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RULE 10b-5 OMISSIONS CASES AND THE INVESTMENT DECISION

MARK A. HELMAN*

INTRODUCTION

The judicially created private right of action¹ under Rule 10b-5 (Rule)² permits a defrauded security purchaser or seller to recover damages from the perpetrator of the fraud. Because the private action is not an action for enforcement,³ the plaintiff must show that his injury was caused by the defendant.⁴ Drawing from the common-law action for fraud,⁵ courts prior to 1972 required the plaintiff, in an

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1. Rule 10b-5 was not originally drafted to create a private right of action. Note, *SEC Rule 10b-5: A Recent Profile*, 13 Wm. & Mary L. Rev. 860, 865-66 & n.27 (1972). Moreover, the legislative history of the Securities and Exchange Act of 1934 indicates that Congress did not intend to create a private right of action for securities fraud. Bromberg, *Are There Limits to Rule 10b-5?*, 29 Bus. Law. 167, 167 (1974) (Special Issue); see Note, *Reliance Under Rule 10b-5: Is the "Reasonable Investor" Reasonable?*, 72 Colum. L. Rev. 562, 563-65 (1972) [hereinafter cited as *Reasonable Investor*]. The first case to imply a private right of action under the Rule was *Kardon v. National Gypsum Co.*, 73 F. Supp. 798, 802-03 (E.D. Pa.), *modified on other grounds*, 83 F. Supp. 613 (E.D. Pa. 1947). The Supreme Court first recognized that a federal securities statute implied a private right of action in *J.I. Case Co. v. Borak*, 377 U.S. 426, 430-31 (1964), and acknowledged a private right of action under the Rule in *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 13 n.9 (1971).

2. 17 C.F.R. § 240.10b-5 (1982) (promulgated under the Securities and Exchange Act of 1934, § 10(b), 15 U.S.C. § 78(j)(b) (1976)). The Rule 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, 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.

3. *Dupuy v. Dupuy*, 551 F.2d 1005, 1016 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977).

4. See 2 A. Bromberg & L. Lowenfels, *Securities Fraud & Commodities Fraud* § 4.7(550-551) (1981); 3 *id.* § 8.7(1); 3 L. Loss, *Securities Regulation* 1430-44 (2d ed. 1961).

5. Because the Rule was designed to protect investors from deceptive practices in connection with the purchase or sale of securities, Crane, *An Analysis of Causation Under Rule 10b-5*, 9 Sec. Reg. L.J. 99, 116 (1981), the common-law tort of fraud has

action under the Rule, to establish inter alia that the defendant misrepresented or omitted a material fact⁶ and that the plaintiff relied on the misrepresentation or omission in making his investment decision.⁷

In cases of misrepresentation, proof of reliance does not pose special difficulties. But in cases in which the defendant omits material facts, the plaintiff's task is far more difficult.⁸ Recognizing the practical difficulty of proving whether an omission was relied upon,⁹ the Supreme Court in *Affiliated Ute Citizens v. United States*¹⁰ came to the aid of plaintiffs. The Court held that proof of reliance in cases involving primarily a failure to disclose was not a prerequisite to recovery; rather, all that was required was a showing that the defendant had an

provided the foundation for developing the compensatory elements of the private right of action under the Rule. See 3 L. Loss, *supra* note 4, at 1430-44; Note, *The Nature and Scope of the Reliance Requirement in Private Actions Under SEC Rule 10b-5*, 24 Case W. Res. L. Rev. 363, 366-69 (1973) [hereinafter cited as *Private Actions*]. Although the private action under the Rule is based on the common law, courts have gone beyond the common law in defining its nature and scope. Whalen, *Causation and Reliance in Private Actions Under SEC Rule 10b-5*, 13 Pac. L.J. 1003, 1015 (1982); Note, *The Reliance Requirement in Private Actions Under SEC Rule 10b-5*, 88 Harv. L. Rev. 584, 585 (1975) [hereinafter cited as *Reliance Requirement*].

6. See *List v. Fashion Park, Inc.*, 340 F.2d 457, 462-63 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965).

7. *List v. Lerner*, 382 U.S. 811 (1965), is the case cited most often for the proposition that reliance is a necessary element of a 10b-5 private action. See, e.g., Stoll, *Reliance as an Element in 10b-5 Actions*, 53 Or. L. Rev. 169, 173 (1974); *Private Actions*, *supra* note 5, at 368. One commentator contends, however, that the *List* test is not one of reliance but is rather a "but for" test indicating causation in fact. Whalen, *supra* note 5, at 1021.

8. It may be impossible for a plaintiff to prove with any certainty that he relied upon the converse of an omitted fact in deciding to engage in a securities transaction. See *infra* notes 38-43 and accompanying text. In the context of omissions, the distinction between materiality and reliance has been blurred. 3 A. Bromberg & L. Lowenfels, *supra* note 4, § 8.6(1) ("[Reliance, causation and materiality] have become partially interchangeable and various combinations [may] suffice in different situations."); see *Wilson v. Comtech Telecommunications Corp.*, 648 F.2d 88, 92 n.6 (2d Cir. 1981) ("The concepts of reliance and causation have often been used interchangeably in the context of rule 10b-5 cases."). One court has noted:

[W]e prefer to recognize that materiality directly establishes causation more likely than not, and that reliance as a separate requirement is simply a milepost on the road to causation. The net result is in either view the same; the validity of either view turns on the assumption that the particular investor is more likely to act like the reasonable investor than not.

Blackie v. Barrack, 524 F.2d 891, 906 n.22 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976). But see *Huddleston v. Herman & MacLean*, 640 F.2d 534, 548-49 (5th Cir. 1981) (subjective reliance standard, "tempered by the requirement of due diligence on the part of the plaintiff," contrasted with materiality and causation), *cert. granted*, 102 S. Ct. 1766 (1982).

9. See Whalen, *supra* note 5, at 1050.

10. 406 U.S. 128 (1972).

obligation to disclose the omitted fact to the plaintiff¹¹ and that the omission was objectively material.¹²

It was initially thought that this holding, characterized in subsequent cases as the "*Ute* presumption" of reliance,¹³ provided the standard of proof of reliance for every action under the Rule. Decisions since 1972, however, have varied in their treatment of *Affiliated Ute*.¹⁴ Most courts, not eager to abandon the linkage of the Rule 10b-5 private remedy to the individual circumstances and injury of the plaintiff, have found the *Ute* presumption to be rebuttable¹⁵ and/or have imposed a requirement of due diligence on the plaintiff.¹⁶ Despite these efforts to circumvent *Affiliated Ute*, defendants still have a difficult burden defending against 10b-5 omissions cases.¹⁷

11. In cases of total nondisclosure, the plaintiff must show before reaching the causation issue that the defendant had a duty to disclose the omitted fact. *See, e.g., id.* at 153; *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith*, 495 F.2d 228, 235-38 (2d Cir. 1974). In *Chiarella v. United States*, 445 U.S. 222 (1980), the Supreme Court held that the duty to disclose arises "when one party has information 'that the other . . . is entitled to know because of a fiduciary or other similar relation of trust and confidence between them,'" *id.* at 228 (quoting Restatement (Second) of Torts § 551(2)(a) (1976)), and the Court limited the applicability of *Affiliated Ute* to such circumstances. *See id.* at 229-30. Whether a duty to disclose material information exists is beyond the scope of this Article; for purposes of this Article such a disclosure duty will be assumed. For a general discussion of the duty to disclose, see Brudney, *Insiders, Outsiders and Informational Advantages Under the Federal Securities Laws*, 93 Harv. L. Rev. 322 (1979).

12. 406 U.S. at 153-54.

13. *Shores v. Sklar*, 647 F.2d 462, 468 (5th Cir. 1981); *see Holdsworth v. Strong*, 545 F.2d 687, 695 (10th Cir. 1976), *cert. denied*, 430 U.S. 955 (1977); *Simon v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 482 F.2d 880, 884 (5th Cir. 1973).

14. *See infra* notes 37-46 and accompanying text. *See generally* Crane, *supra* note 5, at 102-03 (discussion of treatment of *Affiliated Ute* by lower federal courts); Whalen, *supra* note 5, at 1040-55 (same).

15. *See, e.g., Chelsea Assocs. v. Rapanos*, 527 F.2d 1266, 1271-72 (6th Cir. 1975); *Carras v. Burns*, 516 F.2d 251, 257 (4th Cir. 1975); *Rochez Bros. v. Rhoades*, 491 F.2d 402, 410 (3d Cir. 1974), *cert. denied*, 425 U.S. 993 (1976). For arguments in support of the rebuttability of the *Ute* presumption, see Whalen, *supra* note 5, at 1050; *Reliance Requirement*, *supra* note 5, at 597-600.

16. *See, e.g., Bird v. Ferry*, 497 F.2d 112, 114 (5th Cir. 1974); *Rochez Bros. v. Rhoades*, 491 F.2d 402, 409 (3d Cir. 1974), *cert. denied*, 425 U.S. 993 (1976); *Financial Indus. Fund, Inc. v. McDonnell Douglas Corp.*, 474 F.2d 514, 521 (10th Cir) (per curiam), *cert. denied*, 414 U.S. 874 (1973). Articles that have focused upon the plaintiff's "due diligence" requirement include Wheeler, *Plaintiff's Duty of Due Care Under Rule 10b-5: An Implied Defense to an Implied Remedy*, 70 Nw. U.L. Rev. 561 (1976); Note, *The Due Diligence Requirement for Plaintiffs Under Rule 10b-5*, 1975 Duke L.J. 753 [hereinafter cited as *Due Diligence Requirement*]; Note, *A Reevaluation of the Due Diligence Requirement for Plaintiffs in Private Actions Under SEC Rule 10b-5*, 1978 Wis. L. Rev. 904 [hereinafter cited as *Due Diligence Reevaluation*].

17. For the same reasons that plaintiffs had difficulty proving reliance in cases of nondisclosure prior to *Affiliated Ute*, see *infra* notes 39-44 and accompanying text, defendants now have great difficulty rebutting the presumption by introducing

This Article contends that the defendant's burden is more easily met by the use of a careful analysis of the plaintiff's investment decision, which may then be applied to the elements of causation under the Rule. Part I of this Article sets forth the elements necessary to show causation and summarizes the various, often conflicting, positions that courts have taken with respect to each. Part II examines the ways in which evidence concerning the plaintiff's investment decision in a face-to-face transaction has been analyzed and used to show a lack of causation under the Rule. Finally, Part III shows how such evidence has been analyzed and used even more broadly in open market transactions.

I. ELEMENTS OF TRANSACTION CAUSATION

Causation under Rule 10b-5 takes two forms. The first is the requirement "that the defendant's fraud must precipitate the [plaintiff's] investment decision."¹⁸ The second refers to "a direct causal link between the misstatement [or omission] and the claimant's economic loss."¹⁹ These two forms have been referred to, respectively, as transaction causation and loss causation.²⁰ This Article primarily examines the ways in which the investment decision can be analyzed to show a lack of transaction causation. Before examining the defenses to evidence of this form of causation, however, it is first necessary to discuss the three elements courts have required to prove transaction causation—materiality, reliance and due diligence.

evidence of nonreliance. See *Reliance Requirement*, *supra* note 5, at 590 n.33, 598. Moreover, some courts have relaxed the duty of care imposed upon plaintiffs in response to the Supreme Court's decision in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), which was that the Rule requires scienter. *E.g.*, *Mallis v. Bankers Trust Co.*, 615 F.2d 68, 77-79 (2d Cir. 1980) (recklessness standard), *cert. denied*, 449 U.S. 1123 (1981); *Dupuy v. Dupuy*, 551 F.2d 1005, 1020 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977) (same). In addition, several courts have shifted to the defendant the burden of proving plaintiff's lack of due care. *E.g.*, *Mallis v. Bankers Trust Co.*, 615 F.2d 68, 78-79 (2d Cir. 1980), *cert. denied*, 449 U.S. 1123 (1981); *Straub v. Vaisman & Co.*, 540 F.2d 591, 598 (3d Cir. 1976).

18. *Huddleston v. Herman & MacLean*, 640 F.2d 534, 549 n.24 (5th Cir. 1981), *cert. granted*, 102 S. Ct. 1766 (1982).

19. *Id.*

20. This terminology was first suggested in an article analyzing Rule 14a-9. Note, *Causation and Liability in Private Actions for Proxy Violations*, 80 Yale L.J. 107, 123-25 (1970). Although some courts have adopted this terminology in analyzing Rule 10b-5, *e.g.*, *Blackie v. Barrack*, 524 F.2d 891, 906 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976); *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374, 380-82 (2d Cir. 1974), *cert. denied*, 421 U.S. 976 (1975), it is not generally used by courts. *Crane*, *supra* note 5, at 100; *Whalen*, *supra* note 5, at 1016 n.95. Nevertheless, commentators have found this distinction useful for purposes of analysis. *Crane*, *supra* note 5, at 100; *Whalen*, *supra* note 5, at 1016 n.95.

