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POST-TRANSACTION EVIDENCE IN SECURITIES LITIGATION

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I. INTRODUCTION

Proving the basic elements of a securities fraud action normally involves scrutinizing events prior to or at the time of a purchase or sale of securities.¹ Particularly where claims require proof of scienter, as in 10b-5 cases,² the critical issues hinge on the parties' respective knowledge and

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¹ See, e.g., *Kogan v. National Bank of North America*, 402 F. Supp. 359, 361 (E.D.N.Y. 1975) where the court observed respecting rule 10b-5 claims that: "Rule 10b-5 provides that it is unlawful to defraud or misrepresent '... in connection with the purchase or sale of any security.' The phrase 'in connection with' has been construed to mean that the fraud practiced must have been prior to or contemporaneous with the sale of securities." See also *St. Louis Union Trust Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 562 F.2d 1040, 1048 (8th Cir. 1977) (same); *Jackson v. Oppenheim*, 533 F.2d 826, 829-30 (2d Cir. 1976) (claims brought under § 12(2) require inquiry into events preceding securities transaction).

² 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,

(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.

17 C.F.R. § 240.10b-5 (1977). Similarly, suits brought under § 206 of the Investment Advisors Act of 1940 require proof of scienter. Section 206 provides:

It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly —

(1) to employ any device, scheme, or artifice to defraud any client or prospective client;

(2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client;

(3) acting as principal for his own account, knowingly to sell any security to or purchase any security from a client, or acting as broker for a person other than such client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the

conduct leading to the sale.³ This focus on events leading up to the transaction is required because events occurring after a purchaser has already committed himself to purchase cannot be said to have "caused" his purchase.⁴ Similarly, a purchaser cannot be said to have "relied" upon post-transaction events in deciding whether to make the purchase.⁵ Given this conceptual framework, evidence regarding facts after the purchase or sale of securities appears, on its face, to be irrelevant, and indeed may hinder a fair determination of what occurred at the time of sale.

In actuality, the role of post-transaction evidence in securities litigation is not that simple. Several types of securities claims—for example, those arising under sections 11 and 12(2) of the Securities Act of 1933⁶—

consent of the client to such transaction. The prohibitions of this paragraph shall not apply to any transaction with a customer of a broker or dealer if such broker or dealer is not acting as an investment adviser in relation to such transaction;

(4) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. The Commission shall, for the purposes of this paragraph (4) by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative.

15 U.S.C. § 80b-6. See notes 209 and 270 *infra* regarding the scienter requirements of these provisions.

³ See, e.g., *Tully v. Mott Supermarkets, Inc.*, 540 F.2d 187, 194 (3d Cir. 1976) (10b-5 plaintiff must show a causal link between misrepresentation or omission and his purchase or sale); *Titan Group, Inc. v. Faggen*, 513 F.2d 234, 239 (2d Cir. 1975), *cert. denied*, 423 U.S. 840 (1975); *Gross v. Diversified Mortgage Investors*, 431 F. Supp. 1080 (S.D.N.Y. 1977); *Spielman v. General Host Corp.*, 402 F. Supp. 190, 194 (S.D.N.Y. 1975), *aff'd*, 538 F.2d 39 (2d Cir. 1976). See also note 58 *infra*.

⁴ See, e.g., *Halperin v. Edwards & Hanly*, 430 F. Supp. 121, 125 (S.D.N.Y. 1977) (fraudulent acts occurring after transaction are not actionable under 10b-5, since the phrase "in connection with" a securities transaction contained in 10b-5 requires fraud before or contemporaneously with the transaction); *Petersen v. Federated Dev. Co.*, 416 F. Supp. 466, 476 (S.D.N.Y. 1976) (same); *Kogan v. National Bank of North America*, 402 F. Supp. 359, 361 (E.D.N.Y. 1975) (same); *Pepsico, Inc. v. W.R. Grace & Co.*, 307 F. Supp. 713, 720 (S.D.N.Y. 1969) (same). See also *Morgan v. Prudential Funds, Inc.*, [Current] FED. SEC. L. REP. (CCH) ¶ 96,345 (S.D.N.Y. 1978); *Pollak v. Eastman Dillon*, [1974-75 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,987, at 97,412 (S.D.N.Y. 1975); *Pierre J. Lelandais & Co. v. MDS-Atron, Inc.*, 387 F. Supp. 1310 (S.D.N.Y. 1974), *aff'd in part*, 543 F.2d 421 (2d Cir. 1976), *cert. denied*, 429 U.S. 1062 (1977); *Dijullio v. Digicon, Inc.*, 339 F. Supp. 1284, 1291, (D.Md. 1972). *But cf. Lewelling v. First Cal. Co.*, 564 F.2d 1277 (9th Cir. 1977) (actionable though the transaction was complete before disclosure).

⁵ See, e.g., *St. Louis Union Trust Co. v. Merrill Lynch, Pierce, Fenner, & Smith, Inc.*, 562 F.2d 1040, 1048 (8th Cir. 1977); *Cf. Rochez Bros., Inc. v. Rhoades*, 491 F.2d 402, 410 (3d Cir. 1974) (proof of actual reliance is not always necessary in 10b-5 action). See also *Kerrigan v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,446, at 93,602 (S.D.N.Y. 1978).

⁶ Codified as 15 U.S.C. §§77K, 77I (1970). Section 11 provides, in pertinent part:

(b) Notwithstanding the provision of subsection (a) of this section no person, other than the issuer, shall be liable as provided therein who shall sustain the burden of proof—

.... (3) that (A) as regards any part of the registration statement not purporting to be made on the authority of an expert, and not purporting to be a copy of or extract from a report or valuation of an expert, and not purporting to be made on the authority of a public official document or statement, he had, after reasonable investigation, reasonable ground to believe and did believe at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading; and (B) as regards any part

do not require proof of scienter. Moreover, those sections provide for liability based not only upon facts known to the defendant, but also upon those facts which he could have learned through the exercise of reasonable diligence.⁷ In a similar vein, in the past some courts have predicated the plaintiff's right to recover on a showing, in addition to fraud, that he acted

of the registration statement purporting to be made upon his authority as an expert or purporting to be a copy of or extract from a report or valuation of himself as an expert, (i) he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or (ii) such part of the registration statement did not fairly represent his statement as an expert or was not a fair copy of or extract from his report or valuation as an expert; and (C) as regards any part of the registration statement purporting to be made on the authority of an expert (other than himself) or purporting to be a copy of or extract from a report or valuation of an expert (other than himself) he had no reasonable ground to believe and did not believe, at the time such part of the registration statement became effective, that the statements therein were untrue or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or that such part of the registration statement did not fairly represent the statement of the expert or was not a fair copy of or extract from the report or valuation of the expert; and (D) as regards any part of the registration statement purporting to be a statement made by an official person or purporting to be a copy of or extract from a public official document, he had no reasonable ground to believe and did not believe, at the time such part of the registration statement became effective, that the statements therein were untrue, or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or that such part of the registration statement did not fairly represent the statement made by the official person or was not a fair copy of or extract from the public official document.

15 U.S.C. § 77k (1970). Section 12(2) provides, in pertinent part, that

Any person who—

....
(2) offers or sells a security . . . by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission,

shall be liable to the person purchasing such security from him . . . to recover the consideration paid for such security with interest thereon. . . .

15 U.S.C. § 77l (1970). See also text at notes 170 & 267 *infra*.

⁷ See, e.g., *Hill York Corp. v. American Intern. Franchises, Inc.*, 448 F.2d 680, 695 (5th Cir. 1971) (plaintiff need not prove scienter in action brought under § 12(2)); *Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544, 568 (E.D.N.Y. 1971) (civil liability established under § 11, by showing defendant failed to exercise reasonable care in preparing registration statement).

"reasonably" or with "due diligence" in deciding whether to enter into the transaction.⁸ The plaintiff's due diligence may also be a factor in determining whether his claims are barred by the statute of limitations.⁹ In these circumstances, judicial inquiry focuses frequently upon what a party could or should have known. Post-transaction events may illuminate such matters.¹⁰

Although post-transaction evidence may thus prove valuable, objections to the use of such evidence nevertheless persist. Those objections challenge both the discovery and the admissibility of evidence of post-transaction facts as irrelevant to a claim based on events preceding the securities sale. The issue whether post-transaction facts are discoverable or admissible is significant to both plaintiffs and defendants in securities litigation. Consequently, in such suits, the relevance of evidence respecting events transpiring after the sale creates a common problem for the courts.

This article examines the affirmative role post-transaction evidence may play in securities litigation. The role of post-transaction information in discovery is first explored. Thereafter, the article analyzes the relevance of post-transaction evidence in proving intent, materiality, reliance and the fact of fraud. Issues raised by the offer of post-transaction evidence in cases involving lulling, continuing wrongs and multiparty situations are also analyzed. Where pertinent, analogous common law fraud rules and those involving other federal statutes are contrasted with the rules applicable to securities fraud. The article then discusses how post-transaction evidence may aid defendants in raising such defenses as lack of due diligence, estoppel and waiver. The article concludes with an examination of possible objections—for example, those asserted under rules 403 and 407 of the Federal Rules of Evidence—which may prevent the introduction of post-transaction evidence. The discussion reveals that post-transaction evidence does not constitute a special type of evidence susceptible to a set of black letter rules, but rather is subject to the same considerations of relevance, possible prejudice and weight applicable to evidence generally.

II. PRE-TRIAL DISCOVERY OF POST-TRANSACTION FACTS

A. *The General Scope of Discovery*

The least difficult aspect of the debate over post-transaction evidence in securities litigation appears to arise where an adverse party seeks to explore post-transaction matters in pretrial discovery. Post-transaction evidence engenders few problems in this context because of the broad scope

⁸ See text at notes 198-226 *infra*. For the current status of this facet of securities litigation, see *Dupuy v. Dupuy*, 551 F.2d 1005, 1013-24 (5th Cir. 1977), *cert. denied*, 434 U.S. 911 (1977); *Holdsworth v. Strong*, 545 F.2d 687, 692-93 (10th Cir. 1976), *cert. denied*, 430 U.S. 984 (1977); *Straub v. Vaisman & Co.*, 540 F.2d 591, 596-98 (3d Cir. 1976). As pointed out in the text at note 206 *infra*, defenses premised on this basis are not available in a § 12(2) action.

⁹ See text at notes 227-238 *infra*.

¹⁰ See, e.g., *Goldstam v. Bear, Stearns & Co.*, 522 F.2d 1265, 1268 (7th Cir. 1975) (evidence of post-transaction events necessary for determination whether equitable tolling doctrine applies); *Braunstein v. Laventhol & Horvath*, [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,097, at 91,945 (S.D.N.Y. 1977) (same). See text at notes 152-161 & 227-238 *infra*.

of discovery under the Federal Rules of Civil Procedure.¹¹ What is discoverable under these rules exceeds what is admissible at trial;¹² the test for determining whether material is discoverable is whether the information sought is "reasonably calculated to lead to admissible evidence," not whether it is "relevant." Adding to the initially broad scope of discovery is the principle that the discovery rules of the Federal Rules of Civil Procedure are to be construed liberally.¹³ Consequently, regardless of when generated or dated, post-transaction material which leads to other evidence casting light on relevant facts at the time of the transaction at issue is normally a proper subject of pretrial discovery.¹⁴

Parties involved in securities litigation repeatedly seek to challenge discovery requests for post-purchase information on the grounds that it is not within the ambit of the "reasonably calculated to lead to admissible evi-

¹¹ Rule 26(b)(1) of the Federal Rules of Civil Procedure provides, in part:
(b) Scope of Discovery. Unless otherwise limited by order of the court in accordance with these rules, the scope of discovery is as follows:

(1) *In General.* Parties may obtain discovery regarding any matter, not privileged, which is relevant to the subject matter involved in the pending action It is not ground for objection that the information sought will be inadmissible at the trial if the information sought appears reasonably calculated to lead to the discovery of admissible evidence.

¹² See note 11 *supra*. See *Morgan Smith Automotive Prods., Inc. v. General Motors Corp.*, 54 F.R.D. 19, 20 (E.D. Pa. 1971) (applying the "reasonably calculated" test); *Prudential Ins. Co. v. Marine Nat'l Exch. Bank*, 52 F.R.D. 367 (E.D. Wisc. 1971) (same); *Loew's of Roanoke, Inc. v. Jefferson Standard Life Ins. Co.*, 219 F. Supp. 181, 188 (S.D.N.Y. 1963) (it is not an objection to discovery that the information sought is inadmissible at trial, so long as the information is reasonably calculated to lead to the discovery of admissible evidence). *Cf. Reddick v. White Consol. Indus., Inc.*, 295 F. Supp. 243 (S.D. Ga. 1969) (sustaining objection to discovery which could not lead to admissible evidence). See also *In re Penn Cent. Commercial Paper Litigation*, 61 F.R.D. 453, 460 (S.D.N.Y. 1973); *Laird v. United Shipyard, Inc.*, 1 F.R.D. 772, 773 (S.D.N.Y. 1941).

¹³ See, e.g., *Mallinckrodt Chem. Works v. Goldman, Sachs & Co.*, 58 F.R.D. 348, 353 (S.D.N.Y. 1973). See also *United States v. International Business Mach. Corp.*, 66 F.R.D. 215, 218 (S.D.N.Y. 1974); *Steamship Co. of 1949 v. China Union Lines, Hong Kong, Ltd.*, 123 F. Supp. 802, 805 (S.D.N.Y. 1954); *Leonia Amusement Corp. v. Loew's, Inc.*, 16 F.R.D. 583, 584 (S.D.N.Y. 1954); C. WRIGHT, *HANDBOOK OF THE LAW OF FEDERAL COURTS*, § 81 (3rd Ed. 1976) [hereinafter cited as WRIGHT]. Thus, for example, in *Steamship Co. of 1949 v. China Union Lines, Hong Kong, Ltd.*, the court stated "discovery should be allowed unless it is palpable that the evidence sought can have no possible bearing on the issues." 123 F. Supp. 802, 805 (S.D.N.Y. 1954). *Cf. Midland Inv. Co. v. Van Alstyne, Noel & Co.*, 59 F.R.D. 134, 140 (S.D.N.Y. 1973) (*mem.*) (although scope of discovery is broad, court will prohibit discovery which causes defendant great annoyance and expense when the information sought has only minimal relevance); *Dolgow v. Anderson*, 53 F.R.D. 661, 664 (E.D.N.Y. 1971) (*mem.*) (same).

¹⁴ See 4 MOORE'S FEDERAL PRACTICE, ¶ 26.56(1) at 26-129 (2d ed. 1948 & Supp. 1978) [hereinafter cited as MOORE'S], where, addressing the issue of proper subjects of discovery, the authors state that "[q]uestions as to acts subsequent to the events giving rise to liability are permissible as are questions regarding acts subsequent to the date of the complaint. . . ." For cases allowing discovery of post-transaction events in securities litigation, see, e.g., *Cornaglia v. Ricciardi*, 63 F.R.D. 416, 421-22 (E.D. Pa. 1974); *In re Penn Cent. Commercial Paper Litigation*, 61 F.R.D. 453, 460 n.14 (S.D.N.Y. 1973); *Midland Inv. Co. v. Van Alstyne, Noel & Co.*, 59 F.R.D. 134, 137-38 (S.D.N.Y. 1973) (*mem.*); *Ross v. Paul Hardeman, Inc.*, [1964-66 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 91,485, at 94,850 (S.D.N.Y. 1965). This post-transaction discovery issue has been resolved similarly in antitrust cases, see, e.g., *Carlson Cos., Inc. v. Sperry & Hutchinson Co.*, 374 F. Supp. 1080, 1101-04 (D. Minn. 1974); *Goldinger v. Boron Oil Co.*, 60 F.R.D. 562, 564 (W.D. Pa. 1973); *Bass v. Gulf Oil Corp.*, 304 F. Supp. 1041, 1044-47 (D. Miss. 1969), and in other nonsecurities contexts, see, e.g., *United States v. Interna-*

dence" test, even where the post-purchase materials relate back to events prior to the purchase. Such materials may exist, for example, when a party's files contain post-mortem memoranda seeking to reconstruct the facts leading to the sale or purchase either to advise shocked superiors of why an investment failed or to anticipate possible litigation.¹⁵ Such material may

tional Ass'n of B.S. & O. Iron Workers, 438 F.2d 679 (7th Cir.), *cert. denied*, 404 U.S. 830 (1971); *United States v. Sampson Mfg. Corp.*, 64 F.R.D. 83 (N.D. Ga. 1974); *M.S.A. Constr. Co. v. Crafts Corp.*, 58 F.R.D. 215 (E.D. Wisc. 1973); *Buckley v. Vidal*, 50 F.R.D. 271 (S.D.N.Y. 1970); *Paiewonsky v. Paiewonsky*, 50 F.R.D. 379 (D.V.I. 1970); *Quonset Real Estate Corp. v. Paramount Film Dist. Corp.*, 50 F.R.D. 240 (S.D.N.Y. 1970).

¹⁵ Rule 803(5) of the Federal Rules of Evidence excepts specifically from the hearsay rule those memoranda or records which record a witness' past recollections when the witness' recollection has since become hazy, so long as the memorandum was made by a witness "when the matter was fresh in his memory and to reflect that knowledge correctly." But the rule also contains the curiously worded limitation that "[i]f admitted, the memorandum or record may be read into evidence but may not itself be received as an exhibit unless offered by an adverse party." See also *United States v. Kelly*, 349 F.2d 720, 770 (2d Cir. 1965) (collecting cases in support of this rule and determining that this exception to the hearsay rule does not violate the confrontation clause of the sixth amendment).

Rule 803(6) of the Federal Rules of Evidence also continues to permit the "business records" exception to the hearsay rule, insofar as the source of the record is deemed reliable. *Cf. Hoffman v. Palmer*, 129 F.2d 976, 991 (2d Cir. 1942), *aff'd*, 318 U.S. 109 (1943) (holding business records exception inapplicable in circumstances where the statement was prepared following the incident which is the subject of the litigation and the person making the memorandum has, under the circumstances, great motivation to seek to exculpate himself or his employer from liability). This exception to the hearsay rule, previously codified in 28 U.S.C. § 1732 (1970), was often applied to reports following the events actually being litigated. Compare *Korte v. New York, N.H. & H.R. Co.*, 191 F.2d 86, 90 (2d Cir.), *cert. denied*, 342 U.S. 868 (1951) (defining what constitutes records made in the "regular" course of business) and *United States v. Foreign Zone Operators*, 344 F.2d 281 (2d Cir. 1965) with *Matthews v. United States*, 217 F.2d 409, 413-16 (5th Cir. 1954) (holding that where the records are not relied upon by the party making them in the normal course of his business, and where the truthfulness of the records is not necessitated by the party's own interests the business records exception does not apply; expressly rejecting the *Korte* approach) and *Yates v. Bair Transport, Inc.*, 249 F. Supp. 681 (S.D.N.Y. 1965).

When such memoranda qualify as an attorney's work product, the extent to which the records must be produced still frequently presents a difficult question for courts. See, e.g., *Galambus v. Consolidated Freightways Corp.*, 64 F.R.D. 468, 472-74 (N.D. Ind. 1974) (report made in normal course of business and submitted to company's attorney); *Richards-Wilcox Mfg. Co. v. Young Spring & Wire Corp.*, 34 F.R.D. 212, 213 (N.D. Ill. 1964) (notes submitted to the company's attorney made by member of company's inspection team). See also *Goosman v. A.D. Pyle, Inc.*, 320 F.2d 45 (4th Cir. 1963); *Burns v. N.Y. Central R. Co.*, 33 F.R.D. 309 (N.D. Ohio 1963); *Portman v. American Home Prod. Corp.*, 9 F.R.D. 613 (S.D.N.Y. 1949). *Cf. Breedlove v. Beech Aircraft Corp.*, 57 F.R.D. 202 (N.D. Miss. 1972) (discovery of expert reports not allowed, where plaintiffs did not show special needs).

Thus, in *Galambus*, the court stated:

The authorities indicate that prudent parties anticipate litigation and often begin preparation prior to the time suit is formally commenced. Thus the test should be whether, in the light of the nature of the document and the factual situation in the particular case, the document can be fairly said to have been prepared or obtained because of the prospect of litigation. Conversely, even though litigation is already in prospect, there is no work product immunity for documents prepared in the regular course of business rather than for the purposes of litigation The advisory committee note on Rule 26(b); (c) stated:

"Materials assembled in the ordinary course of business or pursuant to public requirements unrelated to litigation, or for other nonlitigation purposes are not under the qualified immunity provided by this subdivision."

64 F.R.D. 468, 472 (N.D. Ill. 1964).

also be generated when an underwriter or investment adviser has a continuing relationship with the subject of the investment or is assisting a financially troubled issuer's attempt to work out or resolve its affairs.¹⁶ Material of this sort is within the normal scope of discovery, since it frequently may lead to admissible evidence. This is especially true when the material sought to be discovered was generated before counsel was called in, since such material does not present a question whether the "work-product" doctrine may prevent discovery.¹⁷

Even where the information a party seeks to discover is clearly calculated to lead to admissible evidence, objections may be raised that the post-transaction evidence is misleading. Post-purchase memoranda in particular may be damaging for misleading reasons. Laymen writing such memoranda may be oblivious to their legal significance, and consequently do not always use language with the care and precision that they would prefer if they knew that the memorandum was going to be used in litigation. A document thus may reflect no more than carelessly worded recollections or theorizing, causing a party in this situation to object to discovery because its use may prejudice him. On the other hand, such post-transaction material may also contain important admissions or provide an untainted statement of what truly happened, and thus yield evidence admissible at trial.

While there are therefore competing considerations as to whether such information properly should be discoverable, objections to discovery premised on such possible prejudice should rarely succeed.¹⁸ Prejudice is an issue best left to resolution at trial rather than during discovery. It is unclear how a party may be prejudiced merely because discovery is permitted; prejudice generally results only from allowing a jury to hear "prejudicial" information. Moreover, prejudicial evidence, in the legal sense, is generally by definition relevant evidence.¹⁹ As a consequence, discovery of

¹⁶ For example, in *Cornaglia v. Ricciardi*, 63 F.R.D. 416 (E.D. Pa. 1974), the court directed defendant Drexel Burnham & Company, Inc., the lead underwriter of a public offering, to answer interrogatories regarding matters after the offering, stating:

Drexel Burnham has admittedly prepared followup reports concerning the prospectus after March 30, 1972, and has continued to serve as Richton's investment banker up to the present It is not unreasonable to conclude with some degree of certainty that consultations and communications between Richton and Drexel Burnham subsequent to March 30, 1972, referred to some extent to events, decisions, or practices relative to the Richton prospectus and financial statement which predated March 23, 1972.

Id. at 421-22. See also *In re Penn Cent. Commercial Paper Litigation*, 61 F.R.D. 453, 461-62 (S.D.N.Y. 1973).

¹⁷ The work-product doctrine prevents an adverse party from obtaining discovery of material prepared by opposing counsel. The doctrine was explicitly adopted by the Supreme Court in *Hickman v. Taylor*, 329 U.S. 495 (1946). Fed. R. Civ. P. 26(b)(3) now provides, however, that such materials may be discovered "upon a showing that the party seeking discovery has substantial need of the materials in the preparation of his case and that he is unable without undue hardship to obtain the substantial equivalent of the materials by other means."

¹⁸ See, e.g., *Camco, Inc. v. Baker Oil Tools, Inc.*, 45 F.R.D. 384, 387 (S.D. Tex. 1968); *Payer, Hewitt & Co. v. Bellanca Corp.*, 26 F.R.D. 219, 222 (D. Del. 1960).

¹⁹ Rule 403 of the Federal Rules of Evidence permits a court to exclude evidence when "[a]lthough relevant . . . its probative value is substantially outweighed by the danger of unfair prejudice, confusion of the issues or misleading the jury . . ." See also C. McCORMICK, *LAW OF EVIDENCE*, § 185 (2d ed. 1972) (E. Cleary, gen. editor), where McCormick observes:

It should be emphasized that prejudice, in this context, means more than simply damage to the opponent's case. A party's case is always damaged by evidence that the facts are contrary to his contentions; but that cannot be ground for exclusion.

such material should be permitted since it is "reasonably calculated to lead to admissible evidence," and the evidentiary rules applied at trial will normally be sufficient to prevent or minimize prejudice.

In those unusual circumstances where discovery itself is truly prejudicial, a party may, of course, seek a protective order to prevent discovery.²⁰ A party seeking such an order will bear the burden of showing that permitting discovery will unduly prejudice his case.²¹ Such an objection is more likely to be upheld as the material sought to be discovered becomes more distant in time from the transaction involved in the litigation and the likelihood of obtaining evidence with significant weight diminishes.²²

This presumption favoring discovery of post-transaction information is illustrated by *Ross v. Paul Hardeman, Inc.*²³ In *Ross*, a purchaser of debentures alleged that the issuer, underwriter, and several individuals involved in the public offering of the debentures violated the antifraud provisions of the securities acts by failing to reveal that at that time, Hardeman, the issuer, was planning to merge with another company, Young Spring & Wire Corp. Prior to trial, the plaintiff propounded interrogatories seeking information relating to purchases of Young stock by Hardeman during January and February, 1964, after the sale of the debentures to Ross. The plaintiff claimed that the information might lead to proof that plans and negotiations for the merger were under way at the time debentures were offered for sale. The defendants moved to vacate the interrogatories. The court denied the motion with a terse brushstroke:

[W]hile any negotiations that did occur for the purchase of Young stock at the time of the debenture offering may have been in fact for the sole purpose of obtaining a majority position in Young and not to bring about a corporate merger, the court may not make such a determination on this application. Plaintiffs are entitled to discovery of the facts surrounding the said purchase of stock. Hardeman has failed to demonstrate that the information sought by the plaintiffs is clearly irrelevant. The mere fact that the transactions inquired about occurred subsequent to

What is meant here is an undue tendency to move the tribunal to decide on an improper basis, commonly, though not always, an emotional one.

Id. at § 185, at 439 n.31.

²⁰ Rule 26(c) of the Fed. R. Civ. P. permits a party to seek to have a court prohibit or limit discovery so long as the party can show good cause. The rule permits a judge to "make any order which justice requires to protect a party or person from annoyance, embarrassment, oppression, or undue burden or expense, . . ."

²¹ As noted in note 20 *supra*, the moving party under Rule 26(c) of the Fed. R. Civ. P. must show "good cause" to have his motion granted. See, e.g., *United States v. Nysco Laboratories, Inc.*, 26 F.R.D. 159, 161 (E.D.N.Y. 1960). See also *Harris v. Nelson*, 394 U.S. 286, 297 (1969). For examples of where a party has made such a showing, see *Econo-Car Intern., Inc. v. Antilles Car Rentals, Inc.*, 61 F.R.D. 8, 10 (D. V. I. 1973); *Konrad v. DeLong*, 57 F.R.D. 123, 124-25 (E.D. Ill. 1972); *Frost v. Williams*, 46 F.R.D. 484, 485 (D. Md. 1969).

²² See, e.g., *Bass v. Gulf Oil Corp.*, 304 F. Supp. 1041, 1044-47 (S.D. Miss. 1969); *Alexander's Dept. Stores, Inc. v. E. J. Korvette's, Inc.*, 198 F. Supp. 28, 29-30 (S.D.N.Y. 1961); *Mall Tool Co. v. Sterling Varnish Co.*, 11 F.R.D. 576, 579 (W.D. Pa. 1951); *Fletcher v. Foremost Dairies of New York*, 29 F. Supp. 744, 745 (S.D.N.Y. 1939), for instances in which the court has indicated that the relevancy of material discovered is likely to become increasingly attenuated the more removed in time the information sought is from the incident leading to the litigation, and has therefore refused to permit discovery of remote materials.

²³ [1964-66 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 91,483 (S.D.N.Y. 1965).

the time the debentures were offered to the public is not enough to justify vacation of the interrogatories propounded by the plaintiff under the liberal procedural rules of this court.²⁴

If one accepts the conclusion that prejudice is an issue more properly resolved at trial rather than during discovery, the *Ross* court's refusal to vacate the interrogatories is undeniably correct. The defendant failed to show the existence of any extraordinary circumstances or undue prejudice warranting refusal to allow the discovery. Using similar reasoning, those few courts which have passed squarely upon the discoverability of post-transaction information in more recent securities litigation have reached the same conclusion as the court in *Ross*.²⁵

Similar authority for permitting discovery exists under other federal and state actions as well. For example, in *Goldinger v. Boron Oil Co.*,²⁶ a former gasoline station manager sued an oil company for alleged violations of the antitrust laws in connection with the termination of the parties' mutual business dealings and contracts. Boron claimed that Goldinger was merely its employee and that, accordingly, it did not violate the law since a company has a right to set its own prices and cannot violate the antitrust laws in dealing with itself.²⁷ Goldinger sought to show that Boron had changed significant aspects of its contract with its dealers and its mode of doing business a year after his dismissal. He suggested that these changes might show that his contract should be interpreted as one creating an independent operator relationship, not a mere employment relationship.²⁸ The court overruled Boron's objections to the discovery request, emphasizing the differences between admissibility and discovery of evidence:

[R]ather than limiting discovery to the issues raised by the pleadings, the correct test for the scope of discovery is relevancy to the subject matter of the suit, so as to accomplish the true purpose of discovery, i.e., to arrive at the truth while at the same time not permitting wholly irrelevant discovery. The requested information sought in this present case falls within the permissible scope of discovery. By and of itself, the agreement with present commission managers may not be admissible at trial, but there is a reasonable chance that by allowing the plaintiff to see such agreement admissible evidence may flow from such discovery.²⁹

²⁴ *Id.* at 94,849.

²⁵ See cases cited at notes 14 and 16 *supra*. See also Transcripts of April 8, 1972 and December 26, 1972, Penn Cent. Commercial Paper Litigation, No. MDL-56A (S.D.N.Y. 1973).

²⁶ 60 F.R.D. 562 (W.D. Pa. 1973).

