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SECURITIES

OVERVIEW

During the period covered by this survey, the Tenth Circuit Court of Appeals was presented with five cases to review under the Securities Act of 1933 (1933 Act)[1] and the Securities and Exchange Commission Act of 1934 (1934 Act).[2] In four published opinions,[3] the court followed established precedents and clarified its position on scienter, statutes of limitations, and damages. Specifically, the court found reckless behavior sufficient to satisfy the scienter requirement of Rule 10b-5;[4] required scienter to be pleaded and proved in an SEC injunction action;[5] delineated the nature of due diligence required to toll the statute of limitations;[6] and clarified the extent to which a benefit-of-the-bargain measure of damages is appropriate in Rule 10b-5 violations.[7]

I. RECKLESS BEHAVIOR SATISFIES SCIENTER REQUIREMENT OF RULE 10B-5

In *Hackbart v. Holmes*[8] the most notable decision of the past year, the court found reckless conduct sufficient to establish the necessary element of scienter required by Rule 10b-5.[9] Hackbart, the plaintiff, in alleging securi-

1. 15 U.S.C. §§ 77a-77aa (1976 & Supp. V 1981).

2. *Id.* §§ 78a-78kk.

3. Loveridge v. Dreagoux, 678 F.2d 870 (10th Cir. 1982); SEC v. Mick Stack Assoc., 675 F.2d 1148 (10th Cir. 1982); Hackbart v. Holmes, 675 F.2d 1114 (10th Cir. 1982); SEC v. Haswell, 654 F.2d 698 (10th Cir. 1981).

In an unpublished opinion, Hyden v. Baxter, Nos. 79-1670, 79-1671 (10th Cir. Sept. 30, 1981), the Tenth Circuit court affirmed the district court's finding of a violation of the registration provisions of the 1933 Act. The defendant, an owner of a working interest in certain oil and gas leases, sold fractional interests in the operation to numerous investors who previously had participated in an uncompleted project on the same properties. The court upheld the trial court's findings that the defendant had entered into a new agreement with the previous operators, and had not merely succeeded to an assignment.

On appeal, the defendant argued that the interest sold was not a security. However, because the interests sold were fractional undivided interests in oil and gas, they were specifically covered by the 1933 Act's definition of a security. The court held that the interests would also qualify as an investment contract, subject to registration requirements. *Id.* slip op. at 7. Because defendant had entered into a new agreement with the former operators, he had sold rather than exchanged securities with existing holders. This sale brought his actions within the definition of "issuer" under 15 U.S.C. § 77b(1), (4) (1976). *Hyden*, slip op. at 6. The transaction was not exempt from registration because the court characterized the transaction as a sale and not an exchange. *See* 15 U.S.C. § 77c(a)(9) (Supp. V 1981) (providing an exemption for an issuer who merely exchanges securities with its existing security holders). Cross-appeals alleging error for dismissing claims against a third party and for failure to award attorneys' fees and costs were rejected. *Hyden*, slip op. at 8, 11.

4. 17 C.F.R. § 240.10b-5 (1982); *see* Hackbart v. Holmes, 675 F.2d 1148 (10th Cir. 1982).

5. Loveridge v. Dreagoux, 678 F.2d 870 (10th Cir. 1982); SEC v. Mick Stack Assoc., 675 F.2d 1148 (10th Cir. 1982).

6. Loveridge v. Dreagoux, 678 F.2d 870 (10th Cir. 1982); Hackbart v. Holmes, 675 F.2d 1114 (10th Cir. 1982).

7. Hackbart v. Holmes, 675 F.2d 1114 (10th Cir. 1982).

8. *Id.*

9. 17 C.F.R. § 240.10b-5 (1982) provides:

ties fraud under Rule 10b-5 sought to recover "his share" of a tire wholesaling company in which he had invested. Hackbart was a friend and former football teammate of the defendant Holmes. In late 1971, knowing that Hackbart's football career was nearly over, Holmes presented him with the possibility of forming a partnership to operate a Denver tire dealership. Initially, an equal partnership was agreed upon, but Holmes later insisted on fifty-one percent ownership to maintain control.[10] The defendant agreed with his attorney's proposal to issue Hackbart preferred stock. This preferred stock was void of any preferences that would allow Hackbart to share in corporate growth. Once Hackbart proved his business acumen, the board of directors, controlled by the defendant, would convert the preferred stock to common stock. Neither the defendant nor his attorney adequately explained the significance of this change to the plaintiff.[11]

The business prospered, evidenced by the addition of new stores. In 1977, the two had a "falling out," and they decided that Hackbart would not remain with the corporation.[12] The plaintiff requested "his share" of the corporate growth, but discovered that he was entitled only to his original contribution.[13]

The trial court held that the defendant's failure to explain clearly the rights of the preferred stock was a "manipulative or deceptive device" proscribed by Rule 10b-5.[14] The court also concluded that recklessness satisfied Rule 10b-5's scienter requirements, and that the defendant acted recklessly in not assuring the plaintiff's understanding of the new terms of the deal.[15]

The recognition of an implied private right of action for damages under section 10(b) and Rule 10b-5 in 1946[16] began a trend toward a liberal interpretation of the proscription found in the federal securities laws. This liberal interpretation resulted from the perception that the securities laws are remedial and are to be construed flexibly in order to protect investors.[17] Never-

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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 connection with the purchase or sale of any security.

10. 675 F.2d at 1118.

