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Unclean Hands and Self-Inflicted Wounds: The Significance of Plaintiff Conduct in Actions for Misrepresentation under Rule 10b-5

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INTRODUCTION

Federal courts have recognized a private right of action for the violation of Securities and Exchange Commission Rule 10b-5[1] since 1946.[2] Although a body of law has developed regarding

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1. Section 10(b) of the Securities Exchange Act of 1934 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j (1982). Pursuant to this authority, the Securities and Exchange Commission (SEC) adopted Rule 10b-5 which provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
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> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
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> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1986).

2. The District Court for the Eastern District of Pennsylvania first recognized this private right in Kardon v. National Gypsum Co., 69 F. Supp. 512, 513-14 (E.D. Pa. 1946). The Supreme Court first recognized the right in 1971 in

the metes and bounds of private suits brought under the Rule, several aspects of the law remain indistinct. One of the more important details that has yet to be fully resolved is the relevance of a plaintiff's conduct to the existence of a private right of action.

Over the years, courts regularly have reviewed plaintiff conduct to determine whether it should constitute a bar to recovery under Rule 10b-5. Although courts have disapproved of conduct ranging from the merely negligent to the blatantly criminal,[3] they have not been uniform in modes of analysis used and results achieved. Since 1976, however, there has been general agreement that a plaintiff's negligence, although regrettable, should not bar recovery.[4] Despite this basic consensus, courts have continued to differ where plaintiff conduct is more culpable than negligence.

This Article reviews the way courts historically have analyzed plaintiff conduct in Rule 10b-5 litigation, then examines the current state of the law on this issue, and finally offers a suggestion for its future direction. The definitional scheme of this Article does not purport to derive from any particular case or cases. Therefore, unless otherwise indicated, the phrases "justifiable reliance" and "justifiable reliance context" refer to situations in which a plaintiff has detrimentally relied on a misrepresentation, and the quality of the plaintiff's attention to self-protection is later raised as a defense.[5] In such situations, a plaintiff's alleged culpability typically ranges from negligence to gross recklessness. In contrast, unless otherwise indicated, the phrases "*in pari delicto*" and "*in pari delicto* context" refer to situations in which a defense is based on allegations that a plaintiff's conduct has threatened or caused injury to another.[6]

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the case of Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6, 13 n.9 (1971).

3. For purposes of this Article, the spectrum of undesirable plaintiff conduct includes negligence, gross negligence, recklessness, gross recklessness (including knowing misconduct), and intentional misconduct.

4. In 1976, the Supreme Court decided Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976). *See infra* notes 55-64 and accompanying text.

5. As used, these phrases contemplate inquiry into failure to use good (or any) judgment in evaluating claims, failure to investigate questionable claims, failure to take advantage of readily available opportunities to investigate claims not questionable on their face, and the like. For a discussion of the tendency of courts to describe at least the latter elements of this spectrum in terms of due care or due diligence, see *infra* notes 38-49 & 74-77 and accompanying text.

6. A plaintiff's justifiable reliance may or may not be called into question at the same time. *See infra* text accompanying and following note 175.

In such situations, a plaintiff's alleged culpability may vary from negligence to intentional wrongdoing.

I. THE TRADITIONAL SIGNIFICANCE OF PLAINTIFF CONDUCT IN RULE 10b-5 CASES

A. A PLAINTIFF'S JUSTIFIABLE RELIANCE

Courts have tended to agree that in a misrepresentation case under Rule 10b-5, a plaintiff generally must establish that, in connection with the purchase or sale of a security, the defendant, (1) with scienter, (2) made a false representation[7] of (3) a material fact, (4) upon which the plaintiff justifiably relied (5) to his or her detriment.[8] Although not conclusive,[9] resort by the courts to the common law tort of deceit[10] has provided substantial guidance to the development of these five elements.[11] The deceit cause of action has particularly influenced

7. Although Rule 10b-5 has been applied to hold a defendant liable for either a false representation or an omission of a material fact, *see, e.g.,* Speed v. Transamerica Corp., 99 F. Supp. 808, 828-29 (D. Del. 1951); 3 L. LOSS, SECURITIES REGULATION 1439 (2d ed. 1961), this Article will refer solely to the former. This simplification does not distort the impact of the discussion.

8. *See, e.g.,* Zobrist v. Coal-X, Inc., 708 F.2d 1511, 1516 (10th Cir. 1983); Dupuy v. Dupuy, 551 F.2d 1005, 1014 (5th Cir.), *cert. denied,* 434 U.S. 911 (1977); Holdsworth v. Strong, 545 F.2d 687, 694 (10th Cir. 1976) (en banc), *cert. denied,* 430 U.S. 955 (1977). Some courts require that plaintiff establish justifiable reliance (in some cases phrased as due diligence) as an element separate from actual reliance. *See infra* note 81 and accompanying text.

9. *See* Note, *The Reliance Requirement in Private Actions Under SEC Rule 10b-5,* 88 HARV. L. REV. 584, 585 n.7 (1975) (noting that "the fraud provisions in the SEC acts . . . are not limited to circumstances which would give rise to a common law action for deceit" (quoting 3 L. LOSS, SECURITIES REGULATION 1435 (2d ed. 1961))).

10. Prosser lists the elements of an action for deceit: (1) a false representation made by the defendant; (2) defendant's knowledge or belief that the representation is false or defendant's lack of a sufficient basis of information to make the representation (scienter); (3) an intention by the defendant to induce the plaintiff to act or refrain from acting in reliance on the misrepresentation; (4) justifiable reliance on the representation by the plaintiff in acting or refraining from action; and (5) damage to the plaintiff due to such reliance. PROSSER AND KEETON ON TORTS § 105, at 728 (5th ed. 1984) [hereinafter PROSSER].

11. *See, e.g.,* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 744 (1975); *Dupuy,* 551 F.2d at 1018; List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir.), *cert. denied sub nom.* List v. Lerner, 382 U.S. 811 (1965); 3 L. LOSS, *supra* note 7, at 1759-63; 6 *id.* at 3880 (2d ed. Supp. 1969); Wheeler, *Plaintiff's Duty of Due Care Under Rule 10b-5: An Implied Defense to an Implied Remedy,* 70 NW. U.L. REV. 561, 575 (1975); Comment, *Negligent Misrepresentations Under Rule 10b-5,* 32 U. CHI. L. REV. 824, 828-33 (1965).

development of the requirement that a successful plaintiff show justifiable reliance on the alleged misrepresentation.

1. The State of the Law Before *Hochfelder*: Common Law Roots and Doctrinal Disparities

a. *Causation, Actual Reliance and Justifiable Reliance*

In Rule 10b-5 actions, as in actions for deceit, the reliance requirement is viewed by courts as a crucial element in establishing that a plaintiff's injury was caused by a defendant's misconduct.[12] Causation "in fact" is lacking if a plaintiff's actions would have been no different had the defendant's misconduct not occurred.[13] Under such circumstances, the plaintiff is barred from recovering any damages on the theory that such damages would constitute an impermissible windfall.[14]

The logic of the requirement that a plaintiff must have actually relied on the defendant's misrepresentation in order to recover has obvious appeal. To recover, however, a plaintiff must also prove that reliance on the defendant's misrepresentation was justifiable.[15] Respectively, the terms "actual reliance"

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12. *See, e.g.*, Lipton v. Documation, Inc., 734 F.2d 740, 742 (11th Cir. 1984), *cert. denied*, 469 U.S. 1132 (1985); Wilson v. Comtech Telecommunications Corp., 648 F.2d 88, 92 (2d Cir. 1981); *Dupuy*, 551 F.2d at 1016; *List*, 340 F.2d at 462; Note, *Plaintiff's Standard of Care After* Hochfelder*: Toward a Theory of Causation*, 31 VAND. L. REV. 1225, 1226 (1978).

13. *Cf.* Chasins v. Smith, Barney & Co., 438 F.2d 1167, 1172 (2d Cir. 1970) (causation in fact present because plaintiff relied on defendant's representations in purchase of securities); Crane Co. v. Westinghouse Air Brake Co., 419 F.2d 787, 797 (2d Cir. 1969) (defendant's conduct must be substantial factor in causing plaintiff's injury), *cert. denied*, 400 U.S. 822 (1970).

14. *See, e.g.*, Bangor Punta Operations, Inc. v. Bangor & Aroostook R.R., 417 U.S. 703, 711 (1974); Rochez Bros. v. Rhoades, 491 F.2d 402, 410 (3d Cir. 1974); *List*, 340 F.2d at 463. This might be the case, for instance, if a plaintiff had already made a decision to invest in a particular security before receiving glowing, although untrue, investment information from the defendant. This assumes, of course, that the additional information did not simply conceal a negative state of affairs.

15. Although the term "justifiable" is used in this Article, courts sometimes employ the term "reasonable" to describe the same concept. *See, e.g.*, Niedermeyer v. Niedermeyer, [1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,123, at 94,500 (D. Or. Aug. 21, 1973); *cf. infra* notes 28-29 and accompanying text.

A less popular alternative approach to examination of the plaintiff's justifiable reliance is to vary the defendant's duty of disclosure by limiting the duty to those facts that the plaintiff could not have independently discovered through reasonable investigation. A defendant's duty under this alternative thus varies with the extent of a plaintiff's knowledge or access to knowledge. *See, e.g.*, White v. Abrams, 495 F.2d 724, 730-36 (9th Cir. 1974); Note, *supra* note 12, at 1232, 1236.

and "justifiable reliance" generally refer to whether a plaintiff actually relied on a misrepresentation and whether reliance in such a case satisfies a given court's standard for suitable plaintiff conduct.

b. *Refining the Doctrine of Justifiable Reliance*

i. *The Deceit Analogy*

For purposes of the tort of deceit, a plaintiff's reliance is deemed to be unjustified, and thus operates as a potential bar to recovery, in two situations.[16] First, reliance is regarded as unjustified if the misrepresentation allegedly relied upon is known to be, or is obviously, false.[17] For example, suppose that defendant, who sells securities issued by a corporation operating a chain of hamburger stands, tells plaintiff purchaser that the National Hamburger Association soon will announce the results of a scientific study proving that eating burgers leads to immortality. Plaintiff's reliance on the statement would be regarded as unjustified.

The second situation in which reliance is deemed not justified for purposes of the law of deceit involves the making of an immaterial misrepresentation.[18] Thus, if the seller had simply overstated by one the number of burgers sold by the chain in the previous year, or had misrepresented the color of his own eyes, the plaintiff presumably would be precluded, as a matter of law, from claiming that he would have decided not to acquire the corporation's securities had the truth been known.[19]

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16. The older common law approach to reasonable reliance was somewhat more severe than the current state of the law reflected in this Article. Thus, it was said that

> [w]hen the means of knowledge are open and at hand or furnished to the purchaser or his agent and no effort is made to prevent the party from using them, . . . he will not be heard to say that he has been deceived to his injury by the misrepresentations of the vendor.

Shappirio v. Goldberg, 192 U.S. 232, 241-42 (1904). *See also* Crane, *An Analysis of Causation Under Rule 10b-5*, 9 SEC. REG. L.J. 99, 111 n.51 (1981) (citing cases in which courts, in the past, have considered whether plaintiff's reliance was justified).

17. RESTATEMENT (SECOND) OF TORTS § 541 (1965); PROSSER, *supra* note 10, § 108, at 750-55.

18. RESTATEMENT (SECOND) OF TORTS § 538 (1965); PROSSER, *supra* note 10, § 108, at 753-54.

19. Because materiality of the defendant's misrepresentation is put in issue by the specific terms of Rule 10b-5 itself, however, it is generally dealt with as a separate matter in Rule 10b-5 cases rather than as part of the doctrine of justifiable reliance. *See* Rule 10b-5 *supra* note 1. *But see, e.g.*, Affiliated Ute Citizens v. United States, 406 U.S. 128, 152-54 (1972) (holding that

The standard imposed under the common law of deceit to determine whether a plaintiff justifiably relied on a given misrepresentation is not demanding.[20] The plaintiff need only refrain from relying on misrepresentations that "any such normal person would recognize . . . as preposterous, . . . or which are . . . so patently and obviously false that [the plaintiff] must have closed his eyes to avoid discovery of the truth . . . ."[21] The plaintiff is not required to act with the prudence of the hypothetical reasonable person.[22] Rather, the plaintiff's conduct is judged by reference to the reasonable actions of a person endowed with those attributes of the plaintiff that are known to the defendant and that the defendant has sought to exploit.[23]

The justifiable reliance requirement has been explained as a means of dealing both with the practical difficulty of proving that actual reliance occurred in unlikely circumstances and with the corresponding possibility that a plaintiff fraudulently may allege reliance on a belief that the allegation cannot be disproved.[24] Thus, in cases where a plaintiff has alleged actual but absurd reliance (such as reliance on a statement that hamburgers confer immortality), the requirement allows the court to resolve the case without assessing the plaintiff's credibility. In such circumstances, the law simply refuses to countenance the plaintiff's claim. Justifiable reliance, as a mechanism to avoid credibility issues, is valued by courts both as a judicial timesaver and as a device to eliminate the possibility of erroneous findings of reliance (and thus causation) in those cases where a plaintiff's reliance is deemed inherently unbelievable.

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under circumstances involving primarily a failure to disclose, proof of reliance was unnecessary where the omitted facts were material); *see also infra* note 102 and accompanying text (discussing the Court's substitution of duty and failure to disclose material fact for reliance to establish cause-in-fact in *Affiliated Ute Citizens*). For a discussion of the general relationship between materiality and reliance, see Crane, *supra* note 16, at 101 n.4.

20. *See* Whalen, *Causation and Reliance in Private Actions Under SEC Rule 10b-5*, 13 PAC. L.J. 1003, 1013 (1982). It also has been said that "[t]he plaintiff's conduct must not be so utterly unreasonable, in the light of the information apparent to him, that the law may properly say that his loss is his own responsibility." PROSSER, *supra* note 10, § 108, at 750.

