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SECURITIES

OVERVIEW

During the recent survey period, the Tenth Circuit Court of Appeals decided three cases[1] involving either the Securities Act of 1933[2] (1933 Act) or the Securities and Exchange Commission Act of 1934[3] (1934 Act). A fourth case, *Chandler v. KEW, Inc.*,[4] was ordered published during the survey period and is discussed in this section.

Chandler's publication reinforced the Tenth Circuit's leading position in the ongoing debate over whether the sale of 100% of the stock in a corporation is a securities transaction within the purview of federal securities laws.[5] In a similar case, *Hackford v. First Security Bank*,[6] the court refused to treat an instrument's denomination as "stock" as the controlling factor in deciding whether the securities laws applied to a transaction.[7] *Zobrist v. Coal-X, Inc.*[8] examined the scope of an investor's duty of diligence when purchasing a security.[9] The fourth case, *Baum v. Great Western Cities, Inc.*,[10] merely upheld a jury's finding that plaintiffs had failed to prove the scienter required to establish a violation of rule 10b-5.[11] *Baum*, because of its limited precedential importance, will not be discussed in this survey.

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1. Zobrist v. Coal-X, Inc., 708 F.2d 1511 (10th Cir. 1983); Baum v. Great Western Cities, Inc., 703 F.2d 1197 (10th Cir. 1983); Hackford v. First Sec. Bank, No. 81-1863 (10th Cir. Jan. 31, 1983).

2. 15 U.S.C. §§ 77a-77aa (1982).

3. 15 U.S.C. §§ 78a-78kk (1982).

4. 691 F.2d 443 (10th Cir. 1977) (ordered published Oct. 18, 1982).

5. *Compare, e.g.*, Canfield v. Rapp & Son, Inc., 654 F.2d 459 (7th Cir. 1981); Fredericksen v. Poloway, 637 F.2d 1147 (7th Cir.), *cert. denied*, 451 U.S. 1017 (1981) (holding that the sale of 100% of the stock in a corporation is not a securities transaction) *with* Seagrave Corp. v. Vista Resources, Inc., 696 F.2d 227 (2d Cir. 1982); Golden v. Garafolo, 678 F.2d 1139 (2d Cir. 1982) (holding that such transactions fall within the purview of the securities laws). *See also* Dillport, *Restoring Balance to the Definition of Security*, 10 SEC. REG. L.J. 99 (1982); Seldin, *When Stock Is Not a Security: The "Sale of Business Doctrine" under the Federal Security Laws*, 37 BUS. LAW. 637 (1981); Thompson, *The Shrinking Definition of a Security: Why Purchasing All of a Company's Stock Is Not a Federal Security Transaction*, 57 N.Y.U. L. REV. 225 (1982); Note, *Securities Law*, 65 MARQ. L. REV. 487 (1982).

6. No. 81-1863 (10th Cir. Jan. 31, 1983).

7. *See infra* notes 40-67 and accompanying text.

8. 708 F.2d 1511 (10th Cir. 1983).

9. *See infra* notes 67-102 and accompanying text.

10. 703 F.2d 1197 (10th Cir. 1983).

11. *Id.* at 1206, 1210-11. Rule 10b-5, an anti-fraud rule promulgated under section 10b of the Securities and Exchange Commission Act of 1934, 15 U.S.C. § 78j(b)(1982), is codified at 17 C.F.R. § 240.10b-5 (1983). The Supreme Court has held that proof of some degree of scienter is necessary to establish a violation of rule 10b-5 when plaintiffs seek money damages under the rule, Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), but has not ruled on whether proof of reckless behavior satisfies the scienter requirement. *Id.* at 194 n.12. *Accord* Aaron v. SEC, 446 U.S. 680, 686 n.5 (1980). The Tenth Circuit holds the scienter element established upon proof of reckless behavior. Hackbart v. Holmes, 675 F.2d 1114 (10th Cir. 1982). *Hackbart* is discussed in last year's Tenth Circuit Survey. *See Securities, Ninth Annual Tenth Circuit Survey*, 60 DEN. L.J. 373, 373-80 (1982).