²⁷ *Id.* at 563-64. Compare *Call Carl, Inc. v. BP Oil Corp.*, 554 F.2d 623 (4th Cir. 1977); *American Oil Co. v. McMullin*, 508 F.2d 1345 (10th Cir. 1975); *Matarazzo v. Friendly Ice Cream Corp.*, 62 F.R.D. 65, 67-68 (E.D.N.Y. 1974) and *Fagan v. Sunbeam Lighting Co.*, 303 F. Supp. 346 (N.D. Ill. 1969) with *Roberts v. Exxon Corp.*, 1976-1 TRADE CASES (CCH) ¶ 60,869 (W.D. La. 1976) and *United States v. Richfield Oil Corp.*, 99 F. Supp. 280 (S.D. Cal. 1951) on this interesting issue. See also *Bernstein v. Universal Pictures*, 517 F.2d 976, 980 (2d Cir. 1975).

²⁸ 60 F.R.D. at 563. Boron eventually prevailed on the merits on this issue. See *Goldinger v. Boron Oil Co.*, 375 F. Supp. 400 (W.D. Pa. 1974), *aff'd*, 571 F.2d 1393 (3d Cir. 1975) (*mem.*). The complex question of when one is an employee as opposed to a franchisee or independent contractor was also directly confronted in *Matarazzo v. Friendly Ice Cream Corp.*, No. 73-C-545 (JRB), (E.D.N.Y. 1977). See Transcript of June 7, 1977, at 4201-21 (Jury charge). See also earlier opinions reported at 62 F.R.D. 65 (E.D.N.Y. 1974) and 70 F.R.D. 556 (E.D.N.Y. 1976). The defendant in *Matarazzo* won a jury verdict on that issue resulting in a dismissal of the antitrust claims. See *Wall Street Journal*, June 10, 1977, at 2, col. 3.

²⁹ 60 F.R.D. at 564.

In sum, so long as the post-transaction discovery sought may lead to relevant evidence, it appears that such discovery requests should be and will be permitted.

B. Cut-off Dates

An alternative method which parties, particularly defendants, employ to prevent discovery of post-transaction information is to attempt to have the court establish an arbitrary cut-off date after which material generated is not discoverable. Examples of cut-off dates often suggested by defendants include the service of the complaint, the last purchase by any plaintiff in the action or the first notice to the defendant that the plaintiff feels aggrieved.³⁰ When the plaintiff's complaint alleges a continuing wrong or a securities fraud claim coupled with claims involving other ongoing wrongs, such a cut-off date is obviously both logically and legally unfounded.³¹ A continuing wrong allegation necessarily implies an expansive notion of fraud encompassing post-transaction as well as pre-transaction behavior. Where a "single transaction" claim is involved, the question is not quite so simple, because no expansive notion of fraud is alleged and it may appear reasonable to conclude that material generated after the transaction occurred will have little probative value. Even in this situation, courts have generally refused to establish an arbitrary cut-off date for discovery unless unusually compelling circumstances are shown. This result appears proper since the discovery rules are to be construed liberally and permitting the discovery may lead to relevant evidence; as observed earlier, if the discovered material is irrelevant or unduly prejudicial, it may properly be subject to objection and exclusion at trial.³²

In determining the proper time period, the courts have generally declined to limit the parties to the strict parameters of the pleadings. *Carlson v. Sperry & Hutchinson Co.*,³³ an antitrust action based upon an alleged tying arrangement, is illustrative. The defendant objected to post-complaint discovery on the theory that it would not be relevant until and unless the plaintiff filed a supplemental complaint to update his claim. Relying upon

³⁰ See, e.g., *Devex Corp. v. General Motors Corp.*, 275 F. Supp. 310, 313 (D. Del. 1967) (antitrust action); *Banana Distrib. Inc. v. United Fruit Co.*, 19 F.R.D. 244, 247 (S.D.N.Y. 1956) (antitrust action); *O'Brien v. Equitable Life Cas. Soc'y*, 14 F.R.D. 141, 141-42 (W.D. Mo. 1953) (action on insurance policy). See also *Carlson Cos., Inc. v. Sperry & Hutchinson Co.*, 374 F. Supp. 1080, 1100-04 (D. Minn. 1974), a securities case where this type of discovery cut-off date was attempted.

³¹ Preventing discovery of post-transaction facts in a case alleging a continuing fraud is illogical, since such post-transaction information will be admissible at trial to prove such matters as knowledge and intent. See, e.g., *Caplin v. United Features Syndicate, Inc.*, 8 F.R.D. 424 (S.D.N.Y. 1948). See also 4 MOORE'S, *supra* note 14, ¶ 26.56[1] at 26-126-28; Transcript of June 4, 1977, *Colocotronis Tanker Sec. Litigation*, No. M-21-19 (CHT) (S.D.N.Y. 1977); *Carlson Cos., Inc. v. Sperry & Hutchinson Co.*, 374 F. Supp. 1080, 1102 (D. Minn. 1974). Since discovery of post-transaction facts is permitted when it is only reasonably calculated to lead to admissible evidence, it surely cannot be justifiable to prevent discovery of facts which may themselves be admissible evidence. But cf. *Manitowoc Milk Producers v. Guernsey*, 61 F.R.D. 499, 500 (E.D. Wis. 1973) (court conditionally adopted arbitrary cut-off date in action claiming continuing violation where it appeared party seeking discovery was doing so more to promote its competitive position, rather than to further the lawsuit).

³² See note 31 *supra*.

³³ 374 F. Supp. 1080 (D. Minn. 1974).

Professor Moore, among others, the court rejected that claim on the ground that, by it, "in effect, the cart is put before the horse."³⁴ The court observed that supplementation or amendment of pleadings usually follows, not precedes, the discovery of new current facts, adding: "unless the litigant seeks to later use the information discovered as material at trial, information which is relevant to the subject matter of the pending litigation, but not specifically within the scope of the issues pleaded, may be discovered and the pleadings need not be amended at any time."³⁵

C. Subsequent Remedial Measures

A potentially more troublesome objection than that posed when a party seeks to prevent discovery merely because the information sought may be inadmissible at trial arises where the post-transaction events about which discovery is sought involve subsequent remedial action. As will be shown in greater detail below,³⁶ parties opposing the discovery and admissibility of post-transaction facts usually rely upon rule 407 of the Federal Rules of Evidence,³⁷ which bars the use of evidence regarding subsequent remedial acts by a party, and on the common law evidentiary rule in negligence cases upon which rule 407 is premised.³⁸ Several common law decisions have sustained this objection to discovery, reasoning that the information would be undeniably inadmissible at trial.³⁹ These courts have further reasoned that the mere act of revealing information about subsequent remedial measures in discovery might so prejudice a party that the bar against admissibility at trial would not sufficiently protect the party objecting to the discovery request.⁴⁰ Underlying this reasoning is the fear that admitting evidence of subsequent remedial measures will discourage parties

³⁴ *Id.* at 1102, quoting 4 MOORE'S, *supra* note 14, ¶ 26.56[5], at 26-187-88 (2d ed. 1972).

³⁵ *Id.* at 1103.

³⁶ See text at notes 263-79 *infra*.

³⁷ Rule 407 provides:

When, after an event, measures are taken which, if taken previously, would have made the event less likely to occur, evidence of the subsequent measures is not admissible to prove negligence or culpable conduct in connection with the event. This rule does not require the exclusion of evidence of subsequent measures when offered for another purpose, such as proving ownership, control, or feasibility of precautionary measures, if controverted, or impeachment.

³⁸ See generally 2 J. WIGMORE, EVIDENCE § 283 (3d. ed. 1940) [hereinafter cited as WIGMORE]; MCCORMICK, *supra* note 19, § 275. Cf. 2 J. WEINSTEIN & M. BERGER, WEINSTEIN'S EVIDENCE, ¶ 407[06] (1975), [hereinafter cited as WEINSTEIN].

³⁹ See, e.g., *Columbia and Puget Sound R.R. Co. v. Hawthorne*, 144 U.S. 202, 207 (1892) (stating this evidentiary rule); *Hammill v. Hyster Co.*, 42 F.R.D. 173, 174 (E.D. Wis. 1967) (refusing to permit discovery of subsequent remedial measure); *Needles v. F.W. Woolworth Co.*, 13 F.R.D. 460, 461-62 (E.D. Pa. 1952) (refusing to permit discovery).

⁴⁰ See cases cited at note 39 *supra*. In his recent treatise on the Federal Rules of Evidence, however, Judge Weinstein has cautioned:

The standard of admissibility established by Rule 407 for evidence of subsequent remedial measures is not the same as that for pretrial discovery. Some courts have failed to make the distinction and denied discovery on the grounds of relevancy. The better view is to permit discovery, not only because Rule 407 is essentially a rule of public policy rather than of relevancy, but also because subsequent remedial measures might be admissible to prove a consequential, material fact in issue other than negligence.

2 WEINSTEIN, *supra* note 38, at ¶ 407[06] (emphasis added) (footnotes omitted).

from undertaking such measures and thus harm the public. Courts therefore have sometimes determined that it is more important to encourage safety precautions necessary to prevent future repetitions of an injury than it is to redress past wrongs, and accordingly have barred discovery related to such precautions.⁴¹

Since the rule barring evidence of subsequent remedial measures stems from a public policy consideration—preventing future injury—it has significant limitations in contexts where this purpose is not served. As discussed more fully below, there are several exceptions to the “rule” against admissibility of subsequent remedial measures.⁴² Even in negligence actions, evidence of subsequent remedial measures may be admitted to prove matters such as the fact that the accident or injury occurred or the feasibility of preventing it.⁴³ In recognizing that subsequent remedial measure evidence may serve a variety of legitimate purposes, a number of courts have permitted discovery of subsequent remedial measures in negligence cases, and deferred for trial the question of admissibility.⁴⁴ For example, in *Richards-Wilcox Mfg. Co. v. Young Spring & Wire Corp.*,⁴⁵ the court permitted discovery of notes and reports by an inspection team sent to observe the allegedly defective conveyor system at the defendant’s factory, reasoning that “the subsequent repair exception to the admissibility of evidence, considered in the light of its public policy rationale, would not apply to the present situation.”⁴⁶

A reasonable analogy can be drawn between this line of common law negligence cases and securities litigation. In both instances, discovery of remedial post-transaction actions may lead to admissible evidence. Moreover, the function of post-transaction evidence in most securities litigation is to prove matters such as intent, materiality, the fact of deception or the feasibility of learning facts claimed to have existed at the time of the

⁴¹ The Advisory Committee which drafted FED. R. EVID. 407 explained its rationale as follows:

The rule rests on two grounds. (1) The conduct is not in fact an admission, since the conduct is equally consistent with injury by mere accident or through contributory negligence. Or, as Baron Bramwell put it, the rule rejects the notion that “because the world gets wiser as it gets older, therefore it was foolish before.” *Hart v. Lancashire & Yorkshire Ry. Co.*, 21 L.T.R. N.S. 261, 263 (1869). Under a liberal theory of relevancy this ground alone would not support exclusion as the inference is still a possible one. (2) The other, and more impressive, ground for exclusion rests on a social policy of encouraging people to take, or at least not discouraging them from taking, steps in furtherance of added safety.

Quoted in 2 WEINSTEIN, *supra* note 38, ¶ 407, at 407-2 (1977). See also *Vockie v. General Motors Corp.*, 66 F.R.D. 57, 61 (E.D. Pa.), *aff’d*, 523 F.2d 1052 (3d Cir. 1975); *Carollo v. Rose*, 43 App. Div. 2d 831, 350 N.Y.S. 2d 929 (1974).

⁴² See notes 142-51 and 275-83 *infra*.

⁴³ See notes 275-79 *infra*. As noted there, rule 407 of the Federal Rules of Evidence itself provides such a limitation to applicability of the subsequent remedial measures rule.

⁴⁴ See, e.g., *Caulk v. Baltimore & O. R.R.*, 306 F. Supp. 1171, 1172 (D. Md. 1969); *Richards-Wilcox Mfg. Co. v. Young Spring & Wire Corp.*, 34 F.R.D. 212 (N.D. Ill. 1964); *Stovall v. Gulf and South America S.S. Co., Inc.*, 30 F.R.D. 152, 155 (S.D. Tex. 1961); *Novak v. Good Will Grange No. 127, Patrons of Husbandry, Inc.*, 28 F.R.D. 394, 396 (D. Conn. 1961).

⁴⁵ 34 F.R.D. 212 (N.D. Ill. 1964).

⁴⁶ *Id.* at 214.

wrongs.⁴⁷ The subsequent remedial measure objection, predicated upon a desire to encourage persons to remedy injurious conditions, has little relevance to a party's desire to discover information about state of mind, rather than about the injury itself.⁴⁸ Objections to discovery based on the subsequent remedial measures doctrine thus appear inappropriate in most securities cases,⁴⁹ in the same way that such objections are inappropriate in negligence actions when the evidence is sought, for example, to show the feasibility of correcting a dangerous condition. As a result, the burden is and should be decidedly upon the objecting party to show specifically that actual serious prejudice will result from permitting discovery of its subsequent remedial measures if the objection is to succeed.⁵⁰

III. THE ADMISSIBILITY OF POST-TRANSACTION EVIDENCE AT TRIAL

A. *Conditional Relevance: Fixing the Time of the Transaction*

While post-transaction information is generally discoverable, its admissibility at trial is a more complex issue. Before turning to this issue, however, it seems advisable to establish what the term "post-transaction" encompasses. Essentially, this involves a question of time, since fixing the time when the transaction is deemed to have occurred determines which evidence is pre-transaction and which is post-transaction.

*Radiation Dynamics, Inc. v. Goldmuntz*⁵¹ contains perhaps the most explicit higher court pronouncement concerning the time at which a securities transaction is deemed to have been completed. A seller of securities sued the purchasers under rule 10b-5, alleging that they had failed to disclose inside information known to them at the time of the sale, specifically that merger discussions were being conducted between the corporation in which plaintiff had held his stock and another corporation.⁵² The merger was concluded a month after the plaintiff sold his stock in the company.⁵³

At trial, the district court allowed the plaintiff to introduce evidence regarding the merger talks and their subsequent consummation. The court, however, charged the jury that the materiality of that evidence must be determined as of the time the transaction was completed, and that such date occurs upon

⁴⁷ See text at notes 96-102 *infra*. For example, in *In re Penn Cent. Commercial Paper Litigation*, 61 F.R.D. 453 (S.D.N.Y. 1973), the court ordered pre-trial discovery of a memorandum by the attorney for the underwriters of a public offering of debentures which had been written months after certain of the plaintiffs had purchased other securities of the issuer. Emphasizing that the plaintiffs were alleging claims under section 12(2), which allows liability to attach upon a showing of mere negligence, the court concluded: "What, when and how Williams [the attorney] learned about the financial condition of PCTC [the issuer] may be relevant for plaintiffs in rebutting any claim by defendant that it could not in the exercise of reasonable care have learned about the alleged false statements and material omissions." *Id.* at 461-62.

⁴⁸ See comments of Judge Weinstein quoted in note 40 *supra*.

⁴⁹ An example of the rare situation in which the subsequent remedial measures objection has been successfully asserted *at trial* in securities litigation is *SEC v. Geon Industries, Inc.*, 531 F.2d 39, 52 & n.16 (2d Cir. 1976), discussed more fully at notes 272-74 *infra*.

⁵⁰ See FED. R. CIV. P. 26(c), 33(a).

⁵¹ 464 F.2d 876 (2d Cir. 1972).

⁵² *Id.* at 879.

⁵³ *Id.* at 882, 884.

the date when an insider has committed himself to purchase the stock. It is not any later date, such as, for example, the formal closing date when the delivery and payment are formally completed and cleared. To determine whether fraud was perpetrated you look to the situation at the date when the parties committed themselves. There is no obligation to pull back from a commitment previously made by the buyer and accepted by the seller because of after acquired knowledge.⁵⁴

In effect, the *Radiation Dynamics* court was instructing the jury to disregard any evidence which it found had arisen after the transaction.⁵⁵ The jury found for the defendants.⁵⁶ On appeal, the Court of Appeals for the Second Circuit sustained the jury instruction, emphasizing that the time rule fixed by the district court was consistent with the underlying policy of the antifraud provisions to prevent fraud "in connection with" the investment decision at issue.⁵⁷

Proving when the parties committed themselves to the transaction may often entail the introduction of evidence subsequently deemed post-transactional, particularly when the two adverse parties disagree as to when the transaction was actually consummated. The relevancy of evidence introduced for this purpose is, thus, conditioned on the ultimate resolution of when the transaction occurred. Such a conditional relevancy test is consistent with the overall approach of the antifraud provisions, which focus on a party's decision whether to buy or sell, rather than on some belated change of heart or hindsight regarding the facts.⁵⁸ This does not mean that the evidence is always irrelevant,⁵⁹ but rather that it cannot be the basis of the fraud itself. In *Radiation Dynamics*, the jury obviously made a factual determination that the post-commitment evidence did not prove the fraud and thus was not material; but, as will be shown below, there are other cases where such evidence has served that function.⁶⁰

Determining when the plaintiff became "committed" to the transaction is not always as easy as it was in *Radiation Dynamics*. For example, an agreement may allow the parties to cancel the transaction prior to the clos-

⁵⁴ *Id.* at 890. This rule has been generally followed by the securities cases since *Radiation Dynamics*. See, e.g., *Morales v. Gulf Energy & Dev. Corp.*, [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,222 (D. Colo. 1977); *Pittsburgh Coke & Chem. Corp. v. Bollo*, 421 F. Supp. 908 (E.D.N.Y. 1976), *aff'd*, 560 F.2d 1089 (2d Cir. 1977); *Schuller v. Slick Corp.*, [1974-75 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,065, at 95,736 (S.D.N.Y. 1975). See also *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1050 (7th Cir. 1977); *Vanderboom v. Sexton*, 460 F.2d 362, 366-67 (8th Cir. 1972); *Fox v. Kane-Miller Corp.*, 398 F. Supp. 609, 646 n.31 (D. Md. 1975), *aff'd*, 542 F.2d 915 (4th Cir. 1976). *But cf.* *Lewelling v. First Cal. Co.*, [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,264 (9th Cir. 1977) (discussed in notes 63 and 93 *infra*).

⁵⁵ 464 F.2d at 890.

⁵⁶ *Id.* at 879-80.

⁵⁷ *Id.* at 889-90. See also *Morgan v. Prudential Funds, Inc.*, [Current] FED. SEC. L. REP. (CCH) ¶ 96,345, at 93,172 (S.D.N.Y. 1978).

⁵⁸ See, e.g., *Speilman v. General Host Corp.*, 402 F. Supp. 190 (S.D.N.Y. 1975), *aff'd*, 538 F.2d 39 (2d Cir. 1976), where the court stated that determinations respecting materiality in a 10b-5 suit are to be made at the time of the transaction, "and not upon a 20-20 hindsight view long after the event." *Id.* at 194. See also *Denny v. Barber*, [Current] FED. SEC. L. REP. (CCH) ¶ 96,438, at 93,583 (2d Cir. 1978).

⁵⁹ See text at note 96-102 & 106 *supra*.

⁶⁰ See notes 130-34 *infra*.

ing on the basis of specified post-contract but pre-closing events.⁶¹ In such a situation, it must be decided whether the parties truly committed themselves at the time they executed the sale agreement, or whether they have remained uncommitted until the closing. Moreover, the courts have strictly limited any duty of the plaintiff in such a case to uncover post-contractual events;⁶² and in no case has a plaintiff been required to renege on an agreement even though a rescission action may have been legally available.⁶³ But, evidence of facts which occurred after the initial commitment date generally will be deemed post-transactional and therefore not be accorded much, if any, weight in determining whether such facts led to the fraud.

In *Pittsburgh Coke & Chemical Co. v. Bollo*,⁶⁴ the court confronted these difficulties of determining both when a transaction occurs and what constitutes post-transaction evidence. The Pittsburgh Coke company entered into an agreement in December 1968 with the Bollo family to purchase control of their successful airliner parts company.⁶⁵ The closing date for the acquisition was fixed as June 30, 1969 to permit application for necessary approvals for the sale from the Securities and Exchange Commission and the Civil Aeronautics Board.⁶⁶ Due to delays in obtaining the approvals, the closing actually took place on September 18, 1969.⁶⁷ The long time lag between the contract and closing dates led Pittsburgh Coke to require that Bollo deliver a certificate at the closing affirming that all representations and warranties in the contract remained "true and correct as of the closing date, with the same force and effect as though they had been made at the closing date" and that there had been "no material adverse change in the financial condition of the company" between the contract and closing dates.⁶⁸ One year following the closing, Pittsburgh Coke sued to recover the purchase price of the stock, alleging that during 1968 the Bollos' company had "suffered severe setbacks because of material changes in major distributor relationships which Bollo had failed to disclose during the 1968 negotiations and prior to the September 1969 closing."⁶⁹ Pittsburgh Coke

⁶¹ In such situations, the degree of due diligence the purchaser has exercised in protecting his interest between contract and closing may have a bearing on a court's sympathy for the plaintiff's position. See *Pittsburgh Coke & Chem. Co. v. Bollo*, 421 F. Supp. 908 (E.D.N.Y. 1976) (*mem.*), *aff'd*, 560 F.2d 1089 (2d Cir. 1977). See also *Metro-Goldwyn-Mayer, Inc. v. Ross*, 509 F.2d 930, 932 (2d Cir. 1975).

⁶² See text and notes at notes 209-38 *infra*, particularly cases cited and discussed in note 224 *infra*.

⁶³ See, e.g., *Radiation Dynamics, Inc. v. Goldmuntz*, 464 F.2d 876, 890 (2d Cir. 1972) (specifically holding that "there is no obligation to pull back from a commitment" based upon post-transaction developments). As shown in note 93 *infra*, in *Lewelling v. First Cal. Co.*, [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,264 (9th Cir. 1977), the plaintiff's right to "pull back" was interpreted to defer the date of the sale to allow the plaintiff to sue on the basis of deceitful conduct after his broker had committed him to an open market purchase. As shown in the text at notes 64-81 *infra*, this type of interpretation was rejected in the context of face-to-face merger negotiations.

⁶⁴ 421 F. Supp. 908 (E.D.N.Y. 1976), *aff'd*, 560 F.2d 1089 (2d Cir. 1977). In its affirmation, as explained in note 77 *infra*, the court of appeals avoided altogether the post-purchase evidence problem.

⁶⁵ *Id.* at 913.

⁶⁶ *Id.* at 914.

⁶⁷ *Id.*

⁶⁸ *Id.*

⁶⁹ *Id.* at 914-15.

also complained that it had been misled about the value and obsolescence of the Bollos' inventory due to substantial inventory write-downs which occurred in 1970.⁷⁰

Several facts rendered impossible a simple resolution of the issues raised in *Pittsburgh Coke*. The company had remained profitable and exhibited rising sales through 1969.⁷¹ Furthermore, Pittsburgh Coke personnel had conducted a careful investigation of Bollo prior to both the contract and the closing.⁷² Also complicating matters was expert testimony attributing the real cause of the company's decline in 1970, just after the closing, to a general "aviation recession."⁷³ Finally, the inventory revaluation complained of had not occurred until a 1970 audit by Pittsburgh Coke's accountants, and Bollo blamed the inventory obsolescence on the 1970 aviation recession.⁷⁴

Pittsburgh Coke presented a threefold threshold issue concerning when the transaction was completed. First, in light of the *Radiation Dynamics* rule that the crucial date in a 10b-5 action is the "commitment date," what should be the effect of the certificate delivered to Pittsburgh Coke at the closing date? Second, if the court determined that the contract date constituted the commitment date, should the court nevertheless receive evidence of the post-contractual events and the post-closing facts? Third, assuming the court did allow such post-contract evidence, what weight should be accorded to that evidence?

In resolving these issues, the district court initially received the post-contract evidence, but then found it "irrelevant."⁷⁵ Determining that the commitment date was the time the contract was signed rather than the closing date,⁷⁶ the court held that "issues of non-disclosure, misrepresentation, materiality and reliance are to be determined by the situation and knowledge of the parties at the time they committed themselves, and not on the basis of subsequent events."⁷⁷ Specifically, the court rejected Pittsburgh

⁷⁰ *Id.* at 920, 928.

⁷¹ *Id.* at 914.

⁷² *Id.* at 918-19.

⁷³ *Id.* at 920.

⁷⁴ *Id.*

⁷⁵ *Id.* at 923.

⁷⁶ *Id.*

⁷⁷ The court's full statement was that:

For purposes of a Rule 10b-5 claim, events occurring after the commitment to purchase stock has been made are irrelevant. Issues of non-disclosure, misrepresentation, materiality and reliance are to be determined by the situation and knowledge of the parties at the time they committed themselves, and not on the basis of subsequent events, even though they occur prior to the formal closing date when the delivery and payment are formally completed and cleared.

Id. at 923. In affirming the district court's decision, 560 F.2d 1089 (2d. Cir. 1977), the Court of Appeals for the Second Circuit did not decide whether this particular ruling was correct; instead it found for the defendant on other grounds. See note 80 *infra*. The court of appeals noted specifically that "[w]e do not need to decide whether the District Court should have considered events occurring between the contract and closing dates, because the District Court in fact *did* consider those events and concluded that [plaintiff] had failed to sustain its charges of fraud and nondisclosure. We agree. . . ." 560 F.2d at 1091 (emphasis in original). The court of appeals also observed that "despite the District Court's belief that post December 20, 1968 events were 'irrelevant' the Court admitted proof as to events in the intervening period and relied thereon in its opinion." *Id.* at 1092. *Cf.* *Lewelling v. First Cal. Co.*, [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,264 (9th Cir. 1977) (discussed in note 63 *supra* and note 93 *infra*).

Coke's attempt to distinguish *Radiation Dynamics* on the ground that its purchase contract had conditioned its duty to perform upon receipt of the Bollos' closing certificate updating their representations and warranties, while in *Radiation Dynamics* all obligations of the parties involved were completed as of the commitment date.⁷⁸ The court found that "in the classical contractual sense, there was a meeting of the minds of the parties"⁷⁹ when the December 1968 contract was executed, and the parties were therefore obligated on that date.⁸⁰

The district court also dismissed Pittsburgh Coke's common law claims, based on the contract and the certificate delivered at the closing. The court held that not even the warranty language of the certificate had given Pittsburgh Coke any greater rights, reasoning that it was designed only to assure the accuracy of the representations, not to broaden them. The warranty, the court held, hence did not alter the pertinent date for testing the relevancy of the facts proffered.⁸¹

Although it had admitted the post-transaction facts into evidence, the court in *Pittsburgh Coke* proceeded to ignore them or simply to discount them. Given that result, one might reasonably ask why the court should receive the evidence in the first place. Particularly in a jury trial, receiving

⁷⁸ 421 F. Supp. at 923.

⁷⁹ *Id.*, quoting *Radiation Dynamics, Inc. v. Goldmuntz*, 464 F.2d 876, 891 (2d Cir. 1972).

⁸⁰ 421 F. Supp. at 923. In reaching this conclusion, the district court employed the following rationale:

The foregoing "representations" [contained in the certificates of warranty delivered by Bollo at closing] were obviously made on the basis of Bollo's knowledge as of December 20, 1968. Rule 10b-5 liability could only attach if on that date the material facts incorporated in the representations were untrue or misleadingly incomplete to Bollo's knowledge at that time and were relied on by PCC in making its commitment to acquire control of Standard.

Id. The district court's decision was influenced by Pittsburgh Coke's sophistication and the detailed nature of Pittsburgh Coke's pre-contract and pre-closing investigation. *See id.* at 922, 926. Thus, in rejecting plaintiff's common law fraud claims, the court determined that [i]t also clearly appears that PCC was the active, sophisticated seeker of investment opportunities; that in acquiring Standard [Bollo's company] it acted in accordance with well-defined long range investment objectives; that [plaintiff's] representatives were men of business skill and acumen well able to deal with Bollo, who took full advantage of the protracted opportunity they had to examine the financial status of Standard prior to closing the deal; and that the acquisition was consummated on the basis of PCC's own assessment of Standard and its compatibility with PCC's entry into the airline business and not in reliance upon the matters alleged in this suit. *See Titan Group, Inc. v. Faggen*, 513 F.2d 234 (2d Cir. 1975), holding that in a case such as this, where both misrepresentations and material omissions are alleged, a plaintiff must show both materiality and reliance—a burden PCC did not meet here.

Id. at 926-27. This determination by the district court also appears to have greatly influenced the Second Circuit's decision to affirm. *See* 560 F.2d at 1091-92.

⁸¹ The court explained the significance of the warranty as follows:

The meaning of "warranty" as used in the agreement is also well understood in New York law. "A warranty is an assurance by one party to a contract of the existence of a fact upon which the other party may rely." *Metropolitan Coal Co. v. Howard*, 155 F.2d 780, 784 (2d Cir. 1946). And it has long been known that if a material state of facts is warranted to exist which turns out not to be the case, the warrantor is liable for the loss or damage caused; and it is no defense that he acted upon misinformation in good faith. *Brisbane v. Parsons*, 33 N.Y. 332 (1865).

421 F. Supp. at 928. *See also* *Fox v. Kane-Miller Corp.*, 398 F. Supp. 609, 623 (D. Md. 1975), *aff'd*, 542 F.2d 915 (4th Cir. 1976), reaching essentially the same conclusion.

such evidence might seriously taint the jury's minds and prejudice the defendant's case. Given this possible adverse result, one might question whether a court should seek to prevent such prejudice by excluding the evidence altogether under the discretionary powers given to the judge by rule 403 of the Federal Rules of Evidence.⁸² Since the court can exclude even relevant evidence which may be unduly prejudicial, it can be argued that a court should not hesitate to do so where the evidence is "irrelevant." Also, once the judge had determined that the evidence was "irrelevant," should he have stricken the post-transaction evidence which had been already introduced and excluded any such evidence offered thereafter?

The answer to these questions appears to be that evidence eventually deemed to be post-transactional often must be introduced to aid in determining precisely when the transaction actually occurred. That determination is, to a great extent, one of fact, and evidence may not properly be characterized as post-transaction until after that threshold question has been resolved. Moreover, the evidence may be relevant on a variety of other issues, as set forth below. The potential problems of prejudice resulting from allowing a jury to hear such evidence, however, remain. Accordingly, in many cases it may be advisable and proper for a court to *voir dire* the evidence prior to allowing it to be admitted at trial.⁸³

⁸² Rule 403 of the Federal Rules of Evidence provides:

Although relevant, evidence may be excluded if its probative value is substantially outweighed by the danger of unfair prejudice, confusion of the issues, or misleading the jury, or by considerations of undue delay, waste of time, or needless presentation of cumulative evidence.