21. *Id.*

22. *See* PROSSER, *supra* note 10, § 108, at 751 (The law is intended to "protect the weak and credulous" from the "artful and cunning" and a reasonable person standard would not accomplish this.).

23. *Id.*; *but cf.* Rochez Bros. v. Rhoades, 491 F.2d 402, 409-10 (3d Cir. 1974) (plaintiff must fulfill duty of due care before claiming reliance).

24. Whalen, *supra* note 20, at 1013; Harper & McNeely, *A Synthesis of the Law of Misrepresentation*, 22 MINN. L. REV. 939, 943 (1938).

The justifiability requirement also is viewed by courts as a "limitation . . . which insures that there is a causal connection between the misrepresentation and the plaintiff's harm."[25] According to this view, the justifiable reliance requirement operates to increase the likelihood that recovery will never occur without such a connection by barring recovery in situations where it is possible, but unlikely, that a causal connection does exist.

ii. *Objective and Subjective Standards*

Because courts have placed so much importance on a plaintiff's obligation to establish a causal connection between defendant's misrepresentation and plaintiff's harm, a primary consideration in determining whether a plaintiff should be barred from recovery appears to be the likelihood that the plaintiff's claim of actual reliance is true. Logically, the point at which a plaintiff's reliance is deemed unjustifiable should reflect a finding that, in all probability, the plaintiff did not actually rely. A more stringent test for determining unjustifiability will presumably reflect a relatively low degree of tolerance for a false finding of actual reliance. One way to increase the stringency of the test is to apply an objective standard of conduct to the plaintiff's claim of justifiable reliance. Thus, if a plaintiff were only permitted to claim reliance on a misrepresentation that would have been believed by a reasonable person, more recoveries would be precluded than if plaintiff were permitted to claim reliance on any misrepresentation that would be believed by a reasonable person with the plaintiff's own attributes.

As noted above, the tort law standard for justifiable reliance has been stated in terms of the attributes of the plaintiff known to and sought to be exploited by the defendant.[26] Before the Supreme Court's well-known 1976 decision in *Ernst & Ernst v. Hochfelder*,[27] however, courts often defined the plaintiff's standard of care in Rule 10b-5 cases by reference to

25. Zobrist v. Coal-X, Inc., 708 F.2d 1511, 1516 (10th Cir. 1983); *cf.* Crane, *supra* note 16, at 111-20 (1980) (noting that the securities acts were intended to provide investors with equal access to information, not with "a scheme of investor insurance"). As noted above, the need to establish a causal connection between the defendant's misrepresentation and the plaintiff's harm also is the primary rationale for the requirement of *actual* reliance in both the deceit and Rule 10b-5 contexts. *See supra* note 12 and accompanying text.

26. *See supra* text accompanying note 23.

27. 425 U.S. 185 (1976).

the care of the "reasonable investor,"[28] and discussions of objective standards of reasonable conduct were common.[29] The analysis that courts invoked resembled, and sometimes was referred to as, contributory negligence.[30]

At least two rationales support the adoption of a contributory negligence approach to justifiable reliance. The first rationale is deterrence of investor carelessness[31] and the second is a desire to limit the number of Rule 10b-5 suits.[32] Interestingly, neither of these rationales is related to a concern with avoiding false findings of reliance.

Despite the general tendency of pre-*Hochfelder* courts to invoke an ostensibly objective standard for measuring plaintiff conduct, a number of such courts actually paid close attention to the knowledge and sophistication of the individual plaintiff and to the factual context in which the disputes arose.[33] Thus, whereas an objective standard would focus on what a reasonable investor would do in similar circumstances,[34] these courts in effect asked what was reasonable for the particular plaintiff,

28. *See, e.g.,* Rochez Bros. v. Rhoades, 491 F.2d 402, 408 (3d Cir. 1974); Smallwood v. Pearl Brewing Co., 489 F.2d 579, 604 (5th Cir.), *cert. denied,* 419 U.S. 873 (1974); Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281, 1301-02 (2d Cir. 1973); Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90, 97 (10th Cir.), *cert. denied,* 404 U.S. 1004 (1971); City Nat'l Bank v. Vanderboom, 422 F.2d 221, 230-31 (8th Cir.), *cert. denied,* 399 U.S. 905 (1970); Allen Organ Co. v. North Am. Rockwell Corp., 363 F. Supp. 1117, 1127 (E.D. Pa. 1973); Niedermeyer v. Niedermeyer, [1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,123, at 94,500 (D. Or. Aug. 21, 1973). *Cf.* SEC v. Dolnick, 501 F.2d 1279, 1283 (7th Cir. 1974) ("It is of course immaterial that [claimant] might have been a knowledgeable investor.").

29. *See, e.g.,* Clement A. Evans & Co. v. McAlpine, 434 F.2d 100, 103-04 (5th Cir. 1970), *cert. denied,* 402 U.S. 988 (1971); *Vanderboom,* 422 F.2d at 230 n.10.

30. *See* Crane, *supra* note 16, at 112; Wheeler, *supra* note 11, at 568; Note, *supra* note 9, at 604. Observe, however, that this identification occurred in the context of cases articulating a due diligence requirement. *See infra* text accompanying notes 38-44. *But see, e.g.,* Carroll v. First Nat'l Bank, 413 F.2d 353, 358 (7th Cir. 1969) (declining to apply the doctrine of contributory negligence to dismiss plaintiff's case), *cert. denied,* 396 U.S. 1003 (1970).

31. *See* Note, *supra* note 9, at 604.

32. *Cf.* Herpich v. Wallace, 430 F.2d 792, 804-05 & n.12 (5th Cir. 1970) (recognizing the need to limit the scope of liability).

33. *See* Wheeler, *supra* note 11, at 600; Note, *supra* note 12, at 1235.

34. *See* RESTATEMENT (SECOND) OF TORTS § 552A (1977) (establishing contributory negligence as a defense to negligent misrepresentation). According to comment *a,* "[t]his means that the plaintiff is held to the standard of care, knowledge, intelligence, and judgment of a reasonable man, even though he does not possess the qualities necessary to enable him to conform to that standard." *Id.* § 552A comment *a.*

given all the circumstances peculiar to the plaintiff.[35] Some courts that adopted this approach specifically stated that the test for justifiable reliance was a subjective one.[36] Several commentators articulated that the appropriate inquiry was whether the plaintiff subjectively knew, understood, and appreciated the risk that a defendant's statement was untrue but nonetheless proceeded in the face of that risk.[37]

iii. *Expanding the Justifiability Requirement: Due Diligence*

During the pre-*Hochfelder* era, courts applying Rule 10b-5 often analyzed the justifiable reliance requirement in terms of whether the plaintiff had exercised "due diligence" or "due care."[38] These courts required that a plaintiff seeking redress under the Rule show that she took appropriate self-protective measures during the investment process.[39] This due diligence requirement was found in appropriate circumstances to encom-

35. *See, e.g.,* Clement A. Evans & Co. v. McAlpine, 434 F.2d 100, 103 (5th Cir. 1970), *cert. denied,* 402 U.S. 988 (1971); City Nat'l Bank v. Vanderboom, 422 F.2d 221, 230 n.10 (8th Cir.), *cert. denied,* 399 U.S. 905 (1970).

Note, however, that "general and particularized standards can . . . blend into one another, depending on how many characteristics one chooses to incorporate in a model of the 'reasonable investor.'" Note, *supra* note 9, at 603 n.87. *See generally* Seavey, *Negligence—Subjective or Objective?,* 41 HARV. L. REV. 1 (1927) (discussing the pertinence of individual characteristics in determining whether conduct is negligent).

36. *See, e.g., Clement A. Evans & Co.,* 434 F.2d at 102; Myzel v. Fields, 386 F.2d 718, 737 (8th Cir. 1967), *cert. denied,* 390 U.S. 951 (1968).

37. *See, e.g.,* Wheeler, *supra* note 11, at 600; Note, *supra* note 12, at 1253.

38. For example, Wheeler, *supra* note 11, at 574, as of 1975, asserts that "[w]hile framed in a variety of ways, a duty of due care has been imposed on 10b-5 claimants in eight courts of appeals."

39. Thus, in *Vanderboom,* 422 F.2d at 230 n.10, the court imposed a "duty of reasonable investigation"; *accord* Vohs v. Dickson, 495 F.2d 607, 623 (5th Cir. 1974).

The due diligence requirement was most often cited in cases involving sophisticated or inside investors. *E.g.,* Holdsworth v. Strong, 545 F.2d 687, 692 (10th Cir. 1976) (citing earlier cases and stating that "[w]here the due diligence standard is applied it requires insiders or sophisticated investors who have access to information to take positive steps to ascertain the facts for themselves"), *cert. denied,* 430 U.S. 955 (1977). For an interesting discussion concluding that, pre-*Hochfelder,* such measures were required only in cases "purporting to reject a Rule 10b-5 scienter requirement . . . [or cases] in which the plaintiff was a securities professional, a corporation, or an insider," see Sachs, *The Relevance of Tort Law Doctrines to Rule 10b-5: Should Careless Plaintiffs Be Denied Recovery?,* 71 CORNELL L. REV. 96, 105-106 (1985) (footnotes omitted). *See also* Note, *supra* note 12, at 1231 ("Although the formulations apply theoretically to any 10b-5 case, the actual decisions have dealt with close corporations and opposing parties who are related or well-known to each other much more often than open-market transactions.")

pass actions such as the reading of a prospectus[40] or the examination of accessible company records.[41]

The responsibility imposed by this standard clearly required that plaintiffs do more than simply not ignore the obvious.[42] As a conceptual matter, then, courts that required due diligence could not find a plaintiff's actual reliance to be justified unless the plaintiff had exercised the requisite amount of diligence.[43] As a result, although courts that imposed a requirement of due diligence sometimes superficially separated that requirement from the requirement of justifiable reliance, the due diligence requirement in fact simply was incorporated into the test for justifiable reliance.[44]

Courts that adopted the expanded due diligence requirement clearly contemplated different levels of responsibility in different circumstances. Thus, courts have said that, under the due diligence requirement, the plaintiff's conduct is to be measured against that of a reasonable investor with the attributes of the plaintiff rather than against an objective standard.[45] Such courts, nonetheless, have sometimes characterized the requirement as a negligence standard.[46] As such, the due diligence requirement has been justified as a deterrent of investor carelessness and a limit on the number of Rule 10b-5 suits.[47]

Although some courts have employed a negligence standard to assess a plaintiff's deviation from ideal conduct (de-

40. *See, e.g.,* Lucas v. Florida Power & Light Co., 575 F. Supp. 552, 570 (S.D. Fla. 1983), *aff'd*, 765 F.2d 1039 (11th Cir. 1985).

41. *See, e.g.,* Frigitemp Corp. v. Financial Dynamics Fund, Inc., 524 F.2d 275, 282 (2d Cir. 1975) (failure to examine transfer sheets); Kaplan v. Vornado, Inc., 341 F. Supp. 212, 215 (N.D. Ill. 1971) (failure to read debenture).

42. *But cf. supra* text accompanying note 21 (discussing the less stringent standard required by the common law tort of deceit).

43. The requirement of due diligence has the effect of charging the plaintiff with constructive knowledge of information that would have been discovered through the exercise of due diligence. *Cf.* Zobrist v. Coal-X, Inc., 708 F.2d 1511, 1518 (10th Cir. 1983) (imputing knowledge of facts in prospectus or like document to investor); Myzel v. Fields, 386 F.2d 718, 736 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968) (charging plaintiff director "with a degree of notice of those facts which the corporate books and the directors' meetings would fairly disclose"). Given such constructive knowledge, reliance on conflicting information given by the defendant is deemed unjustified.

44. Unfortunately, this logical amalgamation was not necessarily perceived by the courts themselves. See *infra* notes 50-54 and accompanying text for an indication of the diversity of approaches taken.

45. *See, e.g.,* Dupuy v. Dupuy, 551 F.2d 1005, 1017 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977).

46. *Id.*; *see also supra* note 30 and accompanying text.

47. *See supra* text accompanying notes 31-32.

fined to include all appropriate acts of self-protection in a given case), the use of a negligence standard is not necessarily related to the definition of ideal conduct.[48] For example, a court could define ideal conduct to include affirmative acts of investigation yet bar a plaintiff's recovery only if the plaintiff's conduct constituted a reckless deviation from the established ideal.[49] A broad definition of what constitutes ideal conduct is related to the use of a restrictive standard for acceptable deviation from the ideal to the extent that both may contribute to the goals of deterring plaintiff carelessness and decreasing the volume of Rule 10b-5 litigation.

iv. *Procedural Approaches to Proof*

A number of courts combined justifiability of reliance, sometimes referred to as the exercise of due diligence, with actual reliance as a single element of the plaintiff's case.[50] Other courts dealt with the justifiability concept as a separate element.[51] Where the latter approach was adopted, use of due diligence terminology was virtually certain. This was also true in the case of a third approach which treated lack of due diligence as an affirmative defense.[52] A fourth approach incorporated something akin to the justifiability concept into the parameters of the scope of the defendant's duty to disclose, establishing by implication that the duty ran only to plaintiffs whose reliance was justified.[53] As might be expected, the use of these varying approaches and terminologies, together with the inconsistent use of objective and subjective standards for measuring plaintiff conduct, resulted in a confusion of the case law.[54]

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48. *See infra* notes 74-77 & 90-95 and accompanying text.

49. In this case due diligence would consist of whatever acts would enable the court to say that the investor had not been subjectively reckless.

50. *E.g.*, Thomas v. Duralite Co., 524 F.2d 577, 585-86 (3d Cir. 1975); City Nat'l Bank v. Vanderboom, 422 F.2d 221, 230 (8th Cir.), *cert. denied*, 399 U.S. 905 (1970). A few district courts have dealt with the due diligence concept in connection with other elements of the plaintiff's case. *See* Sachs, *supra* note 39, at 104.