A. Materiality

The requirement in a common-law action for fraud that a misrepresentation or omission be objectively significant, or "material,"²¹ protects the defendant from a plaintiff's use of any misrepresented or omitted fact, no matter how trivial, "as a pretext for escaping a bargain that he is dissatisfied with on other grounds."²² The conventional test for materiality at common law is whether a reasonable man would attach importance to the misrepresentation or omission in determining his choice of action.²³ Federal courts have drawn upon the common-law tort of deceit to establish a requirement of materiality under the Rule.²⁴ In *TSC Industries v. Northway, Inc.*,²⁵ a Rule 14(a)-9 case,²⁶ the Supreme Court set forth a test of materiality:

An omitted fact is material if there is a substantial likelihood that . . . the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. . . . [T]here must be 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.²⁷

Courts have held this to be the controlling test in Rule 10b-5 actions.²⁸

B. Reliance

At common law, proof of the causal connection between the defendant's fraudulent conduct and the resulting injury to the plaintiff requires a showing that the plaintiff relied to his detriment upon the misrepresentation.²⁹ Initially, federal courts had imposed a similar

21. Restatement (Second) of Torts § 538 (1977) [hereinafter cited as Restatement]; W. Prosser, Handbook of the Law of Torts § 108 (4th ed. 1971).

22. W. Prosser, *supra* note 21, at 719 (quoting Keeton, *Actionable Misrepresentation: Legal Fault as a Requirement II. Rescission*, 2 Okla. L. Rev. 56, 59 (1949)).

23. Restatement, *supra* note 21, § 538(2)(a), at 80; W. Prosser, *supra* note 21, at 719.

24. See *supra* note 5 and accompanying text.

25. 426 U.S. 438 (1976).

26. 17 C.F.R. § 240.14(a)-9(a) (1982), governs, in language similar to that of the Rule, the solicitation of shareholder proxies.

27. 426 U.S. at 449 (footnote omitted).

28. *E.g.*, Piper v. Chris-Craft Indus., 430 U.S. 1, 49 (1977) (Blackmun, J., concurring); S.D. Cohn & Co. v. Woolf, 426 U.S. 944 (1976) (remanding 10b-5 case for reconsideration in light of *Northway*); Kramas v. Security Gas & Oil, Inc., 672 F.2d 766, 769 & n.3 (9th Cir. 1982); Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1040 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977); Berman v. Gerber Prods. Co., [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,506, at 93,956 (W.D. Mich. 1978).

29. W. Prosser, *supra* note 21, § 105, at 686; *id.* § 108, at 714-20.

requirement in 10b-5 actions.³⁰ But in its 1972 decision of *Affiliated Ute Citizens v. United States*,³¹ the Supreme Court departed from the common-law requirement and altered the reliance requirement under the Rule by raising a presumption of reliance in certain circumstances.

Affiliated Ute involved a scheme to sell stock in an association that was formed to manage claims of the Ute Indian tribe concerning oil, gas and mineral rights. The individual defendants, employees of the transfer agent, had been acting as market makers in the securities without disclosing that fact, effecting sales to nonmembers of the tribe at substantial mark-ups over the price at which they bought the shares.³² The Tenth Circuit held that the misstatement of price was a basis of Rule 10b-5 liability,³³ but was unwilling to permit recovery because the record disclosed no evidence of reliance on the misrepresentations.³⁴ On review, the Supreme Court re-characterized the fraud as primarily an omission—the omission to state facts concerning the defendants' function as market makers. The Court went on to hold that in these circumstances reliance could be presumed from the materiality of the omission:

Under the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision. . . . This obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact.³⁵

This holding has become known as the "*Ute* presumption" of reliance.³⁶

30. *E.g.*, *List v. Fashion Park, Inc.*, 340 F.2d 457, 462-63 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965).

31. 406 U.S. 128 (1972). In the early 1970's, the use of Rule 10b-5 was greatly expanded as a private remedy for a defrauded investor. *Herpich v. Wallace*, 430 F.2d 792, 804 (5th Cir. 1970). Among the aspects of the Rule that were affected were the "abolition or relaxation of the purchaser-seller standing rule, erosion of the scienter standard, and elimination of the privity requirement." *Due Diligence Requirement*, *supra* note 16, at 753 (footnotes omitted). *See generally* Bromberg, *supra* note 1.

32. 406 U.S. at 145-51.

33. *Reynos v. United States*, 431 F.2d 1337 (10th Cir. 1970), *rev'd sub nom. Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972).

34. *Id.* at 1348.

35. 406 U.S. at 153-54.

36. *See supra* note 13 and accompanying text. Since *Affiliated Ute*, defendants have attempted to circumvent this presumption. Some of the grounds upon which defendants have sought to distinguish *Affiliated Ute* are:

It is not certain whether, by [its holding in *Affiliated Ute*], the Supreme Court meant to eliminate reliance as an issue altogether. It may be that "under these circumstances" means nondisclosure, or face-to-face transactions, or transactions between the sophisticated and the unsophisticated, or any combination of the foregoing.

Subsequent decisions of lower federal courts have disagreed whether reliance is still required. Several early cases held that proof of reliance is not necessary for 10b-5 recovery.³⁷ Most courts, however, distinguish between misrepresentations and omissions, requiring proof of reliance with regard to the former and imposing the *Ute* presumption on the latter.³⁸ Some have simply applied the *Ute* presumption to omissions cases without analysis,³⁹ although others have found that difficulties of proof support the distinction. Because no special difficulty exists in demonstrating reliance in cases of misrepresentation,⁴⁰ requiring a showing of reliance furthers the compensatory purpose of private actions without imposing an undue burden on plaintiffs.⁴¹ In contrast, proof of reliance “has little rational role” in cases of nondisclosure, largely because of the difficulty of proving reliance on the negative.⁴² Raising a presumption of reliance upon a showing of materiality alleviates this difficult burden,⁴³ and several courts have used the difficulty of proof of reliance to support application of the *Ute* presumption in omissions cases.⁴⁴ However, because the Rule is

Wheeler, *supra* note 16, at 594 n.105; *see, e.g.*, Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974) (defendant argued that *Affiliated Ute* should be applicable only to face-to-face transactions); Simon v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 482 F.2d 880 (5th Cir. 1973) (defendant successfully argued that *Affiliated Ute* should be applicable to nondisclosure only when there was general reliance on defendant's representations).

37. Swanson v. American Consumer's Indus., 475 F.2d 516, 520-21 (7th Cir. 1973); Davis v. Avco Corp., 371 F. Supp. 782, 792 (N.D. Ohio 1974); Allen Organ Co. v. North Am. Rockwell Corp., 363 F. Supp. 1117, 1127 (E.D. Pa. 1973).

38. Crane, *supra* note 5, at 103; *see, e.g.*, Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977); Forrestal Village, Inc. v. Graham, 551 F.2d 411, 414 (D.C. Cir. 1977); Titan Group, Inc. v. Faggen, 513 F.2d 234, 238-39 (2d Cir.), *cert. denied*, 423 U.S. 840 (1975). One commentator has criticized the omission/misrepresentation distinction, noting that most misrepresentations can be phrased in terms of omissions. Crane, *supra* note 5, at 103. One court has extended the *Ute* presumption to misrepresentations. Carras v. Burns, 516 F.2d 251, 257 (4th Cir. 1975).

39. *E.g.*, Holmes v. Bateson, 583 F.2d 542, 558 (1st Cir. 1978); Rochez Bros. v. Rhoades, 491 F.2d 402, 410 (3d Cir. 1974), *cert. denied*, 425 U.S. 993 (1976).

40. Whalen, *supra* note 5, at 1047-48; *Reliance Requirement*, *supra* note 5, at 589. Reliance, by definition, requires a belief in the truth of the misrepresentation and action based on that belief. W. Prosser, *supra* note 21, § 108, at 714-15.

41. *Reliance Requirement*, *supra* note 5, at 589-90. But as one commentator noted, the *Ute* presumption “is not wholly consistent with the compensatory function of the private action. . . . [S]ome plaintiffs who did not in fact rely upon a material nondisclosure might recover if a presumption were adopted.” *Id.* at 590.

42. *Reliance Requirement*, *supra* note 5, at 590 (quoting 3 A. Bromberg & L. Lowenfels, *supra* note 4, § 8.6(1) at 209); *accord* Whalen, *supra* note 5, at 1039, 1050.

43. Whalen, *supra* note 5, at 1050; *Reliance Requirement*, *supra* note 5, at 590.

44. *E.g.*, Holdsworth v. Strong, 545 F.2d 687, 695 (10th Cir. 1976), *cert. denied* 430 U.S. 955 (1977); Chelsea Assocs. v. Rapanos, 527 F.2d 1266, 1271 (6th Cir. 1975); Titan Group, Inc. v. Faggen, 513 F.2d 234, 239 (2d Cir.), *cert. denied*, 423 U.S. 840 (1975).

not a policy of "investors' insurance,"⁴⁵ some of the courts adhering to the misrepresentation/omission distinction have made the presumption of reliance in omissions cases rebuttable.⁴⁶

C. Due Diligence

The common-law action for fraud requires that reliance be justifiable,⁴⁷ as courts have reasoned that a plaintiff who relies on "preposterous" representations or who closes his eyes to the "patently and obviously false" should be responsible for his own loss.⁴⁸ From this concept courts developed the broader requirement under the Rule of due diligence, which requires the investor as a prerequisite to recovery to take reasonable steps to protect his interests.⁴⁹ Particularly following *Affiliated Ute*, and perhaps to circumvent its presumption of reliance,⁵⁰ the requirement of due diligence has been generally treated as a separate element of a 10b-5 claim, distinct from the reliance issue.⁵¹

Prior to 1976, many courts permitted recovery under the Rule even though the defendant's conduct was merely negligent,⁵² provided that plaintiff could show his own due diligence. These courts analogized the requirement of due diligence to the defense of contributory negli-

45. *List v. Fashion Park, Inc.*, 340 F.2d 457, 463 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965).

46. *Rifkin v. Crow*, 574 F.2d 256, 262-63 (5th Cir. 1978); *St. Louis Union Trust Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 562 F.2d 1040, 1049 (8th Cir. 1977), *cert. denied*, 435 U.S. 925 (1978); *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1048 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977); *Chelsea Assocs. v. Rapanos*, 527 F.2d 1266, 1271-72 (6th Cir. 1975); *Carras v. Burns*, 516 F.2d 251, 257 (4th Cir. 1975); *Rochez Bros. v. Rhoades*, 491 F.2d 402, 410 (3d Cir. 1974), *cert. denied*, 425 U.S. 993 (1976).

47. Restatement, *supra* note 21, § 537; W. Prosser, *supra* note 21, § 108, at 715-18.

48. W. Prosser, *supra* note 21, § 108, at 716.

49. *E.g.*, *Clement A. Evans & Co. v. McAlpine*, 434 F.2d 100, 103-04 (5th Cir. 1970), *cert. denied*, 402 U.S. 988 (1971); *City Nat'l Bank v. Vanderboom*, 422 F.2d 221, 230-31 (8th Cir.), *cert. denied*, 399 U.S. 905 (1970). One commentator has recently pointed out that requiring some form of due care on the part of the plaintiff furthers the underlying policies of the Securities Acts—to provide access to relevant information and to ensure market stability: "Market stability may be threatened as much by investor carelessness as it is by manipulations and full access to information is useless if investors are not encouraged to take advantage of that access. Both these policies are promoted by requiring some form of investor caution." Crane, *supra* note 5, at 116.

50. See Crane, *supra* note 5, at 112.

51. *E.g.*, *Rochez Bros. v. Rhoades*, 491 F.2d 402, 409 (3d Cir. 1974), *cert. denied*, 425 U.S. 993 (1976); *Clement A. Evans & Co. v. McAlpine*, 434 F.2d 100, 103-04 (5th Cir. 1970), *cert. denied*, 402 U.S. 988 (1971); Crane, *supra* note 5, at 112; *Due Diligence Requirement*, *supra* note 16, at 760-61.

52. *E.g.*, *Kohler v. Kohler Co.*, 319 F.2d 634, 637 (7th Cir. 1963).

gence.⁵³ In 1976, when the Supreme Court in *Ernst & Ernst v. Hochfelder*⁵⁴ required proof of scienter under the Rule, it prompted lower courts to decide whether due diligence was still a necessary showing when the defendant's actions were intentional.

Several circuits have rejected the due diligence requirement as a distinct element of transaction causation.⁵⁵ For example, in *Holdsworth v. Strong*,⁵⁶ the Tenth Circuit noted that *Ernst & Ernst* brought "the standards for 10b-5 liability closer to the analogous tort of deceit or intentional misrepresentation."⁵⁷ The court reasoned that, "[j]ust as contributory negligence is not a defense to an intentional tort case of fraud, similarly due diligence is totally inapposite in the context of intentional conduct required to be proved under Rule 10b-5."⁵⁸ After holding the due diligence requirement inapplicable, the court stated that the plaintiff must still show that his reliance was justifiable, and that he would not be justified in relying "on a misrepresentation where its falsity is palpable."⁵⁹ In effect, by substituting justifiable reliance for due diligence, the court "submerged the idea of some standard of care into the element of reliance."⁶⁰

Other circuits have retained the due diligence requirement as an independent element of a 10b-5 action but have relaxed the standard of care imposed on plaintiffs from reasonableness to lack of recklessness.⁶¹ In *Dupuy v. Dupuy*,⁶² the court stated that since reliance may never become an issue in omissions cases after *Affiliated Ute*, a justifiable reliance analysis as in *Holdsworth* would "remove from plaintiffs the responsibility of exercising due care to protect their interests in omission cases."⁶³ Because the court recognized "the need for a causal link between the . . . omission and the injury suffered by the private plaintiff,"⁶⁴ it retained the due diligence requirement as a means of

53. See *Dupuy v. Dupuy*, 551 F.2d 1005, 1018-19 (5th Cir.), cert. denied, 434 U.S. 911 (1977).

54. 425 U.S. 185 (1976).