See also 2 WEINSTEIN, *supra* note 38, ¶ 403 for an extensive discussion of the rule and its rationale.

Examples of the rule in actual operation are provided in *Marx & Co., Inc. v. Diner's Club, Inc.*, 550 F.2d 505, 511 & n.17 (2d Cir. 1977); *Apicella v. McNeill Laboratories, Inc.*, 66 F.R.D. 78, 86-87 (E.D.N.Y. 1975); *Fox v. Kane-Miller Corp.*, 398 F. Supp. 609, 633 (D. Md. 1975), *aff'd*, 542 F.2d 915 (4th Cir. 1976). See also text at notes 251-56 *infra*.

⁸³ Rule 104(a) and (c) of the Federal Rules of Evidence give the judge broad discretion on such matters. But the Advisory Committee to those rules cautioned:

[D]etailed treatment of when preliminary matters should be heard outside the hearing of the jury is not feasible. The procedure is time consuming. Not infrequently the same evidence which is relevant to the issue of fulfillment of a condition precedent to admissibility is also relevant to weight or credibility, and time is saved by taking foundation proof in the presence of the jury. Much evidence by preliminary questions, though not relevant to jury issues, may be heard by the jury with no adverse effect. A great deal must be left to the discretion of the judge who will act as the interests of justice require.

Advisory Committee's Note to Rule 104 Subsection (c), quoted in 1 WEINSTEIN, *supra* note 38, ¶ 104 at 104-8 (1977).

The rationale for first taking such evidence outside of the hearing of the jury was aptly summarized by Professor McCormick in the first edition of his treatise on evidence law:

The judge of course ascertains and announces the rule of evidence law setting up the criterion of admission or exclusion, but who is to decide . . . preliminary questions of fact upon which hinges the application of the rule of evidence law?

Issues of fact are usually left to the jury, but there are strong reasons here for not doing so. If the special question of fact were submitted to the jury when objection is made, this would be cumbersome and raise awkward problems about unanimity. If the judge admits the evidence . . . to the jury and directs them to disregard it . . . , the aim of the exclusionary rule is likely to be frustrated for two reasons. First, the jury will often not be able to erase the evidence from their minds. . . . They could not if they would. Second, the average juror will not be interested in performing this intellectual gymnastic of "disregarding" the evidence. They are intent mainly on reaching their verdict in this case in accord

POST-TRANSACTION EVIDENCE

B. Proper Uses of Post-Transaction Evidence: Overview

Three elements — causation,⁸⁴ materiality⁸⁵ and reliance⁸⁶—must be shown to establish a typical securities fraud claim. Each must be shown to have existed prior to or at the time of the plaintiff's decision to commit himself to the transaction, normally a decision to purchase or sell a security.⁸⁷ Not every cognizable claim under the securities laws requires a plaintiff to show each of these elements;⁸⁸ and, even in those situations where all three elements are required, the courts occasionally accept watered down versions of those elements by inferring their existence from the surrounding circumstances.⁸⁹ But, in the usual rule 10b-5 fraud action, those ele-

with what they believe to be true rather than in enforcing the long-term policies of evidence law.

C. MCCORMICK, LAW OF EVIDENCE, § 53, at 123 (1st ed. 1954). McCormick cited examples and concluded that "On all of those preliminary questions the judge, on request, will hold a hearing." *Id.* FED. R. EVID. 104 has obviously limited this broad conclusion by Professor McCormick. See also Maguire & Epstein, *Rules of Evidence in Preliminary Controversies as to Admissibility*, 36 YALE L. J. 1101 (1927) for an early but comprehensive and incisive discussion of this subject.

The principal difficulty in holding such evidentiary voir dres will be where the preliminary fact issues going to the question of admissibility are intertwined with the fact issues going to the merits of the controversy to be submitted to the jury. On that situation, a special evidentiary voir dire will usually not be conducted; rather the court may rely upon limiting instructions to the jury under rule 105 of the Federal Rules of Evidence. See also text at notes 95 & 179-80 *infra* for a discussion of the use of and practical problems attendant to such limiting instructions.

⁸⁴ For cases stating that causation is a crucial element in establishing most securities fraud cases, see, e.g., *Jackson v. Oppenheim*, 553 F.2d 826, 829-30 n.8 (2d Cir. 1976) (12(2) action); *Competitive Assocs. Inc. v. Laventhol, Krekstein, Horwath & Horwath*, 516 F.2d 811, 814 (2d Cir. 1975) (10b-5 action); *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374, 380 (2d Cir. 1974), *cert. denied*, 421 U.S. 976 (1975) (same); *University Hill Foundation v. Goldman, Sachs & Co.*, 422 F. Supp. 879, 893 (S.D.N.Y. 1976) (12(2) action); *Cutner v. Fried*, 373 F. Supp. 4, 12 (S.D.N.Y. 1974) (10b-5 and 17(a) actions).

⁸⁵ See, e.g., *Spielman v. General Host Corp.*, 538 F.2d 39, 40 (2d Cir. 1976) (per curiam); *Titan Group, Inc. v. Faggen*, 513 F.2d 234, 239 (2d Cir. 1975) (10b-5 action). See also notes 130-34 *infra*.

⁸⁶ See, e.g., *Wright v. Heizer Corp.*, 560 F.2d 236, 249-50 (7th Cir. 1977), *Pollack v. Eastman Dillon*, [1974-75 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,987, at 97,412 (S.D.N.Y. 1975). See also note 5 *supra*.

⁸⁷ See notes 4 and 5 *supra* and 144 *infra* for cases focusing on this facet of securities claims, such as those brought under rule 10b-5. Not all securities claims are of the same type, however. In a proxy rule action under rule 14a-9, for example, the claim focuses upon the exercise of corporate suffrage, not a purchase or sale of securities. See, e.g., *Goldberger v. Baker*, [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,203, at 92,428 (S.D.N.Y. 1977); *In re Clinton Oil Sec. Litigation*, [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,015, at 91,575 (D. Kan. 1977); *In re Penn Cent. Sec. Litigation*, 347 F. Supp. 1327, 1342 (E.D. Pa. 1972), *aff'd*, 494 F.2d 528 (3d Cir. 1974). See also cases cited in notes 144-48 *infra* for other such examples.

⁸⁸ See, e.g., notes 200, 206 & 270 *infra*.

⁸⁹ For example, in cases involving non-disclosure, reliance will often be inferred from materiality. See, e.g., *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153-54 (1972). See also *St. Louis Union Trust Co. v. Merrill Lynch*, 562 F.2d 1040 (8th Cir. 1977) for a discussion of the current status of this "inference" of reliance.

In cases involving open market manipulation (e.g., inflation or depression of the market price on a national securities exchange), reliance is inferred from the materiality of the defendants' misrepresentations and omissions. See, e.g., *Blackie v. Barrack*, 524 F.2d 891, 906 (9th Cir. 1975); *Clayton v. Skelly Oil Co.*, [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,269 (S.D.N.Y. 1978); *Weiss v. Drew Nat'l Corp.*, 71 F.R.D. 429, 430 (S.D.N.Y. 1976).

ments form the basis of plaintiff's case. Since most securities fraud actions are brought under rule 10b-5, the "catch-all" antifraud provision of the federal securities laws, it appears appropriate to focus upon 10b-5 suits in analyzing the proper role of post-transaction evidence in securities litigation.

The principal argument against admitting post-purchase evidence in 10b-5 cases is that the plaintiff cannot claim to have relied upon omissions or misrepresentations which occurred after his purchase; thus the transaction at issue cannot have been caused by a misstatement or omission of such facts.⁹⁰ Likewise, it is argued, such facts cannot have been material, because materiality in securities cases centers on those facts which induced the decision to invest or sell, and only facts which preceded the sale can be reasonably said to have influenced the plaintiff's decision.⁹¹ Materiality is tested "in the light of the circumstances" of the transaction, by reviewing the facts known or knowable up to the time of the transaction.⁹² Similarly, it is contended, a statement cannot be false or misleading unless it was untrue at the time of the decision to purchase or sell.⁹³ Nor can a party be charged with failing to discover and disclose facts which did not exist at the time of the investment decision.⁹⁴ On the basis of these arguments, defendants usually seek to limit plaintiff's offers of proof in securities actions to evidence of the facts and events prior to the transaction.

It is significant, however, that in most cases in which a district court has accepted the thrust of these defense arguments, the court has neverthe-

See also *Reeder v. Mastercraft Elec. Corp.*, 363 F. Supp. 574, 581 (S.D.N.Y. 1973) ("reliance may be inferred from the totality of circumstances"). Cf., e.g., *Kahan v. Rosenstiel* 424 F.2d 161, 173 (3d Cir.), cert. denied, 398 U.S. 950 (1970) ("Proof of reliance is not an independent element which must be alleged to establish a cause of action").

⁹⁰ See cases cited in notes 4 & 5 *supra* and 92-94 *infra*.

⁹¹ See notes 130-32 *infra*.

⁹² See, e.g., *Halperin v. Edwards & Hanly*, 430 F. Supp. 121, 125 (S.D.N.Y. 1977); *Phillips v. Reynolds & Co.*, 294 F. Supp. 1249 and 297 F. Supp. 736 (E.D. Pa. 1969); *Value Line Fund, Inc. v. Marcus*, [1964-66 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 93,523, at 94,973 (S.D.N.Y. 1965). See also note 4 *supra*.

⁹³ See, e.g., *Gross v. Diversified Mortgage Investors*, 431 F. Supp. 1080, 1091 (S.D.N.Y. 1977); *Kogan v. National Bank of North America*, 402 F. Supp. 359, 361 (E.D.N.Y. 1975).

The "time" of the sale is sometimes different from the moment of payment. For example, in *Lewelling v. First Cal. Co.*, [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,264 (9th Cir. 1977), a doctor who had reviewed the transactions in his account with his broker after receiving the confirmation slips for the transactions was permitted to sue under the antifraud provisions based on alleged misrepresentations and omissions in those post-confirmation discussions. The court of appeals explained this unusual result as follows:

Precisely when the transactions were finalized is a question of intent for the finder of fact. See *Reliance Finance Corp. v. Miller*, 457 F.2d 674, 677-78 (9th Cir. 1977); *Smith v. Onyx Oil & Chem. Co.*, 218 F.2d 104, 108 (3d Cir. 1955). The trial court found that Lewelling had the power to reject any of the purchases and that no transaction was complete until Lewelling had had the opportunity to exercise his veto and had failed to do so. In deciding whether or not to call off the purchases, Lewelling was guided only by the information given him by Smither. In this respect, the omissions had a direct effect on the disposition of the transactions. Thus, the failures to disclose did not come after the sales had been finalized, and Lewelling therefore cannot be characterized as an aborted seller.

Id. at 92,730.

⁹⁴ See, e.g., *Pittsburgh Coke & Chem. Co. v. Bollo*, 421 F. Supp. 908, 923-24 (E.D.N.Y. 1976), *aff'd*, 560 F.2d 1089 (2d Cir. 1977). See also *Devonbrook, Inc. v. Lily Lynn, Inc.*, [1976-77 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,835, at 91,010 (S.D.N.Y. 1977).

less admitted the post-transaction evidence.⁹⁵ The court has treated the defendant's objection as going to the weight rather than to the admissibility of the evidence. In a jury case, a judge faced with this admissibility issue may admit the evidence, but later present the case to the jury for decision with a specific limiting instruction on the time question, namely that the only relevant time and therefore the only relevant events are those prior to the transaction. In a nonjury case, the court may accept such evidence, but then decline to credit it with any weight in reaching its decision.

Although post-transaction evidence may be irrelevant to the issue of causation, it may nonetheless serve other valid purposes. Among the purposes which such evidence may serve when offered by the plaintiff are: proving the intent,⁹⁶ purpose and state of mind of the defendant;⁹⁷ proving a continuing course of conduct by the defendant which operated as a fraud and deceit on the part of the defendant;⁹⁸ proving what the defendant could have learned in the exercise of reasonable diligence;⁹⁹ proving materiality;¹⁰⁰ proving a lack of credibility on the part of the defendant;¹⁰¹ and proving the nature and quality of the relationship between two defendants or the defendant and another party.¹⁰²

Defendants also offer post-transaction evidence in securities fraud actions. Usually, such an offer of proof will focus upon the so-called due diligence duty,¹⁰³ both on the merits and on corollary or subsidiary issues such as the running of the statute of limitations. Defendants also sometimes offer such evidence to disprove materiality, reliance, causation, scienter or

⁹⁵ See cases discussed at notes 77 *supra* and 116, 119 & 262 *infra* for examples of such situations. This is often necessitated by the fact that preliminary fact determinations necessary for a ruling on admissibility are intertwined with the underlying merits themselves, as discussed in note 83 *supra*. The taking of such evidence, even in the presence of the jury, is not a novel procedure; indeed it has its roots in early English common law. See, e.g., *Stowe v. Querner*, L.R. 5 Ex. 155 (1870). *But cf.* *Bartlett v. Smith*, 152 Engl. Rep. 895 (Ex. 1843) (entirely separate preliminary evidentiary issues were directed to be determined by the judge, without the assistance of the jury).

⁹⁶ See, e.g., *Walling v. Beverly Enterprises*, 476 F.2d 393, 397 n.8 (9th Cir. 1973); *A.T. Brod & Co. v. Perlow*, 375 F.2d 393, 397 (2d Cir. 1967); *SEC v. Glass Marine Indus., Inc.*, 208 F. Supp. 727, 732-33 (D. Del. 1962); *Jacobs, What Is A Misleading Statement or Omission Under Rule 10b-5?*, 42 FORDHAM L. REV. 243, 270-71 (1973). See also *Strong v. Repide*, 213 U.S. 419, 433 (1909). 2 WIGMORE, *supra* note 38, § 316 (3d ed. 1940).

⁹⁷ See, e.g., *Rochez Bros., Inc. v. Rhoades*, 353 F. Supp. 795, 802 (W.D. Pa. 1973), *aff'd and rev'd on other grounds*, 491 F.2d 402 (3d Cir. 1974); *Janigan v. Taylor*, 344 F.2d 781, 785 n.3 (1st Cir.), *cert. denied*, 382 U.S. 379 (1965). See also *Richardson v. MacArthur*, 451 F.2d 35, 41 (10th Cir. 1971); *Glens Falls Ins. Co. v. Satree*, 320 F.2d 92, 95 (9th Cir. 1963); *Williams v. United States*, 199 F.2d 921, 922 (5th Cir. 1952).

⁹⁸ See, e.g., *Janigan v. Taylor*, 344 F.2d 781, 785 & n.3 (1st Cir.), *cert. denied*, 382 U.S. 379 (1965); *Cooper v. North New Jersey Trust Co. of Ridgewood, N.J.*, 226 F. Supp. 972, 978 (S.D.N.Y. 1964).

⁹⁹ See, e.g., *Stier v. Smith*, 473 F.2d 1205, 1208, 1210 (5th Cir. 1973); *In re Penn Cent. Commercial Paper Litigation*, 61 F.R.D. 453, 461 (S.D.N.Y. 1973).

¹⁰⁰ See text at notes 208-11 *infra*.

¹⁰¹ *Janigan v. Taylor*, 344 F.2d 781, 785 n.3 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965); *Strong v. Repide*, 213 U.S. 419, 433 (1909).

¹⁰² See, e.g., *United States v. Pfingst*, 477 F.2d 177, 193-94 (2d Cir.), *cert. denied*, 412 U.S. 941 (1973). See also *Cornaglia v. Ricciardi*, 63 F.R.D. 416, 421-22 (E.D. Pa. 1974); *Ross v. Paul Hardeman, Inc.*, [1964-66 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 91,483, at 94, 850 (S.D.N.Y. 1965).

¹⁰³ See notes 198-238 *infra*.

access to allegedly material undisclosed information,¹⁰⁴ or to establish waiver, estoppel or other similar defenses to the plaintiff's claim.¹⁰⁵

Each of these permissible uses of post-transaction evidence is discussed in detail below. Where pertinent, an examination of the objections which may be raised to each type of evidence accompanies the discussion. In that regard, it is important to keep in mind that the same evidence frequently serves more than one purpose in the same action.¹⁰⁶ Thus, an objection to the evidence may properly prevent or counter one purpose for which the evidence was offered, but it may nevertheless fail to exclude the evidence because of the other purposes that the evidence may serve.

C. *Intent and the Fact of Fraud*

Post-transaction evidence frequently provides important clues to a defendant's actual intent at the time of a securities transaction. Used for this purpose, post-transaction evidence may prove the "fact" of the fraud, rather than establishing the fraud itself.¹⁰⁷ In such instances, post-transaction evidence may also be pertinent to important collateral matters such as credibility.¹⁰⁸

*Janigan v. Taylor*¹⁰⁹ exemplifies the use of post-transaction evidence to prove that fraud was committed, as distinguished from proving the elements of the fraud itself. Taylor and other former stockholders of Boston Electric Steel Casting, Inc. alleged that Janigan, a Boston director, had misrepresented several facts to them when he purchased their shares of Boston stock for a total of \$40,000.¹¹⁰ Two years later, Taylor had sold the shares for \$700,000. In a nonjury trial, the district court held that, at the time of the stock purchases, Janigan had falsely represented that he did not know of "any material change in the affairs of the company or in the past months which could cause [Janigan et al.] to have any different opinion about the company."¹¹¹ Relying on evidence of changes in Boston's financial status, shown by bookkeeping changes in Boston's books within months after the stock purchases, the court concluded that Janigan had really known that Boston would show a profit and was healthier financially than he had said.¹¹² The post-transaction bookkeeping changes indicated that Janigan had sought to conceal the improved condition of the company

¹⁰⁴ See notes 120-29 *infra*.

¹⁰⁵ See notes 241-45 *infra*.

¹⁰⁶ See, e.g., note 115 *infra*.

¹⁰⁷ See, e.g., *Rochez Bros. v. Rhoades*, 353 F. Supp. 795, 802 (W.D. Pa.), *aff'd and rev'd on other grounds*, 491 F.2d 402 (3d Cir. 1973); See also *Devonbrook, Inc. v. Lily Lynn*, [1976-77 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,835, at 91,010 (S.D.N.Y. 1977); *Stier v. Smith*, 473 F.2d 1205 (5th Cir. 1973). The use of post-transaction evidence to prove fraudulent intent and the fact of fraud was recognized by the United States Supreme Court seventy years ago in *Strong v. Repide*, 213 U.S. 419, 433 (1909).

¹⁰⁸ See, e.g., *Janigan v. Taylor*, 344 F.2d 781, 785 n.3 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965), discussed at notes 109-15 *infra*. See also *Richardson v. MacArthur*, 451 F.2d 35, 41 (10th Cir. 1971).

¹⁰⁹ 344 F.2d 781 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965).

¹¹⁰ *Id.* at 783.

¹¹¹ *Id.*

¹¹² *Id.* at 785 & n.3.

until after he had bought out the plaintiff's interests.¹¹³ The Court of Appeals for the First Circuit affirmed, rejecting Janigan's argument that the evidence had been improperly received since the plaintiffs "could not have relied" on it.¹¹⁴ Instead, the court of appeals found that the evidence was "admissible as casting light on the defendant's state of mind, and, very possibly, to affect his credibility."¹¹⁵

Post-purchase evidence of a different nature was received to establish the fact that a fraud had been committed in *Rochez Brothers, Inc. v. Rhoades*.¹¹⁶ In *Rochez Brothers*, an insider had bought out fellow stockholders, ostensibly as the result of a disagreement over whether the corporation should take on a substantial contract requiring considerable expense for new equipment and materials. Unbeknownst to the sellers, the purchaser was in the midst of negotiating an acquisition of the company at the time. Although he did not reach agreement with either of the two companies with which he had been negotiating at the time of the stock purchase, some months later such a take-over was consummated. Whereas the purchaser had paid \$598,000 for the plaintiffs' stock in the fall of 1967, under the 1968 take-over he sold it for \$4,250,000, 50,000 shares of the acquiring company's stock and an employment agreement. The district court found that the purchaser's failure to disclose his pre-purchase merger discussions was a violation of rule 10b-5 and section 17(a). In so doing, the court found that the post-transaction evidence of the purchaser's continued negotiations and actual consummation of a lucrative acquisition agreement "might well be relevant to demonstrate fraud in the transaction,"¹¹⁷ prior to his purchase of the plaintiffs' stock.

These decisions have an obvious logic to them, particularly since they appear to have involved blatant deception and the post-transaction evidence was directly related to the subject of the fraud. Other equally compelling circumstances are not difficult to imagine or recognize. For example, if an underwriter or broker induces a buyer to invest with glowing statements about its faith in a company's prospects, and then sells out its own position in the company shortly after the transaction, one might con-

¹¹³ In its opinion, the district court found that Janigan was not a truthful witness either during the taking of his deposition or while testifying in Court. Specifically, I disbelieve his denials of knowledge of the firming of prices and increase of backlog in late 1955 and, not believing his denials of such knowledge, I find that he did know about them at the time he told Bergen that things were just about the same.

Taylor v. Janigan, 212 F. Supp. 794, 800 (D. Mass. 1962).

¹¹⁴ Janigan 344 F.2d at 786.

¹¹⁵ *Id.* at 785 n.3. The complete text of the court of appeals' statement was:

Defendant is correct that since the bookkeeping changes occurred only after the making of the representation, and were not seen by the plaintiffs, they could not have been relied on. However, they were admissible as casting light on the defendant's state of mind, and, very possibly, to affect his credibility.

Id. This result is analogous in some respects to the rule in criminal actions that evidence of post-event facts such as the destruction of evidence or false explanations of prior conduct may be admissible to show intent or to attack credibility. *See, e.g.,* People v. Leyra, 1 N.Y.2d 199, 208, 134 N.E.2d 475, 480 (1956); People v. Feldman, 296 N.Y. 127, 139, 71 N.E.2d 433, 439 (1947).

¹¹⁶ 353 F. Supp. 795 (W.D. Pa. 1973), *aff'd in part and rev'd in part on other grounds*, 491 F.2d 402 (3d Cir. 1974).

¹¹⁷ *Id.* at 802.

clude that the broker-underwriter acted deceitfully. A similar conclusion would be reasonable where principals of a company have acquired another company in exchange for the stock of the acquiring company, but then sell their personal holdings in the acquirer. In such cases, post-transaction evidence can play a pertinent role in determining both scienter and the fact that a fraud had been committed.

The foregoing analysis does not mean, however, that post-transaction evidence should always be admitted when offered to show the alleged "fact" of deception, or that the court or jury should necessarily credit it or draw the inferences which the proponent suggests from the evidence. The post-transaction evidence may simply be too remote or tangential to warrant such a conclusion. *Devonbrook Inc. v. Lily Lynn, Inc.*¹¹⁸ provides a good recent illustration. Devonbrook sold one of its subsidiaries to Lily in exchange for 42,000 shares of unregistered Lily stock, under an agreement which committed Lily to use its best efforts to register the Lily shares upon request by Devonbrook. Devonbrook's request the following year fell upon deaf ears, and Devonbrook sued Lily under rule 10b-5, alleging that Lily had never really intended to perform the registration provision of the agreement. Relying upon evidence of transactions consummated after its purchase from Lily, Devonbrook argued that Lily had been in the process of negotiating a number of other major acquisitions at the time of its contract with Devonbrook, and must have known that, as a result, it would not be possible for Lily to process a registration statement through the SEC for at least a full year. The district court admitted and carefully reviewed the post-transaction evidence, but the court concluded that the evidence was not sufficiently persuasive to prove that Lily lacked intent to perform at the time of the parties' agreement.¹¹⁹

The foregoing discussion focuses on the use of post-transaction evidence by the plaintiff to attempt to establish scienter and fraud. That is, of course, only one side of the equation. In contrast to showing fraudulent intent and the fact of fraud, post-transaction evidence may be used conversely to aid a defendant to disprove the existence of scienter or otherwise to prove his good faith and honesty.¹²⁰ For example, when a defendant

¹¹⁸ [1976-77 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,835 (S.D.N.Y. 1977).

¹¹⁹ *Id.* at 91,010. The court does not appear to have had an easy time reaching its conclusion, but it obviously felt a strong obligation to give only limited weight to the post-sale evidence. Thus, the court explained:

Although the Court finds disturbing the defendant's purchase of its own securities from the Devonbrook creditor banks [i.e., its post-transaction purchase of the securities and those by the plaintiff which were subject to the registration provision], it recognizes that the defendant is the most likely purchaser of its own unregistered securities. Further, plaintiff's evidence establishes that the defendant made certain representations to the Devonbrook creditor banks of its intent to register the securities which resulted in the banks' decision to delay foreclosure. The Court does not conclude therefore that the purchase evidences that a limited intent existed on the part of the defendant *at the time* it entered into the Miss Devon agreement with the plaintiff.

Id. (emphasis in original).

¹²⁰ The burden of proving scienter is on the plaintiff, not the defendant, *see* note 270 *infra*; but the defendant may, of course, seek to disprove scienter, *see, e.g.*, note 128 *infra*, in those cases where plaintiff is required to show scienter to establish his case.

As observed in note 270 *infra*, several possible securities claims do not require scienter. Nevertheless, in those cases, including actions brought under section 11 and where "control-

broker itself has made substantial purchases of the issuer's securities after recommending its sale to the plaintiff, such conduct evidence may help to negate a claim that the broker intentionally misled the plaintiff into making a bad investment.¹²¹

Post-transaction evidence was used in this manner to disprove intent in *Franklin Savings Bank v. Levy*.¹²² The plaintiff bank had purchased Penn Central securities from Goldman, Sachs & Co. in March, 1970.¹²³ Three months later, Penn Central filed a bankruptcy reorganization petition,¹²⁴ leading to the plaintiff's securities fraud action. Goldman, Sachs argued that it had not intentionally misled the plaintiff, as shown by the fact that its senior partner, a principal figure in its dealings with Penn Central, had continued to hold, as a trustee of a blind trust, Penn Central securities worth over ten million dollars until after PCTC's bankruptcy petition, resulting in a multimillion dollar loss to the blind trust.¹²⁵ This post-purchase evidence, the defense argued, was a "badge of innocent good faith," negating any inference of scienter.¹²⁶ The court of appeals criticized the district court's rejection of the evidence, since the court of appeals determined that the evidence bore upon the rule 10b-5 claim upon which the district court had based its decision.¹²⁷ Due in part to the district court's exclusion of the defendant's post-transaction evidence of alleged good faith, the court of appeals reversed the lower court's judgment against the defendants under rule 10b-5 and remanded the case for consideration of the plaintiff's section 12(2) claim,¹²⁸ on which proof of scienter would not be necessary to es-

ling persons" are sued under § 20(a) of the Securities Exchange Act of 1934 or § 15 of the Securities Act of 1933, the defendant still may defend by showing he acted in good faith. *See, e.g.,* *Zweig v. Hearst Corp.*, 521 F.2d 1129, 1132 (9th Cir. 1975); *SEC v. Management Dynamics, Inc.*, 515 F.2d 801, 807 (2d Cir. 1975); Fiftis, *Liability for Misleading Statements Under Section 11*, 21 PRAC. LAW. 35, 48-50 (1975). *But cf. Rolf v. Blyth, Eastman Dillon & Co., Inc.*, [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,275, at 92,772-73 (2d Cir. 1978) (good faith is not a defense to a 10b-5 action for aiding and abetting, when defendant's behavior was reckless).

While good faith is not a defense under § 12(2), the seller can defend by showing that he did not know of the untruths and omissions, and could not have known of them, even with reasonable diligence. *See, e.g., DeMarco v. Edens*, 390 F.2d 836, 840-41 (2d Cir. 1968); *Gould v. Tricon, Inc.*, 272 F. Supp. 385, 392 (S.D.N.Y. 1967).

¹²¹ Such conduct evidence would not be conclusive, of course, but it permits the drawing of any logical inference that the court may consider, in the same manner as any other possible inference, *see, e.g.,* note 128 *infra*, —subject, of course, to the limitations usually circumscribing such inferences, *see, e.g.,* FED. R. EVID. 407, 608, and 609. *See, e.g., Shull v. Dain, Kalman & Quail, Inc.*, [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,152, at 92,209-10 (8th Cir. 1977).

¹²² 551 F.2d 521 (2d Cir. 1977).

¹²³ *Id.* at 523.

¹²⁴ *Id.*

¹²⁵ *Id.*

¹²⁶ *Id.*

¹²⁷ *Id.*

¹²⁸ *Id.* See note 6 *supra* for text of § 12(2). *Cf. University Hill Foundation v. Goldman, Sachs & Co.*, 422 F. Supp. 879, 895 n.15 (S.D.N.Y. 1976), where the court admitted this evidence and, although holding the defendant liable under § 12(2), the court determined that based upon this evidence, the defendant had "acted in the good faith belief that the Company [PCTC] was credit-worthy," so that it was not also liable under rule 10b-5. *Id.* Interestingly, the jury in *Welch Foods, Inc. v. Goldman, Sachs & Co.*, which heard the same evidence, held the defendant liable under rule 10b-5 as well as § 12(2). *See New York Times*, Oct. 10, 1974, at 69, col. 4; *Wall St. Journal*, Oct. 10, 1974, at 24, col. 4; *N.Y.L.J.*, Oct. 10, 1974, at 1, col. 5.

tablish liability.¹²⁹

Franklin, like the decisions discussed earlier involving offers by plaintiffs of post-transaction evidence, demonstrates that post-transaction evidence may have substantial relevancy to such critical issues in securities litigation as intent, good faith and the fact of fraud. Such evidence should not be deemed inadmissible merely because it relates to facts arising after the transaction occurred. Instead, the court's inquiry should focus, as with evidence in general, upon whether the evidence is probative of the particular issue for which it is offered.

D. Materiality and Reliance

Post-transaction evidence also may have a valid role in determining both whether the defendant's alleged misrepresentation or omission was a material factor inducing a plaintiff's actions, and whether the plaintiff actually relied on such misrepresentations or omissions. Proof of materiality and reliance (and their corollary, causation), are key elements of plaintiffs' cause of action in most securities fraud actions, particularly those brought under rule 10b-5.¹³⁰ A plaintiff suing under rule 10b-5 must show that

¹²⁹ The case was settled before the district court determined the § 12(2) claims. All of the other suits tried against Goldman, Sachs following Penn Central's collapse resulted, however, in findings against the defendant under § 12(2). See notes 128 *supra* and 188 *infra*. For a detailed comparison of the standards of liability under § 12(2) and rule 10b-5, see Kaminsky, *Securities Litigation Under Section 12(2) and How It Compares with Rule 10b-5*, 13 HOUS. L. REV. 231 (1976).