51. *E.g.*, Rochez Bros. v. Rhoades, 491 F.2d 402, 409 (3d Cir. 1973), *cert. denied*, 425 U.S. 993 (1976); Financial Indus. Fund, Inc. v. McDonnell Douglas Corp., 474 F.2d 514, 517 (10th Cir.), *cert. denied*, 414 U.S. 874 (1973).

52. *E.g.*, Clement A. Evans & Co. v. McAlpine, 434 F.2d 100, 104 (5th Cir. 1970), *cert. denied*, 402 U.S. 988 (1971).

53. *E.g.*, White v. Abrams, 495 F.2d 724, 736 (9th Cir. 1974); Arber v. Essex Wire Corp., 490 F.2d 414, 420 (6th Cir.), *cert. denied*, 419 U.S. 830 (1974).

54. These disparate treatments have continued since *Hochfelder*. *See infra* note 72.

2. The Post-*Hochfelder* Reassessment

a. *Recklessness and Comparative Fault*

In *Ernst & Ernst v. Hochfelder*,[55] the United States Supreme Court made it clear that, in bringing suit under Rule 10b-5, a plaintiff was required to show that the defendant acted with scienter, a state of mind that the Court indicated was more culpable than negligence.[56] Lower courts have since struggled with the limits of this rule, particularly in the context of whether reckless conduct by a defendant is sufficient to constitute scienter.[57]

In addition, the *Hochfelder* decision prompted lower courts to re-evaluate decisions that barred contributorily negligent plaintiffs from recovery.[58] The courts articulated several considerations. First, simple equity seemed to suggest that plaintiffs should not be held to a higher standard of care than that imposed upon defendants.[59] Second, under the common law, contributory negligence is generally not a bar to plaintiff recovery in intentional tort cases.[60] Third, the need to limit the vol-

55. 425 U.S. 185 (1976).

56. *See id.* at 201. The Court noted that

> the term "scienter" refers to a mental state embracing intent to deceive, manipulate or defraud. In certain areas of the law recklessness is considered to be a form of intentional conduct . . . . We need not address here the question whether, in some circumstances, reckless behavior is sufficient for civil liability under § 10(b) and Rule 10b-5.

Id. at 194 n.12.

57. *See generally* Metzger & Heintz, Hochfelder's *Progeny: Implications for the Auditor*, 63 MINN. L. REV. 79, 90-112 (1978) (discussing the lower federal courts' efforts to define the limits of the scienter element after *Hochfelder*); Note, *Recklessness Under Section 10(b): Weathering the* Hochfelder *Storm*, 8 RUT.-CAM. L.J. 325, 349-51 (1977) (examining judicial treatment of the recklessness standard by post-*Hochfelder* courts).

58. *See, e.g.*, Dupuy v. Dupuy, 551 F.2d 1005, 1017 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977); Straub v. Vaisman & Co., 540 F.2d 591, 597 (3d Cir. 1976); Holdsworth v. Strong, 545 F.2d 687, 692 (10th Cir. 1976), *cert. denied*, 430 U.S. 955 (1977). *See also* Crane, *supra* note 16, at 112 (stating that "a number of circuits have reassessed the need for a due diligence requirement"); Note, *supra* note 12, at 1237 (stating that *Hochfelder* "provoked a reevaluation of decisions perceived to hold plaintiffs to a standard of contributory negligence").

59. *See, e.g., Dupuy*, 551 F.2d at 1019 (concluding that "[i]f it is fairer for a judicially allocated loss to fall upon the more culpable actor under tort law, the judicially created remedial system for the Securities Acts can respond to similar notions of equity without disrupting the legislative scheme"). *But cf.* Wheeler, *supra* note 11, at 586 (stating that "the rationale which underlies the denial of equitable relief to the plaintiff who has not done equity provides support for the denial of an implied remedy to the careless investor").

60. *See, e.g., Dupuy*, 551 F.2d at 1018; *Holdsworth*, 545 F.2d at 694.

ume of Rule 10b-5 litigation had been alleviated to some extent by requiring a showing of scienter on the part of defendants, thus reducing the number of defendants failing to satisfy their requisite standard of care.[61] Finally, the public policy of deterring investor carelessness was balanced against the clear legislative intent, emphasized in *Hochfelder*, to deter defendant conduct involving scienter. This balancing suggested that deterrence of defendant misconduct was the more pressing concern.[62] As a result, post-*Hochfelder* courts generally have felt safe in concluding that contributory negligence does not constitute a bar to a plaintiff's recovery.[63] Alternatively, courts have often stated that plaintiff recklessness, at a minimum, is required for such a bar to be imposed.[64]

Expanding upon the post-*Hochfelder* rejection of a negligence standard for plaintiff conduct, some courts have indicated that a plaintiff will not be foreclosed from recovery unless he has engaged in "a level of culpable conduct comparable to that of the defendant's"[65] or "gross conduct somewhat comparable to that of [the] defendant."[66] Other courts have stated that the applicable standard of care is one "not exceeding that imposed on the defendant."[67] Even where language of comparable fault is lacking, any reference to *Hochfelder*, which dealt only with the defendant's standard of care, in the context of analyzing the plaintiff's standard of care effectively conveys the notion that the standards of both parties' conduct should be comparable.[68]

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61. *See, e.g., Dupuy*, 551 F.2d at 1019.

62. *Id.*

63. *See, e.g.*, Mallis v. Bankers Trust Co., 615 F.2d 68, 78 (2d Cir. 1980), *cert. denied*, 449 U.S. 1123 (1981); Holmes v. Bateson, 583 F.2d 542, 559 & n.21 (1st Cir. 1978). *But see* Alton Box Bd. Co. v. Goldman, Sachs & Co., 418 F. Supp. 1149 (E.D. Mo. 1976), *rev'd on other grounds*, 560 F.2d 916 (8th Cir. 1977). It has been said that this decision represents post-*Hochfelder* persistence in applying "a varying duty of investigation approach without apparent concern that [courts] might be using a negligence standard." Note, *supra* note 12, at 1242.

64. *E.g.*, Zobrist v. Coal-X, Inc., 708 F.2d 1511, 1516 (10th Cir. 1983); Petrites v. J.C. Bradford & Co., 646 F.2d 1033, 1035 (5th Cir. 1981); Paul F. Newton & Co. v. Texas Commerce Bank, 630 F.2d 1111, 1122 (5th Cir. 1980); *Dupuy*, 551 F.2d at 1020.

65. *See, e.g., Zobrist*, 708 F.2d at 1516.

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

67. *Dupuy*, 551 F.2d at 1020; *accord Paul F. Newton & Co.*, 630 F.2d at 1122.

68. A number of courts have indicated that *Hochfelder* has provoked a reevaluation of justifiable reliance/due diligence concepts without referring to rules of equity or culpability comparison. *See, e.g.*, Holmes v. Bateson, 434 F.

Even where comparisons between parties have been specifically invoked, often it has not been clear whether the court intended to compare the actual culpabilities of the two parties with each other or to test the conduct of each party against a separate, but comparable, standard of care.[69] The significance of this uncertainty can be illustrated by a hypothetical in which a defendant has engaged in grossly reckless conduct, giving rise to a suit in a jurisdiction which holds that merely reckless conduct by a defendant satisfies the *Hochfelder* scienter requirement. In such a case, it is not clear whether intentional or grossly reckless conduct on the part of the plaintiff will be required before recovery is barred (presumably the result under the approach comparing actual culpabilities) or if merely reckless conduct on the part of the plaintiff would give rise to such a bar (as would be the case under an approach comparing standards of care).

Regardless of which of these two approaches is applied, it is clear that the culpability of the plaintiff is examined only with respect to the risk to which she exposes herself and not with respect to the risks to the defendant or third parties.[70] Because plaintiffs normally do not intentionally inflict economic losses on themselves, a court requiring a comparison of actual culpabilities would seldom find itself barring recovery where the defendant's misrepresentation was found to be intentional.[71]

Supp. 1365, 1382 (D.R.I. 1977), *rev'd on other grounds*, 583 F.2d 542 (1st Cir. 1978).

69. Discussion of a recklessness standard for plaintiffs in a case involving alleged intentional misconduct on the part of the defendant suggests the separate, comparable standard approach. *See, e.g.*, Gower v. Cohn, 643 F.2d 1146 (5th Cir. 1981); Dupuy v. Dupuy, 551 F.2d 1005 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977). *But cf.* G.A. Thompson & Co. v. Partridge, 636 F.2d 945 (5th Cir. 1981) (noting that *Dupuy* applied a recklessness standard, even though the defendant's misrepresentations were held to be intentional, *id.* at 954 n.16, that a standard requiring the plaintiff to act more recklessly than the defendant was too strict, *see id.*, and that the definition of "intentional" should include at least severe forms of recklessness, *id.* at 961 & n.32).

70. Risks to the defendant and third parties are discussed only in those cases in which defenses are raised both on grounds of lack of justifiable reliance/due diligence and on grounds of *in pari delicto*. In those cases, the discussions of the two doctrines do not overlap. *See, e.g.*, Mallis v. Bankers Trust Co., 615 F.2d 68, 75-81 (2d Cir. 1980), *cert. denied*, 449 U.S. 1123 (1981).

71. Intentional risk-taking—that is, acting in the face of a known untruth—as opposed to intentional infliction of self-injury will be described for this purpose as grossly reckless behavior. *Cf. supra* note 3.

b. *The Circuits Distinguish Themselves*

Despite the fact that post-*Hochfelder* courts have regularly rejected a contributory negligence standard for plaintiffs in Rule 10b-5 cases, no particular test or single approach has emerged for identifying the type of plaintiff conduct that *will* constitute a bar to recovery.[72] Indeed, many courts have even failed to follow a consistent pattern with respect to their own precedent.[73] A few courts, however, have managed to take a relatively clear position as to what constitutes unacceptable plaintiff conduct. Notable among these is the United States Court of Appeals for the Fifth Circuit.

Through a series of decisions, the Fifth Circuit has determined that ideal plaintiff conduct is defined in terms of compliance with an obligation of due diligence or due care.[74] Only a gross departure from this standard will operate as a bar to plaintiff recovery.[75] A plaintiff has therefore acted with due care or diligence unless he has departed from the ideal by a margin that may be characterized as "gross." A gross departure from the ideal is found only if the plaintiff's conduct was more culpable than negligence,[76] or if the plaintiff acted "in disregard of a risk known to him or so obvious that he must be taken to have been aware of it, and so great as to make it highly probable that harm would follow."[77]

To determine whether the plaintiff's conduct constitutes a gross departure from the ideal, the Fifth Circuit has developed

72. Commentators have sought to categorize approaches of post-*Hochfelder* courts in a number of ways, including acceptance or rejection of the duty of due diligence, *see* Note, *supra* note 12, at 1238, and choice of recklessness or other terminology in describing the requisite standard of conduct, *see* Sachs, *supra* note 39, at 111-12. It is also possible to categorize the courts' procedural approaches on the basis of the courts' consideration of the plaintiff's compliance with the related standard. Thus, a court may examine plaintiff's conduct as a separate matter, in conjunction with some other element, such as reliance or materiality, or as part of the defendant's duty of care. In addition, courts' procedural approaches may be classified on the basis of allocation of the burdens of production and persuasion. The position of a particular court may be identifiable with respect to some or all of the categories.

73. *See infra* notes 85-95 and accompanying text.

74. *See* Dupuy v. Dupuy, 551 F.2d 1005, 1014 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977).

75. Siebel v. Scott, 725 F.2d 995, 1000 (5th Cir. 1984), *cert. denied*, 467 U.S. 1242 (1984).

76. *See* Petrites v. J.C. Bradford & Co., 646 F.2d 1033, 1035 (5th Cir. 1981); Paul F. Newton & Co. v. Texas Commerce Bank, 630 F.2d 1111, 1122 (5th Cir. 1980); *Dupuy*, 551 F.2d at 1020.

77. *Dupuy*, 551 F.2d at 1020 (quoting W. PROSSER, HANDBOOK OF THE LAW OF TORTS § 34, at 185 (1971)).

a list of factors said to be "beyond the intuitive."[78] These factors include "existence of a fiduciary relationship, concealment of the fraud, opportunity for detection, [plaintiff's] position in the industry, sophistication and expertise in the financial community, . . . knowledge of related proceedings . . . [and] whether the plaintiff initiated the transaction or pressured for a speedy resolution."[79] By focusing on the plaintiff's special knowledge, expertise, and circumstances, the Fifth Circuit has clearly rejected an objective standard for assessing plaintiff conduct.[80]

In addition to providing a rough outline of what constitutes ideal plaintiff conduct and providing a checklist of subjective factors to determine what constitutes a gross departure from the ideal, the Fifth Circuit has made it clear that the plaintiff must prove both actual and justifiable reliance in all actions brought under Rule 10b-5. Thus, "the extent of actual reliance by the plaintiff on the defendant's statements and the justifiability of the reliance, frequently translated into a requirement of due diligence by the plaintiff," are distinct matters with respect to which the plaintiff bears separate burdens of production and persuasion.[81]

The practical consequence of the Fifth Circuit's separation of the tests for actual reliance and justifiable reliance is that even where actual reliance is shown (or, in an increasing number of cases, presumed[82]), a gross departure from ideal conduct may preclude plaintiff recovery. The court has asserted two policy grounds to justify this result. First, general equitable principles disfavor the use of judicial resources for plaintiffs who fail to care for themselves.[83] Second, encouraging plaintiff care comports with the anti-fraud orientation of the federal securities laws.[84]

As noted above, the case law produced by other jurisdic-

78. G.A. Thompson & Co. v. Partridge, 636 F.2d 945, 955 (5th Cir. 1981).

79. *Id.* (quoting Clement A. Evans & Co. v. McAlpine, 434 F.2d 100, 102 (5th Cir.), *cert. denied*, 399 U.S. 905 (1970)); *accord Dupuy*, 551 F.2d at 1016 (footnotes omitted).

80. *See Dupuy*, 551 F.2d at 1016 (stating that "[t]he diligence of the plaintiff in 10b-5 cases is judged subjectively").

