Due Diligence: A Post-Sale of Business Doctrine Method of Avoiding Rule 10b-5 Liability

Sherry Rozell
Washington University School of Law

Follow this and additional works at: https://openscholarship.wustl.edu/law_lawreview

Part of the Law Commons

Recommended Citation
Available at: https://openscholarship.wustl.edu/law_lawreview/vol64/iss2/10
DUE DILIGENCE: A POST-SALE OF BUSINESS DOCTRINE
METHOD OF AVOIDING RULE 10b-5 LIABILITY

The once popular sale of business doctrine provided that when an owner of a corporation transfers 100% of the stock, the federal securities laws did not apply to the transaction because the stock was not considered a "security" within the meaning of the Securities Act. Some courts extended the doctrine to the transfer of a majority of shares because the transaction still transfers effective control. The Supreme Court, in Landreth Timber Co. v. Landreth and Gould v. Ruefenacht, two related cases decided in the summer of 1985, held the sale of business doctrine inapplicable to the sale of a controlling interest and 100% of a corporation’s stock. As a result, a threat of securities liability now accompanies the sale of a controlling interest in a corporation’s stock.

The Supreme Court reasoned that if a transaction involves stock, an interest that possesses all the usual attributes of a security, then there is

---


4. The Court warned that it was not deciding whether the coverage of notes or other instruments may be provable by their name and characteristics. Landreth 53 U.S.L.W. at 4605.

5. Common characteristics of a security include dividends, voting rights and appreciation in value.
no reason to look to underlying economic realities to determine whether
the Securities Acts apply. The Court further explained that the Act ap-plies not only to passive investors, but also to privately negotiated trans-
actions involving the sale of control to “entrepreneurs.”

Although applicability of the Act is now certain, liability in the “sale of
business” scenario is not. The sophisticated entrepreneur still may have
difficulty establishing a violation of the antifraud provisions. A sophisti-
cated investor’s ability to analyze, evaluate, and understand the potential
investment may, in fact, be his downfall under the judicially imposed
justifiable reliance or “due diligence” requirements.

For example, to establish a violation of rule 10b-5, the most utilized
and potentially most devastating antifraud provision, plaintiffs must
pass a judicially created “due diligence” inquiry. In affirmative misrepre-
sentation cases, reliance is an essential element of claimant’s rule 10b-5
action. Due diligence requires the plaintiff to show justifiable reliance

---

Howey, 328 U.S. 293 (1946).
7. The Court, however, warned that it would not apply the Securities Act simply because an
instrument is labeled “stock.” But when an instrument’s characteristics “bear out the label,” it is
8. Id. at 4605.
9. Justice Stevens, in his dissenting opinion, states that he would hold that:
the antifraud securities acts are inapplicable unless the transaction involves (i) the sale of a
security that is traded in a public market; or (ii) an investor who is not in a position to
negotiate appropriate contractual warranties and to insist on access to inside information
before consummating the transaction.
Landreth, 53 U.S.L.W. at 4607. The majority opinion, however, does not explicitly address these
factors. But see supra note 7 and accompanying text.
10. Securities and Exchange Commission rule 10b-5, promulgated pursuant to § 10(b) of the
Securities Exchange Act, provides:
It shall be unlawful for any person, directly or indirectly, by the use of any means or
instrumentality of interstate commerce, or of the mails or of any facility of any national
 securities exchange,
(a) To employ any device, scheme, or artifice to defraud,
(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.
 REV. 562 (1972).
754 (1975).
13. Reliance is required in affirmative misrepresentation cases. Rifkin v. Crow, 574 F.2d 256
(5th Cir. 1978). In a failure to disclose case under rule 10b-5, however, positive reliance is not an
on the defendant's misrepresentation.\textsuperscript{14}

At least eight circuits recognize due diligence as an element of a plaintiff's rule 10b-5 action.\textsuperscript{15} The allocation of proof\textsuperscript{16} and the required degree of care\textsuperscript{17} varies, but the purpose is the same. The due diligence requirement attempts to bar claims when the plaintiff has been careless in ignoring or relying on material of questionable merit.\textsuperscript{18}

Due diligence is linked to the element of causation.\textsuperscript{19} It insures a causal connection between the defendant's misrepresentation or omission and the claimant's injury.\textsuperscript{20} Since the Supreme Court in \textit{Ernst & Ernst} v.}

\textsuperscript{14} element of the cause of action. Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972). This lack of a reliance requirement could be extended to remove any requirement of justifiable reliance or due diligence by plaintiff in nondisclosure cases. No court, however, has taken this logical step. Sachs, \textit{The Relevance of Tort Law Doctrines to Rule 10b-5: Should Careless Plaintiffs Be Denied Recovery?}, 71 CORNELL L. REV. 96, 100 (1985).