¹³⁰ The definitions and relationship of the elements of "materiality" and "reliance" are not always easy to discern. Those elements are often jumbled together or merely considered separately in the search for the element of "causation." See, e.g., *Titan Group, Inc. v. Faggen*, 513 F.2d 234, 239 (2d Cir. 1975); *Blackie v. Barrack*, 524 F.2d 891, 906 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976). See also *Wright v. Heizer Corp.* [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,101, at 91,965 (7th Cir. 1977); *Kerrigan v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, [Current] FED. SEC. L. REP. (CCH), ¶ 96,446 (S.D.N.Y. 1978); *Ruszkowski v. Hugh Johnson & Co.*, 302 F. Supp. 1371, 1375 (W.D. Pa. 1969).

One recent attempt to sort out and explain the distinction between materiality and reliance is contained in *Ketchum v. Green*, 415 F. Supp. 1367, 1371 (W.D. Pa. 1976) where the court explained:

The causation element of Rule 10b-5 may be evaluated through the application of materiality and reliance tests The former is measured by the standard of "whether 'a reasonable man would attach importance [to the undisclosed or misrepresented facts] in determining his choice of action in the transaction in question. . . .'" The latter is judged by whether the plaintiff would have acted differently had he known the undisclosed or misrepresented information. . . . Obviously, neither objective materiality nor subjective reliance is present here.

Id. (bracketed material in original). See also *St. Louis Union Trust Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 562 F.2d 1040, 1048-50 (8th Cir. 1977); *List v. Fashion Park, Inc.*, 340 F.2d 457, 462 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965); Note, *The 'Substantial Likelihood' Standard of Materiality Under Section 14(a)*, 50 TEMP. L.Q. 437 (1977); Note, *The Materiality Test—Roman Mills Revisited*, 14 DUQ. L. REV. 724, 729-33 (1976); Note, *The Reliance Requirement in Private Actions Under SEC Rule 10b-5*, 88 HARV. L. REV. 584, 602-03 (1975).

The United States Supreme Court recently formulated the test of materiality under section 14 (a). According to the Court, a fact is material if "there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote" or stated differently, if there is "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *TSC Indus., Inc. v. Northway*, 426 U.S. 438, 449 (1976). The test for materiality is the same regardless of which securities law provision is involved. *Alton Box Bd. Co. v. Goldman, Sachs & Co.*, 560 F.2d 916, 920 (8th Cir. 1977); *Gilbert v. Nixon*, 429 F.2d 348, 355-56 (10th Cir. 1970).

the defendant's omission or misrepresentation was material to the plaintiff's purchase or sale of securities. Information is material if there is a substantial likelihood that a reasonably prudent investor would consider it important in making his investment decision.¹³¹ Materiality is thus an objective test. Reliance, however, requires proof of what the plaintiff himself did or believed, and thus involves a subjective test.¹³²

Post-transaction evidence may yield important information for both plaintiffs and defendants respecting these issues. For example, the plaintiff's post-transaction statements, orally or in writing, regarding the facts which he is claiming constituted a fraud on him may show what he actually deemed important to his investment decision. Similarly, post-transaction evidence may be crucial to the issue of materiality when, for example, an investor has purchased stock before the issuer reveals previously known but undisclosed information about the issuer's prospects. Evidence of what other holders of the issuer's stock — especially sophisticated investors — did after the news was released may show the degree to which the information was material to the prudent investor. If other investors reacted to the information by selling their stock, and a reasonable correlation can be shown between the news and the sales, one may infer that the information was material. No absolute rules on such matters are possible, but the courts should be advertent to the potential significance of such evidence.¹³³

¹³¹ *TSC Indus., Inc. v. Northway*, 426 U.S. 438, 449 (1976). The test is what a "reasonably prudent" investor, not necessarily the plaintiff, would have wanted to know. *See, e.g.*, *Alton Box Bd. Co. v. Goldman, Sachs & Co.*, 560 F.2d 916, 920 (8th Cir. 1977); *SEC v. Parkland Hosiery Co.*, 558 F.2d 1083, 1088 (2d Cir. 1977). *But cf.* *Titan Group, Inc. v. Faggen*, 513 F.2d 234, 239 (2d Cir. 1975) (applying standard focusing on what the particular plaintiff wanted to know).

However, it is not always easy to tell what a "reasonable investor" would have deemed important. Obviously, not every minute detail meets this test; rather, the information appears to be significant in the context of the "total mix" of information. *See TSC Indus., Inc. v. Northway*, 426 U.S. 438, 449 (1976); *Spielman v. General Host Corp.*, 538 F.2d 39, 39-40 (2d Cir. 1976). However, as the court of appeals recently reiterated in *Cole v. Schenley Indus., Inc.*, 563 F.2d 35 (2d Cir. 1977), while "corporations are not required to address their stockholders as if they were children in kindergarten," it is not sufficient that overtones might have been picked up by the sensitive antennae of investment analysts." *Id.* at 40, *quoting* *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1297 (2d Cir. 1973).

The court in *Cole v. Schenley Ind., Inc.* specifically declined to adopt different tests of materiality in terms of strictness for different types of proxy statements. *Id.* at 40 n.9. *Cf.* Comment, *Shareholders and Informed Voting: How Much Information Do They Need?* 28 *MERCER L. REV.* 725, 730-31 (1977) (suggesting that a distinction be drawn between "institutional investors" and the "small investor" for proxy statements).

¹³² *See, e.g.*, *List v. Fashion Park, Inc.*, 340 F.2d 457, 462 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965); *Kerrigan v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, [1977-78 Transfer Binder] *FED. SEC. L. REP. (CCH)* ¶ 96,446, at 93,602 (S.D.N.Y. 1978); *Ketchum v. Green*, 415 F. Supp. 1367, 1371 (W.D. Pa. 1976); *Arlinghaus v. Ritenour*, [1974-75 Transfer Binder] *FED. SEC. L. REP. (CCH)* ¶ 95,288, at 98,472 (S.D.N.Y. 1975). As is true in common law fraud actions, in order to recover the plaintiff must show that he was actually deceived and did not know the truth. *See, e.g.*, *Goldberger v. Baker*, [1977-78 Transfer Binder] *FED. SEC. L. REP. (CCH)* ¶ 96,203, at 92,426 (S.D.N.Y. 1977); *Spielman v. General Host Corp.*, 538 F.2d 39, 40-41 (2d Cir. 1976); *Levy v. Vista Indus. Corp.*, [1977-78 Transfer Binder] *FED. SEC. L. REP. (CCH)* ¶ 96,012, at 91,552 (S.D.N.Y. 1977); *Architectural League v. Bartos*, 404 F. Supp. 304, 309-13 (S.D.N.Y. 1975), as to the securities laws. *See also* *Sutro Bros. & Co. v. Indemnity Ins. Co.*, 264 F. Supp. 273, 288 (S.D.N.Y.), *aff'd*, 386 F.2d 798 (2d Cir. 1967); *Sager v. Friedman*, 270 N.Y. 472, 479 (1963), as to common law fraud.

¹³³ As the court of appeals stated in *Radiation Dynamics, Inc. v. Goldmuntz*, 464 F.2d 876 (2d Cir. 1972), "'materiality' must be determined on a case-to-case basis according to the fact pattern of each specific transaction." *Id.* at 888.

Several courts have observed that subsequent actions of the litigants themselves may be a proper indication of information's materiality.¹³⁴ For example, if a broker-dealer is shown to have made a substantial investment in a company after recommending sale of its stock to the plaintiff, or conversely has himself held the stock and suffered losses on the same investment as the plaintiff, the fact-finder may consider such evidence significant in determining the materiality of matters which the broker is claimed to have misrepresented or omitted. To be sure, such evidence may not be conclusive on the issue. The defendant may have been holding the stock or otherwise acting for other (possibly even nefarious) purposes, but the jury should normally be permitted to consider the post-transaction evidence and determine what the defendant's true purposes and state of mind were, in its fact-finding capacity.

Post-transaction evidence may also serve to disprove the materiality of the defendant's alleged omission or misrepresentation or to disprove the plaintiff's claims of reliance and causation. For example, if a plaintiff purchaser continues to purchase a stock after learning of facts which he is contending constituted material omissions, such later purchases may indicate that he, and presumably a reasonably prudent investor, did not actually deem the information material, or that he would not have relied on those facts even if they had been disclosed to him.

Another aspect of the use of post-transaction evidence to disprove materiality and reliance is found in *Gelman v. Westinghouse Electric Corp.*¹³⁵ *Gelman* was a suit on behalf of a class of sellers of Westinghouse stock who alleged that Westinghouse had misled them regarding its intention to divest its unprofitable major appliance division.¹³⁶ That misrepresentation, the

In this regard, the courts have often held that materiality presents a fact issue for trial. See, e.g., *SEC v. Bausch & Lomb, Inc.*, 565 F.2d 815 (2d Cir. 1977); *Froher v. New York Stock Exch.*, [1976-77 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,416, at 99,106 (S.D.N.Y. 1976); *Marx v. Computer Sciences Corp.*, 507 F.2d 485, 490 (9th Cir. 1974). But cf. *Johns Hopkins University v. Hutton*, 422 F.2d 1124, 1129 (4th Cir. 1970) and *Oscar Gruss & Son v. Natomas Co.*, [1976-77 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,258, at 92,703 (N.D. Cal. 1976) (indicating that materiality may, in certain cases, be so obvious that it is determinable as a matter of law). In other cases, the courts have ruled that materiality is a mixed question of both law and fact. See, e.g., *S. & S. Realty Corp. v. Kleer-Vu Industries, Inc.*, [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96-270, at 92,750 (S.D.N.Y. 1978).

Post-purchase evidence may give an indication of what was actually significant, although not so obvious at the time of the transaction itself. In *SEC v. Shapiro*, 494 F.2d 1301 (2d Cir. 1974), the court found:

But we need not merely speculate as to how a reasonable investor might have received this information. The behavior of appellant, his partner Shapiro, and others who knew of the merger, all of whom were sophisticated investors, demonstrates empirically that the information was material. Almost immediately after the January 6 luncheon at which Rosenbloom responded favorably to the merger proposal, Shapiro and Berman purchased substantial amounts of Harvey's stock.

Id. at 1307.

¹³⁴ See, e.g., *Mittendorf v. J.R. Williston & Beane, Inc.*, 372 F. Supp. 821, 828 (S.D.N.Y. 1974). See also *Hirsch v. duPont*, 553 F.2d 750, 762-63 (2d Cir. 1977); *Spielman v. General Host Corp.*, 402 F. Supp. 190, 194 (S.D.N.Y. 1975), *aff'd*, 538 F.2d 39 (2d Cir. 1976) (*per curiam*); *SEC v. Shapiro*, 349 F. Supp. 46, 53-54 (S.D.N.Y. 1972), *aff'd*, 494 F.2d 1301, 1306-07 (2d Cir. 1974).

¹³⁵ 73 F.R.D. 60 (W.D. Pa. 1976), *appeal dismissed*, 556 F.2d 699 (3d Cir. 1977).

¹³⁶ *Id.* at 62.

plaintiffs alleged, had artificially depressed the market price for Westinghouse stock.¹³⁷ Gelman offered post-sale evidence to show that, soon after his sales, when the Westinghouse divestiture was completed, Westinghouse's stock increased thirty-eight percent in value.¹³⁸ Westinghouse opposed Gelman's motion for class certification on the grounds that the evidence regarding its negotiations for the sale of the division extended over a six to nine month period, during which the relative materiality of the facts involved had changed dramatically.¹³⁹ Thus, the defense argued, noncommon individual questions on the issue of materiality predominated, rendering Gelman's claim inappropriate for certification as a class action.¹⁴⁰ The district court agreed, and denied Gelman's motion for class certification, stating:

[T]he issue of materiality is . . . one of the facts to be determined on the basis of all the circumstances; and in this case, the relevant facts as alleged by plaintiffs changed throughout the selling class period. Clearly, the question of materiality as it pertains to the claim of a shareholder who sold stock in May or June is vastly different from the question as it pertains to claims stemming from sales in November or December.¹⁴¹

E. Post-Purchase Lulling

Post-transaction evidence self-evidently will play a pivotal role where it is claimed that the defendant continued to mislead the plaintiff after the transaction was consummated. In such a situation, the plaintiff may either have continued to be misled, or he may have been prevented from learning that he has been the victim of fraudulent conduct. The latter claim has been termed "lulling."¹⁴² For example, the plaintiff, having learned negative information about the issuer of stock which he has just purchased from the defendant, may call the defendant for an explanation. But the facile deceitful defendant may convince the plaintiff that the information is nothing to be concerned about lulling him into a false sense of security about his investment.

Such a claim is quite difficult to posit under the federal securities laws, particularly rule 10b-5. In *Blue Chip Stamps v. Manor Drug Stores*,¹⁴³ the United States Supreme Court sought to remove any question that the plaintiff in a 10b-5 action must be a purchaser or seller to sue under the principal sections of the antifraud provisions.¹⁴⁴ Since *Blue Chip*, the lower

¹³⁷ *Id.* at 64.

¹³⁸ *Id.*

¹³⁹ *Id.* at 67.

¹⁴⁰ *Id.*

¹⁴¹ *Id.* at 68 (footnote omitted).

¹⁴² See, e.g., *Hoglund v. Covington County Bank*, [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,003 (M.D. Ala. 1977). But see, e.g., *Halperin v. Edwards & Hanly, Inc.*, 431 F. Supp. 121 (S.D.N.Y. 1977); *Manheim v. Wood Walker & Co.*, [1976-77 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,848, at 91,089 (D. Conn. 1977). See also *Garnatz v. Stifel, Nicolaus & Co.*, 559 F.2d 1357 (8th Cir. 1977).

¹⁴³ 421 U.S. 723 (1975).

¹⁴⁴ *Id.* at 731. The Court of Appeals for the Second Circuit recently summarized the policy underlying the *Blue Chip* decision as follows:

In interpreting the express language of section 10(b) and Rule 10b-5 in *Blue Chip*, the Court expressed concern about suits by persons who neither pur-

courts have been assiduous in dismissing attempts by plaintiffs to allege securities frauds founded upon alleged decisions *not* to purchase or sell.¹⁴⁵ But there are a variety of other possible securities claims under other sections — for example, section 36 of the Investment Company Act¹⁴⁶ and

chased nor sold securities but who claimed that they would have purchased or sold securities but for false representations made by someone whom they might not even have known. The Court noted that the "purchase or sale" requirement protected against vexatious suits by a potentially limitless class of plaintiffs and avoided the difficult questions of determining whether a plaintiff would or would not have purchased or sold securities but for the defendant's representations. *Id.* at 745-47.

Far from holding that claims of persons who were neither purchasers or sellers would be too speculative under the other securities acts, the Court interpreted the express language of Section 10(b) and rule 10b-5. And the Court expressly noted that many of the other securities acts have no "purchase or sale" requirement. 421 U.S. at 733-34.

Abrahamson v. Fleschner, 568 F.2d 862, 877 n.25 (2d Cir. 1977).

The "purchaser or seller" limitation rule is not exactly the same for all actions arising under the various sections of the securities laws. For example, section 12(2) covers only purchasers, and is further limited only to misstatements in connection with the particular security sold. *See, e.g.*, *Gross v. Diversified Mortgage Investors*, [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,137, at 92,114 (S.D.N.Y. 1977). Under rule 10b-5, provided there is a security sale, the fraud need not be in connection with the particular security sold to or by the plaintiff. *See, e.g.*, *Frigitemp Corp. v. Financial Dynamics Fund, Inc.*, 524 F.2d 275, 280 (2d Cir. 1975); *International Tel. & Tel., Inc. v. Vencap, Ltd.*, [1975-76 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,398, at 99,039 (S.D.N.Y. 1976). Under § 17(a), non-purchasers have been given standing to sue by some decisions, even though section 17(a) is a close analogue of rule 10b-5. *See, e.g.*, *Reid v. Madison*, [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,231 (E.D. Va. 1977).

Under the Investment Advisers Act, the principal standing requirement is that the plaintiff must have been a client of the adviser being sued. *See, e.g.*, *Gross v. Diversified Mortgage Investors* at 93,113; *Jones Memorial Trust v. TSAI Inv. Servs. Inc.*, 367 F. Supp. 491, 497 (S.D.N.Y. 1973). Recent authority, however, has permitted the plaintiff in an action under the Investment Advisers Act to sue alleged aiders and abettors in addition to the investment adviser itself. *See, e.g.*, *Sullivan v. Chase Inv. Servs.*, [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,224 (N.D. Cal. 1977).

¹⁴⁵ *See, e.g.*, *St. Louis Union Trust Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 562 F.2d 1040, 1049-50 (8th Cir. 1977); *Abrahamson v. Fleschner*, 568 F.2d 862 (2d Cir. 1977); *Saber Corp. v. Johnson*, [1976-77 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,825, at 90,977 (D. Minn. 1976); *Gaudin v. KDI Corp.*, [1976-77 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,785, at 90,843 (S.D. Ohio 1976), *aff'd*, [Current] FED. SEC. L. REP. (CCH) ¶ 96,453 (6th Cir. 1978).

¹⁴⁶ Section 36 of the Investment Companies Act, 15 U.S.C. § 80a-35 (1970), provides, in pertinent part:

(a) The Commission is authorized to bring an action in the proper district court of the United States, or in the United States court of any territory or other place subject to the jurisdiction of the United States, alleging that a person serving or acting in one or more of the following capacities has engaged within five years of the commencement of the action or is about to engage in any act or practice constituting a breach of fiduciary duty involving personal misconduct in respect of any registered investment company for which such person so serves or acts—

(1) as officer, director, member of any advisory board, investment adviser, or depositor; or

(2) as principal underwriter, if such registered company is an open-end company, unit investment trust, or face-amount certificate company

(b) For the purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature,

section 206 of the Investment Advisors Act¹⁴⁷ — which are not characterized by that limitation; wrongful retention or inducement of retention may be the basis for a claim under such sections. Interesting facets of the purchase-sale question also exist in merger cases, where a stockholder suing under the proxy rules may claim to be a "forced" seller or holder.¹⁴⁸

Notwithstanding *Blue Chip's* strictures, the recent case of *Hoglund v. Covington County Bank*¹⁴⁹ suggests a possible exception to the purchase or sale requirement in situations involving lulling. The plaintiffs in *Hoglund* claimed that they were defrauded in two separate ways: first, that they were induced to purchase a security; second, that they were afterwards lulled into retaining the stock.¹⁵⁰ The court denied the defendant's motion to dismiss the portion of the case asserting a separate securities claim based upon the lulling activity, reasoning that "[u]nder the mail fraud statutes,

paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser. An action may be brought under this subsection by the Commission, or by a security holder of such registered investment company on behalf of such company, against such investment adviser, or any affiliated person of such investment adviser, or any other person enumerated in subsection (a) of this section who has a fiduciary duty concerning such compensation or payments, for breach of fiduciary duty in respect of such compensation or payments paid by such registered investment company or by the security holders thereof to such investment adviser or person

15 U.S.C. § 80a-35. See also *Brown v. Bullock*, 294 F.2d 415, 420 (2d Cir. 1961); *Boyko v. Reserve Fund, Inc.*, 68 F.R.D. 692, 696 (S.D.N.Y. 1975).

¹⁴⁷ See notes 2 *supra* & 186 *infra*.

¹⁴⁸ See, e.g., *Goldberg v. Meridor*, [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,152, at 92,264-65 (2d Cir. 1977); *Cole v. Schenley Indus. Inc.*, 563 F.2d 35, (2d Cir. 1977); *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374, 380-88 (2d Cir.), *cert. denied*, 421 U.S. 976 (1975). For examples of a relaxation of the *Blue Chip* rule in forced seller cases, see *Weisman v. Darneille*, [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,278, at 92,796 (S.D.N.Y. 1978); *Houlihan v. Anderson-Stokes, Inc.*, [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,139, at 92,121 (D.D.C. 1977).

However, in several forced seller cases the courts have held that no securities fraud claim exists since the defendant had a contractual right to compel the sale. See *St. Louis Union Trust Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 562 F.2d 1040, 1049-50 (8th Cir. 1977); *Ryan v. J. Walter Thompson*, 453 F.2d 444, 447 (2d Cir. 1971), *cert. denied*, 406 U.S. 907 (1972); *Fershtman v. Schectman*, 450 F.2d 1357, 1359-60 (2d Cir. 1971). But cf. *Ayres v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 538 F.2d 532, 537 (3d Cir. 1976) (a cognizable securities claim was stated where the decision to sell was partially at plaintiff's option, so that defendant could not unilaterally force sale).

¹⁴⁹ [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,003 (M.D. Ala. 1977). But cf. *Morgan v. Prudential Funds, Inc.*, [Current] FED. SEC. L. REP. (CCH) ¶ 96,345, at 93,173 (S.D.N.Y. 1978), where the court dismissed a securities claim against alleged "aiders and abettors" who had conspired to cover up the principal defendants' fraud. The court reasoned that there could be no causal connection between the post-transaction actions of the "aiders and abettors" and the securities fraud which had been committed several months earlier. That reasoning may be too narrow in some circumstances. At common law, it does not matter when a party joins a conspiracy, see, e.g., *Lesnik v. Public Indus. Corp.*, 144 F.2d 968, 973 (2d Cir. 1944); *Meredith v. Art Metal Constr. Co.*, 97 Misc. 69, 78-79 (Sup. Ct. 1916), *aff'd*, 176 App. Div. 945 (4th Dept. 1917); *Bedard v. La Bier*, 20 Misc. 2d 614, 616-17 (Sup. Ct. 1958). And, of course, criminal law recognizes the liability of an "accessory after the fact." The liberal purposes of the antifraud provisions would appear to be better served by also recognizing the possibility of that type of liability in a securities fraud action. The fact finder at trial may, of course, conclude that the alleged "aiding" conduct was too remote to sustain a judgment, against the alleged aider and abettor, but that should not prevent the plaintiff from his day in court and an opportunity to convince the fact finder otherwise.

¹⁵⁰ *Hoglund*, [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) at 91,513.

post-purchase lulling by mail is considered part of a fraudulent scheme, even where the money had changed hands before the mailing. . . . Thus the lulling activity relates back to the fraudulent obtaining of the money."¹⁵¹

Claims such as those presented in *Hoglund* will be difficult to prove, since some additional fraudulent conduct after the sale must be shown to make out a separate claim for lulling. But it is possible to plead such a claim. For example, this requirement of additional fraudulent conduct may be satisfied when a defendant, as part of the investment transaction, makes additional representations specifically suggesting that a plaintiff hold his securities. As a practical matter such evidence will usually be unavailable, since normally the defendant is interested only in profiting from the transaction itself, not in seeing that the purchaser continues to hold the security. Nevertheless it may be adducible in other situations as, for example, where the defendant is hoping to avoid a demand for rescission or a lawsuit by the plaintiff.

Evidence of lulling may also be an important factor in determining whether the pertinent statute of limitations period has lapsed, barring the plaintiff's action. Several recent cases have applied the equitable tolling doctrine to securities claims, holding that the statute of limitations may be tolled when a defendant has concealed his wrongs and lulled the plaintiff into a false sense of security.¹⁵² In *Tomera v. Galt*,¹⁵³ for example, an investor in a group of American corporations conducting Mexican mining operations sued the promoters of the companies under rule 10b-5 and the Illinois blue sky law.¹⁵⁴ Tomera alleged that the defendants had misrepresented the financial health of the companies, particularly that the companies had valid mining leases in Mexico.¹⁵⁵ The defendants continued to solicit her funds for further development of the mines.¹⁵⁶ After her purchases, the defendants had repeatedly ignored her requests for further specific information regarding the companies.¹⁵⁷ She therefore asked the

¹⁵¹ *Id.* (citations omitted). The court relied on two mail fraud cases, *United States v. Sampson*, 371 U.S. 75 (1962), and *United States v. Ashdown*, 509 F.2d 793 (5th Cir. 1975), in support of its holding.

¹⁵² The doctrine was recently summarized and placed in proper historical perspective in *Houlihan v. Anderson-Stokes, Inc.*, [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,100 (D.D.C. 1977):

Plaintiffs seek to escape the effect of the statute of limitations by invoking the federal tolling doctrine. That doctrine, which has been the law in the federal courts "since the case of *Bailey v. Glover*, 88 U.S. 342 . . . (1875) [states] that in cases involving elements of fraud neither a statute of limitations nor the equitable doctrine of laches can be said to begin to run until the fraud is or should have been discovered." *Vanderboom v. Sexton*, 422 F.2d 1233, 1240 (8th Cir.), *cert. denied*, 400 U.S. 852 (1970).

Id. at 91,954. See also *Garnatz v. Stifel, Nicolaus & Co., Inc.*, 559 F.2d 1357, 1362 (8th Cir. 1977); *Schaefer v. First Nat'l Bank of Lincolnwood*, 509 F.2d 1287, 1295-96 (7th Cir. 1975); *Fisher v. New York Stock Exchange*, [1975-76 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,416, at 99,108 (S.D.N.Y. 1976).

The doctrine is not limited to securities actions. See, e.g., *Thee v. Parker Brothers, Inc.*, TRADE REG. REP. (CCH) ¶ 61,966 (E.D.N.Y. 1978) (antitrust action).

¹⁵³ 511 F.2d 504 (7th Cir. 1975).

¹⁵⁴ *Id.* at 507.

¹⁵⁵ *Id.* at 508.

¹⁵⁶ *Id.* at 509-10.

¹⁵⁷ *Id.* at 510.

court to conclude that "the defendant has taken positive steps after commission of the fraud (i.e. in connection with the securities transaction itself) to keep it concealed,"¹⁵⁸ thereby entitling her to the protections of the equitable tolling doctrine. The district court nevertheless dismissed the action on the ground that Tomera's claims were barred by the applicable statute of limitations.¹⁵⁹ On appeal, the court of appeals reversed the dismissal, accepting Tomera's argument that fact issues were presented regarding whether the statute of limitations was equitably tolled by the defendants' affirmative, continued concealment of the true financial status of the companies after the purchase.¹⁶⁰

¹⁵⁸ The conduct of the defendants which the plaintiff claimed gave rise to the equitable tolling doctrine was summarized by the court of appeals as follows:

Briefly, she alleges that the defendants did not keep records of the funds invested in their mining companies nor how these funds were disbursed. They refused to make available even to Mohr, the secretary and treasurer of Astir, S.A., the charters of Astir, S.A. and Candemena, the leases held by Candemena, the Mexican mill and mine permits, any agreements between Astir, S.A. and Candemena, and the minutes of their stockholders' and directors' meetings. They refused to answer any inquiries about the ownership of the mine sites, the mining and processing operations, the companies customers and supplies and the repayment of the Arizona National Bank loan. Whether the plaintiff personally inquired into the business affairs of the two Mexican corporations is unimportant. The defendant's conduct is reason enough to toll the limitations period.

Id. at 510.

¹⁵⁹ The district court applied the Illinois blue sky law three-year limitations period. *Id.* at 509.

Determining which statute of limitations is properly applicable to federal securities law actions often presents a difficult choice of law question for the courts. *See, e.g.,* Gross v. Diversified Mortgage Investors, [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,170, at 92,303-04 (S.D.N.Y. 1977); Bohem v. Singer, [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,083, at 91,901-02 (E.D. Pa. 1977); Arneil v. Ramsey, 414 F. Supp. 334, 337-40 (S.D.N.Y. 1976), *aff'd*, 550 F.2d 774 (2d Cir. 1977); Bailey v. Piper, Jaffray & Hopwood, Inc., [1976-77 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,711, at 90,462-64 (D. Minn. 1976). *See generally* Einhorn & Fellman, *Choosing a Statute of Limitations in Federal Securities Actions*, 25 MERCER L. REV. 497 (1974); Martin, *Statute of Limitations in 10b-5 Actions: Which State Statute is Applicable?*, 29 BUS. LAW. 443 (1974).

After the *Hochfelder* decision made clear that rule 10b-5 requires a showing of fraud, the general conclusion of the courts has been that the policies underlying the federal securities laws are best advanced by applying to such claims the state limitations period relating to common law fraud. *See, e.g.,* Arneil v. Ramsey, 550 F.2d 774, 779 (2d Cir. 1977); Nickels v. Koehler Management Corp., 541 F.2d 611, 618 (6th Cir. 1976); Gaudin v. KDI Corp., [1976-77 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,785, at 90,844-45 (S.D. Ohio 1976), *aff'd*, [Current] FED. SEC. L. REP. (CCH) ¶ 96,453 (6th Cir. 1978). Interestingly, this choice of law has also been adopted for cases under section 14 of the Securities Exchange Act of 1934 which, as indicated in note 270 *infra*, often do not require proof of scienter. *See, e.g.,* Stull v. Bayard, 561 F.2d 429, 431-33 (2d Cir. 1977).

The statute of limitations for claims under sections 11 and 12 of the Securities Act of 1933 is provided in section 13 of that Act, 15 U.S.C. § 77m. *See, e.g.,* Shull v. Dain, Kalman & Quail, Inc., 561 F.2d 152, 155 (8th Cir. 1977). *See also* notes 228 *et seq. infra*.

¹⁶⁰ The court of appeals explained the basis of its holding respecting the equitable tolling doctrine as follows:

At least two types of fraudulent behavior toll a statutory period. [citations omitted] In the first type, the most common, the fraud goes undiscovered even though the defendant after commission of the wrong does nothing to conceal it and the plaintiff has diligently inquired into its circumstances. The plaintiffs' due diligence is essential here. [citations omitted] In the second type, the fraud goes undiscovered because the defendant has taken positive steps after commission of the fraud to keep it concealed. [citations omitted] This type of fraudulent concealment tolls the limitations period until actual discovery by the plaintiff.