81. *Id.* at 1014 (footnotes omitted). *Cf.* Paul F. Newton & Co. v. Texas Commerce Bank, 630 F.2d 1111, 1121-22 (5th Cir. 1980) (discussing the due diligence requirement and citing *Dupuy*).

82. *See infra* note 102 and accompanying text. The *Dupuy* court clearly was concerned with addressing diligence even where reliance was presumed. *See* 551 F.2d at 1015-16.

83. *Dupuy*, 551 F.2d at 1014.

84. *Id.*

tions is less coherent than that generated by the Fifth Circuit.[85] This is particularly true of jurisdictions that have refused to articulate the justifiable reliance requirement in terms of due diligence.[86] For the most part, courts in these jurisdictions have noted the pre-*Hochfelder* association of contributory negligence and due diligence and have perceived that association to be so strong that a rejection of one entails rejection of the other.[87] They reason that, in the wake of *Hochfelder*, both concepts must be discarded.[88]

Because the concept of due diligence is simply an extension of the justifiable reliance requirement, it should logically follow that courts rejecting a due diligence requirement intend to adopt a more restrictive view of what the justifiable reliance requirement demands. Presumably, such an approach would limit the court's concern to whether the plaintiff has ignored the immediately obvious.[89] The case law from courts rejecting due diligence, however, does not reflect this logic. Decisions of the Second and Tenth Circuit Courts of Appeal illustrate this inconsistency.

The Second Circuit has both rejected a negligence standard and specifically declined to define justifiable reliance in terms of the exercise of due diligence.[90] At the same time, however, the Second Circuit has determined that the failure of a sophisticated investor to make use of available information may consti-

85. *See supra* text accompanying note 73.

86. These jurisdictions specifically include the Second, Seventh and Tenth Circuit Courts of Appeals. *See* Mallis v. Bankers Trust Co., 615 F.2d 68, 79 (2d Cir. 1980), *cert. denied*, 449 U.S. 1123 (1981); Sundstrand Corp. v. Sun Chemical Corp., 553 F.2d 1033, 1048 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977); Holdsworth v. Strong, 545 F.2d 687, 693 (10th Cir. 1976), *cert. denied*, 430 U.S. 955 (1977).

87. *Cf. Mallis*, 615 F.2d at 78-79 (responding to plaintiff's argument that, in light of *Hochfelder*, scrutiny of plaintiff's conduct under a traditional due diligence-negligence standard is no longer appropriate by holding that plaintiff's burden is met by simply negating recklessness when her conduct is put in issue by defendant and that plaintiff need not establish due care); *Sundstrand*, 553 F.2d at 1048 (distinguishing *Hochfelder* scienter standard from a negligence standard of liability, where "plaintiff could not claim reliance if he had not exercised due diligence"); *Holdsworth*, 545 F.2d at 693 (doubting the usefulness of due diligence defense where, under *Hochfelder*, plaintiff must prove that defendant's conduct was intentional because plaintiff's burden would be so great that the action would lie only in an extraordinary case).

88. *Cf.* cases cited *supra* note 87.

89. *See infra* notes 92-93 and accompanying text.

90. *See Mallis*, 615 F.2d at 79 ("[A] plaintiff's burden is simply to negate recklessness when the defendant puts that in issue, not to establish due care." (footnote omitted)).

tute sufficient recklessness to bar recovery.[91] To the extent that the investor's failure was described in terms of failure to take self-protective acts, rather than in terms of ignoring obvious information, the Second Circuit seems to have accomplished little by its rejection of due diligence terminology.

The Tenth Circuit has similarly rejected the concept of due diligence,[92] but has retained the requirement that a plaintiff's reliance be justifiable.[93] To assess the justifiability of the plaintiff's reliance, the Tenth Circuit has adopted the same factors used by the Fifth Circuit in assessing due diligence.[94] Curiously, although the Tenth Circuit has expressly relied on Fifth Circuit precedent for its approach, it has failed to note the association between the Fifth Circuit approach and the concept of due diligence.[95]

The confusion generated by the Second and Tenth Circuit opinions stems from their failure to distinguish, as the Fifth Circuit has done, what an ideal (or diligent) plaintiff should have done for self-protection in a given situation and what deviation (negligent or otherwise) from that ideal the court is willing to tolerate.[96] This failure has produced undesirable results. One result has been the melding of the concepts of actual reliance and justifiable reliance into a single element of a Rule 10b-5 action.[97] This melding has, in turn, resulted in a qualita-

91. *Cf. id.* at 78-79, in which the court discussed the case of Hirsch v. du Pont, 553 F.2d 750, 762-63 (2d Cir. 1977), and limited the statement made in *Hirsch* that "[sophisticated businessmen] must, if they wish to recover under federal law, investigate the information available to them with the care and prudence expected from people blessed with full access to information" to cases with similar facts. *Mallis,* 615 F.2d at 79. The *Mallis* court noted that, in *Hirsch,* "the comptroller of a large New York stock brokerage firm contemplating merger with another had received an answer to a questionnaire from the latter revealing 'a possible massive capital deficiency' and failed to pursue the line of inquiry plainly suggested by this. This went far beyond negligence." *Id.*

92. *See* Holdsworth v. Strong, 545 F.2d 687, 694 (10th Cir. 1976) ("[D]ue diligence is totally inapposite in the context of intentional conduct required to be proved under Rule 10b-5."), *cert. denied,* 430 U.S. 955 (1977).

93. *See id.* ("Plaintiff must show that he relied on the misrepresentations and that the reliance was justifiable. . . . And a plaintiff may not reasonably or justifiably rely on a misrepresentation where its falsity is palpable.").

94. *See* Zobrist v. Coal-X, Inc., 708 F.2d 1511, 1516 (10th Cir. 1983).

95. *See, e.g., id.*

96. For clarity, courts also should address the question whether the tolerable deviation is to be measured by reference to a subjective or objective standard. *See supra* notes 33-37 & 78-80 and accompanying text. Failure to make this distinction, however, probably is not related to the confusion under discussion.

97. No court rejecting the concept of due diligence appears to require that

tive loss of coherence that becomes particularly evident when the opinions of the Second and Tenth Circuits are compared to the two-element approach used by the Fifth Circuit.[98]

3. Analysis of the Policies Underlying the Justifiable Reliance Requirement: Is There a Continued Need?

a. *The Call for Re-examination*

Despite the fact that courts have labored for years over the justifiable reliance requirement, the current limits and vitality of the concept are unclear.[99] This state of affairs may reflect judicial apathy toward the policy goals traditionally thought to form the basis of the requirement. It also is possible that other devices have been developed to achieve these same goals. In either case, a re-examination of traditional policy justifications for the justifiable reliance requirement leads to the conclusion that abandonment or modification of the requirement would be appropriate.

b. *Encouraging Care for Reasons of Credibility and Cause*

The justifiable reliance requirement was initially adopted, at least in part, to facilitate proof of actual reliance.[100] By imposing the requirement, courts and juries are spared the difficulty of testing the credibility of the plaintiff's claim in those instances in which that claim is based on a contention that plaintiff acted absurdly. Thus, if the justifiable reliance requirement were abandoned, courts and juries would be forced

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the justifiability of reliance be addressed separately from the question of whether reliance actually occurred. Contrast, for example, the statement in *Zobrist*, 708 F.2d at 1516, that "[i]n a misrepresentation case under Rule 10b-5, a plaintiff generally must establish that . . . the plaintiff justifiably relied to his or her detriment" with the following statement in Dupuy v. Dupuy, 551 F.2d 1005 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977):

> The courts have established that with regard to private recovery for the violation of Rule 10b-5, a properly stated cause of action must establish . . . the extent of actual reliance by the plaintiff on the defendant's statements, and the justifiability of the reliance, frequently translated into a requirement of due diligence by the plaintiff. . . . This Court established "due diligence" as a separate element in 10b-5 cases, apart from questions of materiality, reliance, or defendant's duties.

Id. at 1014 (footnotes omitted) (citing Holdsworth v. Strong, 545 F.2d 687 (10th Cir. 1976)).

98. The Fifth Circuit's approach also has been specifically adopted by the Eleventh Circuit. *See* White v. Sanders, 689 F.2d 1366, 1367 (11th Cir. 1982).

99. *Cf. infra* text accompanying note 117.

100. *See supra* notes 24-25 and accompanying text.

to determine the veracity of apparently incredible factual claims. This would increase the risk that plaintiffs would recover even though they did not actually rely and even though their injuries had no "but for" relationship to a specific defendant's actions.

There are, however, at least two responses to the argument that the justifiable reliance requirement is necessary to simplify the assessment of credibility and buttress the requirement of cause-in-fact. First, it is quite possible for factfinders to deal with credibility issues. Evidence of the absurdity of a plaintiff's alleged reliance may suffice to resolve the matter of the plaintiff's credibility. Obviously, in such cases the existence of the justifiable reliance test removes the burden of assessing credibility at all, but the resulting increase in litigation efficiency is probably not sufficient to sustain the requirement. Moreover, in view of the difficulty courts have encountered in applying the justifiable reliance analysis, it is impossible to say whether eliminating the requirement, and thus increasing the potential difficulty faced by courts with respect to credibility issues, would lead to more or less efficient administration of Rule 10b-5 cases.

The second rationale for maintaining justifiable reliance as a requirement in Rule 10b-5 litigation is that it assists in proving a causal relationship between the defendant's actions and the plaintiff's injury. Proof of a causal relationship may not, however, be an important end in itself. There are several reasons for this position, the most important of which is an increasing judicial tolerance for short-cutting the requirement of factual causation. This was manifested, for instance, in *Affiliated Ute Citizens v. United States*,[101] a Rule 10b-5 case in which the Supreme Court held that, in some rather loosely defined circumstances, actual reliance need not be proved in order to establish the requisite of cause-in-fact.[102]

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101. 406 U.S. 128 (1972).

102. The Court held that,

> under the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision. . . . This obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact.

Id. at 153-54. Similar manifestations, also in the Rule 10b-5 context, appear in a line of cases permitting recovery on the basis of a "fraud on the market" theory. *See generally* Note, *The Fraud on the Market Theory*, 95 HARV. L. REV.

In view of the trend illustrated by the Supreme Court in *Affiliated Ute Citizens*, some courts have required that justifiable reliance be made a separate element of the plaintiff's case on the ground that it is desirable to maintain control over plaintiff conduct, even though actual reliance may fall by the wayside.[103] Courts adopting this view require that plaintiffs who are relieved of proving actual reliance must nonetheless demonstrate that their conduct conformed to some minimum standard of care. In such cases, the justifiable reliance requirement has clearly taken on a function completely independent of proving cause-in-fact.

The substantial body of commentary on the nature of cause as an element of the plaintiff's case further indicates that the requirement of causation is of decreasing importance. Some commentators have recognized that the requirement, as applied, actually reflects a number of policy-related building blocks.[104] For purposes of tort law, such building blocks have been formalized by the judiciary in the requirement of cause-in-law (sometimes referred to as legal or proximate cause).[105] Unfortunately, judicial discussion of the causation requirement in Rule 10b-5 cases has seldom achieved this level of legal sophistication.

1143 (1982) (discussing concept of plaintiff's right to recover based on reliance on the integrity of the market and recommending limitation of theory to developed markets); Note, *Fraud on the Market: An Emerging Theory of Recovery Under SEC Rule 10b-5,* 50 GEO. WASH. L. REV. 627 (1982) (supporting adoption of the theory and contending that it will not result in uncontrolled litigation). Of special interest are cases permitting recovery by plaintiffs who trade in a market in which an insider with material undisclosed information is trading concurrently. *See, e.g.,* Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974) (where defendent sold stock based on inside information while failing to notify public). For a discussion of insider trading and efforts to control it, see Wang, *Trading on Material Nonpublic Information on Impersonal Stock Markets: Who is Harmed, and Who Can Sue Whom Under SEC Rule 10b-5,* 54 S. CAL. L. REV. 1217 (1981).

Examples of relaxation of the plaintiff's burden to demonstrate cause certainly also exist outside of the Rule 10b-5 context. *See, e.g.,* PROSSER, *supra* note 10, § 41, at 271-72 (discussing "clearly established double fault and alternative liability" cases).

103. *See, e.g.,* Dupuy v. Dupuy, 551 F.2d 1005, 1015-16 (5th Cir.), *cert. denied,* 434 U.S. 911 (1977). *See also supra* text accompanying notes 82-84.

104. *See, e.g.,* Whalen, *supra* note 20, at 1009-10.

105. *See generally* RESTATEMENT (SECOND) OF TORTS § 431 (1965) (An actor's negligence is a legal cause of harm if his conduct is a substantial factor in bringing about the harm and there is no exculpatory rule of law.); PROSSER, *supra* note 10, § 42, at 272-73 (same). For an argument that even the requirement of cause-in-fact has policy aspects, see *infra* notes 108-113 and accompanying text.

Lack of judicial analysis notwithstanding, the justifiable reliance analysis in Rule 10b-5 cases effectively operates as a policy-based inquiry into whether the plaintiff's conduct has conformed to a certain standard of care.[106] Only if a given standard is met will a court, as a matter of law, permit a finding that the plaintiff's actual reliance on the defendant's misstatements constitutes a link in the chain of causation. Conversely, when the plaintiff's conduct falls short of that standard, a court's refusal to impose liability on the defendant comprises a policy determination that the plaintiff should be held responsible for resulting injury regardless of whether the defendant committed a wrong contributing to that injury. Viewed in this light, the justifiable reliance requirement combines two arguably conflicting elements: a concern for preserving integrity in the cause-in-fact analysis, and a policy determination that if the plaintiff's conduct is sufficiently defective, the plaintiff's recovery should be barred even if the defendant played a part in the chain of events leading to the plaintiff's harm.[107]

The commentators in support of the cause-in-fact requirement have failed to reach a consensus on the justification for the requirement.[108] They have, however, tended to agree that cause-in-fact is difficult, if not impossible, to prove[109] and that the more important policies to be served by maintaining the causal requirement[110] are better dealt with by inquiry into the

106. *See* Note, *supra* note 12, at 1237, 1252-53.

