the Securities Exchange Act "the Plaintiff must establish each of the * * * elements by a preponderance of the evidence." DeVitt & Blackmar, supra, at 37 (1980 Supp.).

"preponderance of the evidence" to show a violation of Rule 10b-5. Likewise, other cases under the antifraud provisions have accepted the use of the preponderance standard. 5/

2. A Proper Balancing of the Interests Involved in This Case Requires Use of the Preponderance of the Evidence Standard.

Under the analysis of Addington v. Texas, supra, 441 U.S. at 423-427, selection of the appropriate standard of proof requires a balancing of the interests of the opposing litigants. In Addington, where the Supreme Court considered the standard of proof applicable in a state proceeding to involuntarily incarcerate a mental patient, the Court noted that "the individual should not be asked to share equally with society the risk of [factual] error when the possible injury to the individual is significantly greater than any possible harm to the state." Id. at 427. However, when both sides to the controversy have approximately equal interests in avoiding errors, they should "share the risk of error in roughly equal fashion." Id. at 423.

5/ See G.A. Thompson & Co. v. Partridge, 636 F.2d 945, 953-954 (5th Cir. 1981) (this Court, in discussing the "due diligence" instructions in a Rule 10b-5 action, noted that the district court had employed a "preponderance-of-the-evidence" standard of proof); G.A.F. Corp. v. Milstein, 453 F.2d 709, 718 (2d Cir. 1971), cert. denied, 406 U.S. 910 (1972) (the court stated that the plaintiffs should have an opportunity to prove their case by a "fair preponderance of the evidence" in an injunctive action under Sections 10(b) and 13(d) of the Securities Exchange Act, 15 U.S.C. 78j(b), 78m(d)); Globus v. Law Research Services, 418 F.2d 1276, 1291 (2d Cir. 1969), cert. denied, 397 U.S. 913 (1970) (the court held, in an action brought under Section 17(a) of the Securities Act and Section 10(b) and Rule 10b-5 under the Securities Exchange Act, that causation was properly shown "by a fair preponderance of the evidence"); University Hill Foundation v. Goldman, Sachs & Co., 422 F. Supp. 879, 897 (S.D.N.Y. 1976) (the court held that the plaintiffs had established their case under Section 12(2) of the Securities Act, 15 U.S.C. 77l(2), and Section 10(b) of the Securities Exchange Act "by a preponderance of the evidence"). But see Securities and Exchange Commission v. Tip Top Gold Mines, Inc., 1 SEC Jud. Dec. 374 (D. Colo. 1937) (prior to the Supreme Court's decision in Securities and Exchange Commission v. C. M. Joiner, the court held in an action under Section 17(a) of the Securities Act that fraud must be shown by "clear and satisfactory evidence").

In this case, a proper balancing of interests calls for the preponderance standard. The traditional civil preponderance of the evidence standard puts both parties at roughly the same risk of error. A standard of proof more stringent than the traditional preponderance standard protects the favored party against an erroneous decision that is adverse to him, but increases the overall likelihood of error. This special measure of protection for a defendant at the cost of increased error is tolerable only when the possible injury to the defendant is significantly greater than the possible harm to the plaintiff. Where, as here, the interests of persons who are alleged to have intentionally or recklessly participated in the fraudulent sale of securities to the public do not outweigh the interests of investors who purchased those securities, the very class of persons the federal securities laws were designed to protect, there is no valid reason to impose a greater risk of error on the investors. In the present context, a preponderance of the evidence standard of proof that asks the alleged wrongdoers "to share equally with * * * [the victims] the risk of error" (Addington v. Texas, supra, 441 U.S. at 427) is fair and should not be replaced by a standard of proof that shifts the burden to defrauded investors. See Steadman v. Securities and Exchange Commission, 603 F.2d 1126, 1139 (5th Cir. 1979), affirmed on other grounds, 49 U.S.L.W. 4174 (U.S., Feb. 25, 1981).

The panel opinion states that "proof of intent to deceive is often a matter of inference" and that "judgment for the plaintiff detracts from the defendant's reputation to a far greater extent than in other civil litigation" as justification for a higher standard of proof (640 F.2d at 546 n.19). Neither of these considerations warrants placing the risk of error on innocent investors.

Reliance on inferential or circumstantial evidence to prove mental state does not make the preponderance of the evidence standard inappropriate.

In Vance v. Terrazas, 444 U.S. 252, 267 (1980), the Supreme Court upheld the preponderance of the evidence standard in a case requiring proof of specific intent to relinquish citizenship. The Court noted that the duty to prove the state of mind element was "in itself a heavy burden" that militates in favor of using the preponderance standard of proof. Moreover, reliance on circumstantial or inferential evidence should not require a higher standard of proof, since, as the Supreme Court has recognized, "[c]ircumstantial evidence is not only sufficient, but may also be more certain, satisfying and persuasive than direct evidence." Michalic v. Cleveland Tankers, Inc., 364 U.S. 325, 330 (1960). In fact, the Supreme Court in Securities and Exchange Commission v. C.M. Joiner Leasing Corp., supra, 320 U.S. at 355, has recognized the value of circumstantial evidence in proving violations of the antifraud provisions of the federal securities laws without imposing a higher standard of proof for such cases. For these reasons we see nothing unusual or improper about relying on inferences to prove state of mind in a civil proceeding. This is a commonplace inquiry in federal courts and the task is traditionally performed pursuant to the preponderance of the evidence standard of proof.

