Unlawful Securities Transactions And Scienter: An Emasculating Requirement

Recognizing that most people are unfamiliar with the complexities of corporate organization and the intricacies of investing, the legislatures of all fifty states designed laws to protect investors from the dishonest schemes of unscrupulous securities promoters.1 Because of the diverse approaches the states took to regulate the offer, sale, or purchase of securities, the National Conference of Commissioners on Uniform State Laws drafted the Uniform Securities Act2 to achieve a substantial degree of uniformity3 among those states assimilating its provisions. Although uniformity was a paramount objective,4 the Uniform Act’s drafters, realizing the impracticality of complete uniformity among the states,5 provided options to permit expression of each state’s individual regulatory policy.6 In 1959, the Washington Legislature adopted a modified version7 of the Uniform Securities Act.8 A Washington appellate court, however, recently diminished the Washington Act’s protective scope.9

This comment suggests the proper construction of the unlawful transactions provision10 of the Washington Act and rejects
scienter as a necessary element of a violation of that provision. The discussion necessitates consideration of federal rule 10b-5, because the rule is the source of the Uniform Act's unlawful transactions provision. The focus, however, is on the inapplicability of the United States Supreme Court's analysis in Ernst & Ernst v. Hochfelder to the Washington Act's construction.

Massive fraud in securities transactions, culminating in the stock market crash of 1929, demonstrated the need for comprehensive securities regulation. Congress designed the Securities Act of 1933 to insure an investor's access to pertinent facts concerning securities offered for sale and to protect against fraud and misrepresentation in securities transactions. The Securities Exchange Act of 1934 increased investors' protection, substituting "a philosophy of full disclosure for the philosophy of caveat emptor . . . to achieve a high standard of business ethics in the securities industry." Because Congress devised the Acts to protect the public from speculative or fraudulent schemes, and because they are remedial statutes, congressional intent requires that they be given a liberal construction. Section 10(b) of the 1934 Act makes it unlawful for any person, while purchasing or selling any security, to use or employ a manipulative or deceptive device or contrivance in contravention of the Securities and Exchange Commission's rules and regulations.

accompanying note 66 infra.

11. Rule 10b-5 states:
Employment of manipulative and deceptive devices.
It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate [sic] 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.


Acting pursuant to section 10(b), the Commission promulgated rule 10b-5,20 which it intended for use in injunctive proceedings rather than in private damage actions.21 Notwithstanding the Commission's intent, courts have recognized private damage actions under rule 10b-5.22 Because neither the statute nor the rule indicates the elements in a private suit, courts have had difficulty defining rule 10b-5's scope. The elements most commonly considered essential in private 10b-5 actions are: misrepresentation or omission, materiality, scienter, reliance, and causation.23 The element of scienter, in particular, has presented problems for the courts because of varying, often imprecise and contradictory uses of the word.

In misrepresentation actions, common law traditionally defines scienter as the intent to deceive, mislead, or convey a false impression.24 Although some courts have employed the intent to deceive definition of scienter in 10b-5 cases,25 most federal courts have defined scienter to include other states of mind, such as recklessness,26 actual knowledge of falsity,27 negligence,28 or lack of due diligence.29 In one opinion the United States Supreme Court defined scienter as intent30 or knowledge,31 but also sug-

23. 3 A. Bromberg, Securities Law § 8.1 at 195 (1977). The first case to require scienter in a 10b-5 action was Fischman v. Raytheon Mfg. Co., 188 F.2d 783 (2d Cir. 1951).
30. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 214 (1976) (scienter as used by the Court comports with "the commonly understood meaning of intentional wrongdoing").
31. Id. at 197 (the language of § 10(b) "strongly suggests that § 10(b) was intended to proscribe knowing or intentional misconduct"). For two post-Ernst & Ernst cases holding knowledge to be sufficient, see Raskas v. Supreme Equip. & Sys. Corp., 71 F.R.D. 672 (E.D.N.Y. 1976) (referring to knowledge as necessary under the most strict view of the scienter requirement); McLean v. Alexander, 420 F. Supp. 1057, 1082 (D. Del. 1976) ("knowing misconduct").
gested recklessness may supply the scienter element.\textsuperscript{32} Scienter creates further confusion because a court may require varying degrees of scienter depending upon the factual setting and the relief sought.\textsuperscript{33}

