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# LEGAL ANALYSIS OF WHAT CONSTITUTES RELIANCE UNDER SEC RULE 10b-5

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# ABSTRACT

Discusses antifraud statute of Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder in terms of common law principle of reliance in order to establish whether a cause of action for a securities law violation exists.

LEGAL ANALYSIS OF WHAT CONSTITUTES
RELIANCE UNDER SEC RULE 10b-5

The two major securities laws are the Securities Act of 1933 [1] and the Securities Exchange Act of 1934.[2] The Securities Act of 1933 attempts to assure the availability to the public of adequate reliable information about publicly offered securities. In order to accomplish this, the Act makes it illegal to offer for sale or sell securities to the public unless they are registered with the Securities and Exchange Commission.[3] Registration under the 1933 Act covers only the securities actually being offered and only for the purposes of the offering which have been described in the registration statement. Material which must be included in the registration is specified[4] and essentially consists of all material financial information which a prospective investor might need to make an informed investment decision. Certain kinds of securities, such as federal government or state securities, are exempted from the registration process.[5] Further, certain kinds of transactions are exempted.[6] These exempted transactions include private placements, intrastate offerings, and small offerings.

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[1] 15 U.S.C. secs. 77a <u>et seq.</u>

[2] 15 U.S.C. secs. 78a <u>et seq.</u>

[3] 15 U.S.C. sec. 77e.

[4] 15 U.S.C. sec. 77g, with reference to Schedule A, which may be found at 15 U.S.C. sec. 77aa.

[5] 15 U.S.C. sec. 77e.

[6] 15 U.S.C. sec. 77d.

The Securities Exchange Act of 1934 is concerned with many different areas, such as the creation of the Commission,[7] the regulation of the trading markets,[8] the regulation of publicly-held companies,[9] and the ongoing process of disclosure to the investing public through the filing of periodic and updated reports with the Commission.[10] Any issuer which has a class of securities traded on a national securities exchange or total assets exceeding a certain amount and a class of equity shareholders with at least a certain number of shareholders must register with the SEC. Annual reports and other reports as required by the SEC must be filed.[11]

Section 10(b) [12] of the Securities Exchange Act is the major antifraud provision. The statute, which applies to any security whether or not registered on a national securities exchange, makes it unlawful to commit any fraudulent act in connection with the purchase or sale of a security. The statute states:

> 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 national securities exchange -
>
> (a) . . . .
> (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.

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7 15 U.S.C. sec. 78d.

8 15 U.S.C. secs. 78g-78i.

9 15 U.S.C. secs. 78*l*-78o.

10 15 U.S.C. sec. 78m.

11 15 U.S.C. sec. 78*l*.

12 15 U.S.C. sec. 78m.

In order to comply with the requirement that rules be promulgated to implement this provision, the SEC adopted Rule 10b-5:[13]

> 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,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

In determining the elements of fraud for a 10b-5 case, the courts have looked to the common law for guidance. A leading securities case, *List* v. *Fashion Park, Inc.*,[14] states that reliance is one of these common law elements required in a 10b-5 private cause of action:

> Thus, to the requirement that the *individual plaintiff* must have acted upon the fact misrepresented, is added the parallel requirement that a *reasonable man* would also have acted upon the fact misrepresented.[15]

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13 17 C.F.R. sec. 240.10b-5.

14 340 F.2d 457 (2d Cir. 1965), *cert. denied* 382 U.S. 811 (1965).

15 *Id.*, at 462.

This case cites Prosser's definition of reliance and then explains why reliance is a necessary element for a finding of fraud:

> Insofar as is pertinent here, the test of "reliance" is whether "the misrepresentation is a substantial factor in determining the course of conduct which results in [the recipient's] loss." Restatement, Torts sec. 546 (1938); accord Prosser, Torts 550, (2 ed. 1955). The reason for this requirement, as explained by the authorities cited, is to certify that the conduct of the defendant actually caused the plaintiff's injury.[16]

Although it appears settled that a determination of reliance is a necessary element in finding a 10b-5 violation, proving this reliance is often quite difficult. This proof is especially difficult when the plaintiff alleges that he would have acted differently with respect to securities if the defendant had not omitted some material information from his statements. This type of situation is illustrated in Affiliated Ute Citizens of Utah v. United States.[17] In this case the Court held liable for a violation of Rule 10b-5 two people who had omitted material facts concerning the market price of shares of stock even though the record did not disclose evidence of reliance on the omissions. The Court found that positive proof of reliance may not be required in a situation in which a reasonable investor might have considered important facts which were omitted.

> The sellers had the right to know that the defendants were in a position to gain financially from their sales and that their shares were selling for a higher price in that market . . . .
>
> Under the circumstances of this case, involving primarily a failure to

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16 Id.

17 406 U.S. 128 (1972).