107. For a discussion of factors involved in this policy determination, see *infra* notes 114-123 and accompanying text.

108. *Compare* Calabresi, *Concerning Cause and the Law of Torts: An Essay for Harry Kalven, Jr.*, 43 U. CHI. L. REV. 69, 85 (1975) ("[T]he *but for* requirement, far from being the essential, almost categorical imperative it is sometimes described to be, is simply a useful way of toting up some of the costs the cheapest cost avoider should face in deciding whether avoidance is worthwhile.") *with* Chapman, *Ethical Issues in the Law of Tort*, 20 U.W. ONTARIO L. REV. 1, 6 (1982) ("[A]spects of the retributive theory [of tort liability] seem[ ] to loom large in explaining the legal concern for cause-in-fact.") *and* Zwier, *"Cause in Fact" in Tort Law - A Philosophical and Historical Examination*, 31 DE PAUL L. REV. 769, 784 (1982) ("[T]he cause in fact requirement can be traced to the desire for vengeance.").

109. *Cf.* 13 W. MALONE & A. JOHNSON, LOUISIANA CIVIL LAW TREATISE, WORKERS' COMPENSATION LAW AND PRACTICE § 251, at 546 (2d ed. 1980) (maintaining that the fact of causation can never be proved absolutely, but only as a matter of probability).

110. Such policies include the policy of establishing at least some limit on defendant's liability so that a single "bad" act does not give rise to an endless obligation (which would both offend the sensibilities and tend to discourage such acts even in situations where they might have net social benefits) and the policy of permitting defendants to assess the social costs and benefits of their

defendant's creation of risk.[111] If this is the case, it seems unnecessary to insist that the requirement of cause be safeguarded by requiring the plaintiff to prove both actual and justifiable reliance. In light of the dispute as to the value of requiring the plaintiff to prove cause, the causal requirement would seem to be adequately protected by the requirement of actual reliance alone.[112] After all, even if the justifiability re-

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acts before undertaking them. In fact, these policies can be served quite satisfactorily by holding defendants responsible for all losses that are reasonably foreseeable consequences of their actions, rather than for all losses that those actions cause. *See generally* Note, *When Cause-in-Fact is More Than a Fact: The Malone-Green Debate on the Role of Policy in Determining Factual Causation in Tort Law,* 44 LA. L. REV. 1519 (1984) (discussing and supporting Professor Wex Malone's normative approach to cause-in-fact over the atomistic cause theory of Dean Leon Green in Louisiana tort law duty-risk analysis). Although the liability of Rule 10b-5 defendants usually has not been directly analyzed in terms of foreseeability, there are suggestions of such an analysis in the "in connection with," materiality, and scienter requirements of the Rule.

A few courts have described the defendant's duty in terms of the diligence that the court would exact from the plaintiff. Thus, in Arber v. Essex Wire Corp., the court held that

> an insider has no affirmative duty to direct a seller's attention to all routine data commonly found in the statements and books of the corporation, at least where that information is readily available; the outsider has knowledge that it is available and makes no inquiry; and the information thus available is not of an unusual or extraordinary nature.

490 F.2d 414, 420 (6th Cir. 1974). *See also* Hughes v. Dempsey-Tegeler & Co., 534 F.2d 156, 176 (9th Cir. 1976) ("The extent of [defendant's] duty must be determined according to [our established] flexible, duty-oriented approach to Rule 10(b)-5 . . . ."); White v. Abrams, 495 F.2d 724, 736 (9th Cir. 1974) (defendant's duty to the plaintiff investor depends on the nature of their relationship). Where that approach is taken, if defendant has fulfilled her duty, the court is not concerned with plaintiff's care. If defendant's duty has not been fulfilled, the subject of plaintiff's conduct can be raised. In such situations, cause-in-fact (and, consequently, justifiable reliance) should be less sacrosanct.

111. *See, e.g.*, Robinson, *Multiple Causation in Tort Law: Reflections on the DES Cases,* 68 VA. L. REV. 713, 739 (1982). For purposes of this Article, it is not important to distinguish between formulations using foreseeability, proximate cause and duty-risk terminology. For more extensive treatment of the distinctions among these concepts, see generally Calabresi, *supra* note 108; Thode, *Tort Analysis: Duty-Risk v. Proximate Cause and the Rational Allocation of Functions Between Judge and Jury,* 1977 UTAH L. REV. 1; Note, *supra* note 110. Apologies are offered for this somewhat cursory treatment of a complex and interesting area.

112. Although the author doubts the utility of causal requirements in Rule 10b-5 actions, demonstration of that point is beyond the scope of this Article. One argument favoring maintenance of such a requirement, however, may be based on the language of the Securities Exchange Act of 1934 § 28(a), 15 U.S.C. § 78bb(a) (1982), which provides that "no person permitted to maintain a suit for damages under the provisions of this title shall recover . . . a total amount in excess of actual damages on account of the act complained of."

quirement were entirely eliminated, actual reliance, and thus cause, would still have to be established as a matter of fact, if not of law.[113]

c. *Encouraging Self-Protective Measures for Reasons Unrelated to Credibility and Cause*

i. *Litigation Limitations*

The preceding section dealt with the role that justifiable reliance plays in assisting the finding of causal connection. Justifiable reliance has implications other than those related to the requirement of cause. The first of these has to do with the volume of Rule 10b-5 litigation. Concern over limiting such litigation was one of the historical underpinnings of the justifiable reliance doctrine and is a constant theme throughout the development of Rule 10b-5 case law.[114] Although the *Hochfelder* scienter requirement has been cited by the judiciary as alleviating such concerns,[115] some courts continue to mention the need to reduce the volume of Rule 10b-5 litigation as a rationale for adopting the Fifth Circuit's two-element approach for analyzing plaintiff conduct.[116] As a practical matter, however, few post-*Hochfelder* courts have barred a plaintiff's recovery on the ground that the justifiable reliance requirement has not been met.[117] In light of this fact, potential plaintiffs should be neither deterred from bringing, nor encouraged to bring, an action on the basis of the retention or abandonment of the justifiable reliance requirement. Thus, any effect of the requirement on the volume of litigation is probably quite limited.

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113. In those cases where actual reliance is presumed, courts aleady have freed themselves from the notion that proof of cause is necessary if policy suggests otherwise. *See supra* text accompanying note 100. This does not, of course, mean the same result would follow if lack of cause were proved.

114. *Cf.* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 739-49 (1975) (discussing the possibilities of vexatious litigation under Rule 10b-5).

115. *E.g.*, Straub v. Vaisman and Co., 540 F.2d 591, 597 (3d Cir. 1976).

116. *See supra* note 61 and accompanying text.

117. *But see* Thompson v. Smith Barney, Harris Upham & Co., 709 F.2d 1413 (11th Cir. 1983) (Plaintiff knew of risks involved in options trading or with the exercise of reasonable diligence could have discovered risks.); Fallani v. American Water Corp., 574 F. Supp. 81 (S.D. Fla. 1983) (Plaintiffs failed to show that they had exercised due diligence in connection with securities transaction.); Meier v. Texas Int'l Drilling Funds, Inc., 441 F. Supp. 1056 (N.D. Cal. 1977) (Investor who has investment experience and access to information sufficient to understand the nature of his investment must exercise reasonable diligence to recover under securities laws.).

ii. *Permitting Disclosure Flexibility*

The justifiable reliance requirement also has special implications with respect to the disclosure obligations of defendants in those situations in which it is foreseeable that the plaintiff may act with recklessness, gross recklessness, or even deliberate self-destructive intent. The justifiable reliance requirement permits the defendant's disclosure obligation to be tailored to each case.[118] Thus, if the potential plaintiff is known to be a sophisticated investor, a seller may assume that the detail and clarity of the information provided need only meet the needs of a sophisticated investor acting reasonably or, at worst, negligently. This flexibility has presumably resulted in reduced costs for the seller, and a portion of the savings generated has most likely inured to the benefit of investors.

Taken a step further, the argument in support of a potential defendant's ability to disclose only the information required for a specific investor might lead to the conclusion that if a plaintiff does not have to prove justifiable reliance, the average costs of securities offerings might increase. This argument, however, disregards the cost of the current confusion surrounding the definition of a plaintiff's minimum standard of care. More importantly, it assumes a sophistication in calculation by potential defendants that probably does not exist. As a practical matter, then, the effect of the justifiable reliance requirement on the costs of conducting securities transactions is almost certainly negligible.

iii. *Control of Plaintiff Conduct*

From a theoretical standpoint, the elimination of the justifiable reliance requirement involves a third implication that is more troubling than those previously discussed. To the extent that the justifiable reliance requirement is the only control presently imposed by law on plaintiff conduct not tending to jeopardize the interests of third parties,[119] its abandonment would operate as a signal to potential plaintiffs that they have no responsibility for their own protection in those situations where defendants act with scienter. If plaintiffs were thus encouraged to relax their self-protective vigilance, defendants would presumably be emboldened to commit wrongdoing. This

118. This tailoring also is facilitated, of course, by the fragmentary foreseeability analysis referred to *supra* note 110.

119. For reference to doctrines designed to control plaintiff conduct of the other type, see *infra* text accompanying notes 125-26.

reasoning is logical on its face and probably underlies any argument referring to the value of encouraging plaintiff care.[120]

On closer inspection, however, this argument assumes too much on the part of potential plaintiffs. Essentially, it assumes that plaintiffs are able to calculate that their own lack of care will be compensated for by liability on the part of defendants.[121] A plaintiff's ability to detect scienter is also crucial because only where a defendant acts with scienter will recovery be possible.[122] Thus, the plaintiff would be permitted to rely upon the existence of an enforceable action under Rule 10b-5 only where a misrepresentation is reasonably obvious. It is unlikely, however, that a plaintiff would make what is probably a bad investment in the hope of eventually receiving damages through litigation. Even more far-fetched is any suggestion that defendants would respond to relaxed plaintiff vigilance by making more obvious misrepresentations in order to bait potential investors. On balance, then, it seems that eliminating the justifiable reliance requirement would have little impact on plaintiff conduct and next to none on that of defendants.[123]

iv. *Inter-Party Equity*

Perhaps the only remaining ramification of eliminating the justifiable reliance requirement is the effect it would have on inter-party equity. In the relatively rare situation in which a defendant acts recklessly and a plaintiff acts with gross recklessness (as might be the case where an insider purchases from an outsider), application of the justifiable reliance requirement is currently the only device that may be used to bar the plaintiff's suit and therefore achieve a fair result.

If inter-party fairness is the primary goal to be achieved through application of the requirement of justifiable reliance, however, the requirement may be more complicated than it needs to be. It seems painfully apparent that the extent of in-

120. *See supra* text accompanying notes 83-84.

121. An analogous assumption was identified and questioned by the United States Supreme Court in Bateman Eichler, Hill Richards, Inc. v. Berner, 105 S. Ct. 2622, 2623 (1985). *See infra* notes 163-166 and accompanying text.

122. *See supra* note 56 and accompanying text.

123. Accordingly, it may be possible to dispose of arguments related to the value of plaintiff control without resort to the fiction of legislative intent. *Cf.* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737 (1975) ("It would be disingenuous to suggest that either Congress in 1934 or the Securities and Exchange Commission in 1942 foreordained the present state of the law with respect to Rule 10b-5.").

ter-party fairness realized by the application of the justifiable reliance requirement could be achieved by some far simpler comparison of inter-party culpability.

B. THE DEFENSE OF *IN PARI DELICTO*

1. Equitable Origins and Traditional Application

As noted above,[124] common law doctrines significantly influenced the development of the elements of a private action brought under Rule 10b-5. These doctrines also substantially affected the evolution of the defenses allowable in Rule 10b-5 actions, including several defenses based on the conduct of the plaintiff.[125] These defenses include waiver, estoppel, laches and *in pari delicto* (which, literally translated, means "of equal fault").[126]

The defense of *in pari delicto* evolved as part of the doctrine of unclean hands.[127] This doctrine requires that to merit the extraordinary aid of a court sitting in equity the supplicant must exhibit "clean hands," free of the taint of inequitable behavior.[128] Historically, the defense of *in pari delicto* was limited to situations involving a wrong committed by the plaintiff which directly injured the defendant.[129] More recently, its application has been extended to cases in which the parties had a mutual intent to commit the same wrong against one or more third parties.[130] Some courts even have held the defense to preclude a plaintiff's recovery where the plaintiff was merely guilty of unlawful or fraudulent conduct in any way connected to his alleged loss.[131]

Courts have tended to deny use of the *in pari delicto* defense in four situations: (1) where the plaintiff is a member of

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124. *See supra* notes 9-11 and accompanying text.

125. *See* Wheeler, *supra* note 11, at 562.

126. Perma Life Mufflers, Inc. v. International Parts Corp., 392 U.S. 134, 135 (1968) (holding on unrelated issue limited by Copperweld Corp. v. Independence Tube Corp., 467 U.S. 752, 777 (1984)).

127. 2 J. POMEROY, EQUITY JURISPRUDENCE §§ 397-398 (5th ed. 1941).

128. *Id.* § 397. The doctrine of unclean hands ostensibly operates to both prevent profit from undesirable acts, presumably thus deterring them, and to permit the court to avoid the appearance of furthering the goals of the unjust. Note, *Rule 10b-5—Application of the* In Pari Delicto *Defense in Suits Brought Against Brokers by Customers Who Have Traded on Inside Information*, 37 VAND. L. REV. 557, 561 (1984).