Prior to 1976, the United States Courts of Appeals had split on the issue of whether scienter was an essential element of a 10b-5 violation.\textsuperscript{34} The Ninth Circuit Court of Appeals consistently rejected the necessity of proving scienter\textsuperscript{35} and, in \textit{White v. Abrams},\textsuperscript{36} suggested the proper consideration is the extent of the duty to disclose that rule 10b-5 imposes on a particular defendant.\textsuperscript{37} \textit{White} instructed district courts to measure the extent of defendant's duty by a flexible standard. This standard required courts to focus on the goals of securities fraud legislation, by considering factors previously found significant in securities transactions\textsuperscript{38} and all factors relevant to the particular case.

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\textsuperscript{32} 425 U.S. 185, 193 n.12 ("In certain areas of the law reckless behavior is sufficient for liability under § 10(b) and Rule 10b-5."). At least two post-\textit{Ernst & Ernst} lower court decisions have read that case to permit including recklessness under rule 10b-5. Bailey v. Meister Brau, Inc., 555 F.2d 982, 993 (7th Cir. 1976); Rich v. Touche Ross & Co., 415 F. Supp. 95, 101 (S.D.N.Y. 1976).

33. See SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 866 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969) (Judge Friendly, in his concurring opinion, states that although negligent misstatement by a corporation may be enough for injunctive relief under rule 10b-5, the decision is not precedent for corporate liability for damages in a private action.); Mutual Shares Corp. v. Genesco, Inc., 384 F.2d 540, 547 (2d Cir. 1967) (held that a claim was stated under rule 10b-5 for injunctive relief but that the trial court properly dismissed the claim for damages); SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 193 (1963). ("[I]t is not necessary in a suit for equitable or prophylactic relief to establish all the elements required in a suit for monetary damages.").


35. See Royal Air Properties, Inc. v. Smith, 312 F.2d 210, 212 (9th Cir. 1962) ("common law fraud need not be alleged or ultimately proved"); Ellis v. Carter, 291 F.2d 270, 274 (9th Cir. 1961) (proof of genuine fraud unnecessary).

36. 495 F.2d 724 (9th Cir. 1974).

37. \textit{Id.} at 734-35.

38. Without limiting the trial court to the specific factors enumerated, \textit{White} sug-
The United States Supreme Court addressed the scienter issue in *Ernst & Ernst v. Hochfelder*, and concluded that absent some form of scienter, a private cause of action for damages will not lie under section 10(b) and rule 10b-5. Justice Powell, writing for the majority, emphasized section 10(b)’s language, which makes unlawful the use or employment of “any manipulative or deceptive device or contrivance” in contravention of SEC rules. He suggested the words “manipulative” or “deceptive” used in conjunction with “device” or “contrivance” indicate section 10(b) was directed at knowing or intentional misconduct and make unmistakable a congressional intent to proscribe a type of conduct different from negligence. Justice Powell found the word “manipulative” particularly significant, suggesting it is virtually a term of art that, when used in connection with securities markets, connotes intentional or willful conduct designed to deceive or defraud investors.

Although asserting the statute’s plain meaning might make further inquiry unnecessary, Justice Powell drew additional support from the Act’s legislative history. Legislative reports indi-


40. Id. at 193. The opinion fails, however, to define the state of mind necessary for a 10b-5 violation. Justice Powell initially defines scienter as “a mental state embracing intent to deceive, manipulate or defraud.” Id. at 193-94 n.12. The Court specifically declines to decide whether “reckless behavior is sufficient for civil liability under § 10(b) and rule 10b-5.” Id. The Court also fails to state explicitly whether scienter is present when defendant has knowledge, but where there is no proof of intent to deceive. Subsequent to *Ernst & Ernst*, most lower federal courts have found defendants liable under § 10(b) without requiring plaintiff to prove specific intent to defraud. See, e.g., Neill v. David A. Noyes & Co., 416 F. Supp. 78, 82 (N.D. Ill. 1976) (“some forms of scienter beyond mere negligence”). For a discussion of the future impact of *Ernst & Ernst*, see 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); Bucklo, *The Supreme Court Attempts to Define Scienter Under Rule 10b-5; Ernst & Ernst v. Hochfelder*, 29 STAN. L. Rev. 213 (1977); Cox, *Ernst & Ernst v. Hochfelder: A Critique and an Evaluation of Its Impact upon the Scheme of the Federal Securities Laws*, 28 Hastings L.J. 569 (1977). See note 32 supra.