I. *CHANDLER V. KEW, INC:* THE SALE OF BUSINESS DOCTRINE

A. *The Case*

Chandler charged defendant KEW, Inc. with securities fraud in the sale of a liquor business.[12] Chandler contended that because the sales contract for the liquor store included 100% of defendant's outstanding corporate stock, and because "stock" was defined as a security by the 1933 and 1934 Acts,[13] the transaction was subject to federal securities laws.[14] The trial court rejected plaintiff's argument, and dismissed Chandler's claim for lack of subject-matter jurisdiction.[15] In a tersely worded opinion, the Tenth Circuit affirmed the trial court and held that the sale of 100% of the stock in a liquor store as part of the sale of the business was not a securities transaction within the meaning of the 1933 and 1934 Acts.[16]

Relying on *United Housing Foundation, Inc. v. Forman*,[17] the court rejected plaintiff's argument that KEW's sale of stock in the liquor business should be considered a security transaction simply because the statutory definition of security included the word "stock."[18] The court viewed *Forman* as limiting the application of the federal securities laws to those transactions in which the "economic reality" involved an investment in the investment scheme of another.[19] The economic reality of Chandler's transaction was the sale of ownership of a business via transfer of stock, rather than the sale of stock qua security.[20] Hence, the transaction was not subject to federal securities laws.

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12. Chandler v. KEW, Inc., 691 F.2d 442, 443 (10th Cir. 1983).

13. The 1933 Act defines "security" in 15 U.S.C. § 77b(1) (1982). This section provides:

> [U]nless the context otherwise requires—(1) the term "security" means any note, *stock*, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

Id. (emphasis supplied).

The 1934 Act's definition of security is found in 15 U.S.C. § 78c(a)(10) (1982). This definition is almost identical to that found in the 1933 Act; the primary difference between the two definitions is the 1934 Act's exclusion of short-term notes. *Compare* 15 U.S.C. § 77b(1) (1982) *with* 15 U.S.C. § 78c(a)(10)(1982). The minor differences between the two Acts have been found to lack controlling significance. *See* Tcherepnin v. Knight, 389 U.S. 332, 342 (1967); Baurer v. Planning Group, Inc., 669 F.2d 770, 776 (D.C. Cir. 1981). *See also* International Bhd. of Teamsters v. Daniel, 439 U.S. 551, 556 n.7 (1979).

14. 691 F.2d at 443.

15. *Id.* Both the 1933 and 1934 Acts contain provisions for federal jurisdiction over suits asserting violations of those Acts. 15 U.S.C. § 77v(a)(1982)(1933 Act); 15 U.S.C. § 78aa(1982)(1934 Act). Lack of diverse citizenship between the parties precluded subject-matter jurisdiction once the federal securities claims were dismissed. 691 F.2d at 334.

16. 691 F.2d at 444.

17. 421 U.S. 837 (1975).

18. 691 F.2d at 443, *See supra* note 13.

19. *See* 691 F.2d at 443-44.

20. *Id.* at 444.

B. *The Sale of Business Doctrine*

Chandler, although published belatedly, was the first post-*Forman* appellate recognition of the sale of business doctrine.[21] This doctrine restricts the application of federal securities laws to those stock transfers which have the indicia of an investment in a security. Stock transfers which are in effect merely evidence of a commercial sale of property are, under this doctrine, beyond the scope of the 1933 and 1934 Acts.[22]

The source of this restriction on the protection of federal law is found in the Supreme Court opinions setting out the identifying characteristics of those investments constituting federal securities.[23] Lower courts applying the sale of business doctrine read the Court's classificatory opinions as mandating an inquiry into the economic reality of an alleged securities transaction regardless of the formal denomination of the instruments involved.[24] Only when that inquiry reveals the type of investment contemplated by the 1933 and 1934 Acts (33/34 Act investment)[25] will federal securities laws be applicable to a transaction.[26]