55. *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1040 (7th Cir.), cert. denied, 434 U.S. 875 (1977); *Holdsworth v. Strong*, 545 F.2d 687, 692 (10th Cir. 1976), cert. denied, 430 U.S. 955 (1977).

56. 545 F.2d 687 (10th Cir.), cert. denied, 430 U.S. 955 (1977).

57. *Id.* at 693.

58. *Id.* at 694.

59. *Id.*

60. *Due Diligence Reevaluation*, supra note 16, at 914.

61. *Mallis v. Bankers Trust Co.*, 615 F.2d 68, 78-79 (2d Cir. 1980), cert. denied, 449 U.S. 1123 (1981); *Dupuy v. Dupuy*, 551 F.2d 1005, 1020 (5th Cir.), cert. denied, 434 U.S. 911 (1977). Prior to its decision in *Mallis*, the Second Circuit had initially reaffirmed the reasonableness standard. *Edwards & Hanly v. Wells Fargo Sec. Clearance Corp.*, 602 F.2d 478, 485-86 (2d Cir. 1979), cert. denied, 444 U.S. 1045 (1980); *Hirsch v. du Pont*, 553 F.2d 750, 762-63 (2d Cir. 1977).

62. 551 F.2d 1005 (5th Cir.), cert. denied, 434 U.S. 911 (1977).

63. *Id.* at 1015-16.

64. *Id.* at 1016.

preserving causation under the Rule. The court found it necessary, however, to relax the standard of care, in light of *Ernst & Ernst*, from a reasonableness standard to one of recklessness—whether the plaintiff “intentionally refused to investigate” in disregard of a known or obvious risk.⁶⁵

The Third Circuit has similarly retained the due diligence requirement but has refused to relax the standard of plaintiff's care. In *Straub v. Vaisman & Co.*,⁶⁶ the court stated that tort concepts were “not determinative” and must be “balanced against the policies underlying the federal securities laws.”⁶⁷ The need to deter investor carelessness, the court reasoned, justified retaining a standard of reasonable care, despite its inapplicability to common-law fraud. The court treated the failure to meet the standard of due diligence as an affirmative defense, the burden of proof resting upon the defendant.⁶⁸

Despite these apparent differences in the treatment of the duty of due care under the Rule, the cases in fact share important elements. They all impose some standard of care on the investor—reasonableness or lack of recklessness—either as an element of reliance, as a separate element of plaintiff's 10b-5 action or as an affirmative defense with the burden of proof on the defendant. Moreover, courts generally agree that the duty is subjective and flexible, and depends on the training, experience and knowledge of the particular investor.

II. THE INVESTMENT DECISION AND CAUSATION IN FACE-TO-FACE TRANSACTIONS

A. Superior Disclosure

The problem of incomplete disclosure lies at the root of the Rule, which clearly would not be necessary if unlimited information were always provided to and analyzed by investors. Given that unlimited disclosure is impossible, an omission must be analyzed in light of the information which has in fact been disclosed to the investor. In determining causation under the Rule, courts analyze the investor's ability to reason, given his sophistication⁶⁹ and knowledge, from the fur-

65. *Id.* at 1020.

66. 540 F.2d 591 (3d Cir. 1976).

67. *Id.* at 597.

68. *Id.* at 598.

69. The investor's investment training and experience is generally referred to in the literature as “sophistication.” *E.g.*, *Due Diligence Requirement*, *supra* note 16, at 768; *Reliance Requirement*, *supra* note 5, at 602. One commentator has listed five factors which may indicate that an investor has a greater duty to investigate: 1) general business experience and expertise; 2) acquaintance with affairs of the corporation; 3) access to information misrepresented; 4) existence of a fiduciary relationship with the defendant; and 5) whether the investor initiated the transaction. *Reasonable Investor*, *supra* note 1, at 567-75. Some of these factors bear upon sophistication, although others bear upon access to information, and the last clearly relates to investment motivations.

nished information to the alleged omission. If disclosures were sufficient to lead the investor, in view of his level of sophistication, to infer the omitted fact or to make further inquiries, a court may deny plaintiff's recovery on grounds that he did not justifiably rely on the omission (thereby rebutting the *Ute* presumption) or that he failed to live up to his duty of care. Alternatively, the court may characterize the omitted fact as immaterial; that is, given that he would be able to discern the omitted fact from the disclosure a reasonable investor would not have considered the omission important in his investment decision. The disclosure from which this inference or notice is drawn is referred to in this Article as "superior disclosure." As illustrated below, superior disclosure has arisen in the context of three general categories: financial statements, loss of key contracts and mergers and sales of control.

1. Financial Statements

Defendants have successfully used financial statements as superior disclosures to defend against allegations of non-disclosure because of the detail in which such statements are presented. *Hirsch v. du Pont*,⁷⁰ which arose against a backdrop of extensive financial reporting,⁷¹ was well suited to such a defense. The plaintiffs, who had sold a small brokerage firm to the defendants in exchange for limited partnership interests, sued for rescission under the Rule. The defendant's annual "surprise audit" report filed with the Securities Exchange Commission (SEC) revealed a net capital deficiency of \$6.8 million,⁷² with approximately \$37 million in security count differences.⁷³ Moreover, the New York Stock Exchange was dissatisfied with the defendant's treatment of dividend differences, and therefore charged the defendant's net capital with an additional \$10.5 million. The "nub" of the plaintiffs' complaint was the non-disclosure of this additional charge to net capital.⁷⁴

The defendant convinced the court that enough information had been disclosed so that the plaintiffs, "wise in the ways of Wall Street as a result of long and prosperous experience,"⁷⁵ could have inferred the information that was allegedly omitted. The controller of the plaintiffs' brokerage firm had received a completed data questionnaire

70. 553 F.2d 750 (2d. Cir. 1977).

71. In addition to a "surprise audit" report certified by the accounting firm of Haskins and Sells, *id.* at 754, the defendant was required by Rule 416 of the New York Stock Exchange to prepare monthly reports concerning its financial condition. The reports include income and balance sheet information regarding a brokerage firm, and its computation of net capital reserves. See New York Stock Exchange Rule 416, 2 N.Y.S.E. Guide (CCH) ¶ 2416, at 3721.

72. 553 F.2d at 754.

73. *Id.* "Securities count differences exist when physical inventory of securities on hand fail to tally with a broker's records." *Id.* at 754 n.5.

74. *Id.* at 755.

75. *Id.* at 753.

which formed the basis of both the defendant's and the Stock Exchange's net capital computations; had he desired, he could have made his own computations from the accurate information it contained.⁷⁶ Moreover, the disclosure of a massive capital shortage, whatever the extent, was a superior disclosure which should have put the plaintiffs on notice to make further inquiries.⁷⁷ Thus, the additional capital deficiency due to the Exchange's treatment of dividend differences "was not a 'new fact' in the ordinary sense"; it merely represented an exercise of judgment by the Exchange concerning disclosed facts after the audit had been completed.⁷⁸ As a result of these superior disclosures, the court found either that the omission was not material or that the plaintiffs had failed to meet their duty of care.⁷⁹

The distinction between an omission and an investor's mistaken judgment from existing disclosures is further highlighted in a more recent case, *Rice v. Baron*.⁸⁰ The case involved a transfer of control to the plaintiff, who had been groomed to succeed the defendant in management and ownership of a closely held corporation.⁸¹ Two years before the plaintiff's purchase a fire had damaged property managed by the company. The company maintained no liability coverage although it had received an opinion of counsel that any exposure was covered by the insurance of the property owner.⁸² As the claims proliferated, counsel indicated that the exposure exceeded the insurance coverage, but opined that the eventual liability at trial or settlement would in all likelihood be within the coverage.⁸³ Both opinions had been referenced in footnotes to annual reports—the first in the annual report immediately preceding the sale, and the second, modified opinion, in the next annual report, completed before the first payment was due.⁸⁴ The claims liability ultimately exceeded the insurance coverage.⁸⁵

Assuming *arguendo* that the plaintiff had no access to the corporate records concerning the fire litigation,⁸⁶ the court treated these foot-

76. *Id.* at 761.

77. *Id.* at 762-63.

78. *Id.* at 761.

79. *Id.* at 762-63. The standard of care imposed on plaintiffs was subsequently lowered in the Second Circuit in *Mallis v. Bankers Trust Co.*, 615 F.2d 68 (2d Cir. 1980), *cert. denied*, 449 U.S. 1123 (1981), which required plaintiffs to merely negate recklessness. *Id.* at 77-79.

80. [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,200, at 96,579 (S.D.N.Y. Dec. 7, 1979).

81. *Id.* at 96,582.

82. *Id.* at 96,581.

83. *Id.*

84. *Id.* at 96,581-82.

85. *Id.* at 96,581.

86. The court found that the plaintiff, who had recently replaced the defendant as chief executive officer, had had access to the corporate files regarding the fire for

notes as superior disclosures. The footnote reference in the annual report, while optimistic as to the eventual liability, did indicate that the damage claims exceeded the insurance coverage.⁸⁷ Moreover, the statement itself had been qualified as to the extent of liability.⁸⁸ These disclosures had put the plaintiff "on notice to exercise due diligence to inform himself."⁸⁹ His failure to exercise this duty prevented him from succeeding on his claim.⁹⁰

The impact that a plaintiff's sophistication may have upon the adequacy of financial statements as superior disclosures is highlighted in *Holmes v. Bateson*,⁹¹ a case involving a widow. The plaintiff's decedent had originally been a partner in a contracting business, and later became a shareholder after the business was incorporated. The decedent died soon after incorporation, when the business had begun to convert its books from cash to accrual accounting.⁹² The buy-out of the estate by the defendants, until a different valuation was arrived at, was to be related to the book value of the combined operations of the corporation and the partnership.⁹³ Although the estate had been provided with cash basis statements as of the time of death and as of the closing nine months later,⁹⁴ it had not been furnished with accrual basis statements.⁹⁵

two years prior to the stock purchase, during which time he was "situated to learn whatever he wanted to know about the fire action cases and what action [the company] had taken in regard thereto." *Id.* at 96,583. Although the primary responsibility for the cases lay with another principal in the firm, the plaintiff "must have known or should have known what was in those files before he . . . consummated the . . . agreement." *Id.*

87. *Id.*

88. The first page of the financial statements received by the plaintiff prior to his first payment carried the accountants' disclosure that "because of the possible material effect of the lawsuit (note g), we are precluded from expressing an opinion on the accompanying financial statements." *Id.* at 96,582 (emphasis omitted).

89. *Id.* at 96,583.

90. *See id.* at 96,584.

91. 583 F.2d 542 (1st Cir. 1978).

92. *Id.* at 547-48. After the incorporation, the accounts receivable for works in progress were to remain in the partnership, *id.*, while the corporation, its shareholders having elected Subchapter S treatment, showed substantial losses. *See id.* In addition to her difficulties with the cash basis statements, the plaintiff alleged that these losses misrepresented the financial condition of the corporation. *See id.* at 553.

93. The court noted that "deceased partner's share consisted of his capital account, his share of partnership receivables, and his share of work in progress," *id.* at 549 n.7, although the buy-out agreement also provided that the remaining partners could enter into "any other mutually satisfactory arrangement or agreement with the estate of the deceased." *Id.* at 547 n.4.

94. *Id.* at 550.

95. *See id.* at 552-53. The accrual basis statements had been alluded to, however, in a copy of a letter given to counsel for the plaintiff, who also represented the business on matters not concerning the estate. *Id.* at 554. The court diminished the

The defendants argued that the cash basis statements were a superior disclosure from which the relevant accrual items could be determined.⁹⁶ The court rejected this argument, however, noting that the accrual figures could be determined only “[i]f one possess[ed] a high [degree] of accounting skill and [was] thoroughly familiar with the structure of the partnership and the corporation.”⁹⁷ It did not agree “that the statements display the accrual profit of the corporation in any readily understandable fashion.”⁹⁸

Much as in *Dupont* and *Rice*, the result in *Holmes* depended upon the skill of the plaintiff to reason from the information available to her. While a more sophisticated plaintiff may have taken a different view of the \$1.3 million cash loss that was available to the parties for tax purposes, the plaintiff convinced the court that she believed this boded ill for the future of the corporation, even when coupled with the substantial partnership income.⁹⁹ Moreover, a more sophisticated plaintiff would likely have requested accrual figures, particularly after the recent conversion of the business to accrual accounting. In contrast to the *Rice* court, which found that more detail should have been requested by the plaintiff, and the *Dupont* court, which found that the plaintiff was capable of making the necessary calculations from the data furnished, the *Holmes* court expected the financial facts to be spelled out for the unsophisticated plaintiff.