The possible blemish to the reputation of persons liable for civil damages for federal securities fraud falls far short of the constitutional rights or other extraordinary interests which the Supreme Court has held warrant a higher standard of proof. Those exceptional situations in which a higher standard of proof has been employed differ fundamentally from the type of interest involved here and highlight the inappropriateness of using a clear and convincing evidence standard in this case. For example, the Supreme Court has required clear and convincing evidence before an individual may be stripped of personal freedom and confined indefinitely in a mental

institution. Addington v. Texas, supra. Similarly, clear and convincing evidence is required before an individual can be forced to endure the "drastic deprivations" of deportation. Woodby v. Immigration and Naturalization Service, 385 U.S. 276, 285 (1966). Plainly these interests are more substantial than the interests sought to be protected here. Indeed, in Vance v. Terrazas, supra, 444 U.S. at 266-267, the Supreme Court held that the clear and convincing standard of proof is not required even where the proceeding has a potential result as harsh as expatriation. The Court in Terrazas explained that, while "in criminal and involuntary commitment contexts we have held that the Due Process Clause imposes requirements of proof beyond a preponderance of the evidence," expatriation proceedings "are civil in nature and do not threaten loss of liberty." Id. at 266. A fortiori, the risk to reputation of persons who have committed securities fraud does not compel an extraordinary standard of proof.

3. A Higher Standard of Proof is Not Required Simply Because the Proceeding Involves Charges of Violations of the Antifraud Provisions of the Federal Securities Laws.

The panel also imposed the higher standard of proof because, it stated, "[t]he traditional burden of proof imposed in cases involving allegations of civil fraud is the 'clear and convincing' evidence standard" (640 F.2d at 545-546). But proceedings under the federal securities laws are substantially different from common law fraud actions; and even if common law fraud cases were relevant, the better reasoned authorities recognize that the preponderance of the evidence standard governs.

The antifraud provisions of the federal securities laws are not coextensive with common law doctrines of fraud and deceit. See generally Blue Chip Stamps v. Manor Drug Stores, 421 U.S 723, 744-745 (1975). Congress enacted the federal

securities laws to remedy inadequacies in the common law. "A fundamental purpose, common to [the federal securities] statutes, was to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry." Securities and Exchange Commission v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963). Thus, the antifraud provisions of the federal securities laws differ substantially from the common law action for deceit, which was available for misrepresentations but traditionally did not recognize actions for nondisclosure or half-truths. See W. Prosser, Handbook of the Law of Torts § 106 at 695-696 (4th ed. 1971). The federal securities laws were enacted in large part to remedy the inadequacies of the common law in dealing with practices associated with contemporary commerical realities. It is incongruous, therefore, to rely on standards of proof developed for the restrictive common law actions which Congress found inadequate.

Reliance on common law fraud decisions is also unavailing because the better considered common law authorities approve the preponderance of the evidence standard rather than the clear and convincing evidence standard. As the Supreme Court observed in Securities and Exchange Commission v. Capital Gains Research Bureau, Inc., supra, 375 U.S. at 194:

> "There has * * * been a growing recognition by common-law courts that the doctrines of fraud and deceit which developed around transactions involving land and other tangible items of wealth are ill-suited to the sale of such intangibles as [investment] advice and securities, and that, accordingly, the doctrines must be adapted to the merchandise in issue."

Thus, some state courts have declined to apply a more stringent standard of proof in cases involving allegations of fraud when securities were involved

or when violations of state blue sky laws were at issue. 6/

Furthermore, even outside the area of securities fraud "[t]he policy of placing such a special burden [the clear and convincing evidence requirement] on one who claims to be the victim of fraud is debatable." McCormick on Evidence, § 340 at 797 n.74 (2d ed. 1972). The better reasoned state court decisions, in a significant number of states, hold that there is no sound reason for according special evidentiary benefits to those accused of fraud at the expense of those claiming to be their injured victims, and they have explicitly adhered to the preponderance of the evidence standard of proof when fraud is at issue. 7/

6/ See, e.g., S & F Supply Co. v. Hunter, 527 P.2d 217, 220-221 (Utah 1974) (to obtain redress under state antifraud provisions plaintiff must show elements of the violation by a preponderance of the evidence). See also 11C (Part 2) H. Sowards & N. Hirsch, Business Organizations Blue Sky Regulation § 6.01, at 6-4 to 6-5 (1979) (footnote omitted):

> "The nature of the blue sky laws virtually demands that they be liberally interpreted in order to effectuate the antifraud purposes. This * * * has altered the principle governing the weight of evidence in civil cases. * * * [F]raud actions brought under the blue sky laws have been decided in some states according to a fair preponderance of the evidence, which has been described as a probability of belief by triers of fact."

7/ ARKANSAS: Ray Dodge, Inc. v. Moore, 251 Ark. 1036, 1041, 479 S.W.2d 518, 521-522 (1972); CALIFORNIA: Liodas v. Sahadi, 562 P.2d 316, 321-323, 137 Cal. Rptr. 635, 639-643 (1977); COLORADO: Goodfellow v. Kattnig, 533 P.2d 58, 60 (Colo. App. 1975); FLORIDA: Rigot v. Bucci, 245 So.2d 51, 53 (1971); Blaeser Development Corp. v. First Federal Savings & Loan Ass'n., 375 So.2d 1118 (Fla. App. 1979); INDIANA: Grissom v. Moran, 154 Ind. App. 419, 427, 290 N.E.2d 119, 123 (1972); MONTANA: Cowan v. Westland Realty Co., 162 Mont. 379, 383, 512 P.2d 714, 716 (1973); NEW JERSEY: Medivox Productions, Inc. v. Hoffman-LaRoche, Inc., 107 N.J. Super. 47, 69, 256 A.2d 803, 814-815 (1969); OHIO: Household Finance Corp. v. Altenberg, 5 Ohio St.2d 190, 214 N.E.2d 667 (1966); RHODE ISLAND: Smith v. Rhode Island Co., 39 R.I. 146, 153-154, 98 A. 1, 4 (1916); SOUTH DAKOTA: General Electric Credit Corp. v. M.D. Aircraft Sales, Inc., 266 N.W.2d 548, 550 (1978); TEXAS: Hamm v. Crockett, 576 S.W.2d 871, 872 (Tex. Ct. App. 1979); VERMONT: In re Delligan's Estate, 111 Vt. 227, 234-235, 13 A.2d 282, 287 (1940). See also Jensen v. Sohler, 601 F.2d 353, 354-355 (8th Cir. 1979).

