UNC SCHOOL OF LAW

NORTH CAROLINA LAW REVIEW

Volume 67 | Number 5

Article 10

6-1-1989

Basic Inc. v. Levinson: An Unwise Extension of the Fraud-on-the-Market Theory

Gregory C. Avioli

NOTES

Basic Inc. v. Levinson: An Unwise Extension of the Fraud-on-the-Market Theory

For over a decade, federal courts have embraced the "fraud-on-the-market" theory, which is based on the premise that investors in a publicly traded stock rely on both the efficiency and the integrity of the stock market in making their investment decisions. Acceptance of this theory has allowed plaintiffs in securities fraud actions to satisfy their burden of proving that they relied on a defendant's fraudulent statements or acts when the plaintiffs were unable to prove direct reliance. In *Basic Inc. v. Levinson*[1] the United States Supreme Court for the first time upheld the use of the fraud-on-the-market theory to establish a rebuttable presumption of reliance in a securities fraud action brought under section 10(b) of the Securities Exchange Act of 1934[2] and rule 10b-5 promulgated thereunder.[3]

In *Basic* the Court held that the fraud-on-the-market theory could be used by former shareholders of Basic, Inc., a publicly held corporation, to establish the necessary reliance for a rule 10b-5 action.[4] Individual members of the plaintiff shareholder class had sold their Basic shares over a period of time during which Basic, through its agents, issued three statements publicly denying merger negotiations with another corporation, Combustion Engineering.[5] When the merger occured and Basic's share price rose, the shareholders who sold their shares after the reports but before the merger sued Basic, claiming they were defrauded by the company's denials of merger negotiations.[6] The Supreme Court held that each individual plaintiff did not have to prove he directly relied on the public denials, but instead the entire class of shareholders who sold their stock could rely on the fraud-on-the-market theory to establish a rebuttable presumption that the shareholder relied on the integrity of the market price.[7] Such reliance, the Court concluded, would satisfy the requirements of rule 10b-5.[8]

This Note examines the history and purpose of reliance requirements for rule 10b-5 actions and the implementation of the fraud-on-the-market theory to satisfy those requirements in certain cases. The Note concludes that the Supreme Court, in upholding the fraud-on-the-market theory as establishing a rebuttable presumption of reliance on the integrity of the market, has failed to

1. 108 S. Ct. 978 (1988).
2. 15 U.S.C. § 78j(b) (1982).
3. 17 C.F.R. § 240.10b-5 (1988).
4. *Basic*, 108 S. Ct. at 993.
5. Levinson v. Basic Inc., 786 F.2d 741, 742-43 (6th Cir. 1986), *vacated*, 108 S. Ct. 978 (1988). For a discussion of the nature of the three statements and the circumstances under which each was issued, see *infra* note 10.
6. *Id.* at 743.
7. *Basic*, 108 S. Ct. at 991-92.
8. *Id.* at 992.

define the type of causation—transaction or loss—that is established by the presumption of reliance. By failing to expressly limit the plaintiff's use of the fraud-on-the-market theory to satisfy the burden of proving transaction causation, the Court in *Basic* left its opinion open to the interpretation that the plaintiff can rely on the fraud-on-the-market theory to satisfy his burden of proving actual loss. Such an extension of the theory would act to shift the burden of proving damages away from the plaintiff to the defendant who then would have the burden of rebutting the plaintiff's alleged damages. A shift of the burden of proving actual loss from the plaintiff is inapposite to the purpose of the fraud-on-the-market theory as espoused in prior case law and the well-established rule in all securities fraud cases that a plaintiff must prove his actual damages. The Court needs to clarify the potential confusion in its position by limiting the holding of *Basic* so that the fraud-on-the-market theory can be used only to establish transaction causation.