When a post-transaction lulling claim is raised in addition to a securities fraud claim, post-transaction evidence will necessarily be offered to prove the former claim. The court thus may find post-transaction evidence "bootstrapped," albeit properly and reasonably, into the securities fraud aspect of the case by the lulling claim. Careful limiting instructions and careful sorting of the evidence may be needed to preserve the identity of each claim.¹⁶¹

F. Continuing Wrongs

Another claim necessarily involving the use of post-transaction evidence is that the defendant's conduct was a "continuing wrong." Such a claim may be based upon the provisions of either rule 10b-5 or other antifraud sections which bar "any course of business or conduct which operates as a fraud or deceit" upon the plaintiff.¹⁶² A continuing wrong claim may also arise when the defendant has been engaged in a continuing course of wrongful conduct vis-a-vis a group of persons situated similarly to the plaintiff.¹⁶³ The thrust of the continuing wrong theory is that the scope of the fraud expands to encompass post-transaction as well as pre-transaction acts. This expanded fraud theory, in turn, will obviously require post-transaction evidence for its proof.

Admission of post-transaction evidence for this purpose is roughly analogous to the admission of evidence under rule 404(b) of the Federal Rules of Evidence, which permits the introduction of evidence of other wrongs to show matters such as "motive, opportunity, intent, preparation, plan, knowledge, identity, or absence of mistake or accident."¹⁶⁴ Post-

511 F.2d at 510. See also *Arneil v. Ramsey*, 550 F.2d 774, 780-82 (2d Cir. 1977); *Houlihan v. Anderson-Stokes, Inc.*, 434 F. Supp. 1324, 1326-29 (D.D.C. 1977).

Houlihan v. Anderson-Stokes, Inc. demonstrates an important limitation of the equitable tolling doctrine: that the defendant normally must be the one to have concealed the fraud. 434 F. Supp. at 1327. If the concealment is by another person, the statute normally will not be tolled against the non-concealing defendant. *Id.* See also *Koch v. Moseley*, [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,283, at 92,810-11 (E.D.N.Y. 1977). Another potentially important limitation on the doctrine is the requirement, in some situations, that the plaintiff use due diligence to discover the fraud. See notes 224-35 *infra*, as to this requirement.

¹⁶¹ See note 179 *infra*.

¹⁶² See notes 2 & 6 *supra* for the provisions of rule 10b-5 and sections 12(2) and 17(a).

¹⁶³ See, e.g., *Kennedy v. Tallant*, [1976-77 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,779, at 90,824 (S.D. Ga. 1976). One commentator on New York's law of evidence has consequently noted:

Language is occasionally found indicating that the offenses must be so connected as to raise an inference that both frauds were part of one general scheme or plan. Nevertheless this rarely hinders admissibility as the fact that another fraud was committed by the same person in the same manner, or upon the same victim, or even in the same area, is generally held sufficient to raise the required inference.

E. FISCH, *FISCH ON NEW YORK EVIDENCE* § 216, at 128 (2d ed. 1977), citing *Zinman v. Lockwood*, 138 Misc. 592, 245 N.Y.S. 696 (Sup. Ct. N.Y. Co. 1930); *Boyd v. Boyd*, 164 N.Y. 234, 58 N.E. 118 (1900).

¹⁶⁴ FED. R. EVID. 404(b). Professor McCormick strongly recommended the admissibility of such evidence, stating:

[W]here there is testimony asserting the making of the misrepresentation at issue, and testimony denying it . . . [.] it seems evidence in reply of other like misrepresentations by the party (whether or not part of a plan or scheme) will be of much value to the trier of the disputed question and that this need outweighs

transaction evidence may show, for example, that the defendant embarked upon a plan to defraud which led to the plaintiff's injury, or that the defendant knew that his earlier conduct was fraudulent. This facet of the continuing course of conduct theory may arise in multiparty actions or in actions where a defendant, such as an underwriter or accountant, has an extended relationship with the issuer. In such situations, the defendant is often required to perform a variety of duties or to perform repeatedly the same duty.¹⁶⁵ Evidence regarding such actions may show his knowledge at a particular time or establish an inference based upon his continuing course of conduct, even though it relates to specific events which took place after the particular securities transaction at issue.

Black v. Shearson, Hammil & Co.,¹⁶⁶ demonstrates the use of post-transaction evidence to prove a continuing wrong. Purchasers of securities brought suit against a brokerage firm, Shearson, for issuing a series of misleading reports and press releases concerning the issuer. The plaintiffs alleged that one of Shearson's partners, who was also a director of the issuer, had induced Shearson to issue the reports and releases.¹⁶⁷ Throughout the period that the reports were being issued, Shearson had continuously bought and sold the issuer's securities. Shearson attempted to limit its liability, claiming that its partner had not known of the statements' falsehood at the time the statements were made.¹⁶⁸ The court, however, found all of the

the danger of prejudice. While such evidence standing alone would not of course be sufficient to establish the issue, it can be of great value in resolving the conflict.

C. MCCORMICK, *supra* note 83, § 164, at 346 (1st ed. 1954). In particular, Professor McCormick emphasized that evidence of other fraudulent conduct may be appropriate for purposes other than merely to show intent or knowledge, stating that "[c]ourts often seem to overlook the availability of this theory of admissibility and, by their strictness in limiting admissibility to the purposes of showing knowledge and intent, seem unduly to hamper the investigation of fraud." *Id.* at n.4. One important caveat Professor McCormick raised is that the evidence of the alleged prior fraud must show that there was in fact a fraud, that is, that the alleged misrepresentations were in fact false. *See, e.g., Boyer v. United States*, 132 F.2d 12, 13 (D.C. Cir. 1942); *Darling v. Klock*, 33 App. Div. 270, 53 N.Y.S. 543 (2d Dept. 1898), *aff'd*, 165 N.Y. 623, 59 N.E. 593 (1900).

An example of the use of evidence of other fraudulent conduct to show something other than knowledge and intent in common law actions is to show what might have been a reasonable expectation of a party at the time. *See, e.g., Avera v. Florida Towing Corp.*, 322 F.2d 155, 161-63 (5th Cir. 1963). But, as noted in *United States v. 1,129.75 Acres of Land, Etc.*, 473 F.2d 996 (8th Cir. 1973), the admissibility of this type of evidence must "be decided on the facts of each case . . ." *Id.* at 999. Due regard must be given to possible "unfair prejudice" and the other factors under FED. R. EVID. 403. *See also* cases cited at notes 254-59 *infra*.

¹⁶⁵ *See, e.g., United States v. Natelli*, 527 F.2d 311 (2d Cir. 1975); *Fisher v. Kletz*, 266 F. Supp. 180, 197 (S.D.N.Y. 1967). *See also Hirsch v. duPont*, 553 F.2d 750, 761 (2d Cir. 1977); *State Mutual Life Assurance Co. of America v. Peat, Marwick, Mitchell & Co.*, 49 F.R.D. 202, 211-14 (S.D.N.Y. 1969). *But cf. Igenito v. Bermeo Corp.*, [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,214, at 92,487-88 (S.D.N.Y. 1977); *Halperin v. Edwards & Hanly, Inc.*, [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,028 (S.D.N.Y. 1977); *Escott v. Bar-Chris Constr. Corp.*, 283 F. Supp. 643, 697 *et seq.* (S.D.N.Y. 1968) (cases where plaintiffs' actions foreclosed recovery despite defendant's breach of duty). For nonsecurities cases dealing with situations where the defendant was held to have a continuing duty of disclosure, *see also Fitzgerald v. McFadden*, 88 F.2d 639, 642-44 (2d Cir. 1937); *Lower v. Harris*, 57 F. 368, 373-74 (2d Cir. 1893); *Strand v. Librascope, Inc.*, 197 F. Supp. 743, 752-53 (E.D. Mich. 1961); *Hush v. Reaugh*, 23 F. Supp. 646, 652 (E.D. Ill. 1938); RESTATEMENT OF TORTS § 551(2)(b) (1958).

¹⁶⁶ 266 Cal. App. 2d 362, 72 Cal. Rptr. 157 (Ct. App. 1968).

¹⁶⁷ *Id.* at 365-66, 72 Cal. Rptr. at 159.

¹⁶⁸ *Id.* at 364, 72 Cal. Rptr. at 158.

wrongs to have been part of a continuous course of conduct, and admitted post-transaction evidence to prove the wrongful character of such conduct.¹⁶⁹ This holding is particularly significant because of what it suggests about other related situations. Thus, if all the purchasers of the issuers' securities had sued Black, evidence that was post-transaction with respect to some of the purchasers presumably would have been relevant to Shearson's intent and to other factors such as its opportunity to correct its wrongful statements and its knowledge of the falsity thereof. Such evidence might show that Shearson's partner adopted the same pattern of behavior throughout the time that Shearson was trading in the issuer's stock. The repeated issuance of false reports, and the failure to correct them throughout Shearson's directorship, would then appear to be admissible under the Federal Rules of Evidence to show the defendants' motive, opportunity to correct past mistakes, preparation, intent or similar factors.

G. *Multiparty Situations and Extended Time Spans*

The most difficult questions regarding the admissibility of post-transaction evidence arise when a court is confronted with a single trial of multiple claims stemming from multiple transactions. Since different anti-fraud sections require different elements of proof,¹⁷⁰ in multicclaim or multiparty litigation the same evidence may serve various functions. For example, where a claim involves the sale of securities in a company which subsequently goes bankrupt, the defendant's negligent failure to discover the true financial condition of the security's issuer may be in itself a basis for recovery under sections 12(2) and 11.¹⁷¹ Similar negligence would not, however, be sufficient to impose liability under rule 10b-5, because actual knowledge of the truth or reckless disregard for it must be established to show a rule 10b-5 violation.¹⁷²

¹⁶⁹ In so doing, the court stated:

Appellant's argument is based upon their insistence that Dunbar did not know of the falsity of each successive statement *at the time it was made*. Their premise itself is opposed by the evidence that Dunbar was kept closely and currently informed of USAMCO's operations; it was these operations which were misrepresented to Shearson's customers, including respondents. But, irrespective of whether Dunbar knew that each of the statements was false when made, the evidence is clear that he permitted them to stand after he learned the truth and before respondents relied on them. His knowledge and approval of the statements, accompanied by his knowledge of the truth about USAMCO, were elements in a continuing course of conduct.

Id. at 367, 72 Cal. Rptr. at 160 (emphasis in original).

¹⁷⁰ See, e.g., *Gross v. Diversified Mortgage Investors*, 431 F. Supp. 1080 (S.D.N.Y. 1977); *In re Clinton Oil Co. Sec. Litigation*, [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,015 (D. Kan. 1977); *In re United States Financial Sec. Litigation*, [1974-75 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,844 (S. D. Cal. 1974). See also Kaminsky, *An Analysis of Securities Litigation Under Section 12(2) and How It Compares with Rule 10b-5*, 13 HOUS. L. REV. 231, 253-75 (1976); Note, *Causation of Damages Under Section 11 of the Securities Act of 1933*, 51 N.Y.U.L. REV. 217, 219-20 (1976). For example, scienter is required under rule 10b-5 and section 17(a) but not section 12(2) or rule 14a-9. See note 270 *infra*.

¹⁷¹ See, e.g., *Alton Box Bd. Co. v. Goldman, Sachs & Co.*, 560 F.2d 916, 923-24 (8th Cir. 1977). See also Fiftis, *Liability for Misleading Statements Under Section 11*, 21 PRAC. LAW. 35, 48-50 (1975).

¹⁷² See, e.g., *Franklin Sav. Bank of New York v. Levy*, 551 F.2d 521, 528-29 (2d Cir. 1977). See also notes 207 & 270 *infra*.

Differing factual situations may likewise cause identical post-transaction evidence to have differing weight or relevance, even though the evidence is offered in actions under the same statutory provision. For example, where the defendant has misrepresented a fact such as the financial condition of the issuer, the inquiry will focus upon the truth or falsity of the representation at the time of the sale and the defendant's actual knowledge thereof.¹⁷³ But where the defendant has merely offered his opinion on the creditworthiness of the issuer, a court will inquire whether there was a reasonable basis for the defendant's opinion and whether the defendant used reasonable diligence in investigating the issuer.¹⁷⁴ In the first situation, post-transaction evidence may help prove the plaintiff's claim that, at the time of the sale, the defendant knew that the financial condition of the issuer was not as he had represented. In the second situation, revelations after the sale, for example from post-mortem analyses of why the issuer later went bankrupt, may be significant in determining whether the defendant might have known the true status of the issuer had he exercised greater care in forming his opinion and investigating the issuer. Post-transaction evidence may play a valid role and thus properly be admissible in either case, but that role may differ significantly in each.

In a multiparty action involving different sales of the same security over an extended period of time, the same evidence may have different ef-

¹⁷³ See, e.g., *Gross v. Diversified Mortgage Investors*, 431 F. Supp. 1080, 1087-88 (S.D.N.Y. 1977). See also *Heit v. Weitzen*, 402 F.2d 909, 914 (2d Cir. 1968); *Raskas v. Supreme Equip. & Sys. Corp.*, 71 F.R.D. 672, 673-74 (E.D.N.Y. 1976); *Lewis v. Marine Midland Grace Trust Co. of New York*, 63 F.R.D. 39, 44 (S.D.N.Y. 1973). But see *Rich v. Touche Ross & Co.*, 415 F. Supp. 95, 98-99 (S.D.N.Y. 1976); *Vogel v. Brown*, [1974-75 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,831, at 96,785 (S.D.N.Y. 1974). See note 209 *infra* re "recklessness."

¹⁷⁴ See, e.g., *Alton Box Bd. Co. v. Goldman, Sachs & Co.*, 560 F.2d 916, 923 (8th Cir. 1977); *Franklin Sav. Bank of New York v. Levy*, 551 F.2d 521, 527 (2d Cir. 1977), regarding the distinction between factual statements and mere opinions and the duties of a dealer who expressly or impliedly represents that securities are safe and sound investments.

As one leading commentator on securities fraud actions has explained:

A statement made with a reasonable basis is not misleading merely because future events do not bear out the statement. However, if those future events were reasonably foreseeable, that fact alone should be some evidence that the original investigation was not sufficiently complete.

Unlike the other statements discussed in this section, opinions and estimates may relate to a presently existing fact, as well as to a future status. Present facts can be classified into those which can be ascertained with reasonable accuracy after a reasonable investigation (such as the number of items in the inventory of a small business), and those which cannot be so ascertained (such as the amount of ore in a newly-found gold mine). An opinion or estimate regarding an ascertainable fact (the former of the two classes) is the same as a representation of a present fact. Therefore, a statement pertaining to ascertainable facts is misleading if the data are not as represented, even though it is couched in terms of an estimate or opinion. On the other hand, when the facts cannot be reasonably ascertained, the speaker nevertheless should have a reasonable basis for his opinion or estimate and should believe it true, like any opinion or estimate of a future event.

Jacobs, *What is a Misleading Statement or Omission Under Rule 10b-5?*, 42 FORDHAM L. REV. 243, 284-85 (1973). See also *SEC v. Broadwall Sec., Inc.*, 240 F. Supp. 962, 967-68 (S.D.N.Y. 1965); *SEC v. Macon*, 28 F. Supp. 127 (D. Colo. 1939).

Statements of opinion are also evidence of fraud when there is an intention to deceive by them. See, e.g., *Magnaleasing, Inc. v. Staten Island Mall*, 563 F.2d 567, 569 (2d Cir. 1977); *Gray v. Richmond Bicycle Co.*, 167 N.Y. 348, 357, 60 N.E. 663, 665-66 (1901). See also *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1040-41 (7th Cir. 1977).

fects for the different parties. What may have been material on one date may not be on another. Thus, evidence may be relevant to the claims of one party but irrelevant to those of the other parties, whose transactions preceded or followed the first party's.¹⁷⁵ Yet, in an action involving either multiple purchases over an extended time span or several different defendants who each performed different roles in the transactions at issue, a broad array of evidence may be introduced *en masse*. What is post-purchase for some parties will be pre-purchase for others. The jury may have trouble sifting through this broad array of evidence and deciphering which evidence relates to which particular party or particular claim.¹⁷⁶ Some of the parties, particularly on the defense side, may be prejudiced by this confusing array of evidence, or through juror sympathy evoked by hearing repeated stories of plaintiffs having been injured by the defendants' alleged deceptions. Of course, when there is a serious threat of prejudice or confusion as a result of overlapping evidence, the court may sever the various claims and try them separately.¹⁷⁷ In such a case, the court must determine whether the claimed prejudice outweighs the need for efficient and prompt judicial resolution of the controversy and the requirements that necessary parties be joined in one action and that causes of action not be split. More often than not, the court will probably conclude that severance is neither desirable nor feasible, notwithstanding the potential prejudice from the fact that evidence will be post-transactional on some of the claims.¹⁷⁸ When this problem arises in a jury trial, careful limiting instructions and a special verdict for each party on each claim may suffice to counter the claimed prejudice.¹⁷⁹ In a nonjury trial, the court presumably will be able to sort

¹⁷⁵ See, e.g., *Gelman v. Westinghouse Elec. Corp.*, 73 F.R.D. 60, 68 (W.D. Pa. 1976), *appeal dismissed*, 556 F.2d 699 (3d Cir. 1977), discussed at notes 209-11 *infra*.

¹⁷⁶ See discussion in text at notes 189-93 *infra* for an example. See also cases cited in notes 177-80 *infra*.

¹⁷⁷ FED. R. CIV. P. 42(b). The rule recognized that severance cannot be permitted where one's jury trial rights would be impaired. It provides:

(b) SEPARATE TRIALS. The court, in furtherance of convenience or to avoid prejudice, or when separate trials will be conducive to expedition and economy, may order a separate trial of any claim, cross-claim, counterclaim, or third-party claim, or of any separate issue or of any number of claims, cross-claims, counter-claims, third-party claims, or issues, always preserving inviolate the right of trial by jury as declared by the Seventh Amendment to the Constitution or as given by a statute of the United States.

The rule is addressed to the discretion of the court. See, e.g., *Garber v. Randell*, 477 F.2d 711, 714-15 (2d Cir. 1973); *Richmond v. Weiner*, 353 F.2d 41, 44-45 (9th Cir. 1965), *cert. denied*, 384 U.S. 928 (1966).

¹⁷⁸ See, e.g., *Garber v. Randell*, 477 F.2d 711, 714-15 (2d Cir. 1973); *United States v. Benigno*, [1976-77 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,812, at 90,934-35 (S.D.N.Y. 1976); *Anderson v. F.I. duPont & Co.*, 291 F. Supp. 705, 711-12 (D. Minn. 1968); *State Mutual Life Assurance Co. of America v. Peat, Marwick, Mitchell & Co.*, 49 F.R.D. 202, 207-10 (S.D.N.Y. 1969); *Goodman v. H. Hentz & Co.*, 265 F. Supp. 440, 443 (N.D. Ill. 1967). See also *Value Line Fund, Inc. v. Marcus*, 161 F. Supp. 533, 537 (S.D.N.Y. 1958); *United States v. Benigan*, [1976-77 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,872 (S.D.N.Y. 1977). See also note 189 *infra*.

¹⁷⁹ See rule 105 of the Federal Rules of Evidence and rules 49 and 51 of the Federal Rules of Civil Procedure. See *United States v. Kahn*, 381 F.2d 824, 837-38 (7th Cir. 1967), *cert. denied*, 389 U.S. 1015 (1967), and *United States v. Rosenberg*, 195 F.2d 583, 596 (2d Cir. 1952), *cert. denied*, 344 U.S. 838 (1952), *rehearing denied*, 344 U.S. 889 (1952), for examples of limiting instructions in a non-securities context. See generally 1 WEINSTEIN, *supra* note 38, ¶ 105[05] (1977).

out the overlapping evidence to determine which is relevant to the different parties and different claims.¹⁸⁰

Welch Foods, Inc. v. Goldman, Sachs & Co.,¹⁸¹ illustrates the complex evidentiary problems which may arise in multiparty, multclaim securities litigation. *Welch* was the bellwether action of a large multidistrict proceeding, *In re Penn Central Commercial Paper Litigation*,¹⁸² brought by the holders of the commercial paper which Penn Central Transportation Company

See also *Anderson v. F.I. duPont & Co.*, 291 F. Supp. 705, (D. Minn. 1968), a securities action where the court stated:

DuPont and Ritten argue that the jury will become confused due to the length of trial and the complexity of the issues, and will therefore be unable to keep clearly in mind the facts as to each defendant. Such a claim has been held to be not a showing of prejudice. *Fleischman v. Harwood*, 10 F.R.D. 139 (D.C.N.Y. 1950); *Eichinger v. Fireman's Fund Ins. Co.*, 20 F.R.D. 204 (D.C. Neb. 1957). But it is also clear that any danger of prejudice resulting from a joint trial can be avoided by proper instructions to the jury. *Grissom v. Union P.R.R.*, 144 F.R.D. 263 (D.C. Colo. 1953); *Psaroubas v. United Greek Shipowners Corp.*, 5 F.R.D. 398 (D.C.N.Y. 1946). As the Court in *Psaroubas* points out, the refusal to try the cases separately also avoids the possibility of perverse verdicts against plaintiffs.

Id. at 711-12.

There is also much authority for the proposition that a jury is presumed to have understood and heeded the court's instructions. *See, e.g., Kukuruzza v. General Elec. Co.*, 510 F.2d 1208, 1218 (1st Cir. 1975). *See also* *United States v. Kilcullen*, 546 F.2d 435, 447 (1st Cir. 1976), *cert. denied*, 430 U.S. 906 (1977); *Peelers Co. v. Wendi*, 260 F. Supp. 193, 203 (W.D. Wash. 1966). *But see* *Krulewicz v. United States*, 336 U.S. 440, 453 (1949) (Jackson, J., concurring). Whether or not this is a realistic proposition, it is an essential one, if there is to be an orderly prosecution and trial of actions. Otherwise, the appellate courts would be deluged with speculation as to the mental processes and responsiveness of the jurors. *See also* *Garnatz v. Stifel, Nicolaus & Co., Inc.*, 559 F.2d 1357 (8th Cir. 1977). Nevertheless, there are situations where the use of a limiting instruction has been held to be an insufficient protection against potential prejudice. *See, e.g., Bruton v. United States*, 389 U.S. 818 (1968). Each situation must be examined on its own particular facts to determine whether such an instruction will or will not suffice.

Under rule 49 of the Federal Rules of Civil Procedure the court "may require a jury to return only a special verdict in the form of a special written finding upon each issue of fact" or "may submit to the jury, together with appropriate forms for a general verdict, written interrogatories upon one or more issues of fact the decision of which is necessary to a verdict." *See generally* 5A MOORE'S, *supra* note 14, ¶ 49 (1977). For an example of the actual use of the special verdict procedure in a securities action, *see* *Fox v. Kane-Miller Corp.*, 398 F. Supp. 609 (D. Md. 1975), *aff'd*, 542 F.2d 915 (4th Cir. 1976).

¹⁸⁰ At least some of the concerns in allowing jurors to hear the evidence, as summarized by Professor McCormick in note 83 *supra*, are obviously inapplicable on their face to judges. It is presumed that the court will appreciate the importance of the rules of evidence and will heed them. But judges too are only persons and, thus, may also be susceptible to suggestion as a result of improper evidence. In recognition of that fact, trial judges in non-jury cases often decline to conduct settlement discussions with counsel where settlement figures are to be mentioned, so as not to taint their thinking. In such situations, a "neutral" judge or a magistrate will often substitute for the trial judge at settlement conferences. On the other hand, the court must rule on the evidence and, to do so, simply must often pass on preliminary matters going to its admissibility (see note 83 *supra*). As a practical matter, if the court does not hear all of the proffered evidence, it will not be able to conduct the trial. FED. R. EVID. 104(a) therefore mandates that the judge make such evidentiary rulings. In the last analysis, it will be incumbent upon the trial judge himself to determine whether improperly proffered or admitted evidence has been so prejudicial that it renders even him incapable of rendering a just decision.

¹⁸¹ 398 F. Supp. 1393 (S.D.N.Y. 1974).

¹⁸² 337 F. Supp. 1335 (J.P.M.D.L. 1972) and 358 F. Supp. 284 (J.P.M.D.L. 1973). *See also* notes 184-89 *infra*; *In re Penn Cent. Sec. Litigation*, 325 F. Supp. 309 (J.P.M.D.L. 1971).

(PCTC) issued shortly before it filed for reorganization under the bankruptcy laws on June 21, 1970. The plaintiffs sued Goldman, Sachs & Co., the commercial paper dealer which had marketed the commercial paper, for rescission under sections 12(2) and 17(a) of the Securities Act of 1933, rule 10b-5 and section 10(b) of the Securities Exchange Act of 1934, and under the pertinent state blue sky laws and common law.¹⁸³ The litigation resulted in several reported decisions on important questions relating to jurisdiction,¹⁸⁴ discovery,¹⁸⁵ multidistrict procedure,¹⁸⁶ evidence¹⁸⁷ and the merits of securities claims.¹⁸⁸

The plaintiffs in *Welch* had purchased their holding of PCTC commercial paper at different times, one in January 1970 (Anthony), one in February 1970 (Yunker), and another in March and April 1970 (Welch). Following a jury trial, they won a multimillion dollar jury verdict under section 12(2) and rule 10b-5 and, in Welch's case, under the New York blue sky law. The facts applicable to the three different plaintiffs' purchases varied, yet the same jury heard all of the facts offered for each plaintiff. Goldman, Sachs' motion to sever the claims, grounded on the contention that it would be prejudiced if the jury heard all the evidence, was denied.¹⁸⁹ The court found that there was a reasonable relationship among the claims of all of the parties and that considerations of judicial economy outweighed the possible prejudice to Goldman, Sachs arising from a joint trial.

The aspect of the case dealing with the events of the first quarter of 1970 illustrates the overlap of evidence problem. The year-end financial results of PCTC were issued on February 4, 1970, four days after Anthony's

¹⁸³ The claims under § 17(a) were dismissed on the ground that that section does not create a private right of action. 398 F. Supp. at 1401. Whether § 17(a) creates a private right of action is a sharply disputed issue. See Kaminsky, *An Analysis of Securities Litigation Under Section 12(2) and How It Compares with Rule 10b-5*, 13 HOUS. L. REV. 231, 234 n.19 (1976). See also *Alloys Unlimited, Inc. v. Raesler*, [1976-77 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,639, at 90,170 (N.Y. Sup. Ct. 1976), *aff'd*, 55 App. Div. 2d 893, 391 N.Y.S. 2d 371 (1977). The court in *Welch* also dismissed the common law claims and the blue sky claims of the parties other than Welch. 398 F. Supp. at 1401.

¹⁸⁴ *Welch Foods, Inc. v. Goldman, Sachs & Co.*, 398 F. Supp. 1393 (S.D.N.Y. 1974). See also *Franklin Sav. Bank of New York v. Levy*, 551 F.2d 521, 523-25 (2d Cir. 1977); *Mallinckrodt Chem. Works v. Goldman, Sachs & Co.*, 420 F. Supp. 231, 240 (S.D.N.Y. 1976).

¹⁸⁵ *Goldman, Sachs & Co. v. Edelstein*, 494 F.2d 76 (2d Cir. 1974); *In re Penn Cent. Commercial Paper Litigation*, 61 F.R.D. 453 (S.D.N.Y. 1973) (attorney-client privilege); *Mallinckrodt Chem. Works v. Goldman, Sachs & Co.*, 58 F.R.D. 348 (S.D.N.Y. 1973) (discovery of documents turned over to SEC for confidential SEC investigation).

¹⁸⁶ *In re Penn Cent. Commercial Paper Litigation*, 62 F.R.D. 341 (S.D.N.Y. 1974), *aff'd sub nom. Shulman v. Goldman, Sachs & Co.*, 515 F.2d 505 (2d Cir. 1975) (power of transferee court to permit intervention in multidistrict actions). See also *In re Penn Cent. Sec. Litigation*, 325 F. Supp. 309 (J.P.M.D.L. 1971) (severance of third party actions for purposes of 28 U.S.C. § 1407); *In re Equity Funding Sec. Litigation*, 375 F. Supp. 1378 (J.P.M.D.L. 1974).

¹⁸⁷ *In re Penn Cent. Commercial Paper Litigation*, 61 F.R.D. 453, 461-64 (S.D.N.Y. 1973). See also *Alton Box Bd. Co. v. Goldman, Sachs & Co.*, 560 F.2d 916, 919 n.3 (8th Cir. 1977).

¹⁸⁸ *Alton Box Bd. Co. v. Goldman, Sachs & Co.*, 560 F.2d 916 (8th Cir. 1977); *Franklin Sav. Bank of New York v. Levy*, 551 F.2d 521 (2d Cir. 1977); *University Hill Foundation v. Goldman, Sachs & Co.*, 422 F. Supp. 879 (S.D.N.Y. 1976); *Welch Foods, Inc. v. Goldman, Sachs & Co.*, 398 F. Supp. 1393 (S.D.N.Y. 1974). See also *Mallinckrodt Chem. Works v. Goldman, Sachs & Co.*, 420 F. Supp. 231 (S.D.N.Y. 1976); *SEC v. Goldman, Sachs & Co.*, [1973-74 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,556 (S.D.N.Y. 1974).

¹⁸⁹ See Transcript of Pretrial Conference, Oct. 31, 1972, at 25-26, *Welch Foods, Inc.*, 398 F. Supp. 1393 (S.D.N.Y. 1974). See also note 178 *supra*.

purchase, but before Younker's and Welch's purchases. On February 5 and 6, two Goldman, Sachs partners met with officers of PCTC and received inside information that PCTC's prospects for the remainder of 1970 were bleak. Shortly after that meeting, PCTC bought back—at defendant Goldman, Sachs' request—ten million dollars of PCTC commercial paper which Goldman, Sachs was holding in its own inventory. Within two weeks, Goldman, Sachs had sold the balance of its PCTC notes. While the defendant was in the midst of selling its own holdings, it sold PCTC notes to Younker without revealing its knowledge of these new developments. Thereafter, Goldman, Sachs again began to carry PCTC notes in its inventory. On March 23, 1970, before its sales to Welch, Goldman, Sachs' principal commercial paper partner received a phone call from the financial vice president of PCTC. The PCTC vice president provided him with inside information that PCTC's earnings would be "terrible" for the calendar quarter to end March 31, 1970, the date of Welch's first purchase. Goldman, Sachs failed either to investigate this tip or to inform any of the plaintiffs of its contents. On April 14, 1970, two weeks after Welch's purchases, Goldman, Sachs again was advised that PCTC's results for the first quarter of 1970 (which had still not been publicly released) would be "terrible." Goldman, Sachs promptly sold its own holdings of PCTC commercial paper, just prior to PCTC's public announcement of the earnings figures. It never again carried PCTC commercial paper in its inventory, and stopped marketing the notes altogether on about May 1, 1970.¹⁹⁰

At the trial, the jury, which had to decide the Anthony claim, heard all about the bad news of February 4-6, subject of course to a strict limiting instruction from the court. The jury also heard all about the Goldman, Sachs inventory reduction of mid and late February, even though it was to decide the Younker claim relating to purchases before that in early February, again subject to a limiting instruction. The jury also heard about the March events, since the nondisclosure of those events was claimed to be part of Welch's case regarding its March and April purchases.