These cases highlight the difference between an omission and a mistaken judgment from existing disclosures. The defendant need not disclose “mountain[s] of information”¹⁰⁰ to the plaintiff, but is entitled to a reasonable belief that the plaintiff will be able to make inferences from existing disclosures in view of the plaintiff’s sophistication. If a court finds that a plaintiff merely made a mistake in judgment or

significance of the plaintiff’s representation by counsel, hinting that counsel’s joint representation of the plaintiff and the business posed a conflict of interest problem, which may have led to a less than vigilant attitude toward the honesty of the corporate principals. *Id.* Thus the copy of the letter referring to the existence of accrual basis statements was not deemed adequate disclosure to the plaintiff. *Id.*

96. The defendants alleged “that their reading and interpretation of the financial statements would be ‘evident to any reader’ and that ‘no sophisticated analysis of financial statements is required.’” *Id.* at 553. One of the defendants stated, however, that he himself did not know from reading the statements that they contained the accrual information. *Id.*

97. *Id.* at 552.

98. *Id.*

99. *Id.* at 553. As stated by the court, “[a]n indication of a loss, on either a cash or accrual basis, is evidence, at least at first blush, more of financial trouble than of a profitable operation.” *Id.* The court rejected the defendant’s argument that the combined net profit of the partnership and the corporation was more important than the corporate cash loss, *id.*, perhaps because the defendant was found to have concealed the accrual profit figures of both the partnership and the corporation.

100. *Stier v. Smith*, 473 F.2d 1205, 1208 (5th Cir. 1973).

should have inferred the omitted fact from the limited disclosure, the omission should not be actionable under the Rule.

2. Loss of Major Contract

One step removed from the disclosure of historical financial statements are disclosures of events that will substantially affect a company's future financial condition. Among such events, particularly for a small company, is the loss of a major contract. Allegedly insufficient disclosures of such events has led to litigation under the Rule.

*Chelsea Associates v. Rapanos*¹⁰¹ involved the sale of a controlling interest in a company that had been engaged for a number of years in the production of portable water trailers for the United States Army. Although the business had been dependent upon competitive bids, a continuing series of contracts had accounted for thirty to forty percent of the company's total sales.¹⁰² Several months before the sale of the controlling interest, the company announced at its annual meeting that it had lost the renewal of the army contract, being third lowest bidder in a competition. The company had challenged the lowest bidder's qualifications and had requested that the bid be placed "back on the street."¹⁰³ At the meeting it further stated that it was "reasonably confident that [it] would ultimately secure the contract."¹⁰⁴ Although the challenge was subsequently successful, the contract was not "placed on the street," but had been awarded to the second lowest bidder. Upon receipt of this information, and without disclosing it, the controlling shareholder contracted to sell his stock.¹⁰⁵

The defendant successfully treated the announcement of the loss of the contract to a competitor as a superior disclosure. Plaintiffs, a group of sophisticated businessmen and attorneys, had realized that "there was no guarantee [defendant] would obtain another government contract."¹⁰⁶ That the contract had been awarded to a competitor, if not the ultimately successful bidder, had been known by the plaintiff for some months prior to the sale of the controlling interest.¹⁰⁷ In view of this disclosure, the court held that the final award was immaterial: The contract was not "lost" on the date of plaintiff's purchase "because it had never been [the defendant's] to lose,"¹⁰⁸ and

101. 376 F. Supp. 929 (E.D. Mich. 1974), *aff'd*, 527 F.2d 1266 (6th Cir. 1975).

102. *Id.* at 935.

103. *Id.*

104. *Id.*

105. *Id.* at 938-39.

106. *Chelsea Assocs. v. Rapanos*, 527 F.2d 1266, 1270 (6th Cir. 1975).

107. The plaintiff's agent, an investment banker who had initiated the transaction, had been present at a shareholder's meeting at which the results of the bid were made known. 376 F. Supp. at 935.

108. 527 F.2d at 1270.

no objective evidence suggested that had the low bidder been disqualified, the contract would have been awarded to the defendant rather than to the second-lowest bidder.¹⁰⁹

The disclosure that a contract was in jeopardy was treated as superior in *Rorer International Cosmetics Ltd. v. Halpern*,¹¹⁰ an action arising out of the sale of a company that had been an exclusive distributor of a French perfume in North America. Under the terms of the contract, the distributor was only to create or market perfumes and products authorized by the French company, and was to use its best efforts to maximize the American market for the French product.¹¹¹ After the plaintiff's purchase of the distributorship, the French company renounced the contract, for reasons related, among other things, to the defendant's purchase of unauthorized ingredients before he sold the distributorship.¹¹² The plaintiffs asserted that had they known about the unauthorized purchases, this information "would have made them more wary" that the distributorship might be cancelled, and that the omission to disclose the decision to purchase the unauthorized ingredients was therefore material.¹¹³

The court rejected this argument. Prior to the sale the defendant had stated to the plaintiff that the distributorship agreement was in jeopardy, and had refused to make any representations to the contrary in the purchase agreement with the plaintiff.¹¹⁴ Viewing such disclosures as superior, the court ruled that the alleged omission regarding

109. *Id.* Yet the case was not as clear-cut as this language would indicate. Arguably, by purchase of an option, the company had assumed the bidding position of the lowest bidder. Thus the plaintiffs had arguably bargained for a set of risks that included an assumption of the position of the lowest bid should the company's challenge prove unsuccessful, and should the challenge prove successful, an opportunity to bid for the contract "in the street." The defendant had discovered that both of these possibilities were foreclosed on the date of his sale to the plaintiffs. In view of these arguable risks bargained for by the plaintiffs, the defendant's failure to disclose that the company was precluded from bidding may well have been a material omission, contrary to the court's holding.

110. 502 F. Supp. 137 (E.D. Pa. 1980).

111. *Id.* at 138-39.

112. *Id.* at 139-40. Among the other alleged violations were the failure of the distributor to exert its best efforts to maximize markets for the perfume. The president of the French concern had stated to the plaintiff's president that the distributor had been "undermining [his] trademark for years, and that the [defendants] had consistently refused to make a genuine effort to expand the sales of [his] fragrances in the franchised territories." *Id.* at 139. That the defendant had not used best efforts to promote sales had been confirmed in an internal memorandum to the plaintiff's board of directors, and the court therefore found actual knowledge of the alleged omission, and granted summary judgment on the issue to defendant. *Id.*

113. *Id.* at 140.

114. *Id.*

unauthorized purchases was not material as a matter of law.¹¹⁵ The decision to proceed with the transaction notwithstanding the defendant's warnings was evidence that the plaintiffs "consciously decided to accept jeopardy to the [agreement] as a business risk."¹¹⁶

Had the plaintiff in *Chelsea Associates* convinced the court of the importance of the undisclosed fact that the company would be precluded from rebidding on the contract, arguably a result might have been reached more favorable to the plaintiff than that which emphasized the general disclosure that the contract was in danger. The plaintiffs in *Rorer* too might have prevailed had they convinced the court of the importance of the undisclosed fact that ingredients were counterfeited, which might have indicated that the distributorship termination of which they were generally warned was more likely. The superior disclosure defense focuses upon inferences to be made from existing disclosures; but if a number of investment outcomes could be inferred from a general disclosure and undisclosed facts would indicate that an adverse outcome was significantly more likely, the defense should fail.

3. Mergers and Sales of Control

Because both a sale of control of a corporation and a merger may command a premium price for noncontrolling stock,¹¹⁷ the imminence of such events tends to be a material fact.¹¹⁸ Whether the mere disclosure of an intent to sell or merge operates as a superior disclosure depends upon the stage of the negotiations with potential purchasers at the time of the security transaction.

115. *Id.* at 140-41. Departing from the objective materiality standard, the court ruled that the occurrence of unauthorized purchases "was immaterial to *this* investment decision made by *these* plaintiffs." *Id.* at 141 n.1. The court cited authority to the effect that the objective, reasonable man test is inappropriate when, as here, the subject transaction occurred between a single purchaser and a single seller, each well known to the other. *Id.* at 140 (citing *Thomas v. Duralite Co.*, 524 F.2d 577, 584 (3d Cir. 1975)); see also A. Bromberg & L. Lowenfels, *supra* note 4, § 8.3, at 199 (1971) ("A looser or more subjective [test] may . . . be proper in direct-personal transactions because of the greater ability of one party to appreciate the position of the other.").

116. 502 F. Supp. at 140. The court's analysis, however, is subject to criticism, in that if the agreement were in danger it would not end the analysis of a sophisticated plaintiff. If the contract had been improperly abrogated, or even abrogated upon "soft" grounds such as failure to exercise best efforts, plaintiff might have had an action against the French company for breach of contract. Alternatively, had the contract violation been easily and objectively verified, recourse might only have been had against the seller for failure to disclose. Facts bearing upon which of the two events was more likely to occur would tend to affect the sophisticated plaintiff's investment decision, and would not be covered by a simple disclosure that the agreement might be terminated.

117. See generally Bradley, *Interfirm Tender Offers and the Market for Corporate Control*, 53 J. Bus. 345 (1980).

118. A. Bromberg & L. Lowenfels, *supra* note 4, § 7.4(4)(b), at 170.2-171.

In *Hassig v. Pearson*,¹¹⁹ the court found that disclosure of an intent to sell operated as a superior disclosure when at the time of the securities transaction only "inquiries" regarding the purchase of the issuer had been made. The plaintiff, the unsophisticated son of a former director of a bank, relied upon the defendant, the bank's president, in financial matters.¹²⁰ He had told the defendant on several occasions that he wished to sell his holdings of bank stock, and inquired whether there were any purchasers. The defendant told the plaintiff that he was not interested in purchasing the stock personally because he was considering retirement and selling his own block of control stock.¹²¹ When the plaintiff inquired whether he could sell his stock together with that of the defendant, the defendant refused. The defendant then successfully located a potential buyer for the plaintiff's stock.¹²² At the time of the sale, the defendant again indicated that he was considering a sale of his controlling interest in the bank, and although he had been engaged in discussion with the bank's eventual purchasers, he responded in the negative when asked if "[t]here was anything going on at the bank."¹²³ A month after the plaintiff's sale, the defendant's health took a turn for the worse, and within three months his block of stock was sold at a premium over that of the plaintiff.¹²⁴

The *Hassig* court held that the defendant's disclosure of his intent to sell the controlling block of stock was a superior disclosure, which should have led the plaintiff to infer the conclusion that the defendant had conducted discussions with potential purchasers.¹²⁵ The court emphasized that the defendant's contacts with the would-be buyers "were not in any way 'negotiations,' but at the most were inquiries."¹²⁶ Thus, in view of the disclosure of the basic fact that the defendant was considering selling his stock, the defendant's failure to disclose that inquiries had been made by potential buyers was not material. Denying recovery to the plaintiffs, the court referred to this basic fact as follows:

[The inquiries of potential buyers] were an aspect of this "consideration," and were subsidiary to it. It was not an independent fact or

119. 565 F.2d 644 (10th Cir. 1977).

120. *Id.* at 645.

121. *Id.* at 646.

122. *Id.* At the time of the sale, the bank employee who purchased the stock was found not to have known that the bank president was considering selling his bank stock, much less that anyone was interested in purchasing it. *Id.* at 647.

123. *Id.* at 646.

124. The defendant had had "a number of 'spells' or attacks of some nature. At this time [he] agreed with friends to seriously consider selling his interest . . ." *Id.*

125. *See id.* at 649.

126. *Id.*

matter nor did it, under this record, have any significance on the extent or degree of "consideration." Thus plaintiff was put on notice of the fundamental and important "fact."¹²⁷

In contrast to *Hassig, Rochez Brothers v. Rhoades*¹²⁸ involved the nondisclosure of advanced negotiations for the sale of a company at the time of the allegedly fraudulent securities transaction. The case arose from the buy-out of one 50% owner of a privately held corporation by the other. As a result of increasing dissension between the two owners, the board of directors authorized the plaintiff and the defendant to contact prospective purchasers of the company.¹²⁹ At the same time the two began to discuss a buy-sell agreement between themselves.¹³⁰ Although no purchaser was found by the time the plaintiff sold its interest to the defendant, the defendant concealed from the plaintiff that he had hired a finder¹³¹ and the court found that "negotiations had progressed far enough that an offer of a price by one of the prospective purchasers was to be expected shortly."¹³² Soon after conclusion of the buy-sell agreement between the plaintiff and the defendant, the defendant received two offers to purchase the company, both of which fell through.¹³³ Some months later, however, he sold the company to a third offeror at a significantly higher price than he had paid for plaintiff's shares.¹³⁴

The *Rochez* court held in favor of the plaintiff, notwithstanding the board's authorization to sell the company and the plaintiff's own efforts to locate a purchaser. In effect, the court refused to characterize the defendant's desire to sell the company, which was clearly known to the plaintiff, as a superior disclosure because the plaintiff, despite its sophistication, could not have inferred from the known facts that the negotiations for sale had reached an advanced stage. Because even estimates of a possible selling price would have influenced plaintiff's willingness to sell at its original asking price, the court held that the concealment of the negotiations was a material omission.¹³⁵

These cases show that the further along negotiations with potential purchasers are, the more likely the failure to disclose such negotiations will be deemed a material omission. Thus, whether the disclosure of an intent to sell is treated as a superior disclosure depends upon the

127. *Id.*

128. 491 F.2d 402 (3d Cir. 1974), *cert. denied*, 425 U.S. 993 (1976).