42. 425 U.S. at 199.

43. Id.

44. See *Loss, Summary Remarks*, 30 Bus. Law 163, 165 (1975). Professor Loss argues that although the language of rule 10b-5 may not call for scienter, without a scienter requirement 10b-5 may exceed the bounds of its authorizing statute.

45. 425 U.S. at 201.

46. Id. at 201-06.
cated Congress intended good faith to be a defense under those sections of the 1934 Act creating express civil liability for manipulative practices. Accordingly, he concluded that good faith is a defense in suits brought under section 10(b)’s implied right of action.

Justice Powell argues most persuasively for scienter as a necessary 10b-5 element when he discusses the 1933 and 1934 Acts as interrelated components of the federal regulatory scheme governing securities transactions. In many of the provisions expressly creating civil liability in securities transactions, Congress clearly specified whether knowing or intentional conduct, negligence, or innocent mistake is culpable conduct. Congress also created procedural restrictions limiting purchasers’ and sellers’ ability to sue under these provisions. Rule 10b-5 has no comparable restrictions; therefore, if courts do not require some form of scienter, causes of action arising under the express liability provisions could be brought instead under the judicially created private damage remedy of rule 10b-5. This practice would nullify other provisions’ procedural limitations, thereby disrupting the federal regulatory scheme and circumventing congressional intent.

Because of the similarity in language between Washington’s unlawful transactions provision and rule 10b-5, Washington

47. Id. at 206.
48. Id.
49. Id. at 206-11. The Court stated:

We also consider it significant that each of the express civil remedies in the 1933 Act allowing recovery for negligent conduct, see §§ 11, 12(2), 15, . . . is subject to significant procedural restrictions not applicable under § 10(b) . . . . We think these procedural limitations indicate that the judicially created private damage remedy under § 10(b) — which has no comparable restrictions — cannot be extended, consistently with the intent of Congress, to actions premised on negligent wrongdoing. Such extension would allow causes of action covered by § 11, § 12(2), and § 15 to be brought under § 10(b) and thereby nullify the effectiveness of the carefully drawn procedural restrictions on these express actions.

Id. at 208-10 (footnotes omitted).
51. See, e.g., 15 U.S.C. §§ 78i (creating civil liability for any person who “willfully participates” in the manipulation of securities on a national exchange), 78r (creating civil liability for misleading statements filed with the Commission, but providing defendant with the defense that “he acted in good faith and had no knowledge that such statement was false and misleading”), 78t (imposing liability upon “controlling person[s]” for violations of the Act by those they control, but providing defendant with the defense that he “acted in good faith and did not . . . induce the act . . . constituting the violation”) (1970).
courts have looked to federal precedent when construing the Washington statute. In Shermer v. Baker,⁵³ the Washington Court of Appeals first considered whether scienter is necessary for a violation of the unlawful transactions provision. The court relied upon Ninth Circuit decisions holding proof of common law fraud, particularly the element of scienter, unnecessary to establish a 10b-5 cause of action.⁵⁴ Although noting the Ninth Circuit's interpretation of a similarly worded federal statute was not determinative of state law, the Washington court held plaintiff's reliance upon a material misrepresentation or omission established a cause of action under the unlawful transactions provision and proof of defendant's intent to deceive is not required.⁵⁵