11. *Id.* The defendant relied upon his attorney to explain the effect of the issuance of preferred stock, instead of the common stock originally agreed upon. The trial court found the attorney's explanation inadequate. *Id.*

12. *Id.* at 1117.

13. *Id.*

14. *Id.*

15. *Id.*

16. Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946). The Supreme Court has never directly ruled on this issue. It has, however, recognized the existence of the implied right on several occasions. *See, e.g.*, Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972); Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6 (1971); Tcherepnin v. Knight, 389 U.S. 332 (1967).

17. *See* Note, *Judicial Retrenchment Under Rule 10b-5: An End to the Rule as Law?*, 1976 DUKE L. J. 789, 792-94 [hereinafter *Judicial Retrenchment*]; Note, *Recklessness and the Rule 10b-5 Scienter*

theless, beginning with the 1975 term, the Supreme Court has been retrenching from its position.[18] In a number of successive decisions the Court has made it clear that the previous expansion of the class of plaintiffs who may sue under Rule 10b-5 will no longer be countenanced.[19]

Prior to the Supreme Court's decision in *Ernst & Ernst v. Hochfelder*,[20] three circuits had adopted a negligence standard for Rule 10b-5 private damage actions.[21] Although not specifically rejecting a negligence standard, the *Hochfelder* Court avoided an approach that would allow for flexible construction of Rule 10b-5. The Court relied entirely on statutory construction and congressional intent to establish that a finding of scienter[22] was a necessary prerequisite to liability under Rule 10b-5.[23] The Court concluded that negligence did not satisfy the standard, but specifically reserved the question whether recklessness was sufficient conduct to fall under Rule 10b-5.[24] Subsequent to *Hochfelder*, the federal appellate courts addressing the issue have overwhelmingly agreed that recklessness satisfies the scienter requirement.[25]

Until *Hackbart*, the Tenth Circuit court never directly addressed the issue of whether reckless conduct was sufficient to meet the scienter requirement of Rule 10b-5. In affirming the trial court's decision in *Hackbart*, the Tenth Circuit Court of Appeals concluded that proof of reckless behavior

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Standard After Hochfelder, 48 FORDHAM L. REV. 817, 817 n.1 (1980) [hereinafter *Recklessness and Rule 10b-5*]. *See also* Spence, *Civil Liability Under Rule 10b-5: The Supreme Court Acts to Curb a Burgeoning Source of Liability*, 52 L.A.B.J. 326 (1977).

18. In Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975), the Supreme Court held that only actual purchasers or sellers of securities could maintain a private damages action under Rule 10b-5.

19. *See, e.g.*, Chiarella v. United States, 445 U.S. 222 (1980); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975). *See generally* Kaler, *Scienter After* Hochfelder: *Recklessness as a Standard in Rule 10b-5 Private Damage Actions*, 6 J. CORP. L. 337 (1981); Note, *Judicial Retrenchment, supra* note 17, at 794-800.

20. 425 U.S. 185, 214 n.33 (1976).

21. Hochfelder v. Ernst & Ernst, 503 F.2d 1100 (7th Cir. 1974), *rev'd*, 425 U.S. 185 (1976); White v. Abrams, 495 F.2d 724 (9th Cir. 1974); Vanderboom v. Sexton, 422 F.2d 1233 (8th Cir.), *cert. denied*, 400 U.S. 852 (1970). These decisions relied on the "remedial nature" rationale of earlier Supreme Court decisions. *See* Kaler, *supra* note 19, at 339. The tendency for definitions of recklessness to merge into that of mere negligence also has been cited as a reason for the departure from the requirements of common law fraud. *See* Newton, *The Limits of Liability: Recent Judicial Restrictions on Rule 10b-5*, 6 FLA. ST. U.L. REV. 63, 90 (1978) and *supra* note 16 and accompanying text.

22. The term scienter derives from the common law tort of deceit. Scienter in this context is the "intent to deceive, to mislead, to convey a false impression." W. PROSSER, HANDBOOK OF THE LAW OF TORTS § 107, at 700 (4th ed. 1971). It was this element that was stressed in the seminal English stock fraud case of Derry v. Peek, 14 A.C. 337 (1889). There, scienter was held to be satisfied by knowledge that the representation was false or a reckless disregard for its truth or falsity. *Id.* at 374 (per Lord Herschell).

23. 425 U.S. at 193-94 n.12. The *Hochfelder* Court defined scienter as it is applicable to actions under the federal securities laws as a "mental state embracing intent to deceive, manipulate, or defraud." *Id.*

24. *Id.*

25. *See* G. A. Thompson & Co. v. Partridge, 636 F.2d 945 (5th Cir. 1981); McLean v. Alexander, 599 F.2d 1190 (3d Cir. 1979); Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017 (6th Cir. 1979); Nelson v. Serwold, 576 F.2d 1332 (9th Cir.), *cert. denied*, 439 U.S. 970 (1978); Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978); Sundstrand Corp. v. Sun Chemical Corp. 553 F.2d 1033 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977).

was sufficient.[26] The court adopted the recklessness standard for the same reasons given by other circuits:[27] the securities acts require broad construction to achieve their remedial goals;[28] the burden of proving intent would be onerous;[29] the securities acts were intended to proscribe actions akin to common law fraud;[30] and proof of reckless behavior satisfies the scienter requirement of common law fraud.[31] The court's adoption of the recklessness standard is hardly surprising. Although confusion exists over the proper interpretation of some early cases, the Tenth Circuit court's adoption of this standard follows logically from a long trend that has required culpability greater than negligence,[32] but less than outright intent.[33] The question re-

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26. 675 F.2d at 1117.