The admission of that evidence and the end results in *Welch* appear to have been proper, but there remains the unanswerable question of whether the limiting instructions actually worked, particularly on Anthony's January claim. In subsequent actions by single plaintiffs, purchasers as of mid-February and mid-March also prevailed without the benefit of the late March evidence, but their successes are less informative since they also had the benefit of the crucial February evidence.¹⁹¹ A more interesting com-

¹⁹⁰ A detailed statement of the factual basis for the claims is contained in the opinions in companion cases, particularly in *University Hill Foundation v. Goldman, Sachs & Co.*, 422 F. Supp. 879, 885-92 (S.D.N.Y. 1976). An even more extensive factual chronology is contained in the STAFF REPORT, SEC, *THE FINANCIAL COLLAPSE OF THE PENN CENTRAL COMPANY*, PART III, at 271-302 (1972).

¹⁹¹ See cases cited in note 188 *supra*. The potential importance of that post-purchase evidence is illustrated by the conclusion of the SEC Staff in its report, *supra* note 190; regarding the February reduction of Goldman, Sachs' inventory of Penn Central notes following the February 5 and 6, 1970 conversations with Penn Central's officers; the SEC report stated: "Goldman Sachs' analysis about the significance of the [1969] year-end results may be ascertained with greater reliability from the actions they took rather than from their statements." *Id.* at 284. The plaintiffs in the Penn Central litigation sought unsuccessfully to draw this same inference from Goldman, Sachs' April reduction of its Penn Central inventory after the March 23, 1970 telephone conversation referred to in the text. As noted in the text, this particular post-transaction evidence was ruled inadmissible.

parison would have occurred if a January purchaser had tried its case alone but none ever did. *Welch* demonstrates how post-purchase evidence can be a knotty problem in securities cases, but it fails to tell us whether the supposed safeguard of a limiting instruction really works.

There is of course an entirely different and equally plausible view on the *Welch* case problem, and it may be the right one. This latter view holds that the evidence was properly received, regardless of the time sequence, because it was reasonably related to the chain of events at issue—the financial collapse of Penn Central. If the plaintiffs were arguing too broad a view of the post-purchase evidence, this view maintains, Goldman, Sachs could and should have shown that and explained it to the jury. The jury then could decide what significance to give to the evidence. Indeed, plaintiffs may be making a tactical error in offering post-purchase evidence of the type offered in *Welch*, because the defendant may be able to point to such evidence to show that the defendant did not actually know what was happening and only learned the facts after the purchase at issue.¹⁹² Moreover, defendants may even argue that such evidence shows their lack of bad faith and fraudulent intent at the time of the purchases.¹⁹³

Interestingly, to complete the story regarding the Penn Central litigation, the trial judge in *Welch* ruled out all evidence regarding the mid-April events, since it was post-purchase and therefore irrelevant to all of the purchases at issue at the trial.¹⁹⁴ The court rejected the plaintiffs' argument that, on their rule 10b-5 claims, the evidence showed Goldman, Sachs' intent: for example, that Goldman, Sachs' April elimination of its own inventory evidenced a predatory attitude and thus indicated Goldman, Sachs' intentions when it sold to Welch. The plaintiffs also argued unsuccessfully that the April evidence showed the nature and quality of Goldman, Sachs' relationship with PCTC, insofar as Goldman, Sachs had ready access to important nonpublic information and, thus showed what Goldman, Sachs could have learned with reasonable diligence which was directly at issue on the plaintiffs' section 12(2) and blue sky claims. With respect to Welch's purchases, the plaintiffs' argued that the evidence about the first quarter results also showed PCTC's true financial status on the dates of the purchases. This fact, they suggested was relevant on the section 12(2) claims, which are analogous to innocent misrepresentation claims at common law, since intent to defraud and scienter need not be proven under section 12(2).¹⁹⁵ The district court rejected all of those offers of proof. Although it did not state its reasoning, the court was apparently not convinced that the plaintiffs had shown a sufficient link between the evidence and their claims. The court may also have felt that the potential prejudice of the post-

¹⁹² Cf., e.g., *Pittsburgh Coke & Chem. Co. v. Bollo*, 421 F. Supp. 908, 921-23 (E.D.N.Y. 1976), *aff'd*, 560 F.2d 1089 (2d Cir. 1977) (post-transaction evidence suggested that the defendant was not aware at time of transaction); *Devonbrook Inc. v. Lily Lynn, Inc.*, [1976-77 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,835, at 91,009-10 (S.D.N.Y. 1977) (evidence does not establish lack of intent at the time of entering agreement).

¹⁹³ See, e.g., notes 122-29 *supra* for an example of such a construction of post-transaction evidence in some of the other Penn Central commercial paper cases.

¹⁹⁴ This same post-transaction evidence was noted and apparently credited with significance in another of the Penn Central commercial paper cases. See *Alton Box Bd. Co. v. Goldman, Sachs & Co.*, 560 F.2d 916, 924 n.11.

¹⁹⁵ See cases cited in note 270 *infra*.

purchase evidence—the shock effect from the admittedly disastrous results and Goldman, Sachs' prudent but self-serving conclusion that PCTC was no longer a viable investment—was too great to risk admitting evidence which appeared to be only tangentially, if at all, relevant to the claims of the particular plaintiffs.¹⁹⁶

Welch thus illustrates the balancing nature of the court's inquiry in complex and multiparty securities actions. Evidence such as that ruled out in *Welch* may well be deemed relevant and properly admissible in a different action or another securities context. The court must consider many factors in deciding whether to admit the evidence itself: for example, the time lapse between the dates of the evidence and the securities purchases at issue, whether the evidence can be said to relate back to earlier events, whether the facts involve a continuum of events constituting one story or merely a series of independent events, the claimed potential prejudice, the feasibility of the defendant's explaining its meaning and the relationship of the evidence to the other evidence in the action and whether it is merely cumulative and hence unnecessary. It may well be proper to admit the evidence and allow the fact finder to ascribe the degree of weight it warrants to the evidence, but it seems wise to have that matter determined on a case-by-case basis.¹⁹⁷

H. Lack of Due Diligence

Defendants often argue that plaintiffs in securities litigation should not be permitted to recover because they failed to act with due diligence in embarking on the transaction leading to the litigation. This defense is analogous to the contributory negligence defense in negligence actions. Somewhat analogously, defendants also argue that the plaintiff's reliance upon an alleged misrepresentation or omission was unreasonable in light of the circumstances surrounding the transaction. Post-transaction evidence may help to prove or disprove the validity of these proffered defenses. It is in the context of these defenses that defendants most often offer post-transaction evidence.¹⁹⁸

Recent United States Supreme Court securities decisions, however, have literally changed the character of securities fraud litigation,¹⁹⁹ necessitating a rethinking of whether the due diligence defense should be available to defendants. Such a defense might make sense where the claim is premised upon the defendant's negligence; but most "negligence" securities

¹⁹⁶ At the time of the *Welch* trial in 1974, the Federal Rules of Evidence, in particular rule 403 (see notes 251-56 *infra*, were not yet in force. However, as Judge Weinstein has observed: "In the absence of redeeming probative value, exclusion of evidence because of its capacity for prejudice has long been the practice." WEINSTEIN, *supra* note 38, ¶ 403(03), at 403-15 (1976).

¹⁹⁷ See notes 254 & 259 *infra*.

¹⁹⁸ As one commentator has explained, "[i]t is perhaps more difficult to select an appropriate name for the defense than it is to discuss its elements and use. Various courts have required evidence that the claimant exercised reasonable care on his own behalf in connection with the transaction, but few have employed the same terminology." Wheeler, *Plaintiff's Duty of Due Care Under Rule 10b-5: An Implied Defense to An Implied Remedy*, 70 NW. L. REV. 561, 563 n.7 (1975). See also Note, *Scope of the Due Diligence Defense*, 50 TEMPLE L. Q. 124, 127 n.25 (1976); Campbell, *Elements of Recovery Under Rule 10b-5*, 26 S.C. L. REV. 653 (1975); Note, *The Due Diligence Requirement for Plaintiffs Under Rule 10b-5*, 1975 DUKE L. REV. 753 (1975).

¹⁹⁹ See note 218 *infra*.

sections have been held to exclude such a defense because of the legislative and public policy underlying their enactment.²⁰⁰ Claims under provisions which require proof of scienter, moreover, are not negligence claims. It is highly questionable whether a negligence-type defense such as the plaintiff's alleged lack of reasonable care should be permitted to defeat a claim based upon intentional deceit, as rule 10b-5 and section 17(a) actions now must be.²⁰¹

If, as in common law fraud actions, proof of scienter is necessary to sustain a rule 10b-5 claim against the defendant, then an analogy to common law fraud appears to be appropriate in determining the degree of conduct to be required of the victims of the fraud.²⁰² It has been said that the requirements of a rule 10b-5 action are *less* stringent than a common law fraud action.²⁰³ Unless we intend to make the requirements of a securities fraud action *more* stringent than those needed to sustain a common law fraud claim—a result which this writer submits would undercut the very purposes of the securities laws²⁰⁴ and render them mere surplusage—care must be taken to limit defenses like the due diligence defense which are premised upon concepts analogous to contributory negligence and assumption of risk.²⁰⁵ Those defenses are not available in a common law fraud ac-

²⁰⁰ See, e.g., *Hill York Corp. v. American Int'l Franchises, Inc.*, 448 F.2d 680, 696 (5th Cir. 1971); Kaminsky, *An Analysis of Securities Litigation Under Section 12(2) and How It Compares With Rule 10b-5*, 13 HOUS. L. REV. 231, 233 (1976). See note 6 *supra* for the text of section 12(2).

²⁰¹ See notes 218-24 & 271 *infra*. Thus, in *Holdsworth v. Strong*, 545 F.2d 687 (10th Cir. 1976), the court of appeals stated: "If the negligence standard were being applied it might be appropriate to allow due diligence to be exacted from the victim, but where liability of the defendant requires proof of intentional misconduct, the exaction of a due diligence standard from the plaintiff becomes irrational and unrelated." *Id.* at 692. *Accord*, *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1040 (7th Cir. 1977). See also Calhoun, *Divining the Implications of Hochfelder*, 2 CORP. L. REV. 99 (1978).

²⁰² See cases cited in note 224 *infra*. See also *Alloys Unlimited, Inc. v. Raesler*, [1976-77 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,639, at 90,170 (Sup. Ct. N.Y. Co. 1976), *aff'd*, 55 App. Div. 2d 893, 391 N.Y.S.2d 371 (1st Dept. 1977), where the court stated:

The defendants-by-counterclaim also contend due care was not exercised by defendants in discovering the alleged omissions and misrepresentations and that the defendants are therefore barred from maintaining a cause of action (by way of counterclaim) based on fraud. This contention is without merit since the absence of due care in a fraud action is not a defense.

²⁰³ See, e.g., *Norris & Hirschberg, Inc. v. SEC*, 177 F.2d 228, 233 (D.C. Cir. 1949); *Hughes v. SEC*, 174 F.2d 969, 975-76 (D.C. Cir. 1949); *Speed v. Transamerica Corp.*, 99 F. Supp. 808, 828 (D. Del. 1951). See also *Fischman v. Raytheon Corp.*, 188 F.2d 783 (2d Cir. 1951).

²⁰⁴ As a leading securities commentator noted more than a decade ago: "[I]t must be remembered that the broader concern for the integrity of securities markets is the dominant policy theme." Fleischer, *Securities Trading and Corporate Information Practices: The Implications of the Texas Gulf Sulphur Proceeding*, 51 VA. L. REV. 1271, 1275 (1965).

The United States Supreme Court stated in *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963), that the policy of the federal securities laws was "to substitute a philosophy of full disclosure for the philosophy of *caveat emptor*" that existed under the old common law. See also note 211 *infra*.

²⁰⁵ Thus, e.g., in *Holdsworth v. Strong*, 545 F.2d 687 (10th Cir. 1976), the court of appeals stated:

Use of the tort analogy plainly demonstrates the inappropriateness of due diligence in 10b-5 suits under the *Ernst & Ernst* doctrine, for the due diligence standard as applied to 10b-5 suits is about the same as the application of contributory negligence. Just as contributory negligence is not a defense to an inten-

tion, and should not be in a rule 10b-5 action either.²⁰⁶

While scienter may not be inferred from mere negligence at common law, such an inference may be permissible where the plaintiff is shown to have acted with reckless disregard for the facts. Reckless indifference to the facts may amount to constructive knowledge by the plaintiff,²⁰⁷ just as recklessness may constitute constructive fraud by the defendant at common law.²⁰⁸ On this theory, post-*Hochfelder* lower court decisions have held that proof of the defendant's recklessness may satisfy the requirement of scienter in rule 10b-5 actions,²⁰⁹ and it thus may be appropriate to require

tional tort case of fraud, similarly due diligence is totally inapposite in the context of intentional conduct required to be proved under Rule 10b-5.

Further support for this conclusion is found in the statutory language upon which the Supreme Court in *Ernst & Ernst* placed reliance in determining that the Act was meant to proscribe intentional conduct only. Nothing in the wording of either the statute or the rule suggests that a plaintiff is to be barred by failure to exercise due care or due diligence. Nor is there evidence that the framers of 10b-5 intended due diligence to be applicable any more than it had been applied to common law fraud.

Id. at 694. (emphasis in original).

²⁰⁶ See, e.g., *Albany City Sav. Inst. v. Burdick*, 87 N.Y. 40, 48 (1881); *Angerosa v. White Co.*, 248 App. Div. 425, 429, 290 N.Y.S. 204, 211 (App. Div.), *aff'd*, 275 N.Y. 524 (1936); *Rosenchein v. McNally*, 17 App. Div. 2d 834, 834, 233 N.Y.S.2d 254, 256 (1962).

It should also be remembered, however, that those defenses are not available in an action under § 12(2). *Johns Hopkins University v. Hutton*, 297 F. Supp. 1165, 1221-22 (D. Md. 1968), *rev'd on other grounds*, 422 F.2d 1124 (4th Cir. 1970). See also *American Bank & Trust Co. v. Joste*, 323 F. Supp. 843, 847 (W.D. La. 1970).

²⁰⁷ See note 224 *infra*. See also PROSSER ON TORTS § 34, at 185 (1971). This concept appears to have been the intention of those pre-*Hochfelder* cases which required due diligence while also requiring scienter under rule 10b-5. See, e.g., *Clement A. Evans & Co. v. McAlpine*, 434 F.2d 100, 104 (5th Cir. 1970); *Frigitemp Corp. v. Financial Dynamics Fund, Inc.*, 524 F.2d 275, 282 (2d Cir. 1975); *Mitchell v. Texas Gulf Sulphur Co.*, 446 F.2d 90, 103 (10th Cir. 1971).

This concept has found its way into some § 12(2) cases as a requirement that there be some causal connection between the alleged untruth or omission and the stock purchase at issue. See, e.g., *Jackson v. Oppenheim*, 533 F.2d 826, 829 n.8 (2d Cir. 1976). But it is important not to elevate this requirement to the level of requiring scienter or reliance, neither of which is required under § 12(2). See *Hill York Corp. v. American Int'l Franchises, Inc.*, 448 F.2d 680, 695 (5th Cir. 1971). See also *University Hill Foundation v. Goldman, Sachs & Co.*, 422 F. Supp. 879, 892-93 (S.D.N.Y. 1976).

²⁰⁸ See *United States v. Garcia & Diaz, Inc.*, 291 F.2d 242, 245 (2d Cir. 1961); *Pinney & Topliff v. Chrysler Corp.*, 176 F. Supp. 801, 803 (S.D. Calif. 1959); *Gonsalves v. Hodgson*, 38 Cal.2d 91, 100, 237 P.2d 656, 662 (1951); *State St. Trust Co. v. Ernst*, 278 N.Y. 104, 112, *rehearing denied*, 278 N.Y. 704 (1938).

²⁰⁹ See, e.g., *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1044-45 (7th Cir. 1977); *Bailey v. Meister Brau, Inc.*, 535 F.2d 982, 993 (7th Cir. 1976); *Bartels v. Algonquin Properties, Ltd.*, [1976-77 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,870, at 91,204 (D. Vt. 1977); *Continental Assurance Co. v. American Bankshares*, [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,274, at 92,765-67 (E.D. Wisc. 1978). But see *Maudlin v. Schaffer*, [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,211, at 92,456 (M.D. N. C. 1977).

In *Sanders v. John Nuveen & Co., Inc.*, 554 F.2d 790 (7th Cir. 1977), the court of appeals defined such "recklessness" as follows: "We believe 'reckless' in these circumstances comes closer to being a lesser form of intent than merely a greater degree of ordinary negligence. We perceive it to be not just a difference in degree, but also in kind." *Id.* at 793. See also discussion in *Gross v. Diversified Mortgage Investors*, [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,137, at 92,108-09 (S.D.N.Y. 1977); *Steinberg v. Carey*, 439 F. Supp. 1233, 1237-39 (S.D.N.Y. 1977); *Coleco Indus. Inc. v. Berman*, 423 F. Supp. 275, 295-96 (E.D. Pa. 1976).

In *Rolf v. Blyth, Eastman Dillon & Co., Inc.*, 570 F.2d 38 (2d Cir. 1978), the court of appeals explained why and where it felt recklessness should be permitted to satisfy the scienter

that the plaintiff act without recklessness in the transaction. Consequently, where the plaintiff has acted recklessly, the defendant may be able to assert a defense analogous to due diligence.

There is, however, another possible view of the admissibility of a recklessness defense with which the courts are struggling in the wake of the *Hochfelder* decision.²¹⁰ Under this view, *Hochfelder* should not be read to "alter the underlying purpose of the securities laws to" insure full disclosure in securities transactions.²¹¹ Accordingly, it is argued, tipping the due diligence balance against the defendant is necessary and appropriate to encourage full disclosure and to deter wrongful conduct. According to this view, *Hochfelder* and other recent Supreme Court decisions²¹² restricting the scope of securities fraud actions merely represent a response to prior excesses whereby the courts had imposed virtual strict liability on securities defendants.²¹³ Pre-*Hochfelder* decisions had caused defendants to protest

requirement. Among its reasons was the following:

A final basis for applying a recklessness standard in certain instances rests perhaps on the practical problem of proof in private enforcement under the securities laws. Proof of a defendant's knowledge or intent will often be inferential, see Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy in Pari Delicto, Indemnification, and Contribution*, 120 U. PA. L. REV. 597, 635 (1972), and cases thus of necessity cast in terms of recklessness. To require in all types of 10b-5 cases that a fact-finder must find a specific intent to deceive or defraud would for all intents and purposes disembowel the private cause of action under § 10(b).

Id. at 47. (Emphasis in original). See also *Stratton Group v. Sprayregen*, [Current] FED. SEC. L. REP. (CCH) ¶ 96,302, at 93,016-17 (S.D.N.Y. 1978).

²¹⁰ Cf. the lines of cases cited in note 224 *infra*.

²¹¹ See note 204 *supra*. See, e.g., *Goldberg v. Meridor*, 567 F.2d 209, 216-18 (2d Cir. 1977), for one recent reaction to *Hochfelder* and other recent Supreme Court decisions. See also, *Crane Co. v. American Standard, Inc.*, 439 F. Supp. 945, 953-54 (S.D.N.Y. 1977).

²¹² See note 218 *infra*.

²¹³ This trend had a particularly severe effect upon professionals, like lawyers and accountants, who are not themselves "seekers" of securities in the cases involving them. See Van Graafeiland, *Forward: A Lawyer's Observations on Hochfelder*, 51 ST. JOHNS L. REV. 239 (1977); Lowenfels, *Expanding Public Responsibilities of Securities Lawyers: An Analysis of the New Trend in Standard of Care and Priorities of Duties*, 74 COLUM. L. REV. 412 (1974).

Judge Van Graafeiland has observed that application of the *Hochfelder* rule continues to leave much leeway to the courts in such actions:

Unfortunately, the boundary line between "mere negligence" and "something more" is a hazy one, and the *Hochfelder* rule could well be emasculated by defining too narrowly the nature of the conduct which may properly be described as negligent. Where there have been knowing, material misstatements of fact, application of rule 10b-5 is simple. Where, however, liability is asserted because of a failure to discover and disclose what should have been known or because of a deviation from generally accepted accounting principles, difficulty may be encountered in distinguishing conduct which is actionable from that which is simply negligent.

Although it is well established neither accountants nor lawyers may close their eyes to that which is plainly visible, the extent of their duty to inquire and disclose is not so clear.

51 ST. JOHNS L. REV. at 245. See, e.g., *Herzfeld v. Laventhol, Krekstein, Horwarth & Horwarth*, 540 F.2d 27, 37 (2d Cir. 1976); *Gross v. Diversified Mortgage Investors*, [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,136, at 92,108-09 (S.D.N.Y. 1977); *Oleck v. Fischer*, [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,179, at 92,328-29 (S.D.N.Y. 1977); *McLean v. Alexandra*, 420 F. Supp. 1057, 1080-82 (D. Del 1976), indicating that the courts are retaining flexibility in approaching the scienter question in cases involving professionals. This is probably appropriate and important, notwithstanding the legitimate concerns raised by Judge Van Graafeiland. The courts must strive to maintain a proper balance between the

that both the courts and the SEC had lost sight of the practicalities and realities of the securities industry.²¹⁴ But cases such as *Hochfelder, Chris-Craft Industries, Inc. v. Piper Aircraft Corp.*,²¹⁵ *TSC Industries, Inc. v. Northway, Inc.*,²¹⁶ and *Blue Chip Stamps v. Manor Drug Stores*²¹⁷ seem to have done more than redress past excesses; they have severely narrowed the scope of rule 10b-5 and, according to advocates of an expansive reading of 10b-5, unnecessarily and perhaps unwittingly removed too much of its strength.²¹⁸

need to insure that professionals approach their duties diligently and the also important need to preserve their ability to function economically and realistically in the securities market. A case-by-case analysis appears necessary to achieve this balancing.

The court in one recent securities case summarized the duties of accountants with respect to "after acquired" information as follows:

[A]n accountant is under an additional obligation to conduct a reasonable inquiry, but not an audit, to discover whether events subsequent to the audit period up to the effective date of the registration require disclosure in order to maintain the integrity of the portrayal. [citations omitted]. Where financial statements have been certified and released to the public, courts have imposed a continuous duty to disclose after-acquired information which casts doubt on the reliability of the certified figures *with respect to the period covered by the audit*. [citations omitted].

... The mere possession of adverse financial information regarding a public company does not require an independent auditor to disclose it. [citations omitted]. This remains true even if the auditor previously has certified figures for a prior period, so long as the certified statement is still accurate as of the date of its issuance. [citation omitted].

Ingenito v. Bernec Corp., [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,214, at 92,487 (S.D.N.Y. 1977) (emphasis in original).

²¹⁴ See Coles, *Has Securities Regulation in the Private Capital Markets Become a Deterrent to Capital Growth? A Critical Review*, 58 MARQ. L. REV. 395 (1975); Lipton & Mazur, *The Chinese Wall Solution to Conflict Problems of Securities Firms*, 50 N.Y.U.L. REV. 459 (1975); Ruder, *Current Problems in Corporate Disclosure*, 30 BUS. LAW. 1081 (1975); See also *Lanza v. Drexel & Co.*, 479 F.2d 1277, 1306-08 (2d Cir. 1973) (en banc).

²¹⁵ 480 F.2d 341 (2d Cir.), cert. denied, 414 U.S. 910 (1973).

²¹⁶ 426 U.S. 438 (1976).

²¹⁷ 421 U.S. 723 (1975).

²¹⁸ See *Sante Fe Indus. v. Green*, 430 U.S. 462 (1977); *Piper v. Chris-Craft Indus., Inc.*, 430 U.S. 1 (1977); *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438 (1976); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976); *Blue Chip Stamps v. Manor Drugstores*, 421 U.S. 723 (1975). As one commentator recently wrote:

In the last four years the United States Supreme Court has fundamentally altered the scope of the coverage and protection that the federal securities laws offer to the investing public. The depth and sweep of this change have been particularly extraordinary when one considers the short period of time involved. Before recent Supreme Court decisions, plaintiffs' lawyers and the Securities and Exchange Commission had been relatively free to devise original and imaginative causes of action based upon the federal securities laws. Following these decisions, however, the entire momentum has shifted. In these recent holdings, the Supreme Court has consistently decided in favor of the defendants and has enunciated principles that may circumscribe the rights of plaintiffs under the federal securities laws for many years to come.

Lowenfels, *Recent Supreme Court Decisions Under the Federal Securities Laws: The Pendulum Swings*, 65 GEO. L.J. 891, 891-92 (1977) (footnotes omitted). See also Castruccio, *Developments in Federal Securities Regulation*, 32 BUS. LAW. 1537 (1977).

The courts have also taken note of this trend. See, e.g., *Crane Co. v. American Standard, Inc.*, 439 F. Supp. 945 (S.D.N.Y. 1977):

Chris-Craft does not stand alone. It is not *sui generis*, distinguishable from all other cases because of unusual facts or esoteric points of law. Instead, it is one of several recent Supreme Court decisions which indicate that the Court is taking a hard, new look at federal jurisdiction under the securities laws.

Advocates of this view argue that the courts must resuscitate some of the more protective provisions of the securities laws and reinstate less stringent standards of proof favoring plaintiffs in order to revive the important role that the securities laws play in protecting the public from shady and sloppy securities dealing.²¹⁹

Prior to the *Hochfelder* case and the recent Supreme Court trend narrowing rule 10b-5, the lower courts were moving decidedly toward requiring a showing of due diligence, even in those circuits which had already required proof of scienter in rule 10b-5 actions.²²⁰ Since the *Hochfelder* decision, however, three appellate court decisions which have directly confronted the continuing viability of the due diligence defense question, *Straub v. Vaisman & Co.*,²²¹ *Holdsworth v. Strong*,²²² and *Dupuy v. Dupuy*,²²³ have all recognized that the changes effected by *Hochfelder* warrant a lessening of the burden previously placed on the plaintiff to show his own due diligence. The courts in these cases concluded, by analogy to tort law, that the only contributory fault which now may defeat a rule 10b-5 claim is recklessness or "gross fault somewhat comparable to that of the defendant."²²⁴

Id. at 953-54. For examples of how the courts are struggling with the broader meaning of the recent Supreme Court holdings, compare, e.g., *Goldberg v. Meridor*, 567 F.2d 209, (2d Cir. 1977) with *St. Louis Union Trust Co. v. Merrill Lynch*, 562 F.2d 1040 (8th Cir. 1977).

Recent handling of issues such as "recklessness," see note 209 *supra* and cases therein, and "due diligence," see notes 205 *supra* & 224 *infra*, by the courts of appeals and district courts suggest that those courts are seeking to mollify some of the more extreme interpretations of the Supreme Court decisions. See also *Graham v. Exxon Corp.*, [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,279 (S.D.N.Y. 1978), and *Clayton v. Skelly Oil*, [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,269 (S.D.N.Y. 1978) as further examples of this possible liberalizing effect by the lower courts.

²¹⁹ See, e.g., *Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 480 F.2d 341, 369 (2d Cir.), cert. denied, 414 U.S. 910 (1973); *Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544, 580-81 (E.D.N.Y. 1971); *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643, 696-97 (S.D.N.Y. 1968).

As Judge Weinstein stated in *Feit*, "Dealer-managers . . . are expected to exercise a high degree of care in investigation and verification of the company's representations. Tacit reliance on management assertions is unacceptable; the underwriters must play devil's advocate." 332 F. Supp. at 582.

²²⁰ See cases cited in note 207 *supra*. See also *Spielman v. General Host Corp.*, 538 F.2d 39, 40-41 (2d Cir. 1976); *Architectural League v. Bartos*, 404 F. Supp. 304, 313 (S.D.N.Y. 1975). But cf., e.g., *Metro-Goldwyn-Mayer Inc. v. Ross*, 509 F.2d 930 (2d Cir. 1975) (holding the defendants' failure to disclose actionable despite the plaintiff's ability to obtain the same information from analysis of other materials); *Stier v. Smith*, 473 F.2d 1205, 1208 (5th Cir. 1973) (holding that the defendant has a duty to disclose, even though the plaintiff felt it had enough information). See also Comment, *Two Different Standards of Reliance Applied in Individual Private Actions Under SEC Rule 10b-5 by the Second Circuit*, 49 TEMP. L. REV. 182 (1975).

²²¹ 540 F.2d 591 (3d Cir. 1976).

²²² 545 F.2d 687 (10th Cir. 1976).

²²³ 551 F.2d 1005 (5th Cir. 1977).

²²⁴ *Holdsworth v. Strong*, 545 F.2d 687, 693 (10th Cir. 1976). Accord, *Dupuy v. Dupuy*, 551 F.2d 1005, 1020-24 (5th Cir. 1977); *Straub v. Vaisman & Co.*, 540 F.2d 591, 596-98 (3d Cir. 1976). These cases draw a sharp and direct analogy to tort law in determining when and to what degree due diligence should be required of the plaintiff. In brief, they conclude that, just as negligence is not a defense to a common law fraud action, see, e.g., *Wilcox v. American Tel. & Tel. Co.*, 176 N.Y. 115, 117-18 (1903); *Angerosa v. White Co.*, 248 App. Div. 425, 290 N.Y.S. 204, 211 (App. Div.), *aff'd*, 275 N.Y. 524 (1936); PROSSER ON TORTS § 10, at 715 (4th ed. 1971); RESTATEMENT OF TORTS § 540, it should not be a defense to rule 10b-5 after the *Hochfelder* decision. They reason that that decision, by requiring scienter under rule 10b-5, has made rule 10b-5 more analogous to a common law fraud action than a negligence action. The

This limitation of the prior due diligence defense will undoubtedly result in a reduction of the use of post-transaction evidence against plaintiffs in securities actions. Under the pre-*Hochfelder* definition of this due diligence duty, the defendant could show that plaintiff "should have learned" the truth by reference to post-event analyses and developments which might indicate what discoveries and inferences were possible at the time of sale by exercising due diligence.²²⁵ Now, however, to avoid liability on the basis of the plaintiff's conduct, defendants must provide a much stronger showing to prove that the plaintiff acted recklessly.²²⁶ Little room, if any, is left for the mere inferences from post-transaction evidence that the plaintiff failed to exercise due diligence.