The same appellate court recently reconsidered the "no scienter" interpretation of the unlawful transactions provision in Ludwig v. Mutual Real Estate Investors.⁵⁶ Ludwig impliedly overruled the court's previous interpretation and offered two grounds for limiting "fraud," as used in Washington's Securities Act, to its common law meaning.⁵⁷ First, when the Legislature uses a term without defining it and the term has a well known common law meaning, a presumption arises that the Legislature intended the common law meaning.⁵⁸ Second, the United States Supreme Court in Ernst & Ernst overruled the Ninth Circuit line of cases upon which the Washington court relied for its "no scienter" holding.⁵⁹

At common law, a plaintiff may recover damages incurred in the purchase or sale of securities under theories of (1) fraud and deceit, (2) constructive fraud or negligent misrepresentation, (3) liability based upon half-truth, and (4) liability based upon breach of fiduciary duty.⁶⁰ The first theory, fraud and deceit, requires scienter. In nonsecurities cases, however, Washington courts have firmly established their acceptance of the second theory, constructive fraud, which requires proof of negligence, but

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⁵⁴ 54. Royal Air Properties, Inc. v. Smith, 312 F.2d 210, 212 (9th Cir. 1962); Ellis v. Carter, 291 F.2d 270, 274 (9th Cir. 1961).
⁵⁵ 2 Wash. App. at 857-58, 472 P.2d at 597.
⁵⁷ Id. at 40, 567 P.2d at 661.
⁵⁸ Id. The court suggests the Legislature's refusal to adopt § 401(d) of the Uniform Act, which declares "fraud" is not limited to its common law meaning, strengthens the presumption.
⁵⁹ Id. at 40, 567 P.2d at 662.
not of scienter. 61

The Washington Supreme Court first indicated acceptance of the equitable or constructive fraud theory in Hanson v. Tompkins. 62 Relying on Hanson, Grant v. Huschke 63 held a vendor liable for false representations inducing a sale of real property, although he made them without knowledge of their falsity or intent to deceive, where the vendor knew the vendee was ignorant of the facts and relied upon the misrepresentations. By analogy, the rationale supporting application of the constructive fraud doctrine to real property transactions is more compelling in securities transactions because purchasers or sellers of securities are less able to protect themselves against misrepresentations. A real estate vendee can inspect the land to determine whether it conforms to the vendor's representations. Investors in securities, however, cannot realistically inspect a corporation's books, assets, or business practices, but must rely upon the representations of others. Investors, therefore, need more protection against factual misrepresentations. Because negligence, not common law fraud, is the basis of an action for constructive fraud, defendant's duty is to exercise reasonable care in disclosing material facts relevant to a securities transaction. 65

The unlawful transactions provision of Washington's Securities Act makes no specific reference to a scienter requirement. The statute provides:


62. 2 Wash. 508, 27 P. 73 (1891). Hanson was an action upon a promissory note given in part payment for real estate. Because plaintiff misrepresented the acreage, the court limited his recovery to the value of the tract as represented, stating:

If he knew the lot did not contain 36 ½ acres, and represented to defendants that it did, he would be guilty of fraud and deceit; but if he did not know it, and believed that the representations he made were true, and defendants, acting upon such representations, were damaged because it eventuated that they were not true, the liability of the plaintiff would be the same. In neither case will he be allowed to retain the benefit flowing from his misrepresentation.

Id. at 511, 27 P. at 74.

63. 74 Wash. 257, 133 P. 447 (1913). "[W]here the representations are as to pure matters of fact and made under circumstances entitling the adverse party to rely upon them as true, then the fact that they are false raises a legal presumption of fraudulent intent." Id. at 263, 133 P. at 449.


It is unlawful for any person, in connection with the offer, sale, or purchase of any security, directly or indirectly:

(1) To employ any device, scheme or artifice to defraud;
(2) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances in which they are made, not misleading; or
(3) To engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person.66

If courts impose a scienter element, its source, therefore, is judicial statutory construction.