Forman is the Court's most recent delineation of the general characteristics of a 33/34 Act investment. Under *Forman*, application of the federal securities laws is justified whenever there is an investment of valuable consideration in an enterprise with the expectation that the enterprise will generate profits through the management of a promoter or other third party.[27] Thus, even though an instrument may be denominated "stock," it is not a 33/34 Act investment unless the transaction involving the instrument manifests the basic economic realities described immediately above.[28]

The sale of business doctrine is a specific example of how courts apply

21. Seldin, *supra* note 5, at 642.

22. Frederiksen v. Poloway, 643 F.2d 1147, 1150 (7th Cir.), *cert. denied*, 451 U.S. 1017 (1981). *Accord* Thompson, *supra* note 5, at 252. *See also* Dillport, *supra* note 5, at 114. *Cf.* SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 348 (1943) (fact that reality of transaction was not commercial sale of leasehold interest supported finding that transaction involved a security).

23. *E.g.*, United Hous. Found., Inc. v. Forman, 421 U.S. 837 (1977); SEC v. W.J. Howey Co., 328 U.S. 293 (1946); SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344 (1943).

24. *E.g.*, King v. Winkler, 673 F.2d 342 (11th Cir. 1982); Frederiksen v. Poloway, 643 F.2d 1147 (7th Cir.), *cert. denied*, 451 U.S. 1017 (1981); Chandler v. KEW, Inc., 691 F.2d 443 (10th Cir. 1977).

25. The phrase "33/34 Act investment" is used in lieu of the statutory phrase "security" in order to emphasize the judicial focus on the economic reality of a transaction rather than the transaction's formal characteristics.

26. *See, e.g.*, King v. Winkler, 673 F.2d 342 (11th Cir. 1982); Frederiksen v. Poloway, 643 F.2d 1147 (7th Cir.), *cert. denied*, 451 U.S. 1017 (1981).

27. *See* United Hous. Found., Inc. v. Forman, 421 U.S. 837, 852 (1977). *Forman* left open an important question which has occupied the circuit courts since SEC v. W.J. Howey Co., 328 U.S. 293 (1943), the decision *Forman* relys on in articulating the factors distinguishing commercial transactions from securities transactions. *See* 421 U.S. at 852 (quoting SEC v. W.J. Howey Co., 328 U.S. 293, 301 (1943)). *Howey* required an expectation of profits *solely* from the efforts of others. 388 U.S. at 301. *Forman* noted that the Ninth Circuit, in SEC v. Glenn W. Turner Enters., Inc., 474 F.2d 476 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973), had held that a security was present even though profits were partially dependent on the investors' efforts. 421 U.S. at 852 n.16 (citing *Turner*, 474 F.2d at 482). The Court, however, refrained from commenting on the *Turner* holding. 421 U.S. at 852 n.16. *But see* International Bhd. of Teamsters v. Daniel, 439 U.S. 551, 560 n.12 (1979) (stating that the required investment may be in form of services, citing *Forman*'s recognition of *Turner*).

28. *Forman*, 421 U.S. at 848, 850-51.

Forman's economic realities concept to evaluate a class of investment transactions. Typically, courts applying the doctrine find that the transfer of 100% of a business' stock divests the seller of management prerogative, thereby precluding application of the federal securities laws.[29] Thus, although the purchase of a business may be an investment in the conventional sense, it is not an investment entitled to the protection of the 1933 and 1934 Acts.

Not all circuits accept the sale of business doctrine, however. Those courts which reject the doctrine do not read *Forman* to establish the economic reality inquiry as the sole determinant of a statutory security.[30] According to these courts, the federal securities laws are applicable when a transaction involves *either* instruments having the characteristics normally associated with that type of instrument[31] *or* when the transaction has the economic reality of a 33/34 Act investment.[32] These courts read *Forman* as containing two holdings: first, the instruments involved lacked the normal attributes of stock and therefore were not securities, and second, the instruments involved were not securities as a matter of economic reality.[33] Both types of purchasers are entitled to federal protection, the latter because Congress intended to protect the unwary and the former because purchasers of instruments commonly understood to be securities are entitled to rely on the protection of federal securities laws.[34]

Regardless of the merits of reading *Forman* to establish two standards for identifying securities within the meaning of the 1933 and 1934 Acts,[35] *Chandler* and *Christy v. Cambron*,[36] another recent Tenth Circuit decision,[37] clearly establish that the economic reality test is the sole relevant inquiry in the Tenth Circuit. Thus, unless the purchaser of a business can establish that

29. *E.g.* King v. Winkler, 673 F.2d 342 (11th Cir. 1982); Canfield v. Rapp & Son, Inc., 654 F.2d 459 (7th Cir. 1981).