This new limitation on the plaintiff's duty of due diligence may not hold true with respect to statute of limitations questions. Inquiry into when the statute of limitations begins to run frequently involves a review of post-transaction facts.²²⁷ The statutory limitations period for several securities claims—e.g., sections 11 and 12—is provided in section 13 of the Securities Act, which expressly requires that the plaintiff act with reasonable diligence to discover the alleged fraud.²²⁸ Other antifraud provisions—e.g., rule 10b-5, section 17(a) and section 18—have no express statutory limitations period; when faced with claims brought under those provisions, the courts have adopted the pertinent state fraud or blue sky law limitation periods.²²⁹ The state statutes of limitations applicable to those claims often contain a due diligence requirement, which the courts then also apply to the federal antifraud provisions.²³⁰ A reasonable diligence requirement has also been presumed with respect to the equitable tolling doctrine.²³¹ In those instances, what the plaintiff might have learned after the transaction, and when he might have learned it, will directly affect the commencement of the statute's running.²³² His failure to do so will prevent tolling of the stat-

Seventh Circuit recently also accepted that analysis, although it did not discuss the question at length. See *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1040 (7th Cir. 1977). But see *Hirsch v. duPont*, 553 F.2d 750, 762-63 (2d Cir. 1977) and *First Va. Bankshares v. Benson*, 559 F.2d 1307, 1314 (5th Cir. 1977), where the courts simply applied the old rule without analysis of the changes warranted by the *Hochfelder* decision.

See also Note, *Scope of Due Diligence Defense*, 50 TEMP. L.Q. 124 (1976); Wheeler, *Plaintiff's Duty of Due Care Under Rule 10b-5: An Implied Defense to An Implied Remedy*, 70 NW. L. REV. 561, 564-68 (1976); Note, *The Due Diligence Requirement for Plaintiffs Under Rule 10b-5*, 1975 DUKE L.J. 753, 760-61 (1975).

²²⁵ See cases cited in notes 207 & 220 *supra*.

²²⁶ See note 224 *supra*.

²²⁷ See cases cited in notes 230-31 & 238 *infra* re the statute of limitations itself. See cases cited in notes 152-59 *supra* regarding the equitable tolling doctrine.

²²⁸ 15 U.S.C. § 77m (1970). See note 159 *supra*. See also *Natural Resources Corp. v. Royal Resources Corp.*, 427 F. Supp. 880 (S.D.N.Y. 1977).

²²⁹ See note 159 *supra*.

²³⁰ See, e.g., *Stull v. Bayard*, 561 F.2d 429, 432-33 (2d Cir. 1977); *Arneil v. Ramsey*, 550 F.2d 774, 779-80 (2d Cir. 1977).

²³¹ See, e.g., *City of Detroit v. Grinnell Corp.*, 495 F.2d 448, 461 (2d Cir. 1974); *In re Clinton Oil Sec. Litigation*, [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,015, at 91,572 (D. Kan. 1977). See also *Arneil v. Ramsey*, 550 F.2d 774, 781 (2d Cir. 1977); *Hilton v. Mumaw*, 522 F.2d 588, 595 (9th Cir. 1975); *Morgan v. Koch*, 419 F.2d 993, 997 (7th Cir. 1969). Compare, however, *Tomera v. Galt*, 511 F.2d 504, 570 (7th Cir. 1975) with *Friedlander v. Feinberg*, 369 F. Supp. 917, 919 (S.D.N.Y. 1974), *aff'd*, 508 F.2d 836 (2d Cir. 1975). See also notes 158-60 *supra* and the possible caveat in note 236 *infra*.

²³² See, e.g., *Gaudin v. KDI Corp.*, [Current] FED. SEC. L. REP. (CCH) ¶ 96,453 (6th Cir. 1978); *Berry Petroleum Co. v. Adams & Peck*, 518 F.2d 402, 410 (2d Cir. 1975).

ute of limitations. Thus, post-transaction evidence will continue to be pertinent in determining when the statute of limitations begins to run and whether the equitable tolling doctrine is triggered.

For example, in *Braunstein v. Lavenhol & Horwath*,²³³ the plaintiff was barred from suing in 1977 based upon a 1969 private placement where he should have known of another lawsuit by another investor alleging the same wrongs by the defendant several years before. Had the plaintiff investigated the facts underlying the lawsuit or merely followed its progress, he would have learned of the fraud within the statutory limitations period. His failure to do so barred his claim that the statute of limitations had been tolled.²³⁴

Also illustrative is *Goldstant v. Bear, Stearns & Co.*²³⁵ Two partners of a partnership known as II Williams sued Bear, Stearns, a national brokerage firm, in 1975 under the securities laws and common law based upon short sales which Bear, Stearns had arranged for II Williams in 1967. The short sales violated NASD rules, but Bear, Stearns had repeatedly assured the plaintiffs that the short sale arrangement was legal. The NASD filed a disciplinary action against II Williams in 1971, resulting in an adverse determination against it in 1973. At the time of the NASD complaint, the plaintiff had again asked Bear, Stearns whether the short sales had been legal, and Bear, Stearns assured it that they had been. The district court held the action barred by the Illinois three year statute of limitations. The court specifically rejected the plaintiff's attempt to invoke the equitable tolling doctrine, stating:

Due diligence relating to discovery of the fraudulent misrepresentation required the plaintiffs to obtain independent advice on the legality issue so that they could determine if they had been defrauded. Plaintiffs claim that there was no event to trigger such an inquiry. But "[i]t is well established that a plaintiff may not merely rely on his own unawareness of the facts or law to toll the statute." . . . Plaintiffs were obligated to 'bestir themselves to inquire' especially since this would have been relatively easy for them . . . If their only concern was preventing fraud we might always allow such suits no matter when they are filed. But fairness requires a cut-off point and an exception is made to the cut-off point only when a plaintiff, due to defendant's fraudulent concealment, could not have known that a wrong occurred. Here, the plaintiffs could have known. Their failure to act upon the facts known to them resulted in their suit being time barred.²³⁶

²³³ 433 F. Supp. 1077 (S.D.N.Y. 1977).

²³⁴ *Id.* at 1079. The lawsuit about which the court felt the plaintiff should have known was *Herzfeld v. Lavenhol, Krekstein, Horwarth & Horwarth*, 540 F.2d 27 (2d Cir. 1976). The court found distinguishable and inapplicable the contrary decision of *United States v. One 1961 Red Chevrolet*, 457 F.2d 1353 (5th Cir. 1972). 433 F. Supp. at 1080-81.

²³⁵ 522 F.2d 1265 (7th Cir. 1975).

²³⁶ *Id.* at 1269. It is not yet clear to what extent this requirement of due diligence will be lessened by the lessening of the other due diligence requirements on plaintiffs which has resulted in the past two years since the *Hochfelder* decision. See notes 221-24 *supra* and discussion of the *Dupuy*, *Holdsworth* and *Straub* cases there. The same considerations weighed there (*e.g.*, the analogy and reference to tort law) would appear appropriate in determining when due diligence should be required for the statute of limitations also.

The *Goldstant* result may have been correct on the facts, but the court's broad language appears to have gone farther than necessary. The equitable tolling doctrine is intended to provide a remedy for lulling by wrongdoers.²³⁷ In *Goldstant*, Bear, Stearns did not have such a purpose in mind; it was merely stating its continued belief in the legal opinion it had previously rendered. But where the defendant *has* attempted to induce investor somnolence, regardless of whether his attempt takes the form of affirmative concealment of his prior undisclosed wrongs, the tolling doctrine would also appear to have proper application.²³⁸

I. Estoppel and Waiver

A number of cases have recognized waiver and estoppel defenses to securities actions, based upon the plaintiff's conduct following the transaction at issue.²³⁹ The thrust of these defenses is either that the plaintiff, by his actions following the transaction, has abandoned or so prejudiced his rights that he is deemed to have waived them, or that he has committed inequitable acts that make it unjust to allow him to recover for his injury. Post-transaction evidence will necessarily form the basis for such defenses.

²³⁷ See notes 153-58 *supra* for a discussion of the policy underlying the doctrine. The cases there emphasize when the deception "should have been discovered," not the nature of the defendant's conduct. This does not mean that the doctrine does not require a showing that the defendant acted to prevent or discourage discovery of the deceit, but rather that such conduct by the defendant may take on other forms than outright concealment. See also notes 230-33 *supra* & 238 *infra*.

²³⁸ In one recent decision, *Natural Resources Corp. v. Royal Resources Corp.*, 427 F. Supp. 880 (S.D.N.Y. 1977), the court suggested several factors for determining whether the plaintiff has acted diligently enough to meet his burdens under the statute of limitations:

It is impossible to lay down any general rule as to the amount of evidence or number or nature of evidential facts admitting discovery of fraud. But, facts in the sense of indisputable proof or any proof at all, are different from facts calculated to excite inquiry which impose a duty of reasonable diligence and which, if pursued, would disclose the fraud. Facts in the latter sense merely constitute objects of direct experience and, as such, may comprise rumors or vague charges if of sufficient substance to arouse suspicion. Thus, the duty of reasonable diligence is an obligation imposed by law solely under the peculiar circumstances of each case, including existence of a fiduciary relationship, concealment of the fraud, opportunity to detect it, position in the industry, sophistication and expertise in the financial community, and knowledge of related proceedings.

Id. at 888, quoting *deHaas v. Empire Petroleum Co.*, 435 F.2d 1223, 1226 (10th Cir. 1970). Interestingly, the same district court judge also decided *Friedlander v. Feinberg*, 369 F. Supp. 917, 919 (S.D.N.Y. 1974), *aff'd*, 508 F.2d 836 (2d Cir. 1975), where fact questions were held to bar a limitations defense based on the duty to discover the fraud.

²³⁹ See, e.g., *Moody v. Bache & Co.*, [Current] FED. SEC. L. REP. (CCH) ¶ 96,368 (5th Cir. 1978); *Occidental Life Ins. Co. v. Pat Ryan & Assoc., Inc.*, 496 F.2d 1255, 1267 n.9 (4th Cir. 1974); *Hecht v. Harris, Upham & Co.*, 430 F.2d 1202, 1208 (9th Cir. 1970); *Black v. Riker-Maxson Corp.*, [1975-76 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,270 (S.D.N.Y. 1975); *Greenfield v. D.H. Blair & Co.*, [1975-76 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,239, at 98,255 (S.D.N.Y. 1975); *Ferguson v. F.I. du Pont & Co.*, 369 F. Supp. 1099 (N.D. Tex. 1974). *But cf.* *Woolf v. S.D. Cohn & Co.*, 515 F.2d 591, 602-05 (5th Cir. 1975) (*in pari delicto* defense may not be allowed, depending on the degree of plaintiffs' complicity and the impact of defendants' actions on the public).

To a limited extent, similar defenses are also available in common law fraud actions. See, e.g., *Rothschild v. Title Guarantee & Trust Co.*, 204 N.Y. 458, 464 (1912); *Glassman v. Tompkins*, 84 Misc.2d 174, 179 (Sup. Ct. 1975); *Simmons v. Westwood Apartments Co.*, 46 Misc.2d 1093, 1096-97 (Sup. Ct. 1965), *aff'd*, 26 App. Div. 2d 764, *appeal denied*, 18 N.Y.2d 786 (1966).

Post-transaction evidence may also bear upon the nature of the remedy to which the plaintiff is entitled. For example, only a plaintiff who acts promptly and with reasonable diligence in reacting to or discovering the alleged fraud is permitted to seek rescission under rule 10b-5.²⁴⁰ If he fails to act promptly, he must settle for seeking damages.

*Investors Thrift Corp. v. Sexton*²⁴¹ provides a good illustration of how post-transaction evidence may be introduced to establish a waiver or estoppel defense. Investors Thrift Corp. (ITC) had purchased all of the stock of two companies from the defendants. The two companies thereafter went bankrupt, and ITC sued the sellers under the securities laws, alleging that they had misled ITC as to the value of the companies. The sellers defended the action by introducing evidence of ITC's mismanagement of the companies during the two years following the sale, claiming that the mismanagement was the true cause of the companies' failure and ITC's losses. Accordingly, the defendants argued, ITC should be estopped from recovering under the securities laws. ITC objected, contending that the issue before the court was what the companies' stock was worth at the time of ITC's purchases. ITC maintained that the post-transaction evidence was irrelevant, since evidence respecting the subsequent operation of the companies could not determine the stock's value at the time of sale. The district court overruled this objection and admitted the evidence. The defendants thereafter won a jury verdict. On appeal, ITC successfully raised its objection to the evidence and won a new trial. However, although it found for ITC on that issue, the court of appeals did not flatly reject the defense's theory for the admission of the post-transaction evidence. Rather, the court of appeals merely held that, in raising such a defense, "the party offering evidence of subsequent mismanagement [is] required to demonstrate a link between the subsequent mismanagement and value of the stock at the time of sale."²⁴² The court of appeals concluded that, on the record before it, the defense had failed to show that requisite link.²⁴³ Hence, despite the result in the case, *Sexton* demonstrates that the estoppel defense is available to defendants where the proper causal link can be shown.

²⁴⁰ See, e.g., *Baumel v. Rosen*, 412 F.2d 571, 574-75 (4th Cir. 1969); *In re National Student Marketing Litigation*, [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,290, at 92,847 (D.D.C. 1978); *Chelsea Assoc. v. Rapanos*, 376 F. Supp. 929, 942-43 (E.D. Mich. 1974), *aff'd*, 527 F.2d 1266 (6th Cir. 1975); *Marshall Assoc., Inc. v. Lite-Tronics, Inc.*, 372 F. Supp. 905, 908 (W.D. Pa. 1974). See also *McLean v. Clapp*, 141 U.S. 429, 432-33 (1891); *Rochez Bros., Inc. v. Rhoades*, 491 F.2d 402, 415 (3d Cir. 1974); *Johns Hopkins University v. Hutton*, 488 F.2d 912, 917 (4th Cir. 1973), *cert. denied*, 416 U.S. 916 (1974); *Friedman, Delay as a Bar to Rescission*, 26 CORNELL L. Q. 426 (1941).

²⁴¹ 491 F.2d 768 (8th Cir. 1974). The litigation was only one of a series of related cases arising from the same transaction. See *Vanderboom v. Sexton*, 460 F.2d 362 (8th Cir. 1972); *Investors Thrift Corp. v. Sexton*, 347 F. Supp. 1207 (W.D. Ark. 1972); *In re Peoples Loan & Inv. Co.*, 316 F. Supp. 13 (W.D. Ark. 1970); *Vanderboom v. Sexton*, 294 F. Supp. 1178 (W.D. Ark. 1969), *rev'd*, 422 F.2d 1233 (8th Cir.), *cert. denied*, 400 U.S. 852 (1970); *In re Peoples Loan & Inv. Co.*, 292 F. Supp. 594 (W.D. Ark. 1968), *rev'd*, 410 F.2d 851 (8th Cir. 1969); *City Nat'l Bank of Fort Smith v. Vanderboom*, 290 F. Supp. 592 (W.D. Ark. 1968), *aff'd*, 422 F.2d 221 (8th Cir.), *cert. denied*, 399 U.S. 905 (1970); *Miskimins v. City Nat'l Bank of Fort Smith*, 248 Ark. 1194, 456 S.W.2d 673 (1970).

²⁴² 491 F.2d at 772.

²⁴³ *Id.* "As graphically demonstrated by defense counsels' trial statements explaining why this evidence was offered, no such link between subsequent mismanagement and value at the time of sale was established." *Id.*

Other forms of estoppel, waiver, and laches may arise in securities fraud actions.²⁴⁴ Some may bar recovery completely. Others, as previously noted, may affect only the nature or scope of the remedy—as for example, the availability of rescission or damages—which the plaintiff may obtain.²⁴⁵ In either event, post-purchase evidence necessarily will play a cardinal role in evaluating such defenses; and objections that the evidence is irrelevant because it is post-transactional are misplaced.

J. Damages

Post-transaction evidence is often offered by both plaintiffs and defendants in securities litigation on the issue of damages. Plaintiffs may try to show what other reasonable investors did after the disclosure of the allegedly material information to prove that they would not have purchased or held onto the securities at issue if they had known the facts, and that this bears on the selection of the date as of which the amount of their damages should be determined.²⁴⁶ Defendants refer to post-transaction evidence to argue that the plaintiff actually suffered no loss or damage.²⁴⁷

Defendant sellers thus sometimes attempt to introduce evidence of subsequent market conditions to argue that the plaintiff's investment actually increased or maintained its value, so that he suffered no damage on his investment. Such defense efforts to rely upon subsequent market prices have met with little success.²⁴⁸ The courts have recognized that the

²⁴⁴ See, e.g., Note, *Equitable Defenses of In Pari Delicto and Unclean Hands, Denied to Tipper as Against Tippee*, 40 FORDHAM L. REV. 725 (1972). See, also, *Herzfeld v. Laventhol, Krekstein, Horwath & Horwath*, 540 F.2d 27, 35-36 (2d Cir. 1976); *Kuehnert v. Texstar Corp.*, 412 F.2d 700 (5th Cir. 1969). See *Lawler v. Gilliam*, [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,277, at 92,794-95 (4th Cir. 1978) with respect to the relative degree of "fault" necessary to sustain an *in pari delicto* defense.

²⁴⁵ See note 241 *supra*.

²⁴⁶ See, e.g., *Dupuy v. Dupuy*, 551 F.2d 1005 (5th Cir. 1977): "To determine the true value of the stock, subsequent developments may be considered. The jury may consider whether the plaintiff would have held onto the stock absent the misinformation." *Id.* at 1025. See also *Stull v. Bayard*, 561 F.2d 429, 433 (2d Cir. 1977). *But cf.*, *Fox v. Kane-Miller Corp.*, 398 F. Supp. 609, 646 n.31 (D. Md. 1975), *aff'd*, 542 F.2d 915 (4th Cir. 1976) (damages fixed as of date of contract, rather than closing).

²⁴⁷ See *Harris v. American Inv. Co.*, 523 F.2d 220, 224-26 (8th Cir. 1975), *cert. denied*, 423 U.S. 1054 (1976); *Alloys Unlimited, Inc. v. Raesler*, [1976-77 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,639, at 90,171 (Sup. Ct. N.Y. 1976), *aff'd*, 55 A.D.2d 893, 391 N.Y.S.2d 371 (1977). *But see* *Investors Thrift Corp. v. Sexton*, 491 F.2d 768, 770 (8th Cir. 1974) (post-transaction evidence admissible only to show price at time of sale).

The courts have held that a plaintiff cannot recover for lost profits, but rather only for his losses in a securities transaction. See, e.g., *Levine v. Seilon, Inc.*, 439 F.2d 328, 334-35 (2d Cir. 1971); *Estate Counselling Serv. v. Merrill Lynch*, 303 F.2d 527, 533 (10th Cir. 1962); see also *Byrnes v. Faulkner, Dawkins & Sullivan*, 550 F.2d 1303, 1313-14 (2d Cir. 1977); *Wolf v. Frank*, 477 F.2d 467 (5th Cir.), *cert. denied*, 414 U.S. 975 (1973); *Lewis v. Bogin*, 337 F. Supp. 331, 337-38 (S.D.N.Y. 1972). This rule is generally the same in common law fraud cases. See, e.g., *Berkowitz v. Baron*, 428 F. Supp. 1190, 1197 (S.D.N.Y. 1977); *Reno v. Bull*, 226 N.Y. 546, 553 (1919); *Ungewitter v. Toch*, 31 App. Div. 2d 583, 584 (1968).

²⁴⁸ The court in *Harris v. American Inv. Co.*, 523 F.2d 220 (8th Cir. 1975), *cert. denied*, 423 U.S. 1054 (1976), rejected that argument, stating: "The validity of the district court's holding rests upon its legal determination that the defendants may be absolved from liability by showing that the plaintiff could have recouped his loss by selling his stock subsequent to his discovery of their alleged frauds We disagree with this determination." *Id.* at 224. The court specifically rejected the argument that the market price of publicly traded stocks necessarily fixes their "value" on a given date. Quoting from the RESTATEMENT OF TORTS § 549,

wrong in a securities action may be the inducement to purchase itself;²⁴⁹ in such a case, subsequent market fluctuations are irrelevant. Even where the open market price is deemed to be a proper consideration for determining damages, the courts have rejected a simplistic comparison of price fluctuations shortly after the transaction, since other factors may account for the price changes or the public may itself have been misled or may not have reacted promptly when the facts constituting the fraud were revealed.²⁵⁰ In other cases, unique factual considerations—for example, that the plaintiff purchased unregistered or restricted letter stock and hence was not at liberty to sell upon the later public disclosure of the fraud—may render reference to the open market price inappropriate and hence unavailable to the defense.²⁵¹ These factors undercut significantly the probative value of post-transaction market price evidence. The fact that there were a variety

Comment C, the court of appeals stated: "In many cases [market] price is due to the widespread belief of other buyers in misrepresentations similar to that made to the person seeking recovery The fact that the market price is inflated or depressed by such misrepresentations is the important factor which makes the price fictitious." *Id.* at 226. See also *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374, 381-84 (2d Cir. 1974), *cert. denied*, 421 U.S. 976 (1975); *Hotaling v. Leach & Co.*, 247 N.Y. 84, 90-91 (1928); *Reder, Measuring Buyers' Damages in 10b-5 Cases*, 31 BUS. LAW. 1839, 1843-45 (1976). But see *Tucker v. Arthur Anderson & Co.*, 67 F.R.D. 468, 482 (S.D.N.Y. 1975), where the court stated: "'actual value' may be calculated by looking to the market price when the misrepresentation or omission is 'cured.'" See also *Adams v. Standard Knitting Mills, Inc.*, [1976-77 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,683, at 90,372 (E.D. Tenn. 1976); *People ex rel. Knickerbocker Fire Ins. Co. v. Coleman*, 107 N.Y. 541, 544 (1887); *Jones v. Healey*, 184 Misc. 923, 926 (Sup. Ct. 1945), *aff'd*, 270 App. Div. 895 (1946); 3A BROMBERG, SECURITIES LAW: FRAUD ¶ 9.1, at 228 (1974).

Moreover, in market depression cases, the plaintiff may look to the subsequent values to prove his damages. See *Electronic Specialty Co. v. International Controls Corp.*, 409 F.2d 937, 946 (2d Cir. 1969). But cf., *Levy v. Vista Indus. Corp.*, [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,012, at 91,550 (S.D.N.Y. 1977) (plaintiff could not recover for losses due to depressed market).

In one recent case, the Court of Appeals for the Second Circuit ordered the district court to reduce the damages award to the plaintiff "by the average percentage decline in value of the Dow Jones Industries, the Standard & Poor's Index or any other well recognized index of value, or combination of indices, or the national securities markets" during the period of the defendants' alleged improper trading of the plaintiff's portfolio. *Rolf v. Blyth Eastman Dillon & Co.*, [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,275 (2d Cir. 1978).

²⁴⁹ See, e.g., *Garnatz v. Stifel, Nicholas & Co.*, 559 F.2d 1357 (8th Cir. 1977); *Dupuy v. Dupuy*, 551 F.2d 1005, 1024-25 (5th Cir. 1977); *Chasins v. Smith, Barney & Co.*, 438 F.2d 1167, 1173 (2d Cir. 1970); *Baumel v. Rosen*, 412 F.2d 571, 575 (4th Cir. 1969), *cert. denied*, 396 U.S. 1037 (1970). See also *Myzel v. Fields*, 386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968).

There are differing rules of damage for some of the different securities sections. Compare, § 11 of the Securities Act of 1933, 15 U.S.C. § 77K (1970), with Rule 10b-5. See, e.g., *Beecher v. Able*, [1974-75 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,016, at 97,561-62 (S.D.N.Y. 1975); *In re U.S. Financial Sec. Litigation*, [1974-75 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,844, at 96,846 (S.D. Cal. 1974). See also *Mills v. Electric Auto-Lite Co.*, 552 F.2d 1239 (7th Cir. 1977) (regarding damages in proxy rule cases).

²⁵⁰ See discussion in note 248 *supra*. Where there is a long time delay between the transaction and the post-transaction evidence, questions of causation may be raised. See discussion in *Reder, Measuring Buyers' Damages in 10b-5 Cases*, 31 BUS. LAW. 1839, 1846-48 (1976), and *Federman v. Empire Fire and Marine Ins. Co.* [1975-76 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,418 (S.D.N.Y. 1976). But the evidence may still serve the "other purposes" discussed above.

²⁵¹ See, e.g., *Alloys Unlimited, Inc. v. Raesler*, [1976-77 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,639, at 90,171 (Sup. Ct. N.Y. 1976), *aff'd*, 55 App. Div. 2d 893, 391 N.Y.S.2d 371 (1977).

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of alternative investments available to the plaintiff, if he had not been induced by the defendant to purchase the security at issue, may also render a simple comparison of prices before and after the sale an improper indication of the plaintiff's damages.

Nevertheless, there are situations where such evidence may be useful on the issue of damages, particularly to prove damages rather than to disprove damages. The difference between a plaintiff's purchase price and the sale price after a downward turn in the value of the securities at issue following disclosure of the facts constituting the fraud may adequately reflect the plaintiff's loss. Post-transaction evidence of price fluctuations therefore may be of probative value, and hence admissible, but generally the weight to be given to such evidence should be closely circumscribed and determined on a case-by-case basis.

K. *Other Objections to Post-Transaction Evidence*

While, as shown above, post-transaction evidence may be relevant to such diverse purposes as intent, materiality, waiver and damages, there are a number of objections aside from sheer irrelevance which are often raised against the admission of post-transaction evidence. These include objections that the evidence is unduly prejudicial to the objecting party, that it is too remote to be probative, or that its admission would violate the rule prohibiting use of subsequent remedial measure evidence. Each of these potential objections is discussed below.

1. Prejudice

Post-transaction evidence *has* been barred altogether in other actions,²⁵² although not many reported decisions deal with the specific issue of admissibility *per se*. The United States Supreme Court has specifically recognized in at least one nonsecurities action the "established judicial rule of evidence that testimony of prior or subsequent transactions, which for some reason are barred from forming the basis for a suit, may nevertheless be introduced if it tends reasonably to show the purpose and character of the particular transaction under scrutiny."²⁵³ Yet, the lower courts do not always agree on what "reasonably" tends to show such matters, particularly in jury actions. Thus, the lower courts often appear to strain, not necessarily unfairly or unwisely, to be sensitive to the possible prejudice which the evidence may cause and to other factors such as concern over unduly prolonging the trial, or the possibility of confusing or merely boring the jury.

Even though evidence may be relevant, its probative value may nonetheless be outweighed by its inflammatory or prejudicial nature. For example, while the subsequent bankruptcy of a corporation whose stock has been sold publicly may be relevant to a claim that the seller could have known of the weak financial condition of the issuer, it may also unfairly in-

²⁵² See, e.g., *SEC v. Geon Industries, Inc.*, 531 F.2d 39, 52-53 (2d Cir. 1976). See also note 194 *supra*.

²⁵³ *F.T.C. v. Cement Institute*, 333 U.S. 683, 705 (1948). See also 2 WIGMORE, *supra* note 38, cf., e.g., *United States v. 1,129.75 Acres of Land, Etc.*, 473 F.2d 996, 999 (8th Cir. 1973) ("under appropriate circumstances evidence of subsequent comparable sales is admissible as an aid to determining the market value").

fluence a jury to sympathize with plaintiff-purchasers who have lost their entire investment due to the subsequent bankruptcy. Furthermore, such evidence may cause the jurors to be skeptical of the defendant's denial that he knew of the issuer's weak financial condition. Due to this potential for prejudice, the courts should carefully control the circumstances in which such evidence is admitted through such means as limiting instructions. A court may even determine that it is necessary to exclude the evidence, especially when it has only tangential or minimal relevance and is sensational in nature or otherwise has great potential for causing prejudice.

Rule 403 of the Federal Rules of Evidence provides authority for such an exclusion of relevant evidence.²⁵⁴ Rule 403 expressly addresses the problem of prejudice, and permits a court to exclude admittedly relevant evidence "if its probative value is substantially outweighed by the danger of prejudice, confusion of the issues, or misleading the jury."²⁵⁵ It is submitted, however, that this power should be exercised sparingly in cases involving reasonably related post-transaction evidence. In a situation like the subsequent bankruptcy referred to above, the jury should normally be permitted to evaluate the evidence and make its own determination of what it shows. And, in nonjury cases, presumably the court will not be unduly influenced and will be able to weigh properly the evidence. Subsequent dealings between an issuer and an underwriter may also show more clearly the nature of the parties' relationship and, thus, the underwriter's access to information claimed to be beyond its purview or knowledge.²⁵⁶ Subsequent research and credit information, similarly, may demonstrate what the true state of facts was at an earlier date, raising questions about the defendant's version of the facts and his credibility.²⁵⁷ The court should be careful in dealing with such uses of post-purchase evidence to prevent a wholesale diversion of the issues from the time frame to be litigated. However, it should be apparent that there can be a multitude of instances where its reception and relevance are appropriate for such inferential reasoning purposes.

Particularly where the post-transaction events being offered have occurred in close proximity to the stock sale itself, it appears reasonable to require the defendant to bear the burden of showing that he will face *actual* prejudice, as opposed to merely having to respond to damaging evi-

²⁵⁴ See note 82 *supra*. Judge Weinstein has summarized the purpose of the rule as follows:

Rule 403 recognizes that "relevancy is not always enough. There may remain the question, is its value worth what it costs?" Will the search for truth be helped or hindered by the interjection of distracting, confusing or emotionally charged evidence? In making this determination, the court must assess the probative value of the proffered item as well as the harmful consequences specified in Rule 403 that might flow from its admission.