\textsuperscript{15} McLean v. Alexander, 420 F. Supp. 1057-77 (D. Del. 1976); Note, supra note 12 at 754.


\textsuperscript{17} Sachs, supra note 13, at 101, n. 23. See also infra note 23.

\textsuperscript{18} Five circuits measure the duty of care by a recklessness standard. Friedlander v. Nims, 755 F.2d 810 (11th Cir. 1985), aff'd 751 F. Supp. 1188, 1197 (N.D. Ga. 1983) (adopting standard set forth by Fifth Circuit in \textit{Dupuy}); Zobrist v. Coal-X, Inc., 708 F.2d 1511, 1516 (10th Cir. 1983) ("only when plaintiff's conduct rises to culpable level of conduct comparable to that of defendant's will reliance be unjustifiable"); Gower v. Cohn, 643 F.2d 1146, 1156 (5th Cir. 1981) (adopting recklessness standard set forth in \textit{Dupuy}); Mallis v. Bankers Trust Co., 615 F.2d 68, 79 (2d Cir. 1980) ("Securities laws were not enacted to protect sophisticated businessmen from their own errors of judgment"); Dupuy v. Dupuy, 551 F.2d 1005, 1020 (5th Cir.) (incorporating \textit{Ernst & Ernst} recklessness standard into due diligence inquiry), \textit{cert. denied}, 434 U.S. 911 (1977); Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1048 (7th Cir. 1977) (following \textit{Ernst & Ernst} scienter standard and stating "if contributory fault of plaintiff is to cancel out wanton or intentional fraud, it ought to be gross conduct somewhat comparable to that of defendant."). Of these five courts, all but the Seventh Circuit places the burden of proof on the plaintiff. \textit{Sundstrand}, 553 F.2d at 1048. The Second Circuit modifies the burden on the plaintiff by stating that the plaintiff's duty to show due care only exists when the defendant places it in issue. \textit{Mallis}, 615 F.2d at 79.

The Supreme Court refused to clarify plaintiff's standard of care in rule 10b-5 cases by denying certiorari in Dupuy v. Dupuy, 434 U.S. 911 (1977). Justice White, dissenting, stated that the "Court should take this opportunity to clarify the standard of care expected of plaintiffs in litigation under Rule 10b-5." \textit{Id.} at 912.


\textsuperscript{18} Sachs, supra note 13, at 100.

\textsuperscript{19} Zobrist, 708 F.2d at 1516.

\textsuperscript{20} \textit{Id.}
Hochfelder\textsuperscript{21} decided that “something more than negligence” is required in rule 10b-5 actions,\textsuperscript{22} most courts have adopted a recklessness standard for the due diligence standard.\textsuperscript{23} The due diligence requirement reflects a judgment that when the plaintiff's conduct reaches the same level of recklessness, injury is more a function of the plaintiff's own carelessness than the defendant's misrepresentations or omissions.

In view of the recklessness standard, plaintiff-investors may be allowed a certain amount of “unreasonableness” in making their investment decisions. The recklessness standard, however, is capable of violation. In Zobrist \textit{v.} Coal-X, Inc.,\textsuperscript{24} for example, the Tenth Circuit held that warnings and statements\textsuperscript{25} contained in a private placement memorandum\textsuperscript{26} should be imputed to a sophisticated investor even though he has not read them.\textsuperscript{27} The investor, therefore, could not justifiably rely on oral


\textsuperscript{23} Zobrist, 708 F.2d at 1516 (plaintiff's conduct must at least amount to recklessness and rise to a comparable level of culpability with that of defendant); Dupuy \textit{v.} Dupuy, 551 F.2d 1005, 1019 (5th Cir.) (inquiry is whether investor intentionally refused to investigate a known or obvious risk), \textit{cert. denied.} 434 U.S. 911 (1977); Xaphes \textit{v.} Merrill Lynch, Pierce, Fenner & Smith, 600 F. Supp. 692 (D. Me. 1985) (due diligence will be found on part of plaintiff in securities fraud action if he did not act recklessly). See \textit{supra} note 17 and accompanying text.