129. *Id.* at 405.

130. *Id.*

131. *Id.* at 408.

132. *Id.* at 411 (footnote omitted).

133. *Id.* at 406.

134. *Id.*

135. *Id.* at 409.

stage of the negotiations at the time of the securities transaction: As shown in *Hassig*, a plaintiff may be expected to infer from the disclosure of such an intent that preliminary discussions have taken place with potential purchasers, but not, as seen in *Rochez*, that a dollar amount has been under discussion or that an offer has been made. A careful analysis of the expected inference may determine the outcome of the case.

B. *Particular Investment Goals, Perceptions and Opportunities*

While a superior disclosure tends to disprove transaction causation by showing that a plaintiff could or should have inferred the omitted fact, a defense based on particular investment goals and perceptions tends to show that the omitted fact, with or without superior disclosures, was of minor importance in the plaintiff's investment decision. Investment goals, perceptions and opportunities, which are unique to every investor¹³⁶ and which may change over time,¹³⁷ influence the investment decision. They affect the inferences drawn by an investor from a given set of facts as well as the significance of those inferences to him. Thus, in determining whether an omitted fact, if known, would have significantly affected a particular investor's decision to

136. That no single set of investment goals, perceptions or opportunities exists is attested by an elaborate and well-documented set of guidelines concerning investor suitability to purchase securities from financial institutions. National Association of Securities Dealers (NASD) Rules of Fair Practice, art. III, § 2 states:

In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.

Policy of Board of Governors on Fair Dealing with Customers, NASD Manual (CCH) ¶ 2152, at 2051 [hereinafter cited as NASD Board Policy]. Each member has an affirmative duty to seek out facts on a customer's financial situation before recommending speculative securities. *See id.* Rule 15b-10(3), 17 C.F.R. § 240.15b10-3 (1982) imposes a similar obligation upon non-member broker-dealers. Members of the New York Stock Exchange have a further duty to "[u]se due diligence to learn the essential facts relative to every customer, every order, every cash or margin account accepted or carried by such organization and every person holding power of attorney over any account." New York Stock Exchange Rule 405, 2 N.Y.S.E. Guide (CCH) ¶ 2405, at 3697; *see Rolf v. Blyth Eastman Dillon & Co.*, 424 F. Supp. 1021, 1041 (S.D.N.Y. 1977), *aff'd in part and remanded*, 570 F.2d 38 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978). *See generally* Cohen, *The Suitability Doctrine: Defining Stockbrokers' Professional Responsibilities*, 3 J. Corp. L. 533 (1978); Cohen, *The Suitability Rule and Economic Theory*, 80 Yale L.J. 1604 (1971); Roach, *The Suitability Obligations of Brokers: Present Law and the Proposed Federal Securities Code*, 29 Hastings L.J. 1069 (1978).

137. A speculative security, for example, should not be recommended unless facts on the investor's current financial situation are sought out. NASD Board Policy, *supra* note 133.

enter into a securities transaction, the fact finder must assess the significance of the investor's investment goals, perceptions and opportunities.

If such goals, perceptions and opportunities are found to have primarily influenced the investment decision of the investor, notwithstanding an omission, he cannot be said to have relied upon the omitted fact in his particular investment decision,¹³⁸ and therefore his recovery should be barred.¹³⁹ In those jurisdictions that permit a defendant to rebut the *Ute* presumption by introducing sufficient evidence of non-reliance,¹⁴⁰ a defense based upon the particular investment goals of the investor will therefore be recognized. Even if the *Ute* presumption is deemed to be irrebutable, some courts have nonetheless made use of such evidence in face-to-face transactions by applying a subjective materiality test, finding that, given the plaintiff's particular investment goals, the omission was not material to him.¹⁴¹

1. Particular Investment Goals, Perceptions and Opportunities: Cases

Titan Group, Inc. v. Faggen,¹⁴² a case arising out of the acquisition of four actuarial companies, shows how evidence concerning the particular investment goals and perceptions of a plaintiff may defeat a showing of transaction causation in an action arising under the Rule. The plaintiff's acquisition had taken place after several meetings between chief executive officers, at which the plaintiff had been presented with extensive documentation, including copies of the tax returns of the actuarial companies for the previous five fiscal years, a memorandum of anticipated adjustments to earnings arising out of possible economies which would be realized in a merger, and the actuarial companies' client ledgers and employment records.¹⁴³ In addition, the defendant had delivered to the plaintiff's Board of Directors a memorandum which briefly described the companies and

138. *Huddleston v. Herman & MacLean*, 640 F.2d 534, 549 (5th Cir. 1981), *cert. granted*, 102 S. Ct. 1766 (1982); see *Shores v. Sklar*, 647 F.2d 462, 468 (5th Cir. 1981) ("If the plaintiff would have followed the same course of conduct even with full and honest disclosure, then the defendant's action (or lack thereof) cannot be said to have caused plaintiff's loss.").

139. Because most courts do not apply the *Ute* presumption in misrepresentation cases, see *supra* note 38 and accompanying text, evidence of particular investment goals and perceptions can also be used to show non-reliance in cases of misrepresentation.

140. See *supra* note 46 and accompanying text.

141. *E.g.*, *Titan Group, Inc. v. Faggen*, 513 F.2d 234, 239 (2d Cir.), *cert. denied*, 423 U.S. 840 (1975).

142. 513 F.2d 234 (2d Cir.), *cert. denied*, 423 U.S. 840 (1975).

143. *Id.* at 236-37.

emphasized a computer system under development by the defendant. The memorandum was accompanied by exhibits showing pre-tax adjusted net income for the preceding four fiscal years, and an analysis of new clients.

Difficulties arose soon after the acquisition. A disenchanted employee left taking clients with him, and the data processing operation encountered such high start-up costs that it never became profitable.¹⁴⁴ The plaintiff defaulted on its notes tendered in payment, alleging that, contrary to the representations of the defendant's memorandum, no reduction in expenses had actually occurred in the areas of pension funding, salaries, and travel and entertainment expenses. It further alleged that the defendant had misrepresented the present capacity of the computer program in its memorandum to the Board, and had failed to list lost clients.¹⁴⁵

Rather than defending against the alleged misrepresentations and omissions, the defendant stressed the importance to the plaintiff of his particular goals in entering into the transaction. The defendant first introduced evidence of the investment objectives of the chairman of the plaintiff's Board of Directors: He had close professional ties with the defendant,¹⁴⁶ and had initiated and strongly favored the transaction. Instead of focusing upon the data processing failures, the defendant pointed to the plaintiff's interest in the profitable actuarial side of the business, which continued to show strong profits after the merger.¹⁴⁷ Finally, the defendant successfully downplayed the weight attached by the plaintiff to its cost savings estimates by showing that they were merely ball park figures, the only purpose of which was to provide an approximation of savings through the elimination of expenses.¹⁴⁸

The *Titan Group* court concluded that "these broad considerations, rather than interstitial details of client lists or of immediate data processing capacity, sparked [the plaintiff's] acquisitive interest."¹⁴⁹ Among the additional business considerations in the investment decision were that the defendant's "companies had a good liquid asset position [and] were profitable, and . . . the possibility of melding together actuarial and real estate companies was attractive."¹⁵⁰ It was

144. *Id.* at 237.

145. *Id.* at 238.

146. *Id.* at 236. After initiating the transaction, the chairman of the board, an attorney, apparently felt that ties were so strong that he turned the negotiations over to special counsel to avoid a possible conflict of interest. *Id.*

147. *Id.* at 237. In fact, the plaintiff had withdrawn \$2.1 million in cash and securities from the actuarial companies after the acquisition. *Id.*

148. *Id.* at 238.

149. *Id.*

150. *Id.*

these matters, on which "an abundance of evidence" was presented, that the plaintiff "really considered important in entering this face-to-face transaction."¹⁵¹ Applying a subjective materiality test, the court held that under these circumstances the omissions were not material.¹⁵²

This language from *Titan Group* shows both the advantages and the shortcomings of a defense based upon particular investment goals and perceptions. On the one hand, an emphasis upon such goals and perceptions can overcome a too narrow focus upon any single area of disclosure. On the other hand, because the totality of the investment decision is emphasized, a defendant must present evidence in abundance as to what the plaintiff really considered to be important in the investment decision. As a result, a defense based solely upon the particular investment goals of the plaintiff is rare. More frequently, a defense based upon particular goals and perceptions will be used in connection with a superior disclosure defense, which diminishes the significance of the omission in the total mix of information available.

Thus, the defendant in *Hirsch* not only employed a superior disclosure defense regarding the extent of its net capital deficiency,¹⁵³ but also brought into the case the particular investment goals of the plaintiff. The plaintiff not only hoped to see its purchase of the defendant's securities increase in value, but anticipated at least three other significant benefits in connection with the investment. A third party, an "internationally respected underwriter" with substantial underwriting accounts, had expressed interest in joining the transaction, and its underwriting capability "promised all the benefits of diversification."¹⁵⁴ Moreover, the defendant's size and trading volume were capable of supporting the overhead represented by modern automated equipment, which the plaintiffs believed was necessary to the survival of their firm.¹⁵⁵ Despite the plaintiff's discovery that the defendant's back office problems "were a 'bloody mess,'"¹⁵⁶ they admired the administrative skills of one partner in the underwriting

151. *Id.* at 239.

152. *Id.*

153. See *supra* notes 70-79 and accompanying text.

154. *Hirsch v. du Pont*, 553 F.2d 750, 756 (2d Cir. 1977).

155. *Id.* at 753-54. In addition to these particular goals, certain factors diminished the effect of the alleged omission. The existence of a \$20 million line of credit with a prominent family, which had been denied by defendant's controller, was reaffirmed by a principal who was a member of the family. Although \$2.5 million of the line had been drawn down, the principal indicated that he had "never come back from [the family home] empty-handed." The plaintiff testified that "out of respect for [the individual's] honor, [he] refrained from pursuing the matter further." *Id.* at 756-57.

156. *Hirsch v. du Pont*, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,645, at 90,204 (S.D.N.Y. 1976), *aff'd*, 553 F.2d 750 (2d Cir. 1977).

firm, considering him "the perfect man to tackle [the] back office snarl."¹⁵⁷ The defendant successfully proved the importance of these considerations to the plaintiff's investment decision to diminish the significance of the omission concerning the defendant's capital deficiency. In combination with the superior disclosures, this defense was extremely damaging to the plaintiff's case.¹⁵⁸

Similarly, the defendant in *Oleck v. Fischer*¹⁵⁹ successfully combined a superior disclosure defense with a defense emphasizing particular investment goals. In the transaction in question the plaintiffs sold their business to the defendant company for cash and promissory notes. At issue was the company's ability to repay the notes, and the alleged nondisclosure of the precarious financial condition of one of the company's debtors, a former subsidiary.¹⁶⁰ In the months prior to the transaction, the financial condition of the debtor had deteriorated,¹⁶¹ and three months after the transaction the debtor defaulted;¹⁶² seven months later a guarantee of the company was called when the debtor went into bankruptcy.¹⁶³ When the company defaulted on its obligation to the plaintiffs,¹⁶⁴ they brought suit against the company and its accountants.

The defendant¹⁶⁵ first diminished the significance of the omission by claiming it had made superior disclosures in the financial statements. The plaintiffs were "experienced and sophisticated businessmen"¹⁶⁶ who acknowledged that they had been provided with "any information that [they] thought [they] required."¹⁶⁷ They simply had not inquired as to the terms of the debtor's obligations.¹⁶⁸ Moreover, the terms of such obligations and the guarantee had been disclosed in full

157. 553 F.2d at 756.

158. The Court of Appeals was prompted to note that "the securities laws were not enacted to protect sophisticated businessmen from their own errors of judgment." *Id.* at 763.

159. [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,898 (S.D.N.Y. June 8, 1979).

160. *Id.* at 95,691.

161. *Id.* at 95,685-86. Among the allegedly nondisclosed facts said to demonstrate the subsidiary's "precarious financial position" were the debtor's tangible net worth deficit in excess of \$3 million and a six-month loss in pre-divestiture operations of over \$900,000. *Id.* at 95,691.

162. *Id.* at 95,687.

163. *Id.*

164. The defendant had kept up its payments for twenty-one months after the default of the former subsidiary, a fact which further diminished the significance of the omission. *Id.* at 95,687, 95,692.

165. Before trial, the plaintiffs had settled their claims against all the defendants except the company's accountants. *Id.* at 95,681-82.

166. *Id.* at 95,701.

167. *Id.* at 95,686.