While state court decisions in non-statutory fraud cases have sometimes employed a clear and convincing evidence standard, particularly when certain types of equitable relief have been sought, 8/ the use of the higher standard generally has rested on historical considerations that have no pertinence here. The practice of requiring a more stringent standard of proof appears to have arisen in equity actions in which the chancellor was requested to grant relief on claims that were unenforceable at law for failure to comply with the Statute of Frauds or the Statute of Wills, and the higher standard was subsequently applied in actions seeking to set aside or alter the terms of written instruments. A higher standard of proof was employed in such cases because they were believed to involve special dangers that claims might be fabricated. See Note, "Appellate Review in the Federal Courts of Findings Requiring More than a Preponderance of the Evidence," 60 Harv. L. Rev. 111, 112 (1946). 9/

The concerns expressed in these cases have no relevance here. Regulation under the securities laws of the conduct of persons seeking to distribute securities to the investing public poses no danger to the sanctity of written documents. More fundamentally, imposition of a standard of proof borrowed from inapposite common law cases would undermine the important purposes of the federal securities laws, which Congress enacted to remedy inadequacies in

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8/ See 9 J. Wigmore, Evidence § 2498 (3d ed. 1940).

9/ See Ray Dodge, Inc. v. Moore, supra, 251 Ark. at 1041, 479 S.W.2d at 521 ("Clear and convincing evidence of fraud is required to cancel or reform a solemn writing, but not to establish fraud in obtaining a contract by fraudulent misrepresentation."); Household Finance Corp. v. Altenberg, supra, 5 Ohio St.2d 190, 214 N.E.2d 557; In re Delligan's Estate, supra, 111 Vt. at 234-235, 13 A.2d at 287. This same rationale, i.e., the protection of written documents, is apparent in most of the instances in which Dean Wigmore states that "'clear and convincing proof' is commonly applied." 9 J. Wigmore, Evidence § 2498 at 329 n.13 (3d ed. 1940); see Note, supra, 60 Harv. L. Rev. at 112 n.7.

common law protections. It is inconceivable that Congress would have intended to distort the fact-finding process under these statutes so that persons charged with fraud would be absolved of the consequences even though the preponderating weight of the evidence showed their misconduct.

4. To Extend the Clear and Convincing Standard of Proof to District Court Enforcement Actions Brought by the Commission Would Create an Anomalous Result in Light of the Supreme Court's Recent Decision in Steadman v. Securities and Exchange Commission Holding the Preponderance Standard Applicable to the Commission's Administrative Proceedings.

While the Commission believes, for the reasons discussed above, that the panel erred in rejecting the preponderance standard of proof in this private damage action, we are also troubled about the possible implications that this ruling may have for the Commission's own enforcement actions. We are concerned that the reasoning used in rejecting the preponderance standard here might be viewed as supporting the same result in district court actions brought by the Commission.

In Steadman v. Securities and Exchange Commission, 49 U.S.L.W. 4174 (U.S., Feb. 25, 1981), the Supreme Court upheld the use of the preponderance standard in Commission administrative proceedings. While the Court based its holding on an interpretation of Section 7(c) of the Administrative Procedure Act, a provision not applicable in court cases, this Court in its own earlier decision in Steadman, 603 F.2d 1126 (1979), had reached the same result under the balancing analysis contemplated by Addington v. Texas, an analysis with which the Supreme Court expressed no disagreement. This Court had reasoned that the possible risk to a respondent in a Commission administrative proceeding was not significantly greater than the possible risk to the Commission if "its ability to police the [securities] industry is impaired." 603 F.2d at 1142. Thus, this Court concluded that the parties to such a proceeding should

bear the risk of factual error equally by applying the preponderance of the evidence standard.

The public interest served by Commission injunctive actions brought in district court is no less than that served by Commission administrative proceedings, and from the point of view of the defendant or respondent in such proceedings the potential for detriment arising from an injunctive action is certainly no greater than that arising from an administrative proceeding. Indeed, the potential for harm may well be greater in the administrative context, where the Commission has the authority to bar people from their chosen occupations. Under these circumstances, it would be anomalous to require a clear and convincing standard in a Commission injunctive action while permitting the imposition of sanctions on the basis of a preponderance standard in a Commission administrative proceeding.

In Steadman, the Supreme Court was satisfied that the intent of Congress, as set forth in the Administrative Procedure Act, was for agencies to utilize the preponderance standard in administrative proceedings where fraud was to be found and where it was possible that a person could be barred from further pursuit of his livelihood in a regulated business. Use of the preponderance standard in proceedings brought in district court instituted under the same remedial statutes would harmonize, rather than distort, the statutory scheme for protection of investors. 10/

10/ The question of the appropriate standard of proof in Commission injunctive actions is presently before this Court in Securities and Exchange Commission v. First Financial Group of Texas, Inc., No. 79-3420, which was argued on February 10, 1981.

B. Reliance and Causation-in-Fact

1. The Panel's Rulings and the Commission's Position

The panel's decision contains an extensive discussion of the concepts of reliance and proximate cause. The panel stated that, in addition to proof of materiality, proof of reliance and of the related, but distinct, concept of proximate causation is a prerequisite to recovery in a Rule 10b-5 action.

The panel discussed reliance first. Reading the Supreme Court's decision in Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972), as holding that there is a presumption of reliance in certain cases, the panel followed prior decisions of this Court holding that the presumption may be rebutted by the defendant. The panel further held (640 F.2d at 548) that the presumption applies only where a case involves "primarily a failure to disclose, implicating the first or third subparagraph of * * * Rule [10b-5]," and not where the case involves "primarily a misstatement or failure to state a fact necessary to make those statements not misleading, classified under the second subparagraph of the Rule * * *." Here, concluding that misstatements and omissions were involved, the panel refused to apply the presumption.