27. *Id.* at 1117-18.

28. Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017, 1024 (6th Cir. 1979) (citing Affiliated Ute Citizens v. United States, 408 U.S. 128, 151 (1972)). In light of the recent change in Supreme Court policy, the continued validity of this rationale is to be questioned. *See supra* text accompanying notes 19-20, 22-23.

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

30. *See Ernst & Ernst*, 425 U.S. at 212 n.32 (legislative history shows SEC believed the rule would proscribe fraudulent behavior); *see also supra* note 21.

31. *Mansbach*, 598 F.2d at 1024.

32. Early Tenth Circuit cases often are interpreted as holding that negligence was sufficient. *See generally* Note, *Evolving Standards of Personal Liability and Scienter Under Rule 10b-5*, 16 WASHBURN L.J. 344, 357-58 (1977). Later cases implicitly adopted a reckless standard.

In Stevens v. Vowell, 343 F.2d 374 (10th Cir. 1965), the court held that "[i]t is not necessary to allege or prove common law fraud to make out a case under the statute and rule. It is only necessary to prove one of the prohibited actions such as the material misstatement of fact or the omission to state a material fact." *Id.* at 379.

Several years later, the court opined:

> One is not to be held liable, however, because of his misleading misrepresentation or omission of material fact, the truth of the matter being unknown to the purchaser, if the party responsible for the misrepresentation or omission sustains the burden of proving that he did not know, and *in the exercise of reasonable care could not have known that it was a misrepresentation or ommission*. (Emphasis added).

Gilbert v. Nixon, 429 F.2d 348, 357 (10th Cir. 1970). Although the court mentioned scienter, the language definitely sounds like negligence. In fairness, *Gilbert* was confusing because of the court's attempt to reconcile § 12(2) of the 1933 Act with the requirements of Rule 10b-5. *Id.* at 356-57. However, in Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971), the court specifically adopted the language of *Gilbert* as applied to Rule 10b-5 actions. 446 F.2d at 102. The court prefaced its holding with the statement that some degree of scienter was required. (*Mitchell* also rejected application of the State Blue Sky Law statute of limitations in favor of the applicable state limitation period for fraud, because fraud required scienter. *Id.* at 103-04).

In Clegg v. Conk, 507 F.2d 1351 (10th Cir. 1974), *cert. denied*, 422 U.S. 1007 (1975), the Tenth Circuit court attempted to explain and harmonize the earlier cases. This opinion recognized and explicitly rejected the negligence interpretations of the earlier cases. The analysis largely limited the broad language of each case to that case's specific facts. 507 F.2d at 1355-61. This clarification of the Tenth Circuit's did not solve the entire problem. It remained for the court to embrace recklessness as sufficient to satisfy the scienter requirement.

Recklessness was implicitly recognized by the court as sufficient on four separate occasions prior to *Hackbart*. In Utah State Univ. v. Bear, Stearns & Co., 549 F.2d 164 (10th Cir.), *cert. denied*, 434 U.S. 890 (1977), the court stated that "[w]illful or intentional misconduct or *the equivalent thereof* [are] essential to recovery" in a Rule 10b-5 action. 549 F.2d at 169 (emphasis added).

In Edward J. Mawod & Co. v. SEC, 591 F.2d 588 (10th Cir. 1979), a case involving SEC suspension of a broker-dealer for violations of the 1933 Act, the court noted that a finding of recklessness in an action under that Act was in accordance with the *Hochfelder* decision. *Id.* at 596-97.

In Wertheim & Co. v. Codding Embryological Sciences, Inc., 620 F.2d 764 (10th Cir. 1980), the court acknowledged that other circuits had recognized recklessness as equivalent to

mained, however, of how to define recklessness.

The definitions of recklessness adopted by the circuits have not been uniform.[34] The dissemblance arises from *Hochfelder's* ambiguous definition of scienter. Justice Powell, writing for the *Hochfelder* majority, first defined scienter as "a mental state embracing intent to deceive, manipulate, or defraud."[35] Later in the opinion, Justice Powell also stated that the language of section 10(b) strongly suggested it was intended to proscribe "knowing or intentional misconduct."[36] Thus, after *Hochfelder*, scienter would seem to include at least two criteria: knowledge and state of mind.[37] With such ambiguity surrounding the definition of scienter, interpreting and applying a standard of recklessness has been a dilemma for circuit courts of appeal.[38]

The different approaches by the circuits led to a number of formulations, the typologies for which are almost as varied as the formulations themselves, and have been the subject of much comment.[39] Among the many formulations are objective, fixed standards and flexible standards. An objective, fixed standard is considered preferable to a flexible, factoral analysis because it allows for certainty, predictability, ease of application, and satisfies policy considerations.[40] If one conceptualizes culpability as a continuum ascending from purely innocent conduct, through negligence, reckless behavior, knowing, and intentional action, the problem is exactly where recklessness fits on this line between negligent and knowing conduct.

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scienter under certain circumstances. Nevertheless, because recklessness was "closer to being a lesser form of intent than merely a greater degree of ordinary negligence," the trial court's finding of negligence invalidated any reckless conduct argument. *Id.* at 767 (citing Sanders v. John Nuveen & Co., 554 F.2d 790, 793 (7th Cir. 1977)).

Recently, in Cronin v. Midwestern Okla. Dev. Auth., 619 F.2d 856 (10th Cir. 1980), the court noted that evidence of intent or recklessness was essential to establish scienter. *Id.* at 862.

33. Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90, 102 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971). *See* Edward J. Mawod & Co. v. SEC, 591 F.2d 588, 595-96 (10th Cir. 1979) (knowledge equated with willful action).

34. *See generally Recklessness and Rule 10b-5, supra* note 17, at 819.

35. 425 U.S. 185, 193-94 n.12.

36. *Id.* at 197.

37. *See* Kaler, *supra* note 19, at 342-43. Kaler adds a third criterion, duty, based on: the Seventh Circuit's *ratio decidendi* in favor of the plaintiff, Hochfelder; a footnote in the majority's opinion (*see* 425 U.S. at 214-16 n.33); and the grounds for Justice Blackmun's *Hochfelder* dissent (425 U.S. at 215-18 (Blackmun, J., dissenting)).

38. Kaler, *supra* note 19, at 343.

39. *See id.* at 344-51 (should have known, must have known, carelessness, and flexible duty standards); Steinberg & Gruenbaum, *Variations of "Recklessness" After* Hochfelder *and* Aaron, 8 SEC. REG. L.J. 179, 191-208 (1980) (barely reckless, highly reckless, pre-*Hochfelder*, and flexible duty standards); *Recklessness and Rule 10b-5, supra* note 17, at 819 n.8 (fiduciary duty, should have known, must have known, and flexible duty standards).

40. The Ninth Circuit at one time subscribed to a flexible duty standard comprised of five factors to be considered by juries in determining the duty owed by a Rule 10b-5 defendant. *See* White v. Abrams, 495 F.2d 724 (9th Cir. 1974). Such a standard results in scienter requirements which vary from case to case depending on the facts. *See* Steinberg & Gruenbaum, *supra* note 39, at 203-04. Insofar as the standard contemplated is negligence, its use was proscribed by *Hochfelder*. Nevertheless, there is still uncertainty regarding the status of the flexible duty standard. *Id.* at 203-08. Further, inasmuch as *Blue Chip Stamps, Hochfelder*, and *Chiarella* reflect the Supreme Court's attempts to provide more certainty under Rule 10b-5 through a series of substantive pronouncements and a departure from previous liberal interpretations of the securities laws, the flexible duty analysis appears similarly incompatible. *See* Ruder, *Judicial Developments Under Rule 10b-5: Standing, Scienter, Reliance, Materiality and Implied Rights of Action*, 7 INST. SEC. REG. 303 (1976) and *supra* text accompanying notes 19-20.

Under common law fraud, recklessness is best seen as a species of imputed knowing conduct.[41] The actor's knowledge of the truth of his statements is implied from the objective circumstances surrounding his conduct.[42] The theoretical distinctions may thus be described as: the negligent actor should have known; the reckless actor must have known; the knowing actor had actual knowledge.[43] The most prevalent definition of recklessness among the circuits reflects this common law classification:

> [R]eckless conduct may be defined as a highly unreasonable omission, involving not merely simple, or even inexcusable, negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.[44]

Theoretically,[45] this definition has several merits. The "must have known" language clearly distinguishes recklessness from negligence, and actual proof of subjective knowledge is not required. Constructive knowledge may be imputed from the surrounding objective circumstances. The definition satisfies the requirements of objectivity and predictability, while not imposing on plaintiffs the onerous burden of proving a defendant's subjective state of mind, thus striking an equitable balance.[46] Furthermore, because the definition "comes closer to being a lesser form of intent than merely a greater degree of ordinary negligence,"[47] it should reduce the size of the potential class of Rule 10b-5 plaintiffs, comporting with the recent shift in judicial policy.[48] This definition, with minor variations, has been adopted by six circuits.[49]

The *Hackbart* court noted that its previous decisions implicitly accepted reckless behavior as sufficient to meet the scienter requirement. Thus, it had no difficulty explicitly adopting this standard. The court then found that the prevalent definition of reckless behavior was the best definition and adopted it.[50]

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41. *See Recklessness and Rule 10b-5, supra* note 17, at 823-24.

42. W. PROSSER, *supra* note 22, § 107 at 701.

43. *See Recklessness and Rule 10b-5, supra* note 17, at 824-25.

44. Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1045 (7th Cir. 1977) (quoting Franke v. Midwestern Okla. Dev. Auth., 429 F. Supp. 719, 725 (W.D. Okla. 1976)).

45. From a practical standpoint, proof of the defendant's subjective state of mind proceeds from objective evidence. Although an honest belief that the representation is true negates the required finding of scienter, the unreasonableness of the belief is most often strong evidence that it does not exist. *See* W. PROSSER, *supra* note 22, § 107 at 701. This focus on the reasonableness of belief results in a blurring of the distinction between negligence and recklessness. *See* Newton, *supra* note 21, at 90. *Accord* Note, *supra* note 32, at 351.

46. *See Recklessness and Rule 10b-5, supra* note 17, at 837.

47. Sanders v. John Nuveen & Co., 554 F.2d 790, 793 (7th Cir. 1977).

48. *See* Steinberg & Gruenbaum, *supra* note 39, at 198, and *supra* text accompanying notes 19-20.

49. *See* Broad v. Rockwell Int'l Corp., 642 F.2d 929, 961 (5th Cir. 1980), *cert. denied*, 454 U.S. 965 (1981); McClean v. Alexander, 599 F.2d 1190, 1197 (3d Cir. 1979); Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017, 1025 (6th Cir. 1979); Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 47 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978); Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033 (7th Cir. 1977). It was adopted by the Tenth Circuit in *Hackbart*, 675 F.2d at 1118.