In December 1978 Basic, a chemical refractories manufacturer, publicly agreed to merge with Combustion Engineering following a series of complex negotiations that had begun in September 1976.[9] During the twenty-six-month period between the beginning of negotiations and formal agreement, Basic issued three public statements denying involvement in any merger negotiations that would account for the heavy trading activity in its stock.[10] After the merger between Basic and Combustion was announced, former shareholders of Basic who sold their stock prior to the merger announcement and after the first of the denials brought suit against Basic and specified officers and directors of Basic, alleging that the public denials artificially deflated the price of Basic stock and violated section 10(b) of the Securities Exchange Act of 1934 and the corresponding SEC rule 10b-5.[11]

The district court applied a presumption of reliance on the integrity of the market on the part of all plaintiff shareholders.[12] In so doing, the court was able to certify the former shareholders as a class for the purpose of a class action pursuant to rule 23 of the Federal Rules of Civil Procedure.[13] The district court

9. *Levinson*, 786 F.2d at 743.

10. *Id.* at 744. On October 19-20, 1977, after Basic and Combustion had been negotiating for over a year, the trading volume of Basic shares rose from an average of 6,000 to 8,000 shares a day to 29,000 shares traded. On October 21 *The Cleveland Plain Dealer* reported that in a public announcement from Basic, Basic's CEO, Max Muller, issued a statement which said in pertinent part that the company knew of no reason for the stock's activity and that no negotiations were under way with any company for a merger. *Id.*

On September 25, 1978, Basic stock had risen almost five points in the previous two days with a trading volume between 28,500 and 31,900 shares. The normal trading activity in Basic at that time was 2,000 to 8,000 per day. *Id.* at 745 n.3. At that time Basic's senior vice president, Matthew Ludwig, issued another press release which stated that Basic was "unaware of any present or pending corporate development that would result in the abnormally heavy trading activity and price fluctuation in company shares." *Id.* at 745.

Finally, on October 12, 1978, in its "Nine Month Interim Report to Shareholders," Basic again stated "we remain unaware of any present or pending developments which would account for the high volume of trading and price fluctuations in recent months." *Id.*

11. *Levinson*, 786 F.2d at 742-43.

12. *Id.* at 749-50. The district court's opinion was not published.

13. For class certification, subsection (a) of rule 23 requires a showing of numerousness of plaintiffs, common questions of law or fact, typicality of claims, and fair and adequate protection of

held that requiring each individual shareholder to prove direct reliance on the misstatements would be "a barrier to class actions in rule 10b-5 cases."[14] By applying the presumption of reliance, the court left open only the common question of whether or not the misstatement was material.[15] After certifying plaintiffs' class, the district court granted defendants' motion for summary judgment and held as a matter of law that the statements denying the negotiations were not material and therefore not misleading.[16]

The United States Court of Appeals for the Sixth Circuit upheld the district court's class certification, agreeing with the district court's application of the rebuttable presumption of reliance.[17] In upholding the class certification, the court of appeals relied on the fraud-on-the-market theory of reliance, which is based on the premises that "in an efficient market, the price of a stock will reflect all information available to the public,"[18] and that "an individual relies on the integrity of the market price when dealing in that stock."[19] The Sixth Circuit set forth five requirements necessary to invoke the presumption of reliance based on the fraud-on-the-market theory[20] and held that the plaintiff class, having met all the elements, had "established the threshold facts for proving their loss."[21]

The United States Supreme Court granted certiorari[22] and vacated and remanded the case based on the court of appeals' decision on the materiality is-

---

the interests of the class. In addition to satisfying subsection (a), plaintiffs must also satisfy one of three requirements set forth in 23(b). For purposes of the *Basic* discussion, the language in 23(b) reads in pertinent part:

> An action may be maintained as a class action if . . . the court finds that the questions of law or fact common to the members of the class predominate over any questions affecting only individual members, and that a class action is superior to other available methods for the fair and efficient adjudication of the controversy.

FED. R. CIV. P. 23.

14. *Levinson*, 786 F.2d at 750.

15. *Id.*

16. *Id.* at 749.