The panel went on to reconfirm the holding in Simon v. Merrill Lynch, Pierce, Fenner and Smith, Inc., 482 F.2d 880, 884-885 (5th Cir. 1973), that "subjective reliance" alone is not sufficient to satisfy the reliance requirement (640 F.2d at 548). Rather, the panel stated, it is necessary to prove "due diligence" on the part of the plaintiff, as well as his subjective reliance (id.).

Turning to proximate causation, the panel concluded that the "but for" link established by reliance is not a sufficient ground for recovery. In addition, the panel required a plaintiff to show that the misrepresentation

was the proximate cause of his loss -- i.e., that it "touche[d] upon the reasons for the investment's decline in value." (Id. at 549).

The Commission does not disagree with the panel's articulation of the concept of proximate cause, but submits that the panel's analysis of reliance -- the usual method of demonstrating causation-in-fact between the injury suffered by the plaintiff and the deception practiced by the defendant -- is unduly restrictive in several respects. In our view, the panel erred in confining the Affiliated Ute presumption of reliance to situations involving pure non-disclosure. That presumption should also be applied to cases involving an omission of material fact necessary to make the statements made not misleading. In addition, the panel ignored a range of other cases in which a plaintiff should not be required to demonstrate his individual reliance. In those cases, involving market fraud or involving deception in connection with a public offering by the issuer, the deception injures the plaintiff, irrespective of his own reliance, because causation-in-fact arises through other means. Finally, a plaintiff should not be required to prove that his conduct was not reckless. Rather, "due diligence" should be treated as an affirmative defense, and a Rule 10b-5 plaintiff who has demonstrated the defendant's culpability should recover unless the defendant establishes the plaintiff's recklessness.

2. A Plaintiff Should Not be Required to Prove Reliance in Cases Involving Half-Truths.

Historically, the plaintiff's proof of reliance (a form of causation-in-fact) was required in a common-law action for misrepresentation because it is a means of establishing a causal connection between the defendant's misconduct and the course of conduct undertaken by the plaintiff, which in turn results in

harm suffered by the plaintiff. See W. Prosser, Handbook of the Law of Torts § 108 (4th ed. 1971); List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir.), cert. denied, 382 U.S. 811 (1965). Proof of proximate or legal causation, which was also required, served to establish that the plaintiff's injury was a reasonably foreseeable consequence of the defendant's misconduct. W. Prosser, Handbook of the Law of Torts, supra, § 110 at 732. As the law under Rule 10b-5 developed through judicial interpretation, courts imported various of the elements of the related tort cause of action for misrepresentation, including the elements of causation-in-fact and proximate cause. See generally, III L. Loss, Securities Regulation 1430-1432 (1961); Note, "Rule 10b-5, The Elements of a 10b-5 Cause of Action," 43 N.Y.U.L. Rev. 541 (1968); Note, "Civil Liability Under Section 10b and Rule 10b-5: A Suggestion for Replacing the Doctrine of Privity," 74 Yale L.J. 658, 671-674 (1965).

The distinction between these two types of causation can be illustrated by the following example. A company attempts to sell securities to investors by misrepresenting its earnings. Relying on those misrepresentations, certain investors purchase the securities. The company subsequently becomes insolvent, and the securities become worthless. However, the insolvency resulted, not because of an earnings deficiency, but rather because of an unexpected natural disaster which destroyed the company's plant and equipment. Under these circumstances, the investors can establish causation-in-fact: the defendants' misrepresentations induced the plaintiff investors to purchase the securities and, thus, the misrepresentations were a "substantial factor" in bringing about the harm suffered by the plaintiffs. W. Prosser, Handbook of the Law of Torts § 41, at 240 (4th ed. 1971). The plaintiffs, however, may not be able to

establish that the defendants' misrepresentations were the proximate cause of most of the plaintiffs' injury. While it was foreseeable that, in light of the misrepresentation as to earnings, the plaintiffs' stock would be worth somewhat less than the purchase price, the zero value caused by factors unrelated to the subject of the misrepresentation could not reasonably be anticipated. Id., § 110 at 732.

While proximate cause has been the subject of some litigation (see, e.g., Moody v. Bache & Co., Inc., 570 F.2d 523 (5th Cir. 1978)), the focus of Rule 10b-5 authority in the causation area has been causation-in-fact or reliance. An important case dealing with reliance is Affiliated Ute Citizens v. United States, supra, 406 U.S. at 153, where the Supreme Court held that when the fraud involves "primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery." Rather, the Court stated (id.),

> "all that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision. * * * This obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact." 11/

In holding that there are situations where the plaintiff is not required to demonstrate his reliance in order to recover, the Ute Court did not state whether the defendant in such cases would be permitted to prove that the plaintiff

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11/ In Ute, the defendant bank employees induced the plaintiff holders of stock to sell their shares without disclosing to them that the defendants were in a position to gain financially from the sales and that the shares were selling at a higher price in another market which the defendants had themselves developed. The Supreme Court noted that "as to some of the [sellers], these defendants may have made no positive representation or recommendation." 406 U.S. at 153.