129. Comment, *Rule 10b-5: The* In Pari Delicto *and Unclean Hands Defenses*, 58 CALIF. L. REV. 1149, 1163 (1970).

130. *Id.*

131. *Id.* at 1164.

the class of people that the law seeks to protect by making the transaction illegal; (2) where the plaintiff acted under fraud or duress; (3) where the plaintiff did not know that the transaction was illegal; and (4) where the denial of relief to the plaintiff was unjust or against public policy.[132] These four exceptions reflect concern with two principles of public policy.[133] The first and fourth exceptions, protection of plaintiffs as class members or as a matter of justice or public policy, rather clearly reflect a policy determination that the defense will be disregarded when to do so is in the public interest.[134] Exceptions two and three, protection of plaintiffs acting under fraud, duress, or ignorance of the wrong, simply appear to reflect the requirement of equal fault. Thus, the defendant will not be allowed to claim protection under the *in pari delicto* doctrine where the defendant's wrong is more reprehensible than the plaintiff's in terms of either moral turpitude or the amount of damage caused.[135]

Defendants have made use of the *in pari delicto* defense in lawsuits based on a variety of violations of the federal securities laws, including Rule 10b-5.[136] Typically, the Rule 10b-5 cases in which the defense has been raised involve suits brought by tip-

132. Note, *supra* note 128, at 562. The author of the Note also grouped in situation (3) instances of the plaintiff engaging in an independent wrong.

133. Comment, *supra* note 129, at 1164.

134. *See, e.g.,* Perma Life Mufflers, Inc. v. International Parts Corp., 392 U.S. 134, 138-39 (1968) (*in pari delicto* not a defense to private antitrust action where no congressional intent existed to allow the defense and where application would undermine private enforcement of antitrust laws) (holding on unrelated issue limited by Copperweld Corp. v. Independence Tube Corp., 467 U.S. 752, 777 (1984)); *see also* Comment, *supra* note 129, at 1164. Courts consider the public interest not only in deciding whether to disregard the doctrine of *in pari delicto*, but also in applying the doctrine and assessing the parties' relative culpabilities. *See, e.g.,* Precision Instrument Mfg. Co. v. Automotive Maintenance Mach. Co., 324 U.S. 806, 815-16 (1945) (doctrine of unclean hands applied to bar suit for infringement of patents because public interest in having patent monopolies free from fraud or inequitable conduct is paramount); Republic Molding Corp. v. B.W. Photo Utils., 319 F.2d 347, 350 (9th Cir. 1963) (relative wrong of each party's injury to the public must be taken into account in considering applicability of doctrine of unclean hands in action for patent and copyright infringement and unfair competition).

135. *See* Comment, *supra* note 129, at 1164; 3 J. POMEROY, EQUITY JURISPRUDENCE § 942 (5th ed. 1941). For this purpose, the comparison of the parties' culpabilities clearly is direct. This clarity is in contrast to the confusion generated by the justifiable reliance requirement, which leaves uncertain whether culpabilities are to be compared directly or whether the respective culpabilities of the plaintiff and defendant are to be compared separately against the same minimum standard. *See supra* note 69 and accompanying text.

136. *See* Note, *supra* note 128, at 558.

pees against tippers to recover for a decline in the value of securities purchased pursuant to the tippers' inside information.[137] In such cases, the tippee normally alleges that the information was material, incorrect, and delivered fraudulently or recklessly.[138] The tippee further claims that she justifiably relied upon the inside information (or, if required by the circuit in which suit is filed, that she exercised due diligence).[139] In response, the tipper usually claims that trading on inside information is itself a violation of Rule 10b-5[140] and that the tippee should thus be barred from recovery on the basis of equal fault.

Before the decision of the Supreme Court in *Bateman Eichler, Hill Richards, Inc. v. Berner*,[141] the success of the *in pari delicto* defense in the context of insider trading was difficult to predict. The federal courts differed widely in their handling of the defense, both in determining whether a tippee's

137. *See id.* at 558-59; Note, *The Availability of the* In Pari Delicto *Defense in Tippee-Tipper Rule 10b-5 Actions After* Dirks v. SEC, 62 WASH. U.L.Q 519, 523-24 (1984) [hereinafter Note, *The Availability of the* In Pari Delicto *Defense*]. Although the defense has been raised in other cases involving the defendant's violation of Rule 10b-5, the plaintiff's alleged wrongdoing in such cases usually has violated some law other than Rule 10b-5. *See, e.g.*, Mallis v. Bankers Trust Co., 615 F.2d 68, 76 (2d Cir. 1980) (plaintiffs' alleged usurious agreement to advance money for the purchase of unregistered securities insufficiently related to § 10(b) to support *in pari delicto* defense), *cert. denied*, 449 U.S. 1123 (1981).

138. For discussion of the elements of a Rule 10b-5 cause of action, see *supra* text accompanying notes 7-8 & 56.

139. *See supra* text accompanying note 81.

140. *See* Glickman, *"Tippee" Liability Under Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934*, 20 U. KAN. L. REV. 47, 49 (1971). The theory that insider trading by tippees violates Rule 10b-5 followed from the broad interpretation of Rule 10b-5 in SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied sub nom.* Coates v. SEC, 394 U.S. 976 (1969). There, the court held Rule 10b-5 applicable to anyone who possessed and traded on material inside information. *Id.* at 848. Although the court was not faced with the specific question whether a tippee's conduct was violative of Rule 10b-5, it did note that a tippee's conduct "certainly could be equally reprehensible." *Id.* at 852-53. The issue became confused, however, after the United States Supreme Court's decision in Chiarella v. United States, 445 U.S. 222, 235 (1980), which held that an employee of a financial printer that had been engaged by corporations to print corporate takeover bids did not violate Rule 10b-5 by purchasing securities of target companies without disclosing to sellers of securities that he knew of impending takeovers. The Court concluded that, because the employee had no fiduciary relationship with the sellers, and no other breach of fiduciary duty was properly raised, he had no duty to disclose. *Id.* at 228. For a discussion of the fiduciary duty test for tippee liability, see Note, *The Availability of the* In Pari Delicto *Defense*, *supra* note 137, at 538-39.

141. 105 S. Ct. 2622 (1985).

culpability was equal to that of the tipper and in resolving the question whether public policy was better served by allowing the defense or by denying it. Some courts dealt with the relative culpability question by treating tippers as the more culpable class.[142] This reasoning usually was followed by a policy determination that imposing liability on tippers would deter dissemination of inside information and reduce the opportunity for inside trading more effectively than requiring tippees to bear their own losses.[143] Courts based this determination on a belief that tippers are more sophisticated as a group, and thus more likely to respond to deterrent measures than would tippees. In addition, courts observed that there would be no one to complain of the tipper's violation if tippee suits were not allowed.[144]

Courts that allowed the *in pari delicto* defense in insider trading cases usually dealt rather summarily with the requirement of equal or greater fault.[145] The plaintiff's policy argu-

142. *See, e.g.,* Moholt v. Dean Witter Reynolds, Inc., 478 F. Supp. 451, 453 (D.D.C. 1979) (tippers pose greater threat to regulatory framework prohibiting insider trading than do tippees); Nathanson v. Weis, Voisin, Cannon, Inc., 325 F. Supp. 50, 57 (S.D.N.Y. 1971) (tipper who is a broker-dealer "presents a greater potential threat to undermining the statutory protection intended for the public investor" than does tippee). The probable success of the approach of treating tippers as more culpable than tippees was enhanced by the Court's statement in Dirks v. SEC, 463 U.S. 646, 659 (1983) that "the tippee's duty to disclose or abstain is derivative from that of the insider's duty."

143. *See, e.g., Nathanson,* 325 F. Supp. at 54-57; *but see* Kirkland v. E.F. Hutton & Co., 564 F. Supp. 427, 434 (E.D. Mich. 1983) (analyzing policy determination but concluding that *in pari delicto* defense does apply).

144. *See* Kuehnert v. Texstar Corp., 412 F.2d 700, 706 (5th Cir. 1969) (Godbold, J., dissenting) (noting that a private action may be the most important weapon in enforcing laws prohibiting insider trading).

145. *See, e.g.,* Tarasi v. Pittsburgh Nat'l Bank, 555 F.2d 1152, 1161-64 (3d Cir.) (tippees' suit against tippers barred by *in pari delicto* defense because tippees failed to disclose knowledge of possibility of merger before purchasing securities), *cert. denied,* 434 U.S. 965 (1977); *but see Kuehnert,* 412 F.2d at 703-04 (concluding that the *in pari delicto* should be allowed in tipper-tippee suits because disallowance would undermine the integrity of the courts and because allowance would not diminish the deterrent effect of the threat of prosecution by third parties and the enforcement agency). Occasionally, culpabilities were balanced simply by noting that the participation of both parties was voluntary. *E.g., Kuehnert,* 412 F.2d at 704 (noting that plaintiff's actions were entirely voluntary, constituting active participation in wrongdoing rather than mere knowledge of another party's wrongdoing). Other courts required active participation by both parties. *See, e.g.,* James v. DuBreuil, 500 F.2d 155, 159-60 (5th Cir. 1974) (seller's claim against buyer barred by doctrine of *in pari delicto* because of seller's active participation in plan to violate securities laws); Herzfeld v. Laventhol, Krekstein, Horwath & Horwath, 378 F. Supp. 112, 138 (S.D.N.Y. 1974) (counterclaim of underwriter who had actively participated in

ments were rebutted by the argument that because Rule 10b-5 had been adopted to protect innocent investors, its goals would not be hampered by requiring tippees to bear their own losses.[146] Moreover, acknowledgment of plaintiff fault was considered the only method of deterring tippee trading because such trading is typically difficult for either the SEC or private parties to detect.[147] Accordingly, such courts denied tippees an action for breach of warranty against the tipper for losses incurred while trading on information known to be unavailable to the public.[148]

2. *Bateman Eichler, Hill Richards, Inc. v. Berner*

The case of *Bateman Eichler, Hill Richards, Inc. v. Berner*[149] presented a factual situation quite typical of Rule 10b-5 cases in which the *in pari delicto* defense is raised. In *Berner*, the plaintiff investors brought an action charging that they had incurred substantial trading losses after a broker employed by Bateman Eichler, Hill Richards, Inc., together with the president of a corporation, acted fraudulently to induce them to purchase stock in the corporation. The claimed inducement consisted of divulging false and materially incomplete information about the corporation on the pretext that it was accurate inside information. The plaintiffs alleged violations of both Section 10(b) of the 1934 Act and Rule 10b-5.

The district court dismissed the complaint on the basis of the *in pari delicto* defense, noting that, on the face of the complaint, the plaintiffs themselves had violated the very securities laws under which the action was brought. On appeal to the Ninth Circuit, the dismissal was reversed because the district court failed to consider the relative fault of the parties and because of the appellate court's differing resolution of public policy considerations.[150] In light of the conflict among the lower courts with respect to the application of the *in pari delicto* doc-

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issuing misleading securities financial report dismissed on ground of *in pari delicto*), *aff'd in part and rev'd in part*, 540 F.2d 27 (2d Cir. 1976).

146. *See Tarasi*, 555 F.2d at 1162; *Kuehnert*, 412 F.2d at 704-05.

147. *See Kuehnert*, 412 F.2d at 705.

148. *See id.*; *cf.* Pearlstein v. Scudder & German, 429 F.2d 1136, 1148 (2d Cir. 1970) (Friendly, J., dissenting) (arguing that the benefit of private enforcement might be offset by the inducement to violate securities laws provided by tippees' "enviable position" of either reaping the benefits of inside information or suing when they do not), *cert. denied*, 401 U.S. 1013 (1971).

149. 105 S. Ct. 2622 (1985).

150. Berner v. Lazzaro, 730 F.2d 1319 (9th Cir. 1984).

trine in Rule 10b-5 cases,[151] the United States Supreme Court granted *certiorari*.[152]

In its opinion, the Court acknowledged the "dual premises" of the *in pari delicto* defense. These premises were: "first, that courts should not lend their good offices to mediating disputes among wrongdoers; and second, that denying judicial relief to an admitted wrongdoer is an effective means of deterring illegality."[153] The Court held, however, that there was no basis for applying the *in pari delicto* defense at such a preliminary stage of litigation—specifically on a motion to dismiss.[154] In so holding, the Court formally adopted a two-step approach for analyzing the *in pari delicto* defense employed by the lower courts, stating that

> a private action for damages in these circumstances may be barred on the grounds of the plaintiff's own culpability only where (1) as a direct result of his own actions, the plaintiff bears at least substantially equal responsibility for the violations he seeks to redress, *and* (2) preclusion of the suit would not significantly interfere with the effective enforcement of the securities laws and protection of the investing public.[155]

Although the Court assumed for purposes of discussion that the plaintiffs in *Berner* had violated Section 10(b) and Rule 10b-5 by reason of their actual or attempted tippee trading, the Court made it clear that additional evidence of culpability needed to be adduced before the plaintiffs' fault could be regarded as equal to that of the defendants. Borrowing from the reasoning of the lower courts that had found the *in pari delicto* defense generally inapplicable in such situations, the Court recognized "important distinctions" between the relative

151. *See supra* notes 141-148 and accompanying text.

152. 105 S. Ct. 776 (1985).

153. 105 S. Ct. at 2626-27 (footnotes omitted).

154. *Id.* at 2629 n.21.