In Mallis \textit{v.} Bankers Trust Co., 615 F.2d 68 (2d Cir. 1980), the court held that a claimant's burden is not to establish due care, but simply to negate the defendant's allegation of plaintiff's recklessness. Mallis, however, is inconsistent with the Second Circuit's decision in Hirsch \textit{v.} DuPont, 553 F.2d 750 (2d Cir. 1977). The \textit{Hirsch} court pronounced a standard of negligence in determining whether plaintiff's due diligence burden had been met:

The securities laws were not enacted to protect sophisticated businessmen from their own errors of judgment. Such investors must, if they wish to recover under federal law, investigate the information available to them with the care and prudence expected from people blessed with full access to information.

\textit{Id.} at 763. This standard seems to have been implicitly overruled by Mallis.

\textsuperscript{24} 708 F.2d 1511 (10th Cir. 1983).

\textsuperscript{25} The Private Placement Memorandum included the following warning: “These securities involve a high degree of risk. See 'Risk and Special Factors' and 'Who Should Invest.'” \textit{Id.} at 1517.

Another warning also appeared in the Memorandum: “No person has been authorized to give any information or to make any representations not contained in this memorandum . . . and, if given or made, such information or representations must not be relied upon.” \textit{Id.} at 1517-18.

\textsuperscript{26} \textit{Id.} at 1518. The Private Placement Memorandum was equivalent to a prospectus except that it had not been reviewed by the S.E.C. \textit{Id.} at 1514 n.3.

\textsuperscript{27} \textit{Id.} at 1518. Generally, there is “no duty to disclose information to one who reasonably should already be aware of it.” Seibert \textit{v.} Sperry Rand Corp., 586 F.2d 949, 952 (2d Cir. 1978). Therefore, there is no fraud where one fails to disclose information that is “easily enough available by due diligent inquiry.” Rodman \textit{v.} Grant Found., 460 F. Supp. 1028, 1035 (S.D.N.Y. 1978), \textit{aff'd.} 602 F.2d 64 (2d Cir. 1979).
misrepresentations made by sellers. The court found that the investor acted “recklessly by intentionally closing his eyes” and failing to investigate contradictions between oral representations and information contained in the memorandum. The Tenth Circuit, however, has refused to apply the Zobrist rule to unsophisticated investors.

In Zobrist, the Tenth Circuit compiled a list of factors it and other circuits find relevant in determining whether the investor’s reliance is justifiable:

1. the sophistication and expertise of the plaintiff in financial 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; and
8. the generality or specificity of the misrepresentations.

The Zobrist court applied these factors and found that although the parties had prior business dealings, the plaintiff-investor had no long-standing relationship that would justify reliance on the seller’s representations without inquiry. The seller did not conceal the fraud, but exposed it with information and warnings contained in the private placement memorandum. Although not explicitly relied on by the court, it is noteworthy that each investor signed a statement acknowledging the risks set forth in the memorandum, even though it was undisputed that they did not read it. The investors also signed an “Investment Questionnaire” indicating that they understood the nature of the investment and the risks involved.

These signed statements and the Zobrist factors suggest a method for shielding the seller of a closely held corporation from liability under rule

29. Id. at 1518. The contradicting terms used by the Zobrist court should be noted; “reckless” and “intentional” conduct are two separate and distinct standards.
30. Zobrist, 708 F.2d at 1519.
31. Wergiev v. First Commodity Corp. of Boston, 744 F.2d 719, 723 (10th Cir. 1984) (holding Zobrist distinguishable because neither of the plaintiffs were sophisticated investors).
32. Zobrist, 708 F.2d at 1516.
33. Id. at 1518.
34. Id.
35. Id. at 1514.
36. Id.
10b-5. The solution, however, is not without its problems. Both the 1933 and 1934 Securities Acts provide that an attempt to waive compliance with the federal securities laws is void.37 The general counsel for the Securities Exchange Commission, in interpreting these provisions, ruled that the antifraud provisions are violated by the employment of any hedge or other provision waiving investors' securities claims.38 The First Circuit, for example, has employed section 29(a) of the Exchange Act of 1934 to void a contractual provision that provided: "I am not relying on your representations or obligations to make full disclosure."39 The court reasoned that the Securities Act attempts to equalize bargaining power between the individual and corporation through the antiwaiver provision.40 This reasoning does not apply, however, when the investor is sophisticated and already possesses equal bargaining power, as will often be the case in "sale of business" cases.