30. *See, e.g.*, Golden v. Garafolo, 678 F.2d 1139, 1144 (2d Cir. 1982); Mifflin Energy Resources, Inc. v. Brooks, 501 F. Supp. 334 (W.D. Pa. 1980); Titsch Printing, Inc., v. Hastings, 456 F. Supp. 445 (D. Colo. 1978); Bronstein v. Bronstein, 407 F. Supp. 925 (E.D. Pa. 1976).

31. For example, an instrument will be considered stock within the meaning of the 1933 and 1934 Acts when it entitles the owner to dividends, can be hypothecated, and bears other indicia traditionally associated with instruments denominated "stock." *See Golden*, 678 F.2d at 1144; *Mifflin Energy Resources*, 501 F. Supp. at 336; *Titsch Printing, Inc.*, 456 F. Supp. at 449; *Bronstein*, 407 F. Supp. at 929-30.

32. *See Golden*, 678 F.2d at 1144; *Titsch Printing, Inc.*, 456 F. Supp. at 449.

33. *E.g., Golden*, 678 F.2d at 1144; *Titsch Printing, Inc.*, 456 F. Supp. at 449. *Accord* Dillport, *supra* note 5, at 115. *But see* Thompson, *supra* note 5, at 246-50 (*Forman* requires analysis of nature of underlying transaction to determine applicability of federal securities laws regardless of the formal characteristics of a transferred instrument).

34. *Mifflin Energy Sources, Inc.*, 501 F. Supp. at 336; *Titsch Printing Co.*, 501 F. Supp. at 449. *Golden* also rejects limiting federal protection to instruments satisfying the economic reality test, but on a different basis than *Mifflin* and *Titsch*. *Golden* reasoned that the careful statutory list of covered instruments, *see supra* note 13, would have been superfluous had Congress intended to adopt only the economic reality test. 698 F.2d at 1144-45. Further, to adopt the economic reality test as exclusive would create uncertainty in the application of the Act, thereby undermining its prophylactic effect. *See id.* at 1146.

35. *Compare* Thompson, *supra* note 5, at 246-50 (rejecting dual standards) *with* Dillport, *supra* note 5, at 114-16 (supporting dual standards).

36. 710 F.2d 669 (10th Cir. 1983).

37. *Christy* was decided after the close of the survey period, and is therefore not discussed in this section.

the seller has retained control over management of the business,[38] in all probability the buyer will be required to resort to state law remedies for fraud and misrepresentation.[39]

II. GRAZING RIGHTS AS A FEDERAL SECURITY

During the survey period the Tenth Circuit Court of Appeals also relied on the economic reality inquiry to arrive at a decision concerning the nature of the instruments involved in *Hackford v. First Security Bank*.[40] The dispute in *Hackford* grew out of the distribution of Ute Indian reservation lands following execution of the Ute Indian Supervision Termination Act[41] (Termination Act). The Termination Act divided members of the Ute Tribe into two classifications: "full blood" (those who are at least one-half Ute Indian and more than one-half Indian ancestry);[42] and "mixed blood" (those who are part Ute Indian but who do not qualify as full bloods).[43] In accordance with the Termination Act, 490 mixed bloods received 172,000 acres of range land as part of their share of the partition of Ute tribal assets.[44] To facilitate the distribution, the mixed bloods formed two nonprofit corporations to maintain the rangelands.[45] Each mixed blood then surrendered his interest in the land for a share in each corporation.[46] Each share permitted a member to graze a specified number of cattle and sheep for a specified number of days each year.[47]