155. *Id.* at 2629 (emphasis added). The Court discussed each prong of the two-part test separately. For purposes of this Article, the first prong of the test is referred to alternately as the "equal fault," "relative fault," or "relative culpability" test and the second prong is referred to as the "policy" test. The two-pronged test adopted by the Court in *Berner* was not novel. The same considerations had been discussed by lower courts in many other areas, including that of tippee trading, *see, e.g.,* Moholt v. Dean Witter Reynolds, Inc., 478 F. Supp. 451, 453 (D.D.C. 1979), and had been alluded to by the Court itself in the antitrust context, *see* Perma Life Mufflers, Inc. v. International Parts Corp., 392 U.S. 134, 138-39 (1968) (holding on unrelated issue limited by Copperweld Corp. v. Independence Tube Corp., 467 U.S. 752, 777 (1984)). The *Berner* Court briefly discussed the effect of this precedent. 105 S. Ct. at 2628. The superficial importance of *Berner* results only from the Court's application of the two steps in a typical tippee trading case.

culpabilities of tippers and tippees.[156]

In distinguishing between tipper and tippee culpabilities, the Court noted that, in the context of insider trading, a person whose illegal act is solely derivative cannot be said to be as culpable as one whose breach of duty first gave rise to the derivative act.[157] The Court went on to describe the potentially broader range of violations committed by tippers, listing fraud against individual shareholders (the only violation even arguably shared by tipper and tippee), breach of fiduciary duty to the issuer, and fraud against the tippee.[158] The last of these, according to the Court, was exacerbated in the case of securities professionals who breach a duty of honesty and fair dealing toward clients.[159] Further, the Court noted that tippers aroused wrongful urges in tippees that might otherwise have remained dormant and indicated that this factor by itself would suffice to establish the tippers' "far greater" culpability.[160]

Turning to the second prong of its two-step analysis, the Court recognized the primary objective of the federal securities laws to be "protection of the investing public and the national economy through the promotion of 'a high standard of business ethics . . . in every facet of the securities industry.' "[161] The Court concluded that this legislative goal would best be achieved by disallowing the *in pari delicto* defense.[162]

In discussing the policy reason behind its decision, the Court observed that tippees should be permitted to bring lawsuits both to expose false tippers and to supplement SEC enforcement efforts.[163] The Court stated that deterrence of insider trading would be maximized by pressuring the sources, rather than the users, of inside information.[164] The Court reasoned that this would be so both because the "first step in the

156. 105 S. Ct. at 2630.

157. *Id.*

158. *Id.*

159. *Id.*

160. *Id.* at 2631.

161. *Id.* (quoting SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186-87 (1963).

162. *Id.* This conclusion was somewhat limited by the statement that "situations might well arise in which the relative culpabilities of the tippee and his insider source merit a different mix of deterrent incentives." *Id.* at 2632. This statement suggests that the Court's policy findings were premised on an assessment of relative culpabilities. For an argument to the contrary, see *infra* text accompanying notes 171-173.

163. 105 S. Ct. at 2631.

164. *Id.* at 2632.

chain of dissemination" would be obliterated and because corporate insiders and broker-dealers would be more likely than tippees to be advised by counsel and, thus, more likely to respond to deterrent pressures.[165] Finally, the Court rejected the notion that it was granting to tippees an enforceable warranty on the truth of secret information. It indicated that the "enforceable warranty" theory was overstated because recovery could be had by tippees only against tippers who had acted with scienter and because the threat of civil and criminal penalties would deter tippees from attempting to enforce their claims.[166]

3. The Status of the *In Pari Delicto* Defense Since *Berner*

The *Berner* opinion makes it clear that, before the *in pari delicto* defense will apply, a tippee must somehow engage in behavior that is more culpable than simply trading on inside information, presumably illicitly obtained. The tippee's activities must be of such an extreme nature that it becomes appropriate to upset the Court's determination that as a general policy matter it is more important to deter tippers than tippees. Because the cases in which a tippee is found to be the more culpable party will presumably be quite rare, however, it should be easy for a court to conclude that failure to deter tippers in such infrequent circumstances would not be a "[significant interference] with the effective enforcement of the securities laws and protection of the investing public."[167]

The Court in *Berner* engaged in relatively scanty analysis[168] before adopting the classic formulation of the *in pari delicto* defense requiring that the defendant attempting to invoke the defense show substantially equal or greater culpability on the part of the plaintiff. The Court's primary justification

165. *Id.*

166. *Id.* at 2632-33.

167. *Id.* at 2629.

168. The true significance of the Court's reasoning in *Berner* is concealed by its more or less unquestioning adoption of the two-step approach and its apparent belief that both parts of the test would point to the same conclusion. If the Court had instead determined that it is, in general, more important to deter tippees than tippers but also determined that tippees are typically less culpable than tippers, it might not have stated the two tests as cumulative. Of course, such a situation might well be unlikely because the perceived cost of nondeterrence is apt to color one's view of culpability. *See supra* note 142 and accompanying text. *See also infra* text accompanying notes 171-172. Alternatively, the Court might have been more specific about some of the limitations of its tests instead of merely implying that the limitations exist.

for its decision was that it was supported by precedent.[169] Although earlier courts and commentators had attempted to justify the requirement of equal or greater culpability on the part of the plaintiff, the Court simply indicated that the fairness of the relative fault test is self-evident and irrefutable. At first glance, the Court seemed to assume that if a plaintiff's culpability did not exceed that of the defendant, the need to address the relevant policy considerations would be obviated.

In fact, the two-part *Berner* test cannot be taken at its face value. This is evidenced by the Court's analysis of the relative fault of the plaintiff and the defendant. The question of "fairness" as between the parties, without regard to the effects on society, was not specifically addressed by the Court. Nonetheless, if it is assumed that the burden of the plaintiff's injury must fall entirely on one or the other of the parties, allocation of that burden to the more culpable of the two probably comports with common notions of fairness.[170] A concern with inter-party equity was thus reflected in the Court's culpability comparison, although the importance of that equity *vis-a-vis* societal interests was left unclear. If the two-part test stated in *Berner* were strictly applied, in those situations where the defendant is more culpable than the plaintiff, the defendant would automatically be liable. The question of societal interest is considered only where the plaintiff is found the more culpable of the two. The two steps of the test only make sense, however, if societal implications are taken into account and deemed to be pro-plaintiff *before* a defendant's greater culpability is made determinative.

A hard look at the wording of the *Berner* opinion further reveals that the Court concealed its true line of reasoning. This becomes apparent upon a consideration of two statements in the Court's opinion. First, the Court made a qualifying statement that the equal fault and policy tests apply specifically to "these circumstances."[171] Second, the Court's used a quotation from a Supreme Court case that limited the *in pari delicto* defense in federal antitrust cases to situations in which the plaintiff's fault is at least equal to that of the defendant: *"[B]ecause*

169. 105 S. Ct. at 2627-28.

170. This, of course, reckons without such externalities as the parties' relative needs (which may or may not be subsumed as extenuating factors in the relative culpability determination), effects on the parties' families (which probably would not be subsumed either in the relative culpability determination or the policy test), and the like.

171. 105 S. Ct. at 2629; *see supra* text accompanying note 155.

of the strong public interest in eliminating restraints on competition, . . . many of the refinements of moral worth demanded of plaintiffs by . . . many of the variations of *in pari delicto* should not be applicable . . . ."[172] Both of these statements indicate that the Court's initial consideration was one of policy rather than inter-party equity. Only after the policy determination had been resolved did the Court proceed to determine the implications of the parties' relative fault.

If the foregoing analysis is correct,[173] it suggests that the two-step *Berner* test should be recharacterized as a list of at least three questions. The initial question is whether, as a matter of social policy, it is more important to deter the typical plaintiff or the typical defendant in the type of case addressed. In *Berner*, the Court indicated that the answer to this question is that it is more important to deter the typical tipper/defendant. The second question is which of the parties is the more culpable. This question of fact, which involves a direct comparison of the relative faults of the plaintiff and the defendant, was remanded to the lower court.

If the first two questions are answered in the plaintiff's favor, the inquiry terminates. Thus, where it is more important to deter typical defendants (as in the usual Rule 10b-5 *in pari delicto* context) and the defendant is the more culpable of the two, the plaintiff's suit can proceed. Only if the answer to the second question goes against the plaintiff will the third, and final, question be reached. That question is whether, in the particular circumstances of the case, public interest considerations outweigh considerations of inter-party equity. The *Berner* Court left this question open, stating in a footnote:

> Because there is no basis at this stage of the litigation for concluding that the respondents bore substantially equal responsibility for the violations they seek to redress, we need not address the circumstances in which preclusion of suit might otherwise significantly interfere with the effective enforcement of the securities laws and protection of the investing public.[174]

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172. 105 S. Ct. at 2628 (quoting Perma Life Mufflers, Inc. v. International Parts Corp., 392 U.S. 134, 151 (1968) (Marshall, J., concurring in result)) (emphasis added).

173. This is, of course, in contrast to the Court's own suggestion. *See supra* note 162.

174. 105 S. Ct. at 2632 n.30.

II. THE ANALOGY BETWEEN THE *IN PARI DELICTO* DEFENSE AND THE REQUIREMENT OF JUSTIFIABLE RELIANCE

A. THE PRESENT RELATIONSHIP OF DOCTRINES EMPHASIZING PLAINTIFF CONDUCT

In one sense, the justifiable reliance and the *in pari delicto* doctrines may be viewed as related ways of dealing with a single basic question: In the context of the transaction at issue, has the plaintiff acted as society would like? If the answer to that question is "yes," neither doctrine will be called into play and the plaintiff will not be barred from recovery for reasons related to his own conduct. If the answer is "no," the analysis associated with one or the other, or possibly both, of the doctrines may be invoked. Typically, if the plaintiff has been derelict in ascertaining the truth of a misrepresentation upon which he based the decision to invest, the doctrine of justifiable reliance will be raised. If the plaintiff has been derelict with regard to a duty to make disclosure to others, as where a tippee trades without disclosing the tipped information, *in pari delicto* analysis will presumably be called into play.[175]

The relationship of these two doctrines, each of which focuses on the importance of plaintiff conduct, can be illustrated by the following hypothetical. *X*, the chief financial officer of a small but publicly traded corporation, separately informs indi-

175. Although the doctrine of justifiable reliance may seek to manipulate the plaintiff's behavior for his own sake, societal interests, such as a desire to discourage predatory behavior by depriving predators of ready targets, are also at stake. Similar societal interests are considered in determining whether the *in pari delicto* defense is to apply. Moreover, prevention of injury to the plaintiff is sometimes a vital concern in the *in pari delicto* context. This is illustrated, for instance, in cases declining to apply the defense in situations involving federal antitrust laws. *See, e.g.*, Ring v. Spina, 148 F.2d 647, 652-53 (2d Cir. 1945) (applying Sherman Act to excuse plaintiff's participation in the combination, even though there was no showing that he was forced to cooperate, because the "Act seeks to protect [individuals] from combinations fashioned by others and offered to such individual as the only feasible method by which he may do business."); *cf., e.g.*, Mandeville Island Farms, Inc. v. Am. Crystal Sugar Co., 334 U.S. 219, 223 (1948) (applying Sherman Act to relieve plaintiff grower-sellers of sugar beets even though they contracted with respondent refiner, because refiner's control of seed supply and market gave them virtually no option). Refusal to apply the *in pari delicto* defense when the plaintiff is a member of the class intended to be protected, *see supra* text accompanying note 132, simply manifests judicial deference to a legislative determination of the most efficient means of rendering that protection. It does not reflect any necessary conclusion that injury to the plaintiff is somehow different in kind from injury to another.

vidual investors *A* and *B* that the company's net income in the past quarter was three times that of any previous quarter. *X* also tells *A* and *B* that when the company's financial results are released the price of its stock will surely rise. *A* requests and examines the relevant financial statements before purchasing the company's securities. *A* could not have detected that these statements were recklessly prepared. *A* generates sufficient trading activity to result in an increase in the stock's price. *A* makes additional purchases at the increased price. *X* sells her own holdings of the company's stock to *B* in a private transaction at the market price. *B* has conducted no investigation of the company's financial statements. When the company's correct financial results are eventually released, they show a moderate net loss. The price of the stock declines quickly. *A* and *B* each sue *X* to recover their losses, making all necessary allegations. *X* defends against *B* on the grounds that *X*'s statements regarding the performance of the company were clearly suspect and that *B* thus failed to meet the justifiable reliance standard. *X* defends against *A* on the basis that, even if *A*'s reliance were justified by reason of his investigative diligence, trading on information believed to be secret is an attempt to defraud third parties in violation of Section 10(b) of the 1934 Act of Rule 10b-5 and renders *A in pari delicto*.

B. EXTENDING THE *BERNER* ANALYSIS

As discussed above,[176] the test established by the Supreme Court in *Berner* severely limits the use of the *in pari delicto* defense in Rule 10b-5 litigation.[177] In light of this limitation, the requirement of justifiable reliance arguably cannot be sustained. At its simplest and most persuasive, this argument reasons that if a plaintiff who is guilty of intentionally committing a wrong against third parties will not be barred from recovery by the *in pari delicto* doctrine, recovery should also not be denied to a plaintiff who has probably been no more than reckless, and reckless only with respect to the possibility of injury to himself. This argument is based on the notion that although plaintiffs are of different types, they should be treated equally.

176. *See supra* text accompanying note 167.

177. It has not, however, eliminated it. *See, e.g.*, Rothberg v. Rosenbloom, 628 F. Supp. 746, 755-58 (E.D. Pa. 1986) (distinguishing *Berner* by finding that plaintiff tippee was the more culpable party and that barring plaintiff's suit on the ground of *in pari delicto* would not significantly interfere with enforcement of securities laws because defendants, rather than plaintiff, brought the fraudulent practices to light).

The matter of inter-plaintiff equity may be illustrated by reference to the hypothetical discussed above involving *X*, *A*, and *B*. Given the post-*Berner* state of the law, *A*, the plaintiff who investigated *X*'s claims and then traded on the open market, probably will be able to recover from *X* despite having had every reason to believe that he was working a fraud on the public at the time he made his investment. By contrast, *B*, who made no investigation and traded only with *X*, runs somewhat more of a risk of being precluded from recovery by virtue of his failure to meet the justifiable reliance test. This result is, of course, incongruous because *B*, unlike *A*, had no reason to believe that he was presenting any danger to anyone except himself.[178]

One way of resolving the paradox suggested by this illustration would be to modify the existing requirement of justifiable reliance to reflect the *in pari delicto* analysis of the *Berner* opinion. Such a modification, which need not address the requirement of actual reliance,[179] would involve the application of the Supreme Court's relative fault test. That test requires that "as a direct result of his own actions, the plaintiff [bear] at least substantially equal responsibility for the violations he seeks to redress . . . ."[180] As indicated above,[181] a number of cases applying a justifiable reliance requirement already contain language suggesting a comparison of the relative culpability of plaintiff and defendant. Even where courts have not specifically acknowledged a consideration of relative culpability, concern with inter-party equity has been evidenced by the consensus among such courts that a plaintiff will be barred from recovery only if he deviates from the standard of care to an extent that is more culpable than negligence.[182]

Unfortunately, even where courts have considered the relative culpability of the parties, they have failed to answer the question whether the same minimum standard of conduct should apply to both the plaintiff and the defendant or whether

178. The case presented by the *X*, *A*, *B* hypothetical is, of course, a very sympathetic one. The incongruity of result might be less in a more complicated scenario.