17. *Id.* at 749-51. Although upholding the class certification, the court of appeals reversed the district court's summary judgment ruling on the issue of materiality. *Id.* at 749. A complete discussion of what constitutes a material misrepresentation is beyond the scope of this Note; however, a brief explanation of the standard of materiality in merger negotiations is helpful because materiality is an essential requirement of the fraud-on-the-market theory. In *Basic* the Supreme Court expressly adopted the standard of materiality the Court had previously set forth in T.S.C. Indus. v. Northway, Inc., 426 U.S. 438, 449 (1976). The Court held that a statement is material if there is a substantial likelihood that a reasonable investor would consider it significant in making his investment decision. *Basic*, 108 S. Ct. at 988. Applying this standard to the merger negotiation context, the Court said that each case must be decided on its specific facts to determine whether a denial or admission of merger negotiations would be significant to the reasonable investor. *Id.* at 987-88.

18. *Levinson*, 786 F.2d at 750 (citing Note, *The Fraud-on-the-Market Theory*, 95 HARV. L. REV. 1143, 1154 & n.44 (1982)).

19. *Id.* (citing Blackie v. Barrack, 524 F.2d 891, 907 (9th Cir. 1975)).

20. The court of appeals noted:

> A plaintiff must demonstrate (1) that the defendant made public misrepresentations, (2) that the misrepresentations were material, (3) that the stock was traded in an efficient market, (4) that the misrepresentations would induce a reasonably relying investor to misjudge the value of the stock, and (5) that the plaintiff traded in the stock between the time the misrepresentations were made and the time the truth was revealed.

Id. (citations omitted).

21. *Id.* at 751.

22. 107 S. Ct. 1284 (1987).

sue.[23] The Court held, however, that the class was appropriately certified and approved the use of the fraud-on-the-market theory to establish a rebuttable presumption of reliance.[24]

The majority opinion, written by Justice Blackmun, stated that reliance was a necessary element in rule 10b-5 causes of action to establish "the requisite causal connection between a defendant's misrepresentation and a plaintiff's injury."[25] The Court held that although reliance was necessary, requiring direct proof of reliance would have effectively prevented plaintiffs from proceeding with the class action.[26] Thus, the Court approved the presumption of reliance based on the fraud-on-the-market theory. The Court added that the presumption was rebuttable, and if defendants could prove that an individual plaintiff did not rely on the integrity of the market price or the market did not reflect the misstatement, then that plaintiff could not rely on the presumption.[27]

The dissent[28] argued that it was inappropriate for the Court to embrace an unproven economic theory that in effect ignores Congress' clear intent that reliance be a necessary element in a rule 10b-5 action.[29] If the reliance requirement is changed, the dissent argued, such a change should come from Congress and not the Court. The dissent also argued that allowing plaintiffs to bring suit based on misstatements they neither read nor heard undermined the full disclosure policy of the federal securities laws.[30] Lastly, the dissent argued that even if the fraud-on-the-market theory were a valid economic theory, the facts in *Basic* made it "an exceedingly poor candidate" in which to apply the theory.[31]

---

23. *Basic*, 108 S. Ct. at 988.

24. *Id.* at 993.

25. *Id.* at 989.

26. *Id.*

27. *Id.* at 992; *see infra* text accompanying notes 58-61.

28. Justices White and O'Connor joined with the majority on the materiality issue, but dissented in the fraud on the market holding. Chief Justice Rehnquist, Justice Scalia, and Justice Kennedy took no part in the consideration or decision of the case. The fact that the final vote was only 4-2 leaves open the possibility that a full Court in the future may reach a different conclusion.

29. *Basic*, 108 S. Ct. at 996-97 (White & O'Connor, JJ., concurring in part and dissenting in part). The dissent's argument is based upon the congressional decision to require reliance in § 18 of the Securities Exchange Act of 1934. *Id.* Section 18 provides an express civil remedy for plaintiffs defrauded by material misstatements found in documents filed with the SEC. 15 U.S.C. § 78r(a) (1982). Rule 10b-5 does not provide an express right of action. *See* 17 C.F.R. § 240.10b-5 (1988). Courts, however, have consistently implied a private cause of action in 10b-5 cases, beginning with Kardon v. National Gypsum Co., 69 F. Supp. 512, 513-14 (E.D. Pa. 1946). The dissent's argument is that "Congress . . . anticipated meaningful proof of 'reliance' before civil recovery [could] be had under the Securities Act." *Basic*, 108 S. Ct. at 997 (White & O'Connor, JJ., concurring in part and dissenting in part). This view has found acceptance with one legal commentator who wrote, "If the implied remedy relaxes a requirement of the explicit remedy . . . an unacceptable nullification of the congressional scheme results." Black, *Fraud on the Market: A Criticism of Dispensing with Reliance Requirements in Certain Open Market Transactions*, 62 N.C.L. REV. 435, 466 (1984).