Although courts can construe the words “to defraud” in clause (1) and “operate as a fraud” in clause (3) to mean common law fraud and, therefore, to require scienter, clause (2) has no such purport. The issue is whether these three clauses are mutually exclusive or should be read together. Clause (2) consists of two parts: the first speaks to material misstatements, or misfeasance, and the second to material omissions, or nonfeasance. A material misstatement can be considered a clause (1) “device” as well as a clause (3) “act.” Similarly, a material omission can be considered a clause (1) “scheme” as well as a clause (3) “practice.” Therefore, to imply a scienter requirement in clause (2) renders the clause superfluous. Although one can make the converse argument that dispensing with a scienter requirement in clause (2) renders clauses (1) and (3) superfluous, this analysis is faulty. Drafted in much broader terms than clause (2), clauses (1) and (3) apply to any fraudulent “device,” “scheme,” “artifice,” “act,” “practice,” or “course of business.” Clause (3)’s language is particularly expansive, appearing to make conduct unlawful whether or not it defrauds, because it is sufficient if the conduct “would operate” as a fraud or deceit. Clause (3)’s “course of business” suggests culpability arises from the cumulative effects of acts, none of which individually operates as a fraud or deceit. Clause (2), however, is narrowly drafted and applies to “statements” only. Simply because courts can construe the language of clauses (1) and (3) to require intent to deceive, does not mean the language of clause (2) imposes a scienter requirement.

Although the United States Supreme Court held some form of scienter an element of the similarly worded rule 10b-5, the factors underlying the Court’s decision67 have tenuous signifi-

67. See text accompanying notes 39-51 supra.
cance in construing Washington's unlawful transactions provision. Rule 10b-5 makes no explicit reference to a scienter requirement. Section 10(b) is also devoid of any specific language requiring scienter, but authorizes rules and regulations proscribing "any manipulative or deceptive device." Rule 10b-5, like any other administrative regulation, must be within the ambit of its enabling statute to be valid. Therefore, if one accepts Justice Powell's analysis that "manipulative" connotes intentional and wilful conduct, section 10(b) limits the Securities and Exchange Commission's authority to promulgating rules requiring scienter. Rule 10b-5's language, unencumbered by the language of its enabling statute, does not require scienter. Although the language of Washington's unlawful transactions provision is substantially rule 10b-5's, the statute omits the "manipulative or deceptive" language of section 10(b) of the 1934 Act—the language the Court found so convincing in Ernst & Ernst. Ludwig failed to recognize that, by enacting the unlawful transactions provision, the Washington Legislature elevated the language of rule 10b-5 to independent statutory significance and, therefore, the statute does not require scienter.

Ernst & Ernst's legislative history analysis is unpersuasive when applied to Washington's unlawful transactions provision because congressional legislative history is irrelevant to state statutory construction and because Washington's Securities Act contains its own legislative intent section. Although the Washington statute commands courts to construe Chapter 21.20 to coordinate its interpretation and administration with the related federal law, Shermer v. Baker unequivocally states that coordination does not require imitation. The section merely requires the courts to construe and enforce the Washington Act in a manner not interfering with the federal scheme. So long as they meet this requirement, Washington courts may construe the state statute in a manner best promoting its purpose of protecting investors from fraudulent practices and dishonest schemes.

69. Wash. Rev. Code § 21.20.900 (1976) states: "STATUTORY POLICY 21.20.900 Construction to secure uniformity. This chapter shall be so construed as to effectuate its general purpose to make uniform the law of those states which enact it and to coordinate the interpretation and administration of this chapter with the related federal regulation."
71. A plaintiff can choose either a federal or state forum only if he can meet the federal jurisdictional requirements. Eliminating the scienter element under Washington's unlawful transactions provision, and thus reducing plaintiff's burden of proof, will beneficially affect the federal scheme by reducing the number of claims brought in the federal forum.
A "no scienter" construction of the unlawful transactions provision will not undermine the anti-fraud provisions of the Washington Act. Although the structure of the federal securities scheme buttresses Justice Powell's position that construing rule 10b-5 in harmony with other federal securities provisions compels a scienter requirement for 10b-5 actions, his analysis is inapplicable when courts construe Washington's Securities Act. Three statutes comprise the "Fraudulent and Other Prohibited Practices" section of the Act, but only the unlawful transactions provision deals with offers, sales, or purchases. Analysis of the relationship between the unlawful transactions provision and the criminal liabilities provision adds further support to the "no scienter" construction. The latter provides criminal sanctions for any willful violation of the unlawful transactions provision. The Washington Supreme Court defines willful as recklessly making untrue statements, without knowledge of the facts, and with intent to deceive. Based upon the statutory tort theory, under which violation of a criminal statute may result in civil liability, any violation of the criminal liabilities provision may imply a private action for damages after determination of criminal liability. Therefore, to read an intent to deceive requirement into the unlawful transactions provision renders the provision superfluous.