Although not relevant here, the Supreme Court has raised the threshold of materiality to require that "[a]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would find it important * * *." TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 448 (1976).

did not in fact rely on the deceptive statements. The Court, however, did not suggest that it intended to dispense with the element of causation-in-fact in a Rule 10b-5 action. Thus, subsequent to Ute, the lower courts have generally interpreted the Ute ruling as establishing a presumption of reliance upon a showing of materiality — a presumption which the defendant may rebut by demonstrating the plaintiff's lack of reliance. 12/

Nor did the Ute Court articulate a rationale for dispensing with plaintiff's proof of reliance. The general consensus reached following Ute is that the Ute rule is justified by the difficulties of proof which would be created by requiring the plaintiff affirmatively to prove reliance in a nondisclosure case. The plaintiff could be forced "to demonstrate that he had in mind the converse of the omitted facts, which would be virtually impossible to demonstrate in most cases." 13/ Alternatively, reliance could be established if the plaintiff demonstrated that he would have acted differently if he had known the truth. 14/ But, that standard is also difficult to apply since the proof of such "a hypothetical course of action" 15/ is inherently speculative.

12/ Simon v. Merrill Lynch, Pierce, Fenner & Smith, 482 F.2d 880, 883-885 (5th Cir. 1973); Continental Grain (Australia) Pty. Ltd. v. Pacific Oilseeds, Inc., 592 F.2d 409, 412 n. 1 (8th Cir. 1979); Sundstrand Corp. v. Sun Chemical Corp., 553 F.2d 1033, 1048 (7th Cir.), cert. denied, 434 U.S. 875 (1977); Chelsea Associates v. Rapanos, 527 F.2d 1266, 1271-1272 (6th Cir. 1975); Rochez Bros. Inc. v. Rhoades, 491 F.2d 402, 410 (3d Cir. 1974), cert. denied, 425 U.S. 933 (1976).

13/ Note, "The Reliance Requirement in Private Actions Under SEC Rule 10b-5," 88 Harv. L. Rev. 584, 590 (1975); see Moody v. Bache & Co., Inc., supra. 570 F.2d at 528; Dupuy v. Dupuy, 551 F.2d 1005, 1015 (5th Cir.), cert. denied, 434 U.S. 911 (1977); Titan Group, Inc. v. Faggen, 513 F.2d 234, 238 (2d Cir.), cert. denied, 423 U.S. 840 (1975).

14/ See List v. Fashion Park, Inc., supra 340 F.2d at 462-463.

15/ Note, "The Reliance Requirement in Private Actions Under SEC Rule 10b-5," 88 Harv. L. Rev. 584, 590 n.32 (1975).

The Supreme Court in Ute, as noted above, characterized the situation presented to it in that case as "involving primarily a failure to disclose * * *." 406 U.S. at 153. The panel in the present case viewed that phrase in an unduly narrow fashion, holding that it would dispense with plaintiff's proof of reliance only in a pure silence case actionable under subparagraphs (a) and (c) of Rule 10b-5. It rejected application of the presumption of reliance in cases involving "half-truths" -- i.e., the failure to state a material fact necessary to make the statements made not misleading. See 640 F.2d at 547-548.

The Commission submits that the panel erred in excluding the half-truth situation from the scope of the Ute presumption. The language of Rule 10b-5 and sound reasons of policy and of procedure in litigation support the conclusion that, for purposes of determining whether the plaintiff should be required to prove his reliance, pure nondisclosure and half-truths are equivalent.

Half-truths necessarily have two components -- the statements that are rendered misleading and the omitted material facts which render them misleading. The language of Rule 10b-5 indicates that the nondisclosure component of a half-truth is the dominant element. The Rule requires that omitted facts -- not the statements rendered misleading -- be material. Thus, a half-truth should be classified as involing "primarily a failure to disclose" within the meaning of Ute.

Even apart from the language of the Rule, at least in certain cases it is the omission or nondisclosure aspect of a half-truth which in fact predominates. Evaluating each individual case to determine whether it is the defendant's statement or the nondisclosure which is primary would, however,

present a difficult, if not impossible, task. Such case-by-case line drawing would necessarily involve conjecture, which the Ute rule itself is designed to avoid. 16/ Other courts of appeals have applied the Ute rule to half-truths, thus "resolving doubts in favor of those the statute is designed to protect * * *." Mills v. Electric Auto-Lite Co., 396 U.S. 375, 385 (1970). 17/ We believe that this Court too, in its decision in Rifkin v. Crow, 574 F.2d 256, 262-263 (5th Cir. 1978), held the Ute presumption to be applicable to half-truths. The Rifkin Court drew the line between "positive misrepresentations," where it held the presumption to be inapplicable, and "nondisclosure[s]" and "omission[s],"

16/ The courts have recognized the difficulty in attempting to parse distinctions in this area. Indeed, the Ninth Circuit has noted that there is a serious problem even in distinguishing between false statements and nondisclosure:

> "The categories of 'omission' and 'misrepresentation' are not mutually exclusive. All misrepresentations are also nondisclosures, at least to the extent that there is a failure to disclose which facts in the misrepresentation are not true. Thus, the failure to report an expense item on an income statement, when such a failure is material in the Affiliated Ute sense, * * * can be characterized as (a) an omission of a material expense item, (b) a misrepresentation of income or (c) both."

Little v. First California Co., 532 F.2d 1302, 1304 n.4 (9th Cir. 1976).

17/ See Continental Grain (Australia) Pty., Ltd. v. Pacific Oilseeds, Inc., supra, 592 F.2d at 411-412 & n.1 (presumption of reliance may be used where seller of stock of corporation holding patent license for seeds, refused to make warranty concerning corporation's continued ability to use seed subject to patent license, knowing that seed would be reclaimed by licensee upon sale of stock); Holmes v. Bateson, 583 F.2d 545, 558 (1st Cir. 1978) (presumption of reliance may be used where purchasing shareholder in a close corporation portrays the corporate finances as "bleak," when in fact the cash flow is restricted but the company's future is sufficiently promising that the purchasing shareholder has entered into undisclosed and eventually successful negotiations for merger); Chelsea Associates v. Rapanos, supra, 527 F.2d at 1271-1272 (selling shareholder in a close corporation gives purchasers financial information, but fails to disclose that the company has lost its principal customers and contract and has negative working capital; presumption rebutted by purchaser's actual lack of reliance).

where it held that the presumption applied. The panel here has misinterpreted Rifkin by reading the term "positive misrepresentations" as used in Rifkin to encompass not only false statements but also half-truths. We submit, therefore, that the panel decision is inconsistent with Rifkin in declining to dispense with the requirement that a plaintiff prove reliance in a half-truth case.