For a discussion of the acceptability of an implied right of action under rule 10b-5 coexisting with the express right of action under § 18, see Ross v. A.H. Robins, Co., 607 F.2d 545, 552-56 (2d Cir. 1979), *cert. denied*, 446 U.S. 946 (1980).

30. *Basic*, 108 S. Ct. at 997-98 (White & O'Conner, JJ., concurring in part and dissenting in part).

31. *Id.* at 998-99 (White & O'Conner, JJ., concurring in part and dissenting in part). The dissent argued that the presumption of reliance is inappropriate when all the plaintiffs were sellers of stock who sold their shares at a *profit* over a 14-month period. *Id.*

Section 10 of the Securities Exchange Act of 1934 empowered the SEC to create rules to protect the public against manipulative or deceptive conduct in connection with the purchase or sale of any security registered on a national securities exchange.[32] In order to enforce its guidelines, the SEC promulgated rule 10b-5, which states in relevant part, "It shall be unlawful for any person . . . [t]o make any untrue statement of a material fact . . . in connection with the purchase or sale of any security."[33]

Decisions under rule 10b-5 have consistently required that the plaintiff prove not only that the statement was material, as specifically mandated in the statute, but also that the plaintiff relied on the misstatement.[34] Courts have required proof of reliance in order to demonstrate the " 'causal link between the misrepresentation or omission and the injuries suffered by the private plaintiff.' "[35] Proof of reliance was established by a plaintiff's showing that a defendant's "misrepresentation [was] a substantial factor in determining the course of conduct which result[ed] in [the plaintiff's] loss."[36]

The reliance requirement became more difficult to establish when the 10b-5 cause of action was broadened in *Securities Exchange Commission v. Texas Gulf Sulphur* (*TGS*)[37] to include fraudulent public statements made by corporations outside of face-to-face transactions. In *TGS* the United States Court of Appeals for the Second Circuit held that a press release issued by Texas Gulf Sulphur that gave a "gloomy" mining forecast when in fact the company's mining test results were highly favorable could constitute a violation of rule 10b-5.[38] Although the case involved a criminal suit brought by the SEC, the court of appeals' decision that such publicly issued corporate statements could support rule 10b-5 liability laid the foundation for individual shareholders to bring 10b-5 civil suits based on such corporate misstatements.[39]

Shareholders' suits based on corporate misstatements often took the form of

---

32. 15 U.S.C. § 78j(b) (1982).

33. 17 C.F.R. § 240.10b-5 (1988).

34. *See, e.g.*, List v. Fashion Park, 340 F.2d 457, 463 (2d Cir.) (noting that the authorities are clear that reliance is a necessary requirement for civil suits brought under 10b-5), *cert. denied*, 382 U.S. 811 (1965); Kohler v. Kohler, 208 F. Supp. 808, 823 (E.D. Wis. 1962) (suggesting that "[w]ith regard to the element of reliance, although there is dicta to the contrary, this element appears to be indispensable to the [10b-5] cause of action. . . . [a]bsent proof of reliance there is no liability"), *aff'd*, 319 F.2d 634 (7th Cir. 1963); Mills v. Sarjem Corp., 133 F. Supp. 753, 767 (D.N.J. 1955) (holding that a plaintiff who had not relied upon misrepresentation in newspapers could not base suit upon same misrepresentations); *see also* 3 L. LOSS, SECURITIES REGULATION 1765-66 (2d ed. 1961) ("It is difficult not to think in terms of reliance as inherent in the very theory of the action.").