50. 675 F.2d at 1118.

In applying this definition, the *Hackbart* court closely examined the trial court's factual finding of recklessness.[51] Under the particular facts presented by the case, the court had little difficulty in its task. As the trial court found, neither Holmes nor his attorney explicitly informed Hackbart of the nonparticipating nature of his stock.[52] Furthermore, neither the articles of incorporation, the share certificates, nor any other corporate document adequately described the stocks' rights or preferences,[53] thus failing to comply with Colorado law.[54] Additionally, Hackbart's share certificates indicated he owned common stock.[55] The first financial statement of the corporation showed only common stock outstanding.[56] Hackbart testified that Holmes showed him the original financial statement and, pointing to the equity section, told him that his share of the company had increased.[57] The trial court concluded that neither the discussions between the parties nor the documents available to the plaintiff provided adequate notice of the plaintiff's rights, or the extent to which the original deal had been changed.[58]

After reversing the trial court's findings of fact, the court determined that Holmes' behavior presented such an obvious danger of misleading the plaintiff that Holmes must have been aware of it.[59] Holmes knew the plaintiff expected to share in the ownership of the corporation, but failed to explain adequately the change in plans. Furthermore, Holmes knew the plaintiff was naive in business affairs, but made no effort to ascertain if he understood the terms of the deal, or verify the accuracy of the corporate documents. Under these circumstances, the court had no difficulty upholding the trial court's finding that Holmes acted with reckless disregard for the truth.[60]

In *Loveridge v. Dreagoux*,[61] the defendants sold the plaintiffs the last two debentures in a series of twenty debentures for $5000 each. Proceeds from the sale were to be used to finance a joint venture to import commodities from the Philippines.[62] Although the plaintiffs received the last numbered debentures, only one other was sold. The proceeds of the sale were utilized before the defendants ever engaged in the intended business. The trial court found the defendants' action in connection with this sale to be in violation of section 10(b) and Rule 10b-5.[63]

51. As a finding of fact, it would not be disturbed upon appeal unless clearly erroneous. *Id.*
52. *Id.*
53. *Id.* at 1119.
54. COLO. REV. STAT. § 7-2-102(e) (1973) requires that the articles of incorporation contain a statement of the preferences, limitations, and relative rights of each class of stock. Section 7-4-108(2) requires that each share certificate set forth a full statement of the designations, preferences, limitations, and relative rights of the shares of each class of stock to be issued.
55. 675 F.2d at 1119. The trial court found, however, that this was the result of clerical error and not intentional. *Id.*
56. *Id.* at 1119-20. The shareholder's equity section was corrected on later financial statements. *Id.*
57. *Id.*
58. *See supra* text accompanying notes 11-12.
59. 675 F.2d at 1120.
60. *Id.*
61. 678 F.2d 870 (10th Cir. 1982).
62. *Id.* at 873.
63. *Id.*

On appeal, the defendants argued that there had been no finding of scienter. After disposing of a jurisdictional question,[64] the Tenth Circuit responded that under the facts of the case, a specific finding of scienter was unnecessary.[65] The trial court had made several findings of the defendants' knowing misrepresentations. These included the defendants' representations that all, not one, of the earlier numbered debentures had been sold;[66] his representations that the corporation was formally organized when actual incorporation took place subsequent to the sale;[67] and representations that the proceeds would be used to lease ships, when in reality the money was utilized to pay pre-incorporation expenses.[68] Under these specific facts, the court found implicit in the trial court's findings that the defendant either knew of the falsity of the information or acted in reckless disregard of its truth and with the intent to deceive or mislead the plaintiffs. A specific finding by the trial court that scienter had been established was not necessary.[69]

II. SCIENTER AND SEC INJUNCTIVE ACTIONS

In two brief opinions, the Tenth Circuit had its first opportunity to apply the rule laid down in *Aaron v. SEC*.[70] The *Aaron* Court held that proof of scienter was a requisite element when the SEC seeks to enjoin violations of section 17(a)(1) of the 1934 Act,[71] section 10(b) of the 1934 Act, and Rule 10b-5. Scienter was found not to be a requirement under sections 17(a)(2) and (a)(3).[72] However, the Court noted that scienter was not to be disregarded in connection with section 17(a)(2) and (a)(3) actions. In order for the SEC to enjoin future violations of these sections, *Aaron* requires the charging party to establish that the future violations of the law are likely to occur. The degree of intentional wrongdoing in the defendant's past behavior is an important element in proving the likelihood of future violations. District courts were counseled by the *Aaron* opinion that they might appropriately consider scienter (or the lack of it) when exercising their equitable

64. Defendants argued that their contacts with the plaintiffs by intrastate telephone calls were insufficient to establish that interstate commerce was involved. The court rejected this argument, 678 F.2d at 873-74 (citing Kerbs v. Fall River Indus., Inc., 502 F.2d 731 (10th Cir. 1974)).

65. 678 F.2d at 876.

66. *Id.* at 875.

67. *Id.*

68. *Id.*

69. *Id.* at 876.

70. 446 U.S. 680 (1980). The two Tenth Circuit cases were submitted on appeal prior to the Supreme Court's decision in *Aaron*.