> 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.[18]

Thus, this case stands for the proposition that a plaintiff's reliance can be presumed from the materiality of the omissions, thereby placing the burden of proof to show otherwise upon the defendant. Most courts after the Ute decision have followed this rule.[19] However, the Sixth Circuit has denied a 10b-5 claim in a situation in which material facts were not disclosed in an open-market transaction.[20]

It is perhaps axiomatic to state that reliance by the plaintiff in a 10b-5 case must be reasonable, and most of the courts have followed this reasonableness standard. In Zobrist v. Coal-X, Inc.,[21] for example, the court denied plaintiff's fraud action against sellers of stock on the basis that knowledge of warnings and statements contained in the private placement memorandum would be imputed to the plaintiff even though he had not read it. The court stated:

> Under the circumstances of this case, when we impute to Phil Rasmussen knowledge of the warnings contained in the Private Placement Memorandum, it becomes clear that, as a matter of law, his reliance on the misrepresentations was not justified. We reach this conclusion after a consideration of the

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18 Id., at 153-154.

19 See Rivkin v. Crow, 574 F.2d 256 (5th Cir. 1978), and Titar Group, Inc. v. Faggen, 513 F.2d 234 (2d Cir. 1975).

20 Fridrich v. Bradford, 542 F.2d 307 (6th Cir. 1976), cert. denied, 429 U.S. 1053 (1977).

21 708 F.2d 1511 (10th Cir. 1983).

> above noted factors. It is true, that Phil Rasmussen previously participated in investments with Baker, but there was no evidence of any long standing business or personal relationship that, in light of the patent contradiction between Baker's representations and the express warnings disclosed in the Private Placement Memorandum, would justify Rasmussen's reliance on Baker's representations without further inquiry. Not only did the defendants not conceal their fraud from Rasmussen, they provided him with information and warnings which exposed the representations as false. It was not necessary for Rasmussen to delve into voluminous books and records, or to decipher balance sheets and financial statements; the warning on the first page of the memorandum contradicted the representations of no risk, and there were four full pages devoted to concise, informative descriptions of the risks inherent in coal mining and partnerships.
>
> In short, there is simply no evidence which provides a valid reason for Rasmussen's reliance on the general misrepresentations as to risk when he is considered to have knowledge of the specific warnings contained in the memorandum.[22]

The court summarized the relevant factors for determining whether reliance was reasonable:

> (1) the sophistication and expertise of the plaintiff in financial and securities matters; (2) the existence of long standing business or personal relationships; (3) access to the relevant information; (4) the existence of a fiduciary relationship; (5) concealment of the fraud; (6) the opportunity to detect the fraud; (7) whether the plaintiff initiated the stock transaction or sought to expedite the transaction;

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22 Id., at 1518.

> and (8) the generality or specificity of the misrepresentations.[23]

However, there is some authority standing for the proposition that, in a case of intentional misrepresentation, reasonable reliance is not necessary.[24]

In applying the presumption of reliance in cases where there were perhaps no face to face transactions, many courts have looked to whether a fraud on the market occurred. This theory rests on a showing that the market price of the stock concerned was affected by the omission or wrongful statement and that the plaintiff's injury has been caused by a purchase or sale of the stock at the fraudulently induced market price. One of the most recent of these cases, Lipton v. Documentation, Inc.,[25] serves to illustrate how this theory works. Plaintiffs brought this case alleging securities fraud on the basis that the defendants disseminated into the marketplace information that falsely claimed that Documentation had substantial earnings when, in fact, they knew that the company had had a significant loss. Although the plaintiffs had not directly relied on those documents, they asserted the fraud on the market theory because they had detrimentally relied on the market prices in purchasing the securities. The defendants moved to dismiss the complaint on the basis that, since plaintiffs had not directly relied on the misleading documents, plaintiffs had no claim. The court held in favor of the plaintiffs, finding that the fraud on the market theory does not actually eliminate the need to show reliance but in fact presumes

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[23] Id., at 1516.

[24] See, Competitive Associates, Inc., v. Laventhol, Krekstein, Horwath & Horwath, 516 F.2d 811 (2d Cir. 1975), and Metro-Goldwyn Mayer, Inc. v. Ross, 509 F.2d 930 (2d Cir. 1975).

[25] 734 F.2d 740 (11th Cir. 1984), cert. denied, 105 S.Ct. 814 (1985). See also F.J. Raney & Sons, Inc., v. Fort Cobb Oklahoma Irrigation Fuel Authority, 717 F.2d 1330 (10th Cir. 1983); Panzirer v. Wolf, 663 F.2d 365 (2d Cir. 1981), vacated as moot, 459 U.S. 1027 (1982); and Shores v. Sklar, 647 F.2d 462 (5th Cir. 1981), cert denied, 459 U.S. 1102 (1983).

reliance unless the defendant can prove that the misrepresentations were immaterial or that the plaintiff's decision to purchase was or would have been unaffected if he had known the true facts about the securities. In this case the defendant could not so prove. The court in Lipton stated that "The theory thus actually facilitates Congress' intent in enacting the federal securities law by enabling a purchaser to rely on an expectation that the securities markets are free from fraud."[26]

This last quoted sentence brings attention back to the summary at the beginning of this report of the Securities Act of 1933 and the Securities Exchange Act of 1934. Both of these acts take as their premise that companies subject to the SEC filing requirements must disclose all material information so that investors will have the necessary means to make wise decisions. In essence, investors are supposed to be provided with reliable information. Their reliance, however, does not have to be direct or in face to face transactions; it may, instead, be presumed. This is, in fact, what often happens and many courts have interpreted Rule 10b-5 to cover this type of situation.

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26 Id., at 748.