72. See notes 48-50 supra and accompanying text.
74. CRIMINAL LIABILITIES
21.20.400 Penalty for violation of chapter—Limitations of actions.
Any person who wilfully violates any provision of this chapter except RCW 21.20.350, or who wilfully violates RCW 21.20.350 knowing the statement made to be false or misleading in any material respect, shall upon conviction be fined not more than five thousand dollars or imprisoned not more than ten years, or both; but no person may be imprisoned for the violation of any rule or order if he proves that he had no knowledge of the rule or order. No indictment or information may be returned under this chapter more than five years after the alleged violation.

77. The meaning of the term "implied remedy" is set out in this language of the Supreme Court: "[D]isregard of the command of the statute [which does not specifically create a civil remedy] is a wrongful act, and where it results in damage to one of the class for whose especial benefit the statute was enacted, the right to recover the damages from the party in default is implied . . . ." Texas & Pac. Ry. v. Rigby, 241 U.S. 33, 39 (1916).
78. Washington is committed to the rule that the violation of a positive statute or
Washington's Securities Act expresses in its legislative intent section the statutory policy that courts construe the Act's provisions to make uniform the law of those states adopting the Uniform Act. This clearly stated policy required the Ludwig court to consider decisions reached in other Uniform Securities Act jurisdictions. The unlawful transactions provision of the Securities Act of New Mexico is almost identical to Washington's. In Treider v. Doherty & Co., the only other decision construing an unlawful transactions provision, the New Mexico Court of Appeals discussed the elements of a violation of that statute. The court construed the statute to require only a material false statement or an omission of a material fact necessary to make the statement true. The court stated defendant's intent is irrelevant under the statute's terms. Although Washington's legislative intent section did not require Ludwig to accept the New Mexico Court of Appeals' analysis, the section did require the court to consider the Treider precedent when construing the unlawful transactions provision.

In construing Washington's unlawful transactions provision, courts must realize the common law doctrines of fraud and deceit emerged from a business climate very different from that involved in the sale of securities. Unlike purchasers of tangible assets, securities investors generally cannot rely upon their own investigation. Furthermore, expert advice is unavailing where only an "insider" has access to critical information. Scienter encompasses a moral element that is inappropriate in deciding the


79. See note 69 supra.

80. Fraudulent practices—A. It is a fraudulent practice and unlawful for any person, in connection with an offer, sale or purchase of any security, directly or indirectly, to:
   (1) employ any device, scheme or artifice to defraud;
   (2) make any false statement of material fact or to omit to state a material fact necessary in order to make the statements made true in light of circumstances under which they are made; or
   (3) engage in any act, practice or course of business which operates, or would operate, as a fraud or deceit upon any person.

82. 86 N.M. 735, 527 P.2d 498 (1975).
83. Id. at 737, 537 P.2d at 500.
84. Id.
question of civil liability for a securities law violation. The statutory remedy for violation of the unlawful transactions provision is rescission. As in contract analysis, the right of the aggrieved party to be made whole should depend upon whether the opposing party actually performed his promise, not upon whether he intended to perform.

Although strict liability, as in contract analysis, would promote civil liability's compensatory objectives, Washington courts should reject this standard, because it would pit innocent parties against each other and result in compensation of undeserving investors by innocent investors. Additionally, strict liability might have unsettling effects on the securities markets because placing oppressive burdens on good faith sellers may restrict the volume of securities transactions. Conversely, insuring investors against ordinary investment losses upon proof of an inadvertent and faultless misstatement or omission made prior to the transaction encourages speculation. Furthermore, a strict liability standard may adversely affect the flow of information to the public. Liability for inadvertent misstatements or omissions may inhibit voluntary disclosures of information to the market and retard, rather than promote, the goals of the unlawful transactions provision.