71. 15 U.S.C. § 77q (1976) provides:

> It shall be unlawful for any person in the offer or sale of any securities by use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—
>
> (1) to employ any device, scheme or artifice to defraud, or
>
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission 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 transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

72. *Id.* § 77q(a)(2), (3).

discretion in deciding whether to issue an injunction.[73]

In *SEC v. Haswell*,[74] the defendant was charged with violating section 17(a) and the registration provisions of the 1933 Act[75] and the anti-fraud provisions of the 1934 Act.[76] The Commission sought to enjoin those violations.[77] The district court, anticipating the Supreme Court's holding in *Aaron*, concluded that proof of scienter was required before a court could enjoin the violations. The district court found that the defendant had not violated any of the provisions. Furthermore, the district court held that even if the defendant had violated the securities laws, an injunction would be denied because there was no reasonable likelihood the defendant's behavior would be repeated.[78]

On appeal, the Tenth Circuit found the issue squarely settled by *Aaron*.[79] The fact the trial court had failed to differentiate between section 17(a)(1) requiring scienter and sections 17(a)(2) and (a)(3), not requiring scienter, did not compel reversal. The court relied on language in *Aaron* discussing the relevance of scienter in actions under sections 17(a)(2) and (a)(3) to prove the likelihood of future violations.[80] The court summarized the *Aaron* Court's treatment of this issue: "The presence or absence of scienter in a defendant's past conduct, even if that conduct constitutes a violation of the securities laws absent scienter, is a circumstance which bears heavily on a district court's decision to issue an injunction."[81]

The court found additional support from Chief Justice Burger's concurrence in *Aaron*.[82] The Chief Justice wrote that in order to prove the reasonable likelihood of repeated wrongs, "it would almost always be necessary to demonstrate that the defendant's past sins have been the result of more than negligence."[83] Applying these principles, the Tenth Circuit concluded that even assuming the defendant had violated sections 17(a)(2) and (a)(3), the trial court's finding that the defendant lacked scienter sufficiently supported the denial of the injunction.[84]

Similarly, in *SEC v. Mick Stack Associates*,[85] the Tenth Circuit applied the *Aaron* principles and remanded the case. The district court had granted summary judgment and injunctive relief in the section 10(b), Rule 10b-5, and Rule 10b-13[86] action prior to the Supreme Court's decision in *Aaron*.

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73. *Id.* at 701.

74. 654 F.2d 698 (10th Cir. 1981).

75. 15 U.S.C. § 77e(a), (c) (1976).

76. *Id.* § 78j.

77. Authority to seek injunctive relief is provided under § 20(b) of the 1933 Act (15 U.S.C. § 77t(b) (1976)) and § 21(d) of the 1934 Act (15 U.S.C. § 78u(d) (1976)).

78. 654 F.2d at 698-99. When the Commission seeks an injunction barring future actions that "will constitute" a violation of § 17(a)(2) or § 17(a)(3), there must be proof that a future violation will occur. *Aaron*, 446 U.S. at 702.

79. 654 F.2d at 699.

80. *See supra* text accompanying note 65.

81. 654 F.2d at 699.

82. *Id.* at 700. *See Aaron*, 446 U.S. at 702 (Burger, C.J., concurring).

83. *Id.* at 703.

84. 654 F.2d at 700.

85. 675 F.2d 1148 (10th Cir. 1982).

86. 17 C.F.R. § 240.10b-13 (1982). This rule prohibits a person who has made a tender

However, the SEC had not alleged scienter in its complaint, nor had the district court made specific findings of scienter.[87] In light of the *Aaron* requirement that scienter be pleaded and proven in a section 10(b) action, the court remanded for a determination of whether the pleadings could "be amended to permit appropriate allegations."[88] The court required specific findings regarding the presence of scienter.

The court also held that, on remand the SEC must prove scienter with respect to the alleged Rule 10b-13 violation.[89] This issue was not addressed in *Aaron*. The Tenth Circuit used reasoning from *Hochfelder* to arrive at its conclusion. The *Hochfelder* Court found that because the SEC's rulemaking powers were derived from the authority of section 10(b), that section's requirement of scienter applied equally to rules promulgated under its authority. The Tenth Circuit found such reasoning was applicable where the Commission had alleged manipulation and deceptive practices under section 10(b) through open market purchases during a tender offer.[90] The court failed to address whether a showing of scienter was required "to sustain all alleged violations of Rule 10b-13 absent specific allegations of manipulative and deceptive practices in connection with open market purchases of the target's securities during an announced tender offer."[91]

III. DUE DILIGENCE AND THE STATUTE OF LIMITATIONS

In both *Hackbart v. Holmes*[92] and *Loveridge v. Dreagoux*,[93] the defendants contended that the applicable statute of limitations barred the actions. Defendants argued that the plaintiffs had, or by exercise of due diligence should have, discovered the facts constituting the fraud at a much earlier date. In both cases, the Tenth Circuit affirmed the district courts' findings that the actions were not barred.

Both section 10(b) and Rule 10b-5 contain no specific statute of limitations provision. Suits brought under these federal laws are subject to the limitations period for actions of the same type in the state where the alleged violation occurred.[94] This follows from the rule that state statutes govern limitations on federal causes of action unless Congress has specifically provided otherwise.[95] In determining the applicable limitations period, states

offer for a company's shares from purchasing that company's shares on the open market during the pending tender offer.

87. "When the substantive law changes while a case is pending appeal, the general rule requires that the appellate court apply the law in effect at the time the appeal is to be decided, so long as manifest in justice does not occur." 675 F.2d at 1149. *See also* Bradley v. Richmond School Bd., 416 U.S. 696, 711-21 (1974); Key v. Rutherford, 645 F.2d 880, 883 (10th Cir. 1981).