35. Lipton v. Documation, Inc., 734 F.2d 740, 742 (11th Cir. 1984) (quoting Dupey v. Dupey, 551 F.2d 1005, 1016 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977)), *cert. denied*, 469 U.S. 1132 (1985).

36. *List*, 340 F.2d at 462 (quoting RESTATEMENT OF TORTS § 546 (1938)).

37. 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969).

38. *Id.* at 862-63. The court of appeals did not make a final determination as to whether or not Texas Gulf Sulphur had violated 10b-5, but instead remanded to the district court the question of whether the press release satisfied 10b-5's materiality requirements.

39. Following *TGS*, shareholders of Texas Gulf Sulphur successfully sued the corporation under rule 10b-5, claiming that each shareholder sold his stock at a result of the same deceptive press release which was the basis for the earlier criminal proceedings filed against Texas Gulf Sulphur by the SEC. Mitchell v. Texas Gulf Sulfur Co., 446 F.2d 90 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971).

class actions.[40] The class action was an effective means of obtaining relief for individual plaintiffs whose losses taken individually were "too small to justify legal action but which [were] of significant size if taken as a group."[41]

The problem that the 10b-5 reliance requirement creates in a class action suit is compounded by rule 23(b)(3) of the Federal Rules of Civil Procedure, which states that a class may be certified if "the questions of law and fact common to the members of the class predominate over any questions affecting individual members."[42] If each individual plaintiff were obligated to prove his reliance on a corporate misstatement, individual questions concerning whether each shareholder relied on the statement would predominate and rule 23(b)(3) would not be satisfied.[43] To circumvent both the practical and procedural difficulties of establishing direct reliance in class actions, federal courts relaxed the reliance requirement.[44] This relaxed reliance requirement, which manifests itself in the fraud-on-the-market theory, is best illustrated by two cases in which courts held that plaintiffs need not prove direct reliance, but instead may rely on the theory to prove causation. The courts, however, differed as to which type of causation—loss or transaction—was provided by the plaintiff's use of the fraud-on-the-market theory.

In *Blackie v. Barrack*[45] the United States Court of Appeals for the Ninth Circuit dispensed with direct proof of reliance in a class action brought under rule 10b-5. In *Blackie* plaintiffs, who bought stock in a publicly held corporation, claimed that manipulations of the company's finances artificially inflated the value of the stock. The court of appeals, in upholding the district court's class certification, stated that public policy supported allowing such class actions because of the "substantial role that the deterrent effect . . . plays in accomplishing the objectives of the security laws."[46]

The court held that to require each individual shareholder to prove reliance would impose "an unreasonable and irrelevant evidentiary burden."[47] Instead of requiring direct reliance, the court examined the rationale behind the reliance requirement and decided that causation could be established without reliance. The court concluded, "[P]roof of reliance is adduced to demonstrate the causal connection between the defendant's wrongdoing and the plaintiffs' loss. We think causation is adequately established in the impersonal stock exchange con-

40. *See* Black, *supra* note 29, at 439.

41. Escott v. Barchris Constr. Corp., 340 F.2d 731, 733 (2d Cir. 1965). Professor Black has noted, "Unless a class action could be maintained, investors with small losses effectively would be precluded from redressing their injuries." Black, *supra* note 29, at 440.

42. FED. R. CIV. P. 23(b)(3); *see supra* note 13.

43. *See supra* note 13.

44. The Supreme Court had previously dispensed with the requirement of direct reliance in 10b-5 actions based on material omissions, concluding that the connection between a plaintiff's injury and the defendant's wrongful omission could be sufficiently established by proof of the materiality of the omission. Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-54 (1972). In the Court's view, compelling the plaintiff to prove how he would have acted but for the omission—how he relied on the omission—was unnecessary. *Id.*

45. 524 F.2d 891 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976).

46. *Id.* at 903.