First Security Bank was designated as the transfer agent for the shares, and in addition was named by the Secretary of the Interior to act as trustee for assets owned by mixed blood incompetents and minors.[48] The full bloods, with permission of the Bureau of Indian Affairs, offered the mixed bloods, and the bank acting as trustee, $1100 per share for the range corporation stock.[49] The bank, in accordance with Department of Interior regula-

38. *See* Christy v. Cambron, 710 F.2d 669, 672 & n.1 (purchasers of less than 100% of shares not entitled to bring action under federal securities laws because their participation in venture precluded finding profits were derived from efforts of others). *But see* Crowley v. Montgomery Ward & Co., 570 F.2d 875, 877 (10th Cir. 1975) (security present where *essential* managerial efforts those of seller of investment) (citing SEC v. Glenn W. Turner Enters. Inc., 474 F.2d 476 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973)).

39. *Forman* stated that the name given an instrument might lead a purchaser to rely on the protection of the federal securities laws, especially when the instrument "embodies some of the significant characteristics typically associated with the named instrument." 421 U.S. at 850-51. Theoretically, therefore, an investor might be entitled to federal protection even absent purchase of an "economically real" security. It should be noted, however, that the Seventh Circuit, which has adopted the sale of business doctrine, recently held that the purchaser of a business could not justifiably rely on federal security law protection because of the commercial nature of the purchase transaction. Canfield v. Rapp & Son, 654 F.2d 459, 466 n.7 (7th Cir. 1981).

40. No. 81-1863 (10th Cir. Jan. 31, 1983).

41. 25 U.S.C. §§ 677-677aa (1982).

42. *Id.* § 677a(b).

43. *Id.* § 677a(c).

44. Hackbart v. First Sec. Bank, No. 81-1863, slip op. at 2-3 (10th Cir. Jan. 31, 1983).

45. *Id.* at 3.

46. *Id.*

47. *Id.*

48. *Id.* at 4.

49. *Id.*

tions, offered the shares to the mixed bloods, the full bloods, and to the Ute Tribe as a whole for at least $1100 per share.[50] This offer was accepted by the full bloods.[51]

The plaintiffs in *Hackford* represented a class of mixed blood trust beneficiaries whose stock was sold to the full bloods.[52] Among other allegations,[53] the plaintiffs contended that the bank violated the antifraud provisions of rule 10b-5[54] and section 10b of the Securities and Exchange Commission Act of 1934.[55] The Tenth Circuit Court of Appeals, applying the economic reality analysis articulated in *SEC v. W.J. Howey Co.*,[56] rejected the plaintiffs' charge, ruling that the shares in the range corporations were not securities within the meaning of the 1934 Act.[57]

Howey defined a security transaction as an investment in a common enterprise with the expectation of profits to be derived solely from the efforts of others.[58] In *Hackford*, the Tenth Circuit ruled that the range corporation stock failed the expectation of profits branch of the *Howey* test for several reasons. First, the range corporation was organized as a nonprofit corporation under Utah law, precluding any reasonable expectation of distributions.[59] Second, the court found that any intent to capture any appreciation in stock value caused by corporate activities was incidental to the real purpose of the group, which was to facilitate grazing for its members.[60] Because the primary motivation in acquiring the shares was use of the tribal property, the mixed bloods lacked the necessary profit motivation.[61] Alternately, the lack of evidence that the corporation had been promoted as a source of profits precluded any finding of profit motivation by those mixed bloods not

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50. *Id.*

51. *Id.*

52. *Id.* at 5.

53. The plaintiffs also alleged the bank breached its fiduciary trust obligations by not maximizing the sale price of the range land. The trial court ruled that the bank had set an appropriate price; this finding was upheld by the Tenth Circuit. *Id.* at 11-12.

54. 29 C.F.R. § 240.10b-5 (1983). Rule 10b-5 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,
>
> (1) to employ any device, scheme, or artifice to defraud,
>
> (2) 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
>
> (3) 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 sale of any security.

Id.

55. 15 U.S.C. § 78j(b) (1982).

56. 328 U.S. 293 (1943). The *Howey* analysis served as the basis of the *Forman* holding. *See supra* note 27.

57. No. 81-1863, slip op. at 9.

58. 328 U.S. at 301.