88. 675 F.2d at 1150.

89. *Id.* at 1150 n.1.

90. *Id.*

91. *Id.*

92. 675 F.2d 1114 (10th Cir. 1982).

93. 678 F.2d 870 (10th Cir. 1982).

94. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 210 n.29 (1976); Hackbart v. Holmes, 675 F.2d 1114, 1120 (10th Cir. 1982); Aldrich v. McCulloch Properties, Inc., 627 F.2d 1036, 1041 (10th Cir. 1980).

95. UAW v. Hoosier Cardinal Corp., 383 U.S. 696 (1966); M'Cluny v. Sillerman, 28 U.S. (3 Pet.) 270 (1830).

choose between their respective Blue Sky Laws or fraud statutes. The decision rests upon which statute bears the closest resemblance to the particular federal statute involved.[96] Although the factors considered in selecting the appropriate limitations period are fairly well agreed upon, their application yields different results.[97]

In *Hackbart* the parties had agreed that Colorado's three-year statute of limitations for fraud applied.[98] Under this statute, the limitations period begins the day the fraud was committed. The court noted that there was uncertainty over whether Colorado or federal law governed the tolling of the statute. However, under both Colorado and federal law, the limitations period is tolled until the aggrieved party either learns of the fraud, or should have discovered it through reasonable diligence.[99] Hackbart asserted that he did not learn of his lack of equity ownership until 1977, when he and Holmes terminated their relationship. Holmes argued that if Hackbart had exercised reasonable diligence, he would have discovered the nature of his ownership at the time he purchased the stock, which was 1972, well beyond the three-year limitations period.[100]

The trial court found that Hackbart did not learn the true nature of his ownership interest until February 1977, and assessed damages as of that date.[101] The Tenth Circuit found that the trial court implicitly concluded that Hackbart would not have discovered the fraud earlier.[102] The court

96. *See* Comment, *Whether the Statute of Limitations for Common Law Fraud on the Blue Sky Limitation Period Should be Applied in a Federal Securities Claim is Decided by Determining Which State Cause of Action Bears the Closest Resemblance to the Federal Cause of Action Created Under the Securities Exchange Act of 1934 10(b) and Rule 10b-5*—IDS Progressive Fund Inc. v. First of Mich. Corp., 4 N. KY. L. REV. 175 (1977).

97. *Id.* at 177. For examples of circuits applying state fraud statutes see Aldrich v. McCulloch Properties, Inc., 627 F.2d 1036 (10th Cir. 1980); Nickels v. Koehler Mgt. Corp., 541 F.2d 611 (6th Cir. 1976), *cert. denied*, 429 U.S. 1074 (1977); United Cal. Bank v. Salik, 481 F.2d 1012 (9th Cir.), *cert. denied*, 414 U.S. 1004 (1973); Klein v. Shields & Co., 470 F.2d 1344 (2d Cir. 1972); Janigan v. Taylor, 344 F.2d 781 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965).

For examples of federal appellate courts applying state Blue Sky Laws, see Fox v. Kane-Miller Corp., 542 F.2d 915 (4th Cir. 1976); *In re* Alodex Corp., 533 F.2d 372 (8th Cir. 1976); Nortek, Inc. v. Alexander Grant & Co., 532 F.2d 1013 (5th Cir. 1976), *cert. denied*, 429 U.S. 1042 (1977).

98. COLO. REV. STAT. §§ 13-80-108, -109 (1973). Colorado's blue sky analogue to § 10(b), COLO. REV. STAT. § 11-51-123 (Supp. 1981), does not provide for any specific statute of limitations. However, COLO. REV. STAT. § 13-80-106 (1973) provides for a two-year statute of limitations for all actions founded upon a federal statute, or the period specified for comparable actions under Colorado law, whichever is longer. As a result, courts interpreting the scheme have applied the three-year period prescribed by the state fraud statutes COLO. REV. STAT. §§ 13-80-108, -109 (1973). *See* Ohio v. Peterson, Lowry, Rall, Barber & Ross, 472 F. Supp. 402 (D. Colo. 1979) *aff'd*, 651 F.2d 687 (10th Cir.), *cert. denied*, 454 U.S. 895 (1981).

99. *Hackbart*, 675 F.2d at 1120. The court cited *Aldrich v. McCulloch Properties, Inc.*, 627 F.2d 1036, 1041 (10th Cir. 1980), for the proposition that the law was unsettled regarding the applicability of federal or state law to tolling. The confusion arises from Board of Regents v. Tomiano, 446 U.S. 478 (1980). The Supreme Court in *Tomiano* held that in a civil rights action under 42 U.S.C. § 1983, courts must apply both state statutes of limitations and state tolling principles. The Tenth Circuit in Ohio v. Peterson Lowry, Rall, Barber & Ross, 651 F.2d 687 (10th Cir.), *cert. denied*, 454 U.S. 895 (1981), expressly decided that *Tomiano* applied only to civil rights actions and that federal tolling rules applied in cases under the federal securities acts. 651 F.2d at 691.

100. 675 F.2d at 1121-22.