47. *Id.* at 907.

text by proof of purchase and of the materiality of misrepresentations, without direct proof of reliance."[48]

A Third Circuit case explained more thoroughly how the "causal connection" referred to in *Blackie* is established without proof of direct reliance. In *Peil v. Speiser*[49] the purchasers of stock in a publicly held chemical corporation brought suit against the corporation under rule 10b-5, alleging that misrepresentations about the corporation's business prospects artificially inflated the value of the corporation's stock. The court of appeals found that plaintiffs did not bear the burden of proving reliance directly, but instead could rely on the fraud-on-the-market theory.[50] The court explained:

> The fraud-on-the-market theory is based on the hypothesis that, in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business. Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements. The misstatements may affect the price of the stock and thus defraud purchasers who rely on the price as an indication of the stock's value. By artificially inflating the price of the stock, the misrepresentations defraud purchasers who rely on the price as an indication of the stock's value. The causal connection between the defendants' fraud and the plaintiffs' purchase of stock in such a case is no less significant than in a case of direct reliance on misrepresentation.[51]

In *Blackie* the court spoke of reliance in terms of loss causation—the "causal connection between the defendant's wrongdoing and the plaintiff's loss."[52] The *Peil* court more accurately addressed transaction causation—the connection between defendant's wrongdoing and plaintiff's purchase or sale of stock. By explaining reliance in terms of loss causation and not transaction causation, the court in *Blackie* apparently failed to recognize that the plaintiff in a 10b-5 action must prove not only that the defendant's misrepresentation induced

---

48. *Id.* at 906.

49. 806 F.2d 1154 (3d Cir. 1986).

50. *Id.* at 1161.

51. *Id.* at 1160 (citation omitted). The court of appeals stated that the basis of the fraud on the market theory is that "[t]he price of a company's stock is determined by the available public information." *Id.* This "efficient market" theory maintains that " 'security prices reflect all available public information about the economy, about financial markets, and about the specific company involved. Implied is that market prices of individual securities adjust very rapidly to new information.' " *In re* L.T.V. Sec. Litig., 88 F.R.D. 134, 144 (1980) (quoting J. VAN HORNE, FINANCIAL MANAGEMENT AND POLICY 48 (4th ed. 1977)). The theory would hold that any public statement issued by a corporation would be absorbed by the market and be reflected in that corporation's stock price. *Id.*

52. 524 F.2d at 906. Other courts have mistakenly spoken of reliance solely in terms of loss causation. For example, in Schlanger v. Four-Phase Sys., Inc., 555 F. Supp. 535 (S.D.N.Y. 1982), the Southern District of New York upheld class certification in a 10b-5 action based on a misleading omission of a corporation. In failing to differentiate between loss causation and transaction causation the court stated:

> In effect, reliance here means causation. Causation is an essential element of all tort cases, and claims under 10b-5 should be no exception. Where a buyer or seller of securities alters his decisionmaking because of a material falsehood imparted to him, this reliance provides the causal link between the defendants' wrongful act, and the loss suffered by the plaintiff.

Id. at 538.

plaintiff's subsequent transaction, but also that the defendant's actions caused the plaintiff's actual loss. The issue of transaction causation should be addressed separately from the issue of loss causation. The former is a question of reliance, which can be supplied by the fraud-on-the-market theory, while the latter is a completely different question concerning proof of damages.[53]

In a 10b-5 action based on a material misstatement the plaintiff can satisfy his burden of proving transaction causation with proof that "the violations in question caused the [plaintiff] to engage in the transaction in question."[54] As shown in *Peil*, courts have allowed plaintiffs to satisfy their burden of proving transaction causation by relying on the fraud-on-the-market theory to presumptively establish transaction causation.