168. *Id.* at 95,687.

in a footnote to the financial statements,¹⁶⁹ and a reserve against possible losses had been included in the balance sheet.¹⁷⁰ Therefore, "sufficient references [were made] in the report . . . to alert the plaintiffs of a less than completely successful marriage between [the defendant] and [the debtor]."¹⁷¹

The defendant then developed facts tending to show that the obligations of the debtor did not play a prominent role in the plaintiffs' investment decision. It came forward with evidence portraying the company at the time of the transaction as "an aggressive company, embarked on a policy of acquisition," its divested subsidiary having been simply one of many operating divisions.¹⁷² The multifaceted aspect of the company's financial performance had been featured in annual reports, press releases and management advice upon which the plaintiffs relied, which together "painted a broad picture of [the company's] activities and prospects."¹⁷³ The report to shareholders in particular had emphasized that the company's growth program had been dependent upon the growing need for coal and natural gas, a rising demand for business services, and high return-on-investment in non-manufacturing industries,¹⁷⁴ and a recent press release had indicated favorable coal yields from recently acquired mining rights.¹⁷⁵ Assessing the omission in light of these other facets of the company, the court noted that "[n]ondisclosed facts are not viewed in isolation."¹⁷⁶ The divestiture of the debtor "had nothing to do with the coal division," which had assumed particular importance in the plaintiffs' transaction.¹⁷⁷ In view of the plaintiffs' investment goals, had the omission been disclosed the "total mix" of information would not have been significantly altered,¹⁷⁸ and it was therefore immaterial.

In summary, in cases involving face-to-face transactions the defendant may counter the plaintiff's due diligence or materiality evidence by showing that the plaintiff had access to information which should have led him to infer the omitted fact. The plaintiff's level of sophistication is a significant factor in determining the effect of such infor-

169. *Id.* at 95,701.

170. The balance sheet, which had apportioned the promissory notes between current assets and non-current assets, indicated that they were "net of reserve of \$500,000 for losses," referencing the footnote which disclosed the complete terms of the divestiture. *Id.* at 95,685-86.

171. *Id.* at 95,701.

172. *Id.* at 95,692.

173. *Id.*

174. *Id.* at 95,686.

175. The press release indicated that "coal yields of 3000 tons a day [had been attained from the company's] long-term coal mining rights recently acquired in West Virginia and Kentucky." *Id.* at 95,686.

176. *Id.* at 95,691.

177. *Id.* at 95,692.

178. *Id.*

mation,¹⁷⁹ and as long as he had access to it the plaintiff need not have actually read the information.¹⁸⁰ Evidence of such superior disclosure can be an effective weapon in the defendant's arsenal, tending to rebut the reliance presumption or a showing of materiality, or to establish a failure to exercise due care. Moreover, if an omitted fact is found to be material, a defendant may offer evidence that even if the omission had been discovered, other investment considerations of the plaintiff would have outweighed it in the investment decision. Evidence of such considerations by the plaintiff may counter proof that he relied on an omission in face-to-face transactions.

III. THE INVESTMENT DECISION AND CAUSATION IN OPEN MARKET TRANSACTIONS

The elements of a face-to-face investment decision that affect transaction causation under the Rule are also present in public markets. In cases arising under the Rule in public markets, however, the analysis may be made more complex by the presence of secondary sources of information, other traders and brokers and advisors; but the basic principles of the analysis of transaction causation remain valid.

A. Superior Disclosure

In open market transactions, the presence of other traders and the mechanics of information diffusion in the markets may make it easier for the defendant to allege a superior disclosure, as a vastly wider domain of primary and secondary sources of information is deemed accessible to a plaintiff. The amount of information available to investors in the open market is illustrated in *Rifkin v. Crow*.¹⁸¹ An impressive list of disclosures and information was developed by the plaintiff as proof of positive reliance on defendant's misrepresentation, but the list is no less applicable to a defendant's proof of superior disclosure. Included in the *Rifkin* list were direct communications from the company, such as annual and interim reports, press releases and shareholder newsletters, and the text of the company president's speeches.¹⁸² Additionally, the plaintiff cited sources that were not direct communications from the company, but rather "secondary sources." Included among these were newspaper articles and articles

179. See *supra* notes 91-99 and accompanying text.

180. See *Rice v. Baron*, [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,200, at 96,583 (S.D.N.Y. Dec. 7, 1979).

181. 574 F.2d 256 (5th Cir. 1978).

182. *Id.* at 259.

in both financial and trade journals.¹⁸³ This list, while somewhat atypical of the sources used in a decision to purchase shares on the open market,¹⁸⁴ demonstrates the sources of information available to an investor in public markets.

The secondary sources of information listed in *Rifkin* have no direct parallel when securities of closely held companies are concerned. As the number of shares of a company held by the public increases, its coverage by financial analysts and institutions tends to increase. The SEC recently recognized this by reducing the formal disclosure requirements for companies having a "float" that exceeds a specified level.¹⁸⁵ Trading volume, while less susceptible of objective measurement, also bears a positive correlation to coverage by such institutions.¹⁸⁶ Other information disseminators, such as general economic and financial publishers, analytic/advisory services, and statistical/reference services, generally follow the same types of criteria used by

183. The secondary sources included, in addition to financial publications and trade journals, a report of a management consulting firm as to the potential of optical recognition equipment. *Id.*

184. Those with sizeable investments in the stock market will devote significant resources to the development of sophisticated market strategies. Barry, *The Economics of Outside Information and Rule 10b-5*, 129 U. Pa. L. Rev. 1307, 1332 (1981).

185. The SEC has adopted the Form S-2 and S-3 registration statements, reducing the disclosure necessary under the Securities Act of 1933 for companies of a certain size subject to Exchange Act reporting requirements. Form S-3 in particular permits extensive incorporation by reference, and is available to companies with a \$150 million "float" of securities in public hands, or with a float of \$100 million and a 3 million share annual trading volume. Sec. Act Rel. No. 6383, [1937-1982 Accounting Series Releases Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,328, at 62,997 (Mar. 3, 1982) [hereinafter cited as Integrated Disclosure Release].

The proposed Form A, a predecessor to Form S-3, was to be available to companies on the basis of net income requirements and non-default "quality of issuer" requirements having little to do with an efficient market. Sec. Act. Rel. No. 6235, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,649, at 83,491-92 (Sept. 2, 1980). The "quality of issuer" tests were dropped in favor of tests reflecting efficient market criteria, following a review by the Commission of its integrated disclosure proposal. Sec. Act. Rel. No. 6331, 23 pt. 1 SEC Docket 288, 290 (Aug. 18, 1981) [hereinafter cited as Integrated Disclosure Proposal]. In considering prospective criteria, the Commission did not limit itself to simply "reexamining existing standards . . . or the earlier proposed Form A standards." Integrated Disclosure Proposal, *supra*, at 293. It surveyed 1200 companies traded on the New York, American and regional stock exchanges and over-the-counter stocks quoted in the National Association of Securities Dealers Automated Quotation System (NASDAQ), as well as non-NASDAQ over-the-counter markets. *Id.* at 292 n.27. Additionally, the Commission reviewed "various types of criteria used by investment institutions in research coverage decisions, by financial publishers and service providers in reporting decisions, by trading market organizations in listing and delisting situations and by the Federal Reserve Board in determining marginable over-the-counter stocks." *Id.*

186. Integrated Disclosure Proposal, *supra* note 185, at 293.

investment institutions.¹⁸⁷ The markets for debt securities are widely recognized to depend heavily upon independent rating services.¹⁸⁸ At least one court has recognized the value of secondary sources of information in the capital markets, noting that “[i]n the common run of day-to-day business, professional securities analysis is perhaps the best way to aggregate and evaluate information in the securities markets; the analysts thus serve themselves, their clients, and the public interest in efficient capital markets all at the same time.”¹⁸⁹

A defense based on superior disclosure, therefore, may be applicable in open market omissions cases. As in face-to-face transactions, evidence of a superior disclosure may be relevant to the issue of the plaintiff's due diligence, the materiality of an omission or the plaintiff's loss.

1. Superior Disclosures in the Public Domain: Cases

The effect of a plaintiff's broadened “access” to disclosures is illustrated in *Schulman v. Weil*.¹⁹⁰ *Schulman* involved the purchase of a speculative security following a discussion between the plaintiff and the defendant, a major stockholder and consultant to the company. The defendant had suggested that the plaintiff “could make a ‘lot of money’ by purchasing [the] stock,” and that it was something he “could ‘put away for his children,’ ” allegedly omitting the speculative nature of the investment.¹⁹¹ A dispute arose as to whether the defendant had shown the plaintiff a recent prospectus. Additionally, although the plaintiff had requested a prospectus from his broker, he had been informed that it was not readily available, and had instructed his broker to purchase the stock anyway.¹⁹²

The prospectus, which disclosed the speculative nature of the investment, was treated by the court as a superior disclosure. Whether the plaintiff had read it was not the issue; the defendant had been reasonably entitled to believe that plaintiff had access to the prospectus. The plaintiff, an experienced buyer and seller of stock, “knew what a prospectus was, knew that he was entitled to obtain one, and could have obtained one if he had seriously tried to do so.”¹⁹³ The court noted that the defendant had “no duty to disclose information to one who reasonably should already be aware of it.”¹⁹⁴

187. *Id.*

188. *Id.* at 296 n.46.

189. *Dirks v. SEC*, 681 F.2d 824, 841 (D.C. Cir. 1982), *cert. granted*, 51 U.S.L.W. 3373 (Nov. 16, 1982).

190. 466 F. Supp. 432 (S.D.N.Y. 1979).

191. *Id.* at 433-34.

192. *Id.* at 434.

193. *Id.*

194. *Id.*

In *Phillips v. Reynolds & Co.*,¹⁹⁵ the plaintiffs purchased stock from a broker-dealer on the basis of certain oral representations concerning the bright prospects of a new issuer which boasted a new process for the production of steel from low-grade ores.¹⁹⁶ The plaintiffs, a chartered life insurance underwriter and the manager of an insurance company, alleged the nondisclosure of a \$9 million deficit which appeared on the company's earnings statement.¹⁹⁷ Each plaintiff had received from the defendant a copy of an article in a general circulation magazine discussing the new process and indicating that "\$12 million has been poured into [the company] without a cent of profit, but by the end of this year [the president] hopes to start breaking even and by next year to show some earnings."¹⁹⁸

The court held that because there was reasonable certainty that the article had been read,¹⁹⁹ it operated as a superior disclosure.²⁰⁰ The article did not "simply and directly aver . . . a \$9,000,000 deficit" on the earning statement, but the plaintiffs were "experienced business executives undoubtedly familiar with balance sheets, the problems of embarking upon new enterprises, and the tendency of management to be euphemistic about losses."²⁰¹ From the superior disclosures in the article, they "should have been aware that a significant deficit existed, and if they were concerned about the precise amount they could easily have found out before purchasing."²⁰² The plaintiffs' claim of reliance on the omission was therefore defeated.

Superior disclosures have also been found in unread journals and filings, as recognized in *Beissinger v. Rockwood Computer Corp.*²⁰³ The defendant in *Beissinger* had been engaged in a computer leasing business, and had made substantial purchases of one computer model before a successor computer was introduced.²⁰⁴ The annual report on which the plaintiff claimed he had relied indicated that while the successor model had more capacity, it was also more expensive, and

195. 294 F. Supp. 1249 (E.D. Pa. 1969).

196. *Id.* at 1250.

197. *Id.* at 1253.

198. *Id.* at 1251 (quoting *New Era for Steel?*, Time, Apr. 7, 1961, at 94).

199. The court noted that "[h]ad the document given them by [the defendant] been long and detailed, and the deficit disclosed in small print or in an obscure place, plaintiffs might not be charged with knowledge. The . . . article, however, was a concise summary which could be digested in a few short minutes." *Id.* at 1254.

200. *See id.*

201. *Id.*

202. *Id.*

203. [Current] Fed. Sec. L. Rep. (CCH) ¶ 98,613 (E.D. Pa. Oct. 16, 1981).

204. Ninety-six percent of the company's stated \$158 million computer inventory had consisted of IBM System/360 computers, when IBM introduced the System 370. *Id.* at 93,027.

that although the impact of the successor computer could not be predicted, management did not anticipate significant decreases in rentals of the original model.²⁰⁵ The plaintiff alleged that the defendant had not sufficiently warned of the adverse impact of the newer model, had failed to state that the newer model had more capacity per unit cost and that it would only be more expensive for some users.²⁰⁶

The court ruled for the defendant on the basis of superior public disclosures in the public domain other than in the allegedly misleading annual report. Among the disclosures operating as superior in the case was the Form 10-K, filed with the SEC days before the annual report.²⁰⁷ The 10-K had stronger cautionary language regarding the newer computer model than did the allegedly misleading annual report.²⁰⁸ More significantly, for at least a year prior to the plaintiff's purchase, the relative merits of the newer model had been the subject of both public announcements by its manufacturer and extensive public debate in a trade journal.²⁰⁹ In view of the disclosures in the 10-K, the manufacturer's announcements and the trade journal articles, the court found:

205. *Id.* at 93,028.