One commentator, Margaret Sachs, suggests that due diligence itself is inconsistent with section 29(a) of the 1934 Act.41 Sachs argues that section 29(a) and due diligence reflect opposing philosophies. She concludes that Congress' enactment of section 29(a) indicates that it would have rejected any notion of due diligence had it been presented with the question.42 In recognition of the "informational advantage" of securities defendants, Sachs argues that Congress sought to protect investors and place a premium on enforcement of violations.43

Despite the emphasis on enforcement, Congress' employment of terms such as "manipulative or deceptive device" in section 10(b) and the SEC's interpretation in rule 10b-5 suggest that the statute was designed to cover "fraud-like" activity.44 Moreover, in developing a private cause of action under rule 10b-5, courts have adopted many common-law fraud concepts,45 including due diligence.46 Generally, there is no fraud when one fails to disclose information to another who reasonably should be

40. Id.
41. Sachs, supra note 13, at 126.
42. Id. at 129.
43. Id. at 128.
46. See supra note 17 and accompanying text.
aware of or could easily discover that information by reasonably diligent inquiry. Due diligence incorporates these concepts by imposing a duty of care on rule 10b-5 plaintiffs much like that required of claimants in a common-law fraud action.

In view of the statutory language of section 10(b) and subsequent judicial and administrative interpretation, the due diligence requirement is not as inconsistent with congressional intent as Sachs suggests. This is especially true in the civil litigation context, in which it seems highly unlikely that Congress would permit the potentially devastating rule 10b-5 remedies without requiring any exercise of care on the part of plaintiffs.

Nevertheless, courts continue to bar rule 10b-5 claims when sophisticated investors have access to all relevant information, whether or not it is actually read, and reliance on any misrepresentations in view of this access is unjustifiable. A contract provision indicating investors' access to information and recognition of risks should be inserted in every agreement of sale when the transaction involves the sale of a close corporation. Such a provision inserted in the sales agreement preserves the existence of crucial facts for use in potential securities litigation. It also alerts the buyer to the importance of the occasion and the duty to investigate any contradictions between oral representations and information contained in the contract or investment questionnaire. Patent statements of nonreliance should be avoided. Statements regarding access to information and recognition of risks such as the statements used in the Zobrist case,

49. See supra note 29 and accompanying text.
50. Most law firms already utilize investment questionnaires such as those involved in Zobrist. The insertion of these crucial facts into the sales agreement, however, provides more protection for the seller. It is an enforceable part of the contract. The parol evidence rule insures that evidence contradicting contract provisions is not admissible at trial. This rule prohibits the plaintiff from claiming lack of access to information and recognition of risks because the contract states otherwise.
51. See supra note 29 and accompanying text.
however, should not be invalidated on antiwaiver grounds.\textsuperscript{52}

The following sample contract provision for inclusion in the Agreement of Sale provides a method of avoiding the potentially devastating consequences of the \textit{Landreth} repudiation of the sale of business doctrine:

Buyer represents that:

\begin{center}
* * *
\end{center}

Buyer has had unrestricted access to all documentation and information under seller's control and has diligently requested and received all documentation pertinent to the evaluation of the investment which is the subject of this Agreement. Buyer has carefully read and scrutinized all information furnished to him by Seller and understands the fair import thereof. Buyer understands the nature of the investment and the risks involved. Buyer has such knowledge, experience and sophistication in financial and business matters to enable him to evaluate the merits and risks associated with the prospective investment.\textsuperscript{53}

The provision draws upon the concept of due diligence recognized by most of the circuit courts.\textsuperscript{54} This provision emphasizes the investor's access to information regarding the investment and his business expertise that enables him to evaluate the investment. The presence of these two factors makes a showing of due diligence on the part of the investor almost impossible. In view of the buyer's express recognition of his sophistication, expertise, and access to information, any reliance on misrepresentations without further inquiry would probably be deemed unjustifiable.\textsuperscript{55} Even failure to read the provision will not protect the investor.\textsuperscript{56}

\textit{Sherry Rozell}

\textsuperscript{52} See supra notes 31 & 32 and accompanying text.

\textsuperscript{53} The substance of the sample contract provision is primarily taken from the Investment Questionnaire in \textit{Zobrist} and prior rule 146(d)(1) regarding private placements. Private placements required that the interests in the corporation may only be offered to a limited number of investors, all of whom either possess sufficient business expertise to evaluate the investment or are able to bear the economic risk of the investment. 17 C.F.R. § 230.146 d-1 (1981) (removed at 47 Fed. Reg. 11261 (1982)).

\textsuperscript{54} See supra notes 15-17 and accompanying text.

\textsuperscript{55} See supra notes 27-30 & 33 and accompanying text.

\textsuperscript{56} See supra notes 27, 30 & 35 and accompanying text.