179. To modify the justifiable reliance requirement without affecting the actual reliance requirement, the two must be treated as separate elements. *See supra* text accompanying note 81.

180. Bateman Eichler, Hill Richards, Inc. v. Berner, 105 S. Ct. 2622, 2629 (1985).

181. *See supra* notes 65-68 and accompanying text.

182. *See id.*

the culpabilities of the parties must be directly compared. The Court in *Berner*, however, gave no indication that the application of the same minimum standard to both parties would be acceptable for *in pari delicto* purposes. Both the reliance of the Court on lower court precedent, which contemplated a comparison of the parties' culpabilities, and the Court's requirement that the plaintiff bear substantially equal responsibility indicate that the Court adopted the direct comparison approach.

Applying the direct comparison approach to the relative culpabilities of two parties in the context of a justifiable reliance analysis may have quite dramatic effects. Most obviously, such an application would virtually eliminate any implication of the plaintiff's conduct in cases where the defendant intended injury to the plaintiff.[183] Even more sweeping consequences might be achieved if the reasoning of the *Berner* court, that the party initiating a chain of wrongful conduct generally is more culpable than later participants in the chain, were adopted. Accordingly, application of the *Berner* relative fault test in cases applying the justifiable reliance requirement would result in an elimination of the traditional justifiable reliance issues in the vast majority of cases.

The notion that *all* plaintiffs in Rule 10b-5 cases should be subjected to the same test (of whether their individual responsibility exceeds that of the defendant) is appealing. Arguably, however, cases giving rise to an assertion of the *in pari delicto* defense typically involve the offense of fraudulent tipping and thus are substantially different from other types of Rule 10b-5 cases. As such, they merit a greater concern for deterring such defendant conduct. One notable distinction is that fraudulent tipping, as opposed to certain other Rule 10b-5 violations,[184] has

183. Aspects of that conduct, however, still might present implications for *in pari delicto* purposes. Thus, in the hypothetical involving *X*, *A* and *B*, intentional conduct on the part of *X* would virtually eliminate justifiable reliance considerations without necessarily eliminating those traditionally relevant to the *in pari delicto* defense.

184. For example, "garden variety" insider market trading allegedly leads to gradual changes in the prices of securities, thus avoiding drastic price swings at the time the insider's secret information becomes public. *See, e.g.*, Lorie, *Inside Trading: Rule 10b-5, Disclosure and Corporate Privacy: A Comment*, 9 J. LEGAL STUD. 819, 819 (1980) (noting that trading, both inside and outside, brings prices closer to equilibrium and thereby promotes efficiency in the securities market); Wu, *An Economist Looks at Section 16 of the Securities Exchange Act of 1934*, 68 COLUM. L. REV. 260, 265-69 (1968) (discussing classical economic theory under which speculation and, by extension, insider trading theoretically benefit the free market by stabilizing prices); *but see, e.g.*, Mendelson, *The Economics of Insider Trading Reconsidered* (Book Re-

no alleged social benefits. Accordingly, stamping out the activity of fraudulent tipping serves a stronger public interest.

In connection with the argument that fraudulent tipping is "worse" than other Rule 10b-5 violations, it is typically argued that, to stamp out fraudulent tipping, private actions are a "necessary supplement" to SEC enforcement action.[185] Unfortunately, the party injured by fraudulent tipping, and thus able to sue, will often be the *in pari delicto* tippee.[186] In fact, despite the possible breach of duty by the defendant and resulting injury to the larger group identified in *Berner*,[187] the tippee is usually the only party who is injured by and aware of the defendant's wrongdoing. In other Rule 10b-5 contexts, the likelihood is greater that *both* deserving and undeserving parties will be injured *and* aware of the possibility of recovery.[188] Thus, the need in such contexts to permit undeserving plaintiffs to recover is less pressing.

Even assuming that there is a special need to encourage plaintiffs to bring actions in the insider trading context, it does not necessarily follow that the supply of plaintiffs in other Rule 10b-5 cases must be restricted.[189] Accordingly, the argument that the requirement of justifiable reliance must be preserved because there is a greater concern with deterrence of defendants in the typical *in pari delicto* context is illogical. This proposition is illustrated by the hypothetical fraudulent tipping case in which the plaintiff's conduct runs afoul of both the traditional justifiable reliance doctrine and the traditional *in pari delicto* defense. If there really is a need for private plaintiffs in

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view), 117 U. PA. L. REV. 470, 472-76 (1969) (arguing that insider trading does not operate to correct "mispricings" of stock in the market, but rather contributes to a persistent misallocation of resources).

185. *See, e.g., Berner*, 105 S. Ct. at 2628.

186. In fact, unless the tip results in trading sufficient to affect market price, the tippee may be the only party injured.

187. *See supra* text accompanying note 158. Although the Supreme Court pointed out that a breach by the defendant of a duty to the issuer and its shareholders is possible, in many cases this breach will not result in an injury. This generally would be the case when a false tip is passed on only for the purpose of generating commissions. If, however, the tip results in an effect on the market price of the issuer's securities, those trading in the security might have a claim against the defendant based on manipulation, fraud on the market, or otherwise.

188. Justifiable reliance issues most often arise, however, in the context of face-to-face transactions and in any given case there probably will not be a choice of plaintiffs.

189. Such reasoning would be akin to arguing that, although vitamins are good for everyone and are in plentiful supply, only the sick should take them because they need them more than the healthy.

fraudulent tipping contexts, *neither* kind of plaintiff conduct should constitute a bar to recovery. In other words, if fraudulent tipping is involved, it seems that both the *in pari delicto* defense and justifiable reliance requirement should be eliminated (or limited to the same extent) to encourage a steady supply of plaintiffs as private enforcement officers.

Moreover, and more importantly, it is evident that the argument based on the special need for plaintiffs in the insider trading context is unrelated to a concern with either inter-party or inter-plaintiff equity. The *Berner* Court considered such an argument, not in connection with its relative fault text, but rather in connection with its conclusion that barring plaintiff recovery in such cases does not undermine enforcement of the federal securities laws or protection of the investing public. According to the Court's two-step approach, consideration of the effect of barring plaintiff recovery on the securities laws or on the investing public is not necessary unless there is also a finding that the plaintiff is at least as culpable as the defendant. Thus, even if there is no special need to encourage plaintiffs to bring suit in cases outside the *in pari delicto* context, the Court's own articulated analysis suggests that the concept of relative fault is basic to any analysis of the issue.

As noted above,[190] the two-step approach outlined by the Supreme Court in *Berner* was actually a three-step analysis. The Court posed the questions of (1) whether, in a particular type of case, it is more important to deter the defendant's or plaintiff's conduct, (2) which of the two actual parties is the more culpable, and (3) where the answers to the first two questions are not the same, whether public interest outweighs considerations of inter-party equity. Because the nature and quantum of the parties' conduct in the typical *in pari delicto* case was determinable, the Court had little difficulty comparing the impact of the plaintiff's conduct with the impact of the defendant's conduct. To make the comparison, and thus to answer its own first question, the Court assumed ideal behaviors for both the plaintiff and the defendant. These were, respectively, refraining from trading on tips and refraining from fraudulent tipping. The Court then considered the costs associated with deviations from the two ideals—that is, in each case, failure to refrain—and the value of the benefits to be obtained from deterrence.

Standards for measuring deviations from ideal conduct,

190. *See supra* text accompanying notes 173-74.

however, are not as well-developed in the justifiable reliance context.[191] This is most likely the result of both judicial confusion and the variety of factual contexts in which the issue of justifiable reliance has arisen. Reasons for the condition notwithstanding, the lack of standards in the justifiable reliance context appears to preclude easy application of the type of analysis employed by the Court in *Berner*. If this is true, the question of which party generally is favored by the public interest in the justifiable reliance context remains unanswered.[192]

Elimination of the *Berner* general policy analysis in the justifiable reliance context is not as facile as it may initially seem. Part IIA of this Article was itself a policy analysis concluding that the only real significance of the justifiable reliance requirement lay in its implications for inter-party equity. That conclusion suggests, as a general matter, that public policy favors the least culpable of the parties and that the relative-culpability step of the three-part *Berner* analysis may, and should, be reached directly.

If the answer to the first question of the three-part *Berner* analysis cannot be determined, that answer of course cannot conflict with the answer to the second question of the analysis. This does not mean, however, that courts should never address the third of *Berner*'s questions. There obviously should be some reservation about a test that consists of only an inter-party culpability comparison.[193] It would be ridiculous to conclude that, just because the public interest cannot be identified as a general matter, public policy will never be implicated in a justifiable reliance case. The public interest will undoubtedly arise in any number of factual circumstances. Accordingly, in any particular case where a public interest may be identified and runs counter to the result of the inter-party culpability comparison, the policy determination should be weighed against

191. *See supra* text accompanying note 69.

192. Some commentators have attempted to demonstrate that the requirement of justifiable reliance (often described as the duty of care) should be limited as a matter of legislative intent or the like. *See, e.g.*, Sachs, *supra* note 39 (arguing that Rule 10b-5 duty of care is inconsistent with common law and with statutory structure and policy and should be abandoned). These commentators presumably would conclude that the public interest generally favors the plaintiff.

193. This is particularly true insofar as the methodology of this comparison is, as yet, somewhat imprecise. *See infra* note 195 and accompanying text. The outcome of the comparison, however, probably is more predictable in the justifiable reliance context than in the context of *in pari delicto*. *See supra* text accompanying note 183.

the interest of inter-party equity. This, of course, is the final step of the restated three-part *Berner* analysis. It should also be the final step in a modified justifiable reliance analysis.

CONCLUSION

Section IIA of this Article rejected a number of the rationales allegedly underlying the justifiable reliance requirement and concluded that the only legitimate rationale for the requirement is the balancing of inter-party equities. Thus, the consideration of the plaintiff's conduct in this context can be characterized as largely a desire to achieve equity between the parties to the action. This indicates that, in actions brought under Rule 10b-5 for misrepresentation, the requirement that a plaintiff prove justifiable reliance in addition to actual reliance can, and should, be eliminated.[194] In its place, an analysis based on the second and third steps of the Court's restated approach in *Berner* should be substituted.

This proposal is easily justified. An extension of the *Berner* approach would result in an equitable treatment of plaintiff classes, given that courts would apply the same test to all plaintiffs. In addition, because the first applicable step of the *Berner* analysis requires a plaintiff to be "at least" as culpable as the defendant before the final, policy-weighing step of the analysis is reached, inter-party equity also would be consistently achieved.

To fully understand the impact that the *Berner* approach would have in the justifiable reliance context, the two steps of the approach need to be considered separately. Of the two, the step involving comparison of inter-party culpability will have the greater impact because it may dispose of the issue of a plaintiff's conduct in most of the cases in which it is applied. In addition, application of this step will moot the issue of whether justifiable reliance can exist if due diligence is not exercised. Comparison of the parties' culpabilities would also tend to obviate the need to articulate the plaintiff's duty in subjective or objective terms.[195] Moreover, since the inter-party culpability comparison would be considered separately from the test for actual reliance, yet another source of the existing confusion

194. To the extent that actual reliance is not a separate element in all jurisdictions, *see supra* text accompanying notes 96-98, it is suggested that it be made so.

195. Some such articulation, however, might be both possible and helpful. *See supra* notes 48-49 and accompanying text.

would be eliminated. The result of all of this would be a simplification of Rule 10b-5 litigation.

The impact of the application of the final *Berner* test, the policy test, is more difficult to predict. This Article has not directly addressed the rare situation in which a plaintiff's culpability equals or outweighs that of the defendant. As noted above,[196] however, the *Berner* Court itself declined to resolve the question whether the unusually culpable plaintiff should bear her own loss. In contrast, the Court was quite willing to consider other matters, such as the likelihood that a plaintiff's culpability would exceed that of a defendant, from a more general standpoint. This omission in the Court's analysis suggests recognition of the rarity with which courts will have to deal with the relatively more culpable plaintiff. This rarity justifies the assumption that such an occurrence will be too fact-specific to deal with in advance and suggests that the problem, when it arises, be dealt with on a case-by-case basis.

In conclusion, it should be acknowledged that several of the arguments advanced in this Article are based on the present inadequacies found to exist in justifiable reliance doctrine. This Article argues, for instance, that because potential defendants do not know what standard of care plaintiff's conduct will be measured against, abandonment of the justifiable reliance requirement would have no practical consequence on a potential defendant's ability to determine disclosure requirements. If the requirement of justifiable reliance were better defined, however, this argument might not be made. Similarly, it could be argued that in a more perfect world a different and preferable system for dealing with the relative culpability of parties could be devised. A comparative fault approach dividing losses between the parties might be an example of such a system.[197] Any such system, however, represents a drastic change from existing law and is by no means imminent or likely. Accordingly, the proposals described in this section are advanced in the belief that, if adopted, they would improve the present system with a minimum amount of disruption.

196. *See supra* notes 167-68 and accompanying text.

197. *See generally* Note, *A Comparative Fault Approach to the Due Diligence Requirement of Rule 10b-5*, 49 FORDHAM L. REV. 561 (1981) (suggesting that the due diligence requirement that bars recovery to culpable plaintiffs in Rule 10b-5 cases be reformulated as a comparative fault rule which would serve to reduce but not deny recovery).