Analysis of the Ute decision itself supports application of the presumption as to reliance in a half-truth case. While, in holding that the plaintiffs in Ute were not required to prove reliance, the Supreme Court characterized the case as one involving "primarily a failure to disclose," the Court also noted that "positive representation[s]" and "recommendation[s]" were made to at least certain of the injured sellers. 406 U.S. at 153; see note 11, supra. Such recommendations must have been rendered misleading by virtue of the defendants' failure to disclose that they "were in a position to gain financially from [the] sales and that [the] shares [sold by the plaintiffs] were selling for a higher price in [another] market." Id. Thus, while as to certain plaintiffs, Ute may have been a pure nondisclosure case, as to other plaintiffs it was a half-truth case. Since the Ute Court itself refused to draw a distinction between deception resulting from total silence and deception resulting from half-truths, this Court should also treat the two situations as equivalent.

Because the panel treated false statements and half-truths equally for purposes of determining whether to apply the presumption of reliance, the panel found it unnecessary to characterize this case as primarily a case of false statements or primarily a case of half-truths. The Commission, as amicus curiae, takes no position on which characterization is proper here --

a determination which requires an analysis of the evidentiary record which we have not had an opportunity to undertake. If, however, the Court determines that the case involves primarily half-truths, it should hold that the plaintiffs need not establish reliance. On the other hand, if the Court determines that the case involves primarily misrepresentations, before determining whether the plaintiffs need establish their own reliance the Court should consider the analysis set forth below (pages 24-28, infra), concerning another class of cases in which proof of individual reliance should not be required.

3. A Plaintiff's Individual Reliance is Irrelevant in a Case Involving Market Fraud and in a Case Involving Deception in Connection With a Public Offering by the Issuer Where Causation-in-Fact Arises Through Other Means.

In addition to the presumption of reliance applicable in cases involving half-truths and nondisclosure which arises from the Supreme Court's opinion in Affiliated Ute, the Supreme Court's decision in Mills v. Electric Auto-Lite Co., 396 U.S. 375 (1970), suggests another situation in which proof of individual reliance should not be necessary. Such proof should not be required in a situation where a particular plaintiff is injured, irrespective of his own specific reliance, because of the impact of the fraudulent conduct on persons other than himself. Under those circumstances, proof of a particular plaintiff's reliance is "irrelevant". Blackie v. Barrack, 524 F.2d 891, 907 (9th Cir. 1975), cert. denied, 429 U.S. 816 (1976).

In Mills, the Supreme Court addressed the concepts of reliance and causation-in-fact in the context of misstatements and omissions made in a proxy statement in violation of Section 14(a) of the Securities Exchange Act, 15 U.S.C. 78n(a), and Rule 14a-9, 17 CFR. 240.14a-9. Recognizing that "reliance by [the] thousands of individuals [voting pursuant to the proxy statement] can scarcely be inquired into," the Court held that there was no need to prove that the deception "actually

had a decisive effect on the voting." 396 U.S. at 382 n.5. Rather, the Court concluded, a sufficient showing of causation-in-fact can be established by proof that "the proxy solicitation itself, rather than the particular defect in the solicitation materials, was an essential link in the accomplishment of the transaction." Id. at 385. This test "avoid[s] the impracticalities of determining how many votes were affected * * *." Id.

The Mills rationale has been followed by the courts in Rule 10b-5 "market fraud" cases. As in the proxy situation, a fraud involving a publicly-traded security can injure an investor by virtue of means other than his own particular reliance. The courts have recognized that a plaintiff should be permitted to recover, regardless of whether he relied on (or even heard of) the false or misleading statement, in a situation where other traders have relied on the misrepresentation, thus altering the price at which the plaintiff traded. E.g., Blackie v. Barrack, supra, 524 F.2d at 906-907; Ross v. A. H. Robins Co., Inc., 607 F.2d 545, 553 (2d Cir. 1979), cert. denied, 446 U.S. 946 (1980); Wachovia Bank and Trust Co. v. National Student Marketing Corp., No. 79-1595, slip op. 34 (D.C. Cir.1980), pet. for cert. filed. 18/ See generally Note, "The Reliance Requirement in Private Actions Under SEC Rule 10b-5," 88 Harv. L. Rev. 584, 593 (1975). Where such a fraud on the market is involved, "proof that the deception was material * * * is persuasive circumstantial evidence that a sufficient number of traders in the market did indeed rely." Id.; see

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18/ See Zweig v. Hearst Corp., 594 F.2d 1261, 1271 (9th Cir. 1979); Herbst v. ITT, 495 F.2d 1308, 1315-1316 (2d Cir. 1974); Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374, 380-381 (2d Cir. 1974), cert. denied, 421 U.S. 976 (1975); Chris-Craft Industries, Inc. v. Piper Aircraft Corp., 480 F.2d 341, 374-375 (2d Cir.), cert. denied, 414 U.S. 910 (1973). See also Selk v. St. Paul Ammonia Products, 597 F.2d 635 (8th Cir. 1979).

Blackie v. Barrack, supra, 524 F.2d at 906. Thus, proof of materiality establishes the requisite causal link between the deception perpetrated by the defendent and the reliance of market traders and, in turn, the injury suffered by the plaintiff.