101. *Id.*

102. *Id.* Although Holmes argued that in the exercise of reasonable diligence, Hackbart

found substantial evidence to support the trial court's conclusion; this evidence consisted of Hackbart's conversations with Holmes and his accountant, Hackbart's business naivete, and Holmes' failure to disclose the change in plans.[103]

In *Loveridge v. Dreagoux*,[104] the defendants argued that plaintiffs were put on notice regarding the problems of the securities at the time of the purchase and that plaintiffs should have inquired about the other purchasers. Alternatively, they argued because plaintiffs were promised quarterly reports and none were issued, they should have been aware of problems by the second or third quarter after the purchase.[105]

The Utah statute of limitations for fraud provides that actions must be brought within three years of the fraud. The cause of action does not accrue until the aggrieved party discovers the facts constituting the fraud.[106] In rejecting the defendants' argument concerning the timing of plaintiffs' notice, the trial court found that the statute did not begin to run until after the maturity date of the debentures when plaintiffs discovered that no payments would be made.[107] As in *Hackbart*, under the particular facts of the case, the Tenth Circuit upheld the district court's findings.

IV. BENEFIT-OF-THE-BARGAIN DAMAGES

In *Hackbart v. Holmes*, the trial court applied a benefit-of-the-bargain[108] measure of damages and awarded the plaintiff forty-nine percent of the value of the company as of the date the parties terminated their relationship.[109] On appeal, the defendant argued that the usual measure of damages in securities fraud cases was out-of-pocket damages.[110] This measure of damages would have limited the plaintiff to a recovery of the $5000 paid for the ownership interest.[111]

The Tenth Circuit agreed that the out-of-pocket loss was the customary measure, but found support for allowing a trial court discretion in fashioning

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should have discovered the fraud, the court failed to discuss this contention, or define reasonable diligence. *Id.* at 1120.

103. *Id. See also supra* notes 54-58 and accompanying text.

104. 678 F.2d 870 (10th Cir. 1982).

105. *Id.* at 875.

106. UTAH CODE ANN. § 78-12-26(3) (1953). Utah's § 10(b) analogue, UTAH CODE ANN. § 61-1-1 (1953), carries a two year statute of limitations under UTAH CODE ANN. § 61-1-22(5) (1953 & Supp. 1981). The statute has been held not to give rise to a private right of action. Milliner v. Elmer Fox & Co., 529 P.2d 806 (Utah 1974). Therefore the Utah fraud statutes of limitation controls in § 10(b) actions.

107. 678 F.2d at 875.

108. Benefit-of-the-bargain damages is usually taken to mean the difference between the value of the security purchased as represented by the defendant, and the fair value of the security on the day of sale. Some courts will, however, consider the value at a date subsequent to the purchase. *See* Jacobs, *The Measure of Damages in Rule 10b-5 Cases*, 65 GEO. L.J. 1093, 1108-09 (1977). *See also* W. PROSSER, *supra* note 22, § 110 at 734.

109. 675 F.2d at 1121.

110. Out-of-pocket damages generally means the fair value of the consideration paid minus the fair value of the security received (if the security is still held). *See* Jacobs, *supra* note 108, at 1099-102. *See also* W. PROSSER, *supra* note 22, § 110 at 733-34.

111. 675 F.2d at 1121.

a remedy peculiar to the particular case.[112] However, this was unnecessary. The court found that the trial court's damage award could be sustained as an out-of-pocket loss because the plaintiff had relinquished his right to a forty-nine percent ownership interest in the prosperous corporation.[113] After mentioning these alternative justifications, the court upheld the award under the unjust enrichment exception to the Rule 10b-5 out-of-pocket loss standard.[114] The court noted that unjust enrichment occurs when fraud is used to induce another to sell securities that subsequently increase in value, but may also occur when an innocent party is induced to purchase securities.[115] The award of forty-nine percent of the value of the business was seen by the court as giving the plaintiff credit for his years of hard work while the company prospered, and was thus necessary to prevent Holmes' unjust enrichment.[116]

V. CONCLUSION

The most significant contribution to the status of securities law in the Tenth Circuit was the adoption of an objective recklessness standard to satisfy the scienter requirement in private damage actions under section 10(b) and Rule 10b-5. The definition of recklessness utilized comports well with the changed judicial policy in favor of reducing the number of actions brought under the general anti-fraud sections of the federal securities laws, yet does not unduly burden plaintiffs by requiring a more difficult subjective standard of proof. The objective standard also provides needed certainty and predictability for participants in the securities markets. The court's decisions in other areas of securities law—SEC injunctive actions, statutes of limitations, and damages, while following well-established principles and precedents, provided further clarification and guidance.

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112. *Id.* (citing Nye v. Blyth Eastman Dillon & Co., 588 F.2d 1189 (8th Cir. 1978); Blackie v. Barrack, 524 F.2d 891 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976); Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971)).

113. The court seems to be taking notice of the concept of "sweat equity," familiar to entrepreneurs, whereby actual management of an enterprise is substituted for capital. *See infra* text accompanying note 116. Under the general rule in federal courts, only the out-of-pocket measure is allowed, but it may include "such outlays as are attributable to the defendant's fraudulent conduct." Estate Counseling Serv. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 303 F.2d 527, 533 (10th Cir. 1962).

114. 675 F.2d at 1122. "Preventing unjust enrichment is a well-recognized exception to the rule limiting damages to the out-of-pocket loss." *Id.* (citing Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972); Nelson v. Serwold, 576 F.2d 1332 (9th Cir. 1978); Zeller v. Bogue Elec. Mfg. Corp., 476 F.2d 795 (2d Cir.), *cert. denied*, 414 U.S. 908 (1973); Janigan v. Taylor, 344 F.2d 781 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965)).

115. 675 F.2d at 1122.

116. *Id.*