59. No. 81-1863, slip op. at 8. *See* UTAH CODE ANN. § 16-6-21 (1953) (incorporation under nonprofit corporation act limited to corporations not organized for pecuniary purposes).

60. No. 81-1863, slip op. at 8. *Cf.* Aldrich v. McCulloch Properties, Inc., 627 F.2d 1036 (10th Cir. 1980) (recognizing expectation of capital appreciation satisfies *Howey* expectation of profits inquiry).

61. No. 81-1863, slip op. at 8 (citing United Hous. Found., Inc. v. Forman, 421 U.S. 837, 857 (1977)).

wishing to graze cattle.[62]

The court also ruled that the stock failed the third part of the *Howey* test—that profits be derived from the efforts of a promoter or other third party.[63] The court did not provide an explicit basis for this conclusion. Presumably, the fact that the corporations were required to obtain 85% of their income from shareholder assessments[64] and the overall nonprofit nature of the operation[65] precluded an expectation of profits from the efforts of others.[66]

III. Delineation of the Contours of Justifiable Reliance in a Rule 10b-5 Action

The question of the degree of diligence necessary to find justifiable reliance in a private rule 10b-5 action was addressed by the Tenth Circuit Court of Appeals in *Zobrist v. Coal-X, Inc.*[67] *Holdsworth v. Strong*,[68] the first Tenth Circuit opinion to address this issue, held that an investor was required to prove that he justifiably relied on defendant's material misrepresentations in order to recover under rule 10b-5.[69] Under *Holdsworth*, justifiable reliance could be proved in either of two ways, depending on the nature of the alleged misrepresentation. If the misrepresentation consisted of an omission to state facts necessary to prevent a statement from being misleading, justifiable reliance was shown upon proof that the omissions were material.[70] If the misrepresentations consisted of affirmative misstatements, the factfinder was required to evaluate the facts and circumstances surrounding the misrepresentation and determine whether plaintiff was entitled to base his investment decision on the defendant's statements.[71] *Zobrist* considered two issues. The first was the extent to which a plaintiff was entitled to rely on oral statements contradicting written warnings in a Private Placement Memorandum.[72] The second was whether the inference of reliance arising from a material omission could be rebutted by defendants.[73]

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62. No. 81-1863, slip op. at 9.

63. *Id.* at 7, 9.

64. *Id.* at 7.

65. *See id.* at 8.

66. *Cf.* International Bhd. of Teamsters v. Daniel, 439 U.S. 551, 561 (1979) (fundamental importance of employer contributions to success of pension plan indicative of lack of reliance on managerial efforts of others to generate profits).

67. 708 F.2d 1511 (10th Cir. 1983).

68. 545 F.2d 687 (10th Cir. 1976), *cert. denied*, 430 U.S. 955 (1977).

69. 545 F.2d at 696. The Tenth Circuit established the justifiable reliance requirement in order to ensure that a defendant was not penalized for misrepresentations which did not cause a plaintiff's loss. By requiring a showing of reliance, the plaintiff established a prima facie case of causality; by showing the reliance was justified in light of the circumstances of a case, the plaintiff established that the defendant was responsible for plaintiff's actions. *See id.* at 693-95.

70. *Id.* at 695 (quoting Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 153-54 (1972)). An omission is material when "a reasonable investor would have considered the facts important." 545 F.2d at 695.

71. *See* 545 F.2d at 695-97. *Holdsworth* did not provide an explicit set of criteria for evaluating reliance on affirmative misstatements, indicating only that the plaintiff's fault in relying on the misstatements must be less than the defendant's fault in making them. *Id.* at 693.

72. Zobrist v. Coal-X, Inc., 708 F.2d 1511, 1515 (10th Cir. 1983).

73. *Id.* at 1519-20.