1 WEINSTEIN, *supra* note 38, ¶ 403 [01], at 7-8 (1977). See also Schmertz, *Relevance and its Policy Counterweights: A Brief Excursion Through Article IV of the Proposed Federal Rules of Evidence*, 33 FED. BAR. J. 1 (1974); Note, *Relevancy and Its Limits in the Proposed Federal Rules of Evidence*, 16 WAYNE L. REV. 167 (1969).

²⁵⁵ FED. R. EVID. 403.

²⁵⁶ See, e.g., *Cornaglia v. Ricciardi*, 63 F.R.D. 416, 421-22 (E.D. Pa. 1974). See also notes 47 & 99 *supra*.

²⁵⁷ See note 108 *supra*. See also *Strong v. Repide*, 213 U.S. 419, 433 (1909); FED. R. EVID. 607 and 608(b).

dence. The latter is not legal "prejudice."²⁵⁸ Moreover, rule 403 requires a showing that the evidence's probative value be *substantially* out-weighed by the claimed prejudice.²⁵⁹ Merely showing prejudice is not enough in itself to cause exclusion of the evidence.

2. Remoteness

Another possible objection to post-transaction evidence stems from its remoteness relative to the transaction, either in terms of its nature or the time of the evidence or both. The more remote the evidence, the less probative it will be and the less likely to be admitted at the trial. The court should be able to evaluate the question of remoteness in the same manner that it determines any other aspect of relevance, by looking to see if this is reasonably probative to the issue presented. But, in practice, that determination is not so easy.

*Harnett v. Ryan Homes, Inc.*²⁶⁰ illustrates the problems created when the courts seek to weigh the time lapse between the securities transaction and post-transaction evidence. Ryan was a close corporation owned by its principal officers and employees. Harnett, a former Ryan Vice-President, claimed that he had been defrauded into privately selling his stock at a time when Edward Ryan, the principal officer and stockholder, was intending to permit other key employees to participate in a public offering of Ryan's stock. Harnett's principal piece of evidence was a memorandum written two weeks after the parties agreed upon the stock sale; in it, Edward Ryan had discussed the possibility of including certain Ryan employees in the public offering.²⁶¹ Mr. Ryan himself offered other post-

²⁵⁸ See, e.g., *United States v. Ravich*, 421 F.2d 1196, 1205 (2d Cir. 1970); *International Shoe Mach. Corp. v. United Shoe Mach. Corp.*, 315 F.2d 449, 459 (1st Cir.), *cert. denied*, 375 U.S. 820 (1963).

In addition to "prejudice" *per se*, the rule also permits the court to weigh such matters as delay, cumulativeness of the evidence and possible confusion resulting therefrom. See, e.g., *Stengel v. Belcher*, 522 F.2d 438, 442 (6th Cir. 1975); *Watkins v. United States*, 287 F.2d 932, 934 (1st Cir. 1961); *Vockie v. General Motors Corp., Chevrolet Div.*, 66 F.R.D. 57, 60 (E.D. Pa.), *aff'd*, 523 F.2d 1052 (3d Cir. 1975).

²⁵⁹ The prejudice must be "unfair" according to the wording of the rule. At the congressional hearings on Rule 403, the use of that adjective was astutely criticized by one prominent public interest lawyer since it "implied that some kinds of prejudice are fair." *Hearings before the Special Subcommittee on Criminal Justice of the Committee on the Judiciary, House of Reps., on Proposed Rules of Evidence, Serial No. 2*, 93d Cong., 1st Sess. 197 (1973), *quoted in* 2 WEINSTEIN, *supra* note 38, ¶ 403, at 403-2 (1977). According to the Advisory Committee, prejudice is unfair when it has "an undue tendency to suggest decision on an improper basis, commonly, though not necessarily, an emotional one." *Id.*

The court must weigh the various considerations and determine whether the "probative value" is outweighed by the "potential prejudice." *United States v. Wright*, 489 F.2d 1181, 1186 (D.C. Cir. 1973); *Fox v. Kane-Miller Corp.*, 398 F. Supp. 609, 631-33 (D. Md. 1975), *aff'd*, 542 F.2d 915 (4th Cir. 1976). Thus, a matter which constitutes prejudice in one case may not constitute prejudice in another case. Compare, *Travis v. United States*, 269 F.2d 928, 939 (10th Cir. 1959), *rev'd on other grounds*, 364 U.S. 631 (1961) (evidence of Communist Party membership permitted) with *United States v. Turoff*, 291 F.2d 864, 868 (2d Cir. 1961) (evidence of Communist Party membership excluded). In addition, the potential prejudice may sometimes be vitiated by cautionary or careful limiting instructions to the jury. See, e.g., *United States v. Rosenberg*, 195 F.2d 583, 596 (2d Cir.), *cert. denied*, 344 U.S. 838 (1952). See generally 1 WEINSTEIN, *supra* note 38, ¶ 403[03] (1977). See also note 179 *supra*.

²⁶⁰ 496 F.2d 832 (3d Cir. 1974).

²⁶¹ *Id.* at 837.

transaction evidence, including Ryan directors' minutes from 1966 to rebut Harnett's claims, which suggested that Mr. Ryan's thinking on the matter had not been "concrete" and that, in any event, the underwriters would have opposed such employee participation.²⁶² The jury returned a verdict for Ryan. On motions for judgment NOV and a new trial, the district court held that the alleged undisclosed facts were "nothing more than Edward Ryan's random thoughts reduced to paper," and hence could not form the basis of a rule 10b-5 recovery.²⁶³ On appeal, the court of appeals further brushed aside the evidence, stating:

[T]he document indicating that Edward Ryan contemplated employee participation in the public offering, apart from possessing on its face ambiguous import, is, quite significantly, dated May 28, 1965, over two weeks after Edward Ryan and Harnett initially reached agreement regarding the sale of the Ryan Homes stock back to the corporation. Hence, even if it were to be conceded that Edward Ryan's thoughts attained a greater degree of substantiality by virtue of their reduction to writing, such event did not occur until after Harnett and Edward Ryan had agreed to the stock sale. Thus, it is difficult to see how this memorandum, on which plaintiff relies so heavily could be considered material with respect to Harnett's earlier agreement to sell back his stock.²⁶⁴

It may be that the result in *Harnett* was justified on the particular facts there; but the court appears to have worded its rejection of the post-transaction memorandum too broadly and too harshly. The memorandum in question was written barely two weeks after the sale, and might conceivably have contained important admissions against interest by Mr. Ryan.²⁶⁵

²⁶² See opinion of the district court, 360 F. Supp. 878, 888 n.17 (W.D. Pa. 1973).

²⁶³ *Id.* at 889. The court of appeals therefore concluded that the evidence was "not material."

The district court's finding that these undisclosed celebrations represented no more than a set of the numerous thoughts that separately occupy, at their early stages, slight portions of a business executive's time leads us to agree with the district court's conclusion that they were not material. In the corporate world, as elsewhere, the initial ruminations of executives must complete a circuitous course before becoming, if ever, actuality. Further, if we were to require corporate officers to disclose inchoate ideas, musing as it were, on matters that relate to the value of their companies' stock, few stock transactions in which they participate would avoid the possible charge of a Rule 10b-5 violation. If, on the other hand, the district court had found that the undisclosed facts were something more than Edward Ryan's thoughts and that they would likely have an identifiable impact on the fact of any proposal for employee participation in the public offering, a conclusion that the undisclosed facts were material might well have been warranted.

496 F.2d at 838.

²⁶⁴ *Id.* at 837-38.

²⁶⁵ Rule 801(d) of the Federal Rules of Evidence provides:

Statements which are not hearsay. A statement is not hearsay if—

(1) *Prior statement by witness.* The declarant testifies at the trial or hearing and is subject to cross-examination concerning the statement, and the statement is (A) inconsistent with his testimony, and was given under oath subject to the penalty of perjury at a trial, hearing, or other proceeding, or in a deposition, or (B) consistent with his testimony and is offered to rebut an express or implied charge against him of recent fabrication or improper influence or motive, or

It is recommended that the courts not construe *Harnett* to be a precedent for broad application of a "two-week" or other time rule. No hard and fast time limit rule appears either to exist or be advisable. In any event, it is significant and should be kept in mind that the court in *Harnett* did not criticize the admission into evidence of the memorandum; the court's emphasis was upon the weight to be given to it, not whether to admit it in the first instance.

3. Subsequent Remedial Measures

Another objection to post-transaction evidence sometimes asserted by defendants is that the evidence deals with subsequent remedial action taken to cure an allegedly improper condition. Such evidence may be excluded under the authority of both rule 407 of the Federal Rules of Evidence²⁶⁶ and the case law upon which rule 407 is based.²⁶⁷ This subsequent remedial measure objection is the same as that sometimes raised during discovery. In the context of evidence at trial, however, the objection may have greater force.

In securities litigation, the issue of subsequent remedial measures may arise in several situations. For example, when an investment goes sour, an underwriter may undertake a study of what caused this failure, and then change its procedures in an attempt to prevent its recurrence. Similarly, where a claim against a broker-dealer alleges that he negligently failed to investigate an issuer thoroughly, the broker-dealer may wish to restructure its research department immediately, even if it feels the claim is unfounded, rather than await the outcome of the action and face further suits predicated on the same adversely litigated procedure. The subsequent remedial measure objection may also be raised when the SEC or another regulatory body advises or requires the defendant to change his procedures or auditing methods.

In circumstances such as these, defendants often contend that it is more important to protect the public interest served by the subsequent changes than it is to assist a private damage recovery. It is this rationale which underlies the general prohibition contained in rule 407. Hence, defendants maintain that the courts should encourage such remedial actions by assuring the wrongdoer that evidence that it has mended its ways or

(2) *Admission by party-opponent.* The statement is offered against a party and is (A) his own statement, in either his individual or a representative capacity, or (B) a statement of which he has manifested his adoption or belief in its truth, or (C) a statement by a person authorized by him to make a statement concerning the subject, or (D) a statement by his agent or servant concerning a matter within the scope of his agency or employment, made during the existence of the relationship, or (E) a statement by a co-conspirator of a party during the course and in furtherance of the conspiracy.

²⁶⁶ The rule is quoted at note 37 *supra*. As observed earlier, note 49 *supra*, the policy underlying the doctrine may be inapposite in private civil securities litigation.

²⁶⁷ See cases cited in note 39 *supra*. Some commentators have called the subsequent remedial measures doctrine a "rule of privilege." For example, Professor McCormick has stated:

The dominant motive for exclusion, it seems clear, is the reason often relied upon in the opinions; namely the policy against discouraging the taking of steps to remove a danger. Manifestly, this is an external policy, not looking to the trial and truth-finding, but to the interest of public safety. If so, then according to the analysis suggested herein, the rule is one of privilege.

McCORMICK, *supra* note 83, §77 at 159 (1st ed. 1954).

conducted a "safety study" is not admissible against it.²⁶⁸ They also argue that to admit remedy evidence might unfairly influence the jury into drawing an inference of prior wrongdoing, when the change was actually made for reasons other than a recognition or admission of prior recklessness or impropriety.²⁶⁹

As a general evidentiary rule, the prohibition barring the introduction of subsequent remedial measures is predicated on sound and reasonable public policy concerns. However, the rule's logic fails when applied to the garden variety securities case. The subsequent remedial measures doctrine is a creature of negligence law. In contrast, most securities fraud claims are necessarily based upon intentional wrongs, particularly fraudulent deception.²⁷⁰ Accordingly, while there may be some basis for accepting the subsequent remedial measure doctrine in securities cases which involve securities claims analogous to negligence, it appears anomalous to apply that exclusionary rule in most situations where intentional fraud is involved.²⁷¹ In cases alleging intentional fraud, it is not a dangerous negligently-created condition which has caused the loss; rather the plaintiff's injury has been brought about intentionally.

There are, however, situations where rule 407 is properly applied to securities litigation. *SEC v. Geon Industries, Inc.*²⁷² provides an apt example.

²⁶⁸ See discussion and cases cited in notes 39 and 267 *supra*.

²⁶⁹ In *Columbia and Puget Sound R.R. Co. v. Hawthorne*, 144 U.S. 202 (1892), the Supreme Court reasoned that allowance of subsequent repairs as evidence of prior negligence "puts an unfair interpretation upon human conduct, and virtually holds out an inducement for continued negligence." 144 U.S. at 208, *quoting* *Morse v. Minneapolis & St. Louis Ry.*, 30 Minn. 465, 468 (1883). Skepticism about drawing inferences from subsequent repairs can be found in a number of older cases. See, e.g., *Ashland Supply Co. v. Webb*, 206 Ky. 184, 185-86, 266 S.W. 1086, 1086 (1925). See also *Armour & Co. v. Skene*, 153 F. 241, 244-45 (1st Cir. 1907); *Engel v. United Traction Co.*, 203 N.Y. 321, 323-24, 96 N.E. 731, 732 (1911) (cases in which evidence of the discharge of an employee after the accident in question was ruled improperly admitted).

Evidence of subsequent repairs has been held admissible when it is offered for "other purposes" besides the inference that the prior condition was negligent. See notes 278 and 281 *infra*. See also *Norwood Clinic, Inc. v. Spann*, 240 Ala. 427, 431, 199 So. 840, 843 (1941). But see *Smith v. Twin State Gas & Elec. Co.*, 83 N.H. 439, 450-51, 144 A. 57, 63 (1928) (holding that such evidence cannot be used for other purposes unless reasons are "counterbalancing").

²⁷⁰ See, e.g., *Franklin Sav. Bank of New York v. Levy*, 551 F.2d 521, 528-29 (2d Cir. 1977); *Gross v. Diversified Mortgage Investors*, 431 F. Supp. 1080 (S.D.N.Y. 1977) (dealing with rule 10b-5 and § 17(a) of the Securities Act of 1933). See, e.g., *Abrahamson v. Fleschner*, 537 F.2d 27 (2d Cir. 1975); *Jones Memorial Trust v. TSAI Inv. Serv., Inc.*, 367 F. Supp. 491 (S.D.N.Y. 1973) (dealing with § 206 of the Investment Advisors Act of 1940). See, e.g., *Heit v. Weitzen*, 402 F.2d 909 (2d Cir. 1968), *cert. denied*, 395 U.S. 903 (1969); *Barotz v. Monarch Gen., Inc.*, [1974-75 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,933 (S.D.N.Y. 1975) (dealing with § 18 of the Securities Exchange Act of 1934).

Several types of securities claims do not require scienter. See, e.g., *In re Clinton Oil Securities Litigation*, [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,015 at 91,574-75 (D. Kan. 1977). See also Comment, *Shareholders and Informed Voting: How Much Information Do They Need?*, 28 MERCER L. REV. 725, 729 (1977) (re proxy rules and § 14(a) of the Securities Exchange Act of 1934). See also, e.g., *University Hill Foundation v. Goldman, Sachs & Co.*, 422 F. Supp. 879, 892 (S.D.N.Y. 1976); *Johns Hopkins University v. Hutton*, 422 F.2d 1124, 1129 (4th Cir. 1970) (re § 12(2) of the Securities Act of 1933). See also notes 148 & 209 *supra*.

²⁷¹ This kind of distinction has also been recognized for other facets of securities litigation; e.g., for the degree of due diligence required of the plaintiff and the applicability of defenses such as contributory negligence and assumption of risk. See notes 205-07 *supra*.

²⁷² 531 F.2d 39 (2d Cir. 1976).

Geon does not address itself to the type of distinction suggested at notes 270-71 *supra* since it was an SEC enforcement proceeding, not a private civil action. Although the Supreme

Geon involved inside information that was tipped by Geon's president to a stock salesman in a securities brokerage firm. The salesman had approached Geon's president for the information on his own initiative. The SEC brought an action against Geon, the stock brokerage firm, and certain individual defendants. At trial, the SEC sought to introduce evidence that, as a result of the Geon tip and its aftermath, the stock brokerage had promulgated a new regulation requiring its registered representatives to get branch manager approval before contacting any company whose stock they or their customers held.²⁷³ The SEC maintained that this evidence permitted an inference that the brokerage's prior practice was inadequate. Relying on rule 407, the district court rejected this argument and exonerated the brokerage firm, although the court found that Geon and its president were personally liable. On appeal, the court of appeals broadened the judgment to cover all of the Geon defendants, but affirmed the dismissal as against the brokerage firm. The court of appeals agreed that the brokerage firm's new regulation was a subsequent remedial measure covered by rule 407 and held that the district court had correctly refused to draw negative inferences against the brokerage based upon it.²⁷⁴ It would be hard to think

Court in *Hochfelder* specifically left unresolved the question whether proof of scienter is required in SEC enforcement actions (as it is in private damage actions), 425 U.S. 185, 193-94 n.12 (1976), the cases since then appear to have made clear that it is not. *See, e.g., SEC v. Coven*, [Current] FED. SEC. L. REP. (CCH) ¶ 96,462 (2d Cir. 1978); *SEC v. L & S Petroleum, Inc.*, [Current] FED. SEC. L. REP. (CCH) ¶ 96,467 (W.D. Okla. 1977); *SEC v. Trans Jersey Bancorp.*, [1976-77 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,818, at 90,950 (D.N.J. 1976). *Cf. SEC v. Bausch & Lomb, Inc.*, 565 F.2d 8, 14 (2d Cir. 1977) (which had left the matter open, but implied scienter may be necessary). *See also SEC v. Shiell*, [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,190, at 92,386 (N.D. Fla. 1977) (discussing split of authority); *SEC v. Universal Major Indus. Corp.*, 546 F.2d 1044, 1047 (2d Cir. 1976) (holding that scienter is not required for § 5 violations); *SEC v. World Radio Mission, Inc.*, 544 F.2d 535, 540-41 (1st Cir. 1976); *SEC v. Geotek*, [1976-77 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,756, at 90,724 (N.D. Cal. 1976); *Berner & Franklin, Scienter and Securities and Exchange Commission Rule 10b-5 Injunctive Actions: A Reappraisal in Light of Hochfelder*, 51 N.Y.U. L. REV. 769 (1976); *Van Graafeiland, A Lawyer's Observations on Hochfelder*, 51 ST. JOHNS L. REV. 239, 242 n.21. (1977).

Other distinctions between SEC enforcement actions and private civil actions under the securities laws have also been recognized by the courts. As one court of appeals recently observed:

In an SEC enforcement proceeding, the due care of the victim generally does not receive consideration. *SEC v. Dolnick*, 7 Cir. 1974, 501 F.2d 1279, 1283 (disregarding whether the victim was a knowledgeable investor); *Hanly v. SEC*, 2 Cir. 1967, 415 F.2d 589, 596 (disregarding the sophistication of the victims, as well as their previous relationships with the defendants). *But see SEC v. Coffey*, 6 Cir. 1974, 493 F.2d 1304, 1312-13, *cert. denied*, 1975, 420 U.S. 908, 95 S. Ct. 826, 42 L. Ed. 2d 837 (on the peculiar facts of this case the defendant violated no duty because the victims possessed sufficient knowledge about a representation to avoid being misled by it). The dispositive element in these cases is that the defendant owes a duty of full and fair disclosure to the public, not to any particular investor. Whether a private plaintiff might be precluded from recovery, then, need not alter the distinct consideration whether a defendant has violated duties imposed by the Act.

Dupuy v. Dupuy, 551 F.2d 1005, 1015 (5th Cir. 1977). *See also List v. Fashion Park, Inc.*, 340 F.2d 457, 463 (2d Cir. 1965), *cert. denied sub nom. List v. Lerner*, 382 U.S. 811 (1965).

²⁷³ 531 F.2d at 52.

²⁷⁴ The court of appeals in *Geon* stated:

the subsequent taking of measures which would have made a violation less likely normally cannot be considered as proving that failure to take them earlier was negligent, *see Federal Rules of Evidence 407; Smyth v. The Upjohn Co.*, 529 F.2d

of a more classic form of subsequent remedial measure in a securities action and a more apt example of rule 407's application in a securities fraud context. But it is significant that, once again, the court had admitted the subsequent facts into evidence and had merely declined to give them weight, thus again illustrating that post-transaction evidence often should or must be allowed into evidence before its probative value can be evaluated properly. Of course, where the action is being tried to a jury rather than the court, a stronger argument for outright exclusion of the evidence is presented.

A number of important limitations on the subsequent remedial measures doctrine should also be borne in mind. For example, rule 407, by its own terms, does not proscribe all subsequent remedial evidence. Indeed, it expressly provides that such evidence is admissible, even in negligence cases, when offered to prove the feasibility of correcting an improper condition if the defendant disputes that he could have anticipated and corrected the condition before the injury at issue.²⁷⁵

*Boeing Airplane Company v. Brown*²⁷⁶ provides an interesting example of the nuances of the feasibility exception. When a B-52 bomber crashed over Tracy, California, the widow of one of the crew members sued Boeing for damages, alleging that the crash was due to a faulty electrical part in a wing which had exploded in flight. The trial judge, over Boeing's objection, admitted evidence by Mrs. Brown that the part had been substantially changed after the accident.²⁷⁷ Boeing appealed from an adverse jury verdict, insisting that the admission of that evidence was error since its counsel had stipulated that it would have been and was feasible for Boeing to have changed the part before the accident. Mrs. Brown's counsel successfully argued at the trial that this stipulation did not go far enough, because Boeing had not also stipulated regarding the nature of the changes which had later been made. The court of appeals agreed that "an admission that unspecified 'changes' would have been feasible and were actually made does not render irrelevant evidence as to specific changes subsequent to the accident, when offered for the limited purpose of proving the feasibility of such changes to correct the specific defects at issue."²⁷⁸ This may be going

803 (2 Cir. 1975), in part because "the supposed inference from the act is not the plain and most probable one," 2 Wigmore, Evidence § 283 (3d ed. 1940). The trial court, of course, declined to make the desired inference.

531 F.2d at 52. The court also stated that "[t]he departure from the usual principle that evidence should be admitted if a relevant inference is fairly possible is due to the strong policy arguments against consideration of such evidence." *Id.* at 52 n.16.

²⁷⁵ See the second sentence of FED. R. EVID. 407, as quoted in note 37 *supra*. See also *Davis v. Fox River Tractor Co.*, 518 F.2d 481, 485-86 (10th Cir. 1975); *Johnson v. United States*, 270 F.2d 488, 491-92 (9th Cir. 1968); *Slattery v. Marra Bros.*, 186 F.2d 134, 137 (2d Cir. 1951). A corollary of this exception is that such evidence is also admissible to show that the defendant had control over the circumstances in question. See, e.g., *Powers v. J.B. Michael & Co.*, 329 F.2d 674, 676 (6th Cir. 1964); *Dubonowski v. Howard Sav. Inst.*, 124 N.J. 368, 370-71, 12 A.2d 384, 386 (1940); *Mason v. City of N.Y.*, 29 App. Div. 2d 922, 923, 288 N.Y.S.2d 990, 991 (1968); *Priolo v. Lefferts General Hosp.*, 54 Misc. 2d 654, 655 (Sup. Ct. 1967).

²⁷⁶ 291 F.2d 310 (9th Cir. 1961).

²⁷⁷ *Id.* at 315.

²⁷⁸ *Id.* But cf. *Smyth v. Upjohn Co.*, 529 F.2d 803, 805 (2d Cir. 1975) (holding that, despite limited exception, the general rule is still for exclusion); *Daly v. McNeil Laboratories, Inc.*, 509 F.2d 617, 618 (6th Cir. 1975) (holding that post-event evidence was properly excluded); Note, *Exceptions to the Subsequent Remedial Conduct Rule*, 18 HASTINGS L. J. 677 (1967) (discussing general rule that evidence of post-event remedial measures is inadmissible).

too far. Stipulating to what *could* have been done (i.e., was feasible) is one thing. But one can fairly ask: if the defendant has to stipulate to the specific changes which it *actually made* in order to exclude the evidence of what it did, has the purpose of the rule and the objection itself been nullified?²⁷⁹ Nevertheless, defendants had best take heed: the Advisory Committee's note to the Federal Rules of Evidence cites *Boeing* as authority for rule 407.²⁸⁰

There is, in addition, a broad array of settings in which rule 407 is inapplicable. For example, some defendants object broadside to all studies or internal memoranda generated after a bankruptcy or other financial crisis suffered by an issuer, claiming that they were an integral part of a single procedure leading to a subsequent remedial measure. In truth, such studies frequently have other purposes—even if possible remedial action is one of them—and may contain important admissions unrelated to any remedial measure which may later be taken. Where the latter is true, such studies may not reasonably be termed part of a subsequent remedial measure and rule 407 should not apply.²⁸¹

A further weakness of the subsequent remedial measure argument stems from the frequent difficulty of determining what is a subsequent remedial measure in the securities context. For example, efforts by an underwriter to help "salvage" an issuer which is suffering financial setbacks or to administer a subsequent pay-out after the issuer had run into difficulty are often designed to prevent lawsuits against the underwriter or to minimize losses on the investment, not to prevent recurrence. Accordingly, it would be improper to characterize such efforts as subsequent remedial measures under rule 407. The courts must be careful to insure that a claimed remedial measure really is one before upholding an objection to post-transaction evidence under rule 407 in securities litigation.

Which parties may assert the subsequent remedial measures objection is also limited. The courts have held that the objection may be raised only by the party which made the remedial changes involved.²⁸² Thus, the de-

²⁷⁹ Similar cautionary notes have been raised regarding whether the evidence proffered is really necessary or is merely cumulative. Thus, Professor McCormick has stated:

It is apparent that the free admission of such evidence for purposes other than as admissions of negligence is likely to defeat this paramount policy [of encouraging remedial safety measures]. It is submitted that, before admitting the evidence for any of those other purposes, the court should be satisfied that the issue on which it is offered is of substantial importance and is actually and not merely formally in dispute, that the plaintiff cannot establish the fact to be inferred conveniently by other proof, and consequently that the need for the evidence outweighs the danger of its misuse.

McCORMICK, *supra* note 83, § 252, at 545 (1st ed. 1954) and cases cited there. *But see* 2 WEINSTEIN, *supra* note 38, ¶ 407 [02] (1975).

²⁸⁰ Advisory Committee's Note Rule 407, reprinted in 2 WEINSTEIN, *supra* note 38, ¶ 407, at 407-3 (1975).

²⁸¹ In some circumstances, subsequent statements may be deemed part of the *res gestae* if close enough in time and spontaneous enough to be deemed reliable. *See* FED. R. EVID. 803(1). *See also* 6 WIGMORE, *supra* note 38, § 1750 (1942); McCORMICK, *supra* note 19, § 275 (2d ed. 1972). The defense argument referred to in the text, however, does not appear to be analogous to this situation.

²⁸² *See, e.g.,* Wallner v. Kitchens of Sara Lee, Inc., 419 F.2d 1028, 1032 (7th Cir. 1969). On the other hand, such evidence is admissible for impeachment purposes. *See, e.g.,* Polk v. Ford Motor Co., 529 F.2d 259, 270 (8th Cir. 1976). Presumably that type of permissible use of the evidence would apply to all persons, not only those actually making the repairs.

fendant may not prevent the introduction of evidence of a subsequent remedial measure which was instituted by a third party. This limitation may be significant in several situations. For example, the SEC or the American Institute of Certified Public Accountants may direct accountants to change the handling of certain transactions in future audits of financial statements issued to the public. If an issuer is later sued for securities fraud based on alleged accounting improprieties in its treatment of such transactions, the defendant would normally not be able to rely upon rule 407 to prevent the introduction of the new standards into evidence, since they were not instituted by the defendant himself.²⁸³

In summary, rule 407 may provide an appropriate objection to the admission of post-transaction evidence respecting subsequent remedial measures in situations typified by *Geon*, but this objection is subject to a variety of limitations making its operative scope narrow.

CONCLUSION

While it may be irrelevant to issues such as causation in securities litigation, post-transaction evidence has a significant direct and indirect role in proving several other important matters in securities cases. The propriety of admitting such evidence should not be rejected out of hand. Instead, the courts should treat post-transaction evidence in the same way that they treat other evidence. In ruling upon it, they should carefully review the particular claim involved, the factual circumstances of the case itself, the

²⁸³ *Lolie v. Ohio Brass Co.*, 502 F.2d 741 (7th Cir. 1974), illustrates this point in a non-securities context. Lolie's husband, a coal miner, was killed when a power cable fell from the roof of a mine. After the accident, a state mine inspector required the coal company to give the power cable added support by binding it with a sturdy polypropene rope at 60 foot intervals. In an action by Lolie against the company which had manufactured the metal clips previously used to hold the power cable in place, the court refused to allow Lolie to introduce evidence of the subsequent change. Mrs. Lolie lost. On appeal she claimed that the exclusion of the subsequent remedial measures taken to support the power cable was reversible error. The court of appeals agreed that the evidence should have been admitted, explaining:

It is generally held that evidence of subsequent remedial measures is inadmissible to prove negligence or culpable conduct. *See* Rule 407 of the Proposed Rules of Federal Evidence. The primary ground for exclusion 'rests on a social policy of encouraging people to take, or at least not discouraging them from taking, steps in furtherance of added safety.' . . . This basis clearly has no applicability when the evidence is offered against a party, such as this defendant, which did not make the changes.

Since the proffered evidence was relevant and there existed no valid policy reason for excluding it, the evidence was admissible.
502 F.2d at 744.

The court also noted that the evidence might have been admissible under the feasibility exception to the subsequent remedial measures rule. "Plaintiff, however, has not argued that there was any dispute at trial over the feasibility of tying sturdy rope at periodic intervals. And it is highly improbable that a jury could reasonably believe that such an alteration was too costly, impractical or technologically impossible." *Id.* at 745. The court of appeals nevertheless affirmed the decision below, finding that the exclusion of the evidence did not rise to the level of reversible error on the facts of Mrs. Lolie's case, because the evidence was merely cumulative of other evidence in the record which supported the verdict for the defendant. *Id.* at 744. Once again, although found admissible, the post-event evidence was given rather sparing comparative weight.

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purpose for which the evidence is offered, the relationship of the evidence to other evidence in the case, whether the evidence is necessary for a fair determination or merely cumulative, and any possible prejudice it will cause. Often, the objection to such evidence will relate more appropriately to its weight than to its admissibility. No blanket rule is possible for post-transaction evidence. Nor is such a rule desirable, for it may lead to inappropriate oversimplification regarding the proper role and purposes of post-transaction evidence. Each offer of such evidence should be considered on a case-by-case basis.