Wholly separate from the issue of transaction causation, the plaintiff must also satisfy his burden of proving "that the misrepresentations or omissions caused the economic harm."[55] The fraud-on-the-market theory should not be extended to provide a rebuttable presumption of loss causation. As the *Harris* court noted, "In securities fraud cases, damages are determined in accordance with the extent to which a plaintiff is actually damaged as a result of the defendant's fraudulent conduct."[56] Proof of reliance does not establish proof of damages, as a plaintiff must independently show that the statement was not only integrated into the market and he indirectly relied upon it, but also that the statement affected the market price adversely.[57]

The Court's opinion in *Basic* is open to the interpretation that plaintiffs can rely on the fraud-on-the-market theory to satisfy their burden of proving loss causation. The potential confusion in the Court's opinion is brought out in its discussion of ways to rebut the presumption of reliance.[58] The Court stated, "Any showing that severs the link between the alleged misrepresentation and either the price received (or paid) by the plaintiff . . . will be sufficient to rebut the presumption."[59] In effect, the Court is saying that if the defendant can prove that the corporate misstatements did not directly affect the price of the stock, regardless of whether the statements were actually integrated into the market, then the defendant can successfully rebut the presumption of reliance. If, however, the defendant proves that the misstatements did not adversely effect the price at the time of the plaintiff's transaction, the defendant has negated loss

53. *See* Harris v. Union Elec. Co., 787 F.2d 355, 366-67 (8th Cir. 1986) (in addition to reliance, or transactional causation, the plaintiffs were required to prove loss causation); Hatrock v. Edward V. Jones & Co., 750 F.2d 767, 773 (9th Cir. 1984) ("the plaintiff must prove both transaction causation, that the violations in question cause the plaintiff to engage in the transaction, and loss causation, that the misrepresentations or omissions caused the harm").

54. Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374, 381 (2d Cir. 1974), *cert. denied*, 421 U.S. 976 (1975).

55. *Id.* at 380.

56. *Harris*, 787 F.2d at 367.

57. *See* cases cited *supra* note 53. For further discussion of the necessity of distinguishing between loss causation and transaction causation in cases involving nondisclosure of material information, see T. HAZEN, SECURITIES REGULATION § 13.6 (2d ed., to be published 1990) (copy on file at University of North Carolina Law Library).

58. Basic Inc. v. Levinson, 108 S. Ct. 978, 992 (1988).

59. *Id.*

causation, not transaction causation. The Court's holding stands for the proposition that the defendant can rebut the presumption of reliance (which establishes only transaction causation) by negating loss causation. The inescapable conclusion to be drawn from the Court's statement is that the plaintiff can rely on the fraud-on-the-market theory to establish loss causation.

The Court describes a situation in which a defendant's wrongful denial of the existence of merger negotiations was integrated into the market price. "[I]f . . . news of the merger discussions credibly entered the market and dissipated the effects of the misstatements, those who traded Basic shares after the corrective statements would have no direct or indirect connection with the fraud."[60] The Court presents the above situation as an example of a way to rebut the presumption of reliance. As noted earlier, the defendant's proof that the market price was unaffected by the misstatements due to other information does not affect the question of reliance, but instead is concerned with the issue of loss causation. The potential confusion arises out of the Court's failure to choose its terms with precision. In proving that the misstatements did not affect the market price at the time of plaintiff's transaction, the defendant has defeated the plaintiff's claim rather than rebutted the plaintiff's proof of reliance. The defendant alternatively could have defeated plaintiff's claim by showing that the market makers never believed the misstatements and accordingly the information never was infused into the market.[61]

In either case, the defendant would have prevailed. The critical distinction lies in the reasons for the defendant's success. When the defendant puts forth evidence that the market never picked up the misstatements, the plaintiff cannot rely on the integrity of the market to prove transaction causation because the market had no connection with the defendant's fraud. When the defendant proves that other information dissipated the effects of the misstatements after the misstatements had been infused into the market, the plaintiff can still rely on the integrity of the market to prove transaction causation, but he cannot prove monetary damage.