206. *Id.* "In spite of the logical conclusion that the impact of System/370 on [defendant's] operations depended substantially upon whether customers needed greater computer capacity," the Court noted that "neither [of plaintiff's experts] deemed it provident to study [defendant's] customer mix or requirements" or its computer portfolio, or the cost of converting from System/360 to the newer model. *Id.* at 93,031.

207. *Id.* at 93,036.

208. The Form 10-K had referenced the newer computers and stated that any impact upon the company's business would be adverse. It further stated that "[o]bsolence [sic] may also be a significant factor in the Company's ability to further lease or sell computers in that computer manufacturers continually introduce new products and improvements which cannot generally be installed on older computers." *Id.* at 93,032-33 n.34 (emphasis in original).

That disclosures in a Form 10-K may operate as a superior disclosure may become less significant if a plaintiff is precluded from the Rule's implied remedy by the existence of express remedies for deceptive filings under other sections of the securities laws. In *Huddleston v. Herman & MacLean*, 640 F.2d 534 (5th Cir. 1981), *cert. granted*, 102 S. Ct. 1766 (1982), the court held that notwithstanding recognition of the overlap of remedies issue in recent Supreme Court cases curtail the scope of the Rule, *id.* at 541 & n.6, an express remedy concerning deceptive SEC filings should not preclude an implied remedy under the Rule, or else the class of potential plaintiffs would be restricted "to the unlikely few who actually viewed and relied on the misleading [filing]." *Id.* at 543 (quoting *Ross v. A.H. Robins Co.*, 607 F.2d 545, 556 (2d Cir. 1979), *cert. denied*, 446 U.S. 946 (1980)).

209. *Id.* at 93,032. The court noted that "a great deal of information concerning the potential adverse impact of System/370 was already available to the investing public," in part as a result of a series of articles in the journal *Computerworld*. *Id.* at 93,039. The capacities of the newer model, however, were not completely known. *Id.* at 93,030-31.

[T]he market would have already been well aware of any uncertainty concerning the Company's future. Therefore . . . there was no substantial likelihood that a reasonable investor would have viewed [the statements in the annual report], either individually or in combination with each other, as having significantly altered the 'total mix' of information *available to the public*.²¹⁰

Thus, the *Northway* standard of materiality—as expanded to include public information—was not met.²¹¹

Unlike the *Phillips* court, which required reasonable certainty that a superior disclosure in the public domain was read before the reliance presumption was rebutted, the *Beissinger* court held that a plaintiff could be presumed to have read corrective statements or disclosures in the public domain, thereby defeating a claim of materiality. Nevertheless, both cases turned upon a superior disclosure in the public domain to which the plaintiff had "access." In this regard, the proof is similar to that in a face-to-face transaction, with simply a wider domain of information to which the plaintiff may be deemed to have access; it is a difference in degree, not in kind. The presence of other traders in the market introduces the opportunity for a superior disclosure defense of a different kind.

2. Loss Causation

In open market transactions, a superior disclosure may be evidence that the particular plaintiff suffered no compensable injury. In such circumstances even if the plaintiff had been unaware of a superior disclosure in the public domain, other traders may be presumed to have traded upon such information.²¹² The collective trading decisions of such investors would tend to impact the price at which the plaintiff transacted, and because of the effect of the superior disclosure upon market price, the plaintiff would not have been damaged by the omission.

The rationale implicit in *Schulman* and *Phillips*, that unread superior disclosures may impact other traders and hence be "assimilated"

210. *Id.* at 93,032-33 (footnote omitted) (emphasis added). By adding the last phrase "to the public" the court further emphasized that it took an expanded view of information to which an investor has "access" in public markets. The existence of the information on the market in the articles and the Form 10-K tended to demonstrate that the allegedly misleading statements in the annual report were not part of a common scheme to defraud: "Had [defendant] been engaged in 'a common scheme to manipulate the value of stock,' surely such information would have been concealed." *Id.* at 93,036 (quoting *Sargent v. Genesco, Inc.*, 75 F.R.D. 79, 84 (M.D. Fla. 1977)).

211. [Current] Fed. Sec. L. Rep. (CCH) ¶ 98,613, at 93,032 (E.D. Pa. Oct. 16, 1981).

212. *Blackie v. Barrack*, 524 F.2d 891, 906 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976).

in the market price relied upon by plaintiff, was explicitly stated in *Beissinger*.²¹³ The *Beissinger* court went further than *Schulman* and *Phillips* in indicating that not only did the plaintiff have access to such unread disclosures, but that such disclosures would have impacted the market price upon which the plaintiff had relied in his purchase. Therefore the plaintiff, who retained the burden of proof regarding damages, had failed to show damages with any degree of certainty.²¹⁴ Although the plaintiff's expert witness testified that full disclosure in the annual report would have caused an immediate drop in price, he expressed no opinion as to the effect upon market price of appropriate disclosures at times other than the date of the annual report.²¹⁵ He also acknowledged that the spread between price and "true market value" may have narrowed "because the stock price *may* have assimilated some of the announcements of other leasing companies."²¹⁶ The court found this testimony insufficient to prove damages or entitlement to the benefits of a theory that the market had assimilated the adverse information after the purchase.²¹⁷

B. Particular Investment Goals, Perceptions and Opportunities

In open market transactions, as is true in face-to-face transactions, a presumption of reliance may be rebutted by a showing that the plaintiff relied upon matters extraneous to the market and personal to him.²¹⁸ In hypothetically "efficient" capital markets it has been recognized that particular investment goals and perceptions may indeed have little importance: If all information is already incorporated into the price of a security, one stock may be as good a buy as another, because each reflects an intrinsic value around which its price varies randomly,²¹⁹ and an investor might as well invest in an index fund as

213. [Current] Fed. Sec. L. Rep. (CCH) ¶ 98,613, at 93,039 (E.D. Pa. Oct. 16, 1981).

214. *Id.* at 93,037-40.

215. *Id.* at 93,039.

216. *Id.* at 93,037 (emphasis in original).

217. *Id.* at 93,040 & n.71. Compare *id.* (plaintiff failed to prove damages) with *Blackie v. Barrack*, 524 F.2d 891, 906 (9th Cir. 1975) (defendants may disprove causation by a showing that an insufficient number of traders relied on a deception to inflate the price), *cert. denied*, 429 U.S. 816 (1976).

218. See *Blackie v. Barrack*, 524 F.2d 891, 906 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976).

219. *In re LTV Sec. Litig.*, 88 F.R.D. 134, 144-46 (N.D. Tex. 1980); Note, *The Efficient Capital Market Hypothesis, Economic Theory and the Regulation of the Securities Industry*, 29 Stan. L. Rev. 1031, 1035 (1977) [hereinafter cited as *ECMH*] ("Under conditions of efficiency, no investor, using only information also generally available to other investors, can systematically identify and acquire undervalued (or overvalued) securities"); see *id.* at 1040 n.38 citing Samuelson, *Proof that Properly Anticipated Prices Fluctuate Randomly*, 6 Indus. Mgmt. Rev. 41 (1965)).

try to "beat the market" in a particular security.²²⁰ Evidence that the price of a security in "efficient" capital markets tends to reflect all publicly available information has been recognized in the legal literature,²²¹ by the SEC²²² and by the courts.²²³

Whatever the validity of the efficient capital market hypothesis on a broad scale, however, substantial evidence indicates significant departures from randomness "in the contexts provided by particular companies, short-term trading, seasonal patterns, exogenous market effects, and on exchanges other than the New York Stock Exchange."²²⁴ Stated another way, whatever the effect upon price of the activities of a broad aggregate of investors,²²⁵ pockets of inefficiency²²⁶

220. Barry, *supra* note 184, at 1333 ("The proliferation of index funds and the steady increase in the monies committed to them over the past decade provide some measure of the degree to which the ECMH has gained acceptance among both sophisticated and unsophisticated investors."). Such index-related investments have more recently included options on the future value of particular stock indexes.

221. Barry, *supra* note 184, at 1333-59; *ECMH*, *supra* note 219, at 1031; Note, *Broker Investment Recommendations and the Efficient Capital Market Hypothesis: A Proposed Cautionary Legend*, 29 Stan. L. Rev. 1077, 1089-90 (1977); Note, *Disclosure of Future-Oriented Information Under the Securities Laws*, 88 Yale L.J. 338, 339 n.10, 344 n.32 (1978).

222. As stated by the SEC, "[t]his form [S-3] is predicated on the Commission's belief that the market operates efficiently for these [widely followed] companies, *i.e.* that the disclosure in Exchange Act reports and other communications by the registrant, such as press releases, has already been disseminated and accounted for the market place." Integrated Disclosure Proposal, *supra* note 185, at 290. The new dissemination requirements were "developed, in part, on the premise that information regularly furnished to the marketplace . . . may be reflected in the price of the outstanding securities, and thus need not always be reiterated in a prospectus in the context of a distribution." Integrated Disclosure Release, *supra* note 185, at 62,993 n.9.

223. *E.g.*, *Abrams v. Johns-Manville Corp.*, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,348, at 92,157 (S.D.N.Y. 1981) (plaintiff alleged that she would not have paid purchase price "if [she] had known that the market price did not reflect the value of the company"); *In re LTV Sec. Litig.*, 88 F.R.D. 134, 145 (N.D. Tex. 1980) (court cited trading strategy of some institutional investors who rely upon the efficient market hypothesis "by simply buying a random cross-section of stocks").

Several commentators have noted the implications for securities regulation of the efficient capital market hypothesis. Barry, *supra* note 184 at 1333 ("Taken at face value, the ECMH throws into doubt traditional justifications for almost every phase of securities regulation."); *ECMH*, *supra* note 219, at 1034 ("The ECMH evidence . . . calls into question both the goal and the means of SEC regulation."). If the ECMH were completely valid, and capital markets were perfectly efficient, the existence of market prices incorporating all relevant information would make manipulation and fraud theoretically impossible. Barry, *supra* note 184, at 1350.

224. Barry, *supra* note 184, at 1336.

225. As Professor Samuelson noted,

If intelligent people are constantly shopping around for good value, selling those stocks they think will turn out to be overvalued and buying those they expect are now undervalued, the result of this action by intelligent investors

may present the opportunity for rewards for "having the first vision."²²⁷ Through "expenditure of effort, time and money in research, and talent and training in analysis [one may have the] opportunity to capitalize on the value of being the discoverer of [new] information"²²⁸ or of reacting to information in a unique way. The lure of "developable values,"²²⁹ the direct result of short-term and other inefficiencies in the capital markets, would lead an investor—even a passive investor—to select one investment over another and to disregard the market as his "agent."²³⁰

Although favorable information that is not material to a seller may cause other "reasonable" sellers to raise their asking price, the seller who for his own reasons reacts differently to such information might still tend to transact at his original asking price. A buyer would transact at his "ask" before moving to the higher asking prices of the "reasonable" sellers.²³¹ Similarly, adverse information that is not material to a buyer may cause other "reasonable" buyers to lower their bid prices. Yet the buyer who for his own reasons reacts differently to such information might still tend to transact at his original bid price, because sellers would transact at his bid before moving to the lower bid prices of the "reasonable" buyers.²³² Thus, reliance on a defend-

will be to have existing stock prices already have discounted in them an allowance for their future prospects.

B. Malkiel, *The Inflation Beater's Investment Guide: Winning Strategies for the 1980's*, at 63 (1980); accord Barry, *supra* note 184, at 1332 ("Investors are a devoted army of researchers who keep the market continuously informed. By trading, millions of sophisticated and unsophisticated investors continuously transmit to the marketplace valuable information from every corner of the economy.")

226. *The Fraud-on-the-Market Theory*, 95 Harv. L. Rev. 1143, 1155, n.50 (1982) [hereinafter cited as *Market Fraud*].

227. Brudney, *supra* note 11, at 341.

228. *Id.*

229. *Id.* The investor's "search is not merely for bargains, but for developable values in corporate enterprises." *Id.* An investor may take an active part in bringing about or maturing those latent values, as in a tender offer situation, or simply take a passive role, as when the investor's purchase and that of others tend to drive up the price of a security, making new financing more attractive for the company.

230. *In re LTV Sec. Litig.*, 88 F.R.D. 134, 143 (N.D. Tex. 1980). Not only individual investors, but "the investment community continues to act as if undervaluation can be detected," *id.* at 145 n.7, and the fact "that different types of information are impounded into stock prices at varying speeds and with varying degrees of accuracy accords with the common sense of securities professionals." Barry, *supra* note 184, at 1348 n.158.

231. The price move following the transaction goes not to the issue of transaction causation discussed here, but more properly loss causation or damages, on which the actions of other traders, in contrast, do have an impact.