This theory of causation-in-fact should not be limited to deception involving an already publicly-traded security. Rather, it should also extend to deception in connection with a public offering of securities by the issuer, and to subsequent trading in the newly-created after-market for such securities. The Seventh Circuit has upheld this theory of causation-in-fact with respect to commerical paper in an action under Section 12(2) of the Securities Act. In Sanders v. John Nuveen & Co., Inc., 619 F.2d 1222, 1226-1227 (7th Cir. 1980), cert. denied, 101 S. Ct. 850 (March 23, 1981) (footnote omitted), that court stated:

> "Even though short term commercial paper is not ordinarily traded in the same way as stock and instruments of indebtedness of publicly held companies, the price it will bring depends upon the financial condition of the issuer relative to that of other issuers and the going interest rates in the money market. In that sense there is a market price. A prospectus that reports on that issuer's financial condition affects that price. In the case at bar, publication of [the issuer's] * * * true financial condition would have caused a total collapse of the market for its notes."

Consistent with this analysis, fraud in a public offering of securities by the issuer that is likely to affect the existence or outcome of the offering, or alter its terms (such as the offering price at which the securities are marketed), has an impact on investors not necessarily because a particular plaintiff relies on the deceptive statements in the prospectus but either because others involved in the marketing of the security rely on those

representations or because the issuer, if forced to make full and fair disclosure, would not have proceeded with the offering. Individual reliance by the plaintiff on the prospectus is in this sense irrelevant, as in market frauds generally.

We know of no court that has rejected such a market theory of causation-in-fact. In Rifkin v. Crow, 574 F.2d 256, 263-264 (5th Cir. 1978), this Court acknowledged the theory but declined to reach the causation-in-fact question without full development of the facts. And, subsequent to the Rifkin decision, a panel of this Court did recognize that the plaintiff need not prove reliance in a similar type of case. In Shores v. Sklar, 610 F.2d 235, 239-240, opinion vacated and rehearing en banc ordered, 617 F.2d 441 (5th Cir. 1980), the plaintiff, who had purchased bonds in an initial offering, did not allege that he had relied on the misleading offering circular, but claimed that proof of reliance was not necessary because the fraud was essential to any marketing of the bonds. Noting that the plaintiff's theory was "very similar to the fraud-on-the-market theory," the Shores panel stated that

> "[j]ust as the purchaser of a stock on the open market can expect the market to reflect all information about that stock, so, too, can the purchaser of a new bond issue expect [the] procedures [necessary to float a successful bond issue] * * * to have been faithfully performed."

Id. at 240. Therefore, the Court concluded, "causation [was] clearly present irrespective of plaintiff's reliance on the Offering Circular" and "plaintiff's lack of reliance * * * is irrelevant." Id.

The panel opinion here does not mention the fraud-on-the-market rule in its discussion of the reliance issue. The unqualified language it used in rejecting the presumption of reliance because this case involved "alleged misstatements and omissions in a prospectus published pursuant to a public

offering" (640 F.2d at 548), however, indicates that it must have rejected the rule's application to a public offering by the issuer. And, it clearly rejected application of the rule to the TIS public offering since plaintiffs urged application of the rule in their initial brief (Br. 45-46). As amicus curiae, we express no views on whether the record in this case adequately supports application of that rule of causation-in-fact in this case. We do, however, urge that, regardless of the Court's disposition of this case, the Court modify its opinion to permit use of a market rule of causation-in-fact, both in cases involving a publicly traded security and in cases involving a public offering of securities by the issuer. 19/

4. A Plaintiff Should Not Be Required to Prove his Own Due Care; the Defendant Should Bear the Burden of Proving the Plaintiff's Recklessness.

As noted above, the panel concluded that a plaintiff does not satisfy his burden of proof as to reliance by showing merely that he in fact relied; rather, he must also show his due diligence. The Commission urges the Court to clarify that "due diligence" is a recklessness, rather than a negligence, standard and to reconsider the panel's position that the "due diligence" burden rests with the plaintiff.

Prior to the Supreme Court's decision in Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), various appellate decisions had imposed a due diligence requirement (understood to be a negligence standard) on a Rule 10b-5 plaintiff. The "circuits which * * * imposed * * * [such a] requirement," however "did so in the context of the application to the defendant of a negligence standard."

19/ Of course, as noted earlier, causation-in-fact is not the only causation requirement. As the panel recognized, proximate cause must be shown. Accordingly, even though an offering by the issuer would not have taken place if the true facts had been stated in the prospectus, a purchaser could not recover for a loss in value of the security which is not a reasonably foreseeable consequence of the defendant's deception -- for example, a loss resulting from an unexpected natural disaster where the deception related to the company's earnings. See pages 18-19, supra.

Holdsworth v. Strong, 545 F.2d 687, 692 (10th Cir. 1976) (en banc), cert. denied, 430 U.S. 955 (1977) (emphasis in original); accord, City National Bank v. Vanderboom, 422 F.2d 221, 230 (8th Cir.), cert. denied, 399 U.S. 905 (1970). Cf., Frigitemp Corp. v. Financial Dynamics, Inc., 524 F.2d 275, 282 (2d Cir. 1975); Clement A. Evans v. McAlpine, 434 F.2d 100, 104 (5th Cir. 1970), cert. denied, 402 U.S. 988 (1971). In light of Hochfelder's holding that proof of the defendant's negligence would not support a private plaintiff's claim for damages under Rule 10b-5, the courts have reexamined the utility of this type of "contributory negligence" bar to relief.