A. *The Case*

Zobrist arose when the investments of plaintiffs Herman Zobrist, Neil Rasmussen, and Phil Rasmussen in Coal-X, Ltd./'76[74] appeared to have misfired. Plaintiffs filed suit against Coal-X, Inc., the general partner of Coal-X, Ltd./'76, and two of its officers who were alleged to have made false and misleading oral statements regarding the probability of success of the investment.[75] A federal district court jury found that the defendant officers of Coal-X, Inc. had "knowingly violated rule 10b-5 by misrepresenting material facts to Phil Rasmussen, that he justifiably relied on these misrepresentations, and that . . . he suffered $50,000 in damages."[76] The jury also found that the defendants had withheld material facts from Neil Rasmussen and Herman Zobrist, but that these plaintiffs had not relied on those omissions and were therefore not entitled to damages.[77] Coal-X, Inc. appealed the decision in favor of Phil Rasmussen; Neil Rasmussen and Zobrist cross-appealed the verdict in favor of Coal-X, Inc.[78]

B. *Effect of Failing to Read a Private Placement Memorandum*

At the crux of the Tenth Circuit's disposition of the cross-appeal against Phil Rasmussen was his failure to read the Private Placement Memorandum the defendants had provided to all three plaintiffs.[79] This Memorandum expressly recited the generally high risk of investing in a speculative business venture, and the specific risks and difficulties involved in operating a coal company.[80] Additionally, the Memorandum stated that no person had been authorized to make representations not contained in the document, and that potential investors should not rely on such representations.[81] Although Phil Rasmussen signed documents indicating he had read the Memorandum, it was undisputed that neither Phil nor the other plaintiffs read the document.[82]

Based primarily on Phil Rasmussen's failure to read the Private Placement Memorandum, the Tenth Circuit overturned the jury's finding of justifiable reliance, and reversed the jury award of $50,000.[83] The court reached its decision by charging Phil Rasmussen with constructive knowledge of the

74. Coal-X, Ltd./'76 was a Utah limited partnership organized to finance a West Virginia coal mining venture. *Id.* at 1513.

75. *Id.* at 1515.

76. *Id.*

77. *Id.*

78. *Id.*

79. The Coal-X Ltd./'76 stock was sold as a private offering pursuant to rule 146, 17 C.F.R. § 230.146 (1981). Compliance with rule 146 exempted issuers from the registration requirements of the Securities Act of 1933. *See* Rule 146-Transactions by an Issuer Deemed Not to Involve Any Public Offering, SEC Securities Act Release No. 33-5487 (April 23, 1974). Rule 146 required issuers to furnish an offering memorandum with information essentially equivalent to that provided by a prospectus. 17 C.F.R. § 230.146(e)(1) (1981). Rule 146 has since been withdrawn, 47 Fed. Reg. 11261 (1982), and has been replaced by Regulation D, 17 C.F.R. § 240.501-.506 (1983). *See* 47 Fed. Reg. 11252 (1982).

80. 708 F.2d at 1517.

81. *Id.* at 1517-18.

82. *Id.* at 1514.

83. *Id.* at 1518-19.

risks stated in the Private Placement Memorandum,[84] and then examining his conduct in light of that knowledge. The court found that Phil had acted recklessly by relying on defendants' oral statements without investigating the discrepancy between those statements and the risk factors contained in the Memorandum.[85] The court held that in light of his reckless behavior, Phil Rasmussen's reliance on the defendants' fraudulent claims was unjustifiable.[86]

C. *Presumption of Reliance on Material Omission is Rebuttable*

Neil Rasmussen and Zobrist argued that the trial court had improperly instructed the jury that the plaintiffs bore the burden of proving reliance on the defendants' omission of material facts.[87] The district court's instruction stated that once plaintiffs proved an intentional omission of material fact, the defendants were required to prove that plaintiffs would have acted no differently even if the omitted information had been disclosed.[88] The Tenth Circuit held that this instruction was proper, because the trial court had correctly instructed the jury that the presumption of reliance arising from proof of an intentional material omission was a rebuttable presumption.[89] Because plaintiffs had not read the Memorandum, substantial evidence supported the jury's verdict that the nondisclosures had not, in fact, caused plaintiffs' actions, and that the plaintiff had therefore not relied on the omissions.[90]