The Court needs to limit its holding in a way that differentiates between loss causation and transaction causation. Although the Court does not say that a plaintiff can satisfy his burden of proving loss causation solely by relying on the fraud-on-the-market theory, the Court's holding that a plaintiff can rebut transaction causation by proving the absence of loss causation could lead to confusion. As written, the Court's holding can be interpreted to mean that the presumption of reliance, if not rebutted, presumptively establishes that defendant's statements caused the plaintiff's loss. The burden would then be on the defend-

60. *Id.*

61. The Court discusses this situation, in which market makers did not factor the misstatements into the stock's price, and concluded that in such a case, "the basis for finding that the fraud had been transmitted through market price would be gone." *Id.* at 992. The defendant would have rebutted the presumption of reliance with proof that there was no transaction causation. If the misstatements were never infused into the market, then the plaintiff's claim that he relied upon the statement indirectly through reliance on the integrity of the market would be defeated. The court would not have to reach the issue of loss causation unless the plaintiff could somehow prove direct reliance.

ant to rebut that presumption. This interpretion is contradictory to the purpose behind the fraud-on-the-market theory. The theory arose out of courts' desire to aid shareholders who could not prove that they directly relied upon a material misstatement issued by a corporation in the impersonal marketplace.[62] In order to facilitate shareholder recovery and deter future misstatements, courts allowed plaintiffs who could not prove direct reliance on the misstatements to satisfy the reliance requirement by using a presumption that they relied on the integrity of the market price.[63] The basis for this presumption is that the corporate misstatement was issued into an efficient market, which then reflected the fraudulent statement in the price of that corporation's stock.[64] This reliance was the inducement for the plaintiff either to purchase or sell the stock and, therefore, established transaction causation.[65]

The Court's confusion in *Basic* does not render the decision incorrect. The Court was ruling on the specific question of whether the fraud-on-the-market theory could be used to establish a rebuttable presumption of reliance for all shareholders in order to effectuate class certification.[66] The Court even stated that the decision "is not to be interpreted as addressing the proper measure of damages."[67]

The Court should properly interpret its ruling in *Basic* to limit the use of the fraud-on-the-market theory to establish only transaction causation. The case will arise in which the plaintiff will base his claim for damages on the difference in market price when the misrepresentation was made and when he bought or sold stock. When such a case does arise, the plaintiff cannot be allowed to prove his actual loss simply by showing the differences in the price, proving the material misstatement and then relying on the fraud-on-the-market theory to establish the requisite causation between the misstatement and the stock's price change. Instead, a plaintiff must have the burden of proving that the misstatements—as opposed to decline in the overall market or other corporate or economic developments—actually caused the stock to change a specified amount. Although the efficient-market theory is one element of such proof, a plaintiff should have to prove his loss with specific economic data. Otherwise, as Justice White argued in his dissent, a plaintiff could recover by showing "little more

62. *See* Black, *supra* note 29, at 440 & n.21.

63. *See, e.g.*, Peil v. Speiser, 806 F.2d 1154, 1161 (3d Cir. 1986); Harris v. Union Elec. Co., 787 F.2d 355, 367 & n.9 (8th Cir. 1986); Lipton v. Documation, Inc., 734 F.2d 740, 747 (11th Cir. 1984), *cert denied*, 469 U.S. 1132 (1985); T.J. Raney & Sons, Inc. v. Fort Cobb, Oklahoma Irrigation Fuel Auth., 717 F.2d 1330, 1332-33 (10th Cir. 1983), *cert. denied*, 465 U.S. 1026 (1984); Shores v. Sklar, 647 F.2d 462, 471 (5th Cir. 1981) (en banc), *cert. denied*, 459 U.S. 1102 (1983); Ross v. A.H. Robins Co., 607 F.2d 545, 553 (2d Cir. 1979), *cert. denied*, 446 U.S. 946 (1980); Blackie v. Barrack, 524 F.2d 891, 905-08 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976).

64. *See supra* note 51.

65. *Harris*, 787 F.2d at 366.

66. *Id.* at 989. The Court's acceptance of the rebuttable presumption of reliance is in accord with all the federal circuits that have decided the fraud-on-the-market issue and concluded that when materially misleading statements have been infused into the securities market, the reliance of the individual shareholder on the integrity of the market price as an illustration of a stock's true value can be presumed. *See supra* cases cited in note 63.

67. *Basic*, 108 S. Ct. at 992 n.28.

than that [he] sold stock at a lower price than what might have been."[68]

GREGORY C. AVIOLI

68. *Id.* at 996 (White, J., dissenting).