In general, post-Hochfelder decisions of the courts of appeals have agreed that the plaintiff's conduct remains relevant to his recovery. 19/ They diverge, however, with respect to the standard to which a plaintiff must adhere. 20/

19/ See Mallis v. Bankers Trust Co., 615 F.2d 68, 78-79 (2d Cir. 1980), cert. denied, 49 U.S.L.W. 3531 (Jan. 26, 1981); Hirsch v. duPont, 553 F.2d 750, 762-763 (2d Cir. 1977); Straub v. Vaisman & Co., Inc., 540 F.2d 591, 596-598 (3d Cir. 1976); G.A. Thompson & Co., Inc. v. Partridge, supra, 636 F.2d at 953; Dupuy v. Dupuy, supra, 551 F.2d at 1013-1022; Holdsworth v. Strong, supra, 545 F.2d at 692-694. See also Holmes v. Bateson, supra, 583 F.2d at 559 n.21. But see J.H. Cohn & Co. v. American Appraisal Associates, 628 F.2d 994, 999, n.4 (7th Cir. 1980); Goodman v. Epstein, 582 F.2d 388, 403-405 (7th Cir. 1978), cert. denied, 440 U.S. 839 (1981); Sundstrand Corp. v. Sun Chemical Corp., supra, 553 F.2d at 1040, 1048 (these three cases when read together indicate that plaintiff's conduct is not in issue if defendant acted intentionally but is relevant if defendant acted recklessly).

20/ See Dupuy v. Dupuy, 434 U.S. 911, 911-912 (1977) (White, J., dissenting from denial of petition for writ of certiorari). Compare Paul F. Newton & Company v. Texas Commerce Bank, 630 F.2d 1111, 1121-1122 (5th Cir. 1980) Mallis v. Bankers Trust Co., supra, 615 F.2d at 79, and Dupuy v. Dupuy, supra, 551 F.2d at 1020 (recklessness will defeat recovery) with Holdsworth v. Strong, supra, 545 F.2d at 693 (gross conduct somewhat comparable to that of defendant will defeat recovery) and Straub v. Vaisman & Co., Inc., supra, 540 F.2d at 598 (lack of reasonable conduct will defeat recovery).

The panel opinion in this case uses the terminology "due diligence." While this concept is generally associated with negligence, following Hochfelder this Circuit has applied a recklessness standard although continuing to use the "due diligence" label. See, e.g., G.A. Thompson & Co., Inc. v. Partridge, 636 F.2d 945, 953 (5th Cir. 1981); Paul F. Newton & Company v. Texas Commerce Bank, 630 F.2d 1111, 1121-1122 (5th Cir. 1980); Dupuy v. Dupuy, 551 F.2d 1005, 1017-1020 (5th Cir.), cert. denied, 434 U.S. 911 (1977). Under the "due diligence" standard articulated in these cases, a plaintiff will be able to recover unless his conduct is roughly comparable to that of the defendant. We support this substantive standard. We do not read the panel's opinion in this case as altering this standard, but we ask that the Court clarify its reference to "due diligence" in order to emphasize that it embraces the meaning previously articulated by the decisions of this Court -- reckless conduct by the plaintiff. 21/

We disagree with the panel's view that the plaintiff must bear the burden of proving his lack of recklessness. While we recognize that this view is consistent with recent opinions by this Court in G.A. Thompson and Paul F. Newton & Co., which have interpreted Dupuy v. Dupuy as requiring the plaintiff to bear the burden on this issue, placing that burden

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21/ Sitting en banc, this Court recently held, in accord with Sundstrand Corp. v. Sun Chemical Corp., supra, 553 F.2d at 1039-1045, that conduct representing "an extreme departure from the standards of ordinary care" and "present[ing] a danger of misleading buyers or sellers which is either known to the defendant or is so obvious that the defendant must have been aware of it" -- which the Court labelled "severe recklessness" -- satisfies the scienter requirement. Broad v. Rockwell International Corp., No. 77-2963, slip op. at 6152-6153 (April 17, 1981). If that standard is to be applied to the defendant's conduct, a plaintiff meeting the burden of establishing that the defendant failed to meet that standard should be able to recover unless the defendant proves that the plaintiff's conduct similarly amounted to "severe recklessness."

on the plaintiff conflicts with decisions of the Second, Third and Tenth Circuits. 22/ In our view, placing the burden of proof on the defendant is the better-reasoned approach. First, we believe that a defendant whose fraudulent conduct was intentional, knowing or reckless should bear a heavy burden in order to avoid liability. Second, the affirmative defense approach avoids burdening Rule 10b-5 plaintiffs with the difficult task of proving a negative.

In Dupuy v. Dupuy, supra, 551 F.2d at 1013-1020, this Court comprehensively reviewed the "due diligence" issue in a Rule 10b-5 action, and, in particular, considered the analogy to the tort doctrine of contributory negligence. As Dean Prosser has stated, the "great majority of the courts hold that the burden of pleading and proof of the contributory negligence is on the defendant." W. Prosser, Handbook of the Law of Torts 416 (4th ed. 1971). Since contributory negligence "clearly operate[s] to the advantage of the defendant, [it is] commonly regarded as [a] defense [ ] to a tort which would otherwise be established." Id. The hardship of the contrary rule is "apparent * * *." Id. Similarly, the plaintiff in a Rule 10b-5 action must demonstrate the defendant's culpability -- a substantial burden, and it would be an unwarranted hardship if he were forced to bear the additional burden of pleading and proving his own lack of recklessness. Thus, we urge this Court to reconsider its position as to the burden of proof applicable to "due diligence."

22/ See Mallis v. Bankers Trust Co., supra, 615 F.2d at 79 n.10, Straub v. Vaisman & Co., Inc., supra, 540 F.2d at 598; Holdsworth v. Strong, supra, 545 F.2d at 693.

CONCLUSION

For the foregoing reasons, the Commission believes that rehearing or rehearing *en banc* is warranted.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that the foregoing Memorandum of the Securities and Exchange Commission, Amicus Curiae, On Petition For Rehearing and Rehearing En Banc, has been served on counsel of record by causing two copies of the memorandum to be deposited in the United States mail, first class, postage prepaid on this 27th day of April, 1981, addressed as follows:

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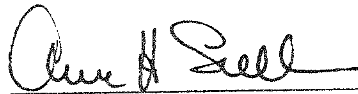

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