D. *Judge Holloway's Dissent*

In a forceful dissent, Judge Holloway disagreed with the majority's holding with respect to Phil Rasmussen. The dissent cited the portion of *Holdsworth v. Strong*[91] which held that a plaintiff's conduct in a securities transaction could only bar recovery under rule 10b-5 when the plaintiff's actions could be characterized as misconduct comparable to that of the defendant.[92] Noting that the special verdict forms established that the defendants had engaged in deliberate misconduct,[93] the dissent contended that liability for intentional misconduct should not be immunized by a plaintiff's negligence or recklessness.[94] Judge Holloway perceived the federal concern with deterring intentional misconduct to outweigh that of deterring negli-

84. *Id.* at 1518. The Tenth Circuit noted that failure to charge an investor with knowledge of the information contained in a Private Placement Memorandum would place that investor in a better position, with respect to justifiable reliance, than the investor who had read the document. Thus, to encourage investor prudence and to prevent unfairness to prudent investors, knowledge of information supplied by legal mandate was imputed to an investor. *Id.*

85. *Id.* at 1518-19.

86. *Id.* at 1518.

87. *Id.* at 1519.

88. *See id.*

89. *Id.*

90. *Id.* at 1520.

91. 545 F.2d 687 (10th Cir. 1976), *cert. denied*, 430 U.S. 955 (1977).

92. 708 F.2d at 1520 (Holloway, J., dissenting). *See Holdsworth*, 545 F.2d at 693.

93. *See* 708 F.2d at 1520 & n.1 (Holloway, J., dissenting).

94. *Id.* at 1523. Judge Holloway also observed that the special verdicts had absolved Paul Rasmussen of intentionally ignoring the possibility of misrepresentation. *Id.* at 1522.

gent or reckless conduct.[95] The majority's decision, which exonerated defendants engaged in intentional misconduct through imputing knowledge of "defendants' exculpatory boilerplate"[96] to the plaintiff, frustrated that policy. Accordingly, Judge Holloway dissented.

E. *Critique*

It is difficult to square the majority's decision in *Zobrist* with its holding in *Holdsworth* that a plaintiff's conduct bars recovery only when it is of comparable culpability to that of the defendant.[97] Although Phil Rasmussen's failure to read the Private Placement Memorandum clearly was negligent, the court elevated this conduct to recklessness by the questionable artifice of imputing constructive knowledge of the Memorandum's contents.[98] Even accepting the court's finding of recklessness, it seems improper to equate the plaintiff's recklessness with the defendants' deliberate fraud and misrepresentation and bar all recovery for the plaintiff.[99] The central purpose of the 1933 and 1934 Acts was to prevent fraud in the financial marketplace, not to institutionalize caveat emptor.[100] Although the majority carefully noted that constructive knowledge of the warnings contained in the Memorandum could not, in and of itself, exonerate the defendants,[101] the result reached by the majority appears to unnecessarily protect, and perhaps encourage,[102] securities fraud.

Douglas D. Koktavy

95. *Id.* at 1522.

96. *Id.* at 1523.

97. 545 F.2d at 693. *See supra* note 71.

98. *But see* Shappirio v. Goldberg, 192 U.S. 232 (1904). The Court, in rejecting a common law fraud claim, held that "when 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 his vendor." *Id.* at 241-42.

99. *Cf.* Note, *A Comparative Fault Approach to the Due Diligence Requirement of Rule 10b-5*, 49 FORDHAM L. REV. 561, 575-88 (1981) (author proposes adapting contributory fault principles for use in securities fraud cases in order to avoid injustice of foreclosing all relief for negligent or reckless plaintiffs deliberately defrauded in securities transactions).

100. *See* United Hous. Found., Inc. v. Forman, 421 U.S. 837, 849 (1977). *See also Zobrist*, 708 F.2d at 1523 (Holloway, J., dissenting) (the majority's holding acts to favor those found guilty of knowing misconduct and to frustrate the antifraud policy of the securities laws and rule 10b-5).

101. 708 F.2d at 1517.

102. Judge Holloway cited evidence in the record indicating that the defendants had consciously dissuaded the plaintiffs from reading the Memorandum. *Id.* at 1522-23 (Holloway, J., dissenting).