When construing the unlawful transactions provision, Washington courts should look to the statute's purpose of protecting investors who rely on market information. Courts should apply a standard that promotes equality of bargaining power between purchasers and sellers of securities. A knowledge standard is superior to a common law fraud standard for three reasons: (1) it is more attuned to the information distribution aspects of securities law; (2) it eliminates judicial reliance upon scienter, or other catch phrases, and promotes sound factual analysis; and (3) it places an equal burden on both parties to the transaction because the knowledge of each determines potential liability. Washington courts, therefore, should focus on what defendant knows or reasonably should know about a particular transaction rather than on his subjective intent.

87. Courts should require both parties to reasonably investigate the facts and circumstances surrounding the transaction. An investor should not be liable unless a reasonable investigation would have disclosed the misstated or omitted information.
89. Id. at 834.
Judicial inquiry must focus on the parties' relative knowledge. Plaintiff may allege either a material misrepresentation or omission, but must prove defendant's representations induced a transaction detrimental to plaintiff. Defendant is not liable, however, if he was unaware of the falsity or omission, and may assert as a defense plaintiff's actual or constructive knowledge of the facts. Thus, if defendant was aware of the falsity or omission, but plaintiff also knew the truth, defendant is not liable. This standard avoids the problems of intent and innocent mistake, yet protects the investor by requiring judicial examination of the parties' knowledge.

In applying a knowledge standard to alleged violations of the unlawful transactions provision, courts must also consider constructive knowledge in determining liability. Actual knowledge is the belief in the existence of a fact that coincides with the truth.\textsuperscript{90} Constructive knowledge is what a reasonable person should know rather than what he does know. Constructive knowledge also means knowledge of facts stimulating inquiry or failure to perform a duty of acquiring information.\textsuperscript{91} The constructive knowledge of both plaintiff and defendant is relevant, but the trier of fact should focus on the reasonableness of each party's investigation into the facts. In analyzing the reasonableness of the parties' investigations, the trier of fact must consider such factors as the parties' relative access to information and defendant's activity in initiating the transaction to determine whether constructive knowledge can be attributed to either plaintiff or defendant.\textsuperscript{92} This approach recognizes that one investor may have less ability than another to give the other contracting party an accurate picture of a particular transaction and apportions liability accordingly. The investor who, in connection with the offer, sale, or purchase of a security, makes a material misstatement or omission should not be liable unless a reasonable investigation under the circumstances would have uncovered the misstated or omitted information. The emphasis is on access to knowledge, and the knowledge standard effectuates the unlawful transactions provision's policy of protecting gullible, unsophisticated investors, without the potential adverse effects of alternative standards of liability.

Nothing in the language of Washington's Securities Act indicates scienter is a necessary element of a violation of the unlawful

\textsuperscript{90} W. Prosser, supra note 24, § 32, at 150.
\textsuperscript{91} 1 M. Merrill, Merrill on Notice § 18 (1952).
\textsuperscript{92} Note 38 supra.
transactions provision. Courts should not read the legislative intent section\textsuperscript{93} of the Washington Act to require intent to deceive. The unlawful transactions provision's relationship to other substantive provisions militates against a scienter requirement.\textsuperscript{94} If Washington courts require scienter, the unlawful transactions provision is little improvement, if any, over the old common law, long ago found incapable of adequately policing modern day securities transactions.\textsuperscript{95} \textit{Ludwig v. Mutual Real Estate Investors} constitutes a complete abdication by a Washington court of any role in policing securities transactions falling outside narrowly defined categories of conduct\textsuperscript{96} and, therefore, represents another instance of state courts refusing to seize the opportunities presented to them and an unfortunate example of a failure of federalism.

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\begin{itemize}
\item \textsuperscript{93} See note 69 \textit{supra}.
\item \textsuperscript{94} See notes 72-78 \textit{supra}, and accompanying text.
\item \textsuperscript{96} E.g., \textit{WAsh. REV. CODE} §§ 21.20.140 (sale of unregistered securities), .350 (false and misleading statements in filed documents) (1976).
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