232. *But see* Panzire v. Wolf, 663 F.2d 365, 367 n.3 (2d Cir. 1981) ("If anything, [plaintiff's] testimony indicates that a lower price accurately reflecting [the company's] true financial position might have led her to buy more stock."), *vacated as moot sub nom.* Price Waterhouse v. Panzire, 51 U.S.L.W. 3418 (Nov. 30, 1982). The

ant's omission of a material fact would be absent, because the investor, for his own reasons, would have transacted absent the omission.²³³

*Vervaecke v. Chiles, Heider & Co.*²³⁴ turned upon an open market investor's particular reasons for entering into an investment. In that case the plaintiff sought to recover damages for alleged deceptions in an offering circular which he had received ten days after the purchase of hospital authority bonds.²³⁵ He could not recall which broker had sent him the bonds, and he had no specific recollection of reading the circular.²³⁶ Even viewing the facts most favorably to the plaintiff on defendant's motion for summary judgment, the court was unable to find a genuine factual dispute concerning reliance. The plaintiff had admitted that he had "purchased [the bonds] because he supported locating the proposed hospital near his home,"²³⁷ leading the court to conclude that the "plaintiff's determination was influenced primarily by factors personal to him and unrelated to the alleged misrepresentations and omissions."²³⁸

court's comment either assumes that the plaintiff would have delayed her order until other trades impacted the price, or addresses the issue of loss causation or damages regarding a price move after her transaction.

233. This analysis may not apply to the investor who invests for reasons concerning technical forces of supply and demand. In such cases the timing of an order and hence transaction causation may directly relate to the actions of other traders, and disclosures regarding market information assume greater importance than "fundamental" disclosures regarding a company. *See, e.g.,* *Pachter v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 444 F. Supp. 417 (E.D.N.Y.), *aff'd*, 594 F.2d 852 (2d Cir. 1978).

234. Civ. No. 76-0-423 (D. Neb. Aug. 29, 1977), *aff'd*, 578 F.2d 713 (8th Cir. 1978).

235. *Vervaecke v. Chiles, Heider & Co.*, 578 F.2d 713, 718 (8th Cir. 1978).

236. The court noted there were "no suggestions that plaintiff was involved in comparison shopping, balancing the instant securities against others, on the basis of the information contained in the offering statements." Civ. No. 76-0-423, slip op. at 5 (D. Neb. Aug. 29, 1977).

237. *Id.* at 4.

238. *Id.* at 5. The court of appeals, quoting this passage, upheld the district court's finding of nonreliance, but "express[ed] no opinion as to which factors did induce [the plaintiff] to buy." 578 F.2d at 719.

The particular investment goals and perceptions of an investor may be used to show nonreliance on price even in a fraud-on-the-market case. In *Panzirer v. Wolf*, 663 F.2d 365 (2d Cir. 1981), *vacated as moot sub nom.* *Price Waterhouse v. Panzirer*, 51 U.S.L.W. 3418 (Nov. 30, 1982), the plaintiff's particular set of investment goals and perceptions related to her familiarity, as a substitute teacher, with potential educational markets for videocassettes. *Id.* at 366. Her particular conception of developable value in the investment related to the company's participation in those markets, which the plaintiff's own experience led her to believe was promising. *Id.* After reading a favorable newspaper article which brought the stock to her attention, the plaintiff checked the price and, as she testified, would not have purchased the shares if the price was "very high" or "outrageous." *Id.* at 367 n.3. Under these circumstances an "outrageous" or "very high" price clearly related to the plaintiff's

Just as market information may be received by the investor through secondary sources,²³⁹ an investor's personal investment strategy and goals may be communicated to an intermediate or "secondary" party. The broker or personal advisor is presumed to take into account the particular factors that may lead the individual to make an investment decision, and as such, may function as the "extension" of such factors personal to the investor in the markets. The advisor assists the investor in evaluating possible pockets of inefficiency or situations perceived to present the opportunity for "developable value."²⁴⁰

In view of the attention presumably given to the personal circumstances of investors by their advisors, the courts have uniformly found that reliance on such advisors may defeat a presumption of reliance upon other communications and disclosures.²⁴¹ Thus, in *Beissinger*, a presumption of reliance was rebutted by a showing that, in addition to the plaintiff's failure to read the annual report in question, the plaintiff "did rely upon the recommendation of . . . the comptroller of a client."²⁴² Similarly, in the *Chelsea Associates* case²⁴³ the court noted that "[t]he facts of this case . . . suggest a buyer who insisted on buying because of the confidence the buyer had in its representative [broker] If there was a Pied Piper of [the transaction] it was not [the defendant] but . . . the intimate representative of the plaintiff buying group."²⁴⁴

In *Greenspan v. Brassler*,²⁴⁵ the plaintiffs alleged that they had relied upon a secondary source, Standard and Poor's "tear sheets,"

particular estimate of the developable value of the investment. To the extent that her estimate exceeded the market price, even at the allegedly inflated level, she found that the price was an "attractive" situation justifying a purchase. *Id.* The Second Circuit held that the plaintiff did not rely on the integrity of the market price, and noted that price was "merely [a] neutral [factor which] presented no impediment to her acting on the favorable notice" in the newspaper article. *Id.* at 367. Nevertheless, the court denied summary judgment against her, extending the fraud-on-the-market theory to hold that the plaintiff relied on the integrity of the market in producing the information reported in the newspaper article. *Id.* at 368.

239. *Panzirer v. Wolf*, 663 F.2d 365, 367 (2d Cir. 1981), *vacated as moot sub nom.* *Price Waterhouse v. Panzirer*, 51 U.S.L.W. 3418 (Nov. 30, 1982).

240. See *supra* notes 224-33 and accompanying text.

241. See, e.g., *Jezarian v. Csapo*, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,692, at 98,640 (S.D.N.Y. 1980) ("[T]he absence of transaction causation cannot be cured by a fraud on the market theory, since [plaintiff's] purchase appears to have been solely the result of reliance on its broker's advice."); *Market Fraud*, *supra* note 226, at 1150 ("[a] plaintiff who purchased on his broker's general recommendation would be barred from recovery, absent actual reliance.").

242. [Current] Fed. Sec. L. Rep. (CCH) ¶198,613, at 93,036 (E.D. Pa. Oct. 16, 1981) (emphasis in original).

243. See *supra* notes 101-09 and accompanying text.

244. 527 F.2d 1266, 1271 (6th Cir. 1975) (quoting district court opinion, 376 F. Supp. 929, 941 (E.D. Mich. 1974)).

245. 78 F.R.D. 130 (S.D.N.Y. 1978).

which in turn were based upon the misleading reports of the defendant.²⁴⁶ The plaintiffs cited *Affiliated Ute* for the proposition that proof of reliance was not necessary in omissions cases, and the court agreed that reliance could also be presumed in cases involving misrepresentations and a "comprehensive scheme to defraud"²⁴⁷ or a "fraud on the market."²⁴⁸ The court held, however, that the defendant could rebut the presumption of reliance with proof that the market's integrity or the alleged misrepresentations "were not material to plaintiffs or that they relied primarily on another source."²⁴⁹ Because all of the plaintiffs' purchases were made in reliance upon their brother's recommendation rather than upon their analysis of the market performance of the stock, the defense was held to be available.²⁵⁰

Perhaps the major case in which reliance upon an advisor defeated the presumption of reliance is *Wilson v. Comtech Telecommunications Corp.*²⁵¹ *Wilson* involved a sophisticated plaintiff, a professional investor who managed his own investments and a small hedge fund. The plaintiff, who drew from a variety of information sources in making his investments, attended an electronics conference at which the company made a presentation. In a question and answer period after one session, the company's president indicated uncertainty as to continued earnings growth if new contracts were not obtained within thirty to sixty days.²⁵² Following the conference, the plaintiff received a quarterly report indicating a continued strong profit position, and a recommendation in the "research list" of the company's market maker.²⁵³ The plaintiff invested on a drop in the price of the stock just before the following quarter's financial results were released,²⁵⁴ and

246. *Id.* at 132.

247. *Id.* at 133 (quoting *Competitive Assocs. v. Raventhol, Krekstein, Horwath & Horwath*, 516 F.2d 811, 814 (2d Cir. 1975)).

248. 78 F.R.D. at 133.

249. *Id.*

250. *Id.* at 132. The plaintiff's brother, "a professional investor with stockholdings in several real estate investment trusts, based his recommendation on a generalized faith in such trusts, rather than on the market's integrity." *Id.* at 132 n.6. Clearly market inefficiencies that may lead an investor to choose one investment over another may also apply to advisers. See *supra* notes 224-33, 240 and accompanying text.

251. 648 F.2d 88 (2d Cir. 1981).

252. *Id.* at 90-92.

253. *Id.* at 91-92.

254. *Id.* at 92. Some investigators have found that securities prices "not only reflect most of the information contained in earnings announcements by the date of the announcement, but also begin adjusting to the information well before the formal announcement date." *ECMH*, *supra* note 219, at 1046 (footnote omitted). While the mechanism by which this occurs is not clear, the plaintiff uncovered an insider sale one month prior to his transaction. His "insider trade" claim was defeated because of a non-contemporaneous purchase. 648 F.2d at 94-95.

when the released results reflected deferrals of substantial deliveries and a bookkeeping error, the plaintiff lost a substantial portion of his investment.²⁵⁵

The court treated the warning at the electronics conference as a superior disclosure, noting that the sophisticated plaintiff had not bothered to determine whether additional contracts had been in fact received within thirty to sixty days. Moreover, the plaintiff had invested without contacting management, knowing that the next quarter's results were about to be released.²⁵⁶ Because there had not been reliance upon the disclosures in the quarterly report, the court found no reliance upon the related omission.²⁵⁷

More damaging than that, in the court's opinion, was that plaintiff's "renewed interest in [the company], leading him to purchase, appear[ed] to have been stimulated by his luncheon with [his broker]." ²⁵⁸ At the luncheon, the broker had urged the plaintiff to buy, and the plaintiff purchased after telephoning another broker to see if its analyst still "liked the stock."²⁵⁹

The superior disclosures at the conference, coupled with the reliance of the plaintiff upon his advisors, defeated the plaintiff's showing that the omission concerning the quarterly results had been a substantial contributing cause of the transaction.²⁶⁰ The plaintiff had failed to show that "the violations in question caused the [plaintiff] to engage in the transaction in question."²⁶¹

These cases show that proof of reliance upon the judgment of a personal advisor who is familiar with the plaintiff's particular investment goals and perceptions, in contrast to mere reliance upon a secondary information source,²⁶² may defeat a showing of transaction

255. 648 F.2d at 90. That the price continued to decline and the investor lost a substantial portion of his investment after the purchase indicates that at least in the particular case of the stock in question, "market efficiency" had not been reached.

256. *Id.* at 92.

257. *Id.* at 94. The court treated the issue of updating an outdated statement analogously to the issue presented by a superior disclosure. Each puts the investor on notice to make further inquiry, and the failure to do so in *Wilson* was taken as evidence that the investor did not rely. *Id.* at 93-94.

258. *Id.* at 94.

259. *Id.* at 91-92.

260. *Id.* at 94. Although the trial judge had spoken of "determinative factors," the context in which he had stated his conclusions indicated that he used the term synonymously with "substantial factors." *Id.* The plaintiff had not been required to prove that the defendant's act was "the sole and exclusive cause of his injury." *Id.* at 92.

261. *Id.* at 92 n.7 (quoting *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374, 380 (2d Cir. 1974), *cert. denied*, 421 U.S. 976 (1975)).

262. See *Panzirer v. Wolf*, 663 F.2d 365 (2d Cir. 1981) (reliance on newspaper column sufficient to defeat summary judgment), *vacated as moot sub nom.* Price

causation in open market transactions. The exercise of judgment by the advisor diminishes reliance upon the nondisclosure as a substantial contributing cause in the investment decision.

CONCLUSION

Transaction causation in an omissions case under the Rule is a difficult concept, involving several overlapping legal tests that impose a subjective standard of care on the plaintiff. In determining whether the plaintiff has met his duty of care, courts and parties to a dispute should make a careful analysis of the investment decision. At the heart of the investment decision is the ability of the investor to make inferences from information available to him and to draw conclusions relating to his investment goals.

A superior disclosure, a fact to which a plaintiff had access and from which he should have inferred the omission or been put on notice to make further inquiry, should defeat transaction causation. The superior disclosure defense is particularly well-suited to open market cases because the realm of information to which a plaintiff may be deemed to have access is vast. Moreover, superior disclosures in open market transactions may defeat a showing of loss causation due to the corrective effect on price of other investors trading in the securities.

Evidence of the particular investment goals of a plaintiff in face-to-face transactions may rebut a presumption of reliance by indicating that even if the plaintiff had known of the omission, other factors outweighed it in the investment decision. Similarly, in open market transactions, notwithstanding the efficient market hypothesis, a plaintiff's particular investment goals or the judgment of an advisor familiar with those goals may defeat a showing that the omission was a significant factor in his investment decision.

An examination of the investment decision, which bears in mind the role of superior disclosures and particular investment goals, illuminates the somewhat difficult application of the legal tests for transaction causation. Counsel and courts would do well to consider them in the future.

Waterhouse v. Panzire, 51 U.S.L.W. 3418 (Nov. 30, 1982); Greenspan v. Brassler, 78 F.R.D. 130 (S.D.N.Y. 1978) (reliance on Standard and Poor's "tear sheet" sufficient to defeat summary judgment). Reliance on secondary sources may be decided on a "third party reliance" theory. See *Market Fraud*, *supra* note 219, at 1151 n.34. The above cases in the text show that this theory may be defeated if the secondary source is an advisor exercising judgment in view of a plaintiff's personal circumstances.